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CONCEPTUAL OBSOLESCENCE IN LAW AND ACCOUNTING — FINANCE RELATIONS BETWEEN RETAILER AND ASSIGNEE OF RETAIL RECEIVABLES

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Commercial law is society's agency for social control of business, and accounting is the means by which the diversity of business is reduced to a common language of dollars. It is a recurring experience that as business problems develop, law and accounting must strain to keep their applicable concepts meaningful and useful. The most notable example of such a readjustment now occurring is in the accounting treatment of the sale-and-lease-back and related direct leasing, and the draftsmanship problems with which lawyers are struggling to plug the hole in indenture debt restriction covenants which leasing had opened up.[1]

Another, less well-known, evidence of the inadequacy of conventional categories appears in the problems of the relationship between a seller of goods who sells on the "instalment plan" and the bank, sales finance company, or other financial institution which provides him with the funds to finance the resulting instalment receivables. The seller of goods will herein be called "the retailer," although he may be a factory selling at retail through a factory branch. The bank or other financial institution will herein be called "financing agency."

The writer has described elsewhere how the twentieth-century development of durable chattels embodying a long-term use-value caused the growth of instalment selling as the economic means by which the users were enabled to pay for the goods over a period of time roughly related to their use, and how the credit so extended has put burdens on the seller for working capital which he solves by entering into some kind of a financing arrangement with a financing

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[1] Gant, Illusion in Lease Financing, 37 Harv. Bus. Rev. 121 (March-April 1959); Cohen, Long-Term Leases: Problems of Taxation, Finance, and Accounting (1954); Kripke, New Developments Affecting Installment Financing Plans—Including Lease Financing, in Proceedings of the Twelfth Annual Convention of the Commercial Finance Industry (1956). For a less questioning view of leasing, see Steadman, Chattel Leasing—A Vehicle for Capital Expansion, 14 Bus. Law. 523 (1959).

The writer once listed several questions as to the semantics of law and accounting, and in reference to leasing asked: "Are the growing sale-and-lease-back of real estate, and the less well-known chattel lease, useful economic devices with substantial differences from mortgages, or are they just means of kidding the literal-minded accountants into omitting the liabilities from the balance sheet?" Kripke, Book Review, 59 Yale L.J. 1551, 1555 (1950).

agency.[2] The terms of the negotiation between the retailer and the financing agency relating to the transfer of the customer obligations (which will be called "receivables" hereinafter) vary. There will be "without recourse" forms of deals and there will be deals with various types of limited recourse. Where the basic arrangement is "full recourse", the question arises whether lawyers can shape the relationship so that it becomes either a *loan* secured by the receivables and creating a direct liability on the part of the retailer, or a *sale*-with-recourse of the receivables, creating contingent liability in the nature of a guarantee or endorsement on the part of the retailer.

Until these alternate possibilities sharply raised the question in the field of receivables financing, lawyers and accountants had assumed that they saw two clearly-marked forms of legal and business relations. One type was a borrowing by a businessman from his financing agency, typically evidenced by his promissory note. The borrowing might be unsecured; or it might be secured by a non-possessory form of lien like a real estate or chattel mortgage; or it might be secured by a possessory form of lien or pledge, as in a field warehouse arrangement or a pledge to a bank of corporate stock or bonds or other forms of evidences of indebtedness.

The other type was the sale of goods, with express or implied warranties; of corporate stock; of negotiable promissory notes, bills, or checks, either without recourse in specialized transactions or with recourse when discounted with a bank. The sale of various kinds of obligations to pay money, with recourse under an endorsement or otherwise, leaves the seller of the obligation with a contingent obligation in the nature of a guaranty.

The devices that have developed to keep pace with the requirements of retailers for financing of their instalment sales fall into two broad categories related to the customary categories of loan or sale. On the one hand, in the field of receivables resulting from instalment sales of automobiles and other major units, the retailer typically "sells" the "retail paper" to the financing agency, which notifies the maker of the receivable that it has acquired his obligation and instructs him to pay the financing agency direct. Even when this transaction is with recourse on the dealer, it is held to be a sale.[3] On the other hand, in the case of department store open-account receivables or instalment receivables covering small appliances, furniture, jewelry, soft goods, etc., the typical arrangement is that a portfolio of such

2 Kripke, Current Assets Financing As a Source of Long-Term Capital, 36 Minn. L. Rev. 506 (1952); Kripke, Inventory Financing of Hard Goods, 1956 Ill. Law Forum 580, reprinted in 74 Banking L.J. 1013 (1957); Kripke, Secured Transactions—Financing the Seller, 76 Banking L.J. 185 (1959).

3 See cases infra, notes 10-14.

receivables, constantly changing as to its individual components but relatively stable in the aggregate, is pledged and the retailer executes his promissory notes to evidence a direct borrowing from the financing agency. In many cases of the latter type, the collection by the financing agency is "indirect", *i.e.*, the retailer continues to collect the receivables, and he accounts for his collections to the financing agency. In such a case where the form frankly purports to be a loan, it would unquestionably be considered a loan by the courts. There are also instalment obligations resulting from the sale of refrigerators, freezers, etc., where both financing patterns exist, and custom offers no conclusive guide to classification.

Essentially, the two forms serve the same function. The retailer is constantly selling goods which create receivables; he obtains an advance of funds from the financing agency in exchange for the transfer of an interest in the receivables; the financing agency is reimbursed as the receivables are paid; and it recreates its advance against newly assigned receivables. The financing agency is paid a "charge" for its services, whether expressed as "interest" under a loan form or as "discount" under a purchase form. In both forms, if the obligor under a receivable defaults, the retailer will ultimately bear the loss if the obligor cannot be made to pay. The transactions are nearly identical, to one who can view them freshly, without the conditioning effect of professional training in law or accounting.[4]

Yet, as applied to the transfer of "receivables", law and accounting have given two separate sets of consequences to the forms of loan-with-pledge on the one hand, and sale-with-recourse on the other.

Balance sheet treatment. A loan does not remove the receivable from the retailer's balance sheet as an asset, but it creates a new asset of cash, and a new liability representing the amount borrowed. On the other hand, a sale-with-recourse removes the receivables from the asset side of the balance sheet, replaces them with cash, does not affect the liability side of the balance sheet, but merely creates a contingent liability to be noted as a footnote to the balance sheet. These differences in balance sheet treatment have important results in the appearance of the balance sheet and in the computation of asset-liability ratios, including particularly the current ratio.

Restrictive covenants. The handling of the transaction as loan-

[4] Compare the Uniform Commercial Code, where sales of receivables and assignments of receivables by way of pledge are subjected to certain identical legal rules, with recognition of the fact that the parties may create contractual differences as to disposition of surplus and liability for deficiencies. Uniform Commercial Code, Text and Comments Edition 1957, § 1-201(37) and Comment 37; § 9-102(1)(a) and (b) and introductory Comment; § 9-502(2) and Comment 3; § 9-504(2) and Comment 3.

with-pledge or sale-with-recourse also has important consequences where the retailer is subject (under the terms of another agreement) to various negative covenants forbidding borrowing, or forbidding secured borrowing, or defining failure to maintain certain balance sheet ratios as an event of default, or forbidding the incurring of contingent liabilities, or forbidding the sale of assets otherwise than in the ordinary course of business or in bulk. Depending on which covenants are in force, the differences in form may make the covenants applicable or inapplicable.

Instalment basis of taxation. If the seller of goods on the instalment plan sells the resulting receivables, he is not permitted to use the instalment method of accounting for taxable profits, because he has received his cash immediately. If, on the other hand, he gets the same or nearly the same amount of dollars in a transaction categorized as a loan secured by the receivables, he is not deemed to have received the money from the sale of the goods, and may continue to use the instalment basis.[5]

Usury. If the transaction is a loan, it is, of course, subject to any local interest and usury rules. If it is a sale-with-recourse of the receivable, the yield to the buyer on the purchase of the receivable at a discount is not subject to usury limitations, because the transaction is deemed to be nothing but the sale of an article of commerce at a negotiated price.[6]

The reader will by now have asked himself whether there is a genuine difference between the loan-with-pledge and the sale-with-recourse to justify such extreme differences in consequences. In both cases the financing agency holding the receivable could look to the retailer for payment, or the financing agency could itself enforce the receivable and collect from the obligor thereof. Under both forms

5 Elmer v. Com'r of Internal Revenue, 65 F.2d 568, 569 (2d Cir. 1933); East Coast Equipment Co. v. Com'r of Internal Revenue, 222 F.2d 676 (3d Cir. 1953); see also note 11.

Other tax points were formerly of importance: (i) A loan-with-pledge was given recognition as indebtedness in the excess profits tax base, but the contingent liability resulting from the sale-with-recourse was not so recognized. See Brewster Shirt Corp. v. Com'r of Internal Revenue, 159 F.2d 227 (2d Cir. 1947); Com'r of Internal Revenue v. Hunt Foods, Inc., 204 F.2d 429 (9th Cir. 1953). (ii) In determining whether a corporation met the definition of a personal holding company, a financing agency's charge on a transaction deemed to be a loan was "interest", but its charge on a sale-with-recourse was not interest. Int. Rev. Code of 1954, § 543; Southeastern Finance Co., 4 T.C. 1069 (1945). The variations in results caused by this irrelevant conceptual distinction necessitated an amendment creating a special exception in the definition of personal holding company. Int. Rev. Code of 1954, § 542(c)(9).

6 See bank and other cases cited in note 10. This is subject to a *caveat* in the case of banks, which are subject to statutory regulations as to the rate of "discounts" as well as loans. National Bank of Gloversville v. Johnson, 104 U.S. 271 (1881); Nash v. White's Bank of Buffalo, 68 N.Y. 396 (1876); Danforth v. National State Bank of Elizabeth, 48 Fed. 271 (3d Cir. 1891).

there is a situation with two parties liable. Attempts have been made to define the distinction in terms of the question whether the financing agency looks to the retailer or to the obligors of the receivables as its primary source of repayment, but these attempts prove to involve esoteric and insubstantial distinctions. The fact is that in both forms the financing agency looks to both possibilities of payment, with varying degrees of emphasis, and there is no clear-cut line. An arrangement which starts with the financing agency's reliance on the apparently excellent credit of the retailer may change its complexion entirely when that reliance proves to have been misplaced.

Bankruptcy. When that time comes—when the retailer is bankrupt—we see the most striking example of drastic consequences flowing from the different legal classifications of two identical or very similar transactions. Although in all cases the financing agency is relying both on the credit of the retailer and on the credit of the obligors on the receivables, supported by the title retention on tangible goods, the rights of the financing agency in the bankruptcy of the retailer may differ widely, depending on how its relationship with the retailer is defined. If the transfer was in loan-with-pledge form, the rule of law is clear, namely, that the financing agency's claim will be allowed only after deducting the value of his security, namely, the receivables.[7] If, on the other hand, the transaction is deemed to be a sale-with-recourse, then the bankrupt retailer was in the position of a guarantor or secondary party. In that case, the rule is clear that one can prove against a guarantor for the full amount of the debt, and it is immaterial that there is a primary obligor who may pay and who has given security in the form of title retention on tangible goods.[8]

The fascinating question arises whether, if a lawyer wants to

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[7] Bankruptcy Act, § 57(h), 11 U.S.C. § 93(h).

[8] Bankruptcy Act, § 1(23), 11 U.S.C. § 1(23), defines "secured creditor" as one who has security upon "the property of the bankrupt". See Hiscock v. Varick Bank, 206 U.S. 28 (1907); Ivanhoe Bldg. & Loan Ass'n of Newark v. Orr, 295 U.S. 243 (1935); Prudence-Realization Corp. v. Prudence Bonds Corp., 189 F.2d 931 (2d Cir. 1951); St. Louis Union Trust Co. v. Jolliffe, 74 F.2d 247 (2d Cir. 1934); In re United Cigar Stores Co. of America, 73 F.2d 296 (2d Cir. 1934), cert. den. 294 U.S. 708 (1935); Gorman v. Wright, 136 Fed. 164 (4th Cir. 1905); In re Keenan, 15 F.2d 1006 (7th Cir. 1926); In re Adair Realty & Trust Co., 35 F.2d 531 (D. Ga. 1929).

There is a third form in which the recourse against the retailer might be expressed—namely, as an agreement to repurchase the retail paper on default. There is then a possibility that the retailer's bankruptcy would be considered an anticipatory breach of contract, and that the remedy would be the standard remedy for breach of contract to purchase, namely, the difference between the agreed-upon price for repurchase and the value of the article to be sold; namely, the retail paper. This analysis would give the same result as the loan-with-pledge analysis, namely, that the value of the paper would be deducted in determining the provable amount of the obligation. See Bankruptcy Act, § 63(d), 11 U.S.C. § 103(d); § 57(d), 11 U.S.C. § 93(d).

invoke one or the other pattern of consequences, he can do so by the form of his documents and by varying the elements of the patterns, or whether there are some extrinsic tests so objective that legal ingenuity cannot render them inapplicable. For instance, if a lawyer wants to avoid the problem of usury, can he draft in the form of a sale-with-recourse a transaction which usually takes the form of loan-with-pledge? On the other hand, if he wants to permit the retailer to use the instalment basis of accounting for tax purposes, can he cast in the form of loan-with-pledge some financing involving types of retail paper which are frequently financed by sale-with-recourse? The answer to the second of these problems is certainly in the affirmative, but the first must be considered not as clear cut.

A number of cases have struggled with the fringes of this problem, most commonly on the question of usury in cases of the financing of open accounts receivable by the "indirect collection, non-notification" method. By this method the financing agency typically advances 70% to 80% of the face amount of each 30-to-90-day item of trade credit; the assignor collects the receivable and accounts to the financing agency; the financing agency charges a stated percentage per day or per month on the amount advanced or on the face of the receivables; and the assignor is liable to "repurchase the accounts", if the account debtor does not pay. For many years, this form of legal arrangement was frequently drafted as a "sale" of the open accounts receivable, but the courts steadily held that in applying the law of usury the financing of open-account receivables as described is a loan and not a sale.[9] In the leading case, *Home Bond Co. v. McChesney*,[10] the Supreme Court of the United States emphasized four

[9] Home Bond Co. v. McChesney, 239 U.S. 568 (1916); In re Gotham Can Co., 48 F.2d 540 (2d Cir. 1931); In re Grand Union Co., 219 Fed. 353 (2d Cir. 1914), cert. den. sub nom. Hamilton Investment Co. v. Ernst, 238 U.S. 626, app. dism. 238 U.S. 647 (1915); Brierly v. Commercial Credit Co., 43 F.2d 730 (3d Cir. 1930), cert. den. 282 U.S. 897 (1931); Commercial Security Co. v. Holcombe, 262 Fed. 657 (5th Cir. 1920); Le Sueur v. Manufacturers' Finance Co., 285 Fed. 490 (6th Cir. 1922), cert. den. 261 U.S. 621 (1923); Petition of National Discount Co., 272 Fed. 570 (6th Cir. 1921), cert. den. 257 U.S. 635 (1921); National Trust & Credit Co. v. F. H. Orcutt & Son Co., 259 Fed. 830 (7th Cir. 1919); Milana v. Credit Discount Co., 27 Cal. 2d 335, 163 P.2d 869 (1945); Barker Piano Co. v. Commercial Security Co., 93 Conn. 129, 105 Atl. 328 (1918); Dorothy v. Commonwealth Commercial Co., 278 Ill. 629, 116 N.E. 143 (1917); Mercantile Trust Co. of Illinois v. Kastor, 273 Ill. 332, 112 N.E. 988 (1916); Wayne Pump Co. v. Dept. of Treasury, 232 Ind. 147, 110 N.E.2d 284 (1953); Abeloff v. Ohio Finance Co., 313 Mich. 568, 21 N.W.2d 856 (1946); Kelter v. American Bankers' Finance Co., 306 Pa. 483, 160 Atl. 127 (1932).

Of these citations, the Grand Union, Commercial Security, Barker, Dorothy, and Wayne Pump cases involved instalment paper.

Opposed to the foregoing weight of authority is In re Eby, 39 F.2d 76 (E.D.N.C. 1929). See also Chase & Baker Co. v. National Trust & Credit Co., 215 Fed. 633 (N.D., Ill. 1914).

See Annot., 95 A.L.R. 1197.

[10] 239 U.S. 568 (1916).

factors: first, that the assignor collected the receivables, and at his own expense; second, that the finance charge depended on the length of time which elapsed before collection; third, that the withholding of the "deferred payment" of the percentage not advanced was a treatment like the collateral margin on a loan; and fourth, the recourse.

While the *McChesney* case has been followed in so many other cases that the syndrome described can hardly fail to produce the same result in the courts in an open-account receivables usury case, there seems to have been no effort in the courts to apply the same considerations in the classification of other financing transactions, and the *McChesney* line of cases has not been cited. For instance, the existence of recourse has been held not to make the transaction a loan as applied to the transfer of automobile paper or of notes to banks for usury purposes;[11] or in determining the applicability of the instalment basis of tax accounting;[12] or for other tax purposes.[13] Indirect collection and non-notification do not keep a transaction from being a sale rather than a loan.[14] It is believed that a percentage of advance below 100% is likewise not of decisive significance, because such advances are characteristic in the financing instalment sales of certain kinds of industrial goods, mobile homes, trailers, etc.[15] It is the writer's view that none of these factors nor any combination of them is decisive outside the types of financing in which the *McChesney* line of cases arose.

This leaves for consideration the significance of the manner of computation of the finance charge. Superficially, it would seem that

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11 Nichols v. Fearson, 7 Peters (U.S.) 103 (1833); G.M.A.C. v. Mid-West Chevrolet Co., 66 F.2d 1 (10th Cir. 1933); 74 F.2d 386 (10th Cir. 1934); In re B & B Motor Sales Corp., 277 Fed. 808 (D.N.J. 1922); Woodall & Son v. People's Bank, 153 Ala. 576, 45 So. 194 (1907); King v. People's Bank, 127 Ala. 266, 28 So. 658 (1900); Baer v. G.M.A.C., 101 Fla. 913, 132 So. 817 (1931); Lynn Morris Plan Co. v. Gordon, 251 Mass. 323, 146 N.E. 685 (1925); American Loan Plan v. Frazell, 135 Neb. 718, 283 N.W. 836 (1939); Coast Finance Corp. v. Powers Furniture Co., 105 Or. 339, 209 Pac. 614 (1922); Seltzer v. Sokoloff, 302 Pa. 449, 153 Atl. 724 (1931).

For the leading bank cases, see National Bank of Gloversville v. Johnson, 104 U.S. 271 (1881); Nash v. White's Bank of Buffalo, 68 N.Y. 396 (1876).

12 Elmer v. Com'r of Internal Revenue, 65 F.2d 568 (2d Cir. 1933); East Coast Equipment Co. v. Com'r of Internal Revenue, 222 F.2d 676 (3d Cir. 1955); Robinson v. Com'r of Internal Revenue, 73 F.2d 769 (9th Cir. 1934); Alworth-Washburn Co. v. Helvering, 67 F.2d 694 (C.A.D.C. 1933).

13 In Com'r of Internal Revenue v. Hansen, 360 U.S. 446 (1959), decided June 22, 1959, the Supreme Court of the United States ended a long controversy, with sharp division among the circuits, as to the realization of profit following sales on the instalment plan, where the retail paper is sold with recourse subject to a retained reserve by the finance company. The court expressly rejected the argument that sale of automobile paper with recourse, and with a retained reserve, was a loan.

See also the second paragraph of note 4.

14 Milana v. Credit Discount Co., 27 Cal. 2d 335, 163 P.2d 869 (1945).

15 See note 12.

the decisive characteristic of the loan classification is that interest runs while the debt is outstanding and is automatically adjusted if the debt is paid late or paid early. On the other hand, superficially the characteristic of a sale transaction is that the price is determined once and for all. While no doubt the discount rate on the purchase of a receivable takes into account the expected duration of the receivable, it is not expected normally that this purchase price will be adjusted between the purchaser and seller of the receivable if the obligor of the receivable pays late or pays early. But on further consideration even this apparently definite basis for distinction between loan and sale shades off into indefiniteness. The note or contract evidencing the receivable will normally require the obligor to pay interest after maturity, or will impose delinquency penalties if the obligor pays late, and the sale-with-recourse can make the retailer liable for everything that the obligor of the receivable is liable for. Thus, if the contingent liability becomes absolute, the retailer is liable for an adjusted amount of finance charge or discount. Conversely, if the retailer repurchases the receivable because of the obligor's default early in the life of the receivable, he receives a rebate of part of the finance charge or discount, which is again adjusted in recognition of the duration of the financing agency's investment as the facts eventuated. Thus, the liability of the retailer for accruing charges in a transaction in sale form, where the actual duration of the investment is greater or less than expected, is not very different from his liability for interest on daily balances in a transaction in loan form.

The writer reaches the conclusion, therefore, that so long as law and accounting give vastly different results to classifications resulting from only minutely differentiated facts, there is a strong possibility that the lawyer can select an important set of consequences by careful draftsmanship.

Even where the *McChesney* line of cases seems to indicate that for usury purposes the transaction may be held to be a loan, this point may not be a problem in the particular transaction, and the lawyer may still hope that his form of drafting may affect balance sheet consequences or the application of restrictive covenants.

Even more uncertain remains the question whether, in the absence of adjudication, accountants must give accounting effect to the form put on the transaction by the lawyers' documents, or whether the accountants may ever, in advance of litigation, undertake to reject the contractual form of the transaction and classify it according to their own conceptions of accounting or law.

Instalment selling presents constantly new challenges, and financing arrangements between retailer and financing agency become increasingly complex and varied. The questions discussed in this paper will sometime have to be faced, and perhaps litigated. In the meantime, they suggest that both for lawyers and accountants, there is need for fundamental thinking as to the meaningfulness of our present categories of loan and sale, and of direct and indirect liabilities.