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Secured Transactions: After-Acquired Property v. Antecedent Debt

Elizabeth Honnold

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CONCLUSION

When faced with one of these vendor-huckster situations, the courts are confronted with the problem of determining whether the defendant is negligent. If the defendant has violated an applicable statute, the problem is somewhat eased in that the legislature has enacted a standard of conduct for the defendant to follow. While the courts will not base their decision solely upon the violation, they have little difficulty in applying the principles of negligence. In absence of a statute the courts that accept the doctrine and the situation where the defendant has attracted the child. However, the tendency of late is to recognize the parallels between the doctrine and the situation where the defendant has attracted the plaintiff to a position of peril. The problem of finding a duty between the defendant and plaintiff has caused some courts to deny recovery. They assert that to hold otherwise would destroy the usefulness of the defendant's vending truck by imposing an impossible burden upon him. Those courts that impose a duty maintain that the defendant, having attracted the child to a perilous situation, must use reasonable measures for his protection. These courts raise the inference that he who seeks to benefit from the infant purchasers must reasonably attempt to protect them. Even assuming the defendant owes the plaintiff a duty, some courts refuse recovery on the basis that the defendant has not caused the plaintiff's injuries. Pointing to the acts of the child or of the other motorist, they hold that the chain of causation has been broken by their intervening acts. Refusing to accept this, other courts rely heavily upon the foreseeability test and hold that the defendant should have foreseen the conduct of the child and the presence of the other motorist. While not necessarily cited in their decision, the courts look to the plaintiff's age as an underlying factor in determining the duty, if any, of the defendant, the awareness of the plaintiff of the peril, and his own negligence as a possible intervening cause.

The decision by the court in *Mackey*⁸⁹ represents the more realistic and better reasoned view. The defendant, having exerted his best efforts to attract customers, is under a duty to ascertain the perils incident to his manner of business and to reasonably attempt to protect his business invitees from these perils. Failing to so act, he should be held liable for those injuries that he could reasonably have prevented. If one of the two parties must suffer, let it be he who is better situated to prevent the event.

Daniel T. Monte

SECURED TRANSACTIONS: AFTER-ACQUIRED
PROPERTY v. ANTECEDENT DEBT

A major trend in state law is the recognition of new methods of financ-

⁸⁹ *Mackey v. Spradlin*, *supra* note 41.

ing businesses on the security of assignments of accounts receivable and inventory. These financing arrangements are designed to encourage loans for current business operations at reasonable rates on the basis of constantly changing security.

Subject to the general limitations on state powers prohibiting the making or enforcing of any law governing bankruptcy that impairs the obligations of contracts, or conflicts with the national bankruptcy law,¹ a state may pass and enforce "bankruptcy" laws which are binding upon persons and property within its jurisdiction.

It goes without saying that state laws will be suspended to the extent of actual conflict with the Bankruptcy Act,² and specifically section 60a. The major question is whether there is an actual conflict between the Bankruptcy Act and the UNIFORM COMMERCIAL CODE.³ The Bankruptcy Act considers a transfer for an antecedent debt one of the requisite elements of a voidable preference;⁴ whereas, the UCC provides that when a secured party gives new value which is secured in whole or in part by after-acquired property, his security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt.⁵ Are the Bankruptcy Act and the UCC in fact speaking of the same transactions? It will be shown that the after-acquired property provision of the CODE is not in contravention of the Bankruptcy Act.

Eight elements must coexist before a secured transaction may be set aside as preferential. The first three of these elements are always present in a financing arrangement, namely (1) a transfer by way of security of (2) the debtor's property (3) to a creditor. The question determining whether this transaction was a voidable preference is: was such transfer (4) made by the debtor while insolvent (5) within four months of bankruptcy (6) on account of an antecedent debt (7) with the effect of enabling the creditor to obtain a greater percentage of his debt than some other creditor of the same class? If so, the transfer may be set aside if (8) the creditor had reasonable cause to believe that the debtor was insolvent when the transfer was made. All of these elements are essential before the bankruptcy court can take the creditor's security away from him. The two elements which concern us, and which are most difficult for the referee to prove, are numbers (6) and (7), *i.e.*, a transfer on account of an antecedent debt with the effect of enabling the creditor to obtain a greater percentage of his debt than some other creditor of

¹ *International Shoe Co. v. Pinkus*, 278 U.S. 261 (1929).

² Bankruptcy Act, 30 Stat. 544 (1898) as amended, 11 U.S.C.A. § 96a(1) (Supp. 1965) [hereinafter cited as the "Bankruptcy Act," by act section number].

³ Citations are to the 1962 OFFICIAL TEXT WITH COMMENTS, with corresponding Oklahoma citations; the UNIFORM COMMERCIAL CODE is hereinafter referred to as the "CODE" or the "UCC".

⁴ Bankruptcy Act § 60a(1), 11 U.S.C.A. § 96a(1) (Supp. 1965).

⁵ UCC § 9-108; OKLA. STAT. tit. 12a. § 9-108 (1961).

the same class. Once it can be shown that the transfer was not for an antecedent debt by bankruptcy terms, there will be no question but that the creditor is not being afforded a voidable preference but is only receiving that to which he is entitled.

The UNIFORM COMMERCIAL CODE was drafted over a period of many years by the National Conference of Commissioners on Uniform State Laws and The American Law Institute. The men who comprised these two groups were very knowledgeable lawyers and certainly credence should be given to their thoughts as reflected in the official comments.⁶ The CODE has been enacted by 43 states,⁷ the Virgin Islands, and the District of Columbia. That the Congress of the United States has enacted the CODE for the District of Columbia adds merit to the contention that there is no real conflict between the UCC and the Bankruptcy Act.

Section 9-108 of the CODE is the section with which we are concerned here:

Where a secured party makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value which is to be secured in whole or in part by after-acquired property, his security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given.⁸

The purportedly conflicting bankruptcy statute reads in part as follows:

A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition . . . , the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.⁹

The above bankruptcy section also says that a transfer shall be deemed to have been made at the time when it became so far perfected that no bona fide purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein.¹⁰

It appears that the only question the courts have recognized as having

⁶ UCC § 9-108, comments 1, 2; see generally official comments throughout Article 9 of 1962 OFFICIAL TEXT.

⁷ The States of Vermont, Delaware, Mississippi, Louisiana, South Carolina, Arizona, and Utah have not adopted the UCC although it has been under consideration in all states but Arizona.

⁸ UCC § 9-108.

⁹ Bankruptcy Act § 60a(1); 11 U.S.C.A. § 96a(1) (Supp. 1965).

¹⁰ Bankruptcy Act § 60a(2); 11 U.S.C.A. § 96a(2) (Supp. 1965).

been left by the Bankruptcy Act to state law is the determination of what constitutes perfection of a transfer. Therefore, if section 9-108 in some way affects the perfection of transfers, it should be recognized in bankruptcy.

As early as 1894 courts were deciding issues with regard to what, in today's vernacular, comes under the classification of "after-acquired" property. The Maine case of *Sawyer v. Long*¹¹ held that a mortgage, which contained permission to sell the stock and replace the sold articles with the proceeds of sale and further provided that it should cover the replacements, was valid and the "after-acquired" goods were covered by the mortgage.

Mitchell v. Winslow,¹² decided in 1843, is the first American case clearly establishing the rights of the mortgagee upon bankruptcy of the mortgagor. Here the mortgage (covering machinery and equipment) contained an after-acquired property provision and was filed properly under the State's laws at the time the consideration for the mortgage was given. When the mortgagor became a bankrupt, Mr. Justice Story found that the mortgage on the after-acquired property was valid and effective as to the general creditors. Analogizing with present assignments of future claims and expectancies which equity held superior to the subsequent "legal" claims of other parties, he wrote: ". . . [I]t is true, that the assignment (mortgage) can have no positive operation to transfer, *in presenti*; property in things not *in esse*; but it operates by way of a present contract to take effect and attach to the things assigned, when and as soon as they come *in esse*; and it may be enforced as such a contract *in rem*, in equity."¹³

In the Ninth Circuit case of *Mason v. Citizens Nat'l Trust & Savings Bank of Los Angeles*¹⁴ the court, after holding an after-acquired property clause in a chattel mortgage to be valid, asked: "Why should a transaction like this be condemned, if made in good faith and to secure an honest debt? . . . The interests of the general public are not prejudiced by any such transaction between the debtor and creditor."¹⁵

In line with the above, one writer,¹⁶ when talking about CODE filings, voiced the opinion that once the creditor has declared himself by executing a security agreement and financing statement covering all of his present and future accounts receivable, inventory, or whatever the collateral may be, all other potential lenders are forewarned that the filing party has made his advance and that all the debtor's collateral as set

¹¹ 86 Me. 541, 30 Atl. 111 (1894).

¹² 17 Fed. Cas. 527 (No. 9673) (C.C.D. Me. 1943) (Story, Circuit Justice).

¹³ *Id.* at 531.

¹⁴ 71 F.2d 246 (9th Cir. 1934).

¹⁵ *Id.* at 254.

¹⁶ Gordon, *The Security Interest in Inventory under Article 9 of the Uniform Commercial Code and The Preference Problem*, 62 COLUM. L. REV. 49 (1962).

forth in the financing statement has been set apart and will not be available for attachment by, or distribution to, general creditors. This author then says: "Hence, there appears to be no conflict with the overriding policy of Section 60—to prevent one creditor from taking or receiving, as soon as the debtor's position becomes uncertain, something to which he had no right prior to such time."¹⁷

In the field of accounts receivable financing, the courts generally seem to have been able to look to the purpose of the financing and the necessity for constant change in the accounts, without finding a preference in accounts coming in just before bankruptcy.¹⁸ This means, at least, that releases and substitutions are not "transfers" and that the "transfer" took place at the time of the original financing.

Whether any particular assignment of accounts receivable can be upheld as against the assignor's trustee in bankruptcy depends, of course, upon the applicable state law, *i.e.* the UNIFORM COMMERCIAL CODE. In the absence of sanctioning and validating legislation, the assignment, even though made prior to the filing of the bankruptcy petition, is likely to be set aside under the voidable preference provision of the Bankruptcy Act.¹⁹

Like accounts receivable, inventory has also become a very necessary source of business financing. In the article "Proceeds' Under the Uniform Commercial Code,"²⁰ the writer gave a very poignant plea for the acceptance of inventory financing without it becoming a preference under bankruptcy. His comments were as follows:

The paradox of Heraclitus is applicable to the flow in inventory into proceeds and back again: you cannot step twice into the same river. Doubtless this would have seemed absurd to Huck Finn as he waded into the Mississippi, but to the philosophically minded, a river is constantly changing in its flow toward the sea; so is its observer. The paradox suggests the process of change in all life. However, admitting that we cannot step twice into the same stage of a river does not require a corresponding admission that we cannot step twice into the Mississippi River, whether it is in flood stage or sluggish flow; for obviously we can. Our intelligence provides a physical referent for the verbal term. And obviously common sense and ordinary usage of language provide a comparable referent when we speak of the flow of inventory and proceeds. No one could possibly be misled by a filed financing statement covering all of the inventory of a named debtor located at a specific address. Of

¹⁷ *Id.* at 65.

¹⁸ *Walker v. Commercial Nat'l Bank*, 217 F.2d 677 (8th Cir. 1954).

¹⁹ *Industrial Packaging Prods. Co. v. Fort Pitt Packing Int'l, Inc.*, 399 Pa., 643, 161 A.2d 19 (1960).

²⁰ Henson, "Proceeds' Under the Uniform Commercial Code, 65 COLUM. L. REV. 232 (1965).

course, the inventory changes—but any collateral changes. Sales and replacement of automobiles in a dealer's showroom are simply more obvious than submicroscopic changes in a pledged stock certificate, whose value on the exchange may fluctuate wildly, though perhaps in an intangible fashion. It is curious that some lawyers have difficulty in conceiving of inventory as a financible unit when no one has any problem in identifying the Mississippi River as a conceptual unit.²¹

The author also used a very interesting analogy with regard to inventory in a paper which he delivered before the 39th annual Conference of the National Association of Referees in Bankruptcy on October 27, 1965.²² Our relator told the story of a farmer who proudly exhibited an axe that had been in his family for a hundred and fifty years. It had had four new heads and seven new handles, but to the farmer it was the same, the original axe. No one is ever misled when what is being financed is the inventory of a named debtor and this is revealed in the public records. What is being financed is whatever that inventory is at any particular time.²³

It is difficult to conceptualize how the referee in bankruptcy can claim that new accounts, inventory or the proceeds thereof, are not valid security for the creditor when he has put the world on notice of his security interest by filing a financing statement. How can it logically be claimed by the referee that these "transfers" on account of an antecedent debt with the effect of enabling the creditor to obtain a greater percentage of his debt than some other creditor of the same class? This contention is difficult to understand when it was within the contemplation of the parties that a security interest should attach to the accounts receivable, the inventory and proceeds thereunder and the state's law was complied with by filing a financing statement to this effect.

The requirements for perfecting a valid security interest are simple. The security interest must attach and it must be perfected. In essentially every case, perfection will be by filing a financing statement. The requirements for attachment are likewise simple. There must be an agreement (in writing and signed by the debtor), the secured party must have given value, and the debtor must have rights in the collateral. These events may occur in any order and, if filing preceded any of these events, perfection occurs when the last of these events takes place.²⁴

When these steps have been taken, according to one writer, the security interest is perfected and the transaction is invulnerable so far as the

²¹ *Id.* at 233, 234.

²² Henson, § 9-108 of the *Uniform Commercial Code and § 60a of the Bankruptcy Act Reconciled*, 21 BUS. LAW. 371 (January, 1966).

²³ *Id.* at 375.

²⁴ *In re United Thrift Stores, Inc.*, 4 CCH INST. CRBD. GUIDE § 98682 (D. N.J. 1965); UCC 9-303(1).

trustee in bankruptcy is concerned.²⁵ There appears to be no logical reason why this should not be so where there is an applicable state statute, and this is exactly what the CODE provides.

No one denies that in the now-antiquated²⁶ case of *Benedict v. Ratner*,²⁷ the kind of financing we are talking about could have been carried on in a revolving fashion with continuing pay-overs and new loans had the secured party exercised proper dominion over the collateral claimed. The CODE transaction gets to precisely the same end with public knowledge of exactly what is happening. Whether the financing pattern is revolving or "stationary," everybody who is interested may, with reasonable inquiry, know what is going on and in neither case is the security interest effective for more than the amount of the outstanding debt.

The after-acquired property provision of the UCC creates a situation quite distinct from that forbidden by section 60. Although the security interest does not technically attach to the after-acquired collateral until it is received by the debtor, since the CODE permits advance publication²⁸ the lien does attach automatically upon receipt of the goods. For all practical purposes, because the CODE has created a truly automatic shifting lien, the interest in the after-acquired collateral could be regarded as being perfected from the time the security interest was first granted. "One possible approach would be to regard as the only transfer in this situation the one made when the 'shifting lien' first attaches to give the security holder an indefeasible hold on the debtor's inventory."²⁹ If the interest first attaches to specific goods when the advance is made, it is contemporaneous with the giving of value and is, therefore, not for an antecedent debt.

Section 9-108 provides that "new value" must be given by the secured party at the time the security interest attaches. Although this phrase is not specifically defined, comment 2 under this section³⁰ says that making an advance, incurring an obligation, and releasing a perfected security interest are all illustrations of "new value." The authors go on to say that in other situations it is left to the courts to distinguish between "new" and "old" value, between present considerations and antecedent debts.

If secured transactions are thought of in terms of old-fashioned chattel mortgages, covering only specifically identified chattels, then a transfer will be said to have occurred, only in the narrowest sense, at the outset. But, there is no reason why the law should not move with the times.

²⁵ Henson, *op. cit. supra* note 22, at 374.

²⁶ UCC § 9-205, comments 1, 2, and 3.

²⁷ 268 U.S. 353 (1925).

²⁸ UCC § 9-303(1); OKLA. STAT. tit. 12a, § 9-303(1) (1961).

²⁹ Gordon, *op. cit. supra* note 16, at 68. This reasoning also applies to accounts receivable.

³⁰ UCC § 9-108, comment 2.

If we understand inventory and accounts receivable financing to be literally defined—that is, the financing of inventories and accounts and whatever items may from time to time compose them—then there is no transfer after the date the original secured transaction has been perfected; which is generally long in advance of the four months preceding bankruptcy. "Perfection would have occurred when the last of four events happened: a financing statement was filed, a security agreement was duly entered into, the debtor had rights in the collateral, and value was given."³¹ It has been said: "After-acquired property would be deemed to be taken for new value because it was acquired in the ordinary course of business, and it would be, in fact, substitute collateral. The property simply is not 'transferred' and there is no question of antecedent debt, for new value was necessarily given at the inception of the financing, the time the transfer was made."³²

In commenting on section 9-108, one lawyer voiced the belief: ". . . [W]here a financier has put new money into a debtor's business to finance constantly changing collateral, the security interest in the new collateral is taken for new value where the debtor's rights are acquired in the ordinary course of business. . . ."³³

In an article which appeared in the *University of Pennsylvania Law Review*,³⁴ the contributor had this to say about the time when a transfer is deemed to have been made:

The very acquisition of future property by the debtor operates automatically to extend the secured party's superior interest to that property, not through some latter supplemental action necessarily invoking the doctrine of relation back, but by force of the after-acquired property clause of the security agreement itself. That agreement constitutes a single unitary transaction contemplating future acquisitions but whose future acquisitions, as part and parcel of the original agreement, are immediately perfected seriatim; they are not to be considered subsequent transfers for a then antecedent debt since they are controlled by operation of law upon acts of the parties consummated as of the date of the execution and filing of notice of the agreement.³⁵

The authors of the CODE say that two tests must be met under section 9-108 for an interest in after-acquired property to be one not taken for an antecedent debt. "First, the secured party must, at the inception of the transaction, have given new value in some form. Second, the after-acquired property must come in either in the ordinary course of the

³¹ Henson, *op. cit. supra* note 20, at 249.

³² *Ibid.*

³³ *Id.* at 236.

³⁴ Friedman, *The Bankruptcy Preference Challenge to After-Acquired Property Clauses under the Code*, 108 U PA. L. REV. 194 (1959).

³⁵ *Id.* at 219.

debtor's business or as an acquisition which is made under a contract of purchase entered into within a reasonable time after the giving of new value and pursuant to the security agreement."³⁶ The "new value" required under this section would be the advancing of funds by the creditor at the time the security interest is granted, which generally would be within a few days of the filing of a financing statement. The after-acquired inventory and accounts we are concerned with in this discussion would arise in the ordinary course of the debtor's re-stocking his inventory or "turning over" his accounts.

The trustee in bankruptcy poses several threats to the after-acquired property transaction under the UCC. He may argue that, in fact, what the debtor and secured party are trying to effect is a "relation back" of a legal lien which arose only when the debtor acquired the property. "It is submitted, however, that the term 'relation back' properly applies only to the situation in which the creditor had an unperfected security interest, legal or equitable, before the four-month period and then perfected his interest within the period either by taking possession or by recording."³⁷ Thus, the lien on after-acquired property is sufficiently perfected when applicable state laws have been complied with. That is, if a transfer is for security and if applicable law requires a signed and delivered writing, and a filing or recording, or other like overt action³⁸ and such action has been taken, then the second party will have an enforceable lien under the state law.

The trustee has also argued that the CODE itself does not provide for an equitable lien. However, since the equitable lien is not a creature of statutes, this is not fatal. The question is whether in substantiating the perfection of our lien we need to resort to an equitable lien theory.

"It is certain from both the language of the CODE and the nature of the secured status which it affords that its security interest in after-acquired property is 'not merely an "equitable" interest'; it is a recorded, immediate interest subject to no subsequent gap in perfection."³⁹

Although the CODE does not recognize so-called equitable liens, it is of slight importance since the only time the equitable lien theory is invoked is when there has been a defective effort to create a legal lien. The CODE requirements for the creation of a legal security interest are so clearly set forth that resort need not be made to "equitable" considerations. In any case, the Bankruptcy Act does not recognize equitable liens where means are available to create a legal interest.⁴⁰

One noted editorialist suggests: "To the extent available, the Com-

³⁶ UCC § 9-108, comment 1. (Italicized in original.)

³⁷ Gordon, *op. cit. supra* note 16, at 68.

³⁸ § 60a(6), 11 U.S.C.A. § 96a(6); (Supp. 1965).

³⁹ Friedmann, *op. cit. supra* note 34, at 218.

⁴⁰ § 60a(6), 11 U.S.C. § 96a(6) (Supp. 1965).

mercial Code gives a legal lien and to the extent it cannot, it gives under section 60 a legal equitable lien. This is what the draftsmen intended and what section 60 permits the Commercial Code to do."⁴¹ It is submitted that what may come under the nomenclature of an "equitable lien" under the Bankruptcy Act (and thus be valid as having complied with applicable state laws) is, in fact, a valid security interest, *i.e.*, a legal lien, under the UCC. Thus, the CODE need not make provision for the so-called equitable lien.

In the well-known and often cited *Newkirk Mining*⁴² case, involving after-acquired inventory and equipment, Referee Hiller said: "There can be no doubt that under the CODE security interests can be made to extend to after-acquired property. . . ."

The Pennsylvania case of *Erb v. Stoner*⁴³ dealt with the seller of a herd of cows who retained a purchase money security interest in the herd. The collateral was described not only as the herd which was sold but also as including the progeny of the herd and any "replacements or additions," which is another way of saying "after-acquired property." The farmer turned the entire herd over to the defendant, an auctioneer, and the latter was held liable in conversion to the secured party not only for the proceeds of that herd but also for the replacements and additions. The court emphasized that it was not necessary to support a security interest in the after-acquired property of the farmer for the holder of that security interest to make a new advance each time a new cow was acquired by the farmer.

Before February, 1966, there apparently were no cases decided in a court of bankruptcy which involved the possible voidable preferences occasioned by the subsequent attachment of security interests in after-acquired property. However, on February 9, 1966, after research for this comment had been completed, a decision was rendered by the United States District Court for the District of Oregon⁴⁴ which held contrary to the theories and suggestions that are propounded herein. The court held that since the secured party gave no new value to the bankrupt within the four months preceding bankruptcy, any attachment of a lien upon accounts coming into existence within four months of bankruptcy constituted a transfer as security for an antecedent debt and, thus, a voidable preference.

This decision will certainly bear watching in the higher courts. If it is not over-ruled, or over-shadowed by contrary decisions, it will have

⁴¹ Keeffe, *Practicing Lawyer's Guide to the Current Law Magazines*, 51 A.B.A.J. 693 (July, 1965).

⁴² *In re Newkirk Mining Co.*, 54 BERKS COUNTY L. J. 179 (E.D. Pa., 1962).

⁴³ 19 Pa. D. & C.2d 25 (1958).

⁴⁴ *In the Matter of Portland Newspaper Publishing Company, Inc.*, No. B64-3282, D. Ore., February 9, 1966, as reported in 4 CCH INST. CRED. GUIDE § 98483.