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CHATTEL SECURITY COMES OF AGE: ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

CHARLES A. BANE

CHATTEL security has been a baffling problem in the law. The superficial resemblances of personal property to real property have led to attempts, from time to time, to apply the principles of real security to chattel security, but never with satisfactory results. Realty and personalty necessarily differ. Personalty of course has none of the immobility of realty. Furthermore, the use of realty as security usually takes place in a one-time, purchase money transaction, whereas borrowing on personalty often represents a continuing business arrangement. These differences have led to the creation of security techniques for chattels completely unknown to the world of realty. In the process of developing these techniques, both new and traditional concepts have been used, and sometimes strained; but despite the use of great ingenuity and imagination, the law has not yet achieved chattel security methods wholly satisfactory to borrowers, lenders and the inevitable third parties.

The proposed Uniform Commercial Code, sponsored by the American Law Institute and the National Conference of Commissioners on Uniform State Laws, would effect great changes in the whole field of chattel security. The proposals seem highly desirable, but to see that that is so, it will first be necessary to review past and present methods of financing with chattels as security and to demonstrate the inadequacy of those methods.

THE PLEDGE AND THE CHATTEL MORTGAGE

The oldest means of creating chattel security is the pledge, whereby a borrower delivers possession of a chattel as security to his lender, the chattel to be returned by the lender upon payment of the debt. This device, going back in its origins to Roman law,¹ recognized that chattels

¹ For a description of the Roman *pignus*, see Buckland, *Textbook of Roman Law from Augustus to Justinian* 470 et seq. (1921).

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could be moved, hidden or destroyed, as land could not be, and it therefore guarded against these dangers by requiring delivery of possession to the lender.

Eventually, as a society advances economically (or at least increases in complexity), it becomes obvious that borrowers on chattels must in many instances be allowed to retain possession of the goods borrowed upon. If the chattels consist of livestock growing on a farm, or equipment used in a business, or tools used in a trade, the borrower must retain possession if he is to continue the very activities which will permit him to repay the borrowed sums. And if the borrower has good credit character and rating, lenders will lend to him upon the security of his chattels, and are willing to grant to him permission for their continued use.

To find an answer in this situation, lawmakers turned for an example to the real property mortgage and approved a written mortgage on chattels. This step was accomplished in most states of the United States in the middle of the nineteenth century, with legislative enactment of fairly standard chattel mortgage acts.² Under these acts, the chattel mortgage instrument is usually required to be in writing, formally signed and acknowledged, and to be filed or recorded in the office of the appropriate county official.³ The transaction then being of public record just as if it were a mortgage on realty, the lender's lien is made valid against third parties, who are charged with notice of it, even though the borrower retains the possession of the mortgaged goods. In recognition of the transitory nature of chattels, the usual chattel mortgage act imposes severe penalties on the borrower for removing the mortgaged chattels from the jurisdiction in which the chattel mortgage is recorded.⁴

Illinois enacted its chattel mortgage act in 1845. It clearly made the chattel mortgage an alternative to the pledge in the following language:⁵

No mortgage, trust deed or other conveyance of personal property having the effect of a mortgage or lien upon such property, shall be valid as against the rights and interests of any third person, unless possession thereof shall be delivered to and remain with the grantee, or the instrument shall provide for the possession of the property to remain with the grantor, and the instrument

² Jones, *Chattel Mortgages and Conditional Sales* §§ 190-235 (Bowers ed., 1933). The statutes of each state are collected in 1 and 2 CCH *Conditional Sale Chattel Mortgage Rep.*

³ 2 CCH *Conditional Sale Chattel Mortgage Rep.* 410-475.

⁴ 2 CCH *Conditional Sale Chattel Mortgage Rep.* 570.

⁵ Ill. Rev. Stat. (1949) c. 95, § 1.

is acknowledged and recorded or filed as hereinafter directed; and every such instrument shall, for the purposes of this act, be deemed a chattel mortgage.

The chattel mortgage did not continue for long to be a completely satisfactory solution. Indexing and filing systems, which could not be related to property with a fixed and definite description as in the case of land, began to break down in most urban centers as transactions increased in volume.⁶ Furthermore, the keying of the chattel mortgage system to county lines, with statutory restrictions on removal of the mortgaged goods from the county, made the device unworkable for such chattels as trucks and rolling stock. There were difficulties for corporate borrowers, such as utilities, whose personal property extended over wide areas; an effective mortgage on the utility's property involved the trouble and expense of filing or recording in every county in which there was personal property, and there was then doubt whether individual pieces of equipment could be moved from one county to another.⁷ But perhaps the greatest single factor tending to make the chattel mortgage inadequate for security needs was the rapid growth of consumer credit, which led to numerous single, small-scale transactions where a seller or lending institution wished to extend credit on the security of the goods sold, but desired to avoid the repeated expense of filing or recording individual chattel mortgages for each transaction.

THE CONDITIONAL SALE

Primarily to meet the needs of consumer credit, the conditional sale came into widespread use. A seller willing to sell on credit, but only if he had security in the goods sold, made arrangements with his purchaser whereby the seller retained title until the full purchase price was paid. Then, having scrupulously avoided any sign of a transfer of title to the purchaser while the debt was outstanding, the seller argued that he was not extending security on the chattels of another and consequently was not within the purview of the chattel mortgage acts. Furthermore, he pressed his rights against subsequent lienors or purchasers by arguing that his purchaser had no interest which could be encumbered or sold.

⁶ It is practically impossible today to make an adequate search of the chattel mortgage records in Cook County. This is no reflection on the Recorder, in view of the difficulty in properly indexing and recording innumerable chattel transactions.

⁷ In Illinois, the 1951 legislature granted utilities some amelioration of their mortgage problems. An amendment (H.B. 1003, approved and effective July 9, 1951) to § 1 of the Chattel Mortgage Act permits a utility mortgage to cover both realty and personalty and to be recorded in the manner provided for mortgages on real property.

These arguments were successful in most states.⁸ Illinois was at first in the minority, holding that a conditional seller is not protected against innocent third parties;⁹ but upon the enactment of the Uniform Sales Act in Illinois,¹⁰ the state supreme court found in Section 20 of that Act the necessary authorization for a conditional sale.¹¹

So extensive did the use of the conditional sale become that a majority of the states, concerned for the rights of third parties, now have statutes requiring that conditional sale agreements be filed or recorded in one manner or another.¹² In addition, ten states, and Alaska and Hawaii, have adopted the Uniform Conditional Sales Act, which likewise requires public filing of the agreement.¹³ Illinois has not adopted that Act, nor imposed any other requirement of filing or recording,¹⁴ with the result that the conditional sale flourishes throughout the state, not only in consumer credit transactions but in all cases where a secured seller and buyer wish to avoid the expense and publicity of a recorded chattel mortgage.

As one result of the use of the conditional sale, the law reports are filled with cases attempting to determine whether a given transaction is a conditional sale or a chattel mortgage.¹⁵ The question is almost always there, and one disadvantage of the conditional sale is that a seller runs the risk that his own conditional sale will turn out to be a chattel mortgage in the eyes of the courts, with a consequent destruction of his rights against third parties.

INVENTORY FINANCING

Just as the chattel mortgage proved inadequate at the consumer level in business transactions, so did it prove inadequate one step back in the merchandising chain. It became unworkable for retailers, wholesalers and manufacturers who wished to finance their businesses on the security of their inventory or stock in trade.

⁸ 2A U.L.A. (Commentaries on Conditional Sales) § 47 (1924).

⁹ *Gilbert v. National Cash Register Co.*, 176 Ill. 288, 52 N.E. 22 (1898); 2A U.L.A. (Commentaries on Conditional Sales) § 47 (1924).

¹⁰ Ill. Rev. Stat. (1949) c. 121½, §§ 1-77.

¹¹ *Sherer-Gillett Co. v. Long*, 318 Ill. 432, 149 N.E. 225 (1925).

¹² 2A U.L.A. (Commentaries on Conditional Sales) § 53 (1924).

¹³ Uniform Conditional Sales Act § 5.

¹⁴ Illinois does require recording with the Secretary of State of conditional sales agreements relating to rolling stock, motor vehicles and equipment used in public transportation: Ill. Rev. Stat. (1949) c. 114, § 50.

¹⁵ The cases are collected in annotations in 17 A.L.R. 1421 (1922); 43 A.L.R. 1247 (1926); 92 A.L.R. 304 (1934); 175 A.L.R. 1366 (1948).

Stock in trade will often constitute the principal asset of a business, apart from its accounts receivable, but in many instances the building up of an adequate stock, or maintaining it at the necessary level, cannot be financed by the business itself. Borrowing becomes necessary, either directly from a bank, finance company or other lending institution, or by securing credit from the manufacturer or wholesaler who sells to the borrower. In either case, the lender will want security and the best security would be a mortgage on the inventory or stock in trade purchased with the borrowed funds.

One distinctive and necessary feature of such an arrangement has created a problem. It will be recalled that the validation of the chattel mortgage as an alternative to the pledge arose from a recognition of the need for permitting the chattel mortgagor to retain possession of the chattel. In the case of a chattel mortgage on a stock in trade, it is essential not only that the mortgagor retain possession of the mortgaged goods but that, in addition, he be allowed to dispose of them in the usual course of his trade or business. The disposition of goods is the borrower's business, and it is in the lender's interest, as well as the borrower's, that the borrower continue in his business in the usual course.

The law has looked with complete disfavor upon any security arrangement whereby the borrower retains power to dispose of mortgaged assets. In *Benedict v. Ratner*,¹⁶ the Supreme Court of the United States was called upon to determine the validity, in bankruptcy, of a lender's lien on accounts receivable where the borrower had been permitted to retain complete control of the accounts and collect on them, with no obligation to remit the proceeds of collection to the lender. The Court, through Justice Brandeis, held that such an arrangement constituted a secret or hidden lien and was therefore void as a fraud on creditors. Particularly was this so, the Court said, when there was no obligation to turn over the proceeds to the lender. Thereafter, the Court of Appeals for the Second Circuit, in *Brown v. Leo*,¹⁷ applied the doctrine to a chattel mortgage on stock in trade, where the mortgagor had the power of disposition.

It is not clear that the holding of *Benedict v. Ratner* necessarily had to be applied to a chattel mortgage on a stock in trade. Ratner's lien

¹⁶ 268 U.S. 353 (1925).

¹⁷ 12 F. 2d 350 (C.A. 2d, 1926). Not all Courts of Appeal have been happy with the *Benedict v. Ratner* doctrine. Chief Judge Hutcheson, speaking for the Fifth Circuit in *Second Nat. Bank of Houston v. Phillips*, 189 F. 2d 115, 117 (C.A. 5th, 1951), said: "Fortunately in this Circuit the Ratner case has never been a fetish." But see *City Nat. Bank of Houston v. Phillips*, 190 F. 2d 97 (C.A. 5th, 1951).

on the debtor's accounts had not been recorded and indeed was not required or authorized to be; but quite the reverse is true of a chattel mortgage which has validity against third parties only if it is filed or recorded. If chattel mortgagee X gives mortgagor Y the right to dispose of the mortgaged goods in the normal course of Y's business, could not X argue, when confronted by *Benedict v. Ratner*, that he has created no secret lien nor perpetrated any fraud on chattel mortgagor Y's creditors, because all that Y's creditors would have to do would be to look at the public records to find that the goods were in fact mortgaged to X? This argument was brushed aside in *Benedict v. Ratner* itself, the Court saying that the essence of the fraud, whether accounts receivable or chattel mortgages were involved, lay in the failure of the lender to require the borrower to pay over the proceeds to the lender. Doubts may nevertheless linger as to the correctness of this position, since it could be argued that the disposition of proceeds is a matter that concerns the borrower and lender only and that other creditors may in any event be helped, rather than hurt, if the borrower retains the proceeds in his business. If there is a legal fraud in the situation, the essence of it would seem to be the absence of public notice of the transaction.

Nevertheless, the courts have consistently applied the *Benedict v. Ratner* doctrine to chattel mortgages, thereby holding that creditors are not required to check chattel mortgage records if a lender has permitted a borrower to deal with goods as if he were the unencumbered owner.¹⁸ It has been speculated that the courts were fearful of validating cozy arrangements whereby a little merchandiser, such as a grocer, might subject his stock to a chattel mortgage in favor of a co-operative wife, all to the great discomfiture of unsuspecting creditors when they later try to attach.¹⁹

The Illinois courts have consistently adhered to the doctrine that a chattel mortgage is invalid when the mortgagor is permitted to dispose of the mortgaged goods. As long ago as 1857, in *Davis v. Ransom*,²⁰ the Supreme Court of Illinois held that a recorded chattel mortgage which permits the mortgagor to sell his stock in trade in the usual course of business is, however well intended in fact, "void as against creditors, as tending to encourage and sustain frauds, and to hinder

¹⁸ The decisions are surveyed in *Turk v. Kramer*, 138 Okla. 35, 280 Pac. 266 (1929), annotated in 73 A.L.R. 236 (1931).

¹⁹ *Dunham, Inventory and Accounts Receivable Financing*, 62 Harv. L. Rev. 588, 590 (1949). Something like this arrangement was the case in *Brown v. Leo*, 12 F. 2d 350 (C.A. 2d, 1926).

²⁰ 18 Ill. 396 (1857).

creditors in the collection of their just demands." Illinois at that time and ever since has had a chattel mortgage act, permitting filing or recording of a chattel mortgage as an alternative to delivery of possession to the mortgagee.²¹ Nevertheless, the Illinois courts have consistently followed *Davis v. Ransom*²² even where the authority to the mortgagor to dispose of the mortgaged property was implied rather than expressed,²³ and whether or not the proceeds from sale are required to be turned over to the mortgagee.²⁴

The Illinois courts not only regard such mortgages as frauds on creditors, but also hold them invalid by reason of the wording of Section 1 of the Illinois Chattel Mortgage Act.²⁵ As already noted,²⁶ that Section provides that a mortgage of personal property shall not be valid as against the rights and interests of any third person "unless . . . the instrument shall provide for the possession of the property to remain with the grantor, and the instrument is acknowledged and recorded or filed as hereinafter directed." The Illinois courts have held that the requirement that "the instrument shall provide for the possession of the property to remain with the grantor" is mandatory; and, they say, when a mortgagor is given a power of sale, there is a failure to provide for possession remaining with him.²⁷

These decisions in Illinois and other states effectively prevented the use of the chattel mortgage for inventory financing. One would not expect that to end the matter, lawyers and merchants being as ingenious as they are. Some wholesalers and manufacturers turned to the conditional sale. There they found themselves on more solid ground, particularly in those states which adopted the Uniform Conditional Sales Act, since that Act expressly authorized a conditional sale with power of resale by the buyer, even though the buyer had no title.²⁸ The price

²¹ Ill. Rev. Stat. (1949) c. 95, §§ 1-11.

²² Accord: *Huschle v. Morris*, 131 Ill. 587, 23 N.E. 643 (1890); *Read v. Wilson*, 22 Ill. 377 (1859); *Oakford & Fahnestock v. Hill*, 135 Ill. App. 511 (1907); *Rhode v. Matthai*, 35 Ill. App. 147 (1889); *Yager v. Mersinger*, 15 Ill. App. 262 (1884).

²³ *Simmons v. Jenkins*, 76 Ill. 479 (1875).

²⁴ *Deering v. Washburn*, 141 Ill. 153, 29 N.E. 558 (1892). Other states, following the strict rationale of *Benedict v. Ratner*, hold the arrangement valid where the proceeds are to be turned over: see *Cohen & Gerber, Mortgages of Merchandise*, 39 Col. L. Rev. 1338 (1939); cf. *Acme Feeds Inc. v. Daniel*, 312 Ill. App. 330, 38 N.E. 2d 530 (1941).

²⁵ Ill. Rev. Stat. (1949) c. 95, § 1.

²⁶ See p. 93.

²⁷ *Deering & Co. v. Washburn*, 141 Ill. 153, 29 N.E. 558 (1892); *Davis v. Ransom*, 18 Ill. 396 (1857).

²⁸ Uniform Conditional Sales Act § 9.

to be paid was that of meeting the Act's requirement that the conditional sale instrument be publicly filed.

Another inventory security device, used in some states though not authorized in Illinois, is that of the non-possessory factor's lien.²⁹ This is an outgrowth of the traditional common law possessory lien and allows a lien against goods purchased by a buyer for advances made by the factor to the seller on the buyer's behalf. As time went on this type of transaction expanded, particularly in the textile business in New York City, and factors came to act like bankers and bankers made themselves up to look like factors. Statutes were then passed in some states, including New York,³⁰ validating the lien even though possession of the goods passed to the buyer with the power of sale, if the required notices were posted and filed.³¹

Two other techniques have been put to use in a number of states, including Illinois: the trust receipt, and field warehousing. Each has its followers.

THE TRUST RECEIPT

The trust receipt is a device whereby a bank or other lender of money to buy goods, takes title to the goods in its own name and then "entrusts" them to the borrower. The transaction has been formally legalized by the Uniform Trust Receipts Act, adopted in Illinois in 1935.³² Under the Act, the entrustor is authorized to give the borrower the power to sell the goods but to require him to account for the proceeds. If the borrower does not so account, the entrustor is entitled to such proceeds to the extent that they are identifiable, or were received by the borrower within ten days of bankruptcy or insolvency, or consist of a debt due the borrower from the transaction. The Act requires the annual filing with the Secretary of State of a simple notice, stating that the entrustor and the borrower are engaged in trust receipt financing.

Trust receipt financing has its infirmities. For one thing, Section 60a of the Bankruptcy Act raised a problem until recently. Prior to 1950

²⁹ See Dunham, *op. cit. supra* note 19, at 592.

³⁰ N.Y. Pers. Prop. Law (McKinney, 1949) § 45.

³¹ For a somewhat unsympathetic account of these developments in the factor's lien, see Steffen & Danziger, *The Rebirth of the Commercial Factor*, 36 Col. L. Rev. 745 (1936).

³² Ill. Rev. Stat. (1949) c. 121½, §§ 166-187. Governor Horner of Illinois allowed the bill to become law without his signature, saying it was "a very complicated and technical act, the purposes of which are not readily discernible": Bogert, *The Effect of the Trust Receipts Act*, 3 Univ. Chi. L. Rev. 26 (1935).

that Section, putting a trustee in bankruptcy in the shoes of a hypothetical purchaser for value from the bankrupt, was applied so that in a trust receipt transaction, where a borrower was empowered to sell the goods free and clear of the entrustor-lender's lien, the trustee in bankruptcy also took the property free and clear of the entrustor's lien.³³ Since the primary concern of secured lenders is to see that their liens stand up in bankruptcy, this result was a real blow. There was considerable agitation for a change, and in 1950 Section 60a was amended in such a manner that trust receipts will now presumably stand up in bankruptcy.³⁴

Another difficulty with trust receipt financing lies in the fact that an entrustor can recapture only "identifiable" proceeds, under the Uniform Trust Receipts Act. Since the proceeds of sale usually consist of money, it is necessary for the lender to "police" the loan to make sure that the proceeds from sales of entrusted goods are turned over to him. Most banks in larger cities, such as Chicago, are not equipped to do a policing job and accordingly do not engage in trust receipt financing. In smaller towns, where the policing task is easier, the trust receipt is acceptable and has furnished the basis for extensive "floor plan" financing by automobile and other dealers.

A still further difficulty with the trust receipt is that the *res* evidently must consist of specific, identified and identifiable goods. The trust receipt therefore does not cover after-acquired goods and probably is not useable for goods which are fungible and part of a larger mass, or which lose identity in the course of a manufacturing process.³⁵

³³ *In re Harvey Distributing Co., Inc.*, 88 F. Supp. 466 (E.D. Va., 1950).

³⁴ 64 Stat. 24 (1950), 11 U.S.C.A. § 96 (1950). But the amendment is not retroactive: *In the matter of Harvey Distributing Co.*, 1 CCH Conditional Sale Chattel Mortgage Rep. 12366 (E.D. Va., 1950), reaffirming *In re Harvey Distributing Co., Inc.*, note 33 *supra*. Lenders on accounts receivable were also concerned about § 60a as a result of the U.S. Supreme Court's decision in *Corn Exchange Nat. Bank & Trust Co. v. Klauer*, 318 U.S. 434 (1943) and they were among the prime movers for its amendment; for the view that lenders on accounts receivable really had nothing to worry about, see Conwill & Ellis "Much Ado about Nothing: The Real Effect of Amended 60(a) on Accounts Receivable Financing," 64 *Harv. L. Rev.* 62 (1950).

³⁵ "Goods" which may be the subject of a trust receipt are defined in § 1 of the Uniform Trust Receipts Act as "chattels personal, other than: money, things in action, and things so affixed to the land as to become a part thereof." Neither the Act nor any cases decided thereunder indicate that "goods" may extend to after-acquired goods or to a non-identified portion of a mass. In a jurisdiction where a trust receipt was valid apart from the Act, it has been held that an entrustor's lien extended to a mass of commingled goods when the borrower violated his agreement not to commingle: *People's Nat. Bank v. Mulholland*, 228 Mass. 152, 117 N.E. 46 (1917).

FIELD WAREHOUSING

To meet the difficulties of the trust receipt and the unavailability of the chattel mortgage, the ingenious device of field warehousing has come into use where a borrower on inventory is to be permitted to dispose of goods in the usual course of his business.

Field warehousing consists of the creation of a warehouse on the borrower's premises, where the goods which are security for the loan are kept and may be worked on.³⁶ All the indicia of a warehouse are set up: that part of the borrower's premises where the goods are to be set aside is put under separate lock and key; a guard or custodianship system is established; a lease of the premises for warehouse use is often executed, for a nominal consideration, between the borrower and the third person who is the warehouse operator. Notices are posted on the premises so set aside, informing the world that it is a warehouse and that the goods therein are under warehouse control. The borrower on whose premises the warehouse has been set up has access to the goods only under conditions of strict surveillance. Warehouse receipts (usually in non-negotiable form) covering the goods maintained in the warehouse are then issued to and held by the lender. When the borrower wishes to dispose of the goods to his purchasers, he can secure their release only upon the turnover of the proceeds against the surrender of the warehouse receipts by the lender. Since all of this has the appearance of a warehouse arrangement rather than the creation of a lien, no filing or recording is required. Independent operators have gone into the field warehousing business and are available for the establishment of proper warehouse conditions on the borrower's premises.

Lenders are generally quite pleased with this arrangement, particularly since the expense of it, like most expenses of financing arrangements, is borne by the borrower. It gives the lender assurances that the goods will not be released from his control until they are paid for and that he need not be concerned about following proceeds. And he has the word of the Supreme Court of the United States, in *Union Trust Co. v. Wilson*,³⁷ that his warehouse receipts will be fully recognized in bankruptcy, if the field warehouse is properly established.³⁸

³⁶ *Heffron v. Bank of America Nat. Trust & Savings Ass'n*, 113 F. 2d 239 (C.A. 9th, 1940), annotated in 133 A.L.R. 209, (1941); *Bradley v. St. Louis Terminal Warehouse Co.*, 189 F. 2d 818 (C.A. 8th, 1951). See Birnbaum, Form and Substance in Field Warehousing, 13 Law & Contemp. Prob. 578 (1948).

³⁷ 198 U.S. 530 (1905).

³⁸ For a case where a lender was careless about the details of the field warehouse and lost his lien, see *Security Warehousing Co. v. Hand*, 206 U.S. 415 (1907).

For the borrower, the device has the disadvantage of expense and inconvenience.

Most states, including Illinois, have been quite receptive to this scheme.³⁹ Under the Illinois statutes such a field warehouse falls into the category of a Class "C" warehouse,⁴⁰ for which no license or bond is required.⁴¹ And there is express statutory authority to intermingle fungible goods,⁴² making the device particularly valuable as to such goods.

SUMMARY OF PRESENT METHODS

So there they stand, the present day devices for chattel security: the pledge, requiring that possession of the chattel be transferred from the borrower to the lender; the chattel mortgage, difficult to locate in the recorder's office, too expensive for the volume of consumer credit transactions, and outlawed where the borrower is to have the power of disposition; the conditional sale, required at a seller's peril to be distinguishable from a chattel mortgage, and not ordinarily useable by a lender who is not a seller; the trust receipt, unavailable to sellers and feasible for lenders only in limited circumstances; and field warehousing, artificial and expensive for the borrower. All are designed to create chattel security, and yet none will fit every form of chattel financing. Each creates a lien, but whether that lien will be a private affair or will be publicly recorded depends upon the form in which the transaction is cast: if you use the pledge or field warehousing or a conditional sale (at least in Illinois), you need not record or file; use a chattel mortgage or trust receipt and you must.

With this multiplicity of devices, not one can be used for a simple type of chattel financing that would be welcomed by borrowers and lenders. That would be an arrangement whereby a lender could lend, and a borrower borrow, on the security of an inventory or stock in trade, with goods in inventory moving out from under the lien as they are disposed of and with new goods coming in under the lien as they are acquired. The lender would have a constant security on the inventory, in whatever ratio he and the borrower agreed upon, and the borrower could avoid the necessity of making new borrowings as he disposes of goods and wishes to replenish his stocks.

This device of a floating lien or floating charge has been recognized

³⁹ See annotation, Goods Warehoused on Owner's Premises, 133 A.L.R. 209 (1941).

⁴⁰ Ill. Rev. Stat. (1949) c. 114, § 190.

⁴¹ *Ibid.*, at §§ 191, 192.

⁴² *Ibid.*, at § 253.

in English law;⁴³ but its use in this country is hampered by the fact that trust receipts and field warehousing, the only two methods that could be adapted, must deal with goods that are in existence at the time of the financing arrangement and do not and cannot extend the security to after-acquired goods. The use of either one of these methods to create a floating lien requires a number of cumbersome steps, with the borrower disposing of the goods, paying over the proceeds to the lender and then borrowing back the proceeds as a new loan to purchase new goods which would then become security for the new loan. And each step has to be repeated each time the borrower makes a substantial disposition of goods from inventory.

Not only do the existing security devices not afford a simple procedure for effecting inventory financing, but they permit no correlation between inventory and accounts receivable financing. Stock in trade and accounts receivable constitute two sides of the same coin, and the one representing the physical asset before sale, the other the intangible asset into which the physical asset is transmuted by sale. Each represents the borrower's asset before he has actually received cash from the sale, and lenders would be perfectly willing to see their security on inventory transformed into security on the accounts receivable resulting from sales in the normal course of business. But under our laws, there is no way in which financing can be done with inventory and accounts jointly constituting the security. Each must be financed in its own way. We have seen the complications in financing inventory. The rules respecting accounts receivable financing are equally distinctive, involving such questions as whether the borrower's creditors must be notified of the lien, whether notations of the lender's lien must be made in the account books of the borrower, and whether the proceeds of collection must be paid over to the lender.⁴⁴

THE PROPOSALS OF THE UNIFORM COMMERCIAL CODE

Surveying the law of chattel security, the draftsmen of the proposed Uniform Commercial Code have determined that profound changes ought to be made. Their proposals, embodied in Article 9, entitled "Secured Transactions," received the approval in May, 1951 of the Code's sponsoring organizations, the American Law Institute and the National Conference of Commissioners on Uniform State Laws.

Article 9, first of all, recognizes no distinctions between types of

⁴³ Companies Act, 19 & 20 Geo. V, c. 23, § 266 (1929).

⁴⁴ Dunham, *op. cit. supra* note 19.

security transactions, such as pledge, chattel mortgage, factor's lien, conditional sale and trust receipt. Any transaction which heretofore would have fallen into these categories is to be known under the Code as the creation of a "security interest."⁴⁵ The rules with respect to security interests are, with some exceptions, to be uniform, whether the security be chattels or accounts receivable,⁴⁶ and regardless of whether "title" may be said to be in the lender or the borrower.⁴⁷ All that is required to create a security interest is an agreement creating or providing for it.⁴⁸ The goods subject to the security interest shall be those to which the parties agree. The security interest may include after-acquired goods and may extend to future advances to the borrower as well as his present obligations.⁴⁹

The lender's lien will not be destroyed by any authorization to the borrower to dispose of the goods, with or without an accounting for the proceeds:

A security interest is not invalid or fraudulent against creditors by reason of liberty in the debtor to use or dispose of all or any part of the collateral (including returned or repossessed goods) or to collect or compromise accounts, contract rights or chattel paper, or to accept the return of goods or make repossessions or to use or dispose of proceeds, or by reason of the failure of the secured party to require the debtor to account for proceeds or replace collateral.⁵⁰

The security interest may, but need not, extend to the proceeds of sale of goods or resulting from the collection of accounts receivable.⁵¹

What the draftsmen propose to accomplish with these provisions is clear. First of all, they would simplify the entire field of chattel security by abolishing all distinctions, in nomenclature and legal effect, of the chattel mortgage, conditional sale, trust receipt, factor's lien and all the other existing devices of chattel financing.

Furthermore, they would, in Section 9-205, reverse the rule of *Benedict v. Ratner* and would then, by authorizing security interests

⁴⁵ Uniform Commercial Code, § 9-102. All references are to the Spring, 1951, Proposed Final Draft No. 2 of the Code.

⁴⁶ Code, § 9-102. The provisions of Article 9 do not apply to security interests in real property: § 9-104.

⁴⁷ Code, § 9-202. In lieu of the terms lender and borrower, the code uses "secured party" and "debtor." "Secured party" includes a lender, seller, other persons in whose favor there is a security interest or to whom accounts, contract rights or chattel paper have been sold.

⁴⁸ Code § 9-201.

⁴⁹ Code § 9-204.

⁵⁰ Code § 9-205.

⁵¹ Code § 9-306.

in after-acquired property and for future advances, enable lenders and borrowers to create a floating lien or charge. Further, by assimilating accounts receivable and chattel financing, the Code would make possible an over-all financing arrangement between lenders and borrowers whereby the security for a debt could be maintained through an entire manufacturing, distributing and selling process, with the security changing along the line from raw materials to finished goods, then to accounts receivable upon sale of goods, and finally to proceeds arising from collection of the accounts.

The Code has not overlooked the required protection for third parties in such an arrangement. Respecting the security interest on proceeds, third parties benefit from the limitation of the rights of a lender to those of an "entrustor" under the Uniform Trust Receipts Act: the lender can reach only "identifiable" proceeds and cash proceeds received by the borrower within ten days of insolvency proceedings.⁵²

A purchaser of goods in the ordinary course of business from a borrower is protected whenever a lender has a security interest in inventory, or in any case where the lender claims a security interest in proceeds. In such cases, an ordinary course purchaser takes free of the security interest, even if he knows of it,⁵³ and of course he should do so, since the lender has in effect authorized the borrower to sell in the usual course of business.

For the protection generally of third parties, particularly unsecured creditors, the Code requires that public notice of a security interest be given by the filing of a "financing statement" with the Secretary of State and in the borrower's county if all of his places of business are in one county.⁵⁴ The financing statement, modelled on the notice required to be filed under the Uniform Trust Receipts Act, will merely set forth the names and addresses of the debtor and secured party, the types of property subject to the security interest, and whether proceeds are covered by the security interest.⁵⁵ A financing statement is not required where possession of the goods passes to the lender, as in a pledge,⁵⁶ and in recognition of the burden which would be placed on dealers who sell consumers' goods on credit, the Code does not require notice filing for security interests in consumer goods retained by the seller as security for the purchase price.⁵⁷ Since notice

⁵² Code § 9-306.

⁵³ Code § 9-307.

⁵⁴ Code §§ 9-301, 9-401.

⁵⁵ Code § 9-402.

⁵⁶ Code § 9-305.

⁵⁷ Code § 9-302.

filing, where required, will relate to parties engaged in a course of financing and not to individual transactions, the difficulties of chattel mortgage indexing and recording systems ought to be avoided.

The Code's requirement of public notice of security interests represents no substantial difference from present requirements in the case of trust receipt financing, and for chattel mortgagees it is simpler than present filing or recording requirements. Public filing will be new for conditional sellers in Illinois and a few other states, but since purchase money interests in consumer goods are exempted, the filing requirement should not be burdensome.

Public filing will also be new for field warehousemen and for lenders on accounts receivable. Groups concerned with each of these types of financing opposed the filing requirement. The field warehousemen have argued that notice of their transactions ought not to be required of them any more than it is of public metropolitan warehouses, that in any event the notices they post on the borrower's premises constitute adequate notice, and that their transactions are in all respects similar to pledges, for which no filing is required.

Those who finance accounts receivable are strenuously opposed to public filing. The Code's requirement in this respect has been as controversial as any other single provision and may continue to be so when the Code comes before the legislatures. Lenders on accounts receivable believe that public filing will destroy this type of financing. Their argument is that the public, rightly or wrongly, regards borrowing on accounts receivable as a sign of financial distress and that a borrower, knowing the transaction will be made public by notice filing, will therefore be most reluctant to engage in it.

There have been other objections to the chattel security scheme proposed by the Code. Perhaps the principal one is a criticism that the Code makes it too easy for a lender to establish a lien on all of the borrower's personal property; that the size of a particular loan might not justify, for example, a lien on a borrower's inventory, accounts and the proceeds therefrom, but that nevertheless the Code will make it so easy to set up such a lien that lenders will insist on it and borrowers will agree; and that then no assets will be free from lien and available to unsecured creditors.⁵⁸ The argument assumes, however, that borrowers will have lost all bargaining power in Code transac-

⁵⁸ See Gilmore, *The Secured Transactions Article of the Commercial Code*, 16 *Law & Contemp. Prob.* 27, 36, 43-44 (1951). Mr. Gilmore merely reports the argument; he does not approve it.

tions, whereas in fact they ought to be able, by careful negotiations, to confine the security to that which will be adequate for lenders but not excessive.

CONCLUSION

On the whole, the Code's proposed revisions of the law of chattel security are imaginative and intelligent. They wipe out the variety of bewildering devices now in use and substitute one simple form of security interest. The mechanics for creation of the interest are easy and the abolition of hampering restrictions will make it useable for purposes beyond the scope of present devices. Lenders and borrowers ought to be able to achieve, within reasonable limits, whatever they wish in the way of chattel security, and the protection afforded third parties seems adequate.

The approval of the Code by the American Bar Association,⁵⁹ at its annual meeting in New York City in September, 1951, has cleared the way for legislative consideration of the Code. The proponents of the Code now expect to submit it to the New York legislature in 1952, with Illinois' turn coming perhaps in 1953. It seems clear that, whatever the future of the Code as a whole may be, Article 9 represents a real contribution for the commercial world.

⁵⁹ N.Y. Times, § 1, p. 17, col. 1 (Sept. 21, 1951).

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