University of Baltimore Law Forum

Volume 8
Number 2 *February, 1978*

Article 10

2-1978

Recent Decisions - State and Federal: No Talisman Required for Floating Lien

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Recent Decisions

MARYLAND AND DISTRICT OF COLUMBIA

No Talisman Required for Floating Lien

by John Jeffrey Ross

When a merchant executes a security agreement with his financier without specifying that "after acquired property" shall serve as collateral, a valid security interest is nonetheless created in that merchant's inventory, present and future, when the document shows the intent to cover "floor plan" or inventory financing.

This is the salient holding of a recent Court of Appeals decision in answer to questions certified from the United States District Court for Maryland. *Frankel v. Associates Financial Services, Inc.*, 281 Md. 172, 377 A.2d 1166 (1977).

The parties, an Article Nine creditor and a trustee in bankruptcy, were before the court after a bankruptcy adjudication in the matter of the Prince George's Truck Center. The District Court certified the following questions of law to the Court of Appeals pursuant to MD. CTS. & JUD. PROC. CODE ANN. §§12-601-609 (1974):

> 1. Did the security interest created . . . attach to that property repossessed by [creditor], which property was acquired by the [bankrupt Truck Center] after the [security] Agreement was signed?
> 2. Where financing statements were properly filed in the local circuit court prior to the 1971 amendment to Maryland Code (1957, 1964 Repl. Vol.) Art 95B, §9-401 changing the requirements regarding place of filing, did the filing of a superfluous subsequent financing statement in the local circuit court in . . . 1973, rather than with the State Department of Assessments and Taxation [as required by the amended code] adversely affect any prior perfection of the security interest?

281 Md. at 174 , 377 A.2d at 1167.

When a commercial entity passes away there can be a spectacular series of disputes over the spoils. Often the litigants are a secured creditor whose rights are dictated by Article Nine of the Uniform Commercial Code and a trustee in bankruptcy existing pursuant to 11 U.S.C. §1 *et seq.* (The Bankruptcy Act).

Essentially, a bankruptcy trustee is to bring order to the financial affairs of the bankrupt debtor's estate. She must consolidate that estate and attempt to distribute the remaining assets to the creditors on an equitable basis. If one creditor is preferred, the others, of course, suffer from this favored distribution. Especially subservient to the consolidation and then redistribution of the bankrupt's assets is the creditor without any promise of security to buttress his loan. On the other hand, a secured creditor may present a valid claim to recover the entire amount of collateral due on the basis of her loan. The secured creditor goes to the head of the line, in effect, to recoup all of her outlay in financing the bankrupt's business. Security thus able to withstand the vacuum left by bankruptcy, a vacuum filled by the unprotected creditors, must be established properly ("perfected") or it too shall be included in the trust. As White and Summers have indicated at page 865 in their text on the Uniform Commercial Code: "[T]he acid test of the quality of an Article Nine security interest is its capacity to survive trustee attack."

On June 10, 1970, the Prince George's Truck Center executed a Wholesale Security Agreement with Associates Financial Services which covered "all of [the Truck Center's] collateral" and "proceeds thereof whether or not identifiable, and the value thereof." This agreement, of course, represented the bargain of the parties to grant a security interest in the designated property. *See* 48 Temple L.Q. 833.

Subsequent to this, on 12 June, the parties filed a financing statement with the clerk of the Circuit Court for Prince George's County. Further statements were recorded in the court on January 14, 1971 and November 12, 1973.

On February 18, 1975, the Truck Center transferred 19 trucks to Financial Services which had financed their purchase the prior year and for which Financial remained unpaid. Four months later, on June 17, 1975, the Truck Center was adjudged bankrupt.

Roger Frankel, appointed trustee in bankruptcy, attempted to recover these trucks for the estate in bankruptcy. He contended that their transfer to the lender was a voidable preference under §60 of the Bankruptcy Act (11 U.S.C. §96), which reads in pertinent part:

> §60(a)(1) A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against

him of the petition intitiating a proceeding under the [Bankruptcy] Act, the effect of which transfer will *enable such creditor to obtain a greater percentage of his debt than some other creditors of the same class.* (emphasis supplied).

The preferential transfer of the 19-truck collateral to the secured lender gave Financial Associates a proportionately greater slice of the estate than the other creditors. In arguing that the transfer was voidable and ineffective to prevent the inclusion of the trucks into the trust in bankruptcy Frankel stated that "the Security interest created by the 'Wholesale Security Agreement' . . . did not attach to that property repossessed by [Financial Associates], which property was *acquired* during 1974, *after* the Wholesale Security Agreement was executed." Trustee's brief at 5 (emphasis supplied). Trustee Frankel urged that the 1970 agreement's extension to the 1975 truck repossessions was frustrated by the failure of the parties to *specify,* as supposedly contemplated by Maryland COMMERCIAL LAW CODE ANN. (1975) §9-204, that the agreement shall cover *after acquired* property; He insisted that the Code required that the intended collateral must be made clear:

(1) A security interest cannot attach until there is agreement that it attach and value is given and the debtor has rights in the collateral. . .

(3) Except as provided in [another section not relevant here] a security agreement may provide that collateral, whenever acquired, shall secure all obligations covered by the security agreement.

An interest in after acquired property, *a fortiori specifically unidentifiable at the creation of the security agreement,* is the notorious "floating lien". The trustee's arguments against this type of security find sympathy in what section three of the Official Comments to §9-204 describes as a prejudicial attitude against allowing a commercial borrower to "encumber all his assets, present and future." The commitment of future assets may be thought to cast an umbra of hardship on the debtor; such unfairness is mitigated by the explicit articulation of what shall be utilized as collateral.

Neither the unfavored view of this "continued general lien" nor the explicitness demanded by the trustee survive the court's reading of §9-204. The following passage expresses the law in Maryland, an effective "YES" answer to the first certified question:

We reject the notion that the security agreement must specifically contain the talisman of "after acquired property", or its equivilant, however phrased, and prefer instead to interpret the agreement in the light of trade custom and commercial practice. It seems to us that . . . a continuing relation was contemplated, in which the lender's lien extended to the collateral, as it might exist from time to time, until the indebtedness was satisfied.

281 Md. at 176, 377 A.2d at 1168. Thus, although the "inartfully drafted" security agreement was viewed as inadequate for §9-204 purposes by the hypertechnical eye of a trustee in bankruptcy charged with the vigorous consolidation of all of the debtor's assets, the court reasonably perceived a clear intent by the parties to secure a collateral which remains in a state of flux, *as inventory necessarily must.*

In *In re Page,* 16 U.C.C. Rep. 501 (M.D. Fla. 1974), the trustee in bankruptcy argued that the security agreement which failed to state "after acquired property" placed a clear and unambiguous limit on the collateral covered and should not have been altered by the court to include assets not described in the agreement. In finding a valid "floating lien" prevalent over the trustee's claims the court noted that

[t]he fallacy of this argument should be evident if one considers the nature and character of the collateral. . . Needless to say, any reasonable secured party would be fully aware that this type of business presupposes a constant change in the inventory.

To attribute and adopt the narrow construction urged by the trustee would destroy all inventory financing unless the security agreement and the financing statement include an after acquired clause. This approach is contrary to the general liberal philosophy of the Code and certainly is contrary to the currently prevailing and accepted commercial practice of financing retail merchandising businesses.

16 U.C.C. Rep. at 504-505.

It is thus clear that a security interest resulting from payments for Floor Plan Advances, increases in, or replacement of inventory, can only reasonably mean the intent to attach a floating lien. *See* HENSON, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE, at 44 ("inventory . . . includes after acquired collateral"); 48 Temple L.Q. at 835 (creditor would not be willing to let his security evaporate as it is sold). *See also Whitworth v. Krueger,* 98 Idaho 65, —, 558 P.2d 1026, 1031-1032 (term "replacements" enough to create after acquired interest).

His first argument rejected, the trustee in *Frankel* next contended that the second certified question should be answered in the affirmative because the creditor filed his third Financing Statement at the wrong place; the security interest lost its

photo by John Clark Mayden

perfected status, and thus could not prevail over the trustee's inclusion into the bankrupt's estate. On July 1, 1971 §9-401 was amended to change the proper place for filing a financial statement from the circuit courts to the State Department of Assessments and Taxation. Instead of filing the third statement with the Department, the creditor acted as he had the first two instances and filed this final statement with the Circuit Court. The basic issue here was whether the final statement modified the earlier filings. In rejection of the trustee's argument, the court conceded that the third filing was ineffective, but that under §9-401(d) such error had no effect on the properly filed statements.

Court Shoots Down Air Force

by Thomas G. Ross
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The August 30, 1977 decision in *Mead Data Central, Inc.* v. *United States Department of the Air Force, et al.* (No. 75-2218), ___ U.S.App.D.C. ___, ___ F.2d ___, concerned the applicability and scope of exemption five of the Freedom of Information Act (FOIA), 5 U.S.C. §552(b)(5)(1970 Supp. V 1975). The appellant appealed from a summary judgment in favor of the Air Force in which the U.S. District Court for the District of Columbia denied Mead Data's request for an injunction to compel the Air Force to disclose the contents of seven documents relating to a licensing agreement between the Air Force and the West Publishing Company. The court held that the requested documents were not subject to disclosure because the fifth of nine exemptions enumerated within the FOIA specifically protected the Air Force against mandatory release of the documents.

Enacted in 1966, the FOIA was intended to increase public access to government records and to encourage agency responsibility. Congress, through the Act, changed its policy from one favoring nondisclosure of governmental information (under the Administrative Procedure Act [APA] of 1946) to one of mandatory disclosure. Whereas the APA was very restrictive and often abused, requiring access only to "persons properly and directly concerned" with the matter, the FOIA mandates disclosure of identifiable governmental records to "any person" requesting them, subject to the nine specific exemptions, and provides for judicial remedy for a government agency's improper withholding of information. 86 HARV. L. REV. 1047-1048 (1973).

The United States Supreme Court in *N.L.R.B. v. Sears, Roebuck and Co.*, 421 U.S. 132 (1975), held that the "purpose of the [FOIA] is to establish a general philosophy of full agency disclosure unless information is exempted under clearly delineated statutory language" and that the Act's intent was to assure the public's right of access to virtually all governmental agency documents. The Court reiterated its position on the FOIA's function in *Dept. of Air Force v. Rose*, 425 U.S. 352 (1976), holding that "disclosure, not secrecy, is the dominant objective of the Act."

Congress did, however, recognize the need to allow government agencies the right of nondisclosure for certain documents. The information, to be protected, must be within one of the following nine specific exemptions:

1. national defense or foreign policy interests;
2. agency's internal personnel rules and practices;
3. specific statutory exemption;
4. trade secrets;
5. inter-agency or intra-agency memoranda;
6. invasion of personal privacy;
7. investigatory files for law enforcement purposes;
8. regulation of financial institutions; and
9. information concerning oil wells.

See 5 U.S.C. §§552(b)(1) through (9).

In *Mead Data*, the Air Force was successful at the trial court level after asserting a claim that the seven documents requested by Mead Data were privileged in that they fell within exemption five of the FOIA. That exemption, at 5 U.S.C. §552(b)(5), states:

> [The Act does not apply to] inter-agency or intra-agency memoranda or letters which would not be available by law to a party other than an agency in litigation with the agency.

The broad and unclear language of exemption five thrusts upon the courts a major role in the administration of the Act. 86 HARV. L. REV. at 1066-67 (1973). The two basic defense claims that can be made to invoke the privilege under this exemption are the attorney-client privilege and the privilege protecting those memoranda involved in the deliberation and decision-making governmental process. *See generally* C. M. Marvick (Ed.), Litigation Under the Amended Freedom of Information Act (ACLU 1976).

The seven documents that Mead Data sought to have disclosed dealt with an Air Force project involving a computerized legal research system. Of these, the Air Force claimed that three were legal opinions in which Air Force attorneys were advising their client as to applicable law concerning contract negotiations. The Air Force further asserted that the other four documents were privileged as internal memoranda prepared by its employees.

Mead Data argued that the information requested was purely factual and thus subject to disclosure, while the Air Force asserted that it consisted of advisory opinions and deliberations protected from disclosure by exemption five.

The circuit court agreed with the trial court's ruling that both the attorney-client and deliberative process privileges are incorporated into exemption five. However, it reversed the judgment of the district court due to its "impermissibly broad interpretation" of these privileges and remanded for a decision based on narrower constructions outlined in the case. No. 75-2218 slip op. at 34. The court noted that the congressional intent was that the exemption be applied "as narrowly as consistent with efficient government operation." *Id.*, at 11, n. 16; S. Rep. No. 813, 89th Cong., 1st Sess. 9 (1965).