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SECURED TRANSACTIONS AND THE UNIFORM COMMERCIAL CODE

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The Uniform Commercial Code has now been adopted by six states.[1] At present the State Bar Association of North Dakota is seriously urging its enactment in this jurisdiction and has prepared repeal sections to facilitate that action. It seems appropriate, therefore, that some study should be devoted to its possible impact on the legal profession, whose members will be the first to be concerned with the Code's application should it be adopted. In short, something like an educational program for the Bar seems in order.

Encompassing as it does the entire field of commercial law, it would be a vast undertaking to contrast the Code section by section with the current law of North Dakota. The writer has done so in the past as to portions of the Code.[2] These studies indicate that a goodly portion of the Code constitutes a redoing of our existing law. However, in the field of secured transactions the drafters of the Code have attempted to cut free from the past and thus accomplish a major reform. One cannot deny that this is a field where reform was long overdue. Our security devices sprang into being one by one to further the needs of an earlier day. They are still with us in the old form, although somewhat stretched to meet the needs of a more complex world. Where these earlier devices refused to bend, the resort has been to remedial legislation,[3] again to meet a specific need; but never before has there been an attempt to bind the whole field of secured transactions into a scientific whole as the Code purports to do.

Whatever the faults of existing law, the profession might well hesitate to recommend adoption of an experimental statute. To merit consideration at all a code of this type must be able to meet

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1. The usual practice has been to postpone the effective date to enable the bar to become acquainted with its provisions. The states with the effective date in parenthesis are: Conn. (1961); Ky. (1960); Mass. (1958); N. H. (1961); Pa. (1954); R. I. (1962).

2. Tisdale: *Bulk Sales Act: Should It Be Revised*, 33 N. Dak. L. Rev. 267 (1957); *Uniform Commercial Code-Commercial Paper*, 30 N. Dak. L. Rev. 189 (1954); *Uniform Commercial Code-Commercial Paper*, 27 N. Dak. L. Rev. 383 (1951); *Uniform Commercial Code-Commercial Paper*, 1950 N. Dak. Bar Briefs 252.

3. An example of this is found in N.D. Rev. Code § 35-0406 (Supp. 1957) providing "no chattel mortgage filed against a motor vehicle shall be valid as against subsequent purchasers and encumbrancers in good faith for value unless the chattel mortgage is also clearly indicated upon the certificate of title to the motor vehicle, or unless the original certificate of title to the vehicle is in the possession of the mortgagee", and § 28-29071 provides in part that the seller shall hold the non-perishable goods 15 days after the retaking on conditional sales contracts to provide the buyer a reasonable period in which to redeem the goods retaken; see, also, N.D. Sess. Laws 1959, c. 271 (Factors Lien Act).

at least two minimum standards. First, it must make the law accessible. To accomplish this it must be organized in a logical and usable manner, be reasonably free from ambiguity, couched in language familiar to the profession, and be adequately indexed. Second, as a tool of the profession it must fit the needs of clients and of society as a whole more adequately than existing law. By and large, it is the purpose of this paper to examine into these two questions in relation to secured transactions under the Code.

WILL THE CODE MAKE THE LAW MORE ACCESSIBLE?

Under present law we deal with distinct security devices. These devices appear in various portions of the statutes and are perhaps more or less adequately indexed, but in most instances case law covers a major portion of the substantive law and necessitates a search of the precedents in addition to the statutes whenever a dispute arises. If a lawyer were confident that he could find North Dakota law covering all his client's problems this situation would not be intolerable. But we are a comparatively young state in more than one sense. Our needs in the field of business finance have increased manyfold since the end of the war and it is an unfortunate truth that many gaps in our law cannot be filled by resort to the case law of North Dakota. While the legislature has seen fit to fill some of these gaps with new statutory enactments it has not filled them all and the lawyer faces the probability that he will have to rely on guess work to resolve many practical business problems facing his client.

True, by experimentation, by combining these security devices, casting them in modern form, by adding or subtracting clauses, one may seem to bridge any particular gap in the law. But experiments in drafting are tricky things frequently leading to unforeseen consequences, and the lawyer would much prefer a statutory guide than to rely upon the gradual development of a body of case law that would meet the needs of commerce.

Just what does the Uniform Commercial Code claim to do for us in this matter of making the law more accessible?

First, it abolishes the distinction between security devices: No longer need the lawyer decide whether his best tool for the problem at hand is a chattel mortgage, a conditional sale, trust receipt, factor's lien, or some form of pledge. Now every one of these separate devices is encompassed within the descriptive term "security interest." True, the Code adopts a functional approach which

results in a slightly different treatment of any particular security interest and makes it dependent on the type of asset utilized for security. But this approach is new only in the sense that it is now spelled out in statutory form. It is the method the lawyer always uses in deciding what security device to utilize. Now his problem is simplified because internal indexing takes him at once to the sections which deal specifically with the type of asset to be used as security.[4]

Second, since the drafters necessarily drew upon the devices used in the past, the old forms are still usable. The Code has, however, cut down on red tape. Particularity in description of the collateral is cut to a minimum, and statutory requirements[5] as to witnessing, acknowledgment, delivery of copies to the mortgagor and receipt there for by the mortgagee are abolished. On the other hand, counsel may elect to use the simplified "financiing statement" set out in the Code.[6]

Third, does the Code escape ambiguity? We are dealing here with a complex field of law. One should not anticipate that a statute of this type will prove easy to read. Lawyers who have had occasion to use the Trust Receipts Act must find it difficult to comprehend —and yet, given a specific problem, that Act offers more concrete solutions than the former law. The same thing is true of the Code. It is a complex statute because of the very fact that it does attempt to give more answers to specific problems. Yet it seems surprisingly usable and free from ambiguities. The answer lies in the fact that it has been subject to analysis not only by the drafters[7] but by legislators,[8] interested lay groups,[9] and bar associations of the various states.[10] Many criticisms have been directed to the drafters,

4. Uniform Commercial Code § 9-102. The comment to this section contains an internal index based upon the type of collateral involved in the transaction at hand.

5. Although North Dakota has separate filing statutes for mortgages and conditional sales, section 51-0710 of the N.D. Rev. Code (1943) provides they are to be filed in the same office; however, section 35-0403 does require delivery of an acknowledged copy of the original mortgage to the mortgagor. For general statutory requirements see N.D. Rev. Code §§ 35-0401-0414 (1943)) (In case of witnessing in lieu of acknowledgement, the witnesses must sign in presence of each other and the mortgagor).

Cases where failure to comply causes difficulty occasionally arise, see Security State Bank v. Bernstad Farmers Elevator, 60 N.D. 43, 232 N.W. 295 (1930) (failure to show acknowledgement on copy); Pease v. Magill, 17 N.D. 166, 115 N.W. 260 (1908) (not properly witnessed or acknowledged); Donovan v. St. Anthony and Dakota Elevator, 8 N.D. 585, 80 N.W. 772 (1899) (improperly witnessed).

6. Uniform Commercial Code §§ 9-105 (h), 9-203 (b).

7. See Uniform Commercial Code, Introductory Comment at 9, listing the drafters of Article 9.

8. See Report of New York Lew Revisions Commission 1954, 1955 for general analysis.

9. See Uniform Commercial Code, Introductory Comment at 9.

10. See Cullen, *What About a Uniform Commercial Code*, 20 Ky. B.J. 72 (1956); Goldmer and Auerbach, *Why Ohio Should Adopt the Uniform Commercial Code*, 32 Ohio Bar 66 (1959); Kohn, *Present Status of Uniform Commercial Code*, 45 Ill. B.J. 224 (1956); Kuhns, *Uniform Commercial Code*, 16 Tex. B.J. 67 (1953); Littleton, *Pennsylvania Law-*

and where they were of sufficient weight amendments resulted which now appear in the 1958 Official Text. It is of interest to note that these amendments have also been adopted by the states now operating under the Code with a few minor exceptions.[11]

But admitting that the code is difficult to comprehend when considered in the abstract, the answer lies in the fact that a lawyer does not approach a statute in the abstract but with a specific problem in hand. Approached from this point of view one can reasonably contend that the Code is a far better tool than the materials available to the lawyer without the Code. The reason is clear, although not obvious. It goes back to the fact that all present day financing devices have a more or less clearly defined function to perform. The Code recognizes this, and while it abolishes technical distinctions between security devices it retains the substance of these devices as the basis for its functional approach.

IS THE CODE DESIGNED TO MEET NEEDS OF CLIENTS MORE ADEQUATELY THAN EXISTING LAW?

One can best approach this problem by considering briefly what our present security devices are and what function they fill in the commercial world. It seems simplest to give a concrete example.

Assume Jones owns a small factory producing an item that sells in the national market and buys his raw materials from various producers. His first problem is to procure machine tools to manufacture his product. If Jones is short of cash he may either buy on conditional sale terms or borrow the purchase price from a third party, giving the latter a chattel mortgage as security.[12] Normally if he borrows the trust receipt would not be utilized. That device, originally developed to finance importation of raw materials, is commonly utilized in domestic commerce to finance dealers in procuring their stock of goods. [13] As a common law proposition the

yers and the Uniform Commercial Code, 26 Pa. B.A.Q. 150 (1957); Littleton, *Uniform Commercial Code*, 24 Pa. B.A.Q. 32 (1952); Pisano, *Kentucky Considers the Uniform Commercial Code*, 21 Ky. B.J. 182 (1957).

11. Pennsylvania, which adopted the 1951 form of the code, has amended §§ 9-403 (2), (3) which relate to filing. Since 1951—although numerous changes were made—the basic framework of the act remains. The five other states adopted the code in its 1957 form, which includes substantially all the amendments.

12. The chattel mortgage is available as a purchase money security devicie, but here again the conditional sale proved more popular because unhampered by restrictions on foreclosure common in the mortgage device.

13. The Uniform Trust Receipts Act § 15 very carefully relegates this device to areas not covered by mortgages or conditional sales.

The N.D. Rev. Code § 41-1815 (Supp. 1957) defining entrustor, excludes any creditor ". . . who at the outset of the transaction has, as against the buyer general property in such goods or instruments, and who sells the same to the buyer on credit,

trust receipt was a three party transaction. The financing agency prevented title from going into the buyer. This type of financing operated successfully only in areas where the chattel mortgage gave inadequate security and won out over the conditional sale for resale in the automobile field because no filing or recording was necessary. Although the Uniform Trust Receipts Act now requires filing, it is notice filing at one central point in the state, a mode of filing which has proved to be inexpensive and satisfactory to all parties.

If Jones seeks to use his raw materials, including goods in the process of manufacture and the ultimate finished product, as collateral, none of the devices considered above would appear to be satisfactory. We are now dealing with an entirely different type of collateral. This collateral is made up of goods in motion.[14] Not only that, the raw materials will in course of time lose their identity in the finished product, and since they are purchased from different suppliers, intermingling and change in form produce unanswerable problems where the standard security devices are considered.[15] Further, what Jones needs here is a line of credit on which he can depend and the right to use his inventory freely in carrying on his business. The result is that new devices had to be developed to meet a pressing need. For these reasons field warehousing was developed. By setting up a warehouse on the buyer's premises with suitable controls, warehouse receipts became available as a basis for loans through pledge of the receipts. But field warehousing had its drawbacks. Before the manufacturer could get his raw materials he would have to pay the lender or substitute other materials in the warehouse. His line of credit would be constantly fluctuating in many instances, he would not have the control over the raw materials that business needs require, and unless his business had a large volume the expense of setting up a field warehousing system would foreclose its use. It became clear that a new device was necessary, a device that would give the lender a lien on a changing stock of goods, and one that would follow the raw materials into the finished product and even into the accounts flow-

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retaining title or other security interest under a purchase money mortgage or conditional sales contract or otherwise . . ."

14. See Axelrod and Gilmore, *Chattel Security*, 57 Yale L.J. 517 (1948); Gilmore, *Chattel Security*, 57 Yale L.J. 761 (1948).

15. The chattel mortgage has been used on occasion to cover a merchant's inventory, see Madson v. Ratten, 16 N.D. 281, 113 N.W. 872 (1907) (held invalid since mortgagor not required to account); Red River Valley Nat'l Bank v. North Star Boot and Shoe, 8 N.D. 432, 79 N.W. 880 (1887) (held valid where proceeds to be turned over daily to mortgagee, less expense money). One might note that the merchant who must account daily cannot expand, he is the creditor's creature.

ing from sale of that product. The first modern factor's lien act was adopted in New York in 1911. North Dakota adopted such a statute in 1959.[16] The specific purpose of the act is to give a continuing lien on inventory of a manufacturer which follows the raw material through the process of manufacturing into the proceeds or accounts flowing from sale of the finished product.

To complete the picture we must now consider how Jones could make use of the finished product as collateral. Usually the finished product must be sold on short term credit, but Jones needs immediate cash for operating expenses. Use of the negotiable bills of lading with trade acceptances attached, drawn on the buyer for the price, suggests a well-established way Jones can obtain his cash. A bank or finance house may discount the paper trusting in the security gained by control of the bill of lading. A correspondent bank in the buyer's town hands over the bill only after securing the buyer's acceptance, and may demand of him collateral to secure payment on the due date. Frequently the trust receipt is utilized, the goods standing as collateral. The law and commercial practice have reached a high stage of development in this field, and the lawyer customarily encounters only a few problems concerning it.

But usage and custom may require consigning the goods direct to the buyer on credit terms and without security. Assignment or sale of outstanding accounts has long since become a respectable business. Accounts receivable financing would seem to afford Jones an opportunity to set up a continuing line of credit. Hence a financing agreement in this field would normally call for a blanket assignment of accounts arising during the loan period. Serious questions arise as to how the agreement should be drafted. For example, should it be on a non-notification basis? May the debtor be left in unfettered control or must he account regularly for collections and returned goods? Can the agreement effectively create a lien on future accounts or is the only safe procedure to call for supplemental assignments as the accounts arise? How can the drafter guard against claims of another assignee of the same accounts? These are all questions that have given rise to litigation in the past and they remain potential trouble-makers.[17]

On the other hand, if Jones markets his goods direct he may of

16. N.D. Sess Laws 1959, c. 271. The act is discussed in this issue, *infra* p. 261 (Ed.)

17. See Kupfer, *Accounts Receivable Financing, a Legal and Practical Look-See*, 62 Com. L.J. 327 (1957); Kupfer, *Accounts Receivable, Trust Receipt, and Related Types of Financing Under Article 9 of the Uniform Commercial Code*, 27 Temp. L.Q. 278 (1954); Stiller, *Inventory and Accounts Receivable Financing*, 18 Md. L. Rev. 185 (1958); Symposium, 42 Ill. B.J. 732 (1959).

course use the conditional sale device, or if he sells to dealers the trust receipt is available. Where he markets direct to the consumer he has available for collateral purposes the chattel paper arising from the sales transaction.

To summarize, we find that the types of collateral in the above transactions included machine tools (durable goods), raw materials (intended for immediate consumption in business), and finished products (intended for immediate sale in regular course of business), accounts reecivable and chattel paper (choses in action), and documents (negotiable bills of lading).

The purpose or ultimate end of the borrower (aside from the purchase of machine tools) is to secure a line of credit enabling him to continue his business during slack periods. If he is shackled by having his goods placed in pledge, if he must account for every sale, this purpose would be defeated; he would no longer consider himself master of his fate. Convenience of both borrower and lender would be served if this lien could be secured through a single financing agency and by filing a single instrument. Such an instrument could cover raw materials, goods in process, the completed product and the accounts flowing from sales. In short, a lien that floats over the inventory as an entity has a valid place in our economy.[18] The approach in the past was piecemeal. The chattel mortgage served best for durable goods owned by the borrower, the conditional sale was a convenient purchase-money security device where goods were sold to consumers, the trust receipt performed a similar function for dealer's inventory in automobiles and hard goods, while the factor's lien gave a non-purchase-money security interest in general inventory. Until the last device came into being anything resembling a floating lien would require the execution of numerous instruments with the consequent burden of filing or recording each, not to speak of other requirements for perfection in particular fields of financing.

What is the result under the Code? First, the Code recognizes that differences in the type of collateral and the nature of the debtor-creditor relationship are important. A manufacturer's stock of raw materials and finished products, his inventory, cannot be dealt with in the same way as a dealer's stock in trade, which consists of finished products held for sale. The problems faced when one sells to consumers are not the same as where a wholesaler sells

18. For a keen analysis of problems in this area, see Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien"*, 72 Harv. L. Rev. 838 (1959).

to a dealer. Questions arising in the field of agricultural products have long been the subject of special legislation, a recognition that the area is unique. It is for this reason that the Code divides goods into consumer goods, equipment, farm products, and inventory; and intangibles into accounts, contract rights, chattel paper, documents and instruments, and general intangibles.[19]

Second, the drafters realized that some distinctions existing between pre-Code security devices were fundamental whereas others were based on rules of the past that might be considered outgrown. Hence the Code abandons those distinctions based on the accidental separate development of these earlier devices, such as filing requirements, form requirements, place of title, etc.[20] It should be noted that the Code does not displace existing, or prevent development of, legislation designed to protect the consumer against fraud and overreaching. This field, the drafters concluded, was not within their province.[21]

Third, the Code greatly expands the field of secured transactions. It not only displaces the standard devices of today, but includes within its scope the whole field of assignments, whether in the form of a security interest or that of an outright purchase.[22] Thus the Code covers substantially the whole field of security interests in goods, from the simplest form of pledge to the ever changing inventory of a manufacturer. Because of this broadening of the area of secured transactions, the complexity of the accompanying rules makes analysis in the abstract very difficult indeed. On the other hand, this is perhaps the greatest strength of this remarkable statute. It answers questions that pre-Code law left unanswered or vague. While it is too early to pass final judgment on the adequacy of these answers, experience in the one state where the Code has been in effect since 1954 indicates that it has been well received with a minimum of litigation. Perhaps one reason for this, and this will hold true in any state which adopts the Code, is that financing under the Code proceeded much as it did under pre-Code law. Forms were modified and procedures brought into conformity with the filing and notice requirements of the Code with little actual change in business practice.

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19. Uniform Commercial Code §§ 9-106, 109 and classification in comment to § 9-102.
20. See note 5 *supra*.
21. North Dakota adopted a Retail Installment Sales Act in N.D. Rev. Code § 51-1301 (1957 Supp.), as amended, N.D. Sess. Laws 1959, c. 352. See Uniform Commercial Code § 9-201.
22. Uniform Commercial Code § 9-105 (i), (j).

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