Boston College Law Review

Volume 2 | Issue 2 Article 5

4-1-1961

The Status of the Unsecured Creditor in the Modern Law of Secured Transactions

Jesse S. Raphael

THE STATUS OF THE UNSECURED CREDITOR IN THE MODERN LAW OF SECURED TRANSACTIONS

JESSE S. RAPHAEL*

The conflict between secured creditors and unsecured creditors, and their respective advocates, goes back at least to the days of the Roman Empire.[1] In Anglo-American law, it is discernible in the development of the common law and statutory rules delineating the rights of these claimants and the restrictions imposed on security devices.

There never seemed to be any legal objection to the concept of security as such. If, by agreement between a debtor and a creditor, specific property of the debtor was dedicated to the satisfaction of that creditor's claim, the fact that the debtor's property, to the extent of the security, was placed beyond the reach of other creditors of the debtor for the satisfaction of their claims, was not considered unjust or unlawful. But if the transfer of property by a debtor, whether by way of security or not, was made with intent to defraud creditors, the transfer was void and of no effect. This was the rule of the English Statute of 13 Elizabeth I.[2]

In interpreting the statute, the English courts from time to time found certain types of acts to be "badges of fraud." The first important case in this regard was *Twynes' Case*[3] decided in 1601, which is said to have established the doctrine that "where the mortgagor of chattels was left in possession with power to sell them for his own benefit,"[4] the transaction was fraudulent as to the creditors of the mortgagor "without reference to bona fides of the mortgage debt, or

* Professor of Law, Pace College. B.A. 1913, City College of New York; LL.B. 1916, Columbia University.

[ED. NOTE: In 1 B.C. Ind. & Com. L. Rev. 65 (1959), William A. Schnader, Chairman of the Commercial Code Committee of the National Conference of Commissioners on Uniform State Laws, discussed six years of satisfactory experience in Pennsylvania with Article 9 of the Uniform Commercial Code, in The Unsecured Creditor—"The Little Businessman"—and the Uniform Commercial Code. See, The Uniform Commercial Code in Pennsylvania, 1954-1961, Experience—Not Theory, Commercial Code Committee, National Conference of Commissioners on Uniform State Laws (1961). Professor Raphael states that his ultimate quarrel is not with Article 9 of the Uniform Commercial Code in its reflection of modern trends in secured financing, but rather with the trends in financing which preceded the Code and which it reflects.]

1 Radin, Fraudulent Conveyances at Roman Law, 18 Va. L. Rev. 109 (1931).

2 Statute of Fraudulent Conveyances, 1570, 13 Eliz., c. 5.

3 3 Coke 80b, 76 Eng. Rep. 809 (K.B. 1601).

4 73 A.L.R. 236, 237 (1931).

the honesty of the intention of the parties."[5] The debtor's retention of possession, with power of disposition, according to the reasoning of the court, tended to delude those who advanced unsecured credit into believing that the retained property was still owned by the debtor and was available for the payment of their claims.

The American courts were not unanimous in holding possession retained, with power of disposition, as a badge of fraud. The majority considered it as conclusive proof of fraud;[6] a few held that it raised a rebuttable presumption of fraud[7] and others held that it was a valid transaction unless an actual intent to defraud creditors could be shown from the statements or conduct of the parties.[8]

The mortgage transaction in which the debtor retains the power to dispose of the secured chattels after the mortgage concerns primarily mortgages of the debtor's stock-in-trade, i.e., inventory. The disapproval of these transactions was intensified by another rule which frowned upon mortgage transactions covering after-acquired goods. Here, the New York courts, adhering to the theory that a mortgage was a conveyance of title, developed the rule that it was legally impossible to create a mortgage "conveyance" of goods not yet in existence or not yet owned by the mortgagor.[9]

The United States Supreme Court in *Benedict v. Ratner*,[10] applied the New York prohibition to the assignment of accounts receivable as security but developed a new theory for declaring the transactions void as to creditors.[11]

---

[5] See Annot., 73 A.L.R. 236 (1931).

[6] In Clow v. Woods, 5 S. & R. 275 (Pa. 1819), Duncan, J., says at page 286: "In chattels, possession is the strongest evidence of ownership. That a secret mortgage to secure a creditor, without any change of possession, the debtor in the daily and constant occupation of the goods, . . . should be valid, and bind the property against creditors . . . would be a reproach to the law. It ought not, it cannot be so. If it were so, it would put an end to all credit."

[7] Supra note 5, at 250.

[8] Id. at 253.

[9] Stone, The Equitable Mortgage in New York, 20 Colum. L. Rev. 519 (1920).

[10] 268 U.S. 353 (1925).

[11] Id. at 360. The court said: "Under the law of New York a transfer of property as security, which reserves to the transferor the right to dispose of the same, or to apply the proceeds thereof, for his own uses, is, as to creditors, fraudulent in law and void. This is true whether the right of disposition for the transferor's use be reserved in the instrument or by agreement *in pais* oral or written; whether the right of disposition reserved be unlimited in time or be expressly terminable by the happening of an event; whether the transfer cover all the property of the debtor or only a part; whether the right of disposition extends to all the property transferred or only a part thereof; and whether the instrument of transfer be recorded or not. . . .

"But it would seem clear that whether the collateral consists of chattels or of accounts, reservation of dominion inconsistent with the effective disposition of title must render the transaction void. Ratner asserts that the rule stated above rests upon ostensible

To synthesize, then, the principles which, since *Twyne's Case*, have been developed by the English and American courts, applicable to the restrictions on secured transactions involving merchandise inventory and accounts receivable, one may say that, in general, the courts expressly condemned these transactions as "fraudulent" or "illusory" if (1) they created secret liens, (2) the debtor remained in possession of the property after hypothecation, (3) the debtor had permission to dispose of the hypothecated chattels without accounting to the secured creditor and (4) the security contract purported to cover after-acquired goods thereby making the security contract a sort of floating lien or charge on a shifting stock of goods.

It is possible that the courts instinctively sensed that the foregoing situations constituted injustices to the unsecured creditors because they failed to provide for a "cushion of free assets" to which unsecured creditors could look for the satisfaction of their claims. The authors of the Uniform Commercial Code agree with this interpretation of the old common law doctrines.[12]

Due to certain business pressures (later discussed), in the forty-year period roughly between 1910 and 1950, new security devices were sanctioned, principally by legislative action. The new rules were aimed at validating transactions by which a creditor could have a security interest in chattels despite the power of the debtor to dispose of the property by sale, and regardless of the fact that the security items were constantly shifting due to sales and replacements.

The New York Act of 1911, known as the Factors' Lien Act,[13] and subsequently adopted in substance by other states, provides that "a lender may, by agreement with a borrower, obtain a continuing general lien upon the borrower's merchandise, including after-acquired merchandise, to secure present and future advances and other obligations effective against the borrower's creditors."[14] Such a lender is generally called "a factor." Publicity is given to the transaction by requiring the parties to file a "notice" of the agreement in a designated public office and, in some states, by requiring the posting of another "notice" in the premises of the borrower. The statutes also usually

ownership, and argues that the doctrine of ostensible ownership is not applicable to book accounts. . . . But it is not true that the rule stated above and invoked by the receiver is either based upon or delimited by the doctrine of ostensible ownership. It rests not upon seeming ownership because of possession retained, but upon a lack of ownership because of dominion reserved. It does not raise a presumption of fraud. It imputes fraud conclusively because of the reservation of dominion inconsistent with the effective disposition of title and creation of a lien."

12 Infra at 308.

13 N.Y. Pers. Prop. Law, § 45.

14 Skilton, The Factors' Lien on Merchandise, 1955 Wis. L. Rev. 356, 357.

provide that accounts receivable arising from the sale of the hypothecated merchandise shall likewise be covered by the security right of the factor, provided that separate assignments are delivered by borrower to factor of each account as it is created or provided that the account debtor is notified of the assignment.[15]

Another modern security innovation, the trust receipt transaction, also has as one of its purposes the creation of a lien on inventory valid against other creditors regardless of the debtor's power of sale. In the absence of statute,[16] the trust receipt transaction has had a checkered career in the courts.[17]

---

[15] Supra note 12.

[16] The Uniform Trust Receipts Act (hereinafter cited as U.T.R.A.) has been adopted in the following jurisdictions: Alabama, Ala. Code tit. 39, §§ 191(4)-191(22) (Supp. 1953); Alaska, Alaska Comp. Laws Ann. ch. 40 (1951); Arizona, Ariz. Rev. Stat. Ann. §§ 44-821 to 44-839 (1956); California, Cal. Civ. Code §§ 3012 to 3016.16; Connecticut, Conn. Gen. Stat. Rev. §§ 40-60 to 40-80 (1958); Delaware, Del. Code Ann. tit. 6, §§ 1101-1118 (1953); Florida, Fla. Stat. §§ 673.01-673.18 (Supp. 1958); Hawaii, Hawaii Rev. Laws §§ 206-1 to 206-17 (1955); Idaho, Idaho Code Ann. §§ 64-1001 to 64-1020 (1948); Illinois, Ill. Rev. Stat. ch. 121½, §§ 166-187 (Supp. 1958); Indiana, Ind. Ann. Stat. §§ 51-601 to 51-621 (1951); Maine, Me. Rev. Stat. Ann. ch. 189, §§ 1-20 (1954); Maryland, Md. Ann. Code art. 95½, §§ 1-20 (1951); Massachusetts, Mass. Gen. Laws Ann. ch. 225A, §§ 1-21 (Massachusetts By-Laws 1957, ch. 765 adopted the Uniform Commercial Code, Mass. Gen. Laws Ann. ch. 106, §§ 1-101 to 9-507, effective October 1, 1958 thereby repealing the provisions of the U.T.R.A.); Michigan, Mich. Comp. Laws §§ 555.401-555.419 (Supp. 1956); Minnesota, Minn. Stat. §§ 522.01-522.17 (1957); Mississippi, Miss. Code Ann. §§ 5080-01 to 5080-23 (1957); Montana, Mont. Rev. Codes Ann. §§ 65-201 to 65-219 (1953); Nebraska, Neb. Rev. Stat. §§ 69-701 to 69-720 (1958); Nevada, Nev. Rev. Stat. §§ 93.010-93.200 (1957); New Hampshire, N.H. Rev. Stat. Ann. §§ 445.1 to 445.19 (1955); New Jersey, N.J. Rev. Stat. §§ 46:35-1 to 46:35-21 (1940); New Mexico, N.M. Stat. Ann. §§ 50-13-1 to 50-13-19 (1953); New York, N.Y. Pers. Prop. Law §§ 50 to 58-1; North Dakota, N.D. Rev. Code §§ 41-1801 to 41-1819 (Supp. 1957); Oregon, Ore. Rev. Stat. §§ 73.010 to 73.200 (1959); Puerto Rico, P.R. Laws Ann. tit. 10, §§ 611-633; South Dakota, S.D. Code §§ 39.1801 to 39.1820 (Supp. 1960); Tennessee, Tenn. Code Ann. §§ 47-1001 to 47-1019 (1955); Texas, Tex. Rev. Civ. Stat. art. 5499a-51 (Supp. 1960); Utah, Utah Code Ann. §§ 9-2-1 to 9-2-20 (1953); Virginia, Va. Code Ann. §§ 6-550 to 6-568 (1950); Washington, Wash. Rev. Code § 61.20.010-61.20.190 (Supp. 1958); Wisconsin, Wis. Stat. §§ 241.31 to 241.50 (1957); Wyoming, Wyo. Stat. Ann. §§ 34-296 to 34-314 (1957). See also, Vol. 9C Uniform Laws Annotated 220.

[17] Durfee, Cases on Security (1951). For example, prior to the adoption of the U.T.R.A., many states held that only triparty trust receipt transactions were valid. The entruster had to acquire his title to the secured goods from a source other than the trustee. Dissatisfaction with this common law rule was expressed in the Commissioner's Note to the U.T.R.A. "There is also, for instance, the established rule (at common law) that if the importer (or auto or radio dealer) happens to get title into himself before the financer acquires his security interest, the unrecorded trust receipt will be void against the importer's (or dealer's) trustee in bankruptcy. One can put case after case of common occurrence in auto finance, in which a lawyer must remain in doubt as to whether the title had passed to the financer directly or had passed through the dealer, with resultant invalidity of the financer's interest." Vol. 9C, Uniform Laws Annotated 222. See generally, McGowan, Trust Receipts, The Variations in Their Legal Status (1947); Stiller, Inventory and Accounts Receivable Financing, The Maryland Maze, 18 Md. L. Rev. 185-233

There is much more justification for supporting the financing creditor's security interest in a trust receipt transaction than in a factor's lien transaction. The trust receipt covers a specific chattel which becomes an asset of the borrower-merchant only by reason of the payment advanced by the secured creditor. The original supplier is, as a matter of practice, if not as a matter of legal requirement, paid in full before the lien attaches. Under the Uniform Trust Receipts Act, as each specific chattel is placed in the hands of the borrower, a trust receipt in which it is identified is delivered to the secured creditor. In the absence of the trust receipt, the creditor has no security interest. In the trust receipt transaction, therefore, the secured creditor, by a general agreement, acquires security rights over a shifting inventory.

In a factoring transaction, on the other hand, the inventory is acquired ordinarily by the borrower and comes under the factor's lien only after such acquisition. Since the borrower may, and most often does, acquire such inventory from suppliers on open credit, there arises immediately a conflict of interest between the secured creditor (factor) and the unsecured creditor (the supplier).

Because of the fundamental differences in the nature of trust receipt financing from other forms of inventory and accounts receivable financing, the impact of the former on the rights of unsecured creditors will not be discussed further in this article.

The latest attempt at statutory regulation of secured transactions generally, and hence those involving inventory and accounts receivable, is the Uniform Commercial Code.[18]

Article 9 of the Code "sets out a comprehensive scheme for the regulation of security interests in personal property and fixtures. It supersedes existing legislation dealing with such security devices as chattel mortgages, conditional sales, trust receipts, factor's liens and assignments of accounts receivable."[19]

The architects of the Code frankly admit that the Code aims to abolish all the common law prohibitions against liens in after-acquired property and to make applicable to all secured transactions the principle of the "continuing general lien" stated in Section 45 of the New

(1958).; Rudolph, Judicial Construction of the Trust Receipt and Its Reflection in the Commercial Code, 19 U. of Pitt. L. Rev. 1-20 (1957); Heindl, Trust Receipt Financing under the Uniform Trust Receipts Act, 26 Chi.-Kent L. Rev. 197-268 (1948); Bogert, Effect of the Uniform Trust Receipts Act, 3 U. of Chi. L. Rev. 26 (1935).

18 The Uniform Commercial Code (hereinafter cited as the UCC) is now on the statute books of nine states—Pennsylvania (1953), Massachusetts (1957), Kentucky (1958), Connecticut (1959), New Hampshire (1959), Rhode Island (1960—to become effective as of January 2, 1962), Arkansas (1961), Wyoming (1961) and New Mexico (1961).

19 UCC § 9-101 and Comments.

York Personal Property Law (Factor's Act).[20] The Code also "validates a security interest in the debtor's existing and future assets, even though . . . the debtor has liberty to use or dispose of collateral without being required to account for the proceeds or substitute new collateral,"[21] thus sweeping aside all the common law objections to these transactions. The Code likewise expressly repudiates the rules laid down in *Benedict v. Ratner.*[22]

In general, the lien under the Code is perfected against creditors by filing a financing statement giving the names and addresses of financer and borrower and a statement indicating the types or describing the items of collateral.[23] The required statement is similar to the one required under the Uniform Trust Receipts Act.[24]

There is general agreement that the Code provisions go as far as any existing statute or case law to make it easier for the financer who takes inventory or accounts receivable as his security to maintain and perfect his security interest as against other creditors. The sponsors of the Code state their philosophy in Comment 3 to Section 9-204 of the Code:—

> "The widespread nineteenth century prejudice against the floating charge was based on a feeling, often inarticulate in the opinions, that a commercial borrower should not be allowed to encumber all his assets present and future, and that for the protection not only of the borrower but of his other creditors a cushion of free assets should be preserved. *That inarticulate premise has much to recommend it. This Article decisively rejects it not on the ground that it was wrong in policy but on the ground that it has not been effective.* (Italics mine.) In the past fifty years there has been a multiplication of security devices designed to avoid the policy: field warehousing, trust receipts, 'factor's lien' acts and so on. The cushion of free assets has not been preserved. In almost every state it is now possible for the borrower to give a lien on everything he has or will have. There have no doubt been sufficient economic reasons for the change. This Article, in expressly validating the floating charge, merely recognizes an existing state of things."

All that has thus far been said indicates that in the past half

[20] UCC § 9-204, Comment 3.
[21] Ibid.
[22] UCC § 9-205, Comment 1.
[23] UCC § 9-402.
[24] U.T.R.A. § 13(3), (4).

century, particularly in the past 30 years, the changes in statutory law have tended to break down the old common law safeguards with a view towards encouraging the lending of money against the security of present and future inventory and accounts receivable. The position of the secured creditor in this area, vis-à-vis the unsecured creditor, has been strongly entrenched and strengthened. The rights and interests of unsecured creditors have been pro tanto weakened.

The writer takes as his basic thesis that the law does not fulfill its fundamental purpose if, as the authors of the Uniform Commercial Code state in their Comment, it merely seeks to reflect and encourage prevailing business practices. If such practices are economically or morally unjustifiable, then the law does a disservice to the community in providing a framework in which such practices can continue and grow.

We should, therefore, be concerned with the following questions: (1) Are the modern business practices involved in advances against the collateral of inventory or accounts receivable economically justifiable? (2) Does the available evidence indicate that these practices result in a gross injustice to the unsecured creditors of the borrower who seeks or takes this type of financing?

Commentators (lawyers and economists) in Law Reviews and other professional journals, who justify these practices, applaud the new laws for favoring the factors and other financers of inventory and accounts receivable, and contend that those laws and the practices they encourage are a great boon to the business enterprise borrower, to the general community, and even to the unsecured creditors. Their arguments for this type of financing may be summed up as follows:

(1) They enable enterprises with insufficient capital to begin and expand in business;

(2) Business enterprises are able to obtain temporary financing of seasonal goods bought or made in advance of the seasonal time of distribution;

(3) Creation and expansion of credit is a good thing even if some groups are harmed;

(4) Through the new recording acts and available credit information, a supplier of goods on open credit is fully aware of the risk he takes;

(5) The funds obtained by the financer will help the unsecured creditor since the borrower can thus discount his supplier's bills.

As to the first argument—that this type of financing enables enterprises with insufficient capital to begin and expand in business—

it is logical to examine the nature of the enterprises thus sought to be encouraged. The following excerpts from articles written by economists and others are in point:

> "Because small businesses are often under-capitalized, it becomes necessary, if they borrow at all, to do so on a secured basis. The 300,000 to 500,000 new enterprises which come into existence each year are sometimes pioneered by men who have little or no experience in financing a new business, and consequently begin their operations under-capitalized. As these businesses grow, even if they are successful, they find themselves constantly in over-extended positions and often have difficulty in obtaining the credit they need to survive. Depository banks circumscribed by law, cannot or will not make loans to them, at least in the amounts they require."[25]

As to field warehouse financing, which is one of the currently popular devices for inventory financing:[26]

> "It is a relatively expensive type of financing and it is most frequently resorted to by businesses in a weak financial position. Its growth during the depression was due both to the fact that businesses, particularly those in a weak financial position, required a large volume of working capital financing and to the fact that banks were eagerly seeking additional outlets for their capital funds."[27]

And, again:—

> "The growth of receivables financing by commercial banks . . . was due primarily to the weakened financial

[25] Silverman, Factoring: Its Legal Aspects and Economic Justification, 13 Law & Contemp. Prob. 593, 594 (1948).

[26] This device did not require statutory modification of common law principles to validate it. The device is based on the principles of the "pledge," in which the financer's security rights are based upon his possession of the collateral. Since it is costly and inconvenient to transport a bulky stock of goods from borrower to financer, the ritual of change of possession is carried out by setting up on the premises of the borrower an enclosure—a field warehouse—which is rented to an independent warehouseman. The goods constituting the collateral are placed in the enclosure under the exclusive control of the warehouseman who issues negotiable warehouse receipts to the borrower. The latter in turn transfers these receipts to the financer, thus giving the financer symbolic and constructive possession of the collateral. The borrower is usually permitted to withdraw goods from the field warehouse by either delivering to the warehouse other goods of equal value, or by payment of a proportionate part of the loan to the financer. Thus the financer is enabled to maintain a continuous lien on a shifting stock of goods.

[27] Koch, Economic Aspects of Inventory and Receivables Financing, 13 Law & Contemp. Prob. 566, 570 (1948).

condition of business, their resultant need for financial assistance, and the plethora of lending capacity in the banking system."[28]

Apparently, the type of enterprise which is compelled to resort to inventory and receivables financing is the business which is undercapitalized and in a weak financial position. Such a business cannot obtain open money credit from the regular commercial banks, obviously because it is not a good credit risk. Is it economically justifiable for such business to exist or even to begin? Is mere business activity an economic desideratum for its own sake? Is an economy sound that is built on such frail reeds?

It is significant to note that at least one statute, now law in many states, and the provisions of which are incorporated in the United States Bankruptcy Act, condemns the practice of commencing business with insufficient capital.[29] It provides that the transfer of assets without fair consideration is a fraud on future creditors when the transferor, by the transfer, *leaves himself with insufficient capital to conduct the business he intends to start.*

It is also interesting to note that none of the economist-advocates of the new financing offer specific statistical proof as to how many of the enterprises thus financed have profitably continued in business. The actual case histories set forth later in this article are evidence of what happens to many of them.

In the case, then, of the business entrepreneur without capital of his own who accepts financing against his inventory and accounts receivable, all of the hypothecated property has first to be acquired by the borrower before the financer's lien is effective. How does the borrower acquire this property, taking into consideration that he starts off with insufficient or no capital of his own? The borrower naturally acquires these chattels on credit, in whole or in substantial part.

The merchant who obtains goods on credit is, in effect, borrowing from his supplier, since the supplier of the goods, after delivery, has a mere money claim against the buyer. In this transaction, ordinarily, the amount lent represents the entire purchase price of the goods. The assurance to the supplier that he will be paid is co-extensive with the integrity and merchandising ability of the buyer, the amount of the buyer's business equity (unencumbered capital belonging to

28 Id. at 571.

29 Uniform Fraudulent Conveyances Act § 5. Cf. Bankruptcy Act § 67, 30 Stat. 550 (1898) as amended, 11 U.S.C. § 107 (1958).

him) and the increase in his assets created by the delivery of the goods on credit.

When this merchant takes these unpaid-for goods and hypothecates them, he is using the same property twice for credit purposes. He is, in effect, "robbing Peter to pay Paul."

Argument (2)—that the new financing offers temporary aid for the production of seasonal goods—is valid only if it is economically and morally justifiable to permit under-capitalized businesses to begin operations. If the enterprise is on a firm capital base, it can obtain temporary funds from the commercial banks on open credit, and does not need to hypothecate its basic enterprise resources.

Argument (3)—that expansion of credit is economically advantageous even if some groups are harmed—is also to a great extent dependent on whether it is economically justifiable to expand credit by devices which weaken the capital base on which credit rests for ultimate support. A merchant who carries on his business almost entirely with other people's money is apt to be less efficient and prudent than he would have been had his own property been involved in the business risks.

Argument (4)—that the procedures for new financing provide against secret liens and set up safeguards of information—has been stated in one article, as follows:

> "But the horse-and-buggy days have gone, and today there is available at moderate cost constantly brought up-to-date information with respect to the complete financial status of prospective debtors."[30]

However, another equally astute writer says:

> "An adequate credit check of any business enterprise requires investigating records in half-a-dozen different places. . . . The national and regional credit information agencies, which do the credit job for business today, do not and cannot maintain facilities for keeping their credit ratings up to date under present filing systems."[31]

The fact is, of course that the new filing systems under the Factor's Acts, and under the Uniform Commercial Code, give less information than the old systems do. The financer and borrower under the new practices merely inform the public that they are

[30] Gerber & Cohen, Mortgages of Merchandise, 39 Colum. L. Rev. 1338, 1342 (1938).

[31] Gilmore, The Secured Transactions Article of the Commercial Code, 16 Law & Contemp. Prob. 27, 32 (1951).

engaged in the financing of a general type of commodity. The supplier who is contemplating extending unsecured credit has no way of knowing, without questioning financer and borrower, the total of the assets being hypothecated, or the total of the moneys advanced against them. As these vary from day to day, it is hopeless to get a true picture as of any specific period.

One writer, praising the recording requirements of the Uniform Commercial Code, says:

> "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."[32]

The foregoing statement takes the naive view that the "prospective unsecured creditor," with his eyes wide open as to the financial weakness of his customer, has a free choice to extend or not to extend credit to his factored customer, and that if he does so, he knows that he must look solely to the personal integrity and honesty of the customer for payment of the bill. This is hard to believe. That so many suppliers continue to sell goods to such customers on open credit strongly indicates either that these suppliers are ignorant of the true asset position of the customer, or that the pressures of competition are such that the supplier must take a credit risk which is grossly unfair to him or leave the field to his more reckless competitor. It is also evident that to offset the abnormal risks which suppliers of open credit to factored customers must take, their prices must be artificially raised to take care of the abnormal credit losses, thus inflating costs generally.

Argument (5) takes the astonishing position that making it legally easier for financing of inventory and accounts receivable actually helps the unsecured creditors. This argument is stated by one writer, as follows:

> "In many situations a supplier who has been waiting for sixty or ninety days to collect his accounts from an undercapitalized buyer will welcome the idea that that buyer can more easily create a security interest in his inventory or his accounts, and thus obtain the money to discount his bills within ten days."[33]

---

32 Schnader, The Unsecured Creditor—"The Little Businessman"—and The Uniform Commercial Code, 1 B.C. Ind. & Com. L. Rev. 65 (1959).

33 Coogan, Operating under Article 9 of the Uniform Commercial Code without help or hindrance of the "Floating Lien," 15 Bus. Law. 373, 391 (1959-1960).

The foregoing statement brings us squarely to the issue raised in the present article. Do the new statutes which make possible the financing of inventory and accounts receivable without legal restriction, operate favorably or justly in regard to the unsecured creditor?

The fundamental objective of the security transaction is to place the secured creditor in a favored position when the borrower is unable to meet all his obligations, that is, when the borrower is insolvent. If the borrower has indeed used his financing to pay or anticipate payment on his unsecured obligations, the unsecured merchandise creditors at the time of the borrower's insolvency should suffer very slight losses. What are the true facts?

The writer has examined the court records of four cases, taken at random, in which an enterprise receiving financing against inventory and accounts receivable became insolvent. The cases have been taken from the records of state and federal courts in New York City, where most of the financers of inventory and accounts receivable have their principal offices. The situations and results in these cases can probably be duplicated throughout the United States.

CASE #1[34]

The Interstate Screw Corporation was engaged in the business of jobbing nuts, bolts and screws. It made a general assignment for the benefit of creditors on July 30, 1954.[35]

Prior to the assignment for the benefit of creditors, a financer had made advances to the Screw Corporation, some secured by a field warehousing arrangement as to inventory, and some secured by an assignment of the corporation's accounts receivables.

As of the date of the general assignment for the benefit of creditors the liabilities of the corporation contained the following items:

Due to factor—secured by accounts receivable	$19,435.41
Due to factor—secured by inventory	52,257.83
Total due to factor	$71,693.24
Due to unsecured creditors (mostly for merchandise) approximately	$59,000.00
Due to Federal government for taxes	10,938.16

In the four months prior to the assignment, the corporation had

[34] Interstate Screw Corporation, Assignor, Supreme Court, New York County, N.Y., File No. 23-333 (1954).

[35] All figures mentioned are taken from the auditing report of the certified public accountant employed by the assignee and from the final report of the assignee.

purchased approximately $53,000 in merchandise, practically all on open credit.

The inventory and equipment were sold by the assignee at public auction for a gross price of $63,167.04, and a net return, after payment of the expenses of sale, of $57,926.96 resulted. Of this amount, $51,235.80 was remitted to the factor under the security arrangement, and $2,000 to another secured creditor.

In the two months prior to the assignment, the factor had received remittances of $18,353.42 against its advances (including interest and charges). A further collection of accounts receivable, after the assignment, of approximately $15,000, brought the balance due to the factor down to about $5,500, most if not all of which constituted interest and charges on loans.

The free (unencumbered assets) remaining in the hands of the assignee after liquidation amounted to $4,694.16. The expenses of administration amounted to $2,358.55. The balance of approximately $2,300 was paid to the United States in part payment of its priority tax claims. *The 118 unsecured creditors with claims of approximately $59,000, received nothing at all.*

CASE #2[36]

The Allied Trimming Corporation was engaged in the business of manufacturing and selling trimming supplies.

It made a general assignment for the benefit of creditors on June 9, 1958.

As of the date of the assignment, the assets of the corporation consisted of inventory and accounts receivable (all pledged to a financing factor), a small amount of free accounts and cash in bank, as follows:

Inventory and fixtures (gross realization $3,929.59) brought net	$ 3,184.30
Accounts receivable (pledged to factor)	27,690.18
Cash in bank	136.87

The liabilities were approximately:

Due to factor for advances, interest and charges, against accounts receivable	18,441.14
Alleged balance of loan by factor against inventory	2,284.41
Unsecured creditors	38,841.19
Taxes	2,105.95

[36] Allied Trimming Corp., Assignor, Supreme Court, Kings County, N.Y., File No. D-4 P 1551 (1958).

The factor's inventory lien was compromised with the assignee for the benefit of creditors at $1,000, but the claims of the factor against accounts receivable were apparently paid in full. Out of the free assets in the hands of the assignee, there were paid modest sums for administration expenses and $708.52 to the Federal government on its tax claim.

The unsecured creditors, with claims totalling approximately $39,000, received nothing at all.

CASE #3[37]

Magna Products Corporation was engaged in the business of manufacturing and selling bicycle parts and accessories. It filed a voluntary petition in bankruptcy on October 2, 1957.

The factors had mortgages on machinery and equipment and liens on inventory and accounts receivable. The receiver and trustee collected approximately $190,000 on the accounts receivable and from the sale of the physical assets. Of this sum, approximately $152,000 was paid over to the factors against claims, including charges and interest, of about $200,000. After the payment of expenses of administration, including substantial charges for use and occupation of the bankrupt's premises, *the following claimants received nothing at all:*

Priority wage claims filed	$23,248.31
Priority tax claims filed	48,633.09
Unsecured creditors' claims filed	489,336.29

CASE #4[38]

Enel Manufacturing Co., Inc. was engaged in the business of selling wrist-watch bands.

An involuntary petition in bankruptcy was filed against it on June 30, 1953. The factor had mortgages on its equipment and fixtures, and a lien on its inventory and accounts receivable.

According to the report of the accounts for the Trustee in bankruptcy, the condition of the bankrupt as of the date of the bankruptcy was as follows:

Assets

Machinery and equipment (mortgaged to factor)	$36,869.32
Inventory (at auction sale price)	3,278.62
Accounts receivable (assigned to factor)	31,027.44
Total	$71,175.38

[37] Magne Products Corp., Bankrupt, U.S. Dist. Court, Eastern Dist. N.Y., File No. 54314 (1957).

[38] Enel Manufacturing Co., Inc., Bankrupt, U.S. Dist. Court, So. Dist. N.Y. File No. 89483 (1953).

Liabilities

Due to factor against accounts receivable	$22,241.22
Due to factor against fixed assets	20,100.00
Unsecured liabilities, consisting of general creditors and tax claimants	66,497.07

There were also certain priority wage claims.

As a result of the liquidation, payment of sums due to the factor, and expenses of administration, there was enough left to pay only 50% on priority wage claims. *Unsecured creditors, having claims mostly for merchandise totalling $38,860.56, and tax claimants, having claims totalling $27,696.51, received nothing at all.*

Conclusion

The foregoing cases show the actual plight of the unsecured creditor where borrowers receive financing against inventory and accounts receivable and the borrower eventually becomes bankrupt.

The reason for the condition is summed up in a statement made by the attorneys for the assignee for the benefit of creditors in the *Interstate Screw Corporation* case. Speaking of the assignor, they say:

> "All of its accounts receivables had been previously assigned to [factor] and the funds which came in as a result of sales had to be transferred to the factor pursuant to the factoring arrangement leaving the assignor without operating capital.
>
> "Substantial loans had been made by the factor which had been secured by field warehouse receipts. Inventory could not be sold without permission from the factor and the proceeds of the sales would again have to be turned over to the factor, leaving the assignor without operating capital.
>
> "Interest rates and charges resulting from field warehousing and assignment of accounts were so exorbitant, it made it impossible to continue operations since no capital would result from sales, etc."[39]

It is interesting to compare the above statement of the attorneys for the assignee for the benefit of creditors with a paragraph appearing in *Mortgages of Merchandise* written by Professors Gerber and Cohen.[40] The authors of that article favor the abolishment of the old common law restrictions on the validity of mortgages where the mortgagor retains possession with power of disposition. They point out

[39] Supra note 34.
[40] Gerber & Cohen, supra note 30.

that the old common law courts relaxed the prohibition against such mortgages provided the mortgage agreement required the mortgagor to turn over all the proceeds of sale of the mortgaged property to the mortgagee. In complaining of the impracticality of such a relaxation, the authors of the article say:

> "Certainly the interests of creditors are not furthered by this arrangement. If Jim (a suppositious debtor or merchant) is permitted to retain the proceeds in order to operate the business, buy an automobile and perhaps build up a bank account, creditors will have a going concern to look to for the payment of debts as well as possible new sources of payment in the event of Jim's subsequent failure. *If the Mortgagee takes all the proceeds of the sales out of the business, the effect is the liquidation or at least the shrinkage of the business. At the same time the requirement that the mortgagor turn over all the proceeds to the mortgagee renders the arrangement impracticable as a means of financing business. Most merchants do not have independent incomes. It is therefore extremely doubtful whether this type of mortgage is worth serious consideration by attorneys or businessmen.*"[41] (Italics mine.)

Substitute "factor" for "mortgagee" in the above statement and it coincides with the complaint of the attorneys for the assignee of *Interstate Screw Corporation* regarding current factoring practices under the present statutory law.

In the four insolvency proceedings outlined above, there is strong evidence that the unsecured creditors furnish the assets from which the secured financer is enabled to satisfy his claims, while the unsecured creditors and often even priority wage and government tax creditors suffer a total loss.

This is an intolerable injustice which calls for reform. Although it is not the purpose of this article to offer a blueprint for solution of the problem, it is evident that the matter calls for a thorough legislative investigation, with a view to amending the law so that merchandise suppliers who sell to their customers on open credit are assured that the customer will retain some measure of free and unencumbered assets out of which the unsecured creditors' just claims may be realized.

[41] Id. at 1346.