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Secured Transactions

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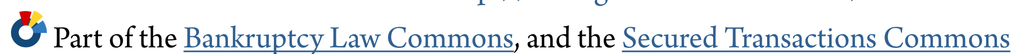
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SECURED TRANSACTIONS

THE CODE IN THE BANKRUPTCY COURTS: SOME SIGNIFICANT CONFLICTS OF POLICY

In a credit-oriented economy, the relationship between the bankruptcy courts and secured creditors can obviously be critical. With the adoption of the Uniform Commercial Code in forty-seven states,[1] it is of paramount importance that the secured credit provisions of both the Code and the Bankruptcy Act[2] be compatible, at least to the extent that neither can frustrate the basic purposes of the other. Writers have commented upon potential conflicts since the very conception of the Code,[3] and two recent cases[4] have demonstrated that the conflicts are not only real but, in some areas, fundamental. This comment will examine the relationship between secured creditors and the bankruptcy courts in the light of this recent litigation.

I. THE CASES

In re Portland Newspaper Publishing Co.[5] is the first case in which provisions of the Uniform Commercial Code were held to be in conflict with the Federal Bankruptcy Act. This case concerned a newspaper publishing company which had been formed by a number of labor unions whose members were on strike against two local papers. To provide space for this new venture, eighty-eight union locals then formed the Rose City Development Company. In the course of its dealings with the newspaper, Rose City took a security interest in present and future accounts receivable. Pursuant to section 9-205 of the Code,[6] the newspaper was permitted to retain control over the collateral without accounting to the creditor. One year after the

[1] Only Arizona, Idaho, and Louisana have not enacted the Code.

[2] Bankruptcy Act, 30 Stat. 544 (1898), as amended, 11 U.S.C. §§ 1-1103 (1964).

[3] E.g., Kripke, The "Secured Transactions" Provisions of the Uniform Commercial Code, 35 Va. L. Rev. 577 (1949); Countryman, The Secured Transactions Article of the Commercial Code and Section 60 of the Bankruptcy Act, 16 Law & Contemp. Prob. 76 (1951); Kripke, The Modernization of Commercial Security Under the Uniform Commercial Code, 16 Law & Contemp. Prob. 183 (1951); Note, Article 9 of the Uniform Commercial Code—A Potential Policy Conflict With the Federal Bankruptcy Act, 2 Vill. L. Rev. 395 (1957); Friedman, The Bankruptcy Preference Challenge to After-Acquired Property Clauses Under the Code, 108 U. Pa. L. Rev. 194 (1959); Kennedy, The Trustee in Bankruptcy Under the Uniform Commercial Code: Some Problems Suggested By Articles 2 and 9, 14 Rutgers L. Rev. 518 (1960); Riemer, Conflict Between Section 9-108 of Uniform Commercial Code and Section 60(a) of Bankruptcy Act, 70 Com. L.J. 63 (1965).

[4] In re Portland Newspaper Publishing Co., 2 Bankr. L. Rep. (4th ed.) ¶ 61722 (D. Ore. Feb. 9, 1966); In the Matter of Yale Express Sys., Inc., 250 F. Supp. 249 (S.D.N.Y. 1966).

[5] 2 Bankr. L. Rep. (4th ed.) ¶ 61722 (D. Ore. Feb. 9, 1966).

[6] For purposes of this comment, all citations to the Uniform Commercial Code refer to the 1962 Official Text of the American Law Institute, rather than to the various state statutes. There are no state variations from the Official Text which are pertinent to the comment.

security agreement was signed, the newspaper was adjudged a bankrupt. The trustee refused to permit Rose City to claim the proceeds of the newspaper's accounts, which had been collected and were held jointly by the trustee and a representative of the secured creditors. He contended that the security interest was a preferential transfer[7] and thus voidable under the Bankruptcy Act. In support of this contention, the trustee argued that substantially all the accounts had been received within the four months immediately preceding the filing of the petition in bankruptcy, that Rose City was aware of the newspaper's insolvency at all times during the four-month period, and that since Rose City's interest in the accounts could not be perfected until they were obtained by the debtor, the transfer had occurred during the four-month period and was thus a voidable transfer of the debtor's property in payment of an antecedent debt.

In accepting the trustee's position, the referee rejected the claimant's argument that under section 9-108 of the Code an interest in after-acquired property is deemed to be taken for new value, and not for antecedent debt.[8] The referee held that section 9-108 represented an attempt by the state to contravene the Federal Bankruptcy Act by imposing upon the bankruptcy courts an unacceptable definition of antecedent debt; it was therefore inoperative.

The referee referred to section 9-108 as a "fiction"[9] and concluded that "if no new value is actually given at the time, then the lien as to such property is in truth and in fact perfected as security for an antecedent debt."[10] The referee acknowledged that the claimant might have avoided the preference challenge if it had insisted upon policing the accounts.[11] Under this procedure, the creditor must retain control over proceeds in a cash collateral account and pay them to the debtor periodically in exchange for an assignment of new accounts, thus giving "new value" for each successive security interest. The effect of the referee's holding, therefore, is not to make the lien on current and future accounts voidable per se, but rather to make it potentially unenforceable in bankruptcy unless the creditor has policed the accounts.

A second case illustrates a different aspect of the relationship between the Code and the Bankruptcy Act. *In the Matter of Yale Express Sys., Inc.*[12] involved an attempt by the holder of a chattel mortgage to reclaim the collateral from a defaulting debtor. The chattel mortgagee had originally sold trailers and truck bodies to Yale for nearly $380,000; payment was to have

[7] The elements of a preferential transfer are set out in detail at pp. 104-05 infra.

[8] Section 9-108 reads as follows:

Where a secured party makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value which is to be secured in whole or in part by after-acquired property his security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given.

[9] Supra note 5, at 71142.

[10] Id. at 71143.

[11] Id. at 71136.

[12] 250 F. Supp. 249 (S.D.N.Y. 1966).

been made in cash thirty days after the delivery of each truck and ninety days after the delivery of each trailer. Apparently, the seller had relied upon a mercantile agency's report which showed that Yale was in good financial condition. Upon learning from Yale that the report was in error, and that Yale had in fact operated at a loss during the period covered by the report, the seller claimed from the buyer the right to repossess the trucks and trailers for which payment had not yet been made. After negotiation, however, the seller agreed to take a purchase money security interest in the form of chattel mortgages and to permit Yale to pay for the equipment on an installment basis. Two months later, Yale filed its petition for reorganization under Chapter X of the Bankruptcy Act.[13]

When the buyer defaulted on the installment payments, the seller applied to the reorganization court for reclamation of the property. The court denied the application, citing provisions of the Bankruptcy Act which give the court the power to postpone the foreclosure of liens on the "property of the debtor" until reorganization can be effected.[14] The court indicated that in establishing what exactly was "the property of the debtor," the location of title was determinative, and that a reclamation which might jeopardize reorganization of a debtor corporation would not be allowed if title to the property in question was in the debtor. The seller contended that under section 9-503 of the Code, it had the right to reclaim collateral from a defaulting debtor either by peaceable repossession or by judicial process. Petitioner argued further that this right was not vitiated by the lack of title, since section 9-202 of the Code provides that as between debtor and creditor the location of title is immaterial. The court stated, however, that in applying the Bankruptcy Act, appellate courts have preserved the distinction between the chattel mortgage and the conditional sale insofar as they locate title to the collateral,[15] and that in this case the chattel mortgages represented only a lien on, as opposed to title in, the property. The opinion thus recognized that had the security agreement been written as a conditional sale, reclamation would have been permitted, despite the potentially harmful effect on the pending reorganization.[16]

The *Yale* and *Portland News* cases illustrate two different aspects of the relationship between the secured creditor and the trustee in bankruptcy. In order to recognize the common implications of the cases, an examination of the two relevant statutes is necessary.

II. The Federal Bankruptcy Act

State-created rights of a consensual lien-holder may be affected by bankruptcy proceedings in several ways. The provisions of the Bankruptcy

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13 Bankruptcy Act §§ 101-276, added by 52 Stat. 883 (1938), as amended, 11 U.S.C. §§ 501-676 (1964).

14 Bankruptcy Act § 116(4), added by 52 Stat. 885 (1938), as amended, 11 U.S.C. § 516(4) (1964).

15 250 F. Supp. at 254.

16 Since the application was denied, the case does not actually hold that property can be reclaimed whenever the creditor has used a title retention device. It is, however, the clear implication of the opinion that had this been the case, the reclamation would have been allowed.

Act which are relevant in *Portland News* give the bankruptcy courts the power to avoid transfers of the debtor's property, including security interests,[17] which are preferential and thus contrary to the act's policy of equitable distribution among creditors.[18] Specifically, section 60 of the act defines the elements of a preference as: (1) a transfer of the debtor's property, (2) to or for the benefit of a creditor, made or suffered (3) while insolvent, and (4) within four months of the filing of a petition under the act, (5) for or on account of an antecedent debt, (6) the effect of which is to permit that creditor to realize a higher percentage in payment than other creditors of the same class.[19] The time of transfer is established as the point at which no lien creditor could obtain superior rights in the property through legal or equitable proceedings on a simple contract. Transfers not so perfected under applicable state law are deemed to have been made immediately prior to the filing of the petition.[20] The trustee may avoid the transfer upon showing

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[17] Bankruptcy Act § 1(30), as amended, 66 Stat. 420 (1952), 11 U.S.C. § 1(30) (1964).

[18] Some of the provisions which are not relevant to this comment should be set out to give context to the material presented. The Bankruptcy Act provides that the trustee in bankruptcy shall have the status of an hypothetical lien creditor. Bankruptcy Act § 70(c), as amended, 66 Stat. 429 (1952), 11 U.S.C. § 110(c) (1964); 4 Collier, Bankruptcy ¶ 70.49 (14th ed. 1964) [hereinafter cited as Collier]. Thus security interests not fully perfected against a lien creditor under applicable state law cannot be enforced against the estate. To protect creditors from fraudulent transfers and insider manipulation, the act also sets out a variety of objective standards which may be referred to for purposes of nullifying transactions made as long as one year before the commencement of bankruptcy proceedings. Bankruptcy Act § 67, as amended, 66 Stat. 427 (1952), 11 U.S.C. § 107 (1964).

The act also gives the federal courts equity jurisdiction in bankruptcy. The act reads: "[C]ourts of bankruptcy are created . . . and invested . . . with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction . . . (2) allow claims, disallow claims . . . ." Bankruptcy Act § 2(a)(2), as amended, 52 Stat. 842 (1938), 11 U.S.C. § 11(a)(2) (1964). In Pepper v. Litton, 308 U.S. 295 (1939), the Supreme Court interpreted the act as enabling the courts to disallow or subordinate the claim of a lienholder whose "planned and fraudulent scheme" to prejudice other creditors would otherwise succeed in defeating the equitable distribution of the bankrupt estate. Id. at 312. Similarly, the courts have the power to disallow or subordinate claims of controlling parties who have mismanaged the bankrupt, Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939), of creditors who have fraudulently led other creditors to take actions which were to their detriment, Bird & Sons Sales Corp. v. Tobin, 78 F.2d 371 (8th Cir. 1935), and of creditors who have obtained security under unconscionable contracts, In the Matter of Elkins-Dell Mfg. Co., 253 F. Supp. 864 (E.D. Pa. 1966).

It should be noted that the doctrine of Erie R.R. v. Tompkins, 304 U.S. 64 (1938), has the effect of making the validity of a claim a question of state law, except to the extent that Congress has specifically legislated to the contrary. The courts are free, however, to disallow or subordinate a valid claim on equitable grounds which relate to the distribution of a bankrupt estate. See 3 Collier ¶ 63.03[3]; Hill, The Erie Doctrine in Bankruptcy, 66 Harv. L. Rev. 1013 (1953). One case appears to have invalidated a claim on federal grounds. In the Matter of Laskin, 316 F.2d 70 (3d Cir. 1963), 5 B.C. Ind. & Com. L. Rev. 430 (1964).

[19] Bankruptcy Act § 60(a)(1), as amended, 64 Stat. 25 (1950), 11 U.S.C. 96(a)(1) (1964). For purposes of section 60(a), secured and unsecured creditors are members of the same class. See 3 Collier ¶ 60.34.

[20] Bankruptcy Act § 60(a)(2), as amended, 64 Stat. 25 (1950), 11 U.S.C. § 96(a)(2) (1964).

that the creditor had reasonable cause to believe that the debtor was insolvent at the time of transfer.[21] Such a creditor is thus prevented from protecting himself at the expense of other creditors in the four months preceding bankruptcy.

In order to fully appreciate the scope of section 60, it is important to note one additional provision which has no direct bearing on the *Portland News* case. This provision deals with the so-called "pocket lien." Under the laws of some states, the holder of an equitable lien, such as an unrecorded chattel mortgage, could take possession of the collateral at any time, and the date of the transfer would relate back to the date of acquisition of the equitable lien.[22] In order to protect other creditors, who might have extended credit in the belief that the debtor's property was unencumbered, section 60(a)(6) provides that an equitable lien which *could* be perfected legally against other good faith creditors, *must* be so perfected. Otherwise it will be considered a transfer made immediately before bankruptcy, and thus be subject to avoidance if the other elements of a preference exist.[23]

Additional checks upon the rights of secured creditors are provided by the chapters of the Bankruptcy Act which are designed to rehabilitate the debtor. For example, while a petition for reorganization is pending, the court may grant, as it did in *Yale*, a stay of any judicial proceeding or temporarily enjoin any other attempt to enforce a lien on the property of the debtor.[24] After approval of a petition, such a stay is provided automatically.[25]

The Bankruptcy Act does not specifically define the term "property" for this purpose. In the leading case, *In re Lake's Laundry, Inc.*,[26] the Court of Appeals for the Second Circuit held that the location of title was determina-

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21 Bankruptcy Act § 60(b), as amended, 52 Stat. 869 (1938), 11 U.S.C. § 96(b) (1964).

22 Sexton v. Kessler, 225 U.S. 90 (1912).

23 Some discussion of the legislative history of section 60 may be necessary to put the preference challenge into perspective. Under the 1938 amendment to the act the problem of the secret lien was treated by fixing the date of all transfers at the point when no bona fide purchaser could acquire superior rights in the property. 52 Stat. 869 (1938). While this served to avoid the doctrine of relation back, it also produced unexpected results. In Corn Exch. Nat'l Bank v. Klauder, 318 U.S. 434 (1943), the Court held that an assignment of accounts receivable was voidable as a preference because the assignee had not complied with state requirements necessary to protect the transfer from a possible second assignment. The transfer had been made long before the four-month period.

Recognizing that the wording of section 60 had the potential to jeopardize many legitimate transactions (including trust receipts and conditional sales, virtually imperfectible against bona fide purchasers), Congress in the 1950 amendment to the act put the trustee in the position of a lien creditor by fixing the date of transfer with respect to the rights of potential lien creditors. 64 Stat. 25 (1950). To avoid the secret lien, section 60(a)(6) of the act now requires that an equitable lien which could be perfected against bona fide purchasers must be so perfected before the transfer is deemed to have been made. Thus, legal encumbrances effective more than four months before bankruptcy are not voidable under section 60; purely equitable liens are voidable unless there was no way to perfect them legally. See generally 3 Collier ¶ 60.38; Conwill and Ellis, Much Ado About Nothing: The Real Effect of Amended 60(a) on Accounts Receivable Financing, 64 Harv. L. Rev. 62 (1950).

24 Bankruptcy Act § 113, added by 52 Stat. 884 (1938), 11 U.S.C. § 513 (1964).

25 Bankruptcy Act § 148, added by 52 Stat. 888 (1938), 11 U.S.C. § 548 (1964).

26 79 F.2d 326 (2d Cir. 1935).

tive; where state law gave a conditional vendor title to the property until it was paid for, the seller could reclaim it from a defaulting debtor in reorganization.[27] The opinion in *Yale* indicates that this remains the law today.[28]

III. The Uniform Commercial Code

Outside the bankruptcy court, the relationships among the secured creditor, the debtor, and third parties are governed in most jurisdictions by the Uniform Commercial Code. The Code provides the states with a comprehensive commercial statute which was intended by its draftsmen to be sufficiently flexible to accommodate existing security devices and to permit the development of legitimate business techniques without constant legislative change.[29] The Code distinguishes transactions along functional lines, avoiding distinctions based on form alone. Title to the collateral is considered unimportant as between debtor and creditor, regardless of the form of the security interest,[30] and the rights of the parties in the event of a default are made more uniform than they were under older law.[31]

Article 9 provides a mechanism for establishing a "floating lien" on assets such as inventory and accounts receivable, which normally "turn over" in the ordinary course of the debtor's business.[32] Under the Code, a security agreement may provide that after-acquired as well as presently owned property will serve as security for the debtor's obligation.[33] Moreover, the security agreement may provide that the debtor will have the power to use or dispose of the collateral at will, without an accounting to the creditor.[34] This is an express rejection of the doctrine of *Benedict v. Ratner*,[35] in which the Supreme Court held, interpreting New York law, that a financing arrangement which gave the debtor unfettered dominion over the collateral was fraudulent as to third parties, and hence void as a matter of law. In repudiating the rule of *Benedict v. Ratner*, the draftsmen of the Code noted that it had since been rejected in a number of states, in both accounts receivable and inventory financing.[36]

The security interest in after-acquired property has equal status with interests obtained in existing property, except that the Code permits subsequent purchase money security interests to take priority if certain notice

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[27] District court cases prior to *Lake* had not been in harmony. See Annot., 102 A.L.R. 250, 251 (1936).

[28] See note 16 supra.

[29] U.C.C. § 9-101, Comment.

[30] U.C.C. § 9-202.

[31] See, e.g., U.C.C. § 9-504, Comments 1, 6.

[32] Use of these assets as collateral can be an important source of capital for many types of businesses. See Kripke, Current Assets Financing as a Source of Long-Term Capital, 36 Minn. L. Rev. 506 (1952); Kripke, Secured Transactions—Financing the Seller, 76 Banking L.J. 185 (1959); Lowenstein, Assignments of Accounts Receivable and the Bankruptcy Act, 1 Rutgers L. Rev. 1 (1947). For a discussion of pre-Code financing devices of this type, see Ogline, The Factors Lien Act as a Method of Inventory Financing, 4 W. Res. L. Rev. 336 (1953).

[33] U.C.C. § 9-204(3).

[34] U.C.C. § 9-205.

[35] 268 U.S. 353 (1925).

[36] U.C.C. § 9-205, Comment 2.

requirements are met.[37] Thus, if the security interest in inventory or accounts receivable is properly perfected, the debtor may use the collateral as his business needs indicate. The creditor's security interest is nonetheless protected from all claims except those of: (1) prior holders of perfected security interests in the same property,[38] (2) subsequent holders of perfected purchase money security interests,[39] and (3) buyers in the ordinary course of business.[40]

Under the Code, a security interest becomes perfected when the last of the following four events occurs: (1) the parties agree that the interest should attach, (2) value is given by the creditor, (3) the debtor acquires rights in the collateral,[41] and (4) the creditor takes a prescribed additional step, usually the filing of a financing statement.[42] In the case of after-acquired property, the interest will usually be perfected when the debtor acquires rights in the collateral, the other steps having been taken earlier.

IV. The Conflicts Between the Code and the Bankruptcy Act

Since the Code explicitly delays perfection of an interest in a *specific* account or item of inventory until the debtor acquires rights in it,[43] many such "transfers" of the debtor's property will naturally occur within four months of bankruptcy. They will thus be subject to avoidance as preferences, since the debt which they secure antedates the transfer. The Code attempts to obviate this difficulty and protect the floating lien from the preference challenge. Section 9-108 provides that a security interest in after-aquired property *which the debtor acquires in the ordinary course of his business* shall be deemed to have been taken for new value at the time it becomes perfected (in most cases when the debtor acquires rights in it), provided that new value was given *originally*.[44]

Although the bankruptcy courts must look to state law to determine the validity of a security interest, several commentators have predicted that section 9-108 would not be given effect.[45] The principal basis for their position is that by adopting the mere presumption of a contemporaneous exchange for new value, state law cannot alter the simple fact that the attachment and perfection of the security interest occurs some time after the obligation of the debtor arises. Section 9-108 is said to have no other purpose than to protect a perfected security interest from the preference

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37 U.C.C. § 9-312(3), (4).

38 U.C.C. § 9-312(5)(b).

39 U.C.C. § 9-312(3), (4).

40 U.C.C. § 9-307(1).

41 These first three events constitute the requirements for attachment of a security interest. U.C.C. § 9-204. At this point, the property becomes *subject to* a security interest. U.C.C. § 9-303, Comment 1.

42 U.C.C. § 9-302 provides that with certain exceptions, all security interests must be perfected by filing. Section 9-303 states in effect that the interest becomes perfected only when it has attached and when filing or other necessary steps are taken, regardless of the order in which the events occur.

43 U.C.C. § 9-204.

44 Section 9-108 is set out in full at note 8 supra.

45 E.g., 3 Collier ¶ 60.51A[7.2]; Kennedy, supra note 3, at 548-49; Riemer, supra note 3.

challenge,[46] and it is clear that the bankruptcy courts are not bound to follow state law which contravenes the Federal Bankruptcy Act.[47] This is essentially the position which was adopted by the referee in *Portland News*.[48]

At least two writers, however, have expressed the opinion that the preference challenge can be avoided even without section 9-108.[49] Their argument centers around the fact that a security interest in after-acquired property becomes perfected automatically. Consequently, perfection of the security interest in the individual components is considered unimportant and the collateral—either inventory or receivables—is treated as a single entity. Under these circumstances, the transfer is said to occur when the debtor and creditor have agreed, value is given, and the creditor satisfies statutory requirements for notice to third parties.

Judicial support for this theory comes from a dictum of Chief Judge Magruder in *Manchester Nat'l Bank v. Roche*.[50] In that case, an assignment of future accounts receivable was held to be a voidable preference. In discussing the applicable state law,[51] however, the judge indicated that a similar result would *not* be reached in the case of inventory financing:

> In other words, the *res* which is the subject of the lien provided in Section 1 [of the New Hampshire statute] is the merchandise or stock in trade, conceived of as a unit presently and continuously in existence—a "floating mass," *the component elements of which may be constantly changing without affecting the identity of the res*.[52] (Emphasis added.)

Under such an interpretation, the fact that particular accounts or items of inventory have come into existence within four months of bankruptcy would not mean that the security interest in those accounts was *transferred* at that time. Applying this theory in a similar situation arising under the Code, it is said that if reference is made solely to Section 60 of the Bankruptcy Act, the date of transfer could be set at the point when no lien creditor could obtain superior rights in the collateral.[53] In that case, the date of transfer would be the date at which all requirements for perfection were met, *except* for the debtor's acquisition of rights in the collateral. The argument is that the floating lien is thus perfected in terms of section 60, and it is therefore irrelevant whether it is perfected under the Code. Under this inter-

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[46] 1 Coogan, Hogan, & Vagts, Secured Transactions Under the U.C.C. § 11.07[1] (1966); Riemer, supra note 3, at 66.

[47] International Shoe Co. v. Pinkus, 278 U.S. 261, 265 (1929).

[48] Supra note 5, at 71143-44.

[49] Friedman, supra note 3, at 215; Hanna, The Secured Creditor in Bankruptcy, 14 Rutgers L. Rev. 471, 486 (1960).

[50] 186 F.2d 827 (1st Cir. 1951).

[51] N.H. Rev. Laws ch. 262-A (1949).

[52] 186 F.2d at 831.

[53]
> [A]ssuming secured party had taken proper steps to perfect his security interest, perfection occurs the moment the debtor has rights in the collateral, whatever those rights are, which leaves no gap during which the debtor has any rights upon which a creditor could attach or levy ahead of the security interest.

Hart & Willier, Forms and Procedures Under the Uniform Commercial Code ¶ 94.05, at 9-336 (1966).

pretation, the security interest in after-acquired inventory or accounts would be protected from the preference challenge, notwithstanding the fact that some or all of the collateral has come under the lien within the four-month period.

Read as a whole, Article 9 of the Code clearly seeks this kind of *result*. Section 9-108 seems to be conclusive evidence that the draftsmen sought to provide a system which would permit the floating lien to escape the preference challenge. That is not to say, however, that the result can be achieved in the bankruptcy courts without section 9-108; the Code has not adopted Chief Judge Magruder's characterization of the collateral as a unit. What it does provide, on the other hand, is that the creditor has no interest in individual items of after-acquired collateral until the debtor acquires rights in them.[54]

In *Portland News*, the court held that under the Code's floating lien the creditor had no interest in the after-acquired collateral until the debtor acquired rights in it, and, therefore, no "transfer" from the debtor to the creditor *could* take place until that time. Collier strongly supports this interpretation:

> A transfer includes the voluntary fixing of a lien upon the property, for example, by way of security. Taking the Bankruptcy Act together with the Code, it is certainly arguable that a transfer occurs whenever the security interest attached to after-acquired property. . . . The U.C.C. is explicit in its requirement that the debtor have rights in the collateral before the security interest can attach. It would therefore appear unreasonable to construe the interest attaching at any earlier date . . . .[55]

In *Portland News*, the referee adopted this interpretation of the Code and simultaneously negated the effect of section 9-108. The result is that the flexibility with which the floating lien can be used has been severely limited; it will no longer be possible for the debtor to exercise dominion over inventory or accounts when these assets are used as collateral.

The referee pointed out that the preference problem could have been avoided if the creditor had "policed" the collateral.[56] This, he said, would require an initial assignment of accounts to the creditor at the time an advance was made. The proceeds of these accounts would then be placed in a cash collateral account, over which the debtor would have no control. These proceeds could be paid over to the debtor in immediate exchange for an assignment of new accounts. In this way, the preference challenge is avoided because there is a contemporaneous exchange of value in each subsequent transaction; the subsequent transfers are for "new value" and not for antecedent debt. This situation embodies an obvious inconsistency between the underlying policies of the Bankruptcy Act and its implementation by the courts. The result in *Portland News* demands that financing of inventory and accounts be attended by policing of the collateral in order to avoid the preference challenge. This seems highly inappropriate in view of the purposes

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[54] U.C.C. §§ 9-204, -302, -303. See p. 107 supra.

[55] 3 Collier ¶ 60.51A[7.1], at 1050.15.

[56] Supra note 5, at 71136.

of section 60. The Code's floating lien does not represent a scrambling for position on the eve of bankruptcy. Moreover, it embodies none of the evils of the secret lien, with which Congress has dealt directly.[57] The Code's floating lien is not merely equitable; the creditor need perform no additional step to perfect his lien when collateral is acquired by the debtor.[58] In addition, it is not secret; in any case where the security interest covers inventory or a significant portion of the debtor's accounts, a public filing is required.[59] Certainly the substitution of collateral on a revolving basis gives other creditors no more notice of the lien than do the Code's filing provisions. The net result of such policing is that the debtor's accounting costs must be increased with each successive transfer in order to *simulate* the infusion of new value.

It is difficult to find any way in which the principles which form the basis for the present Bankruptcy Act can be served by the policing of assets. As a practical matter, the principles of *Benedict v. Ratner* are for the most part still enforceable by the bankruptcy courts,[60] but this is not to say that the rules for policing dictated by that decision have any legitimate place in current bankruptcy law. Originally the rule was required by state law, but it has been expressly repudiated by the Code,[61] which is now the relevant state law. Moreover, there is no mention of the requirement for policing in the Bankruptcy Act, there is thus no statutory basis for its retention. The result in *Portland News* is therefore incongruous; because of the intricacies of the two statutes, the form and not the substance of the transaction made it vulnerable to the preference challenge. Notwithstanding the absence of a clearly defined federal policy either against the floating lien in general or in favor of policing collateral, the Code is frustrated in its attempt to remove this type of technical obstacle in order to make these transactions more flexible.[62]

While the result in *Portland News* perhaps sacrifices Code objectives for the sake of form, *Yale* indicates that a reluctance to deal with substance can similarly frustrate legitimate bankruptcy objectives. The court in that case was ruling on the secured party's application to reclaim equipment from a defaulting debtor, who was then undergoing Chapter X reorganization proceedings. In deciding whether it had the power to postpone the enforcement of liens on the debtor's equipment, the court relied upon *Lake*[63] and its progeny in determining exactly which "property" it had the power to protect. In so doing, it looked to the form of the security agreement to locate "title,"

[57] See note 23 supra and accompanying text.

[58] See U.C.C. § 9-204, Comment 2.

[59] U.C.C. § 9-302(1).

[60] See note 35 supra and accompanying text. The difference is that when Benedict v. Ratner was in effect, failure to police collateral rendered the entire transaction totally void, whereas it is now voidable only to the extent that collateral is obtained by the debtor within four months of bankruptcy, and only if the creditor had reason to believe that the debtor was insolvent at the time. Considering the nature of the collateral and the relationship of the parties, the differences may often be insignificant in practice.

[61] U.C.C. § 9-205.

[62] U.C.C. § 9-205, Comment 1.

[63] In re Lake's Laundry, 79 F.2d 326 (2d Cir. 1935).

and thus it retained the distinctions between the chattel mortgage and the conditional sale in deciding whether the creditor would be permitted to reclaim the equipment. This represents a serious limitation on the effectiveness of the bankruptcy courts in reorganization proceedings; its foundation should therefore be examined.

In the *Lake* case, the court noted that the applicable state law[64] retained the common law distinctions between the chattel mortgage and the conditional sale. The court felt that Congress did not intend to ignore the distinction between property mortgaged by the debtor and property held by the debtor as a conditional vendee.[65] The sale had been made under a conditional sales contract, and the court permitted the property to be "repossessed and dealt with as the laws of New York provide."[66] In a strong dissent, Judge Learned Hand argued that there were so few differences in the legal relationships which result from the chattel mortgage and the conditional sale that the location of title ought to be ignored in dealing with the reorganization of the debtor's property.[67]

Under the Code, the distinctions between the two types of transactions are non-existent as between debtor and creditor,[68] and should not limit in any way the bankruptcy courts' jurisdiction over conditionally sold property. The draftsmen of the Code anticipated this very situation in a comment to the 1962 Official Text:

> But since this Article adopts neither a "title" nor a "lien" theory of security interests, . . . the granting or denying of, for example, petitions of reclamation in bankruptcy proceedings should not be influenced by speculations as to whether the secured party had "title" to the collateral or "merely a lien."[69]

By continuing to acknowledge this distinction, the bankruptcy courts tend to limit the Code's abolition of distinctions which are no longer necessary for ordinary commercial practice. In this particular case, the effect upon the implementation of the Code's basic policies is insubstantial; what is more important is the apparently self-imposed limitation on the courts' power to carry out the rehabilitation of debtors under the Bankruptcy Act. It should be recognized that it is the courts, and not the act itself, which equate "property" with "title." In so doing, they are permitting the perhaps otherwise meaningless choice of printed forms to determine whether equipment vital to a successful reorganization can be protected from reclamation until the reorganization is accomplished. Conversely, of course, the choice of forms is no longer "meaningless," as all secured parties will endeavor to use a title retention device in the future.

Surely there is ample reason to re-examine the *Lake* case in the light of present day chattel security law. Any support which that decision may have

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64 The Uniform Conditional Sales Act was then the governing statute in New York.

65 79 F.2d at 328.

66 Ibid.

67 Id. at 329.

68 U.C.C. § 9-202. See p. 106 supra.

69 U.C.C. § 9-507, Comment 1.

derived from state law is absent under the Code; indeed the Code provides exactly the opposite. In any event, if the rehabilitation of the debtor will serve a more useful end, it hardly seems appropriate to risk a liquidation, with a potentially greater loss to creditors in general, when it could be avoided by putting this aspect of the debtor-creditor relationship into a more realistic perspective.

V. CONCLUSIONS

The *Yale* and *Portland News* cases serve to illustrate specific problems associated with the implementation of the Code and the Bankruptcy Act; neither case appears to achieve a satisfactory reconciliation of the two statutes in the bankruptcy courts. The problems lie not in the fact that the statutes are in conflict, but rather in the fact that in each case the ultimate resolution of the conflict cannot be directly identified with a paramount bankruptcy interest in that result.

There are many broad social and economic factors which must be balanced in order to deal satisfactorily with the subject of bankruptcy. It may well be true that shaky, undercapitalized businesses operated through financing of inventory and accounts receivable are a trap for their employees and for the suppliers who extend unsecured credit. Wage earners have no practical means of obtaining security for back wages, and day-to-day suppliers in a competitive environment have little choice but to extend unsecured credit. This is said to be inherently unfair in the event of bankruptcy, because it is *their* goods and services which become the very collateral which secures the floating lien.[70] In addition, it is foreseeable that the incidence of technical error in perfecting security interests will decrease under the simplified procedures of the Code, with the result that fewer secured transactions will be defeated in bankruptcy, and the funds for payment of unsecured creditors will be diminished still further.[71]

An analysis of these and similar problems, adequate to permit any general conclusions regarding the effectiveness of the present bankruptcy system, is not within the scope of this comment. What is suggested here is that the adoption of the Code has radically altered certain relationships between state-created security interests and federal bankruptcy law. These changes can have so great an impact commercially that it is undesirable to

[70] Raphael, The Status of the Unsecured Creditor in the Modern Law of Secured Transactions, 2 B.C. Ind. & Com. L. Rev. 303, 318 (1961).

[71] In liquidation cases, the unsecured creditor recovers almost nothing from a bankrupt debtor. In the fiscal year ending June 30, 1965, for example, the courts disposed of 145,655 straight bankruptcy cases. Of these, 18,513 were "asset" cases, with an average payment to creditors of $5,227 per case. An additional 19,008 cases were "nominal asset" cases, in which assets of the estate were consumed by administrative costs, and in the remaining 108,134 cases there were no assets available after exemptions. Administrative Office of the United States Courts, Tables of Bankruptcy Statistics, Fiscal Year Ending June 30, 1965, Comments, pp. 1-7.

In the relatively few asset cases, secured creditors were paid 60.7% of their claims, and unsecured creditors received 7.5%. Id. at Table F.6. An examination of these statistics for the last twenty years indicates that when an unsecured creditor is fortunate enough to find some assets in the debtor's estate, on the average he is not likely to recover more than eight or nine cents on the dollar.

permit the courts to continue to apply bankruptcy law not specifically designed to deal with the Code. Problems which the Code creates in bankruptcy should be recognized for what they are and faced directly. Anachronistic guidelines must be abandoned, especially if, as in *Yale*, they can permit a secured creditor to gain a decided advantage over others similarly situated under state law. Such an advantage is clearly contrary to the basic principles of bankruptcy law.

It has been demonstrated that policing of assets works no essential changes in the floating lien's effect on other creditors. After *Portland News*, however, policing is a conclusive requirement. If the lien on current and future assets is itself an evil, then it should be banned effectively and completely. If it is only objectionable when used by shaky, undercapitalized businesses, then these circumstances should be identified and dealt with by the Bankruptcy Act. It is self-delusion to assume that failure to police will defeat *only* liens which are in some way objectionable or that it will be effective to defeat *all* such liens. It is equally absurd to assume that where these objectionable characteristics do not exist, all the parties will find policing to be an efficient and desirable commercial technique. In most cases, commercial considerations would probably tend to dictate the opposite result.[72]

With the widespread acceptance of the Code as the law under which the debtor and his creditors operate, it would be well for Congress to re-examine the Bankruptcy Act and to make such amendments as are necessary to clearly state bankruptcy policy in terms which acknowledge the Code's innovations. If specific changes to the Code are also necessary to achieve these bankruptcy goals with a minimum of unnecessary commercial inconvenience in other areas, then the draftsmen of the amendments to both statutes should perhaps work more closely than in the past.[73]

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[72] It has been indicated that secured creditors police the collateral in any case in which there is danger of insolvency or carelessness of the debtor. See Note, Policing Accounts Receivable and Inventory Under Modern Factor's Legislation, 101 U. Pa. L. Rev. 392 (1952).

[73] The U.C.C. was drafted during the same period as the 1950 amendment to the Bankruptcy Act. The lack of any communication at that time has been noted. 2 Gilmore, Security Interests in Personal Property § 45.3.3, at 1303 n.15 (1965).