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# The Unsecured Creditor - "The Little Businessman" - and the Uniform Commercial Code

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# THE UNSECURED CREDITOR — "THE LITTLE BUSINESSMAN" — AND THE UNIFORM COMMERCIAL CODE

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The Uniform Commercial Code is now on the statute books of five states—Pennsylvania (1953), Massachusetts (1957), Kentucky (1958), Connecticut (1959) and New Hampshire (1959). The legislatures of Pennsylvania, Kentucky and Connecticut passed it unanimously after interim legislative commissions had given it favorable consideration. The Pennsylvania Code is the original version. The other states enacted the revised version. On October 2, 1959, the Governor of Pennsylvania signed an act amending the Pennsylvania Code to conform with the revised version. The act becomes effective on January 1, 1960.

The Code has been effective in Pennsylvania for more than five years and in Massachusetts for more than a year. In neither of these states has any substantial complaint been reported from any segment of business or finance.

However, doubtless because the Code is so obviously an improvement over pre-existing law regulating lending secured by personal property, some persons in states in which the Code is not in effect have raised the cry that it benefits the secured creditor to the disadvantage of the unsecured creditor. And because the great majority of large Pennsylvania and Massachusetts banks and other businesses enthusiastically approve it, some persons without either experience under, or knowledge of, its provisions conclude that the Code must be bad for "the little businessman." Neither of these fears is justified in theory or in practice.

First let us take up the case of the unsecured creditor.

The only possible basis which I can imagine for the charge that the Code favors the secured creditor to the disadvantage of the unsecured creditor is the undeniable fact that the Code offers to the creditor who chooses to be protected by a security interest[1] in personal property or fixtures a far simpler as well as a cheaper method of perfecting his security interest than was afforded by the pre-existing

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[1] A "security interest" is defined in § 1-201 (37) as an interest in personal property or fixtures which secures payment or performance of an obligation. All references to sections or subsections of the Uniform Commercial Code are to the 1958 Official Edition.

chattel mortgage or conditional sale or factor's lien or other acts regulating secured transactions. This is a less blunt way of saying that the Code renders so easy the perfection of security that certain alarmists predict that the unsecured creditor will gradually disappear from the business community.

To these alarmists I say, "Your fears have no basis in experience."

The Code has been in effect in Pennsylvania since July 1, 1954. For more than a year prior to its effective date its provisions were the subject of institutes in various centers of the state, which were well attended by businessmen as well as lawyers. At these institutes Article 9 of the Code received more attention than any other article, because it replaced so much old law and procedure. Certainly after more than five years the business community, the financial interests and the legal profession know how simple it is to perfect a security interest in this state.

Therefore, if the continued existence of unsecured credit were threatened by the Code, Pennsylvania would be the place in which to obtain the facts demonstrating that the fear has substance.

In the course of preparing to write this brief article, I contacted officials of a number of financial institutions in the Philadelphia area for the purpose of ascertaining, if I could, whether the relative volume of unsecured loans in comparison with the volume of secured transactions has diminished appreciably during the more than five years that the Commercial Code has been in force in Pennsylvania. Without exception I was told that the volume of unsecured as compared with secured loans bears substantially the same relation to the total volume of loans as it did five years ago.

My informants tell me that it is true that because of the much simpler and much less expensive procedure provided by Article 9 of the Code, security is demanded in some cases in which prior to the Code the loan would have been unsecured. But, by and large, the reasons motivating financial institutions, manufacturers and other businessmen to extend unsecured credit, are the same under the Code as they were previously.

I personally know of a Pennsylvania concern which has quite recently been forced to seek shelter under the bankruptcy law, and which has no secured creditors whatever and more than a million dollars in unsecured debts.

The National Association of Credit Management, while taking no official position either for or against the Code, does not hesitate to confirm the fact that its members in Pennsylvania, Massachusetts, Kentucky and Connecticut are friendly to the Code and that the

Pennsylvania experience of the members of the Association has been good. I quote the following paragraphs from a letter dated July 31, 1959, from an officer of the National Association:

> Our members in states where the Code has now been adopted favored the Uniform Commercial Code in those states. Our members in Pennsylvania, Massachusetts and Connecticut have been particularly active in its support. Incidentally, it may be of interest to you to know that it was primarily at the behest of our members in Connecticut that the Connecticut Commission on the Code agreed finally to include Article 6 [on Bulk Sales] in its recommendations to the legislature. Our Kentucky members did not object to the Code in that state and so far as our records indicate lent their support to its adoption.
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> Several years ago we made a survey of NACM members in Pennsylvania for their experience in operating under the Uniform Commercial Code. The survey indicated the majority of members in Pennsylvania feel that the Code has not been detrimental to credit interests and in a number of instances has proved beneficial. Thus far there has been no evidence of any change of attitude on the part of our Pennsylvania members.

It is sheer nonsense to prophesy that by adopting the Code any state will dry up unsecured credit.

To sum up, the most important advantage—if not the only advantage—which the Code gives the secured creditor over advantages he formerly enjoyed is to make it easier and cheaper to become secured.

Now what does the Code do for the unsecured creditor?

In the first place it makes very clear what the rights and duties of the secured creditor are in case of default. The secured creditor can no longer impose, in fine print or otherwise, terms and conditions enabling him to treat his debtor's pledged property at will if a default occurs and thus deprive unsecured creditors of whatever equity there may be.

Part 5 of Article 9 of the Code is entitled "Default." It spells out in meticulous detail what the secured creditor may and may not do in the event of default, and under Section 9-501(3) provides that certain rules stated in Part 5 giving rights to the debtor and imposing duties on the secured party may not be waived or varied. The titles of the sections in this part of Article 9 sufficiently indicate the type of definite provision which the Code contains relating to the rights and duties of the secured party after default. Thus, Section 9-502 deals with "Collection Rights of Secured Party"; Section 9-503 with the "Secured Party's Right to Take Possession After Default"; Section 9-504 with the "Secured Party's Right to Dispose of Collateral After Default; Effect of Disposition"; Section 9-505 with "Compulsory Disposition of Collateral; Acceptance of the Collateral as Discharge of Obligation"; Section 9-506 with "Debtor's Right to Redeem Collateral" and Section 9-507 with "Secured Party's Liability for Failure to Comply with this Part."

The rules which cannot be waived or varied are those requiring an accounting for surplus proceeds of collateral,[2] dealing with disposition of collateral,[3] dealing with acceptance of collateral as discharge of obligation,[4] dealing with redemption of collateral,[5] and dealing with the secured party's liability for failure to comply with Part 5 of Article 9.[6]

We shall not discuss these rules in detail as their mere titles are sufficient to indicate that they are for the protection of the debtor and consequently of his unsecured creditors.

Subsection (1) of Section 9-507 provides that if the secured party is not proceeding in accordance with Part 5, disposition of the collateral may be ordered or restrained on appropriate terms and conditions, and that if disposition has been made, the secured party is liable to the debtor for any loss caused by a failure to comply with the provisions of Part 5.

The remedies afforded by this subsection for the protection of the debtor and his other creditors are not contained in any of the former uniform commercial acts which the Code supersedes.

Another benefit conferred on the unsecured creditor is that contained in Section 9-311, which provides that the debtor's rights in collateral may be voluntarily or involuntarily transferred (by way of sale, creation of a security interest, attachment, levy, garnishment or other judicial process) notwithstanding a provision in the security agreement prohibiting any transfer or making the transfer constitute a default.

This too is a new provision not found in any former uniform act. As stated in the Comment to this section, its purpose is to make clear that in all security transactions the debtor has an interest (whether legal title or an equity) which he can dispose of and which his creditors can reach.

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[2] § 9-502(2).

[3] § 9-504(3) and § 9-505(1).

[4] § 9-505(2).

[5] § 9-506.

[6] § 9-507(1).

Compare this provision with the decisions in a number of jurisdictions that when a mortgagee or conditional seller has "title" to the collateral creditors are barred from proceeding against it by any form of judicial process.

Finally, the Code virtually does away with "secret liens." I say "virtually" because while there are certain exceptions to the requirement that all "financing statements" must be publicly filed,[7] these exceptions are comparatively unimportant as I shall show later.

Under the scheme of Article 9, a security interest cannot attach until there is agreement that it attach, and value is given and the debtor has rights in the collateral.[8] Also a "financing statement" must be filed to perfect "all security interests except the following":[9]

Then follow nine exceptions, the most significant of which are:

(a) if the security interest is in collateral in the possession of the secured party under Section 9-305;

(c) a purchase money interest in farm equipment having a purchase price not in excess of $2,500, but the exception does not apply to fixtures or to motor vehicles required to be licensed; and

(d) a purchase money interest in consumer goods with the same limitations as under (c).

"Consumer goods" are defined as goods if they are used or bought for use "primarily for personal, family or household purposes."[10]

Farm "equipment" is defined as goods used or bought for use primarily in farming.[11]

However, while *as between seller and purchaser* of farm equipment having a purchase price not in excess of $2,500 or of consumer goods, the security interest is perfected without filing, the purchaser can defeat the seller's security interest by re-selling the collateral to another farmer or another consumer, as the case may be, if the second purchaser has no knowledge of the security interest, gives value and buys the goods for his own use.[12] The only way the original seller can protect himself against this disposition of the collateral is by filing.

Thus in all cases in which the collateral is of substantial value and the secured party does not have or control possession, the secured party will be likely to file his financing statement.

Up to the present time a number of states do not require condi-

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7 § 9-302.

8 § 9-204. Unless the secured party has possession of the collateral, the agreement must be in writing, signed by the debtor and the collateral must be described. § 9-203(1).

9 § 9-302.

10 § 9-109.

11 Ibid.

12 § 9-307(2).

tional sale agreements to be recorded and a number of states permit the assignment of accounts receivable without requiring the public filing of any notice whatever.

Some national organizations chiefly concerned with the problems of the unsecured creditor, have these many years been seeking to ban the "secret lien." These organizations should do all in their power to urge the passage of the Code in the remaining 45 states.

And now a few words about the Code's advantages to "the little businessman."

Under the Code, accounts receivable,[13] future as well as existing,[14] may be pledged as security for a loan and it is not necessary for the lender himself to collect the accounts[15] although on default he is given the privilege of doing so.[16] Similarly, inventory may be used as collateral for a loan and this includes future as well as presently owned inventory[17] and the proceeds derived from sales.[18]

This extension of the right to use accounts receivable and inventory as collateral gives the little businessman what is in effect a fund of capital which renders it unnecessary for him in many cases to increase and thus dilute his capital stock to enable him to continue in business.

This is not mere theory. I know of actual instances in which small businesses in Pennsylvania have been helped in this way through the operation of the Code's provisions.

True, by the use of this device, the small businessman may possibly use practically all of his current assets as collateral. Our unsecured creditor friends may ask, "Where does that leave us?"

There are several answers.

Because financing through the use of accounts receivable or inventory or both cannot be kept secret under the Code, our prospective unsecured creditor will become such only if he thinks the particular businessman is a good risk even though most of his assets are tied up. He may even believe his chances for prompt payment are enhanced by reason of the financing which the businessman has been able to negotiate through the use of his accounts receivable and inventory.

This at least is the point of view expressed by a Philadelphia credit man in a letter written in response to an inquiry from a neighboring state less than a year ago. He said:

> The fact that loans on accounts receivable are on a

13 § 9-102.

14 § 9-204(3).

15 § 9-205.

16 § 9-502.

17 See notes 13 and 14 supra.

18 § 9-205.

notification basis is looked upon as a very favorable point. While the loan on a transaction of this nature places the asset in the form of accounts receivable, merchandise, machinery, etc., beyond the reach of general creditors, they have not suffered as a result of this position and feel that it is in a great measure counteracted by the fact that the money is frequently used to pay their bills.

In conclusion, let me say that I believe that the movement to attain uniformity in commercial law through the enactment of the Uniform Commercial Code is gaining real momentum. In more than a dozen states, annotations of the Code are now being prepared in anticipation of the introduction of a Code bill in the 1961 session of the legislature. These annotations are, of course, calculated to show what changes the Code makes in the existing statutory and decisional law of the particular state.

I am confident that by the conclusion of the 1961 sessions of their legislatures, more than 25% of the states will have the Code on their statute books. The figure may well be larger.

When it is considered that the revised version of the Code was first ready for consideration in December 1956, and when the further fact is remembered that it required 34 years to have the Uniform Negotiable Instruments Law enacted by every American jurisdiction, the enactment of the Code by five states up to the present moment marks excellent progress indeed!