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Return to the Conservative View of Security Agreements in Commercial Transactions

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RETURN TO THE CONSERVATIVE VIEW OF SECURITY AGREEMENTS IN COMMERCIAL TRANSACTIONS

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I. INTRODUCTION

The law of secured transactions in Article 9 of the Uniform Commercial Code has been adopted by the legislatures in virtually every jurisdiction.¹ These statutory enactments basically retain the language and form of Article 9 as written by the original drafters. However, the uniform law adopted by the legislatures has not received corresponding uniform legal application in the judicial system. Judicial interpretation of commercial transactions involving a security interest created by written agreement illustrates that uniform statutory law does not necessarily create uniform judicial results.

Article 9 applies to transactions which are intended to create a security interest.² The Code provides two basic means of evidencing an intent that a security interest be created.³ A creditor may retain possession of the collateral by mutual agreement as security for the debt. Alternatively, the creditor and debtor may execute a written security agreement which establishes the security interest. The more frequently used device is the written security agree-

1. *Foreward to 1978 Official Text and Comments, UNIFORM COMMERCIAL CODE OFFICIAL TEXT—1978* at xli (9th ed. 1978).

2. U.C.C. § 9-102 (1978).

3. *Id.* § 9-203.

ment.⁴ A security agreement is an integral part of the Code law governing the creation of a security interest in modern commercial transactions.

Close scrutiny of what constitutes a security agreement under the Uniform Commercial Code is warranted by divergent judicial response to this question. Two broad classifications arise in this area. First, the conservative judicial view narrowly interprets U.C.C. section 9-203 to require a single document to satisfy the requisites for a security agreement. The liberal view broadly interprets section 9-203 to allow the combination of several documents to meet the requirements for a security agreement.

To effectuate the Code policies of simplicity, modernization, clarity, certainty, and uniformity in commercial transactions concerning security agreements, the Code should be strictly construed to require a single document to satisfy the minimal requirements imposed by the Code. Liberal judicial interpretation of what constitutes a security agreement does not further the policies enunciated by the drafters of the Code. Comparative analysis of the liberal approach adopted by North Carolina and other jurisdictions with the single document approach contemplated by the Code reveals strict adherence to Code requirements is the better commercial policy. Upon analysis of the merits of these respective views, this comment will recommend the conservative approach as the better means of determining secured status.

Due to the narrow focus of this inquiry, the areas relating to security agreements not covered by this comment are substantial. Secured transactions law prior to the Uniform Commercial Code is beyond the scope of this comment. It is generally acknowledged that the Code is a vast improvement over the formalistic, complicated law in this area prior to the Code.⁵ Sufficiency of collateral descriptions in the security agreement, creation of a security interest by possession, what constitutes a sufficient signature, whether value is given for the security interest, and whether the debtor has legal rights in the collateral will not be examined in this comment.⁶ Developments in the law following enactment of the Code will be analyzed in the statutory and judicial developments sections of the comment.

4. A. SQUILLANTE, *The Security Agreement*, 86 COM. L.J., 99, 101 (1978).

5. A. SQUILLANTE, *supra* note 4, at 138.

6. For a further discussion of these matters see 8 W. HAWKLAND, R. LORD, & C. LEWIS, UNIFORM COMMERCIAL CODE SERIES §§ 9-101 to 9-402, (Art. 9, 1986).

The purpose of this comment is to explore judicial interpretation of what constitutes a security agreement, to delineate the arguments available to an attorney confronted with a deficient security agreement and to advocate a return to the conservative single document approach. Attorneys should also recognize that continued reliance on formal security agreements is advisable.

II. STATUTORY DEVELOPMENTS AND SECTION 9-203

Since the original Uniform Commercial Code was promulgated in 1951 and first enacted by Pennsylvania in 1953, the Code has been adopted in its entirety by virtually every state.⁷ The first official text with comments was issued in 1962.⁸ Further revisions were made in the Code to reflect changes in commercial practices and commercial policies.⁹ North Carolina formally adopted the Uniform Commercial Code in 1965.¹⁰ Generally, North Carolina has made corresponding revisions to Chapter 25 of the North Carolina General Statutes as changes occurred in the official text.

This comment will focus on section 9-203, which establishes formal requisites for the creation of a security interest.¹¹ "Security interest" is defined in the Code,¹² but may be characterized as the

7. *General Comment*, UNIFORM COMMERCIAL CODE OFFICIAL TEXT—1978 at xv (9th ed. 1978).

8. *Id.*

9. Revisions were made in 1962, 1968, 1972, and 1978.

10. N.C. GEN. STAT. § 25-1-101 (1965).

11. N.C. GEN. STAT. § 25-9-203 is identical to U.C.C. § 9-203 and is representative of most state enacted statutes. Section 25-9-203(1) and (2) states:

(1) Subject to the provisions of G.S. 25-4-208 on the security interest of a collecting bank and G.S. 25-9-113 on a security interest arising under the article on sales, a security interest is not enforceable against the debtor or third parties with respect to the collateral and does not attach unless (a) the collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral and in addition, when the security interest covers crops growing or to be grown or timber to be cut, a description of the land concerned; and (b) value has been given; and (c) the debtor has rights in the collateral.

(2) A security interest attaches when it becomes enforceable against the debtor with respect to the collateral. Attachment occurs as soon as all of the events specified in subsection (1) have taken place unless explicit agreement postpones the time of attaching.

N.C. GEN. STAT. § 25-9-203 (Cum. Supp. 1985).

12. "Security interest means an interest in personal property or fixtures which secures payment or performance of an obligation." U.C.C. § 1-201(37) (1978).

property right which results from the parties' agreements.¹³ Creation of a security interest is accomplished by the agreement itself, but the interest does not apply to specific collateral until "attachment" occurs. Under the Code terminology, a security interest attaches when three prerequisites are satisfied. First, possession of the collateral must be retained by the secured party pursuant to agreement or there must be a written security agreement containing a description of the collateral and signed by the debtor. Second, value must be given by the secured party. Third, the debtor must have rights in the collateral.¹⁴ When these requirements are fulfilled a security interest attaches automatically.¹⁵

The agreement of the parties to create a security interest is most often evidenced by a written security agreement. Agreement is defined by the Code as "the bargain of the parties in fact."¹⁶ Therefore, a security agreement is the bargain of the parties in fact which creates or provides for a security interest.¹⁷ In less definitional terms, the security agreement is a writing which sets out the terms of the agreement and establishes the secured party's right to the collateral. The minimal requirements for a valid security agreement are met by the debtor's signature, a description of the collateral, and language creating or providing for a security interest in a writing.¹⁸

The security agreement provides an evidentiary function and serves as a statute of frauds for the parties' agreement.¹⁹ Once a valid security agreement is created and the security interest attaches, the creditor is deemed to be secured. The creditor's security interest is generally enforceable against the debtor and against third parties.²⁰ Absent a sufficient writing or possession of the collateral pursuant to agreement, the secured party's interest in the collateral is not enforceable, even against the debtor.²¹ The eviden-

13. A. SQUILLANTE, *supra* note 4, at 99.

14. N.C. GEN. STAT. § 25-9-203(2).

15. A security interest does not arise automatically when there is explicit agreement to postpone the time of attaching. N.C. GEN. STAT. § 25-9-203(2).

16. N.C. GEN. STAT. § 25-1-201(3) (1965).

17. N.C. GEN. STAT. § 25-9-105(1)(l) (Cum. Supp. 1985).

18. N.C. GEN. STAT. § 25-9-203(1). The language requirement is discussed *infra*, notes 40-69 and accompanying text.

19. N.C. GEN. STAT. § 25-9-203 comments 3-5.

20. N.C. GEN. STAT. § 25-9-203(1).

21. N.C. GEN. STAT. § 25-9-203 comment 5. However, even though the debt is not secured by specific property, the debt still exists and is payable from the debtor's general assets.

tiary purpose is fulfilled when a writing specifies the terms of the agreement and describes the collateral.²²

In the normal course of commercial transactions, the Code contemplates a written security agreement, attachment of the security interest, and perfection of the security interest to determine priority of claims. Perfection is a status whereby the secured party's rights cannot be defeated by subsequent interests.²³ One objective of perfection is to protect the security interest from insolvency of the debtor. Generally, to perfect a security interest, a financing statement must be filed.²⁴ Requisites for a financing statement are the signature of the debtor, addresses of the debtor and secured party, and a description of the collateral.²⁵ Perfection occurs when the security interest is filed and has attached.²⁶ The purpose of filing a financing statement is to give notice to third parties that a security interest is or may be claimed in the collateral. The basic difference between requirements for a security agreement and a financing statement is that the Code does not require language creating or providing for a security interest in a financing statement.

The Code provisions concerning financing statements are essential to understanding what constitutes a security agreement under the liberal and conservative views. Section 9-402 states that a filed security agreement is sufficient as a financing statement if it complies with the requirements of this Code section.²⁷ Yet, no court has held a financing statement, standing alone, sufficient to constitute a security agreement.²⁸ The arguments for both the conservative and liberal approaches to security agreements utilize this distinction. The liberal position argues the apparent equivalency of a security agreement and financing statement, while the conservative position notes their functional differences.

This section of the comment has attempted a basic outline of the law applicable to security agreements to provide a framework

22. *Id.* comment 3.

23. N.C. GEN. STAT. § 25-9-302 and comment 1. Other priorities are set out in §§ 25-9-312 to 25-9-315.

24. N.C. GEN. STAT. § 25-9-302 and comment 1.

25. N.C. GEN. STAT. § 25-9-402.

26. N.C. GEN. STAT. § 25-9-303(1).

27. N.C. GEN. STAT. § 25-9-402(1).

28. J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 23-3 at 906 (2d ed. 1980); *Mitchell v. Shepherd Mall State Bank*, 458 F.2d 700 (10th Cir. 1972).

for understanding the arguments for the liberal and conservative views. The statutory law in all states is virtually identical, so what constitutes a security agreement for a particular jurisdiction is largely a result of judicial developments.

III. JUDICIAL DEVELOPMENTS

Judicial developments in interpreting section 9-203 are divisible into two approaches as to what documents satisfy the Code requirements for a security agreement. The conservative single document approach emphasizes that section 9-203's requirements must be contained in a single writing to constitute a valid security agreement.²⁹ A liberal composite documents approach effectuates the parties' intent by allowing documents to be combined to satisfy the requirements of section 9-203.³⁰ The trend in recent cases clearly favors the composite documents approach.³¹

The initial point of divergence for the two approaches is a consequence of the Code language. The Code language contemplates a single document as the security agreement representing the parties' bargain in fact.³² However, section 1-102 mandates that the Code provisions be liberally construed.³³ Comment 1 to section 1-102 indicates that a narrow or broad view may be utilized in applying the Code language to particular circumstances.³⁴ A narrow, literal construction of the language supports the single document view. The language, broadly construed, supports the view that relevant documents may be used in combination. While interpretation of the Code language does initially separate these positions, the

29. *American Card Co. v. H.M.H. Co.*, 97 R.I. 59, 196 A.2d 150 (1963).

30. See *In re Bollinger*, 614 F.2d 924 (3d Cir. 1980); *In re Amex-Protein Development Corp.* 504 F.2d 1056 (9th Cir. 1974); *Evans v. Everett*, 279 N.C. 352, 183 S.E.2d 109 (1971).

31. J. WHITE & R. SUMMERS, *supra* note 28, at 908.

32. N.C. GEN. STAT. § 25-9-203 and comment 5 (Cum. Supp. 1985) contain singular language when referring to the writing required.

33. "This Act shall be liberally construed and applied to promote its underlying purposes and policies." U.C.C. § 1-102(1) (1978).

34. However, the proper construction of the Act requires that its interpretation and application be limited to its reason The Act should be construed in accordance with its underlying purposes and policies. The text of each section should be read in light of the purpose and policy of the rule or principle in question, as also of the Act as a whole, and the application of the language should be construed narrowly or broadly, as the case may be, in conformity with the purposes and policies involved.

Id. comment 1.

divisive issue is which approach best accomplishes the purposes behind section 9-203 and Article 9.

The Code attempts to promote uniformity of decisions and simplicity in document execution by requiring language in a document to show the parties created a security interest in their negotiated bargain. To comply with the conservative position, a security agreement must be a single writing which contains the debtor's signature, a description of collateral, and language creating or providing for a security interest.³⁵ A writing containing these minimal requirements is a security agreement regardless of whether it is denominated as such. In contrast, the liberal approach allows different writings to satisfy the individual requirements for a security agreement when the writings can be combined by the intent of the parties. Uniformity of the law is enhanced by consistent application of the conservative approach, rather than the varying positions taken by liberal jurisdictions on what will satisfy the Code requirements. Determination of the parties' intent is greatly simplified by a clear statement in the document that the debtor grants the creditor a security interest in specified collateral.

The contract law principle that the intent of the parties controls is fundamental to the judicial position that a security agreement need not be solely confined to a single document. The liberal approach lacks much of the uniformity that characterizes the conservative approach. Those states adhering to the liberal approach have substantial variations to their requirements for security agreements. The weight actually given to the parties' express intent differs among states. For instance, is an intent to create a security interest recognizable if not clearly evidenced in the documents?³⁶ Granting language that actually conveys the security interest may be required in some jurisdictions.³⁷ The documents that may permissibly be combined differ.³⁸ Some jurisdictions require that multiple documents refer internally to one another or that they be executed contemporaneously.³⁹ All or some of the fac-

35. *American Card Co. v. H.M.H. Co.*, 97 R.I. 59, 196 A.2d 150 (1963).

36. See *In re Bollinger*, 614 F.2d 924 (3d Cir. 1980); Comment, *Security Agreements*, 57 TEMP. L.Q. 791, 814 (1984).

37. *American Card Co.*, 97 R.I. at 63, 196 A.2d at 152.

38. J. WHITE & R. SUMMERS, *supra* note 28, at 906.

39. See *Little v. County of Orange*, 31 N.C. App. 495, 229 S.E.2d 823 (1976); *In re Carmichael Enterprises, Inc.*, 334 F. Supp. 94 (N.D. Ga. 1971); *Casco Bank & Trust Co. v. Cloutier*, 398 A.2d 1224 (Me. 1979); *In re Center Auto Parts*, 6 U.C.C. Rep. Serv. (Callaghan) 398 (C.D. Cal. 1968).

tors set out above may be relevant to the question of whether a security agreement exists for the purposes of a particular jurisdiction.

A. *The Liberal Approach*

The basic foundation for the liberal approach is that the intent of the parties should govern the transaction and creation of the security interest, rather than strict technical compliance with the statutory language. Initial determinations of intent are derived from the formal language of the documents.⁴⁰ Under the liberal view, the objective threshold does not require formal language granting a security interest.⁴¹ Inferences that a security interest may have been intended by the parties satisfy this "objective threshold."⁴² Following this initial assessment of the instrument's language, the actual intent of the parties must be determined by the factfinder.⁴³ The critical stage for a secured party in a judicial proceeding is proving the language of the documents reveals an intent by the parties to provide for a security interest. Formal words granting a security interest are not required at either stage of ascertaining intent.⁴⁴ The composite documents approach allows language in any of the documents to fulfill this minimal documentary intent. Thus, the objective threshold is surpassed relatively easily under the liberal approach.

The liberal view lacks a uniform position among jurisdictions applying it to the creation of a security interest. There are three basic divisions of "liberality" among the jurisdictions. First, some jurisdictions allow a security interest to be established when there is language arguably transferring the interest to the secured party.⁴⁵ Second, language referring to a security interest already in

40. Commentators have labelled this as the "objective threshold". J. WHITE & R. SUMMERS, *supra* note 28, at 905.

41. See *Evans v. Everett*, 279 N.C. 352, 183 S.E.2d 109 (1971); *Komas v. Small Business Administration*, 71 Cal. App. 3d 809, 139 Cal. Rptr. 669 (1977); *In re Amex-Protein Development Corp.*, 504 F.2d 1056 (9th Cir. 1974).

42. Such intent must be ascertainable from the documents themselves because parol evidence is not admissible to prove intent at the objective threshold stage of analysis. U.C.C. § 9-203 comment 5 (1978).

43. J. WHITE & R. SUMMERS, *supra* note 28, at 905.

44. See cases at *supra* note 41 and *In re Bollinger*, 614 F.2d 924 (3d Cir. 1980).

45. See, e.g., *Evans*, 279 N.C. 352, 183 S.E.2d 109; *Komas*, 71 Cal. App. 3d 809, 139 Cal. Rptr. 669. The conservative view follows the *American Card Co.*

existence may be sufficient to prove a security interest in the collateral.⁴⁶ Third, the most liberal approach allows a security interest to be formed by scrutinizing the entire transaction between the parties, even when a formal security agreement was not contemplated by the parties.⁴⁷ To a great extent, the differences result from an interpretation of whether the language in the documents "creates or provides for a security interest."⁴⁸ Generally, the liberal approach permits very informal language in documents related to the transaction to constitute an agreement between the parties.

In *Komas v. Small Business Administration*,⁴⁹ the court took the position that an absence of formal language granting a security interest does not violate section 9-105(1)(l) which requires that a security agreement "create or provide for" a security interest. In *Komas*, a loan application, promissory note, and financing statement were combined to show an intent to create a security interest.⁵⁰ The court held that language in the promissory note was sufficient to evidence creation of a security interest.⁵¹ Some active language of creation is required, though not formal words of conveyance, to meet the objective threshold of documentary intent.⁵²

Further expansion of the liberal approach occurred in *In re Amex-Protein Development Corporation*.⁵³ Presented with a promissory note reciting, "this note secured by a security interest in subject personal property as per invoices,"⁵⁴ the court found an intent to create a security interest.⁵⁵ This language merely referred to the security interest instead of language conveying such an interest. "No magic words or precise form are necessary to create or

case in requiring that the document must contain language of conveyance.

46. See, e.g., *In re Amex-Protein Development Corp.*, 504 F.2d 1056 (9th Cir. 1974).

47. See, e.g., *In re Bollinger*, 614 F.2d 924 (3d Cir. 1980).

48. N.C. GEN. STAT. § 25-9-105(1)(l) (Cum. Supp. 1985). The general rule was established in *American Card Co.* that the document must contain words of grant to comply with the "creates or provides for" language of § 9-105.

49. 71 Cal. App. 3d 809, 139 Cal. Rptr. 669 (1977).

50. "It is sufficient if the parties use language which leads to the conclusion that it was the intention of the parties that a security interest be created." 71 Cal. App. at 817, 139 Cal. Rptr. at 672.

51. *Id.* at 817, 139 Cal. Rptr. at 672.

52. J. WHITE & R. SUMMERS, *supra* note 28, at 907. See *Evans*, 279 N.C. at 360, 183 S.E.2d at 114.

53. 504 F.2d 1056 (9th Cir. 1974).

54. *Id.* at 1057.

55. *Id.* at 1060.

provide for a security interest so long as the minimum formal requirements of the Code are met."⁵⁶ *In re Amex-Protein* occupies an intermediate position between cases holding language of conveyance is required⁵⁷ and cases which look beyond the language to the entire transaction.⁵⁸

*In re Bollinger*⁵⁹ exemplifies the most liberal interpretation of the "creates or provides for" language of section 9-105(1)(l). A promissory note, financing statement, and written correspondence between the parties were combined to constitute a security agreement.⁶⁰ The court scrutinized the entire transaction to determine if a security interest existed. By not construing the language of the promissory note in isolation from the remainder of the transaction, the court effectively circumvented analyzing the intent expressed in the documents to effectuate the overall intent of the parties. In fact, the parties expressly stated a desire to execute a formal security agreement.⁶¹ *Bollinger* represents the most expansive reading of the "creates or provides for" language of the Code by giving it little practical effect and emphasizing the ultimate intent of the parties.⁶²

Analysis of the language contained in the document purporting to establish a security interest is but one aspect of the liberal approach to security agreements. The second prong entails an analysis of what documents may be combined to constitute a security agreement. A combination of writings to meet the requirements of 9-203 is central to the composite documents approach. It is uniformly held that a financing statement not complying with section 9-203 requirements cannot constitute a security agreement standing by itself.⁶³ Generally, a financing statement is combined

56. *Evans*, 279 N.C. at 358, 183 S.E.2d at 113 (citing *In re Nottingham*, 6 U.C.C. Rep. Serv. (Callaghan) 1197, 1199 (D. Tenn. 1969)); see also *Komas*, 71 Cal. App. 3d 809, 139 Cal. Rptr. 669.

57. See *infra* cases at note 92.

58. *In re Bollinger*, 614 F.2d 924 (3d Cir. 1980); *In re W.J. Clark Co., Ltd.*, 30 Bankr. 675 (E.D. Pa. 1983).

59. 614 F.2d 924 (3d Cir. 1980).

60. *Id.* at 927.

61. Language in the promissory note read: "This Promissory Note . . . is further secured by security interests in a certain security agreement to be delivered by Bollinger to Z and J with this Promissory Note . . ." *Id.* at 925. However, no formal security agreement was ever executed between the parties.

62. See also *In re Numeric*, 485 F.2d 1328 (1st Cir. 1973); *Casco Bank & Trust Co. v. Cloutier*, 398 A.2d 1224 (Me. 1979).

63. See *American Card Co.*, 97 R.I. 59, 196 A.2d 150; *Evans*, 279 N.C. 352,

with other writings to form the security agreement. Courts have allowed a financing statement to be joined with a promissory note,⁶⁴ loan application,⁶⁵ corporate director's resolution,⁶⁶ or other documents to establish a security agreement.⁶⁷

The impact of the *Bollinger* decision on the composite documents view allows virtually all writings connected with the transaction to be utilized by the court to establish a security agreement. However, some jurisdictions have limited the joinder of documents to cases where the documents internally refer to each other⁶⁸ or are executed contemporaneously.⁶⁹ Courts reluctant to follow the *Bollinger* decision have occasionally employed these devices to restrict the documents admissible to show the intent of the parties.

B. *The North Carolina Approach*

North Carolina applies the liberal composite documents approach and a broad interpretation of intent to determine what constitutes a security agreement under North Carolina General Statutes section 25-9-203. No formal language granting a security interest is required in the document.⁷⁰ However, there must be some language evidencing an intent to create a security interest.⁷¹

183 S.E.2d 109; *Mitchell v. Shepherd Mall State Bank*, 458 F.2d 700 (10th Cir. 1972); *General Electric Credit Corp. v. Bankers Commercial Corp.*, 244 Ark. 971, 429 S.W.2d 60 (1968); *Clark v. Vaughn*, 504 S.W.2d 550 (Tex. Civ. App. 1974); J. WHITE & R. SUMMERS, *supra* note 28, at 906. A financing statement does not contain language creating a security interest and its purpose is primarily one of notice to third parties.

64. *See Evans*, 279 N.C. 352, 183 S.E.2d 109; *Komas*, 71 Cal. App. 3d 809, 139 Cal. Rptr. 669 (promissory note combined with a financing statement).

65. *Casco Bank & Trust Co. v. Cloutier*, 398 A.2d 1224 (Me. 1979) (financing statement, Small Business Administration loan application, and promissory note were combined).

66. *See In re Numeric*, 485 F.2d 1328 (1st Cir. 1973) (financing statement combined with a corporate director's resolution). *See also*, J. WHITE & R. SUMMERS, *supra* note 28 at 906; Comment, *supra* note 36, at 810.

67. *See supra* note 65; *Little v. County of Orange*, 31 N.C. App. 495, 229 S.E.2d 823 (1976).

68. *See In re Center Auto Parts*, 6 U.C.C. Rep. Serv. (Callaghan) 398 (C.D. Cal. 1968); *In re Carmichael Enterprises, Inc.*, 334 F. Supp. 94 (N.D. Ga. 1971).

69. *Evans*, 279 N.C. 352, 183 S.E.2d 109; *see also Little*, 31 N.C. App. 495, 229 S.E.2d 823; *In re Mid-Atlantic Piping Products of Charlotte*, 24 Bankr. 314 (W.D.N.C. 1982); *E-B Grain Co. v. Denton*, 73 N.C. App. 14, 325 S.E.2d 522 (1985).

70. *Evans*, 279 N.C. at 359, 183 S.E.2d at 114.

71. However, in *Evans* the Court was presented with a fact situation where

North Carolina cases have not expressly required the documents presented to internally refer to each other or be executed contemporaneously.⁷² The intent of the parties predominantly influences the decisions in this area.⁷³

The leading North Carolina case in the security agreement area is *Evans v. Everett*.⁷⁴ Evans, the plaintiff, loaned \$75,000 to the defendant. This loan was allegedly secured by crops to be grown on certain land during 1969. The defendant gave a promissory note for the loan and a financing statement was filed by the plaintiff. The note and financing statement referred to each other.⁷⁵ The note stated that it was "secured by [the] U.C.C. financing statement of North Carolina."⁷⁶ Reference to the note was made by the following language in the financing statement: "'same securing note for advanced money to produce crops for the year 1969.'"⁷⁷ A security agreement complying with sections 25-9-203(1)(b) and 25-9-105(1)(l) was held to have been created under these circumstances.⁷⁸

The court held no formal language of conveyance was necessary to create or provide for the security interest. The court looked to the language of the financing statement and construed the word "securing" as providing for a security interest.⁷⁹ Intent to grant a

the documents did internally refer to each other and were executed at the same time. *In re Mid-Atlantic Piping Products of Charlotte*, 24 Bankr. 314 (W.D.N.C. 1982), involved a defective security agreement which referred to the financing statement, but the financing statement and promissory note did not have cross references to each other. The court held that there was enough evidence to link all the documents together. An implied factor in combining the documents was the fact that the documents were executed as part of a single transaction. Although the court was to apply the law of South Carolina in its determination, South Carolina had not ruled on this question. Therefore, the court cited *Evans* as persuasive authority to decide the issue.

72. Several North Carolina commentators have criticized the decision in *Evans*. See R. LORD AND C. LEWIS, *North Carolina Security Interests*, § 3-1(A)(1) at 21 (1985).

73. *Evans*, 279 N.C. 352, 183 S.E.2d 109.

74. *Id.*

75. *Id.* at 353, 183 S.E.2d at 110.

76. *Id.*

77. *Id.* (emphasis in original).

78. *Id.* at 360, 183 S.E.2d at 114.

79. We harbor no doubt that the instant financing statement and the note manifest defendant Everett's intent to create in plaintiff a security interest in the described collateral and that he did, in fact, provide for such interest when he stated that the crops described therein secure the

security interest was found by analyzing the language of both the financing statement and promissory note.⁸⁰ On the question of what satisfied the "creates or provides" language of section 25-9-105(1)(l), the court required some language in the documents which might be construed as creating a security interest.⁸¹

Joinder of the financing statement and promissory note allowed the court to ascertain that the parties intended to create a security interest in the defendant's crops. It is clear that the court considered both documents in its decision.⁸² Yet, the court's holding implies that the financing statement alone constituted a security agreement.⁸³ Further, the court faced a fact situation where the documents were related by reference and contemporaneous execution.⁸⁴ *Evans* establishes that combining documents to show intent of the parties is permitted in North Carolina.⁸⁵

The decisions which follow *Evans* basically adhere to the liberal view taken by the North Carolina Supreme Court. The North Carolina Court of Appeals in *Little v. County of Orange*⁸⁶ stated that failure to "execute an instrument denominated as a 'security agreement' is not necessarily fatal to plaintiff's claim."⁸⁷ However,

note for money advanced to produce these crops.
Id. at 359 (emphasis in original).

80. *Id.* at 358. This position corresponds with the later view taken by *Komas*. See *supra* notes 49-52 and accompanying text for a discussion of the position taken in *Komas*.

81. "We hold, therefore, that the financing statement in question meets the requirements of an enforceable security agreement and serves the double purpose." *Evans*, 279 N.C. at 360, 183 S.E.2d at 114. The court did, however, combine the financing statement with the promissory note. Otherwise, this holding would be an extremely liberal position not adopted by any other jurisdiction.

82. *Id.* at 360, 183 S.E.2d at 114.

83. *Id.* at 353, 183 S.E.2d at 110.

84. The court did not express an opinion on whether there are limitations to the documents which may be presented, i.e., whether contemporaneous execution and cross references are necessary.

85. See *Little v. County of Orange*, 31 N.C. App. 495, 229 S.E.2d 823 (1976) (promissory note and financing statement combined); *In re Mid-Atlantic Piping Products of Charlotte*, 24 Bankr. 314 (W.D.N.C. 1982) (defective security agreement, financing statement, and promissory note were combined); *E-B Grain Co. v. Denton*, 73 N.C. App. 14, 325 S.E.2d 522 (1985) (financing statement combined with a document entitled Future Advance Note and Security Agreement).

86. 31 N.C. App. 495, 229 S.E.2d 823 (1976).

87. *Id.* at 497, 229 S.E.2d at 825. However, the court did not allow the plaintiff secured status because of a failure to have a sufficient signature on the financing statement. The debtor's signature was typed on the financing statement. The court followed the liberal *Evans* ruling, but allowed a minor technicality to pre-

a recent bankruptcy case exhibits an implicit dissatisfaction with the *Evans* ruling.⁸⁸ North Carolina follows the liberal composite documents approach but this position has not been immune from criticism.⁸⁹

C. *The Conservative Approach*

The conservative approach requires a security agreement to be a single integrated document which grants a security interest to the creditor. Parties to a commercial transaction must comply with the minimum requirements of section 9-203 for a security interest to arise. Absent a writing containing these requirements, the security interest is not enforceable against third parties or the debtor.⁹⁰ In contrast to the liberal approach, combining documents is not allowed to satisfy the requirements of section 9-203.⁹¹ Although formal language containing the word "grant" is not required, there must be language indicating that a transfer of a security interest was intended by the parties.⁹²

clude the creditor from secured status. The normal Code requirements for a sufficient signature permit almost any mark intended as a signature to suffice. The court's action implies that application of other requirements for a valid document may be strictly applied to limit the *Evans* decision. This is not consistent with the overriding importance attributed to the parties' intent established in *Evans*.

88. *In re Murray Brothers, Inc.*, 53 Bankr. 281 (E.D.N.C. 1985). A sales agreement, promissory note, financing statement, and the parties' intent were alleged to constitute a security agreement. The court determined that the objective threshold of intent (evidenced from the language of the documents) was not met by the documents in this case. The court did apply the liberal view established by *Evans*, but with apparent reluctance. Criticism of the *Evans* decision was noted in the opinion by the court. Further, the court concluded the opinion with this statement, "Mr. Maroon's failure to obtain a written security agreement from the debtor, as required by law, is fatal to his secured claim, and the trustee's objection to his claim must be allowed." *Id.* at 285. The decision, taken as a whole, reveals an implicit dissatisfaction with the *Evans* case.

89. R. LORD & C. LEWIS, *supra* note 72. These two commentators recommend that the *Evans* decision be overruled at the earliest possible opportunity.

90. U.C.C. § 9-203 comment 5 (1978).

91. *American Card Co.*, 97 R.I. 59, 196 A.2d 150.

92. *Pontchartrain State Bank v. Poulson*, 684 F.2d 704 (10th Cir. 1982); *Transport Equipment Co. v. Guaranty State Bank*, 518 F.2d 377 (10th Cir. 1975); *Shelton v. Erwin*, 472 F.2d 1118 (8th Cir. 1973); *Mitchell v. Shepherd Mall State Bank*, 458 F.2d 700 (10th Cir. 1972); *Needle v. Lasco Industries, Inc.*, 10 Cal. App. 1105, 89 Cal. Rptr. 593 (1970); *Trust Co. of Columbus v. Associated Grocers Cop.*, 152 Ga. App. 701, 263 S.E.2d 676 (1979); *Kaiser Aluminum & Chemical Sales, Inc. v. Hurst*, 383 Mich. 561, 176 N.W.2d 166 (1970) *In re Don Miller, Inc.*, 35 Bankr. 714 (E.D. Wis. 1984); *American Card Co.*, 97 R.I. 59, 196 A.2d 150 (1963).

*American Card Company v. H.M.H. Company*⁹³ was the first case to consider whether documents other than a formal security agreement comply with section 9-203. A promissory note executed by the debtor corporation and a filed financing statement were presented by the creditor as a security agreement.⁹⁴ The Rhode Island Supreme Court denied the creditor secured status.⁹⁵ "The financing statement which the claimants filed clearly fails to qualify also as a security agreement by the debtor because nowhere in the form is there any evidence of an agreement by the debtor to grant claimants a security interest."⁹⁶ The general rule and conservative approach emanate from *American Card Company*.⁹⁷

Though the current trend is one of liberal interpretation, many jurisdictions still adhere to the conservative approach.⁹⁸ The conservative view rejects subjective intent in favor of an objective analysis of the language contained in a single document.

IV. ARGUMENTS FOR A LIBERAL VIEW

The overriding concern under the liberal view is to discern the intent of the parties.⁹⁹ It is a basic tenet of contract law that the intent of the parties should govern their transaction. The liberal approach effectuates the intent of the parties by broadly interpreting the provisions of the U.C.C. A writing signed by the debtor describing the collateral which shows an intent to create a security interest serves as a security agreement under the liberal position.¹⁰⁰ Effectuating the intent of the parties prevents the harsh result of a creditor being denied a security interest and possible recovery when the parties obviously contemplated the secured nature of the debt.¹⁰¹

The U.C.C. does not contemplate great formality and form is

93. 97 R.I. 59, 196 A.2d 150 (1963).

94. *Id.* at 61, 196 A.2d at 151.

95. *Id.*, 196 A.2d at 151.

96. *Id.* at 63, 196 A.2d at 151.

97. See A. SQUILLANTE, *supra* note 4, at 140.

98. See *supra* note 92. See also *Amoco Oil Co. v. G. Sims & Associates*, 162 Ga. App. 307, 291 S.E.2d 128 (1982); *In re Cambridge*, 34 Bankr. 88, (W.D. Mo. 1983); *In re Nottingham*, 6 U.C.C. Rep. Serv. (Callaghan) 1197 (E.D. Tenn. 1969).

99. See *supra* notes 40-69 and accompanying text.

100. *In re Bollinger*, 614 F.2d at 928. See also J. WHITE & R. SUMMERS, *supra* note 28, at 904.

101. *In re Numeric*, 485 F.2d 1328; Comment, *supra* note 36, at 813; J. WHITE & R. SUMMERS, *supra* note 28, at 904.

not to be exalted over substance.¹⁰² Section 1-102 states that the Code is to be liberally construed to promote the policies behind the rules.¹⁰³ The liberal position interprets these statements as support for not requiring a formal security agreement document. A security agreement may be filed as a financing statement, which supports the notion that two separate documents are not mandated by Article 9.¹⁰⁴ Allowing any symbol intended by the parties to function as a signature to satisfy the requirement that a security agreement be signed by the debtor shows that the intent of the parties rather than form was contemplated to govern by the Code drafters.¹⁰⁵ The liberal view uses these arguments to support reliance on the broad definition of security agreement provided in section 9-105(1)(l).

The comments to section 9-203 reveal two primary purposes supporting the requirement for a sufficient writing.¹⁰⁶ A financing statement or other document which adequately describes the col-

102. Under this Article the traditional distinctions among security devices, based largely on form, are not retained Under the Article distinctions based on form (except as between pledge and non-possessory interests) are no longer controlling The scheme of the Article is to make distinctions where distinctions are necessary, along functional rather than formal lines.

U.C.C. § 9-101 comment 3 (1978).

103. U.C.C. § 1-102(1) (1978).

104. U.C.C. § 9-402. Also, the primary reason a financing statement is filed is to perfect a security interest. N.C. GEN. STAT. § 25-9-402(1) (Cum. Supp. 1985); see 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY, § 11.4 (1965); *Evens*, 279 N.C. at 356, 183 S.E.2d at 112.

105. Comment, *supra* note 36, at 814. However, the conservative view would argue this example of liberalizing the Code requirements in one area is inadequate to justify the conclusion, that a formal security agreement can be dispensed with by merely extrapolating from an intent to relax one of the requirements for a security agreement.

106. "One purpose of the formal requisites stated in subsection (1)(a) is evidentiary. The requirement of written record minimizes the possibility of future dispute as to the terms of a security agreement and as to what property stands as collateral for the obligation secured." U.C.C. § 9-203 comment 3 (1978).

The formal requisite of a writing stated in this section is not only a condition to the enforceability of a security interest against third parties, it is in the nature of a Statute of Frauds. Unless the secured party is in possession of the collateral, his security interest, absent a writing which satisfies paragraph (1)(a), is not enforceable even against the debtor

U.C.C. § 9-203 comment 5.

lateral fulfills the evidentiary function.¹⁰⁷ A document other than a security agreement cannot meet the statute of frauds function unless the "creates or provides for" language of section 9-105(1)(l) is satisfied.¹⁰⁸ This statute of frauds function is of less concern when the judicial action involves only the immediate parties to the transaction.¹⁰⁹ The liberal view maintains that if creation of a security interest can be ascertained from some document in the transaction then the statute of frauds function is fulfilled by a wording which demonstrates that a security interest was created. Therefore, the evidentiary and statute of frauds purposes are achieved by the liberal composite document approach.

Advocates of the liberal position observe that prior or subsequent creditors are not harmed because they have effective notice of the security interest by the filed financing statement.¹¹⁰ "The only party harmed by the denial of the security interest is the party claiming the status of a secured creditor."¹¹¹ Preventing a harsh result between the immediate parties is not accomplished at the expense of other creditors.

The reasoning which supports the liberal view rests on the equitable nature of following the intent of the parties. U.C.C. language explicitly upholds following intent, the primary purposes of section 9-203 are fulfilled, and no harsh results accompany the liberal view. The liberal composite documents approach incorporating relaxed requirements for creation language is the current trend in evaluating whether a security agreement exists.

V. ARGUMENTS FOR THE CONSERVATIVE APPROACH AND REBUTTAL OF THE LIBERAL VIEW

The Uniform Commercial Code clearly contemplates two documents in its approach to the creation and perfection of a security interest.¹¹² Creation of a security interest is accomplished by executing a security agreement which provides the creditor secured status.¹¹³ Priority determinations hinge on when the creditor files a

107. Comment 3 of § 9-203 goes on to note that possession of the collateral fulfills the evidentiary function as to the terms of the agreement.

108. See Comment, *supra* note 36, at 807.

109. J. WHITE & R. SUMMERS, *supra* note 28, at 903.

110. See Comment, *supra* note 36, at 813.

111. *Id.* at 813.

112. U.C.C. §§ 9-203, 9-402 (1978).

113. U.C.C. § 9-203.

financing statement perfecting his security interest.¹¹⁴ This two-step process illustrates the different requirements and purposes for the documents.¹¹⁵ The security agreement is meant to create the security interest and evidence conveyance of that interest.¹¹⁶ A financing statement merely gives notice that a security interest is or may be claimed in the collateral described.¹¹⁷ Therefore, the liberal view's reliance on financing statements as evidence that a security interest exists or constitutes a security agreement is misplaced due to the different purposes ascribed to each document by the Code.¹¹⁸

It also follows from the Code language that a single document containing the minimal requirements of section 9-203 is contemplated by the drafters. Signature of the debtor on "a writing" which describes the collateral and "creates or provides for" a security interest constitutes a valid security agreement.¹¹⁹ The Code requirements are minimal. Further dilution of such minimal requisites for a valid security agreement could have easily been expressed in the Code if the liberal view was intended.¹²⁰ Since parol evidence is not allowed to establish a secured status,¹²¹ it seems unlikely that oral evidence necessary to connect documents would be favored by the drafters. The conservative approach is therefore the most consistent reading of the Code language.

The purposes for a written security agreement are evidentiary and in the nature of a statute of frauds.¹²² A conservative approach satisfies both purposes in a single document. The terms of the agreement and creation of the security interest are evidenced by one document, thus limiting the opportunity for fraud. Under the liberal view,¹²³ where parol evidence may be necessary to establish the parties' intent to create a security interest, a subsequent credi-

114. U.C.C. §§ 9-402, 9-301, 9-312, 9-313, 9-315.

115. See U.C.C. §§ 9-203, 9-402.

116. U.C.C. §§ 9-203, 9-105(1)(l).

117. According to section 9-402, the financing statement may be filed prior to the existence of the security interest.

118. Generally, the liberal view combines a financing statement with one or more other documents.

119. U.C.C. §§ 9-203, 9-105(1)(l).

120. This commentator realizes a similar argument is available to the liberal view, but the language is structured in the singular.

121. U.C.C. § 9-203 comment 5.

122. U.C.C. § 9-203 comments 3 and 5.

123. The liberal view includes all three variations of that position discussed *supra* notes 45-69 and accompanying text.

tor is exposed to a situation where collusion between the original creditor and debtor may be to their advantage. Clearly, the Statute of Frauds purpose is best met by the conservative approach. In terms of an evidentiary purpose, the liberal view enhances the risk that terms in the assimilated documents will be inconsistent.¹²⁴ Inconsistent documents joined with a subjective determination of intent increase the possibility of future disputes.¹²⁵ Requiring more of the terms of the agreement to be in a single document reduces the likelihood of future disagreement. A more subjective standard may result in increased litigation. The conservative approach best serves the purposes for a written security agreement underlying section 9-203.

The most persuasive argument for not following the composite documents approach is that it contravenes the overriding purposes and policies of the U.C.C.¹²⁶ Simplicity is achieved by consolidating the parties' agreement in a single document.¹²⁷ A determination of intent by a judicial body or by a subsequent creditor involves considerations which are by no means simple. The Code requirements of section 9-203, when given their ordinary meaning, are minimal and simple to comply with. It is much easier to achieve uniformity in the law concerning security agreements when the conservative position is strictly applied. Uniformity of the law is certainly not achieved by the varying positions taken by individual liberal jurisdictions. Although the Code is to be "liberally construed and applied to promote its underlying purposes and policies,"¹²⁸ a liberal approach toward security agreements contradicts the simplicity and uniformity envisioned by the drafters.

Advocates of broad intent, through the composite documents position, state that third parties are unharmed by the lack of a formal security agreement.¹²⁹ The basis for this reasoning is that constructive notice occurs through the filed financing statement.¹³⁰ The flaw in this reasoning is that it relies on the false assumption

124. Note, *In re Bollinger*, 50 CIN. L. REV. 225, 236 (1981).

125. See U.C.C. § 9-203 comment 3.

126. See U.C.C. § 1-102(1), (2).

127. "Simplicity certainly is not promoted when a court must engage in a complicated search through various documents for the intent of the parties." Note, *supra* note 124, at 235.

128. U.C.C. § 1-102(1).

129. Comment, *supra* note 36, at 813.

130. *Id.* at 813. A system of notice filing was established to be supplemented by further inquiry. See U.C.C. § 9-402 comment 2.

that no harm results from creating uncertainty among other interested creditors or potential creditors. Subsequent creditors must bear the added burden and risk of determining whether a valid security interest was "intended" by the parties. Assuming the utmost cooperation from the original creditor and debtor¹³¹ upon inquiry by the third party, the status of the security interest may still remain uncertain in a liberal approach jurisdiction. It is, of course, possible for the subsequent creditor to pursue a security interest in property not covered by the financing statement or conduct a similar transaction with other parties.¹³² Under this example, a creditor may escape unharmed—but not unaffected. A formal security agreement integrated in a single document virtually eliminates the uncertainty engendered by the liberal approach.

There are several problems attributable to reliance on a liberal approach. Encouragement of sloppy drafting and dispensing with formal security agreements may be byproducts of the liberal attitude.¹³³ In the absence of a default clause, what circumstances trigger default under the combined documents?¹³⁴ Conversion of property by the debtor is made easier when no formal security agreement exists.¹³⁵ These problems arise solely because of the failure to execute a security agreement complying with requirements easily fulfilled by a simple written instrument.

The conservative approach suffers from the disadvantage that an occasional harsh result will accrue to the creditor who fails to execute a formal security agreement. This result can be justified on several grounds. One commentator emphasizes that requiring a creditor to execute a single document denominated a security agreement is a valid pre-condition to granting the benefits of secured status.¹³⁶ Liberal courts are in effect resolving "a failure to comply with the minimal formal requirements of section 9-203 in favor of the noncomplying party."¹³⁷ Since the requirements of section 9-203 are reduced to a minimum, there should be strict adher-

131. This may be a risk-filled assumption for the subsequent creditor where the parties inquired of have such a personal interest in the subject property.

132. This assumes that other parties would be available to conduct similar transactions and that substitute property is available.

133. Note, *supra* note 124, at 236.

134. Comment, *supra* note 36, at 815-16.

135. *Id.* at 819.

136. A. SQUILLANTE, *supra* note 4, at 187.

137. *Id.* at 187.

ence to the standards enunciated.¹³⁸ The risk of a seemingly harsh result is outweighed by the greater uniformity, certainty, and simplicity inherent in the conservative approach. Parties to a secured transaction can promote Code policies and easily avoid any harsh results by executing a simple security agreement complying with section 9-203.

VI. CONCLUSION

North Carolina and other jurisdictions adhering to the composite documents approach should revert to the single document approach. A return to this approach would result in a more sound commercial policy for North Carolina and other liberal jurisdictions. Article 9 of the Uniform Commercial Code provides a rational, simple method for creating and perfecting a security interest in commercial transactions. Attorneys should not rely on the liberal attitude prevailing in some jurisdictions, but should execute formal security agreements for their clients as a matter of common practice. The uniformity and simplicity obtained by a strict adherence to the language of the Code outweighs the benefits of allowing the parties' intent to govern the commercial transaction.

Gregory D. Hutchins

138. R. LORD & C. LEWIS, *supra* note 72, § 3-1(A)(1) at 19.