Reduction of Lending Risks in Inventory Financing

John H. Stroh
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I. INTRODUCTION

One of the purposes behind the enactment of Article 9 of the Uniform Commercial Code was to place the law of commercial security into such a form that the commercial lender could reach his business decisions on a basis of his business judgment rather than on the inexorable dictates of the law. In a way commercial leaders were in the same position as a business man contemplating a proposed transaction and the Federal income tax; in both cases, the tail wagged the dog; in one, it still does. One of the results obtained from the enactment of Article 9 was that the barriers, imposed mainly by the technicalities and queer twists of pre-Code law, which held back many inexperienced lenders and their counsel from engaging in inventory and accounts receivable financing, were removed. Inventory and "proceeds" financing in pre-Code days was a hard school, and its practitioners acquired an experience which stood them in good stead and which still has great carry-over value. One purpose of this article is to provide a cautionary note to the general practitioner who is asked to give an opinion on a plan of financing on the security of inventory. A slight knowledge of the basic Article 9 concepts, as well as general knowledge of the Bankruptcy Act, is presupposed.

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1. There are marked similarities between inventory and "proceeds" financing. Both represent collateral in economic motion, and their use as collateral may subject the lender to the same risks. Many lenders finance on both inventory and proceeds collateral of the same borrower, since financing on the latter is a logical extension of financing on inventory. On the whole, proceeds are probably more desirable as collateral, whether they be receivables, chattel paper, or whatever. Self-liquidating, they do not take on the label of distress merchandise with a consequent fall in value if the lender is forced to look to the collateral for satisfaction of the debt.

2. "It is . . . possible, however, that lenders—let us say 'country banks'—who do not have the painfully acquired expertise of the specialists will be tempted to take advantage of the Code's lowering of barriers." Gilmore, *The Assignee of Contract Rights and His Precarious Security*, 74 YALE L. J. 217, 219 (1964).
Under pre-Code law, it was perfectly possible for a lender to finance on the security of a borrower's inventory from raw material through work in process and finished goods to the proceeds. It was, however, extremely technical, somewhat expensive, required the use of several types of security devices, and involved a good deal of paper shuffling, all merely to keep the arrangement in the framework tolerated by the law. Article 9 changed all of this. The diverse catalog of security interests-mortgages, field warehouse receipts, trust receipts, factor's liens and so on, each with its own formalities and inconsistencies—was eliminated, and in its place was substituted the single or unitary concept of a security interest. And the lender, if he so chooses, may, once his security agreement is executed and his financing statement filed, do no more, but sit back and reflect upon the law which renders legally adequate that which would have been unviable in Missouri prior to July 1, 1965.

Although the security interest may be conceptually unitary, practice, as always, may make it something else. There is wide latitude for variation of practice allowable under Article 9, and this variation may have a substantial effect on the rights and duties of lenders, borrowers and third parties. Those reasons calling for a lender to use pre-Code practices resembling those used in trust receipt financing in one situation, a field warehouse operation in another, and factors lien financing in a third, can be

3. "The essential purpose of Article 9 was to bring to an end the long period of fragmentation of personal property security law." Gilmore, supra note 2, at 227.

4. For example, something known as a "trust receipt" was upheld in Missouri as a "bailment for sale," or consignment, typically a seller's title retention device, which did not have to be recorded. In the situs of the origin of the trust receipt, the Eastern seaboard, and under the Uniform Trust Receipts Act (UTRA), however, it was a third party lending device unavailable to a seller. See, Globe Sec. Co. v. Gardner Motor Co., 337 Mo. 177, 85 S.W.2d 561 (1935), and Commercial Credit Co. v. Interstate Sec. Co., 197 S.W.2d 1000 (K.C. Mo. App. 1946).

Under the Code, if the parties "intend" a security transaction it falls under Article 9 by virtue of § 400.9-102(3), RSMo 1963 Supp. even though it is, in form, a "consignment." A true consignment may in any event be subject to Article 9 filing rules if the consignor wants to hold off the consignee's creditors.

Caveat: "It is the whole matter floats nebulously in that fog 'the intent of the parties' out of which courts are so apt to evoke what they most want." L. Hand, J., In re German Publication Soc'y, 289 Fed. 509, 510 (S.D.N.Y. 1922).

Hereinafter, citations to the Uniform Commercial Code as enacted in Missouri (ch. 400, RSMo 1963 Supp.) will be made without the reference to the revised statutes, e.g. § 9-201. Citations to the Uniform Commercial Code, 1962 Official Text with Comments, published by The American Law Institute and the National Conference of Commissioners on Uniform State Laws, will be made in the following form: UCC § 9-201 (1962).

For general reference to pre-Code security law, see, Dusenberg, Financing Inventory Under the Uniform Commercial Code: A Resumé for Missouri Lawyers, 29 Mo. L. Rev. 462 (1964).
best expressed by the phrase “reduction of lending risks.” Less cryptically stated, there is a world of difference between the minimum of care allowable under the Code and that which the prudent lender may feel called upon to do in a given situation.

II. Basics

A security interest is nothing but an interest in someone else’s property to secure performance of an obligation.5 It matters not how it was created, by a written security agreement transferring some intangible rights, or by an oral security agreement evidenced by a transfer of possession; the rights and duties of the lender and borrower to each other and the collateral are much the same.6 The key for solution of the problems raised by the risks of lending, which in the main are third party problems, lies not in the means of creation of the security interest, but, primarily, in the means by which the security interest is perfected.

“Attachment” initiates the relationship of the lender and borrower to the specific item of property serving as collateral. This article will define “perfection” as the status of the property with regard to certain third persons who seek to assert claims to it, and will define “priority” as the relationship to the property and to each other of secured lenders, other creditors, and purchasers claiming an interest in it. It is essential that counsel distinguish between the concepts of perfection and priority in order to gain any perspective of Article 9 other than that of a hodge-podge of rules to be learned by rote.

“Perfection” means immunization of the security interest from attacks made by persons having no previous contractual or property rights in the collateral: primarily, lien creditors. No security interest can be perfected until it has attached and the lender has either taken possession of the collateral or filed a financing statement. Once the three-step attachment process plus the additional step of possession or filing has been made, no matter what their order, the security interest is perfected.8 Perfection is selective; a perfected security interest may be protection against the attack

5. § 1-201(37).
6. See generally Article 9, parts 2 and 5.
7. § 9-204(1). A security interest may not attach until there is an “agreement” that it attach (not necessarily a “contract”), the lender has given “value,” and the borrower has “rights” in the collateral. The reader is constantly admonished to refer to § 1-201 for definitions.
8. § 9-303(1).
of lien creditors, yet at the same time may be no protection against other persons attempting to reach the collateral, such as a buyer.

III. Notice As Perfection

Perfection, under prior law, was attained by foreclosing two avenues of lienor attack against the collateral. If the collateral were inventory, a lien creditor seeking to reach it could assert that it was "fraudulent" on the basis of (a) the ostensible ownership of the mortgagor, if the mortgage or other security device were unrecorded, or (b) the lack of the mortgagee's dominion, if the mortgagor had the power to deal freely with the collateral and its proceeds.

By its very nature, perfection through recording insured that a mortgage would be perfected against the attacks of creditors only some time after it was executed. Since the document itself was recorded or filed, there was always a lapse of time between execution and recording, a gap in which trouble could occur. Missouri law provided that if the mortgage were recorded within a reasonable time after its execution, the time of recording related back to the time of execution. If recording was not done in a reasonable time, this benefit did not obtain; there was a "fraud" committed against anyone who became a creditor in the gap because he had been misled by the apparent affluence of the mortgagor. Perfection dated only from the time of recording. If there were no time gaps, the lien creditor could not prevail, so it was easy to see that the lien creditor's assault would be made upon the "reasonableness" of the time in which the mortgage was recorded. Under state law, this was not necessarily dangerous. The "gap creditor," for example, the stationer who delivered five dollars' worth of rubber bands and paper clips while the mortgage was unrecorded, could sue to judgment and levy on the collateral after recording. But the mortgagee himself, if he had to, could satisfy the lienor's claim and save his mortgage, and even if he did not, the judgment creditor could levy on only enough of the collateral to satisfy the debt. In bankruptcy, however, the result was more dangerous. The trustee acquires, under section 70(e) of the Bankruptcy Act, the rights

9. § 9-301(1)(b).
10. §§ 9-307(1), 9-301(1)(c).
11. Barton v. Sitlington, 128 Mo. 164, 30 S.W. 514 (1895); United States Hoffman Mach. Corp. v. Lauchli, 150 Fed.2d 301 (8th Cir. 1945), and cases cited therein.
13. See, Mercantile Trust Co. v. Kahn, 203 F.2d 449 (8th Cir. 1953).
of any existing creditor, and under bankruptcy doctrine the trustee expands the "gap creditor's" claim for five dollars to take up the entire value of the mortgaged collateral. Astonishingly, under state law if the mortgagee took possession under a late recorded mortgage before the "gap creditor's" levy, he would win; needless to say, this did not work out the same way in bankruptcy.

Under the Code, recording is eliminated, and notice filing, a concept borrowed from the Uniform Trust Receipts Act, substituted. Instead of filing or recording the mortgage itself, a simple notice, signed by both the borrower and lender, is filed. This gives public notice that the latter is financing the borrower on the security of certain collateral described in either specific or general terms in the notice or "financing statement." It may include more than one type of collateral, such as inventory, proceeds and equipment, and may cover after-acquired property; it also serves to perfect any security interest arising to secure advances made in the future. The third party examining the records is put on notice that some of the borrower's property may not be free from encumbrance. If he has a legitimate interest, it is up to him to inquire of the borrower or the lender to ascertain the details, although a financing statement covering,

all inventory of sugar, including raw sugar, sugar in refining process,
and finished or refined sugar, whenever acquired, all proceeds of the sales of sugar, and sugar refining equipment

could hardly be any clearer and could hardly tie up the borrower's chattel property more effectively under the priority rules.

14. 11 U.S.C. § 110(e)(1) (1958); by virtue of § 70(c), 11 U.S.C. § 110(c) (1958), the trustee acquires the rights of a hypothetical creditor who, under state law, makes a general levy on the bankrupt's property on the date of bankruptcy; and through § 67(a), 11 U.S.C. § 107(a) (1958), the trustee takes over lien rights of certain creditors who have made their levies within four months.


17. The trustee, even if he had no chance to reach the collateral under §§ 70(c) or (e), could possibly reach it as the subject of a preferential transfer under § 60(b), 11 U.S.C. § 96(b) (1958). If the mortgagee recorded at any time before a levy made by one who was a creditor prior to the mortgage, the mortgage was valid against the levy. Rock Island Nat'l Bank v. Powers, 134 Mo. 432, 34 S.W. 869 (1896).

18. This was never enacted in Missouri, although the Factors Lien Act §§ 430.260-320, RSMo 1959 (repealed) also provided for "notice" filing.

19. § 9-110.
The requirements set out in the Code for execution of an effective financing statement are both simple and explicit. They are the subject of much literature, and nothing need be added here except the admonition that the prudent lender should hew close to the line; there have been some rather harsh and mechanistic opinions regarding failure to comply with the rules, and bona fide efforts to comply have not been good enough. The end result is substantially the same as under pre-Code law, except that the result is reached by dealing with the matter as a question of priority of claims rather than of fraud. There is no perfection and the security is vulnerable to any lien creditor without knowledge of the security interest. Lender's counsel should be extremely careful not to allow himself to be jollied or browbeaten by lender's sales manager or loan manager into allowing field men to cut corners so as not to clog or delay sales or making loans. It is generally not the manager who has to explain what happened when a security interest goes sour.

Because the financing statement is separate from the security agree-

20. The required contents of financing statements are set out at § 9-402. The Missouri Secretary of State's Office has prepared a pamphlet in which approved forms are set out and filing instructions given. Uniform Commercial Code Manual (1965).

21. In re Kane, 55 Berks County L.J. 1, 7, 10 (E.D. Pa. 1962), held a photographic copy of a properly signed financing statement was not a signed financing statement. The 1965 Missouri legislature remedied this by amending § 9-402. S.B. No. 241, § 1, Laws 1965. In the Matter of Leiby, 58 Lanc. L.R. 39 (E.D. Pa. 1962), held that the nature of the collateral controls the place of filing. In Cain v. Country Club Delicatessen, 25 Conn. Supp. 327, 203 A.2d 441 (1964), a conditional seller and buyer in their contract provided that what would otherwise have been a fixture was to remain personal property. The seller filed a financing statement locally, the proper place for fixtures, but not centrally. Filing did not perfect. The seller should have filed as though the security interest was in personal property. (Where would a creditor have looked to check liens on the borrower's equipment?) In the Matter of Smith, 205 F. Supp. 27 (E.D. Pa. 1962), "substantial compliance" was not found where borrower's address was omitted from financing statement.

22. See § 9-401(2).

23. § 9-301(1)(b). Under prior law, the levying creditor's knowledge of the security interest was irrelevant. See § 443.460, RSMo 1959 (repealed); Bevans v. Bolton, 31 Mo. 437 (1862). Failure to record was a "fraud in law." The Code has not repealed the Missouri statutes relating to fraudulent conveyances, §§ 428.010-.110, RSMo 1959, but as a statute enacted later in time, the Code should control in case of conflict.

24. The views of a financing seller toward his credit transactions may vary widely from those of a third party lender. Although he may derive some revenue from financing charges (we are not speaking of consumer financing), the seller's prime source of revenue is the sale, or the manufacture and sale, of his goods. Accordingly, he is sales oriented and does not think himself a lender as such, and he may legitimately determine that his best interests lie in keeping open the greatest number of outlets through which his goods pass to the buying public.
ment, it can be filed before execution of the agreement, insuring that the security interest is perfected when it is created. It was the intent of the drafters that the notice would warn off other lenders, allowing the borrower and the lender to complete their arrangements in peace. But, if the financing statement is filed after creation of the security interest, there is no relation-back to give protection from the lien of any creditor without knowledge which reaches the collateral before filing: his claim is prior to that of the lender. Only in the special case of purchase money financing is there any relation-back, or rather escalation of priority, to cut off the intervening lien creditor. The rule is simple: except in the special case of the purchase money lender who must perfect by filing within ten days to gain a priority over intervening lienors, perfection of the inventory security interest, or invulnerability to liens, dates from and after the date of filing. The former exception made for the “gap creditor” is eliminated; if he levies with knowledge of the security interest or after the financing statement is filed, his lien is subordinated to the security interest. The “gap lienor” is substituted. The question of fraud is eliminated as well. In bankruptcy, the Code lender is given twenty-one days to file before the trustee may attack the security interest under section 60 as a preference.

To do this, he may sell, for credit, to dubious risks or eliminate the use of risk foreclosure procedures available to him, even though it means that he will be faced with credit losses that he could otherwise have avoided. On the other hand the third party lender generates his revenue on loan interest and other charges. Although he must maintain a volume of loans to operate at a profit, he may be far more concerned with reduction of risks and the safety of his loan, even though, by his insistence on the adoption of risk reduction procedures, he may not make as many loans as he might otherwise do. The money which he loans is money which he, himself, has borrowed or has received from depositors, and he must eventually repay it.

26. § 9-301(1)(b).
27. § 9-301(2).
28. The drafters of Article 9 have removed the label of “fraud” from failure to file by providing that unperfected security interests are “subordinate” (not void or voidable) to the rights of the lien creditor without knowledge who levies before the security interest is perfected. No provision is made for the “misled” gap creditor; he must levy before perfection of the security interest or his lien is subordinate to the security interest.
29. Under § 60(a)(7)(I), 11 U.S.C. § 96(a)(7)(I)(1958), if state law provides that a lender must file (or record) within a certain time limit, up to a twenty-one day maximum, to perfect, and the lender does so, the transfer is deemed to have been made at the time of the actual transfer; if no time limit is specified, the lender is given twenty-one days to perfect. If he perfects after the twenty-one day period, the transfer is deemed to have taken place at the time of perfection. See, Corn Exch. Nat'l Bank & Trust Co. v. Klauder, 318 U.S. 434 (1943).
filing is made during that period, the trustee cannot view the transaction as a preferential transfer made within four months of bankruptcy, so there is a "relation-back" of perfection in bankruptcy. Under sections 70(c) and 70(e), the trustee can reach the collateral only if the security interest is unperfected on the day of bankruptcy or if there was some actual creditor who could have reached it. With the elimination of the "gap creditor" by the Code, much of the sting was taken out of section 70(e).

Inasmuch as the object of carrying an inventory is to ultimately sell it, a buyer in the ordinary course of business takes his purchase from the borrower free and clear of the lender's security interest. He, in effect, has priority over the lender, who cannot perfect a security interest in inventory against such a buyer, even though the latter has actual knowledge of the security. This is merely a continuation of the doctrine running through the Code rendering sales by a merchant in the ordinary course of his trade virtually unassailable. In other words, the law merchant doctrine of inviolability of sale is favored over the common law doctrine.

The twenty-one day time limit is not the time in which a lender must perfect to receive the benefits of relation-back under state law; it is the time in which a lender must perfect to avoid the effect of a subsequent levy. There are no "gap" creditors under the Code. Every Code lender is subject to, and protected by, this twenty-one day limit, even the purchase money lender who is given a special ten day grace period for filing. The ten day limit does not impose any penalty on the purchase money lender; he still has twenty-one days in which to file before he encounters preference problems. When any Code lender perfects his security interest, he is safe from subsequent levy. If he happens to occupy the special status of a purchase money lender, and if he perfects by filing within ten days after his borrower takes possession, he receives priority over the claim of an intervening lienor. If he perfects after ten days, he loses his chance for priority status against intervening lienors, but his perfection is still good against any subsequent lienors. This is really, then, a situation of filing to achieve perfection, but doing something else, in addition, to achieve a special priority status. And under § 60, perfection, not priority, controls. See, the statement of Peter Coogan, Symposium—A Practical Approach to the Uniform Commercial Code for the Practicing Lawyer, 19 Bus. Law. 5, 29-30 (1963).

31. § 9-307(1). The "buyer in the ordinary course of business," although nothing but a special case of common law tort-feasor, is given preferred treatment throughout the Code. See § 1-201(9).
32. If, however, the buyer knows that a sale to him by a borrower is a violation of the security agreement, he no longer occupies his special priority status as a buyer in the ordinary course of business, § 1-201(9), and he can no longer cut off the lender's rights. Regardless of any prohibition against it in the security agreement, the borrower may always transfer his "equity" in the collateral, § 9-311, but, in turn, the lender may provide in the agreement that such a transfer will constitute a default. Prohibitions against transfer—at least absolute prohibitions against transfer—when the collateral is inventory, would undoubtedly be stricken by the courts.
of inviolability of title, thus completing the trend fostered by the growth of commerce through the centuries. Even so, the lender, however, receives more than he did prior to passage of the Code.\(^{33}\) If the security agreement covers "proceeds,"\(^ {34}\) they are automatically transferred to him as security, without separate assignments, and the same financing statement that perfected his security interest in the inventory can perfect his interest in the proceeds.\(^ {35}\)

IV. Possession As Protection

As under pre-Code law, perfection of a security interest may also be obtained by taking possession of the collateral,\(^ {36}\) or more properly, by denying possession of the collateral to the borrower.\(^ {37}\) Denial of possession to the borrower served two purposes in the eyes of the pre-Code law: (1) he was deprived of the apparent affluence to deceive general creditors who might advance funds on the strength of his inventory and then, on levy, be unable to reach it because title was outstanding in another, and (2) he was deprived of the power to deal with the property as though it were his own, which power was, according to the courts, inconsistent with the existence of a security interest and vitiated the mortgage on the grounds of fraud. A lien creditor could levy on the inventory successfully even though the chattel mortgagee had recorded, if the mortgagor had power to deal with the goods.\(^ {38}\) If the lender or someone else for him had possession

\(^{33}\) By consenting to the sale of the collateral and the collection of the proceeds by the mortgagor, the mortgagee was held to look personally to the mortgagor for the payment of the debt and to surrender the lien. Morris Plan Co. v. Universal Credit Corp., 237 Mo. App. 365, 168 S.W.2d 136 (K.C. Ct. App. 1943). Usually, in the situations in which the question arose, the mortgagor was insolvent in both the equity and the bankruptcy meaning of the word.

\(^{34}\) "Proceeds" may include both "cash" and "non-cash" proceeds. § 9-306(1) and (2).

\(^{35}\) Filing alone may not protect the lender on chattel paper. He may either have to take possession, or at least make his interest known by marking the actual instrument itself, often with a rubber stamp. This itself may be inadequate if the proceeds are claimed under § 9-306(3) as proceeds of the sale of collateral subject to a perfected security interest. § 9-308.

\(^{36}\) §§ 9-302(1) (a), 9-305.


\(^{38}\) In Missouri, as opposed to, say, New York, the rule was much less rigorously applied; the lender must have consciously allowed the borrower to sell the collateral and dispose of the proceeds. Compare Brooks v. Wimer, 20 Mo. 503 (1855), with Lee v. State Bank & Trust Co., 54 F.2d 518 (2d Cir. 1931).
though, that was another story. And under the Code, the lender who perfects by possession still foils the lien creditor.

The oldest security interest known is possessory (probably the pledge or pawn or something very similar), and in the days prior to the Code the pledge was the safest security interest a lender could use. Although by no means invulnerable to attack, so long as the lender held his possession, he had only to fear three things: defects in the underlying obligation, such as a usurious note\(^39\) or lack of proper execution of the agreement;\(^40\) defects in the collateral, that is, "quasi-contraband"\(^41\) or loss of value in a declining market; and defects in the pledgor’s ownership, usually some pre-existing claim of a third party which cannot be cut off by the pledge. These, however, were and are the ills to which all security interests are subject. There was one joker in the deck: the pledgor could not have possession if there was to be a pledge. And if he did not have possession, how could he sell? Possession, when held by the lender, could be an onerous burden for him, too.

Because of the physical limitations of bank vaults, which are fine for holding jewelry, watch movements and securities, lenders turned to commercial warehouses to hold possession of boat loads of raw sugar, car loads of air conditioners and bags of cement.\(^42\) Commercial warehouse space is costly, however, and many borrowers objected to meeting this cost when they, themselves, had available storage space on their own premises. To meet this demand, the commercial warehousemen established warehouses away from their regular premises in the "field," and field warehousing was begun. The field warehouseman simply establishes a regular warehouse on the borrower’s premises. He is a licensed public warehouseman,\(^43\) and he leases warehouse space from the borrower, receives goods for storage and issues warehouse receipts.

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39. Usury, small loan legislation, and retail installment sales acts are not repealed by the Code, § 9-201.

40. Unfortunately for the unwary, the Code does not eliminate all of the traps of the common law. Delivery of a writing may be conditional; if a condition precedent to the formation of a contract is unfulfilled, there is no contract. See Kelley v. Illinois Cent. R.R., 352 Mo. 301, 177 S.W.2d 435 (1943).

41. The prime example of "quasi-contraband" is liquor. Many states strenuously regulate the amount and duration of loans between liquor "manufacturers," wholesalers and retailers.

42. Generally, reference is made to Article 7, §§ 7-101-603 for the ground rules for documents of title. See Stroh, Documents of Title, 30 Mo. L. Rev. 300 (1965).

43. Formerly, it was important that warehouse receipts be issued by "warehousemen." See National Bank of Commerce v. Flanagan Mills & Elevator Co.,
Both commercial and field warehousemen are subject to Article 7 of the Code, and their receipts have the status of documents of title: they are commercially valuable, and the holder of a warehouse receipt has, generally, good collateral for a loan. Practice generally varies between the commercial warehouseman and the field warehouseman. The borrower, if he uses commercial warehouse facilities, makes the bailment himself, takes the receipt, and pledges it to the lender. The lender then makes his loan on the collateral of the receipt itself. On the other hand, the field warehouseman, by prearrangement, receives the goods from the borrower and issues non-negotiable receipts directly to the lender. Because of the characteristics of non-negotiable warehouse receipts and the pre-arrangement, the field warehouseman is less an independent bailee, and more an agent who holds possession for the lender. But he cannot escape his obligations on the warehouse receipts.

If a warehouseman does not deliver the warehoused goods to the receipt holder, if he cannot deliver because the goods are missing, or if he cannot deliver the goods described in the receipt, he is subject to suit. Since he is normally both solvent and bonded, he may be in the eyes of the lender-receipt holder a far more satisfactory person to sue than the insolvent borrower who actually caused the trouble by misdescribing the goods to the warehouseman. In addition, the warehouseman’s possession is akin to a pledgee’s for audit purposes. Each receipt must state the quantity of goods stored under it. The lender can make a “paper audit” of his collateral without sending one of his field men to the borrower’s premises to make a full physical inventory every month, by using this information.

268 Mo. 547, 188 S.W. 117 (En Banc 1916). Otherwise the receipts may not be “warehouse receipts.” Compare §§ 406.010(13), 405.020, 405.200, RSMo 1959 (repealed), with §§ 7-102(1)(h), 7-201, 7-401(d).

44. See Braucher, Documents of Title, UNIFORM COMMERCIAL CODE HANDBOOK, No. 4 (1958).

45. There is very little literature on field warehousing in the journals. See Friedman, Field Warehousing, 42 COLUM. L. REV. 991 (1942). Practice has changed. See also, Funk, Secured Borrowing by Small Business, 13 BUS. LAW. 335 (1958).

46. Under the Warehouse Receipts Act, ch. 406, RSMo 1959 (repealed) and under Article 7 of the Code, the person who deals with negotiable receipts deals with the documents themselves as things of value, for they stand in place of the goods. To a much less degree is this true of non-negotiable warehouse receipts; for example, to effect a complete transfer of the goods, the bailee who has issued a non-negotiable warehouse receipt must be notified of the transfer, and to procure delivery of the goods from the bailee the receipt need not be surrendered.

47. §§ 7-403, 1-106(2), 1-103 when taken together provide for a suit for mis-delivery.
and deducting authorized withdrawals. Common prudence would dictate, however, that the contents of containers, whether they be oil tanks or cartons of canned goods, be spot-checked on occasion. Finally, a warehouseman is bound to hold the goods until the warehouse receipts, if they are negotiable, are surrendered to him, or until he receives written instructions to deliver, if they are non-negotiable. If the warehouseman is competent, the borrower cannot liquidate his inventory without the lender's knowledge.48

One of the often repeated dicta in the field warehousing business is that the warehouseman must maintain open, notorious, and continual possession of the collateral.49 The presence of the warehouseman on the borrower's premises must be open and notorious, but it was never quite true that the warehouseman had to hold continual possession in the sense that it had to be tightly held with both hands.50 Possession, as every first-year law student learns to his chagrin, means a variety of things. Since Article 9 does not purport to change the law of pledge, at least so far as the quantum of possession required for perfection is concerned, pre-Code law is, presumably still valid.51 And in the law, possession, like a woman, can be a sometimes thing.

V. THE LENDER'S DOMINION AND QUALIFIED POSSESSION

Prior to the Code, there was no such thing in Missouri, or most other states, as a safe, non-possessory security interest on inventory without the lender exercising such control over the borrower's operation to be tantamount to possession. The reason for this was the lack of

48. Section 7-403(4) defines a "person entitled [to delivery] under the document" as a "holder," if negotiable, and if non-negotiable, as "a person to whom delivery is to be made by the terms" of a non-negotiable document or "pursuant to written instructions."

49. Security Warehousing Co. v. Hand, 206 U.S. 415 (1907); Heffron v. Bank of America, 113 F.2d 239 (9th Cir. 1940).

50. See Bostian v. Park Nat'l Bank, 226 F.2d 753 (8th Cir. 1955); Proctor v. Shotwell, 105 Mo. App. 177, 79 S.W. 728 (K.C. Ct. App. 1904). Where the borrower had a right of access to warehoused grain to stir it and inspect it, the court held that it could not be said as a matter of law that the warehouseman did not have possession. Grand Ave. Bank v. St. Louis Union Trust Co., 135 Mo. App. 366, 115 S.W. 1071 (St. L. Ct. App. 1909). There is "a need in commercial affairs for less onerous conditions regarding change and retention of possession in cases of pledge than was extracted formerly." Id. at 375, 115 S.W. at 1073.

dominion rule or the rule of Benedict v. Ratner,\textsuperscript{52} which, simply stated, forced the chattel mortgage lender to demand and receive an accounting for proceeds of sale periodically, often daily, to take control of returned goods, to have veto power over compromising accounts, and generally to deny the borrower the right to deal with his inventory as though it were his own.\textsuperscript{53} The rule was an old one,\textsuperscript{54} and, had the courts applied it with a little more finesse, it would have been a good one to deal with actual attempts by a borrower to screen his property from his creditors—true fraudulent conveyances. As it was, it served to disrupt commerce substantially, for the presumption of fraud was conclusive, and since the rule could also apply to corporate debt financing, it managed to unnerve people who dealt in securities. But in any event, if the lender did not exercise this control, or "police" the loan, his security interest could be attacked by a lien creditor or his surrogate, the trustee in bankruptcy, on the grounds that it was conclusively fraudulent. A firmly held possessory security interest, although subject to the same rule, was safe from its application.\textsuperscript{55}

Section 9-205 of the Code eliminated the lack of dominion rule by providing that a "security interest is not invalid or fraudulent" because of the freedom of the borrower to deal with the goods as though they were his own or because of "the failure of the secured party to account for proceeds or replace collateral." This benefit was reserved only to those lenders who file a financing statement, for the requirement of possession is not relaxed if perfection of the security interest depends upon possession. However, there is nothing in Article 9 which prevents the pledgee or the lender on field warehouse receipts from filing a financing statement as

\textsuperscript{52} Benedict v. Ratner, 268 U.S. 353 (1925), contains Mr. Justice Brandeis' oft-quoted lines, at page 365: "It [the rule] rests not upon seeming ownership because of possession retained, but upon a lack of ownership because of dominion reserved."

\textsuperscript{53} See In the Matter of the New Haven Clock & Watch Co., 253 F.2d 577 (2d Cir. 1958) (accounts receivable).

\textsuperscript{54} For those with an antiquarian bent, an early Star Chamber case sets out the elements of the law of ostensible ownership, retention of dominion, and other fraudulent conveyances. See Twyne's Case, 3 Coke 80b, 76 Eng. Rep. 809 (1601), where the court found fraud in a conveyance, denominated a "secret assignment" by the court, whereby the mortgagor remained in possession of the mortgaged sheep, shearing and selling the wool without accounting for the proceeds.

\textsuperscript{55} Heffron v. Bank of America, 113 F.2d 239 (9th Cir. 1940).
well as perfecting by possession. In this case perfection would not depend upon possession, and the security interest would be saved from lien creditor attack even though the field warehouse was not all that it might be.

There are no prohibitions against changing from one type of perfection to another; in fact, it is provided that if perfection is effected by one means originally and then another means substituted without there being a time when the security interest was unperfected, it is treated as having been continuously perfected. Nor are there prohibitions against perfecting by both filing and possession at once. It may be that the situation of a particular borrower may require that the lender take possession at one point in his operation and perfect by filing at another, or that the lender both take possession and perfect by filing at the same time. The various means of perfection are not repugnant to one another, and each may give the lender certain advantages in his dealings with the borrower and third parties denied him by use of the other.

"Straight" field warehousing parallels the commercial warehouse practice of issuance of receipts and delivery orders. The warehouseman who has leased all or a portion of the borrower's storage space, partitioned it and secured it with his own locks, and posted signs about the premises, is openly and notoriously present. He has control over goods in the leased area, for he allows the borrower no access to the goods without the lender's permission.

The doors or partitions separating the borrower from the goods may be flimsy or inadequate to prevent his forceable entry, but the fact that the borrower can gain possession of the goods illegally does not invalidate the security interest, any more than the theft of pledged stock certificates from a bank vault by a pledgor invalidates the pledge. If there is a soft

56. Earlier official versions of the Code, including that initially adopted in Pennsylvania, specifically required that the lender file a financing statement to perfect a security interest involving the use of a field warehouse. See UCC § 9-305(2) (1952) and Comment 4, UCC § 9-305 (1952).

57. § 9-303(2): Continuity of perfection where subsequent means of perfection follows original means with no intermediate gaps.

§ 9-305: Security interest may be otherwise perfected before or after period of possession.

§ 9-312(6): Security interest, continuously perfected, is treated as though it were perfected by original means for purpose of determining priority.

58. Theft from a bailee is simply that: theft. Theoretically, the borrower, if he commits a trespass or a technical breaking and entering to gain possession of the collateral, establishes the bailee's possession. Successful criminal prosecution of the borrower is generally quite rare. As a practical matter, he is usually a local resident, and the lender and the bailee are not. Suits for conversion or on the indemnity agreements executed by the borrower or those persons financially in-
spot in field warehousing, it lies in the use of the "bonded agent" to make releases and issue warehouse receipts. Because the costs of the operation must be borne by the borrower, it is frequently impossible to install a regular employee of the warehouseman as the local agent on the borrower's premises. An employee of the borrower, usually a stock clerk, is "discharged" by the borrower and "hired" and bonded by the warehouseman and placed on his payroll.\textsuperscript{50} This bonded agent still generally performs most of his former services for his former employer, the borrower, and, more important, expects to be "hired back" when the warehouse closes. The agent may, therefore, be willing to allow the borrower to take some or all of the stored goods from the warehouse without a delivery order or other prior authorization from the receipt holder. Although this appears as though the lender is not maintaining possession, it is not enough yet to subject the warehouse to a successful attack by creditors.\textsuperscript{60}

To assert control and maintain possession, the field warehouseman provides for duplicate copies of all warehouse receipts and delivery orders to be sent to its accounting offices for continuous "paper audits." But more important, "field audits" to physically check the contents of the warehouse against the "paper audits" are performed at irregular intervals. It is not the connivance between the bonded agent and borrower that vitiates the warehouse receipts; fraud practiced on the warehouseman by his employee is not chargeable to the warehouseman under the lack of dominion rule. It is the continuing practice of free dealing with the inventory by the borrower when the warehouseman knows, or should have known, of it, that invalidates the security interest. When, over a course of time, the borrower is allowed unlimited access to all of the collateral for general purposes through the warehouseman's neglect or inadvertance, it must be inferred that the warehouseman (and through him, his principal, the lender) has "agreed" with the borrower that such acts are permissible.

\textsuperscript{50} See Bostian v. Park Nat'l Bank, 226 F.2d 753 (8th Cir. 1955).
There is then no other course open but to invalidate the warehouse for "lack of dominion" on the part of the lender.61

If a shortage is discovered during an audit, the warehouseman must act: he may close the warehouse, substitute a professional watchman for the regular bonded agent, force the borrower to "cover" the shortage by an indemnification agreement or threat of prosecution, or take possession of other of the borrower's property as a substitute for that which vanished.62 In any event, the warehouseman or the surety must make up the shortage under the warehouseman's obligation to deliver imposed by Article 7 of the Code. Thus the economic value of the security interest may be saved for the lender. The key to the situation is really not the quality of field warehouseman's possession but whether or not, from all of the facts, it must be inferred that there was no initial delivery of possession or that the "general possession" of the borrower was rightful. These inferences may be rebutted only by prompt action of the warehouseman in asserting his possession and demonstrating that the borrower's possession is wrongful by putting a halt to the borrower's practices.63

The Code in part recognizes the common law rule that limited possession by the pledgor does not invalidate the pledge. The lender further may give the borrower possession for limited purposes for twenty-one days.64 Section 9-304(5) continues perfection for this time period following the surrender of the goods to the borrower for purposes of manufacture, processing or even sale, and, if before the twenty-one day period

62. In Keystone Warehouse Co. v. Bissell, 203 Fed. 652 (2d Cir. 1913), a warehouseman who took a depositor's property to cover a loss occasioned when the latter fraudulently obtained warehoused property was held not to be a creditor, and so he did not receive a preference in the ensuing bankruptcy.
63. § 9-205. The initial theory of the Benedict v. Ratner doctrine was that there had never been a transfer in the eyes of the law because the borrower had never conveyed out the requisite incidents of ownership: the power to control the disposition of the goods. Thus, it could be inferred that the parties never really intended to create a security interest in the first place. Under the aegis of the second circuit, the doctrine was extended to reach those cases in which, after a valid initial transfer, the quality of the lender's ownership deteriorated until it could be "inferred" from the lender's "acquiescence" in the borrower's assumption of control that the security agreement had terminated. See Lee v. State Bank & Trust Co., 54 F.2d 518 (2d Cir. 1931).
64. § 9-304(5). This may pro-empt the common law limits to which a pledgor might be given temporary possession of the collateral. Compare Leahy v. Simpson's Adm'r, 60 Mo. App. 83 (St. L. Ct. App. 1894) and Petition of Chattanooga Sav. Bank, 261 Fed. 116 (6th Cir. 1919) (involving collateral meeting the Code definition of "equipment"). See also Restatement, Security § 11(2) (1941).
lapses, the security interest in those goods is perfected again, either by filing or by possession, the goods are treated as having been under a continuously perfected security interest.\textsuperscript{65} Presumably, during the twenty-one day period, the borrower may deal freely with the goods released to him without danger to the lender under the lack of dominion rule, for the lender's perfection does not depend upon possession, but upon statute. Thus the lender may allow the borrower to obtain his raw sugar from one warehouse, refine it, and place the refined sugar in another warehouse without danger of third party attack on the grounds of the borrower's ostensible ownership or his lack of dominion. Prudence would again dictate that the lender or warehouseman maintain a running audit of release and receiving records to make certain that none of the sugar in process or other goods in the borrower's possession is being siphoned off.

When the borrower requires goods from the warehouse, he may procure a delivery order from the lender, deliver it to the warehouseman, and take delivery of the goods called for.\textsuperscript{66} If the borrower has a high volume of sales, this procedure can be time consuming, yet the lender cannot allow the borrower to take what he wants, as he wants it, without losing his security, or if he has filed, then at least without giving the borrower the unlimited access to the inventory goods which would allow him to dissipate it. Pre-authorized releases of merchandise solve the problem. All that the lender is really concerned with is keeping control over a sufficient quantity of collateral to equal the value of the debt, allowing for the inevitable shrinkage in value on forced sale plus a "cushion."\textsuperscript{67} Pre-authorized releases may be on a "blanket release" basis, authority given the warehouseman to release a stated dollar amount in a given period,

\textsuperscript{65} § 9-303(2) grants continual perfection when the security interest is originally perfected in one way and then the means of perfection are subsequently changed without a "gap." It is difficult to believe that a lender, after making delivery to the borrower under the twenty-one day rule of § 9-304(5), could not, by retaking possession before the end of the twenty-one days, achieve continuous perfection. The situation is common enough; for example, a lender may have a field warehouse at a lumber mill, one warehouse for logs held in a yard and one for finished or curing lumber. The difficulty is created by § 9-305 which dates perfection from the time that possession is taken unless "otherwise" provided. Perhaps the "temporary perfection" of § 9-304(5) will serve to place this situation into § 9-303(2).

\textsuperscript{66} This practice is more typical of commercial warehousing.

\textsuperscript{67} In Pittman v. Union Planters Nat'l Bank, 118 F.2d 211 (6th Cir. 1941), the cotton seed warehouse was upheld as valid where the level of collateral never dropped below that called for in the receipts; the collateral, cotton seed, was fungible.
or on a "hold figure" basis, authority to release all contents of the warehouse except a stated dollar amount. Periodically, usually at the end of the week, a delivery order will be prepared by the warehouseman on which the borrower acknowledges receipt of the previously released items and which the lender executes and returns to the warehouseman to validate the releases and to provide him with stock information. So long as the warehouseman maintains control and legal possession over the unreleased collateral, the lender's security interest is safe from creditor attack and borrower dissipation.

One final innovation made in field warehousing changed the lender's essential character to that of a pledgee rather than that of a warehouse receipt holder, although retaining the bare form of warehousing. Used initially where the borrower had a high volume of items coming into the warehouse, the bailment agreement came into use in other situations as well and is ideally suited for operations under Article 9.68 Very briefly, the lender, borrower, and warehouseman agree that all of the borrower's inventory shall be pledged to the lender and placed in the warehouse as it arrives at his premises, and that the act of bailment, itself, constitutes the pledge, whether warehouse receipts are issued immediately or not. The receipts are normally issued weekly showing deposits of the previous week, and the warehouse receipt has become in reality an accounting memorandum.69 Warehouse receipts and delivery orders are still used, and the transactions are still couched in the form of warehousing, for several reasons: the warehouseman's liability as a warehouseman is retained; banking rules may prescribe the scope of acceptable collateral or may require loans to be made on warehouse receipts; and many lenders (and their attorneys) prefer them as security over a "bailment agreement" because they have had experience with them and a body of case law has developed about them, thus giving predictability regarding outcome in most disputes.

VI. PITFALLS OF THE BORROWER'S POSSESSION

A lender might legitimately ask: if all of that rigamarole is involved in protecting a field warehouse from a creditor's attack, why does my

68. See Bradley v. St. Louis Terminal Warehouse Co., 189 F.2d 818 (8th Cir. 1955), for an example of a bailment agreement.

69. Union Trust Co. v. Wilson, 198 U.S. 530 (1905). A warehouse receipt need not be a "warehouse receipt" under state law for there to be a valid transfer of possession sufficient to support a pledge.
counsel advise taking all of that trouble and going to all of the expense when a security interest in inventory can be perfected by filing two sheets of paper at a cost of no more than ten dollars including postage, overhead and handling? And he would be right except that the lender runs risks other than attacks of lien creditors on unperfected security interests in state courts. There is always the trustee in bankruptcy and the bankruptcy court.

The trustee in bankruptcy, as the general creditor's surrogate, is armed with all of the rights and powers of an actual creditor with lien rights under state law,\(^70\) plus a few special rights and powers of his own.\(^71\) However, the arena in which he usually exercises those powers is of most particular concern to the lender. That arena is the bankruptcy court. The bankruptcy court has jurisdiction over property in the possession of the bankrupt,\(^72\) and that jurisdiction is exercised in a summary manner before a referee,\(^73\) rather than by plenary proceeding, and the referee, oriented toward general creditors, is more apt to be inclined to listen to the trustee than counsel for lenders.

If the lender who allowed the collateral to remain in the borrower's possession, seeks to recover it from the trustee's grip, he must file a reclamation petition in the bankruptcy court, and by so doing, he submits himself to the summary jurisdiction of that court, at least to the extent of his secured interest.\(^74\) This can be disastrous if the trustee attempts to defeat reclamation on the ground of, say, preference, and if the lender does not try to reclaim his property, or more properly, his collateral, he may find it being administered as part of the assets of the estate, or being reduced in value to next to nothing as part of the inventory or other assets of a defunct business.

If, however, the lender is in possession he can take his collateral—at least as far as a commercial warehouse, where he can hold a sale to realize

\(^{70}\) Bankruptcy Act, § 70(c), 11 U.S.C., § 110(c) (1958).

\(^{71}\) Supra note 14.


\(^{73}\) Normally by a turn-over order or an injunction. 2 Collier, Bankruptcy ¶ 23.04[21] at 452-3 (14th ed. 1964).

\(^{74}\) Slocum v. Edwards, 168 F.2d 627 (2d Cir. 1948); James Talcott, Inc. v. Galvin, 104 F.2d 851 (3d Cir. 1939). This may act as an entering wedge for the extension of summary jurisdiction over all controverted matters arising out of the transaction as a whole.
the loan value of his collateral at his leisure.\textsuperscript{75} If the trustee attempts to stop him or to recover the value of the collateral it must be by a plenary suit in state court or United States District Court.\textsuperscript{76} If the trustee attempts to deny the lender the right of access to the collateral or attempts to gain access to it and administer it, he may find himself defending a conversion suit or answering in replevin, again in a state or federal district court,\textsuperscript{77} both of which are likely to be a good deal less sympathetic to the trustee. All that the lender must do is take care not to make anything remotely resembling an appearance in the bankruptcy court that would subject the warehoused assets to the court's jurisdiction. If he does, the warehouseman may claim, with some merit, that by so doing the lender has admitted that the field warehouse transaction was invalid, and he is, hence, the author of his own misfortune.

Aside from technical matters such as jurisdiction of courts, possession is protection, protection against that which might euphemistically be called "the risk of the lack of borrower integrity."\textsuperscript{78} This is not to say that all borrowers are dishonest and secrete the collateral or proceeds of its sale, nor is it intended to mean that they will refuse to pay back their loans or fail to apply the proceeds of the sales of the collateral to the business. But this sort of thing, repugnant to most when times are good, may be the only apparent course open to a borrower who wants a "cushion" for his after-bankruptcy recovery or who is pressed hard by other creditors. The borrower in possession may find his power of sale over the inventory and his new found power to apply the proceeds as he sees fit, no longer restricted by the lender's once necessary policing, too much to resist. Sometimes the borrower may find his desire to enjoy expensive automobiles, boats, clubs and private schools for his children so strong as to overwhelm

\footnotesize{75. The lender can claim the value of the collateral only to the extent of the indebtedness, plus expenses. § 9-504(2) requires him to account to the borrower, or his trustee, for any overage resulting from the sale of the collateral.

Of course, the court has jurisdiction to prevent the pledgee from disrupting the pledgor's entire enterprise or asset value by "foreclosing" the pledge. See Mann v. Peoples First Nat'l Bank, 209 F.2d 570 (4th Cir. 1953) (petition pending, pledgee's motives were not confined solely to recovery of his loan).


77. See Bradley v. St. Louis Terminal Warehouse Co., 189 F.2d 818 (8th Cir. 1951).

78. By virtue of § 9-205 the lender who perfects by filing is saved from disastrous legal consequences if he makes an error in judgment in giving the borrower dominion. The economic consequence, that of having no collateral, may be equally grave.}
any temporary qualms about stripping his business of capital. In a surprisingly short time, an industrious borrower can sell off enough of his inventory—and the lender's collateral—and dissipate the proceeds to seriously discomfort his lender and strip his own business of sufficient capital to place it beyond even the most enthusiastic hopes of rehabilitation, if he is not restrained by either the lender's possession or by his active policing.

Naturally, the extent to which the lender must police each borrower is a matter for his own business judgment, but the degree of control over the borrower to be exerted will run the gamut from verbal assurances on the part of the borrower in the case of some, to possession, or at least good, old-fashioned vigorous policing, in others. From some borrowers, the lender may not require more than periodic reports to reflect the status of the collateral and the volume of sales; from others it may be necessary to install one or more of the lender's own employees as a watchdog in the borrower's stockroom or accounting department; from still others, daily reports and actual assignment and a manual transfer of each day's proceeds may be the only solution. Probably no lender, unless he is a relative, can be content to rely on the borrower's integrity and good will without some form of control over his free hand. And since any situation, particularly an inventory financing situation, can change with the passage of time, it would be well for the lender that the security agreement provided for various degrees of control to be imposed at the lender's option and the borrower's cost. So, if the lender learns of changes of ownership, death or turnover of key employees, extraordinary movements of inventory, unusual variations of bank deposits, and so on, the signs of stormy weather, he can move rapidly to save and rehabilitate. The point is that it is up to him. If he has filed, he is not compelled by law to police.

The possessory lender has two strings to his bow: (1) if the field warehouse is run properly, he has a very sure check on the borrower's movements of inventory for unless he is careless, the value of the collateral must always exceed the loan value; and (2) even if the borrower removes

79. The lender in Benedict v. Ratner was "family." See 282 Fed. 12 (2d Cir. 1922), sub. nom. In re Hub Carpet Co.

80. A possible solution to achieve maximum security might lie in the use of a security agreement based on the Bailment Agreement in which the borrower not only pledges all collateral placed in the warehouse, but also conveys, as security, all of his rights in the collateral as those rights are acquired. Both filing and possession are then used to establish perfection simultaneously.
the collateral from the warehouse, the warehouseman is generally answerable on his warehouse receipts, and he is far more apt to be solvent, or possessed of reachable assets, than any borrower who has been stripping himself of capital.81

VII. INVENTORY AS AN ENTITY: A MIXED BLESSING

Not all non-possessory financing is done on the basis of the so-called "floating lien" which the Code is said to have established. In the past, non-possessory financing developed down two main avenues. Those approaches are best exemplified by the practices required and developed under the Factor's Lien Act and the Uniform Trust Receipts Act.82 Since both approaches are available and have their uses under Article 9, they are of more than archeological interest, and, better, they have been stripped of certain disabilities imposed more by their form and historical development than by necessity. For lack of better terms they might be denominated general lien financing and specific lien financing respectively.

In an ideal financing under the factor's lien,83 the predecessor of the general lien, the lender advanced a lump sum to the borrower based on the value of his inventory in possession and usually his accounts receivable as well. The borrower made sales from his inventory, and in pre-Code days forwarded his proceeds daily to the lender, receiving corresponding credits in return. As new inventory arrived, it came automatically84 under the security interest without a further advance from the lender. This was not

81. The lender would be entitled to the value of the warehoused items up to the amount of the loan. Normally a storer is entitled to asset value. Russell v. Empire Storage & Ice Co., 332 Mo. 707, 59 S.W.2d 1061 (1933). However, the borrower-depositor would also have a claim against the warehouseman for the value of his "equity" (unless it was the borrower's actions which caused the loss), so to prevent double recovery or a lender's windfall, the lender is limited to a recovery of the amount of the loan.

82. Neither the factor's lien nor the trust receipt were much used in Missouri. The chattel mortgage was the predominant instrument of chattel security.

83. The Factor's Lien Act, §§ 430.260-320, RSMo 1959 (repealed) gives "a continuing general lien" to anyone "who advances money on the security of merchandise." It was never determined in Missouri whether or not a financing seller, one who advances merchandise on credit, could procure a valid factor's lien. See In the Matter of Freeman, 294 F.2d 126 (3d Cir. 1961).

84. Factors received their lien "on all merchandise from time to time consigned to or pledged with the factor." No one cared to do more than speculate upon the sufficiency of means by which the borrower "consigned" or "pledged" the merchandise to the factor. Compare Irving Trust Co. v. Commercial Factors Corp., 68 F.2d 864 (2d Cir. 1934), with Colbath v. Mechanicks Nat'l Bank, 96 N.H. 110, 70 A.2d 608 (1950).
typical purchase money financing;\textsuperscript{85} it was financing that treated the borrower's inventory as an entity through which goods passed, and, in general, the level of the loan remained about the same, or rose and fell finally with variations in the borrower's operations and his ability to reduce the loan.

As opposed to this, the ideal trust receipt financing was purchase money financing;\textsuperscript{86} the lender supplied the wherewithal to acquire new inventory only and, in fact, could not, under the mechanism of a statutory or common law trust receipt, reach inventory already in the borrower's ownership or possession.\textsuperscript{87} The lender received a security interest in each item to be acquired. If the borrower was to receive thirty refrigerators, the lender had thirty sets of papers and thirty security interests.\textsuperscript{88} As each item was sold, the borrower repaid that portion of the loan attributable to that item. As each item was to be acquired the lender advanced new funds. Here, the loan level varied exactly with the collateral. Naturally, the trust receipt was, and specific lien financing is, as a practical matter, available only on fairly expensive pieces of collateral, or "hard goods," such as white goods, bales of cloth, automobiles, and so on, being purchased and re-sold. The factor's lien and the general lien financing was and is primarily intended for smaller items, or "soft goods," offered for sale or component items in the process of manufacture where maintaining a hold on, and a record of, each individual item is either impossible or impractical, such as needles and spools of thread or the nuts and bolts used in the manufacture of an automobile.\textsuperscript{89}

The lack of dominion rule always had its greatest impact on general lien financing. The specific lien and the possessory security interest gave the lender much more control over the borrower's dealings with his inven-

\textsuperscript{85} It could be so used, however, and was so used. See note 83 supra.

\textsuperscript{86} Where the UTRA was in force, it could only be used by a third party lender who generally took title directly from the seller by paying an order bill of lading. In Missouri, the trust receipt was categorized either as a bailment for sale (valid) or a chattel mortgage (invalid for failure to record, etc.) depending upon the "borrower's" absolute obligation to pay (debt) or his option to pay or to return the merchandise (bailment). In re Bell Motor Co., 45 F.2d 19 (8th Cir. 1930). The transaction could apparently be either tripartite, In re Bell Motor Co. supra, or bipartite, Globe Sec. Co. v. Gardner Motor Co., 342 Mo. 778, 85 S.W.2d 561 (1935).

\textsuperscript{87} If he did, the lender had an invalid mortgage, supra note 86, or else nothing at all. Forgan v. Bridges, 281 S.W. 134 (Mo. App. 1926).

\textsuperscript{88} The factor, as opposed to the entruster, would have received an undivided interest in each item composing the inventory entity as security.

\textsuperscript{89} Factor's lien financing was not confined to "soft goods."
tory; they also tended to protect the lender from risks other than the lien creditor.

For many years, the public, including many of the legally trained, regarded the merchant or manufacturer who borrowed on the security of his inventory and accounts as unreliable and on the verge of bankruptcy. In the past, with the "Mom and Pop" store or the two-man workshop, this may have been true; to some extent and in other contexts it may still be true today. But the very great expense outlay required to open a new business is a compelling reason to give any responsible man with the courage to consider beginning a new enterprise access to any source of financing available to him, from leases of equipment\(^\text{90}\) to mortgages on merchandise. If he can convince the lenders, who seemingly have more ice water in their arteries than equity investors,\(^\text{91}\) he should be allowed to go ahead. This apparently was the thought of the drafters of Article 9. But in the view of judge-made law, still operating under the inertia of the landed wealth, cash payments and bubbles of the eighteenth century, the borrower on something as unstable and evanescent as inventory was himself unstable, and the lender who lent on inventory was truly a second-class citizen.

The borrower who paid off his inventory loan as quickly as possible and who only borrowed to help himself over a rough spot was understandable and could be tolerated, for at least, in theory, as he paid off his loan with the entire proceeds of his sales, that portion of his inventory which secured it was lowered and that portion of it which was available to general creditors was increased. Any new inventory was supposed to be free of any secured interests, although how the borrower would stay in business and feed himself, much less acquire new inventory, if the lack of dominion rule required the application of the entire proceeds of his sales to pay off the loan was never satisfactorily explained. Some excuse also could be found for such borrowing in cyclical industries. The toy manufacturer who accumulated inventory through the year with a big sell-off at Christmas, and the canner who had a large acquisition of inventory at the end of growing season and a gradual sell-off during the year, might find long term debt too onerous and equity financing too unwieldy; both situations

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91 Note that there are no Blue Sky laws or their like protecting lenders.
produce chronic, periodic, over-capitalization. For the manufacturer or merchant who raised long term capital on his relatively level volume of short term assets, inventory and accounts, and for the lender who aided and abetted him, however, no excuse could be found.  

Part of this "evil" could be prevented by judicial application of the lack of dominion rule which required that the entire proceeds be forwarded to the lender as they were generated, to reduce the amount of the loan. But some clever gent, whose name is lost to us, decided that every time the borrower forwarded the proceeds which would otherwise have reduced the loan, a fresh advance of equal size could be made to him. So, if under a 100,000 dollar loan, borrower received proceeds of 1,000 dollars on Monday and forwarded it that night (in the same form) to the lender, then the lender credited 1,000 dollars to the borrower's drawing account on Tuesday. This created some problems of an administrative nature; it created a volume of paper shuffling, with consequent chances of error, and also created a substantial expense to be borne by the borrower, caused by the necessary policing.

The other half of the problem created by general lien financing, how to get newly acquired inventory under the security interest to take the place of that which was removed by the borrower's sales, created a more knotty problem, since it had to face both intrinsic defects in the old fashioned security devices, and the Bankruptcy Act, particularly section 60. Under Missouri chattel security law, after-acquired property did not come under the protection of the mortgage as it was acquired, even


93. This is a vastly oversimplified statement. See, Wilson, The New Haven Clock Case—Another Look at Benedict v. Ratner, 13 Bus. Law. 633 (1958). The text also ignores differences of approach between "factoring of accounts" and "pledging of accounts." Although the end result is about the same, the factor purchases the accounts, assumes the credit risks, and makes the collections. Both are secured transactions subject to Article 9 by virtue of § 9-102(1)(a) and (b). See, O'Leary, Accounts Receivable as Security, 29 Mo. L. Rev. 486 (1964).

94. Errors could be fatal. In Lee v. State Bank & Trust Co., 54 F.2d 518 (2d Cir. 1931), an assignment of accounts in the amount of $85,590.82 was invalidated because the lender had failed to control the borrower's disposition of $1,574.75 (or 13½% of the total collateral) of returned merchandise. In Brown v. Leo, 12 F.2d 350 (2d Cir. 1926), a mortgage conveying land, fixtures, and stock was totally invalidated because of the borrower's right to dispose of the stock "for his own use." The doctrine of infectious invalidity did not apply in Missouri. Bullene v. Barrett, 87 Mo. 185 (1885); Smith-Wallace Shoe Co. v. Wilson, 63 Mo. App. 326 (1895).

though the security agreement called for it, unless the borrower had at the time of the mortgage existing rights in that property.

A mortgage for purchase money allowed a seller to take his security interest in the newly acquired property, at the time of sale, and a trust receipt allowed a third party lender to take his security interest in the newly acquired property, at the time of sale. The factor’s lien was supposed to pick up after-acquired property automatically, but, in Missouri, nobody knew whether it did or it didn’t. The lender who used field warehousing got his security interest when he had the warehouse receipts or, if a bailment agreement was used, when the goods were in the warehouse. All of this was fine, but in Missouri there was no way to get a predictable, safe, general lien on inventory that automatically picked up after-acquired property.

The Code, in section 9-204(3), provides that a security interest can be made to apply to after-acquired property by the simple expedient of so providing in the security agreement, and perfection is obtained by mentioning it on the financing statement. By executing a simple agreement with the borrower, and procuring the borrower’s signature on a financing statement, the lender may acquire a security interest on the borrower’s inventory both as it stands when the agreement is signed and as it may change from time to time through acquisition to and withdrawals from the borrower’s stock. The internal defects, spawned by the historical development of the mortgage and furthered by the legal disapproval of inventory financing, have been overcome. This leaves remaining but one deterrent to taking a general lien type security interest on after-acquired property: section 60 of the Bankruptcy Act.

Briefly stated, the law on preferences provides that transfers to a creditor may be voidable if made within four months of bankruptcy, upon antecedent consideration, while the debtor is insolvent. This has two applications in the context of secured financing. The trustee may reach back

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96. Bank of Kennett v. Clayton, 241 Mo. App. 487, 245 S.W.2d 678 (1951). It was effective between the parties in equity, France v. Thomas, 86 Mo. 80 (1885).
97. Notes 83, 84 supra.
99. § 9-402 (1).
100. The preference is voidable only if the creditor knew, or should have known, that the debtor was insolvent. Bankruptcy Act § 60(b), 11 U.S.C. § 96(b) (1958).
four months to destroy security interests which for a while were unperfected during that time, but which became perfected prior to the date of bankruptcy and were then no longer vulnerable to lien creditor attack, and consequently, attack under sections 70(c) or 70(e).\textsuperscript{101} For example, a chattel mortgage on inventory violating the lack of dominion rule could not be reached under either subparagraph of section 70 if the lender took possession of the inventory before bankruptcy, for no lien creditor attacking after the mortgagee took possession could reach it. However, the trustee, under section 60, could reach the same collateral if the lender had taken possession within the four month period since the “transfer” took place at the time that the security interest was perfected. Under the Code and the Bankruptcy Act combined, a security interest may attach to the inventory as it becomes the property of the debtor, and, if the financing statement is filed within twenty-one days, perfection relates back to execution. This area of application of section 60 need not concern the nonpossessor or possessory lender who, with a little care makes sure that his security interest is perfected by filing\textsuperscript{102} without a gap.

The other aspect of section 60 is of more concern to the Code lender. This may be illustrated by the following example: $A$, the lender, advances 10,000 dollars to $B$ on security of $B$’s inventory, worth, at present, 10,000 dollars. The pre-Code security interest is a factor’s lien, perfected, policed and immune from attack on the basis of fraud. $B$ receives 3,000 dollars of additional inventory the next week. The security interest now covers 13,000 dollars of inventory, assuming that no sales have been made. If $B$ goes into bankruptcy, the trustee, assuming he can make his case, may avoid $A$’s security interest to the extent of 3,000 dollars, and if $B$ had sold 2,000 dollars of his original inventory by that time, $A$’s security interest might only apply to 8,000 dollars of that inventory and no more. The reason: $A$ had received some of $B$’s property for an antecedent consideration.\textsuperscript{103} This could have been avoided had “specific lien” financing and “revolving credit” been used. Ideally, there a fresh advance is made to

\textsuperscript{101} Corn Exch. Nat’l Bank & Trust Co. v. Klauder, 318 U.S. 434 (1943) (a transfer, for the purpose of § 60(a), is “made” when it is perfected). This aspect of preference law is directed at either “secret liens,” which becomes “public” (by filing or recording) immediately prior to bankruptcy or at the creditor who did not act like a creditor until the imminent failure of his borrower (the Benedict v. Ratner situation).

\textsuperscript{102} § 9-205.

\textsuperscript{103} This second aspect of preference law is directed against the creditor who is given better treatment than the other creditors of the same class by the borrower.
the borrower at the time that the security interest in the new property is transferred to the lender,¹⁰⁴ and the borrower, of course, repays a portion of the total loan as he makes his sales. Likewise, the lender could have released an amount of inventory from the security interest to the borrower whenever a corresponding amount of new inventory was presented to the lender as security, for the release of the collateral to the borrower constitutes fresh consideration or "new value."¹⁰⁵

Because mortgages and other security devices are creatures of state law, state law—the Code—can remove any of their intrinsic defects. The Bankruptcy Act is, however, federal law, although it operates in the field of rules created by state law.¹⁰⁶ If a pre-Code chattel mortgage was invalid because of the lender’s failure to take dominion in Missouri, but not in Massachusetts, a trustee in bankruptcy acting under section 70 could reach it in Missouri, but not in Massachusetts. The same rules generally apply to section 60. The logical course open to the drafters to avoid the effect of section 60 was to change the state law rules in which the Bankruptcy Act operated. Section 9-108 simply provides that after-acquired collateral should be deemed taken for new value if the debtor acquires the property “in the ordinary course of business or under a purchase contract made pursuant to the security agreement within a reasonable time after new value is given.” The ideal of the general lien on inventory has been achieved. The lender can make his one big advance, file, and simply sit back while his security interest gathers in new collateral as it arrives without the necessity of policing or of doing one further thing to avoid application of section 60, even though the security interest swells in value due to the excess of new additions over withdrawals by sale.¹⁰⁷ The short term assets of the borrower have been placed on parity as collateral with his buildings and other long term assets.

The Comments to section 9-108 indicate that the drafters feel that the redefinition of what makes up antecedent consideration will be effective in bankruptcy, since "the determination of when a transfer is for

¹⁰⁴. In this way, each security interest in each item of collateral stands by itself on a fresh loan.
¹⁰⁵. Walker v. Commercial Nat'l Bank, 217 F.2d 677 (8th Cir. 1954). Exchange of collateral of equal value under a security interest do not constitute a preference, either under a "net worth" theory or a "fresh value" theory.
¹⁰⁶. 4 COLLIER, BANKRUPTCY ¶ 70.07 at 984 n.8 (14th ed. 1964).
¹⁰⁷. No matter what type of security interest the lender may have, he can only claim its sale price up to the loan level plus expenses and no more without agreement from the borrower. §§ 9-504(1), 9-505(2).
antecedent debt is largely left by the Bankruptcy Act to state law.\textsuperscript{108} Maybe, but there are grounds to believe that this is not quite so clear as the Comments seem to indicate. The typical instance in which state law makes this determination is in the area of perfection of transfers, \textit{i.e.}, the question of late perfection constituting a preference, or whether or not the parties really intended to create a debt\textsuperscript{109} rather than determining whether or not consideration was actually antecedent to an actual acquisition of property.\textsuperscript{110} The law of preference, although not uniquely a creature of the Bankruptcy Act, has most of its force and effect under that Act, and the formidable corpus of law growing out of section 60 might be said to be a body of federal common law expressing the spirit of the Act: "Equality (among creditors) is Equity." If a federal court ignored section 9-108 it would not be the first time that the contrary provisions of state law had been overridden by the "spirit" of the Bankruptcy Act,\textsuperscript{111} and the federal courts might do just that on the grounds that: (a) section 9-108 is contrary to the plain meaning of the words "antecedent consideration" in section 60;\textsuperscript{112} and (b) the general lien, if applied to the maximum extent allowable, leaves too little in the way of assets for unsecured creditors and special claimants.\textsuperscript{113} Many lenders are proceeding cautiously in this area, still using specific lien financing of the trust receipt or field warehouse type rather than the general lien until they are certain of the course that the courts will take, choosing to accept disadvantages of fresh advances and constant pay-offs reminiscent of pre-Code days in order to protect their security interest from attack and dissolution.

VIII. PRIORITY AND COMPETING LENDERS

Up to this point, one of the most fascinating areas of Article 9 has been ignored: priority and its attendant problems. Priority between con-

108. Comment, UCC § 9-108 (1962). Sometimes the Comments do not say what the statute says. Many of the Comments are survivors of earlier versions of the Code and were not revised when the sections to which they pertain were revised. Then, too, the Commentators knew what they wanted the Code to say.


112. After all, the words are very clear.

113. Determining the intention of the parties has always been a nearly irreversible ground for the courts to accomplish "substantial justice," which generally means taking a quick swing at a "fat cat" secured creditor. Using the spirit of the Bankruptcy Act as a \textit{ratio decidendi} amounts to about the same thing.
fllicting claims of secured lenders and other persons is determined by rules which are themselves dependent upon the means used by the lender to perfect his security interest and the time at which he did it. 114 Simply put, the priority status of any lender is shorthand for saying what advantages that lender may, or may not, have over another person claiming an interest in the property. Article 9 provides that priority among inventory lenders, who are not in the special category of purchase money lenders, is determined by either the “first to file” or “first to perfect” 115 rules. These rules are somewhat more easily stated than applied, for like perfection, priority rules may be selective. Because a lender is the first to perfect his security, he is not guaranteed priority; he may have to do something else other than merely perfect by filing or by possession in order to gain an advantage over another person who may otherwise be dangerous to him.

By itself, the first to file rule, if all secured parties file, does not lead to an unjust result between the lenders. It is highly unlikely that any lender would advance funds to any borrower on the security of his inventory or any other property without first checking the filings. If a potential lender discovers that someone else has filed with regard to his borrower on the same type of collateral he wants to lend on, he is asking for trouble if he advances one cent on that property, for the first person to file has the potentiality to take a prior position whether or not he has a security interest in that inventory at the time that the second filer makes his advance. For example, Jones, the first filer who takes a security agreement and files on March 1st and then advances 10,000 dollars on March 20, takes the prior position to Brown who both filed and made his advance on the 10th. But not all lenders may choose to perfect by filing. If Jones had not advanced any money by the 10th, and Brown took possession on the 10th, Brown would hold the paramount position since the first to perfect rule would award priority to him. 116 Jones could not prevail against the possessory lender because he (Jones) could not have perfected until March 20. The first to perfect rule is couched in terms of perfection of a security interest, and Jones had no security interest to perfect until he gave value.

A “non-possessory” security interest, to digress for a moment, may

114. Generally Art. 9, part 3.
115. §§ 9-312(5)(a), 9-312(5)(b) respectively.
116. Whether or not Brown would take the borrower’s word that no “value” had passed is another matter.
attach to the property at a much earlier time than under previous law. The existence of the lender's non-possessory security interest in the collateral no longer depends upon title being in the borrower or on the borrower's possession, although, where third parties' rights may be involved, the lender can acquire only that which the borrower has or has the power to give.\textsuperscript{117} Attachment of a security interest cannot occur until the borrower acquires "rights" in the collateral,\textsuperscript{118} but a security agreement granting a security interest in after-acquired property can be executed long in advance, and the general lien interest attaches to the collateral automatically as the borrower acquires rights in it, without the necessity of "consignments" and the like. The nature of the "rights" that the borrower must have for attachment is left undefined,\textsuperscript{119} but in the case of a buying borrower, sufficient rights in the incoming collateral would probably be acquired no later than that time at which he acquires an "insurable interest" in the goods under Article 2.\textsuperscript{120}

If the financing statement covers after-acquired goods of that kind, the security interest is perfected \textit{eo instante} with no gaps into which another lender can insert himself. In contrast, a strictly "possessory" security interest, if there is no written agreement providing for attachment at an earlier time, attaches upon the lender's possession—the same time as perfection, generally.\textsuperscript{121} Observe the time gap: the non-possessory interest attaches instantly with the acquisition of rights and is perfected upon attachment, but the possessory security interest normally attaches and is perfected sometime later, when the lender gets possession. If two lenders who perfect by different means are competing for priority in the same property, the time of perfection controls, under the first to perfect rule, and a security interest cannot be perfected until it attaches. Assume that Brown, who has examined the records and has found no filing on his

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\textsuperscript{117} § 9-311. Although the second lender may acquire only an interest in the borrower's "equity," the priority system could give him a boost up the ladder. The first lender could prevent this as a practical matter by filing and by making the transfer constitute a default.
\textsuperscript{118} § 9-204(1).
\textsuperscript{119} § 1-201(36). See Cain v. Country Club Delicatessen, 25 Conn. Supp. 327, 203 A.2d 441 (1964), where a buyer who had possession of property did not have "rights" in the property until he executed a conditional sale contract, absent a showing of the nature of his possession. When the contract was signed the rights accrued to a security interest held by a general lienor under an after-acquired property clause. The purchase money lienor had neglected to file in the proper place.
\textsuperscript{120} §§ 2-501.
\textsuperscript{121} §§ 9-203, 9-305.
\end{flushright}
borrower's inventory, establishes a field warehouse under a combination of a bailment agreement and hold figure release instructions on March 10. Assume further that Jones on March 11, with full knowledge of the field warehouse, files and advances money to the borrower on his inventory. Finally, on March 15, the hold figure limit is reached, and on March 18 new inventory arrives which is intermingled with that remaining in the warehouse. The possessory lender has acquired a perfected security interest in the new collateral already subject to a perfected interest by filing. Over the course of time, as the goods turn over, the possessory lender will find himself with a field warehouse full of goods on which someone has a prior security interest, and which came into the warehouse subject to that perfected security interest. If Brown had modified the security agreement to pick up intangible rights and had also filed on the 11th but before Jones, as well as taking possession, he would be doubly protected, since he would still have been first to file on the after-acquired property.

Apparently, the possessory lender who does not file must check the filings at least periodically to make certain that no one is cutting in ahead of him with a non-possessor interest. It makes no difference in the priority scheme on this type of financing if one lender has knowledge of the other when he gives value and his security interest attaches. Between competing security interests, knowledge is immaterial.122 Filing a financing statement is strictly "notice" filing, putting the file searcher on notice that the borrower's inventory is not "clean." He has been warned; it is up to him to ascertain the details. Similarly, a field warehouse gives notice of the possessory lender's claim to anyone who visits the borrower's physical plant. Presumably, no professional lender would advance a significant amount on inventory without physically examining that inventory as well as making a file search. Proof of this knowledge, important only in the context of purchase money financing,123 is another matter.

Since the purchase money financer may file his financing statement within ten days after his security interest attaches and achieve "relation-back,"124 it may be contended that, even though he does not qualify for

122. Except in the case of the purchase money lender. § 9-312(3)(b).
123. § 9-312(3)(c).
124. See text, supra at 215.
the special priority under section 9-312(3), he may yet be the winner as "first-to-perfect" in a contest with a field warehouse lender who took possession prior to the time of actual filing, but after the date that the purchase money interest attached. Here is another instance where the difference between perfection and priority must be observed. When he files on the ninth day, the purchase money lender obtains protection from creditors whose liens may have reached the collateral in the gap and bulk transferees. This protection is confined to attacks made by these two categories of persons. It may be "perfection," but it is not the perfection referred to in the first to perfect rule which deals, rather, with the time that the act giving perfection was accomplished, for section 9-301(2) merely gives the purchase money lender priority over the lien creditor and bulk transferee if he files within the ten day period; it does not give him priority over other secured lenders.

Double financing, particularly when carried on over a period of time, highlights one of the more intriguing theoretical, and yet eminently practical, questions in Article 9: what are the dimensions of a security interest? Consider the following: Jones advances 10,000 dollars to borrower on his inventory (worth 20,000 dollars at distress prices), and files to perfect, the filing covering future advances. Brown moves the collateral into a field warehouse and advances 10,000 dollars. Jones, as the first to perfect, clearly had the prior interest. On the borrower's default and the sale of the inventory, he takes the first 10,000 dollars. Brown takes what is left up to the amount of his loan.

If Jones advances a second 10,000 dollars after Brown's advance the result may not be so simple. It is possible to contend that Jones is prior to Brown to the full extent of his advances, that is, he takes the first 20,000 dollars, and Brown gets the remainder. After all, Jones had filed, and his first filing is an umbrella; since Brown was warned by the claim for future advances made in the financing statement he cannot be heard to complain. The primary thrust of this argument is directed to protection of the integrity of the filing system. Once having examined the filings and the borrower's credit, and having learned that there were no filings made

125. If the purchase money lender failed to give the proper notice to other secured lenders, he would lose his priority status as against them although his perfection under the ten day rule would still relate back as against intervening lienors, giving him priority against them. See Thomson v. O. M. Scott Credit Corp., 28 Pa. D. & C.2d 85 (Chester County Ct. 1962).

126. This is perfectly true under § 9-312(5)(a), but there are two rules.
previously to his, the lender should be entitled to rely on this. The weakness in this position is that lenders do not advance significant sums of money, particularly on a flow of property, even though it is repeat business, without, as a practical matter, actually checking judgments, tax liens and the borrower's credit status and physically visiting his premises. It is equally possible to contend that, although Jones is prior to Brown to the extent of the first 10,000 dollars, he is subordinate, with regard to his second 10,000 dollars, to Brown's claim for 10,000 dollars. Had Jones, at the time of the first advance, obligated himself to make the second advance, justice would require that the entire 20,000 dollars be held to be one obligation and entitled to priority for the whole. But if he had not committed himself to make the second advance, his two loans constitute two separate givings of value and two separate obligations to pay on the part of the borrower.

A security interest is, by definition, an interest in property to secure performance of an obligation.127 The first to file rule may effect a merger and up-dating of security interests, bringing them all up to the date of filing, but the first to perfect rule does not so operate. Since the second advance was a separate obligation, and security interests can exist only in terms of the underlying obligation, there should be no merger under the first to perfect rule. There was no security interest until the advance was made, and the security interest could not be perfected until it had attached.128 The fact that Jones' security agreement and the filing covered future advances (if made) does not militate against the foregoing analysis since he did not have to make the second advance. Only judicial resolution can supply the answer,129 but the question should never be raised in the first place except in the case of inadvertance or plain laziness on the part of various lenders. It has been previously demonstrated that there is a wide gap between that which the lender may do without loss of his security interest by operation of law through inadequacy or insufficiency of the instruments or his efforts, and what the prudent lender will do to protect his interest from attack or other subsequent loss of value.

The priority rules are subject to the same sort of built-in goad to

127. § 1-201(37).
128. There must also be in existence a security agreement by which the borrower grants an interest to the lender either in writing and signed or evidenced by possession. See American Card Co. v. H.M.H. Co., 196 A.2d 150 (R.I. 1963).
129. The conflicting views are spread through recent literature on Article 9. To generalize, the teaching portion of our profession lean toward the first view; the practicing lawyers toward the second.
compel the lender to protect himself in areas of risk exposure. It cannot be reiterated too often that inventory financing, like dealing with negotiable documents of title, is a matter for energetic professionals, and the amateur, the lazy, or the inadvertent have no place in the business.

We have seen that a lender can acquire a prior position with regard to all of the borrower's inventory, as well as his other chattel property by filing a financing statement in broad, general terms, and advancing money. If only the financing statement is filed, and no value given nor security agreement executed, the lender cannot have a perfected security interest but by filing. He has placed himself in a position from which he may at any time obtain priority over other lenders merely by executing the agreement and giving value. Much has been made of this: that such a lender, if he so desires, may by his filing cut off the borrower from any other source of secured financing on his chattel property, and by use of this leverage, extort ruinous conditions, *et cetera*, from him. It is possible, although it is highly unlikely to happen for several reasons.

It is, first, doubtful that any borrower would sign such a broad financing statement except through ignorance, negligence, or inadvertence, unless there was every indication that such a loan would actually be made. Second, unless the lender has made an advance, or has obligated himself to make one, the borrower can compel the execution of a termination statement by the lender, terminating the filing, possibly by use of an equity proceeding if no other way is available. Finally, if he can convince another lender that no money has been advanced, or value given, he has available collateral if the second lender will use possessory financing, taking priority under the first to perfect rule. But if the first lender has filed, if he has advanced ten dollars to the borrower, and the security agreement provides that future advances may be made and will be secured by the same collateral if made, and the financing statement covers future advances, the situation is not the same. So long as he has an obligation outstanding, the borrower cannot compel the execution of a termination statement. The second, the would-be possessory lender, unable to predict the outcome in

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130. § 9-404(1) provides for a $100.00 plus amount-of-the-loss penalty to be assessed against the lender who refuses to execute a termination statement. Presumably the availability of this remedy does not preclude any other remedies the borrower might otherwise have had. The Code does not displace the general rules of law and equity, by virtue of § 1-103. See French Lumber Co. v. Commercial Realty & Fin. Co., 346 Mass. 716, 195 N.E.2d 507 (1964). And generally, obligations created by the Code may be enforced in a civil action. § 1-106(2).
a double financing priority scramble, may hesitate to make a loan because of the future advances clause in the financing statement. If he wanted to, the ten dollar lender could subordinate his security interest on future advances to the loan of the second lender, but, after all why should he?

IX. THE PURCHASE MONEY EXCEPTION

It was foreseen that a lender could pervert the provisions made for the benefit of all lenders into a trap for an unwary borrower when Article 9 was drafted. The general lien’s power and the broad financing statement can be limited and their effects curbed by the use of a special sort of specific lien financing: purchase money financing. Form in this instance is not very important: documents resembling the conditional sale contract if the financer is the seller, the trust receipt if a third party lender, or a purchase money mortgage or straight field warehouse, if either, may be used. The economic substance of the transaction is vital: the credit extended to the borrower must be actually used to acquire new merchandise. For a financing seller, this is simple and automatic; for a lending agency, it requires a small amount of preparation and care. The lender may pay the seller directly, pay on an order bill of lading as in trust receipt financing, or deliver a check payable to the seller’s order to the borrower earmarked for application to acquisition of new collateral.

If the collateral is inventory, the purchase money lender must perfect his security interest by taking possession or filing before the borrower takes possession, and must notify, before the borrower receives possession, any other secured party of whom he knows or who has filed claiming the same collateral, that he, the purchase money lender, has or will have a purchase money security interest in certain specified inventory of the borrower. If the purchase money lender has followed the rules, then he will achieve a priority over all other lenders with regard to those items

131. § 9-316.

132. The classic situation is the lender who lends on the security of a bulldozer and procures the borrower’s signature on a financing statement covering “road building equipment.” Although the lender does not have a security interest in any other of the borrower’s equipment, he may have foreclosed the borrower’s access to most other equipment financing. In the future, if the lender did advance further sums and procured a security agreement on a tractor, he would have priority over any lender other than a purchase money lender who had also lent the borrower money on the security of that tractor.

133. § 9-107.

134. § 9-312(3).
of collateral for whose acquisition he supplied the value. The purchase money lender receives another benefit which has been previously discussed, giving him a unique status. If he files his financing statement within ten days after the goods come into the borrower's possession, he cuts off the lien of any lien creditor which attached to the property during that period.

As a result of section 9-312(3), the purchase money lender receives priority in the goods acquired through his extension of credit, but the general lienor who claimed, and filed on, "all inventory" through his security agreement also has an interest in those goods, albeit subordinated.\[135\]

If the items composing the collateral making up the purchase money security interest are readily identifiable as being different in type or kind from all other items or identifiable by serial numbers, and they are so identified, all well and good; the purchase money lender can demand payment of his loan as the items composing his collateral are sold and retire from the field having been made whole, or he can continue to finance on a purchase money basis. But if the purchase money collateral is not identifiably different from the remainder, or if it is composed of items which are fungible with other items of the borrower's inventory, a problem presents itself. How can the purchase money lender, or the general lienor, for that matter, tell when his collateral has been sold? This is imperative for the purchase money lienor. He has no prior interest in property not under his security interest because of the very nature of his security agreement. The mere fact that he executed a broad security agreement and filed a financing statement covering "inventory" does not operate to broaden or upgrade his lien on the remainder of the inventory, and in actual practice, his security agreement will only cover that collateral for which he supplied the value.\[136\] Unless the purchase money lender segregates his "fungible" collateral, he may be relegated to an unsatisfactory

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\[135\] § 9-312(3)(c) requires the purchase money lienor to set out with some specificity, compared to the general requirements of the financing statement, § 9-110, the collateral in which he claims an interest. In any event, the purchase money lienor's only hope will be in showing the finder of fact that he supplied the wherewithal for the borrower's acquisition of specified collateral, § 9-107, which he is presently attempting to recover. The other lienors are not so limited, and a security agreement and financing statement in broad terms is adequate for his protection.

\[136\] In connection with a broader security agreement, he might receive a subordinate security interest in the remainder of the collateral. The fact that a broad financing statement was filed would not give the lender a broad security interest unless the security agreement was equally broad in coverage. Cain v. Country Club Delicatessen supra note 119.
tracing contest with the general lienor to determine how much of the collateral of each has been sold, and more important, whose collateral is remaining. The convenient means of segregation would be to require the borrower to store the purchase money collateral in a different location from the rest of the inventory. This may be impractical for a number of reasons. The purchase money lender may have to turn to a field warehouseman to protect himself, invoicing the goods directly to the warehouseman, even though he may also file a financing statement for protection if he believes that he is, or will be, exposed to other risks of lending.

X. "Dual" Perfection for Notice and Control

In a situation in which maximum risk exposure can be anticipated, counsel's solution should be a recommendation to the lender that he perfect by filing a financing statement and also take possession of the collateral, if not personally, then by a field warehouse. The arrangement may be expensive to the borrower, and by his insistence upon possession in risk situations the lender may lose the chance to make some loans or the financing seller will lose a few sales. But simple arithmetic will demonstrate to the lender that in maximum or high risk situations, his reduction of revenue from making a few less loans cannot be compared to the unreimbursed loss of the entire value of even one loan. On the other hand the financing seller may be in a different position: his interest in maintaining product outlets may so far outweigh the potential loss on a bad risk, that he may feel compelled to lend where it might not otherwise be prudent. Under prior law with its fragmentation of chattel security law, such a combination of possession and recording would have been unthinkable.\footnote{137 The lender had either a mortgage or a pledge. If he took possession of the mortgaged collateral, the lender obviously thought the mortgage was no good; if the lender took a chattel mortgage on collateral in the field warehouse, he obviously thought the warehouseman did not have possession. Thus the lender either rose or fell with his choice of security device; the fact that one of them was inadequate to give the lender the protection called for in any situation made no difference to the law.}

A security interest under the Code is simply a security interest; any lender can get one. It is what he does with it that controls the outcome.

\footnote{137. Actually it was only unthinkable under judge made law. The Factor's Lien Act allowed "perfection" by possession rather than by notice filing, if the lender chose. § 430.300, RSMo 1959 (repealed).}
of any dispute. Article 9 provides for three methods of perfection of a security interest on chattels: filing a financing statement, taking possession, and a temporary immunization from lien creditor attacks following possession. But filing and taking possession are each something more than the means of staving off a hungry creditor with a lien; they are, to varying degrees, the means of halting borrower incursions into collateral, keeping the property out of the bankruptcy court, advancing the time of attachment of the security interest, overcoming the lack of dominion rule, and manipulating the priority ladder. They are means of reducing lending risks, just as specific lien financing reduces lender’s risks which are otherwise present in general lien financing. The Code contemplates that the lender may take possession of the collateral and file a financing statement either alternatively or simultaneously. By taking extra care, time and expense, and using the specific lien financing methods available under Article 9 combined with filing and possession, the lender can achieve the most secure security possible to the inventory financer.

In conclusion, it can only be reiterated that there is a tremendous difference between that very minimum allowable under the Code which gives the lender a security interest cognizable in the eyes of the law and that which may be done to render a security interest secure. The various gradients of control which the lender may exert on the borrower and some of the several kinds of trouble which may be eliminated have been explored to suggest, at least, that in more cases than not, counsel should recommend to his client that he continue his pre-Code practices, but now, for reasons of choice rather than of legal compulsion. The lodestar of any commercial security transaction, especially one intended to operate over some period of time, must be the achievement of outcome-control over any of several potential risk situations by the exercise of risk-eliminating procedures, not merely control procedures. After the potential danger has developed into actuality, it may be too late. By selective use of the available mechanisms, predictability of outcome can be assured. The question which lender’s counsel must ask as his client prepares to make a loan is: to what material risks may the security interest be exposed? He has at hand the means to eliminate them.

Certainly, the lender should do more than the Code’s minimum; the extent to which he exceeds that minimum is left to his own business judgment. No one would insist upon the application of specific lien financing procedures, filing, and the use of a field warehouse in every situation.
But Article 9 has given the inventory lender the means to exercise more control over his own destiny than he ever had before; it is up to him to use the thought, foresight, and judgment necessary to avail himself of them.