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Financing the Manufacturer: 
Article 9 of the Uniform Commercial Code

By Oscar Spivack

As an introduction to the provisions of Article 9 of the Uniform Commercial Code, it would be well first to examine some of the problems involved in financing a manufacturer. Although the example used for this purpose concerns a manufacturer of cigarettes, cigars and pipe tobacco, the financing problems involved would be much the same for other manufacturers.

In order for the cigarette manufacturer to have a package of cigarettes available for sale to the consumer at the drugstore counter, he first must assemble or acquire, either directly or indirectly, the crop of tobacco from the tobacco farmer. Now, part of his preparation of that crop might include ageing the tobacco or in some way warehousing it for a certain period of time in order to make it ready for processing into cigarettes or pipe tobacco. Once he has accumulated this crop and begins to process the tobacco, certain chemicals and other materials may be added to the tobacco. More important, something is going to be done to the tobacco leaf. It is going to go through certain machines, and the tobacco leaf is going to be cut up and processed, both through a mechanical operation and by the employment of human labor, into a piece of goods that can be finally shaped into a cigarette. There is going to be added to this processed tobacco the paper that goes around it to make the cigarette. And today, there may be added at the tip some sort of filter. In addition to the major commodity which he must acquire from the farmer he must go through the atomic energy laboratories and pick up the filter materials.

The manufacturer is going to have this cigarette available for the consumer, at the tobacco confectioner's counter, perhaps eighteen months, two years, or three years after he has acquired the crop from the farmer. During that interval, there will be the expense and cost of storing the tobacco; the expense and cost of paying for additional materials that go into making up the cigarettes, and the expense and cost of paying the employees who will assist in the processing of the cigarette. In addition, great sum of money will be spent on television, billboard and magazine advertising in order to induce the consumer to buy this cigarette. But the manufacturer is not going to realize a dime from that tobacco crop until perhaps three years later, when a package of cigarettes has been sold over the counter. Many people have been involved in handling that cigarette during this three-year interval. How is the manufacturer going to pay for all these things until he has the cigarette ready for sale and consumption? That is the problem that the tobacco manufacturer faces. Of course, the tobacco manufacturer might be considered a poor example, because I doubt if the American Tobacco Company or Reynolds or some of the others really have any problem in arranging for financing, but if we translate this process to a small furniture manufacturer who makes up bedroom and dining room suites and has perhaps ten employees, we can see that this is a real problem that most types of industry must face.

If we analyze the cycle that I have tried to illustrate, and examine the financial requirements of this manufacturer, we can see four or five occasions along the way when it may be possible for the manufacturer to acquire some capital with which to work towards the end product. First of all, if we are dealing with a responsible manufacturer who have been in business for some period of time, there is no doubt that he is going to have some credit established with the banks. Perhaps he will have an open line that will permit him to carry on daily operations—to keep his factory running and pay overhead, electricity and similar—but which, in all probability, will not permit him to pay many thousands of dollars to farmers so that he can acquire their tobacco crops.

Secondly, there are available credit lines based on collateral security that the manufacturer may be able to offer a lender.
Some of the security that he can offer might be in the form of fixed assets—real estate and machinery and equipment. In all probability, however, in acquiring the real estate and the machinery and equipment, he has already had to mortgage those assets to pay for them. So, as a general proposition, a manufacturer very seldom has available this fixed type of collateral to finance his manufacturing operation.

What then is left? There is the tobacco crop, the tobacco in the process of being converted into cigarettes, and perhaps, after he has sold the cigarettes on credit to his distributors and to his dealers, the created account receivable represented by the money that his buyers owe him.

Unfortunately, until recently unless this type of collateral was in the possession of the lenders, it was not often recognized by the law as good security. The reason for this was that the law traditionally favored security as being the rigid, fixed type of asset such as real property. Of course, the very nature of inventory as collateral precludes it from having any economic utility if it is going to be possessed by the lender in such a way that the borrower cannot process it or sell it. If you analyze what inventory is, you can, of course, see that we are dealing with something that is changing. Something that changes not only when it is converted from the tobacco leaf through the manufacturing process into the cigarette, but also in another respect. As new tobacco crops are processed into cigarettes, the finished product leaves the manufacturer and is delivered to customers. The stock of inventory maintained by the manufacturer is then supplemented by new crops of tobacco. Thus we have a dual type of change. There is a change in the inventory as a result of the manufacturing process and a change in adding to and subtracting from the stock of goods as raw materials are purchased and finished products are sold.

In Kentucky there never has been recognition of an effective lien on this dual shifting type of collateral. Never having enacted statutes such as the Factor’s Lien Act or even the Uniform Trust Receipts Act, it has been virtually impossible in Kentucky to obtain a lien that would shift and follow collateral as collateral changed in form and substance.

It is necessary to use an historical approach in order to
explain how the law has developed to the point where this floating or shifting lien may now be used to enable the manufacturer to secure adequate financing. Historically, working capital was first obtained by the manufacturer by utilizing accounts receivable as collateral. In most manufacturing operations, sales of the finished product are made to the distributors or the dealers on open lines of credit of thirty, sixty or ninety day terms. This increases the problem of the manufacturer as he does not get his cash at the time he makes the sale, but he must wait up to three months for payment.

The use of accounts receivable as a means of financing originated in the textile industries in New England where it sprang from the concept of the common-law factor. A factor then was much different than what we call a factor today. Actually, a factor was a sales agent for a manufacturer—a commission merchant—one who would sell goods on behalf of a manufacturer, and as compensation for that sale, would receive a commission. Because of the way the textile industry worked in the early days of factoring, the sales were generally made from the place of business of the factor rather than the place of business of the manufacturer. Thus, the factor had in his possession the goods that he was offering for sale. If a factor made a sale, and the manufacturer incurred an obligation to pay the factor his commission, it was a simple problem for the factor to have a lien to secure his commission because he had goods of the manufacturer in his possession.

Eventually the factors became more financially able and responsible than the manufacturers, so that in addition to selling goods, they began to lend money to finance the manufacturer of goods. As security for these loans, the factors had a lien on the finished goods which they possessed for the purpose of sale. The common law factor's lien was a possessory one, which the factor could enforce by foreclosing on the collateral in his possession.

Later in this development the factor began to do something more. He would not only sell on behalf of the manufacturer, but he would guarantee to the manufacturer that the person to whom he sold would pay the invoice, and for doing this, he would receive an additional commission.
It was not long until the factor, in addition to guaranteeing the payment of accounts, started to discount them and advance the invoice prices to the manufacturer before the expiration of the credit term or period. For this function of "cashing sales" the factor charged interest for the use of his money by the manufacturer from the date of the advance to the date of actual payment by the customer. Of course, if the credit of the customer was guaranteed by the factor, the interest charges ceased on the due date of the invoice whether the customer paid or not.

This kind of account receivable lending was accomplished very simply. When the invoice went out it would be mailed by the factor to the customer and the invoice would state, "This account is assigned to and payable only to the XYZ Factoring Company." Thus, everybody had notice of the transaction, and nobody seemed to object to the disclosure that this particular textile mill was being financed by a factor.

With the changing economy the merchandising of goods changed. The factor was no longer needed in modern day selling as an agent to handle and distribute goods. He was still virtually needed to finance manufacturing operations. As a consequence, there developed a statutory factor's lien device.¹

By complying with the Factor's Lien Act, the factor was able to accomplish substantially the same result in the way of a lien on the manufacturer's inventory and receivables as was possible when the factor actually possessed the inventory for purposes of sale. In lieu of possession, the statute substituted a form of public notice designed to tell anyone who might deal with the manufacturer that the assets—the receivables and inventory—were subject to a factor's lien even though physical possession of the inventory remained with the manufacturer. This notice generally took one of two forms. First, the manufacturing premises would be posted with signs advising anyone who walked into the plant that the goods in the plant were subject to a factor's lien; and secondly, a notice would be filed in some central or local filing office so that any person checking the record could observe and learn that some arrangement existed.

¹ Including states which have enacted the Uniform Commercial Code, 32 states now have statutory factors' lien provisions. The first Factors' Lien Act was adopted in New York in 1911 and has since been amended several times. It now constitutes section 45 of its Personal Property Law.
between the factor and the manufacturer. This was a recognition in effect, by the law, of the floating or shifting type of lien. If the above discussion is analyzed, it should be seen that one of the important attributes of this type of lien was that it was on a type of goods that changed and that the object of the entire financing transaction was to create a finished product which could be sold and converted into cash. The factor's lien, logically, since it was already a type of shifting lien on the inventory itself, could easily then shift to the proceeds of the sale (either the cash received by the manufacturer or the account receivable, if, as was usually the case, the sales were credit transactions).

The factor situation had one serious drawback in areas other than the textile field. The account receivable part of the financing was on a notification basis, so that the customers of the manufacturer knew that his accounts receivable had been given as security or were not his property. In order to make this type of financing available to other segments of the manufacturing economy, there had to be devised a way to accomplish the same thing without tipping off or telling the buyer that the account was assigned. There developed in the finance industry a mechanical way of buying accounts receivable or lending money on the security of accounts which did not require that the account debtor, as he is called under the Uniform Commercial Code, be notified that the money which he has to pay actually belongs to the finance company, the factor, or the bank.

This was accomplished in many states by a statutory recognition of non-notification financing. To some extent it was accomplished in other states by a judicial recognition that non-notification financing gave the assignee of the receivable complete and total ownership of the accounts receivable, even though no notice of any kind was given to the person who owed the money.

In the common law states where no statutory implementation ever arose, this was accomplished by saying that if $X$ assigned his accounts to $Y$, $Y$ was the owner of that account, even though $A$, the person who owed the money, never knew about it, and

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2 The sign-posting originally required in some of the factors’ lien statutes has now been eliminated from all of them.
even if $X$ assigned that account thereafter to another assignee. The court would say, insofar as the second assignee was concerned, that $X$ had no interest left in the account to assign to the second assignee, and therefore $Y$ still had a good account receivable. The court would say the same thing, if, for example, a creditor of $X$ levied an attachment or garnishment on the account debtor. In such event the creditor obtained nothing because the account debtor no longer owed $X$ any money: everything that was due $X$ had been assigned to $Y$.³

In other states, where these rules were rejected and the attaching creditor or the second assignee, if he gave notice first, was held to prevail against the first assignment, a book-marking statute was adopted, under which non-notification financing could still be accomplished if the assignor at the time of assignment was required to make a notation on the ledger sheet that the account had been assigned.

There are principles which the Uniform Commercial Code has incorporated into Article 9 in order to accomplish the same result. A great many of the mechanics, some of the devices like book-marking, some of the formalities like sign-posting, have been eliminated. The formal requisites have been kept to a minimum. But under the Code we have an absolute and clear recognition that it is legally desirable and economically essential that the floating charge on a shifting stock of goods be recognized.

It is interesting to note how Article 9 accomplishes the purpose of permitting the flexible financing of a manufacturer's inventory, from the raw-materials stage all the way to the proceeds of the sale of the finished product. Essentially, there are two principles of Article 9 which accomplish the object of the floating lien. The first method is the abolition of a long-standing rule which is based upon Benedict v. Ratner.⁴ The abolition of the Benedict v. Ratner rule means that the Code recognizes what a business man would presume the law to be. It distinguishes between what may be called credit control of the debtor and the legal effectiveness of formal requirements of a mortgage or security interest.⁵

³ Fortunato v. Pattern, 147 N.Y. 277 (1895).
⁴ 268 U.S. 353 (1925).
⁵ UCC § 9-205.
Benedict v. Ratner is a United States Supreme Court decision which involved an interpretation of the law of New York in a bankruptcy case. In that case, the bankrupt had assigned its accounts receivables to Ratner, who permitted the bankrupt thereafter to collect the money from the account debtors, to deposit the money into his own bank account and to use the money in the course of his business. The assignment was to secure loans made by Ratner which were repayable according to a fixed repayment schedule.

The Supreme Court said that under the law of New York, because the bankrupt had been permitted to exercise unfettered dominion over the proceeds of the assigned receivables, the assignment was fraudulent as against other creditors of the bankrupt and that a trustee in bankruptcy therefore had superior rights to the accounts than did the assignee.

The Benedict decision, which was the law of New York as construed by the Supreme Court of the United States, actually became a part of the federal bankruptcy law in the sense that most states that recognize the problem thought or found that they had the same law as the State of New York. This decision in effect caused a combination in a secured transaction that the Code now separates.

The test of legal effectiveness under the Benedict decision was "how much control did the assignee exercise over the assignor and the receivable proceeds." Despite any practical credit risks which the assignor chose to assume, if he did not exercise strict supervision, he lost not only that security which the assignee may have dissipated or dishonestly diverted, he also lost any legal claim to that which may not have been diverted.

Now, as a practical matter, that does not make too much sense to a businessman, although it makes a good deal of logical sense to a lawyer. If a businessman who lends money to another businessman is willing to take as security something which he will permit his debtor to use, whether it be the proceeds of an account receivable or inventory which he will sell, the lender is the one who is running the risk that his collateral may be dissipated. If there is a default, if the loan is not repaid and the lender has to resort to the collateral and some of it has been dissipated, that is a risk which the lender assumes, a risk which
he could guard against by adequately policing his security. If he does not want to assume the risk, he may guard against it by policing his security and seeing that the debtor does not make improper use of the collateral. But if he chooses not to do this, if he chooses to run a credit risk, why should he be deprived of legally enforceable rights with respect to what has not been dissipated?

The Code recognizes and distinguishes between these two problems, and in section 9-205 the rule of *Benedit v. Ratner* is abolished not only with respect to accounts receivable, but also with respect to any type of collateral where use by the debtor is permitted. Section 9-205 states:

> A security interest is not invalid or fraudulent against creditors by reason of liberty in the debtor to use, commingle, or dispose of all or part of the collateral (including any return or repossessed goods) or to collect or compromise accounts ... or to accept the return of goods or make repossessions, or to use, commingle, or dispose of proceeds, or by reason of the failure of the secured party to require the debtor to account for proceeds for replaced collateral. . . .

A tremendous protest went up in Massachusetts among commercial lawyers when they learned that Article 9 of the Code repealed the *Benedit v. Ratner* rule. It is of interest to note that this protest was probably more emotional than actual, because, according to the experts in Massachusetts law, *Benedict v. Ratner* had never been the law in Massachusetts. Nevertheless, its repeal has been a rallying point for opposition to the Code.

If opposition to repeal of the *Benedict* rule is analyzed, however, it does not make much sense from a sound business point of view. The creditor who lends money on the strength of collateral security is either going to protect his own security by adequate policing requirements or run the risk of losing it through dissipation or even the fraud of his borrower. If he chooses to run that risk, why should he be penalized by saying, "Having run that risk, you lose everything even if your trust was placed in an honest borrower who did not abuse his privilege to use the collateral."

In effect, by the repeal of *Benedict v. Ratner* (and the recognition of the type of financing that can be accomplished with-
out Benedict v. Ratner) Article 9 gives protection, not against a debtor's dishonesty or a debtor's defalcations or diversions, but against the honest insolvency of a debtor. If one can grasp that philosophy, if one can understand that Article 9 from a very practical point of view merely attempts to accomplish protection against a debtor's honest insolvency—then he has the gist of Article 9.

The older security laws, both at common law and by statute, sometimes do not recognize that the law can attempt to protect the creditor against an honest insolvent and at the same time offer no real protection against a dishonest debtor. As a practical matter, there is very little hope of recovery against a dishonest debtor who may have absconded with thousands of dollars of receivable proceeds or who may have diverted tangible collateral and disposed of it. That debtor may be found. He may be placed in jail, but as a practical matter, under such circumstances will the creditor see the benefits of his security? The Code, recognizing this, does not attempt to give the creditor that kind of protection in commercial transactions.

The second principle of Article 9 which is designed to effectuate the fluid or flexible type of financing is set forth in sections 9-201 and 9-204.

Section 9-201 is simple enough, but what it says is very significant:

Except as otherwise provided by this Act, a security agreement is effective according to its terms between the parties against purchasers of the collateral and creditors.

In other words, if the parties agree that there is to be a lien that goes from the cradle to the grave, so to speak, the law will recognize that agreement. Its very simplicity makes it quite profound, because it is quite different from what will be found in chattel mortgage statutes or the older type of security law.

To implement section 9-201, section 9-204 was placed in Article 9. In section 9-204(3), we find that a “security agreement may provide that collateral, whenever acquired, shall secure all obligations covered by the security agreement,” thus recognizing that after-acquired property can fall under the lien or security interest of a prior transaction. This makes it possible, then, for the lien to revolve in fact, because in the inventory
manufacturing cycle, where goods move in and move out, and move back in, you cannot have this flexible type of lien without a broad after-acquired property clause.

A word of caution is necessary. The after-acquired property clause that is necessary for this type of lien and which section 9-204 recognizes is limited to commercial transactions. By this is meant that this type of clause will be given effect only when the parties who are involved in the agreement are business people, when one is a manufacturer and the other is a lender, a bank, or a finance company. Section 9-204(3) does not apply to a case where the debtor or borrower is a consumer, one who buys the goods or has the goods that he is pledging for his own personal and family use, or to a farmer with respect to his crops. Section 9-204(4), pertaining to farm crops provides:

No security interest attaches under an after-acquired property clause (a) to crops which become such more than one year after the security agreement is executed.

This is in line with the existing Kentucky law, except that under section 9-204(4) a “security interest in crops which is given in conjunction with a lease or a land purchase or improvement transaction evidenced by a contract, mortgage, or deed of trust, may, if so agreed, attach to crops to be grown on the land concerned during the period of such real estate transaction.” In other words, if the after-acquired property clause is in an agreement with a farmer-borrower, who is negotiating only with regard to his crops, the crops must come into existence within a year in order to be subject to the lien, unless the farmer is giving a lien on future crops in conjunction with a real estate transaction, a mortgage on his farm, a lease on the farm, or the like.

No security interest attaches under the after-acquired property clause to consumer goods (other than accessions) unless the debtor acquires rights in them within ten days after the secured party gives value. In the case of a consumer there cannot be a valid all-embracing mortgage which goes beyond ten days or purports to cover property acquired by the debtor more than ten days after the secured party has given his value. In commercial transactions there is no time limit, and the broadest

possible after-acquired property clause will be effective to accom-
plish the floating lien.

Section 9-204 contains another provision which implements this philosophy, and which again is an extension of the present law. Section 9-204(5) states:

Obligations covered by a security agreement may include future advances or other value whether or not the advances or value are given pursuant to commitment.

One can enter into a valid agreement today and perfect his security interest by the appropriate filing, even though the secured party is not to make his advance until some time in the future. If he does make his advance in the future, he has a security interest which has priority from the date of perfection (i.e., filing) rather than the date of the advance. This changes Kentucky law in the following respect: previously where a lien secured a future advance, the priority of that lien dated only from the time of the actual advance unless the lender was under a binding and legally enforceable commitment to make the advance in the future. The Code removes that restriction and says that the priority dates from the time of the agreement and perfection of the security interest if the advance is subsequently made, regardless of whether or not the lender was legally obligated to make it. If he is under no legal duty, and he makes no future advance, then of course the lien secures nothing, and the debtor can under appropriate provisions of the article secure the lien's removal from the record.

Section 9-806 is another section which implements and complements this concept. The substance of it is that if there is a security interest in property that is sold or disposed of by the debtor, the security interest continues in any proceeds that come into existence as a result of that sale or disposition.

When we deal with inventory, inasmuch as the very nature of inventory is such that we contemplate that goods are going to be disposed of in the ordinary course of business, we find that section 9-306 logically provides that when the debtor does sell the goods, the secured party's lien then shifts to the proceeds of the sale. Generally, the proceeds will either be cash (and unless the secured party can trace that cash or reduce it to posses-

sion, he is in danger of losing that lien) or it will be, in the commercial situation, an account receivable.

The provisions just discussed will probably face some challenge in the bankruptcy courts, where the concept of the floating lien has not yet been fully recognized. It is all well and good for the Code to say that an after-acquired property clause will be given full recognition by the law of Kentucky and that if a manufacturer acquires raw materials a year after the date of the original security agreement and the year after the perfection of the security interest, he then has that new inventory subject to the earlier lien. But is it not possible that bankruptcy court will say, "Now, wait a minute, you made an advance a year ago, and you attempt to say that this property which he is acquiring today is entitled to the priority of the lien that was created a year ago. That transfer, that after-acquired property, may be subject to your lien, but you are taking it at a time that your manufacturer happens to be insolvent and on account of an antecedent transaction, and you have reason to know or do know of his insolvency; therefore, that after-acquired property can be set aside as a voidable preference."

The Code attempts to overcome in section 9-108 this possible objection in bankruptcy:

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 party 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. . . . [Emphasis added.]

The Code is trying to satisfy section 60 of the Bankruptcy Act by saying that this after-acquired property is deemed to be taken for new value rather than an account of an antecedent debt. In some factual situations this may not be a problem. In others, the bankruptcy courts might hesitate to say that "deeming" makes it so.

In the above discussion, we were concerned with the general background of the Code rules pertaining to the floating lien and how it is effectuated. Attention will now be given to some of the rules relating to receivables and inventory.

Discussing accounts receivable financing first, where a seller has performed by shipping goods to a credit buyer so that the only thing that remains to be done in the contractual situation is for the buyer to pay for the goods, the buyer’s obligation is termed an “account receivable.”

Article 9 applies to all types of accounts receivable financing. While Article 9 and the security interest provided by it is said to be applicable “to any transaction, regardless of its form,” which is intended as security, some question is possible where accounts receivable are involved. In the case of accounts receivable, there are two types of transactions which might be involved in any financing situation. In one, an assignor borrows money and pledges or assigns his accounts receivable as collateral security for repayment of the debt; this is generally the type of arrangement the manufacturer will have if a bank or finance company does the receivable financing. The other way in which a manufacturer or merchant can finance through receivables will be to actually discount or sell the receivables; he will transfer not merely a title for purposes of security, but he will give actual ownership to someone who buys the receivable and pays for it at face value less whatever discount the parties agree to.

In the one case we have what is clearly a secured transaction—a loan secured by receivables; in the other case, we have a sale. Because the situations and the uses made of these two devices are so similar and because the purpose generally in each case is the same, Article 9 governs not merely the assignment for purposes of security, but the rules of Article 9 apply also to the sale of accounts receivable. It may be determined whether the Code applies to a particular situation in Kentucky by determining where the assignor’s office is, that is, where the records are kept. If the records of the assignor are in Kentucky, Article 9 governs.

In order to perfect either accounts receivable financing arrangement in the case of a continuous series of transactions between the assignor and the assignee, there must be filed public

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9 UCC § 9-106.
10 UCC § 9-102(1).
11 UCC § 9-102(1)(b).
12 UCC § 9-108(1).
notice of transactions in the office of the county clerk.\textsuperscript{13} This is
a notice which is designed to let whoever is interested in search-
ing the record know that as between the manufacturer and the
bank or finance company, there is an arrangement relating
to the receivables. This notice is not designed to tell anyone
any more than that, but simply to put them on their guard. If
they go to the record and find that there has been a financing
statement (which is the terminology used to describe this notice)
filed on record, then they may go to the parties themselves to
learn whether they are in trouble if they deal with this par-
ticular debtor, or whether they can freely look to his receivables
or other assets described in that financing statement.

The financing statement, mentioned above, is a very in-
formal type of instrument. It must be signed by the parties,
and, under section 9-402, it must contain a description of the
collateral. This description may be in the broadest general
terms and merely has to describe the type of collateral involved,
not the specific collateral. Thus, a description such as "account
receivable" would be adequate, the rule being that any descrip-
tion is sufficient as long as it reasonably identifies that which
is being described. The statement must also contain the ad-
dresses of the parties. Beyond this, there is no formal re-
quirement.

If the parties have entered into an involved agreement re-
lating to repayment terms, interest rates, rights of the assignee,
rights of the assignor and similar matters, that agreement binds
both parties with respect to their rights, duties, and obligations,
but that agreement need not be put on record. If the parties
wish to file the actual agreement as a financing statement, they
may do so, since that undoubtedly will meet the minimum re-
quirements of a financing statement. But in most commercial
transactions, the parties will hesitate to spread on the record
the intimate details of their particular agreement.

To the extent that filing in the case of accounts receivable
financing is now the law of Kentucky, this represents a change
in the law. Prior to this, there has been no requirement of,
nor any provisions for, any kind of filing or recording. The
question has often arisen whether this requirement that a financ-

\textsuperscript{13} \textit{UCC} §§ 9-302, 9-401.
ing statement be filed so that the public may have notice of the transaction destroys whatever utility might exist in not notifying the account debtor that the account is really the property of the bank. Based upon the experience in Pennsylvania where there was no filing provision prior to the Code with respect to receivables, non-notification receivable financing still continues, even though filing is required in order to perfect it. This is because a customer who buys goods from the assignor will not ordinarily take the trouble to search the record to learn whether or not the money he is paying for the goods really belongs to his seller or to the bank or the finance company. Thus, non-notification financing will probably continue as before; at least it has in Pennsylvania.

Where there is an assignment of an occasional account by a debtor to the bank or the finance company, which is not part of a series of transactions or part of a receivable-financing arrangement, the occasional assignment is subject to the rules of Article 9, except that a financing statement need not be filed to protect it.

The Code probably changes the law in Kentucky, assuming that the law of Kentucky is like it is in most states, by repealing what is known as the Caristo doctrine.\textsuperscript{15} The Caristo doctrine provides that if there is an agreement between the parties to a contract to the effect that the rights of either of the parties may not be assigned, that agreement will be given effect.

The Code repeals the Caristo doctrine in section 9-318(4) by providing that a term in any contract between an account debtor and an assignor which prohibits assignment of an account to which they are parties is ineffective. If on the back of an order form there is a fine-print provision that “We are ordering goods but one of the conditions of this order is that anything we may owe you as a result of buying these goods may not be assigned to someone else” such a provision under section 9-318(4) would be ineffective, and the assignee acquires whatever rights the assignor had despite the prohibition.

Of course, to the extent that the ordinary contract rules relating to assignments make good sense in a commercial set-

\textsuperscript{14} UCC § 9-302(1)(e).
\textsuperscript{15} Allhusen v. Caristo Const. Corp., 303 N.Y. 446, 103 N.E.2d 891 (1952).
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ERING, they are also incorporated or included within the provisions of the Code. Thus, in the case of non-notification financing, although an account debtor may have actual knowledge of this financing, if he, in good faith, makes payment of the account to the assignor, he is discharged. In other words, until actual notification to the account debtor not to pay the assignor but to pay the assignee, a payment in good faith by him discharges the obligation.\(^6\) It is up to the assignee to police his assignor and see that money collected is paid over to him.

A security agreement which provides that the financing is to be on a non-notification basis may also provide that at the option of the secured party it can be converted at any time to a notification basis. Even if the agreement does not so provide, if the assignor should default, the Code in section 9-502(1) gives the assignee the right to notify all the account debtors of the assignment.

It has been the practice to include in commercial security agreements a provision relating to default which is designed to be all-embracing and all-inclusive. There is found in many a security agreement, relating both to receivables and to inventory, a statement that the secured party may terminate the agreement and demand payment of all outstanding debts upon the determination by the secured party that his security is or may become impaired. Article 9, in a commercial transaction, is not intended as a nursemaid for businessmen who should be competent enough to know what they are doing and who at least should know enough to be represented by counsel. Article 9 does not declare such a provision in a security agreement invalid or in any way repugnant to the purposes of Article 9. A security agreement is effective between the parties and as against third parties according to its terms. However, section 1-208 does say that if there is such a clause in an agreement, it may only be invoked by the secured party in the good-faith belief that the prospect of payment is actually impaired. Good faith is defined in the Code as meaning "honesty in fact." Therefore, theoretically at least an insecurity clause may be invoked only when there is the honest belief that the prospect of payment is impaired. The burden of showing lack of good faith is on the

\(^6\) UCC § 9-318(3).
debtor, and this may destroy some of the protection that section 1-208 is designed to give.

We now consider some of the rules of Article 9 with respect to inventory and equipment. These may come as a surprise to many lawyers, although not to most businessmen. Many lawyers are surprised at a system which can give perfection and good security interest in part of the area and leave it alone in other parts. By this is meant that lawyers are sometimes surprised to hear that a perfected security interest in inventory may be cut off when the inventory is sold to a buyer in the ordinary course of business; their reaction is, “Well, what good is it? If you lose your lien, if you lose your mortgage on these goods when they are sold, what good is the security interest to begin with?”

In examining the purpose that inventory is designed to accomplish, we find the answer to these objections. Inventory will be sold or disposed of in the ordinary course of business. People will buy goods from a merchant only if they are assured that they need not worry about a chattel mortgage that might exist on that inventory or a security interest that might exist. Naturally, one who finances inventory contemplates that the inventory is going to be sold and he expects that he is going to be paid out of the proceeds of the sale. That is all he is looking for. So it is not such a surprising thing to find that when we deal with inventory, a buyer of that inventory in the ordinary course of business will get a good title to the goods, free and clear of the lien of the secured party. This is logical when we bear in mind that the draftsmen of the Code were designing rules to protect a secured party against only the honest insolvency of the debtor.

By definition, inventory, being something that is to be sold in the ordinary course of business, consists of goods that are held by a merchant for sale or disposition. Therefore, the rules relating to inventory apply only to transactions involving merchants and do not apply to transactions where a farmer sells his crops or a consumer sells his property. A sale does not cut off the lien of a perfected security interest in the crops of a farmer. Of course, the buyer-in-the-ordinary-course-of-business concept, with the cutting off of the security interest by such a buyer, is
logically complemented by the rule in section 9-306 that the security interest shifts from the goods so disposed of to the proceeds of the sale.

In the case of inventory financing, there are simple requirements for the financing statement, much like those that apply to the statement in the case of receivables financing, discussed above. However, in covering the inventory of a manufacturer, the description of the collateral should cover not only the end product that might result from the manufacturing operation, but the whole mass of his inventory which results or exists as a result of the manufacturing operations.\(^\text{17}\)

When the manufacturer already owns equipment, it may be used as collateral security for future borrowing. Here the law under the Code will be much the same as it has been under the Chattel Mortgage Act. No reason is apparent why, after July, 1960, presently-existing mortgage forms could not be used to cover the situation where a businessman or a manufacturer goes into a bank and offers a piece of machinery or equipment as collateral for a loan.

Of course, the broad after-acquired property clause which is permitted under section 9-204 will enable the mortgagee to provide in his agreement for a security interest in any replacement of the equipment given as collateral, and, if the parties agree, it can be made broad enough to cover any other equipment or property that the mortgagor may thereafter acquire.

One further problem to be noted concerns the determination in a given case whether the equipment you are going to offer as collateral security is personal property or is so annexed to or made part of the real estate as to constitute a fixture. Section 9-313 contains new provisions relating to this question, and relating to possible security interests in fixtures.

If the equipment happens to be a motor vehicle (one that is required to be licensed under the motor vehicle registration laws) then the manner of perfecting the security interest may be somewhat different.\(^\text{18}\)

\(^\text{17}\) UCC § 9-315(1)(b).

\(^\text{18}\) See recent enactments by the Kentucky General Assembly relating to security interests in motor vehicles, particularly amendments to Ky. Rev. Stat. § 186.195.
CONCLUSION

The courts of Pennsylvania have had an opportunity on perhaps a dozen occasions during the past five years to review and interpret and apply the Code provisions. In most of those situations, the courts took a very liberal and friendly view toward the Code, and it is hoped that Kentucky will have the same good fortune. The Supreme Court of Pennsylvania was so impressed with the Code that even before it went into effect in Pennsylvania, the court took occasion to say, in a case where there was no recent ruling on the point in question, that the Code looked to it like the best rule on the subject. The court applied the Code the year before it went into effect in Pennsylvania.19

There has been some question whether Article 9, especially in the field of financing a manufacturer or a merchant, now changes the balance that existed in an insolvency situation and puts all the aces into the hands of the secured lender or the mortgagee to the detriment of the general unsecured creditor. This has not been the result in Pennsylvania. The experience there has been that while mechanically it is easier to accomplish the financing, except for a very few situations, people that took security before the Code continue to take security after the Code. That it is relatively easy under the Code to do so has apparently not been sufficient reason to induce many newcomers to enter the field of secured financing. Therefore, it is believed that the same balance between secured and unsecured creditors exists under the Code as existed prior to the Code.