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# FINANCING INVENTORY UNDER THE UNIFORM COMMERCIAL CODE: A RESUMÉ FOR MISSOURI LAWYERS

RICHARD W. DUESENBERG\*

## I. INTRODUCTION

Of the Uniform Commercial Code's nine substantive articles, the ninth is beyond question the most complex. A first excursion into other articles of the Code is likely to find most lawyers feeling comfortably assured, but Article 9 requires considerable readjustment of traditional thinking regarding chattel security law.<sup>1</sup>

Designed as a comprehensive code<sup>2</sup> for the regulation of secured

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1. Immediately, for example, the lawyer is faced with terms and definitions with which he must become acquainted. In addition to the thirteen basic definitions of §§ 400.9-105-.9-107, RSMo 1963 Supp., there are the classifications of "consumer goods," "equipment," "farm products" and "inventory" provided for in § 400.9-109, RSMo 1963 Supp., as well as the more than half-dozen cross references to other articles of the Code for the meaning of terms appearing in Article 9. See, e.g., § 400.9-105(3), RSMo 1963 Supp. The meaning of some of the terms is so self-evident that definitions could have been left unstated; yet occasionally the drafters labored hard in putting together cumbersome explanations. "Security interest," which is what Article 9 deals with, is defined not in that article, but in the general definitional chapter of Article 1, § 400.1-201(37), RSMo 1963 Supp. Similarly, the significant term "buyer in the ordinary course of business" is defined in § 400.1-201(9), RSMo 1963 Supp. For a delightful exposé of Article 9's "sources of confusion" see Coogan, *The Lazy Lawyer's Guide to Secured Transactions under the Code*, 60 MICH. L. REV. 685 (1962).

2. In the words of the Official Comments to the Code, "This Article sets out a comprehensive scheme for the regulation of security interests in personal property and fixtures. It supersedes existing legislation dealing with such security devices as chattel mortgages, conditional sales, trust receipts, factors' liens and assignments of accounts receivable . . . . The aim of this Article is to provide a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward with less cost and with greater certainty." Comment to § 9-101, UNIFORM COMMERCIAL CODE, 1962 OFFICIAL TEXT WITH COMMENTS, published by the American Law Institute and the National Conference of Commissioners on Uniform State Laws [hereinafter cited UCC (1962) with a section number, e.g., UCC § 9-101 (1962)].

In Missouri, the adoption of the Code repeals the following portions of the Revised Statutes: Chapters 401 (negotiable instruments), 402 (bank collection code), 406 (warehouse receipts), 407 (bills of lading), 410 (assignment of accounts receivable), 427 (bulk sales), and §§ 403.010-240 (relating to corporate

transactions involving fixtures, personal property and intangibles, Article 9 is a synthesis of the old and new in nonrealty security law. The emphasis is clearly upon the new. Since among the uniform laws making the most impact on Code Article 9 is the Uniform Trust Receipts Act, which was never adopted in this state, Missouri lawyers, unlike their brethren in many other jurisdictions, will have more than their share of new experiences in drafting and designing secured transactions to fit their clients' needs and the Code's requirements.

The purpose and assignment of the following comments are to survey briefly the impact of the Code on inventory financing. The focus will be on dealers as distinct from manufacturers, though most of what is written has equal application in either context. Rather than to tread through the Code section by section making comparisons to present law, the approach will be to survey where current law and practice do not coincide, in order better to perceive the reasons for the changes wrought by the Code.

## II. BACKGROUND<sup>3</sup>

The two most common forms of chattel security are the conditional sale and the chattel mortgage. Creations of the nineteenth century, both of these devices grew up and flourished in the context of essentially bipartite transactions. The major conceptual distinction between them was that a conditional sale involved title retention for security, while a chattel mortgage (at least prior to the period of the "lien theory") spoke in terms of transferring title to secure an indebtedness.<sup>3</sup>

Because of this distinction, conditional sales have historically been used to finance the acquisition (usually at the retail level) of goods, while an indebtedness incurred other than in connection with a purchase presented the orthodox factual pattern for use of a chattel mortgage. This is not to deny the existence of a purchase money mortgage—a device com-

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stock transfers), §§ 428.100, .110 (relating to conditional sales), §§ 430.260-320 (relating to liens of factors), and §§ 443.450-520 (relating to chattel mortgages). Mo. LAWS 1963, at 637, § 10-102.

3. *E.g.*, in *Burroughs Adding Machine Co. v. Wieselberg*, 230 Mich. 15, 19, 203 N.W. 160, 162 (1925), the Supreme Court of Michigan stated: "The pure conditional sale gives possession of chattels with the right to ownership upon payment of the agreed price, retaining title in the seller with right of reclamation in case of default or the alternative of passing the title by suit for the purchase price. The right to retake the property, retain payments made, estimate wear and tear, compute damage and look to the buyer for deficiency in the agreed price is consonant only with remedies under instruments providing for security in the nature of a chattel mortgage; for in such a case the security is but an incident of a debt absolutely due from the buyer to the seller."

monly used in Missouri<sup>4</sup>—but rather to underscore the traditional use-distinction between the two.<sup>5</sup>

The problems encountered in financing inventory are not the same as those arising in other secured transactions. In selling a chattel at retail, the dealer, or the financing agency to which a conditional sale contract or purchase money chattel mortgage might be sold, is concerned with proper title retention or title transfer language, a correct description of the collateral, covenants as to use, removal, insurance, and provisions for remedies in case of default. The chattel mortgage form, especially in the non-sale situation, may add future advance and after-acquired property clauses, but in any event the chattel relied upon is generally specific and ascertained.

Always, however, inventory financing requires thoughtful consideration of a number of matters about which the law is not clear. To begin with, the security must stand the test of permissive sale. Also, since inventory is purchased to be sold, the ability to include within the secured transaction after-acquired property is essential, at least where it is not practicable to take separate security instruments with the acquisition of each unit of inventory—the distinction between financing large, individually identifiable pieces (hard goods) and financing an inventory of soft goods. Similarly, the validity of future advance clauses should be considered, for the shifting nature of the inventory may demand fresh loans for the acquisition of replacement goods. Because financing inventory also serves to supply a merchant with working capital, to buy stock, to pay light, heat and rent, and to meet the payroll, it is frequently necessary to allow the merchant to retain a portion of the proceeds of sold inventory to discharge these obligations. Not infrequently traditional concepts of chattel mortgage or conditional sales law have not accommodated these needs.

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4. Missouri law provides that on repossessing property sold under a conditional sales contract the price paid therefor must be refunded, subject only to a deduction of reasonable compensation for use, which may not exceed 25% of the amount paid, unless the property has been damaged. § 428.110, RSMo 1959. In the absence of a similar limitation in chattel mortgage law, it is not surprising that conditional sales have been rarely used in this state.

5. "A contract of conditional sale creates the relation of vendor and vendee. The relation of debtor and creditor is not created. It is not the function of a conditional bill of sale to secure a money loan. Its purpose is to permit the owner of personal property to make a sale on credit, reserving the title in himself as security until the purchase price is fully paid." *Smith v. Downs*, 48 Wash.2d 165, 169, 292 P.2d 205, 208 (1956).

## FINANCING INVENTORY

A. *After-Acquired Property*

The validity of after-acquired property clauses has been tested exclusively in the context of chattel mortgage law, for not only is a conditional sale a less popular instrument in Missouri,<sup>6</sup> but it is not an appropriate transaction for inclusion of such a provision. It is conceivable, of course, that a long-term contract for the purchase and sale of merchandise from a single supplier might contain title retention language, and that as performance of the contract takes place, individual purchase orders would be placed with the seller. But it certainly is not common practice. No statutory language in Missouri addresses itself to this possibility, and with the general advantages of chattel mortgages over conditional sales, the legal climate has not been such as to occasion a litigated case involving an after-acquired property clause in a conditional sales transaction.

The foremost conceptual objection raised in connection with an after-acquired property clause is that one cannot encumber a chattel not owned at the time of executing the security document.<sup>7</sup> This objection has not prevailed in Missouri, at least not to the extent that mortgages containing such clauses are declared to be invalid for all purposes. From early in the 1800s, there are reported cases in which the courts have said that after-acquired property clauses do not render the chattel mortgage invalid *per se*,<sup>8</sup> and a few of these decisions came out of inventory financing transactions.<sup>9</sup>

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6. See note 4 *supra*.

7. "It appears to be a fundamental rule of the common law that a mortgage can operate only on property actually belonging to the mortgagor when the mortgage is given. A mortgage of after-acquired property is void in law because it has nothing to operate upon. A mortgage is an executed contract, a present transfer of title, although conditional and defeasible, and it cannot bind property afterwards acquired by the mortgagor. Such a mortgage is void as to third persons having no notice respecting it. The rights of third persons are not affected thereby unless the mortgagee takes actual possession of the property before it is purchased by third persons or seized by creditors, and if such third persons purchase it or such creditors seize it before the mortgagee takes actual possession thereof the third persons or creditors obtain the better right thereto." *Personal Fin. Co. v. Lewis Inv. Co.*, 138 S.W.2d 655, 656 (St. L. Mo. App. 1940).

8. *Rutherford v. Stewart*, 79 Mo. 216, 217 (1883): "It seems to me the clear result of all authorities, that whenever the parties, by their contract, intend to create a positive lien or charge, either upon real or personal property, whether *in esse* or not, it attaches, in equity, as a lien or charge upon the particular property as soon as the assignor or contractor acquired title thereto" against the mortgagor and all persons claiming thereunder with actual notice of the mortgage.

9. Compare *Voorhis v. Langsdorf*, 31 Mo. 451, 452 (1862) (construing the words "which may be added from time to time, to said stock," the court said it was not a necessary conclusion that the mortgagor was authorized to sell and replenish stock, and therefore the mortgage was not void on its face) with *Stanley v. Bunce*, 27 Mo. 269, 271 (1858) (conveyance held fraudulent as to creditors

It is not enough, however, to know only that an after-acquired property clause is not in itself invalid. To be meaningful, it must permit the mortgagee to acquire an interest in subsequently purchased chattels immediately upon their acquisition by the debtor, and this interest must be good, without any further act, against all competing creditors, not simply against the mortgagor-debtor.<sup>10</sup>

The usual characterization has been that an after-acquired property clause gives the mortgagee an "equity" or "equitable lien" in the chattels when acquired. This can be said to mean at most that upon acquisition, it has not generally been necessary for the mortgagee to procure from the mortgagor new documentation to secure the lien against the mortgagor.<sup>11</sup> But the mortgagee's position has not always been so clear as against the rights of intervening third parties, for often Missouri courts have held that the constructive knowledge furnished by the recording of the mortgage is not sufficient notice to innocent third parties.<sup>12</sup>

To the extent that the after-acquired property clause is not effective against purchasers in the ordinary course of business, its utility for inventory financing is not impaired. Most purchasers intend to buy merchandise, not lawsuits, and as against them the clause should not be effec-

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where it included "all goods, wares, and merchandise, which [the mortgagor] may at any time within twelve months purchase for the purpose of renewing or replenishing" his stock). See also *Barton v. Sitlington*, 128 Mo. 164, 30 S.W. 514 (1895); *Williams v. Kimball Co.*, 188 Mo. App. 646, 176 S.W. 478 (K.C. Ct. App. 1915) (upholding as against intervening creditor a clause allowing debtor to exchange items of inventory and providing that the lien attaches immediately to new items); and *Smith-Wallace Shoe Co. v. Wilson*, 63 Mo. App. 326 (K.C. Ct. App. 1895) (suggesting that recording gives constructive notice of after-acquired property clause).

10. *Bank of Kennett v. Clayton*, 241 Mo. App. 487, 497, 245 S.W.2d 678, 683 (Spr. Ct. App. 1951) holding that a bank which took an assignment of a purchase money mortgage given to a dealer the day after the purchaser executed in favor of a financier a mortgage on the same property prevailed against the financier who had advanced funds and recorded first, the court saying that a "chattel mortgage upon property which the mortgagor does not own, but afterwards acquired, does not become a legal lien in favor of the mortgagee until he actually takes possession of the property."

11. As such, the mortgagee might take possession and sell under the mortgage without the aid of judicial foreclosure. *Keating v. Hannenkamp*, 100 Mo. 161, 13 S.W. 89 (1890).

12. *Steckel v. Swift & Co.*, 56 S.W.2d 806, 808 (St. L. Mo. App. 1933): "the rule is that, where the mortgagee does not take possession of the after-acquired property upon its acquisition by the mortgagor and before the rights of an innocent third party have attached, the provision in question will be held void as to such innocent third party, nor will the constructive knowledge furnished by the recording of the instrument be regarded as sufficient notice." See also *Barton v. Sitlington*, *supra* note 9 (taking possession under the mortgage but without consent of mortgagor before creditors intervened allowed the mortgagee to prevail). Cf. *Smith-Wallace Shoe Co. v. Wilson*, *supra* note 9.

tive.<sup>13</sup> The same is not true, however, when the contest is against intervening creditors. And, except in certain situations statutorily provided for,<sup>14</sup> the line of cases protecting intervening interests seems sufficiently strong to handicap seriously the usefulness of after-acquired property clauses. Such clauses are indispensable in financing inventory, especially an inventory of soft goods (hardware, drugs, groceries, etc.). As to inventories of hard goods, their ineffectiveness is not so crippling, since to handle each unit as a separate transaction is more practicable. Even then, however, it prevents setting up an efficient revolving credit transaction, for the paralysis of the clause imposes the cumbersome burden of taking care to enter into new documentation and new recording covering each piece of inventory as it is acquired.<sup>15</sup>

### B. Future Advances

Equally important to a successful inventory financing scheme is the

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13. Mortgages or conditional sales contracts covering inventory should never prevail against purchasers in the ordinary course of business. *Morris Plan Co. v. Universal Credit Co.*, 237 Mo. App. 365, 168 S.W.2d 136 (K.C. Ct. App. 1943). It should be completely irrelevant whether the purchaser knew, constructively or in fact, that the goods were floor planned, and any restrictions against the debtor-dealer's selling for cash or only on approval of the mortgagee should also be inoperative against such a purchaser. Inventory implies authority to sell. See *Moffett Bros. & Andrews Comm'n. Co. v. Kent*, 5 S.W.2d 395 (Mo. 1928); *Daas v. Contract Purchase Corp.*, 318 Mich. 348, 28 N.W.2d 266 (1947). American cases have had some difficulties in this area, see, e.g., *Bayer v. Jackson City Bank & Trust Co.*, 335 Mich. 99, 55 N.W.2d 746 (1952); *Southern Ill. Finance Corp. v. Strubel*, 228 S.W.2d 374 (St. L. Mo. App. 1950), because in many states chattel mortgage recording acts, originally designed as constructive notice to purchasers as well as to creditors, were not redrafted in recognition of the fact that the floor plan chattel mortgage, though a descendant of the common law chattel mortgage, was developed for use in connection with inventory financing rather than consumer financing. Whether the financing agency holding the retail sale chattel paper should stand in the same protected position as the purchaser is a question with different considerations, and is discussed elsewhere in this symposium. Both the Code, § 400.9-306(4), RSMo 1963 Supp. and the UNIFORM TRUST RECEIPTS ACT § 9(1)(a), prefer the retail financier in this controversy. See *Fidelity Corp. v. Associates Discount Corp.*, 340 Mich. 610, 66 N.W.2d 235 (1954) and the excellent case note in 103 U. PA. L. REV. 684 (1955).

14. E.g., involving the mortgaging of future crops, where Missouri law provides that the mortgage shall be effective to convey title as of the day of the mortgage, as though the crop were then in existence. § 443.450, RSMo 1959.

15. Other matters must also be kept in mind in the use of after-acquired property clauses. For example, cases have generally held that such clauses will not be valid unless the property is of a kind or class enumerated in the mortgage, or has a definite location, both of which are matters going to the sufficiency of description. *Bostian v. Rosen*, 144 F.2d 808 (8th Cir. 1944). Others have indicated the necessity of contemplating the later acquisition. *Littlefield v. Lemley*, 75 Mo. App. 511 (K.C. Ct. App. 1898); Cf. *Petrin v. Heer Dry-Goods Co.*, 90 Mo. 649, 3 S.W. 405 (1886).

validity of a future advance clause.<sup>16</sup> Most situations of financing inventory contemplate a revolving credit transaction, where the lien on inventory shifts from sold merchandise to replacement goods, and where the credit extended remains relatively constant. Again, unless the chattels are such that it is feasible to relate each advance to a specific unit, the financier will want all units, whenever acquired, to stand as collateral for advances whenever made.

There are no statutory provisions pertaining to future advances in either conditional sales or chattel mortgage law in Missouri. Decisional law speaks in favor of enforceability,<sup>17</sup> but in fact there is surprisingly little authority on this point.

Looking to other jurisdictions, it is not uncommon to find the requirements that for future advance clauses to be effective and not to lose priority to intervening encumbrancers, it is necessary that the chattel mortgage state the maximum limit of the indebtedness for which the mortgage stands as security,<sup>18</sup> that the advances be made within a stated period of time,<sup>19</sup> or that the mortgagee be under obligation to make the advance.<sup>20</sup> Missouri cases have said that a chattel mortgage may cover future advances,<sup>21</sup> provided the mortgage so stipulates, reasoning that without this stipulation there is no debt to which the mortgage refers or which it covers.<sup>22</sup> Behind this language is undoubtedly the idea that inclusion of

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16. Almost any mortgage will provide that to protect the security interest the mortgagee may pay taxes, insurance, or other expenses, and add these to the indebtedness. In a sense this is a future advance clause. Such clauses are generally effective, and do not fall within the scope of the generic term "future advance clause" as used here.

17. *Rice v. Davis*, 99 Mo. App. 636, 74 S.W. 431 (K.C. Ct. App. 1903); *Smith-Wallace Shoe Co. v. Wilson*, *supra* note 9.

18. *E.g.*, COLO. REV. STAT. ANN. § 20-3-6 (1961); CAL. CIV. CODE, § 2975.

19. For a general discussion, see Blackburn, *Mortgages To Secure Future Advances*, 21 Mo. L. REV. 209 (1956); Schimberg, *Future Advances Clause in Chattel Mortgages*, 56 COM. L.J. 31 (1951); Comment, *Mortgages To Secure Future Advances*, 31 N. CAR. L. REV. 504 (1953).

20. These words of an Ohio Court typify the pre-Code view: "Obviously, where there is no obligation to make future advances, a mortgage, purporting to secure such future advances, cannot secure such advances until the advances have been made. Until then, so far as such advances are concerned, there is nothing for the mortgage to secure; and the provisions of such a mortgage merely represent an expression of the intention of the mortgagor and mortgagee that the mortgage shall operate as a security for the obligations of the mortgagor with respect to such advances, if and when such obligations arise. At most, those provisions represent an offer by the mortgagor to provide the security of the mortgage for such advances if and when they are made. . . . If such offer is accepted by the mortgagee in making a subsequent advance, then the necessity of executing and recording a new mortgage to secure such advance may be avoided." *Second Nat'l. Bank v. Boyle*, 155 Ohio St. 482, 486, 99 N.E.2d 474, 476 (1951).

21. See *White v. Meiderhoff*, 281 S.W. 98 (Spr. Mo. App. 1926) (intentional overstatement of indebtedness held fraudulent as to creditors).

22. *Jacques v. Goggin*, 362 Mo. 1005, 1015, 245 S.W.2d 904, 910 (1954):



the clause in the mortgage gives notice to subsequent third parties of the possible existence of other obligations, the extent of which may then be investigated.

Whatever the case, it does not seem that the law surrounding these clauses has been a serious obstacle to their use.<sup>23</sup> Much of the litigation has related to the scope of the particular clause at issue, resolving such questions as whether it should include only direct advances or also indirect indebtedness through judgments, surety relations or assignments.<sup>24</sup> Where the subsequent advance is optional, many courts have felt that the mortgagee's priority should depend on whether he had notice of the intervening encumbrance.<sup>25</sup> The apparent policy consideration is to prevent the use of future advance clauses from operating as a dragnet in subjecting the debtor to a single source of financing. If a creditor could be certain that its after-acquired property clause would prevail against other creditors and the trustee in bankruptcy, it could sustain this burden, for it would then only be necessary to refrain from making any further advance or otherwise to work out a suitable arrangement of priority with the intervening party.<sup>26</sup>

### C. *Authorized Resale*

As in other American jurisdictions, Missouri decisional law has been hostile to provisions authorizing the debtor to sell collateral put up as security for a loan. This disposition of cases reflects the antipathy of the early cases to allowing effective security interests in property without a physical transfer. The thought has been common that if parties could transfer their interest in chattels as security for their indebtedness, without

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"It is fundamental that for a transaction to constitute a chattel mortgage there must be a debt covered by the mortgage." See also *Smith-Wallace Shoe Co. v. Wilson*, *supra* note 9.

23. While there is nothing in decisional or statutory law expressly prohibiting a condition other than payment of purchase price as the condition of a conditional sale contract, there is no reported Missouri case on the point. Theoretically, payment of all obligations, including future ones, might be made a condition, but once the sale took place, future advances would not relate to the price, and the pattern of the transaction would be that of a chattel mortgage.

24. See *Rose City Foods Inc. v. Bank of Thomas County*, 207 Ga. 477, 478, 62 S.E.2d 145, 146 (1950) (clause reading that it was applicable to "any and all other indebtedness now due by me to said bank or hereafter incurred by me, whether directly or indirectly, as principal, endorser, guarantor, or otherwise" held to apply to purchase of unsecured claim, with result that claim of general unsecured creditor was brought within the security of the mortgage).

25. *In re Harris Estate*, 156 Misc. 805, 282 N.Y.S. 571 (1935) (requiring actual notice).

26. See Weeks, "*Floating Liens*" in *Inventory Financing*, 1956 ILL. L. F. 557, 564.

at the same time surrendering possession, it would be too easy for debtors in the grip of financial difficulty to defraud creditors by giving chattel mortgages to creditors they wished to prefer or to some other party with whom a convenient arrangement might be worked out. True, fraudulent conveyances might be set aside, but the burden of proving the fraud is an imposing one in most cases.

The objection to allowing an effective pledge without transfer of possession was met essentially by the requirement of giving public notice through recording. Courts have had more difficulty in breaking away from earlier concepts in regard to authority to resell. To talk in terms of using certain chattels as security for an indebtedness, and yet to allow the debtor to sell such collateral was, through the nineteenth and early twentieth centuries, regarded as inconsistent.<sup>27</sup> A creditor could not both assert a claim against property and authorize its sale, for such conduct would allow the debtor to act as though the goods were his. Consequently many cases held fraudulent and void mortgages given upon a stock of merchandise which the mortgagor was to retain and sell in the ordinary and usual course of business.<sup>28</sup>

Here again, the question must be asked, against whom is the security ineffective—the original debtor, intervening general creditors or lien creditors, purchasers in the ordinary course of business? The respective positions of these groups are not the same. Cases protecting buyers in the ordinary course of business arrive at a correct result, irrespective of whether the reason is based on the clause permitting resale.<sup>29</sup> Such decisions do not

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27. *Farmers State Bank v. Garrison*, 344 S.W.2d 323 (K.C. Mo. App. 1961): "It is the general rule that upon a sale of the mortgaged property with the mortgagee's unconditional consent, the mortgage lien does not attach to the proceeds. The reason frequently given is that a consenting by the mortgagee to a sale of the property by the mortgagor and the passing of the title and a retention by him of the mortgage lien are wholly inconsistent positions. The mortgagee cannot in effect make the mortgagor his agent to sell the property and then when a sale is effected through such agency retain his lien notwithstanding." See also *Walter v. Wimer*, 21 Mo. 63 (1856) (though proceeds of sale were required to be used to replenish stock, held fraudulent).

28. *Rock Island Nat'l Bank v. Powers*, 134 Mo. 432, 34 S.W. 869 (En Banc 1896); *Barton v. Sitlington*, *supra* note 9 (mortgage not void on its face where no provision for resale included, and oral agreement between parties as to proceeds and resale held not to affect validity of mortgage between parties); *Embree v. Roney*, 152 Mo. App. 257, 133 S.W. 83 (K.C. Ct. App. 1911) (mortgage on stock of drugs).

29. *Morris Plan Co. v. Universal Credit Co.*, *supra* note 13 at 374, 168 S.W.2d at 140: "When a mortgagee or conditional sale vendor of an article permits the mortgagor or vendee to remain in possession of the article knowing that it is to be offered for sale in the ordinary course of business, the mortgagee or vendor is estopped to deny the right of the mortgagor or vendee to sell the article and pass title to the purchaser." See also *Moffett Bros. & Andrews Comm'n v. Kent*, *supra*

on this account pose any serious impediment to the use of these clauses in inventory financing transactions.<sup>30</sup> On the other hand, as between the parties the transaction should be effective, and if the merchant promises to turn over the proceeds on resale, his promise should be enforced.<sup>31</sup> It is when the transaction fails against creditors of the merchant that the peril of using the clause is tested.

Authority to sell the mortgaged property is probably not as operative an element in these cases as is the failure to require an accounting. Most cases have said that the permissive sale clause jeopardizes the security only where the debtor is not required to apply the proceeds to the payment of the debt for which the transaction stands as security.<sup>32</sup> If it is feasible,<sup>33</sup> therefore, that on resale the proceeds be fully applied on the indebtedness, the chattel mortgage may give adequate protection. There are many instances, however, where it is simply impractical to impose this requirement, because the capital needs of the debtor require retention of at least part of the proceeds. Whenever this is the case, the choice between

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note 13 at 400: "By consenting to a sale and the collection of the proceeds by the mortgagor, the mortgagee surrenders his lien and looks to the mortgagor personally for the payment of the mortgage debt." Nor is it necessary for the consent to be express. *Stockyards Nat'l Bank v. Wool Co.*, 316 Mo. 426, 289 S.W. 623 (1926).

30. See note 13 *supra*.

31. *Cf.*, *Farmers State Bank v. Garrison*, *supra* note 27 (mortgagee protected against claims of unsecured creditors who as selling agent knew or should have known of the existence of the mortgage).

32. *Columbia Savings Bank v. Limerick*, 216 S.W.2d 119 (St. L. Mo. App. 1948) (mortgagee's taking possession before creditors became lien creditors said to validate mortgage as to such creditors); *Citizens' Trust Co. v. Elders*, 212 Mo. App. 589, 259 S.W. 136 (Spr. Ct. App. 1923) (mortgage held invalid as to stock in trade, but valid as to furniture and fixtures); *Embree v. Roney*, 152 Mo. App. 257, 262, 133 S.W. 83, 85 (K.C. Ct. App. 1911) ("It is held that although the mortgage is fair on its face if the mortgagee permits the mortgagor to remain in possession and sell and dispose of the property in the usual course of business for his own benefit, the mortgage is void as to creditors . . . 'It is not the right to remain in possession with power to sell in the ordinary course of business that renders a chattel mortgage fraudulent and void under the first section of our statute of fraudulent conveyance, but it is the right to remain in possession and to sell and convert the proceeds to the mortgagor's own use that renders the instrument void.'" quoting *Rock Island Nat'l Bank v. Powers*, 134 Mo. 432, 445, 34 S.W. 869, 871 (En Banc 1896); *Anderson v. Cleveland*, 186 S.W. 1142 (K.C. Mo. App. 1916) (debtor who had mortgaged stock of groceries transferred entire stock to wife).

33. The requirement substantially limits use of the security device to large-unit inventories. It should also be noted that remittance of proceeds be prompt. See *Rock Island Nat'l Bank v. Powers*, *supra* note 28 (daily remittance); *Smith-Wallace Shoe Co. v. Wilson*, 63 Mo. App. 326 (K.C. Ct. App. 1895) (daily remittance).

what the circumstances require and what the law allows<sup>34</sup> is an unhappy one.

#### D. Factors' Lien Act

In response to the needs of modern commercial financing, and in recognition of the limitations of decisional law in relation to conditional sales and especially chattel mortgages, many states passed factors' lien acts, assignment of accounts receivable statutes, and the Uniform Trust Receipts Act. Except for the last of these, the statutes compared favorably only in basic outline, there being considerable differences among state versions.

Missouri enacted an assignment of accounts receivable statute<sup>35</sup> in 1943 and the Factors' Lien Act<sup>36</sup> in 1945. Unfortunately, the Uniform Trust Receipts Act,<sup>37</sup> designed to up-date the financing of large-unit inventories, failed of passage in this state, thus depriving Missouri lawyers of the opportunity of intimate acquaintance with several key concepts incorporated in the Uniform Commercial Code. Some of these were, however, expressed in the Factors' Lien Act, which went a considerable distance in accommodating the commercial needs of bulk inventory financing.<sup>38</sup>

The modernization attempted to be accomplished through the Factors' Lien Act was to permit a floating lien on a shifting stock of merchandise. This Act attempted to free merchandise financing from the paralysis of decisions rendering ineffective security agreements containing after-acquired property clauses, future advance clauses, authorizations of resale and permission for the retention of proceeds of sold inventory. These objectives are expressed in language which reads that "if so provided by any written agreement," the factor may "have a continuing general lien upon

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34. See, e.g., *Globe Securities Co. v. Gardner Motor Co.*, 337 Mo. 177, 85 S.W.2d 561 (1935) for a case which points up the consequences of frequently inadvertent digressions from the technical distinctions between various forms of security, all of which have a common purpose.

35. Accounts receivable, the assignment of which is usually a facet of financing inventory, are considered in another article of this symposium. See O'Leary, *Accounts Receivable as Security*, infra, this symposium.

36. The original Factors' Lien Act was passed by New York, in 1911, and is now part of N.Y. PERS. PROP. LAW § 45. The Missouri Act is §§ 430.260—320 RSMo 1959. For a general discussion see Fechteler, *The Factor's Lien Statutes*, 11 Bus. Law. 60 (1956).

37. Approved by the Uniform Commissioners in 1933, it became law in 32 jurisdictions.

38. It is important to bear in mind that the Factors' Lien Act applies only to inventory, and may not be extended to equipment, machinery, supplies or other types of property.

all merchandise from time to time consigned to or pledged with the factor, whether in the factor's constructive, actual or exclusive occupancy or possession or not, and such lien shall secure the factor for all his loans and advances to or for the account of the borrower."<sup>39</sup> Furthermore, it is provided that such "lien shall be valid from the time of recording."<sup>40</sup> "Recording" refers to the filing of a relatively brief notice, and not to a complete instrument as has been essential in the law of chattel mortgages. The Act also provides that the lien on the goods should carry forward automatically to the proceeds of sale.<sup>41</sup>

Though representing a significant forward step, certain inherent limitations in these words might have been avoided had the adopting legislature given consideration and study to a few decisions under earlier statutes from which the Missouri language was derived. For example, it had been ruled in a 1934 case<sup>42</sup> that to subject subsequently acquired property to the security allowed by the Act, separate instruments or conduct of consignment or pledge were necessary. Though the burden was not the same as previously demanded under chattel mortgage law, for no new filing was required, nevertheless it did impose as a condition of a valid security the performance of acts which, though they amounted to good business practice, had little to do with protecting the interests of competing creditors. Whether this interpretation would have been accepted in Missouri courts will probably never be known, for with the adoption of the Code the issue becomes moot because it avoids repeating the same verbal limitation.<sup>43</sup>

Perhaps the primary—and most objectionable—limitation of the

39. § 430.270, RSMo 1959.

40. § 430.270(2), RSMo 1959. Originally the Act required sign-posting, but this requirement has been eliminated by amendment.

41. § 430.270(2), RSMo 1959.

42. *Irving Trust Co. v. Commercial Factors Corp.*, 68 F.2d 864 (2d Cir. 1934). The same problem of executing separate lien documents exists in the common law or statutory form of trust receipts financing. The obvious mechanical inconvenience is one of requiring the debtor-dealer to appear at a financing office each time the papers of a given item of inventory are received. The practice is for the debtor to authorize an employee of the financing institution to act as its agent in signing documents. *Commercial Credit Corp. v. Davis*, 117 F. Supp. 3 (W.D. Mo. 1953). See also *Eastern Acceptance Corp. v. Camden Trust Co.*, 59 N.J. Super. 96, 157 A.2d 155 (Camden County Ct. 1959) (decided under the Uniform Trust Receipts Act).

43. Later decisions construing these Acts retreated from the position of *Irving Trust Co.*, *supra* note 42, and made it possible to effect the necessary consignment or pledge through the language of the original agreement. See *Colbath v. Mechanics Nat'l Bank*, 96 N.H. 110, 70 A.2d 608 (1950). For a similar problem involving accounts receivable, see *Manchester Nat'l Bank v. Roche*, 186 F.2d 827 (1st Cir. 1951). See also, Silverman, *Factoring: Its Legal Aspects and Economic Justification*, 13 *Law & Contemp. Prob.* 593 (1948).

Factors' Lien Act is contained in the definition of the term "factor," defined as "any person, firm, or corporation who advances money on the security of merchandise."<sup>44</sup> Consider, for a moment, the possibility of a manufacturer supplying inventory on credit attempting to secure its claim through the Factors' Lien Act. Does a manufacturer selling on credit "advance money" in the sense of the statute? This question was never decided in Missouri courts, and for decades went unanswered under acts of other states until finally in 1961 the Third Circuit took the position that the term included banks, finance companies and old-line factors, but excluded sellers of merchandise.<sup>45</sup> While the phrasing of the statute and its decisional construction have historical explanation,<sup>46</sup> the discrimination has no commercial justification, and it is well that it does not persist under the Uniform Commercial Code. As a practical matter, the Factors' Lien Act has given little comfort to suppliers seeking an efficient security device in their customers' inventory.

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44. § 430.260, RSM $\alpha$  1959.

45. In the Matter of Freeman, 294 F.2d 126, 132 (3rd Cir., 1961) ("The word 'advance' as used in . . . [the Act] refers to an advance of money . . . . It would thus appear that . . . [the Act] grants a lien to those factors who lend upon the security of merchandise for all their loans and grants a lien to all those factors who 'advance money on goods consigned to or pledged with them' for all their advances. In both instances, however, 'loans and advances' refer to money.") It may also be noted that through a narrow definition of the term "borrower" contained in the Act as adopted in a number of states, the financing of retail merchants was excluded. This limitation does not appear in the Missouri form. For an example of financing retail inventory, see Matter of Cut Rate Furniture Co., 163 F. Supp. 360 (N.D. N.Y. 1958).

By excluding manufacturers or other suppliers, the Factors' Lien Act contemplates an essentially tripartite transaction. The same is true with the common law form of trust receipts financing under which it was crucial to prevent the movement of title other than from the supplier to the financier (entruster) and then to the debtor-merchant (trustee). If the title moved first to the debtor, the trust receipt security would fail. *In re Fountain*, 282 Fed. 816 (2d Cir. 1922); *Globe Securities Co. v. Gardner Motor Co.*, *supra* note 34; *Commercial Credit Co. v. Interstate Securities Co.*, 197 S.W.2d 1000 (K.C. Mo. App. 1946). While UNIFORM TRUST RECEIPT ACT § 2(1) eliminated the emphasis on title flow, the transaction is still essentially three party, requiring that the financier acquire its interest in the purchased goods promptly. *Volusia Discount Co. v. Alexander K-F Motors*, 88 So.2d 302 (Fla. 1956); *Eastern Acceptance Corp. v. Camden Trust Co.*, 33 N.J. 227, 163 A.2d 134 (1960). These distinctions are rejected in the Code.

46. Though the growth of factoring began with the agent employed to sell goods for a commission having a lien on the goods for both advances and his commission, the modern factor is a financier who generally lends monies and takes in return an assignment of receivables. It is these financing agencies which originally supported the Factors' Lien Acts in order to get a security equal to that which was possessed by earlier factors in the goods themselves. Because of this sponsorship and historical growth, the acts were directed at benefiting these institutions. In the Matter of Tele-Tone Radio Corp., 133 F. Supp. 739 (D. N.J. 1955); *Fechteler, op. cit. supra* note 36.

## II. CODE CHANGES

A. *Uniform Commercial Code*

The preceding panorama sketches the major inhibitory legal doctrines making the business of financing inventory in Missouri one filled with pitfalls. The surest method of protecting a financier's interests against the claims of creditors would be the common law pledge, with its physical delivery of the goods, or its direct descendant, field warehousing.<sup>47</sup> But, at least as to retail inventory, neither of these schemes is practicable, and in the case of wholesalers, processors or manufacturers, the cost of necessary control measures detracts substantially from whatever other virtues a field warehousing program may have.

Building on a synthesis of prior security law, the Code sets out to make feasible the lending of money or extending of credit on the security of shifting inventory. Each unit of inventory, no matter when received, may be subjected to the lien provided for in the security agreement, which is to be "effective according to its terms between the parties and against purchasers of the collateral and creditors,"<sup>48</sup> unless otherwise provided for by the Code. If the objective of the Code is attained, it will allow business to be carried on as usual by the debtor, without peril to the creditor that its secured position will be lost, and without risk to ordinary course purchasers that what they buy will be subject to a prior encumbrance.

The first step taken by the drafters of the Code in developing the framework for a unified scheme of chattel security was to eliminate the purely formal distinctions between the traditional security devices. Though continued use of the terms may be made,<sup>49</sup> the designation "security interest"<sup>50</sup> is substituted for the former titles of conditional sale, chattel mortgage, factor's lien, trust receipt, and so on. It will no longer be

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47. For a field warehousing device to be effective, there must be either an actual or constructive delivery of the property to the warehouse. To accomplish this, often it is provided that a part of the debtor's property be leased to the warehouseman, the property pledged be segregated and located at that place and kept under control of the warehouseman who on authorization releases it to the debtor. Sign posting is also generally insisted upon. See, for an example of the necessary elements, *Bostian v. Park Nat'l Bank*, 226 F.2d 753 (8th Cir. 1955).

48. § 400.9-201, RSMo 1963 Supp.

49. Comment to UCC § 9-101 (1962) in stating that old forms may continue to be used, refers to UCC § 9-102(2) (1962), which reads that Article 9 "applies to security interests created by contract including pledge, assignment, chattel mortgage, chattel trust, trust deed, factor's lien, equipment trust, conditional sale, trust receipt, other lien or title retention contract and lease or consignment intended as security."

50. The term "security interest" is not new to security law. See, e.g., *Uniform Trusts Receipts Act* § 10.

necessary to check statutes to determine whether one type of security instrument needs recording and another not, whether an acknowledgment or affidavit of good faith is required, whether the whole instrument, a memorandum thereof or mere notice need be filed or recorded, whether the financier is supplier, factor or bank, and other similar inquiries. The wasteful litigation debating form should be relegated to history, and as one informed observer has noted, grown men should not hereafter spend time in court arguing whether a document is good or bad because the acknowledgment was fastened by brass staples instead of glue.<sup>51</sup>

In section 400.9-204(1) there is found a provision that a security interest "attaches" when three things have happened: there is agreement that it attach, value is given, and the debtor has rights in the collateral. The language sounds strange, but the idea is basic—though not new. "Attaches" is a word used by the drafters to mean simply that an interest is "obtained," and if the section is reflected on for a moment, it neither changes existing law nor does it state much more than what to any careful lawyer would be obvious. All that the section requires is that there be an agreement, that a loan be made, and that the debtor have an interest in property to which the security might apply. Without these, there is no security in collateral. For the interest to be good, two further steps are necessary. Section 400.9-203(1)(b) requires that the agreement be in a writing<sup>52</sup> signed by the debtor, and section 400.9-204(3) states that for the interest to be "perfected" (a term lifted from the Bankruptcy Act) a filing, transfer of possession, or other necessary step, must be taken. For the purpose of becoming perfected, the order in which these events take place is not important.

While it will be permissible to record the entire security agreement, the Code borrows from the factors' lien acts and the Uniform Trust Receipts Act the concept of notice filing. The document to be filed, called a financing statement, is not too unlike that required under the Missouri

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51. *Topper v. Jeffrey Mfg. Co.*, 191 F. Supp. 105 (S.D. Ohio, 1960). See Coogan, *The Lazy Lawyer's Guide to Secured Transactions under the Code*, 60 Mich. L. Rev. 685 (1962). *But see*, Panel Discussion, *A Practical Approach to the Uniform Commercial Code*, 19 Bus. Law 5, 43 (1963), where reference is made to a holding that a photocopy of a signed financing statement was not a signed copy, even though the Code provides that "signed" includes any "symbol executed or adopted by a party with present intention to authenticate a writing." § 400.1-201, RSMo 1963 Supp.

52. It has been held that the financing statement which does not contain language granting a security interest cannot constitute the security agreement. *American Card Co. v. H.M.H. Co.*, 196 A.2d 150 (R.I. 1963). The requirement of a writing does not apply to a pledge.



Factors' Lien Act or Assignment of Account Receivable statute, and calls for the name, address, and signature of the debtor and secured party, and a brief description of the collateral being used.<sup>53</sup> It may be anticipatory, or it may refer to an existing agreement; in any case, it is a simpler document than required under either conditional sales or chattel mortgage law, and if the Code is properly construed, the existing perils of improper or insufficient descriptions of collateral will no longer haunt the draftsman.<sup>54</sup> The place of filing depends basically upon the type of collateral being used.<sup>55</sup> By adopting the concept of notice filing, and avoiding the type of inhibitory language noted in the Factors' Lien Act,<sup>56</sup> it is possible to avoid separate filings or other documentation for each item or shipment of inventory as it is received.

Two of the most significant provisions of Article 9, insofar as it concerns inventory financing, are found in section 400.9-204. First, the pre-Code emphasis on presently owned collateral gives way in section 400.9-204(3),<sup>57</sup> which provides that the obligations encompassed by a security agreement may be secured by collateral, whenever acquired. At last, therefore, the after-acquired property clause has broad statutory blessings and so long as the financing statement is of record, no further act need be performed<sup>58</sup> upon the subsequent acquisition of goods. If at that

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53. § 400.9-402, RSMo 1963 Supp. Where the collateral is crops or fixtures, a brief description of the real estate where located is required.

54. § 400.9-402, RSMo 1963 Supp. requires the financing statement to indicate the "types" of collateral, or to "describe" the items. Section 400.9-110, RSMo 1963 Supp. provides that "any description of personal property or real estate is sufficient whether or not it is specific if it reasonably identifies what is described." The Official Comments say that the "test of sufficiency of a description . . . is that the description do the job assigned to it—that it make possible the identification of the thing described. Under this rule courts should refuse to follow the holdings, often found in the older chattel mortgage cases, that descriptions are insufficient unless they are of the most exact and detailed nature . . ." Comment to UCC § 9-110 (1962).

55. The Code as adopted by the Uniform Commissioners offers three basic options. One provides that except for fixtures, filing always is with the Secretary of State, the so-called central filing option. The second calls for local filing for consumer goods and farm-connected collateral, and central filing for all other collateral. Here, local filing has usually meant filing at the residence of the debtor. The third option is like the second, except that it provides for local filing plus central filing where the debtor is a business, but only central filing where the debtor has places of business in more than one town or county. In Missouri, the third of these options applies.

56. See note 42 *supra*.

57. Section 400.9-204(3), RSMo 1963 Supp.: "Except as provided in subsection (4) a security agreement may provide that collateral, whenever acquired, shall secure all obligations covered by the security agreement." Subsection (4) refers to crops, and essentially limits the clause to one year.

58. See note 43 *supra*, as to the subsequent additional documentation required under the Factors' Lien Act. Similarly, in those states with the Uniform

time there is an indebtedness to be secured, the later acquired property is immediately subject to the security interest created by the agreement. The interest is intended to prevail against even levying creditors, and relates back to the date of the original agreement.<sup>59</sup> Consequently, that debtors might refuse to make new filings or execute new chattel mortgage agreements or other documentation after acquiring new inventory will no longer be the concern it was under pre-Code law.

Still, however, the debtor will be able in a limited way to thwart the protection intended by the after-acquired clause. First, he may not acquire any subsequent inventory, in which event things may look rather bleak for all parties, and second, he may purchase subsequent inventory subject to a purchase money security interest.<sup>60</sup> The latter of these deserves particular attention.

The Code provision,<sup>61</sup> which allows a supplier of inventory (or for that matter anyone financing the purchase of inventory) to come ahead of a prior secured party whose agreement contains an after-acquired property clause represents a policy decision of some importance. In those jurisdictions which recognized after-acquired property interests, pre-Code law often employed rationale to protect purchase money interests. Since a purchase money interest would usually be expressed in the form of a conditional sale or purchase money chattel mortgage, logic had it that by having acquired the goods subject to the interest, there was either nothing, or a less-than-full ownership interest, to which the after-acquired clause could attach.<sup>62</sup> The policy objective of such reasoning was to help preserve the possibility that other financiers might compete for the debtor's business, or stated conversely, it was a design to prevent the debtor from being tied

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Trust Receipts Act, while no further public notice was necessary, a trust receipt document did have to be executed on the receipt of new units into inventory. §§ 400.9-203(1), 400.9-402, RSMo 1963 Supp.; UNIFORM TRUST RECEIPT ACT §§ 2(1), 7(1)(a), 13(4).

59. §§ 400.9-108, 400.9-312(5)(a), RSMo 1963 Supp. See text under section on UCC in Bankruptcy, *infra*.

60. For an extended discussion of the purchase money security interest, see Hogan, *Financing the Acquisition of New Goods under the Uniform Commercial Code*, 3 B.C. Ind. & Com. L. Rev. 115 (1962).

61. Section 400.9-312, RSMo 1963 Supp. states the priority rules of the Code, and specifically covers the matter of financing the purchase of goods. Section 400.9-312(3), RSMo 1963 Supp. relates to a purchase money interest in inventory, and requires that the interest be perfected at the time the debtor receives the possession of the collateral and that notice must be given to the holder of the conflicting security interest. Noninventory purchase money security interests do not require this notice. See § 400.9-312(4), RSMo 1963 Supp.

62. See, e.g., *Simons v. Lee James Finance Co.*, 56 Wash.2d 234, 351 P.2d 507 (1960) (involving a non-inventory situation).

to a single financier. Recognizing the policy as sound, the drafters of the Code included this limitation on the otherwise broadly validated after-acquired property clause.<sup>63</sup> Since for the second financier to assume a position of priority it is necessary for him to give notice of his intention to make purchase money advances, the first financier can be confident of his priority until such notice is received.<sup>64</sup>

Second of the section 400.9-204 provisions contributing to the effectiveness of the floating lien is contained in subsection 5, which reads that "obligations covered by a security agreement may include future advances or other value whether or not the advances or value are given pursuant to commitment." As with the after-acquired clause, a security interest based on future advances may be subordinated to a conflicting purchase money interest. But the pré-Code restrictions of dollar and time limitations are not carried into the Code, which includes as its sole condition that the security agreement provide for a future advance coverage. The advance in the future has priority, in general, from the date of filing, rather than from the date of advance.

Not least among the Code's sections bearing directly upon characteristics of inventory financing is its provision that a security interest is not impaired legally by permitting the debtor to sell the collateral. The section<sup>65</sup> by which this is accomplished will bring about a major adjustment in Missouri law. True, under the Factors' Lien Act sale was permitted, but the protection of that statute extended only to a limited class of creditors. The Code makes no distinction whether the financing agency is the manufacturer of the supplied inventory, or some third party, such as a bank, factor or other class of creditor. Therefore, the liberalization of section 400.9-205 is as much in the broadened groups of creditors who may

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63. Priorities under the Code is itself a topic meriting separate consideration. For an excellent discussion, see Coogan, *Article 9 of the Uniform Commercial Code: Priorities among Secured Creditors and the "Floating Lien,"* 72 Harv. L. Rev. 838, 861 (1959) for a treatment of purchase money priority.

64. If such a notice is received, and the inventory is of indistinguishable items, it would probably be necessary for one of the financiers to step out, unless the inventory has several distinct lines, one or more of which might be used by the subsequent financier as collateral. However, where the items are individually identifiable, this stepping aside would not be essential, and the financing would be carried on in a manner similar to the procedure common under the Uniform Trust Receipts Act, where that act was effective before the Code.

65. § 400.9-205, RSMo 1963 Supp. See also § 400.9-302, RSMo 1963 Supp., which gives other creditors the opportunity to ascertain from public sources whether property of their debtor is subject to secured claims, and § 400.9-306(4), RSMo 1963 Supp., which enables creditors to claim collections made prior to ten days before an insolvency.

enjoy its advantages as in the substantive shift in legal doctrine that it proclaims.

The goal of section 400.9-205 is to expressly validate the floating lien. It rejects pre-Code restrictions which proceeded from traditional preachings that debtors act like debtors, and creditors see to it that they do. Old alleged inconsistencies imagined in situations of attempting to preserve a security interest against creditors while allowing it to terminate in case of a sale in the ordinary course of business have no place under the Code, which acknowledges that if inventory financing is to have honor in the commercial world, the law must permit a security document to mean different things against different groups—it must permit resale.

Basically, the Code gets at this problem by relaxing the degree of control over the collateral which the creditor must exercise. This becomes a matter of consensual agreement between the parties, and not a matter of legal doctrine. In the language of the section, the parties may agree that the debtor may “use, commingle or dispose of all or part of the collateral (including returned or repossessed goods) or . . . collect or compromise accounts, contract rights or chattel paper, or . . . accept the return of goods or make repossessions, or . . . use, commingle or dispose of proceeds . . .” Nor is the security interest invalid or fraudulent against creditors by reason of the failure to require the debtor to account for proceeds or replace sold inventory. These are all matters on which the parties may bargain, without the risk of invalidating the security interest. As a result, Missouri cases which have required, for example, a remittance of full proceeds of the sale of collateral are overruled and should no longer operate restrictively on inventory financing programs.

The full sweep of section 400.9-205 should be clearly recognized. It goes much further than merely eliminating the prior prevalent rule of proceeds remittance. To appreciate its broad strokes, the reader should go back to *Benedict v. Ratner*,<sup>66</sup> the famous Supreme Court of the United States case involving an interpretation of New York security law, which is the specific target of the Code section. That decision allowed the trustee in bankruptcy to attack an accounts receivable financing program wherein proceeds did not have to be remitted to the creditor; but it has stood as a symbol for equating credit control with legality as well as a symbol for the handling of proceeds.<sup>67</sup> As a business matter, the rule of *Benedict v.*

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66. *Benedict v. Ratner*, 268 U.S. 353 (1925).

67. In referring to the rule that right to dispose without an obligation to apply proceeds renders the security fraudulent and void, the court made its now oft-quoted remark that the rule “rests not upon seeming ownership because of

*Ratner* is very largely honored, but the Code takes the position that the exercise of dominion is not an element which should determine the validity of the security program against other creditors. Consequently, under the Code it will be unimportant, for purposes of determining the validity of the security document, whether returned merchandise is or is not segregated, whether proceeds are commingled, used in part or in full for current operating expenses, whether the debtor may compromise disputed accounts or establish the sale price of pledged articles of inventory, or perform many other normal functions of the type of business in which it is engaged. This is a major achievement in inventory financing.<sup>68</sup>

What happens to proceeds is, of course, a very significant topic. Also important is what rights, if any, the creditor gets in them. The pre-Code rule in Missouri was that a creditor had to look to the personal obligation of the debtor once collateral was sold as authorized in the security document.<sup>69</sup> Even if the agreement provided otherwise, no case ever allowed the priority to date from the original agreement.

This, too, is changed under the Code, for in section 400.9-306(2) it is provided that the security interest "continue" in the proceeds of sold inventory, and to make the point clear subsection (3) states that the interest is a "continuously perfected" interest. "Proceeds" are defined as whatever is received by the debtor in exchange for collateral.<sup>70</sup> The right to proceeds is not automatic, however, and must be claimed either in the original financing statement or in a supplemental filing made within ten days after their receipt.<sup>71</sup> The obvious counselling point in any case of inventory financing is to claim proceeds in the original financing statement. The one major limitation of the section relates to cash proceeds, which are often either deposited in a bank or otherwise commingled with other

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possession retained, but upon a lack of ownership because of dominion reserved. It does not raise a presumption of fraud. It imputes fraud conclusively because of the reservation of dominion inconsistent with the effective disposition of title and creation of a lien." *Id.* at 363.

68. See Spivack, *Financing the Manufacturer: Article 9 of the Uniform Commercial Code*, 48 Ky. L.J. 397 (1960), and SPIVACK, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE, ch. 5 (1963).

69. *Farmers State Bank v. Garrison*, 344 S.W.2d 323, 326 (K.C. Mo. App. 1961). ("By consenting to such a sale and to the collection of the proceeds by the mortgagor, the mortgagee surrenders his lien and looks to the mortgagor personally for the payment of the mortgage debt."); *Morris Plan Co. v. Universal Credit Co.*, 237 Mo. App. 365, 168 S.W.2d 136 (K.C. Ct. App. 1943); *Moffett Bros. & Andrews Comm'n Co. v. Kent*, 5 S.W.2d 395 (1928).

70. "Money, checks and the like are 'cash proceeds.' All other proceeds are 'noncash proceeds.'" § 400.9-306(1), RSMo 1963 Supp.

71. §§ 400.9-306(3), 9-402(2), RSMo 1963 Supp.

cash and checks of the debtor. In the case of insolvency, the creditor is limited to claiming no more than the cash proceeds collected during the ten days preceding the date of insolvency, less any amount actually paid over to the creditor, and subject to the right of set-off by the bank. It is not, however, necessary to be able to trace and identify the proceeds.<sup>72</sup>

While section 400.9-306 provides for shifting the lien from inventory to proceeds, once the inventory is sold the security interest therein terminates, as it should. In this connection, the Code recognizes the concept of split perfection wherein the validity of the security prevails against creditors and the trustee in bankruptcy, but terminates in favor of a purchaser in the ordinary course of business. Notice that the requirement of the Code is couched in terms of an ordinary course purchaser, and not a bona fide buyer. Lack of knowledge of the security interest is not important, for the policy position is to protect the finality of the transaction contemplated by the financing program. There may be some question as to what constitutes a purchase in the ordinary course,<sup>73</sup> but there is no question that such a purchase is free from the attack of the inventory financier.<sup>74</sup>

### B. *Conflicts with the Bankruptcy Act*

Certain of the Code concepts are sure to be challenged in bankruptcy cases, with consequences yet to be determined. Primarily two areas, after-acquired property and proceeds, will be the center of any conflict which courts may find between the two pertinent laws.

The problem of competition between federal bankruptcy and state security laws is not new; it has existed under pre-Code security legislation, due primarily to a lack of coordination between the Bankruptcy Act and whatever statute may have been involved. It derives from the Bankruptcy Act's extension of authority to the trustee to set aside a transfer of the bankrupt's property made or suffered by the bankrupt, while insolvent and within four months of the filing of a petition in bankruptcy, to

72. § 400.9-306(4), RSMo 1963 Supp.

73. See note 13 *supra*. Sales may be made to relatives, or at excessively low prices to move goods when on the brink of bankruptcy, or to other dealers. Whether such sales are in the ordinary course of business may be questioned, as they have been under the Uniform Trust Receipt Act. *Commercial Credit Corp. v. General Contract Corp.*, 233 Miss. 774, 79 So.2d 257 (1955) (dealer took car in trade from dealer); *State Sav. Bank v. Universal Credit Corp.*, 233 Iowa 247, 8 N.W.2d 719 (1953) (employee of dealer).

74. *Sterling Acceptance Co. v. Grimes*, 194 Pa. Super. 332, 168 A.2d 600 (1961). This case, in holding that the UCC protects the buyer in ordinary course, discusses the coordination of the UCC with automobile certificate of title legislation. For treatment of this subject under Missouri law see the article of this symposium on notice and recordation.

a creditor for or on account of an antecedent debt.<sup>75</sup> This is the voidable preference definition.

As applied to the situation of after-acquired property, the Code has attempted to avoid the problem by providing<sup>76</sup> that the security interest in subsequently acquired goods will "be deemed"<sup>77</sup> to have been given for value. The objective of the section is to eliminate the element of an antecedent debt, without which there cannot be a voidable preference under the Bankruptcy Act.<sup>78</sup> It is a question of federal law whether this provision of the Code will be determined to be in conflict with the policy of the Bankruptcy Act. If the response is affirmative, the resolution is required to be in favor of the Bankruptcy Act.<sup>79</sup>

In support of the Code, it should be observed that the object of the Bankruptcy Act's preference provision is to prevent a depletion of assets by a transferring of them to preferred creditors on the eve of bankruptcy. As applied in the context of inventory financing, this policy is not transgressed, for the purpose of the Code's provision is to allow a substitution of new inventory for that which has been sold, to the end that the creditor's collateral security is retained at a relatively constant level, rather than improved by an attempted preferential transfer. A search for supporting rationale suggests the argument that the debtor be regarded as transferring<sup>80</sup> his interest at the time of executing the agreement, even though

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75. Bankruptcy Act § 60a(1), 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(1) (1952).

76. § 400.9-108, RSMo 1963 Supp.: "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."

77. Similar language appears in the Factors' Lien Act, where the act says that the "lien shall be valid from the time of recording . . ." § 430.270(2), RSMo 1959.

78. See also § 400.9-204, RSMo 1963 Supp., and official comment that a "security agreement may be executed and value given before the debtor acquires rights: the security interest will then attach under subsection (1), as to after-acquired property when he does." Comment 4 to UCC § 9-204 (1962).

79. *Moore v. Bay*, 284 U.S. 4 (1931).

80. The Bankruptcy Act, § 60a(2), 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(2) (1952), provides that a transfer made on a given date will be deemed to have taken place on some other date, if such other date is the time at which it has been so far perfected that it would have been effective against a creditor acquiring a lien by equitable or legal proceedings on a simple contract. This hypothetical creditor test should be no obstacle to the after-acquired property situation under the Code, where at the time of entering the security agreement the necessary acts for perfection have been taken.

at that time there is no property to which the security interest may attach. Nevertheless, this is the time when the debtor alienates his rights and does everything necessary for purposes of creating the security interest, except that he does not then have the collateral. If he has availed himself of every means of perfecting the legal lien, the declared policy of the Bankruptcy Act, to the effect that equitable liens shall not be recognized "where available means of perfecting legal liens have not been employed"<sup>81</sup> is in fact satisfied. And for purposes of reconciling the objectives and policies of the respective statutes, this concept of a present transfer of a future interest might well be urged.<sup>82</sup>

The Code objective fortunately has withstood the first major test of a bankruptcy litigation,<sup>83</sup> though several commentators have expressed doubt<sup>84</sup> or the belief that such would not be the case.<sup>85</sup> In case of doubt, a lawyer's only choice in advising a client who wishes to avoid all risks is to make sure that his client makes no advance which is not coincident in time with the acquisition of new stock sufficient in value to cover the advance.

The problem with regard to proceeds is again one of reconciling the policies of the Code and the Bankruptcy Act. The Code provides that the security interest in proceeds is a continuously perfected interest. As to non-identifiable<sup>86</sup> cash proceeds, the secured party's continuing security is in the debtor's cash and bank accounts in an amount equal to the cash proceeds received and commingled or deposited within ten days before institution of insolvency proceedings, less the amount of proceeds paid over during that time.<sup>87</sup> Though the designation of the right as continuous might be deemed arbitrary, the better view would be that since the claim

81. Bankruptcy Act § 60a(6), 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(6) (1952).

82. Howarth v. Universal C.I.T. Cred. Corp., 203 F. Supp. 279 (W.D. Pa. 1962). Cf. *In re Comet Textile Co.*, 15 F. Supp. 963 (S.D. N.Y. 1936), *aff'd*, 91 F.2d 1008 (2d cir. 1937) (involving Factor's Lien Act).

83. Howarth v. Universal C.I.T. Cred. Corp., *supra* note 82.

84. See, e.g., Kupfer, *Accounts Receivable, Trust Receipt, and Related Types of Financing under Article 9 of the Uniform Commercial Code*, 27 Temp. L. Q. 278 (1954); Friedman, *The Bankruptcy Preference Challenge to After-Acquired Property Clauses under the Code*, 108 U. PA. L. REV. 194 (1959).

85. Gordon, *The Security Interest in Inventory under Article 9 of the Uniform Commercial Code and the Preference Problem*, 62 Colum. L. Rev. 49, 71 (1962): "The policy of section 60 is also clear, and therefore any attempt to treat an equitable lien on goods to be acquired in the future as a 'transfer of the property of the debtor' would be doomed to failure."

86. The problem is not as acute with identifiable proceeds, for even the common law did not demur to a creditor's tracing proceeds of an out-of-security sale.

87. § 400.9-306(4)(d)(ii), RSMo 1963 Supp.



to the cash funds and bank accounts is limited to the value of the cash received it is substitutionary, and not a transfer for an antecedent debt, notwithstanding that the interest provided for is intended to attach to assets, whether or not they were themselves proceeds of the disposed collateral. Perhaps it might also be argued that the release of the chattel security through the authorized sale constitutes the giving of new value.<sup>88</sup> The same case which has upheld the after-acquired property provision of the Code has also upheld the Code proceeds section against attack under the Bankruptcy Act, although it took care to state that the secured creditor is only entitled to commingled cash when it is received as proceeds of collateral within ten days of the filing of the petition in bankruptcy.<sup>89</sup>

#### IV. CONCLUSION

In states where the Code has been existing for long enough to discern its effect, it is working well. Shortly after its promulgation by the Uniform Commissioners, there arose a number of criticisms, including the assertion that the secured creditor is favored to the detriment of the unsecured. This is not borne out by cases. The Code is not that revolutionary a document. Lengthy and complex as it is, for most of its pronouncements there is a pre-Code counterpart. The outstanding contribution of the Code is that it attempts to bring order to a hodgepodge of confusing and confounding legislation and decisions. To the extent that the preceding resume of the Code's effect on inventory financing is helpful to lawyers of yet another adopting jurisdiction, these pages will have been well-spent.

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88. The same problem existed under the Uniform Trust Receipt Act, and the writer has elsewhere treated this topic in full with a comparison to the Code. See Duesenberg, *Lien or Priority under Section 10, Uniform Trust Receipt Act*, 2 B. C. IND. & COM. L. REV. 73 (1960).

89. Howarth v. Universal C.I.T. Cred. Corp., *supra* note 82.