AMERICAN PERSPECTIVE ON SECURED TRANSACTIONS.

[This article is presented substantially as delivered in lecture form at the Law Summer School held at the University of Western Australia in February 1962. The author wishes to acknowledge the assistance provided by his colleague at Northwestern University, Professor William Trumbull, in supplying background material. The usual footnotes that ornament academic writing have been eliminated in favour of a general bibliography that follows the article. In the referenced items, to be found among other places in the Law Library of the University of Western Australia, are a plenitude of citations.]

It is my assignment to describe within the time allotted to me some of the commercial credit practices employed currently in the United States, as an introduction to more immediately useful presentations that follow. In short I am to generate a certain amount of confusion which the other speakers will in due course dispel; I submit that my choice of the term "due course" is not a particularly unhappy one, because the other lecturers certainly took their assignments without knowledge of what I proposed to do and in good faith at that. I can make the same statement in my own behalf.

THE PERVASIVE USE OF CREDIT IN THE UNITED STATES.

We have a clause in the United States Constitution called the "full faith and credit clause", designed to assist in the resolution of problems in the conflict of laws, but it is actually a very apt description of the American way of life. It is a strange thing to recall that back in the depression of the thirties, when I was growing up as some of you were, we were taught that one ought not to buy beyond one's means, that one ought to pay cash for everything, that debt was an evil thing; in short, that virtue required that the deal should always be for "cash on the barrel head". How things have changed! The patriotic approach now is to buy as much as the creditors will permit. Actually the economy, the American economy as least, would grind to a halt if people only bought that for which they could pay cash. In the post-30's period we have had a great revolution in the use of credit, particularly for the purchase of consumer goods.

There are a number of statistics which may not be particularly meaningful here, because all sorts of translations are required. Nevertheless it is of some interest that, in the United States, consumer credit outstanding in 1962 represents about fifty-six billion dollars ($56,000,000,000). The Australian figure, presently reported with respect to hire-purchase, is about three hundred and eighty-six million pounds (£386,000,000), and if you do a little juggling with population figures and then decide what exchange rate to apply to our respective currencies you will probably conclude that we in the United States are in a little deeper than you are. Of this fifty-six billion in the United States, automobiles make up the largest single item with seventeen billion. Eleven billion is outstanding for a variety of other consumer items like television sets, refrigerators, and the like. Ten billion is outstanding for personal loans which frequently go to buy consumer items. Three billion is owed for modernisation and repair of residences.

We not only have a great variety of methods for buying items *on hire*. In the United States we have all sorts of ingenious arrangements which I dare say you have out here as well, such as revolving credit extended by the merchants. Under this system the merchant advises that as long as you don't get in deeper than a specified figure, you don't have to make a new credit application. In other words one just keeps paying and buying on credit as long as purchases don't go out the top limit of this so-called revolving credit. Some American banks are now in this business too, and will extend a line of credit to the individual who can simply draw and repay and draw and repay to finance the purchase of consumer and other items. We are besieged by requests to travel on credit. Just "pay a little bit down", and if you are willing to pay for the rest of your life you can see all sorts of exotic spots around the globe. Credit cards abound. One is implored to take Diners Club Cards, American Express Credit Cards, Hilton Credit Cards. A story is reported in one of the legal publications about a nineteen year old boy who picked up somebody else's credit card and in the course of one month managed to expend the sum of ten thousand dollars. He is reported to have said it was just like Aladdin's lamp except that you didn't have to rub it!

One rather interesting statistic is the one indicating that in the United States about 15% of our disposable income is already committed to payment for items purchased on credit. The percentage of disposable income that is firmly committed has been steadily increasing over the past two decades. Eventually we will all be slaves to the system. When the taxes are added on to the payments that have to be made on account of instalment or hire-purchase sale, many of us will not have many decisions left to make. The consumer rides along on credit—sometimes to disaster. We've had some very sad individual stories, human-interest stories reported in our press of suicides and of people who become absolutely demoralized about the problem of coping with these obligations which they are implored to take on by sellers who seem to be not at all concerned about the kind of personal problem they are generating.

But it is not only the consumer. The business man as well operates very very largely, of course, with someone else's money. In the United States to an increasing extent the capital for business is not raised by the sale of shares or stock. The bulk of our business capital is actually generated internally from earnings. Indeed, it is said that in excess of 80% of the capital outlaid for business in the United States comes from earnings. To a considerable extent, however, substantial businesses do go into the bond market as we call it. These corporations sell bonds or debentures, not for the most part to the general public. More and more these instruments of indebtedness, long-term instruments of indebtedness, are sold to insurance companies and to pension funds, the great modern day collectors of capital. One of the prime features of the developing American economy has been the democratization of our capital collection. Many, many people now contribute through insurance companies and through pension funds, and these tremendous funds have to be invested. Thus the large, "solid" corporations commonly will place an issue of bonds with one of the insurance companies or with a pension fund.

Of course, the business man turns not only to the insurance companies but also to the banks, and the business that is really "solid" with a substantial credit standing does in fact rely very heavily on what amounts to unsecured bank loans. My banking friends report that they go in more and more for establishing lines of credit for corporations; the corporate debtor is then free to draw up to the stipulated amount without any further formalities. In the United States this is a rather recent development. The borrower doesn't have to pay any interest except as he does, in fact, withdraw money. This is, again, a kind of revolving credit arrangement. Very commonly the banks will charge a commission, a type of overriding commission, but the interest actually will be charged only on the outstanding balance, usually figured on some sort of average approach. Of course the business that is substantial, one that is well known, may have problems about raising capital but its sources are relatively readily available—bank loans, placing an issue of bonds, or generating capital from their own earnings. There are very many businesses in the United States, however, that are not so situated. These businesses, including manufacturers, dealers (or the wholesaler, as I would say), and the retail outlet or merchant rely very heavily on secured credit. The development of commercial practice and the law of secured transactions in the United States has been much affected by that pervasive machine—the automobile.

THE DEVELOPMENT OF SECURED FINANCING.

It is interesting to recall that the Ford Motor Company was founded in 1903. The company was organized with a stated capital of roughly twenty thousand pounds. In fact, they had only twelve thousand pounds in hand at the outset. Many of us no doubt wish that we had been on hand to have made a modest contribution to that capitalization. At that time, however, the automobile was viewed with very grave doubts; some of us continue to share those doubts but not in the same way. The banks were then very hostile towards automobile manufacturers. Perhaps they did not think the automobile was really here to stay. It was then a kind of seasonal business anyway. The automobiles in those days were all open touring cars. In the United States that really meant that they were in the category of seasonal products.

At the turn of the century there were very few consumer items that had any real life-expectancy. Things wore out. They were soft goods, as we say. The automobile as it developed, however, became a consumer item with a relatively long life-expectancy. But because the banks did not believe in the automobile, the automobile manufacturers began with the idea of always selling for cash and they hold to that way of doing business. Indeed, quite a number of other manufacturers of somewhat similar type products in the United States also follow this same system. No doubt they follow the practice because they are in a very strong bargaining position with their chains of distribution. From the manufacturer's point of view it solves many problems to get cash at once for the product. But this insistence on cash from the dealer for a relatively high cost item that had a long life generated some immediate problems. First for the dealer: How was he to pay for the item? Secondly for the consumer: How was he to pay? Some system had to be devised of financing both the dealer and the consumer.

What happened was that very quickly several methods were devised. The basic method was for the buyer, the ultimate consumer, to make a small down payment or a deposit and pay off the balance over a considerable period of time. In the United States currently for automobiles I think thirty-six months is the most common period and ninety per cent. of all new cars in the United States are sold on time. The average unpaid balance is two thousand six hundred dollars. One can see where an outstanding debt of seventeen billion on automobiles comes from. Under this arrangement the automobile dealers were then selling automobiles either under a chattel mortgage arrangement (which you might call a bill of sale for security) or under what we call a conditional sale, where the title remains with the seller and does not go to the buyer till he has completed the payments. What came into that setting was a new form of business organization which we may call the sales finance corporation, best illustrated by the giants in the field like General Motors Acceptance Corporation or the Commercial Credit Corporation. Indeed there are now some two thousand sales finance companies in the United States in the business of picking up this so called "chattel paper", *i.e.*, the obligation of the buyer to pay, over a period of time, for his automobile or his television set or what-not. These sales finance companies actually perform a considerable part of the function of resale, because they customarily take this paper over without recourse. In effect they buy the paper from the dealer and handle all the collection problems. They handle as well the problems of disposing of repossessed automobiles and television sets, sometimes with a side agreement with the dealer to sell repossessed items back to him. These are very substantial operations. Lawyers' work, in this setting, is the drafting of the agreements between one of these sales finance companies and the dealer. Such agreements are likely to be fairly elaborate. Of course, the conditional sales contracts themselves tend to be quite stereotyped, unread documents, as previously suggested. The contracts do, of course, generate a considerable amount of collection work.

These sales finance companies, in the United States at least, are not willing to get involved to the extent of taking on the functions of collecting, re-possessing, etc., unless the particular retailer is doing a fairly substantial business. I'm told there have to be about twenty-five thousand dollars a year gross sales before the sales finance company will be interested in coming in to take over the functions I have described. For the smaller businesses the commercial banks, after a long period of doubts and misgivings, have moved into the field. Frequently they are not willing to do so on what we call a non-recourse basis. They take the chattel paper, the obligation of the buyer to pay off the price; then if he kicks over the traces or fails to make his payments, the transaction will come back to rest on the retailer, who has to make good to the bank what he previously borrowed against the security of this kind of obligation.

ACCOUNTS RECEIVABLE FINANCING.

If one moves out of the hard goods field into the so-called soft goods operation somewhat different practices are encountered. Here you will very commonly find "accounts receivable financing" being used. Instead of the secured obligation of the buyer of the automobile and television, the buyer of soft goods may simply buy on open account. The retailer wants, of course, to get his money out of this account receivable without waiting for the buyer to pay. Here again one encounters a specialized type of finance company, which might be called a business finance company in the business of making loans against the security of these accounts receivable. This mode of operation involves concern on the part of some businesses that it be not generally known that they are financing their receivables. If it is known that a business is "hocking" its accounts receivable it is feared this may suggest the business is not as strong as it ought to be. This concern in turn relates directly to a legal proposition that governs the effectiveness of an assignment of accounts receivable as against a second assignee.

What happens if the merchant, having assigned his accounts receivable to A., finds it a pleasant experience and decides to do the same thing with B.? Under the so-called English rule, I understand that, unless there has been a notification to the debtor, the first assignee is not protected against the second assignee, at least if the second assignee gets payment. If the business man is concerned about not having it generally known that he is, in fact, hocking his accounts receivable, this notification rule is a nuisance and in the United States we have gotten away from it. In some States we have, in effect, a court rule of law, a judicial decision, holding that notification is not necessary—that if one conveys title to an account receivable the transferor who sold it no longer has it and cannot convey anything later to another. If the rule is not rationalized by judicial decisions, a number of States have statutes that, in effect, enact the same rule and enable the merchant to go in for accounts receivable financing without notification to the debtor. Apparently business proceeds both in those States requiring notification in order to protect against the subsequent assignee and in those States where they do not require notification. Under both notification and non-notification apparently accounts receivable financing can proceed in the United States.

FINANCING INDUSTRY.

If we move on to the dealer, I suppose the most significant feature of the background here is the fact that, at least formerly in the United States, we did not admit to having anything like your "floating charge."

I find a "floating charge" very difficult to visualise. Whether the charge floats like a ship or a balloon, it floats, and it floats quite a while, I gather, even to the point where things can happen that are disadvantageous to the holder of the floating lien. In any case, in the United States, we did not admit that we had anything of the sort. This meant that at one time it was not possible for a dealer simply to go to a banker or to a finance company and say: "Look, I'll give you a lien on my turning-over stock of goods." Our law recognised no such lien. It was not possible to have a lien against property which the debtor was free to sell in the ordinary course of business conveying title.

Like so many rules, such a prohibition was a challenge to the ingenuity of the lawyer. In some areas, if there are not too many items, it might be possible to accomplish the floating charge objective with what we would call a chattel mortgage. If there are very many items that are moving in and out, however, too many instruments must be prepared and recorded. This is a great nuisance, so the desire was to have some sort of arrangement that would really give the creditor a good claim as against general creditors. He wanted to be a secured creditor even though it was recognised that the stock of goods on which he wanted to have his lien was a constantly turning over stock. Creditors worry (they hope it will never happen—but they do worry) about the possible bankruptcy of the dealer, and they want a claim that will permit them in bankruptcy to come in ahead of the general unsecured creditors. No doubt you know the story about the fellow who was going into bankruptcy, I guess for the seventh or eighth time, and his accountant said, "George, you know this time we're only going to be able to pay eight cents on the dollar." George said: "Why, that's outrageous, we always pay ten." The accountant said, "Well, I don't know how you're going to manage this time." To which George said, "Well, if necessary, I'll pay it out of my own funds."

The gadget that the lawyers came up with in the United States is something we call the trust receipt. It was a curious arrangement really, and, schematically, it seemed to go something like this: Title to the goods went from the seller to the bank; then the bank would execute an instrument called a trust indenture whereby the bank entrusted the dealer with the goods and permitted him or authorized him to dispose of the goods with an obligation then to remit the proceeds to the bank at once. So it was that in the United States very many of these security transactions have involved the use of the trust receipt, and this had some incidental advantages. Initially, before there was any legislation on the subject, the lawyers said, "Well, this is not a chattel mortgage" (we have statutes requiring recordation of chattel mortgages); "this is something new, you know, something different. It doesn't have to be filed!" Eventually the State legislatures required some filing, but they rcognised the legitimacy of the business man's complaint that with a turning-over stock of goods, it is just not feasible to require separate instruments for the various items of goods that come in and go out. The State legislatures did not say that they were willing to embrace the floating lien but in effect that is about what they did with so called trust receipts statutes that provided for what is called "notice filing." Notice filing simply means that all you need to do is file a very simple and a very short notice statement in a central registry office, reciting that the financier in fact is extending credit to the dealer and that the dealer in fact is giving security in the form of a lien on his inventory. Many States, twenty-five or thirty in number, adopted this type of legislation. Other States revised their recording requirements with respect to chattel mortgages. The result was that it became possible through the use of the trust receipt or a modified type of chattel mortgage to have a kind of "floating lien" on the dealer's stock or his inventory—a lien that didn't sink very easily. It was good against unsecured creditors and good for that matter even against judgment creditors. The lien was not good against purchasers in the ordinary course of business. In short, trust receipt legislation provided for the creditor a relatively solid prior claim as against the general unsecured creditor.

FIELD WAREHOUSING.

Let us move on to the position of the manufacturer, who also may be conspicuously lacking in capital of his own, and may have to use secured financing to conduct his operations. Here we encounter a considerable variety of devices. The substantial concern can finance its inventory with unsecured loans, and very commonly does, but in dealing with a new company or one that, because of prior history, looks a bit risky to the banker, something else must be done. One of the devices that has had a very considerable popularity in the United States is something called field warehousing. This technique apparently started on the west coast, originally I'm told with the canning industry. It is a fairly simple idea. As one of the writers has put it, if the mountain can't go to Mahomet, then you reverse the process. The motion is that if you do not or cannot for practical reasons of business necessity keep your goods in a public warehouse, where the public warehouseman could issue a document enabling the manufacturer to secure credit, then the thing to do is to bring the warehouse to the manufacturer. Here again the concern is the problem of achieving an effective lien on a shifting stock of goods. Many of the courts in the United States adopted a very firm position that it was not possible to have a security interest in goods which the debtor was authorized to sell. There is the practical problem, too, that the creditor may wish, in effect, to watch over the debtor. He may want to be there to look over the shoulder and see what is happening, to see whether the goods in fact are put to the use to which they are supposed to be put, and to require a regular and frequent accounting for proceeds. Hence this device of field warehousing was conceived.

The term almost defines itself. There are in the United States firms that specialize in this type of warehousing. Such a firm will send a man out to look at the factory. He will find a corner of the factory he thinks would be suitable for a warehouse on the spot and then they proceed to put up a fence or partition physically separating that area of the plant. Then someone is recruited to serve as a field warehouseman. He ought not to be an employee of the manufacturer. (Some of our governmental authorities take a rather cool view of having too much intimacy between the warehousing operation and the manufacturer, if the arrangement is going to stand up as against other creditors). After the installation of the warehouseman, who obviously has to know quite a bit about the stock of goods to handle it, some sort of procedure must be set up whereby the manufacturer withdraws from this warehouse on-the-scene articles of inventory as needed in the manufacturing process—either paying cash or perhaps executing a trust receipt or other security instrument which gives him authority to hold the goods and process them with an obligation to account for the proceeds. Of course, there are disadvantages to this system. It costs something. Money figures are not particularly meaningful, but it costs several hundred dollars just to effect a physical separation of the field warehouse, with further expense involved in getting the warehouseman on a different payroll. Sometimes manufacturing processes do not lend themselves too well to having material locked up and withdrawn a piece at a time. Even so field warehousing works very well in some instances. Many banks in the United States provide this service. Special finance companies do this sort of thing as well. The procedure fills the need in some situations.

THE FACTOR'S LIEN.

Another financing device which I suppose is more generally known and very commonly used in the United States involves something called the "factor's lien." The term "factor" is a curious one. There was a time apparently when people advertised themselves, and in a few centres they still advertise themselves, as factors. In the early days of the textile business in the United States when the manufacturer was rather distant from the area in which his product was being sold, he employed an agent both to sell the product and to arrange credit for the buyer. These textile factors were given a lien on the goods for their own commission. Then the factors became ambitious. Perhaps you recall the tale about the fellow, perhaps a factor, who said: "One of the glories of the United States is that you can start in as a ditch digger and by hard work and study and application eventually get to be a banker if you don't mind the financial sacrifice involved." Well, these factors got ambitious. They wanted to be bankers. In fact that is what they became and the feature they contributed to our commercial law, perhaps to the English law as well, was the factor's lien on a turning-over stock of goods.

In most of the United States, the commercial States particularly, we have so called factor's lien statutes. These statutes provide that when a factor (or a financial house or a sales finance company) extends credit and the borrower acknowledges that the finance house has a lien on his turning-over stock of goods, then if a notice of this agreement, which can be a fairly simple and short notice, is filed at a central registry office, the lien is good against general creditors, though not good against purchasers in the ordinary course of business. Here again as with the so-called trust receipt legislation reliance is placed on so-called notice filing. Instead of filing the individual instruments describing particular property, a general notice is given to the world that there is in fact a financing arrangement going on and that potential creditors would be well advised to check into the situation before extending any credit on the face of inventory or related property. Here again, of course, there is lawyers' work to be done. The agreement between the factor and the manufacturer or the dealer, the kind of document that is to be filed as regards notice, etc., provide ample drafting exercises.

LEASING AND FINANCING.

There are of course other arrangements. I noticed in a morning paper recently an advertisement by a company in Sydney touting leasing as the solution to the problem of financing a business which is short of cash. Of course this is a very popular device in the United States. We even have a musical now going in the United States entitled, "How to Succeed in Business Without Actually Trying";

these people who extend credit, I think, supply most of the words and music to fit that title.

Very commonly you will encounter this so called "lease-financing" in connection with the physical plant itself. In many cases in the States very large corporations have found that they can more profitably employ their capital in financing their own inventory and sales activity than by leaving the capital invested in real estate and plant. Some of these companies have actually sold their plant and equipment to a buyer, a charitable organization or an insurance company. Then the seller leases back the plant and equipment on a very long term lease. A number of these deals were sold as tax-savers. The notion was that one gets no income tax reduction on account of depreciation of land, whereas a rent paid under a lease arrangement should be a fully deductible item as far as the United States federal income tax authorities are concerned. Many have found that, while there might be some slight tax advantage, basically the decision whether to sell and lease back ought to be made in terms of whether the capital thereby released can be better employed in other phases of the operation.

Leasing is used, of course, with respect to the purchase of equipment, particularly in connection with fairly heavy and costly equipment. Some companies manufacturing equipment are willing to rent it out; the International Shoe Company, for example, has traditionally operated that way. More commonly you are likely to find that a special finance corporation may be organized to buy this equipment. The equipment is then leased by the new finance corporation to the concern that is going to use this equipment in its business. The latter executes a rental or lease agreement. Then, on the faith of the lease agreement, possible re-inforced with a security interest in the equipment itself, the newly formed company that came into being to finance the transaction will go to a bank. The bank is then willing to loan a very substantial part of the purchase price of this equipment to this newly organized corporation. If the equipment is of very long life the banks, at least in the United States, do not want to be involved for more than about five years in these arrangements. I am told that the bank commonly will find an insurance company to join in the financing. The bank would come in on the first five years of rental; it is willing to lend that much, and an insurance company may loan the balance. To some extent these lease arrangements are accounted for by the inducement of claimed tax savings. But there are certain risks involved on the tax side. Sometimes the bank or insurance company likes to have the obligation paid off as rapidly as possible. If the equipment price is paid very rapidly, what happens after it is paid for? One natural arrangement is to give the tenant, the renter, an option to purchase the equipment. Further, since he has already paid for it anyway, he may be permitted to buy it at a very low price indeed. This sounds alright except that the tax authorities in the United States become agitated. The tax authorities will then suggest that the so-called rent paid over a period of time was not really rent at all, but was really the purchase of the property. The result is denial of any rental deduction for tax purposes. The situation can get pretty confused! The moral of the story, as it so frequently is when one is concerned with tax considerations, is that the tax saving should not be too great. If it is too great it won't work!

To this point I have endeavoured to sketch some of the commonplace financing arrangements used in the United States at the various levels of manufacturing, wholesaling, and retailing. In the United States the field of commercial law for the lawyer has been a somewhat confusing area in which to work. So many different devices and different procedures are used that it has been very difficult for the legal profession always to know how to do and do well the work entrusted to it by the financial and commercial communities. The profession in the United States deals with chattel mortgages, trust receipts, factor's liens, conditional sales for resale, assignments of accounts receivable, and numerous other financing arrangements. Such matters as the proper procedure to follow, how many and what kind of documents need be prepared, how many need be filed and where, what kind of security interest could properly be exacted, and how such interest would fare as regards general creditors or purchasers in the ordinary course of business, were inquiries not easily or confidently answered.

THE DRAFT UNIFORM COMMERCIAL CODE.

In recognition that the state of commercial law in the United States left something to be desired, the National Conference of Commissioners on Uniform State Laws in 1942 joined with the American Law Institute, a private foundation whose prior work had been largely concerned with the production of the various Restatements of the Law, to work up a draft model law of commercial transactions. The project did not lack for ambition as the draft bill was intended to cover the areas of sales, commercial paper, investment securities, and security interests in personal property, including accounts receivable. Over the next decade and a half a multitude of experts laboured long and it is generally believed to good effect. The product of that long gestation period is now known as the Uniform Commercial Code, a model statute prepared for submission to the various State legislatures. Already, more than seven States have adopted the Code, with Pennsylvania leading the way in 1954. More will soon follow.

Article 9 of the Uniform Commercial Code deals with the subject of secured transactions and it is that portion of the Code that may be of some interest. The Code has made a number of changes in the law of secured finance in those States in which it has been adopted.

One of the simplest yet significant changes that it has brought about is a change of terminology. We have had all the various types of security interests to which I have referred, with a complete set of labels for each. Thus we've had to talk about mortgagees, conditional sellers, trustees, and the like. Terminology can be troublesome. Perhaps you recall the anecdote of the church meeting where they were debating the question of whether they should buy a new chandelier. One member of the congregation got up and said, "I'm against it on three grounds. First of all, I don't believe anybody in the congregation could spell it, and secondly even if we had one I don't think we have anybody in the congregation who could play it, and finally, what we really need is a new light fixture." The Uniform Commercial Code provides one set of terminology to cover all types of secured transactions. We are now, according to the Code, to talk about the security interest, the secured party, and the debtor. These terms are intended to cover any kind of device, any sort of imaginative approach, the lawyer can come up with.

The location of title, the bane of the profession's existence, is to be of no importance at all as regards the validity of the security interest. We are abandoning this elusive search for title in favour of a statute which says the security interest is good in specified situations and not good in certain other situations. Title may still be of some importance for some other reasons, such as taxation and matters of that sort, but no more in determining creditors' rights in respect of a secured transaction.

We have in the Commercial Code adopted the floating lien. Moreover, we have adopted it in very thoroughgoing fashion. Our new model floating lien is good against unsecured creditors, against subsequent creditors, and even against creditors who get judgment and satisfaction. The mechanism for implementing this robust lien is the notice-filing system to which I referred in connection with trust receipts and the Factors Acts. There are about six or seven individual statutes in all which are supplanted by this comprehensive uniform act.

The Code eliminates any legal requirement that the creditor actively police or oversee the operations of the debtor to safeguard his lien. A practice stimulated by our rule of law to the effect that one could not maintain a security interest in goods which the debtor has authority to sell, was for the creditor to set up a rather comprehensive overseeing machinery, almost to live with the debtor, in a relatively intimate relationship. The Commercial Code obviates any legal necessity for such arrangements. Of course close supervision may by dictated by business prudence; but insofar as maintenance of a legally effective security is concerned, it is not required.

The Code has only recently been adopted in my home State of Illinois. It is the law in Massachusetts and Pennsylvania and is expected to become law in New York. No doubt there will now be quite a wave of adoption in other States. It is widely believed that the Code presents new opportunities for lawyers to serve the business community, in that it provides very great flexibility in the choice of financing arrangements. All of the older devices that I have tried to describe in short compass are permissible of course under the Commercial Code. Many of the limitations and restrictions of the prior law have now been abandoned. In short the lawyer is given more leeway in terms of coming up with a hand-made or tailor-made arrangement between the debtor and the financing institution.

On the subject of the relationship between the kind of floating lien adopted by the United States Uniform Commercial Code and the floating lien of English law, I would like to quote from an article by Coogan and Bok on *The Impact of Article 9 of the Uniform Commercial Code on the Corporate Indenture*.[1] In their extensive article Coogan and Bok comment as follows:—

> "Fortunately, the Code allows the parties great flexibility in shifting, from time to time, by agreement or by conduct, the degree of control exercised by the trustee, and with it the quality of the security interest in current assets. An agreement could, for example, allow the debtor complete freedom so long as the amount of his current assets exceeds the amount of his current liabilities by a certain figure, and thereafter require him to account strictly and either to apply proceeds to paying down the debt or to substitute new collateral.
>
> This type of arrangement presents one possible solution to the problems of the debtor . . . who is annoyed by short-term policing procedures. The parties cannot legitimately object to

1 (1959) 69 YALE L. J. 203, at 257-259.

a certain amount of what may be considered "red tape" when the application of controls is deferred until circumstances indicate an actual need for them. The secured party may also find this arrangement to his liking. Under [a conventional type of] indenture, . . . the bondholders could enforce their rights only by calling a default and initiating procedures similar to those necessary to "crystallize" the English floating lien—for example, the appointment of a receiver. Both debtor and secured parties usually suffer greatly from this kind of enforcement proceeding. By providing for an increase in the trustees' power [*of course they're speaking here really of a long-term bond issue secured not only with fixed assets but with such things as receivables and inventory*][2] and duties in appropriate circumstances, the draftsmen can avoid requiring the unnecessary labor that goes with policing an eminently solvent debtor, yet ensure that effective control measures short of calling a default will be initiated when the situation warrants. Since the Code gives full legal protection to a lien on current assets except for the purchase money priority and the possibility that unsecured creditors could reach unidentifiable proceeds, policing methods which prevent the creation of competing interests and prevent proceeds from becoming unidentified will have the same practical effect as the appointment of a receiver, and yet not require judicial intervention. The opportunity that the Code offers the creditor to bring his security into full play in many instances by initiating procedures foı strict accountability without killing the debtor in the process appears to be a distinct advantage of the American system, and raises interesting possibilities for the draftsman. It is nevertheless to be hoped that the possible advantages of the floating lien will not lead to its use in long-term finance when it is not needed. The debtor should think twice before he agrees to an action which may shut him off from possibilities of making use of current assets for seasonal and other short-term borrowings. There are and will continue to be many situations in which a combination of long-term and short-term finance is proper, particularly when the need for money fluctuates with seasonal or other factors, and the long-term creditor who ties up all the debtor's securities may do a disservice to himself and his debtor. In this case the difference between the Code's floating lien and its English counterpart cuts the other way. The English debtor can ordinarily obtain money or credit by creating a superior "specific charge" on then

2 Author's interjection.

owned as well as after-acquired property notwithstanding the earlier filed floating lien. The Code allows the debtor to create a superior lien only if it is a purchase money security interest, a device useful for the acquisition of new noncash assets, but one which fails to solve the problem of a debtor pressed for ready cash. Theoretically, the Code debtor could appeal to the bondholders for modification of the indenture to permit secured borrowings from others. But when the holders of long-term debt are scattered, modifications of an indenture are difficult to obtain. Flexibility must be built into the indenture in advance, in order to get its full advantages. This requires a careful projection of the debtor's potential credit requirements, and drafting so that they can be met in an expeditious fashion. Whether or not current assets fit into the long-term security picture will be a matter for the business judgment of both parties.

The draftsman of a code indenture will find the English "floating charge" an interesting example of a workable long-term security interest in current assets. Some of the problems involved in this type of financing are solved by the Code in a somewhat different manner, but others are left to be worked out by the parties [*and I might add by litigation*].[3] In theory the Code system, which combines great flexibility with a high degree of legal protection for whatever agreement is ultimately reached, should prove even more workable than its English counterpart. But only intelligent and imaginative use of the "floating lien" will ensure that its potential value is achieved in practice."

The suggestion that those in America can look with profit at security instruments employing the English floating lien might conceivably work the other way as well. Perhaps some of these modern American commercial instruments, though they certainly cannot serve directly as forms here, may nevertheless be examined with some profit, if for nothing else than to see other ways in which these common commercial credit problems are being met by the profession.

In all of this not very much has been said, apart from an expression of sadness by Chief Justice Wolff, echoed in some of my earlier remarks concerning the plight of the forgotten man in all this—the target, the consumer, the buyer, the man who cannot afford his present scale of living. There is concern in the United States with respect to these all too willing victims of the system. For the most part we have been thinking along these lines:—

3 Author's interjection.

1. Should we insist upon a full disclosure to the purchaser who is buying on time, insist that he be advised what the cash price is, what the credit charge is, and what it really means in terms of an annual interest rate? Legislation has been introduced into our federal Congress to require this disclosure as a federal matter. There are some States that already have State legislation in this field. Personally I am not too optimistic about the effectiveness of this legislation because I think, unfortunately, you can tell a man that he's stepping straight into disaster, and the artful salesman will simply propel him there with greater speed.

2. The other possibility which is getting some consideration is the matter of limiting the interest charges payable by consumers when they purchase on time. The usury statutes have no application to sales of goods on time, and in many States we do not have specific legislation designed to restrict the charges to be made for this type of credit. We do have so-called small loan Acts, which provide for higher rates of interest than the conventional usury statute. But these people who sell on time are either greedy, or the risks in their business are very substantial, because the charges which they make for credit are sometimes very high indeed. There is unfortunately an inverse relationship between the interest charged and the buyer's position in society. We find, for example, that our negro population is often victimised by excessive credit charges which retailers impose on the ground that the risks are even higher in dealing with this part of our population group. The problem of trying to frame regulatory legislation in this area that will face up to the economic realities of life and provide a livable maximum rate, livable for the consumer and livable for the commercial community, is a problem that is still unresolved in the United States.

Now, there are some other aspects on credit transactions, tag ends, that I would like to mention before I conclude. There are some tax considerations to be borne in mind. At least in the United States it is possible to generate income on the forgiveness of indebtedness. It is a situation where the rabbit comes out of the hat and you do not know how he ever got in there. One of the considerations that very much concerns anyone counselling in connection with adjustment of indebtedness is the rather disturbing possibility that the debtor may, by virtue of the creditor's reduction of a debt, be found to be in the receipt of taxable income. Our government has a prior claim against the assets of a debtor and there is, then, a distinct prospect that the creditor may have reduced his claim to help rehabilitate the debtor, only to find that a new, different, and rather powerful creditor has entered the picture to bring the debtor to his knees—which is just what the creditor wished to avoid. This is a very tricky area under our law. I don't know whether you have anything of this sort to worry about or not but it does worry us.

There is another area in the law which is of particular interest to me, since I commonly teach in the field of Tort Law. We have a whole body of law in the United States designed to make creditors behave in gentlemanly fashion—which is not always easy. One of the cases that I teach in Torts, for example, concerned a daughter-in-law whose father-in-law had sold to her and to her husband an automobile on a time-payment basis. The couple failed to keep up the payments and the father-in-law undertook to repossess the car—with the daughter-in-law in it! She refused to dismount. He put the car with the daughter-in-law still in the car in his own garage. She of course was pregnant (I don't know how it happens that the people who litigate in Tort cases are so often in this condition!). She sat shivering in the garage for several hours and ultimately brought a law suit against her father-in-law—a very happy family, obviously. The court was very quick to find that this was a case of assault and battery and false imprisonment. I think that they reacted to the fact that they thought the father-in-law had behaved in a really outrageous fashion.

We have quite a number of cases where the creditor employs what he thinks are fairly effective means for getting the debtor to pay up, like posting a notice in the window of a shop, "The following people are indebted to me for the following amounts." I remember hearing about a case where the creditor resorted to skywriting, and this raises some interesting questions. But in our country the courts have been rather hard on creditors, taking the position that it is not open to creditors to publicize to the community the indebtedness of the debtor, even though the indebtedness exists. The theory is that the courts are still here, they are open to creditors; we do not want to sanction extra-legal methods of enforcing collection. Whether the legal doctrine is called "intentional infliction of mental suffering", or invasion of the "right of privacy", our courts have been pretty ingenious in keeping the creditor within bounds. I personally think this is a very good thing. To the extent that the creditor is limited to the legal machinery for enforcement of his claim, the legal profession benefits. More importantly, restriction of self-help collection methods may slow up the seller a little in pressing these goods on the buyer at the outset.

CONCLUSION.

The law in the area of secured transactions is very much a fugitive thing. These commercial practices, as I am sure you know well, change with every decade, if not with every year. New business arrangements constantly are conceived and put to use. We have an old body of law which sometimes can be accommodated to the new methods of doing business though sometimes it is a bit creaky in the way it responds. But the commercial community, at least in our experience, will not be denied; what the business men want the law will ultimately provide. Those members of the legal profession who practice in this field are faced with the necessity of trying to keep pace with commercial practice, and to relate that practice to a constantly developing body of law which stands there to serve the needs of our credit-based economy.

WILLARD H. PEDRICK*

BIBLIOGRAPHY.

WHITNEY, THE LAW OF MODERN COMMERCIAL PRACTICE (Students' ed., 1948; Baker, Voorhis & Co.).

DENNON, SECURED TRANSACTIONS (1958; Practising Law Institute).

SPIVACK, SECURED TRANSACTIONS (1960; American Law Institute).

Secured Transactions: Rights between the Parties, (1958) 53 Nw. U.L. REV. 381-398.

Commercial Code: Part I, (1951) 16 LAW & CONTEM. PROB. 1-164.

Kripke, *Kentucky Modernizes the Law of Chattel Security,* (1959-1960) 48 KY. L.J. 369.

Dunham, *Inventory and Accounts Receivable Financing,* (1949) 62 HARV. L. REV. 588.

* *Professor of Law, Northwestern University; Visiting Professor of Law at the University of Western Australia, 1956-1957, and at the University of Melbourne, 1962.*