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COMMENTARY

THE *PORTLAND* CASE

*Ray D. Henson**

THE *Portland* case, to give *In re Portland Newspaper Publishing Co.*[1] its familiar name, is an excellent example of the malaise infecting our bankruptcy system. Here some creditors lent money on the security of assigned accounts receivable. Naturally these accounts changed constantly. In broad terms, because the security interests were perfected more than four months before bankruptcy and the accounts arose within the four-month period, the security interests were said to be preferential under section 60a of the Bankruptcy Act.

While the referee's opinion was long, it is difficult in some cases and impossible in others to find what would appear to be essential facts. There is, however, a lengthy discussion of the "legal" theory involved. Because the case is most peculiar on its facts, such as they are, and it did not involve ordinary commercial accounts financing, it would seem more profitable to discuss the usual kind of accounts financing in the context of the referee's legal analysis.

Suppose we have a financer willing to lend $100,000 for five years against the accounts then existing and thereafter arising in the operation of an ordinary retail store. The accounts are not to fall below $125,000, and it will be an event of default under the loan agreement if they do. Subject to the occurrence of an event of default, the lender is willing for the debtor to exercise dominion over the accounts, to

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1 No. B 64-3282, D. Ore., Feb. 9, 1966 [hereinafter cited as *Portland*]. The opinion in full text is printed in 4 CCH INST. CRED. GUIDE ¶ 98483 (1966) and 3 UCC REP. SERV. 194 (1966). In his opinion Referee Snedecor makes a number of references to Henson, *"Proceeds" Under the Uniform Commercial Code*, 65 COLUM. L. REV. 232 (1965). While I have no pride of authorship, I do have a firm belief in the fundamental rightness of the basic ideas contained in that article and consequently have accepted the invitation of the editors of the GEORGIA LAW REVIEW to make this "reply" to Referee Snedecor. Although I disagree with substantially every legal point in the Referee's *Portland* opinion and, because of the importance of the issues involved, have no hesitation in saying so, it is only fair to state that Referee Snedecor has a high reputation in bankruptcy circles, which I believe to be deserved by long years of devoted service. I only regret that he did not bring to the *Portland* case the perception he has shown in another highly important area in Snedecor, *Why So Many Bankruptcies in Oregon?*, 40 REF. J. 78 (1966). In any event, this comment is related only to Rose City Development Company, Inc.,'s claim in the *Portland* case, or, more accurately, to the issues raised by accounts financing in a bankruptcy context.

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make collections, to accept returned goods and adjust accounts, and to carry on ordinary business transactions. Interest will be paid quarterly on the loan, but no principal will be repaid until the loan matures at the end of five years unless an event of default occurs and maturity is accelerated. A financing statement claiming a security interest in "accounts"[2] is properly filed. Three years after the security interest is perfected the debtor goes into bankruptcy. There are no competing security interests. The accounts subject to the security interest have never fallen below $125,000,[3] and the accounts on hand at bankruptcy have all arisen within four months of bankruptcy. Is the security interest entitled to recognition and enforcement in bankruptcy?

Presumably the referee in the *Portland* case would find this security interest a preference and therefore unenforceable in bankruptcy. (If so, he would have on his side a considerable number of referees and bankruptcy specialists, both practicing and academic.)[4] The reason, subject to some elaboration, would be that the relation back of the security interest in after-acquired property provided by the Uniform Commercial Code will not be recognized in bankruptcy.

2 That "Accounts" is an adequate description for all accounts covered by the security agreement which arise during the period the financing statement is effective cannot be open to reasonable doubt. See *In re* Platt, 4 CCH INST. CRED. GUIDE ¶ 98448 (E.D. Pa.) (in bankruptcy), *vacated on other grounds*, 4 CCH INST. CRED. GUIDE ¶ 98323 (E.D. Pa. 1966); National Cash Register Co. v. Firestone & Co., 346 Mass. 255, 191 N.E.2d 471 (1963). For an intimation to the contrary, however, see *Portland*, 4 CCH INST. CRED. GUIDE ¶ 98483 at 89071 (1966). The Code adopts a system of notice filing, and anyone fluent in the English language would know that a filed financing statement covering "Accounts" could include all present and future accounts arising within the effective period of the filing; no other meaning is sensible. See UNIFORM COMMERCIAL CODE § 9-110 [hereinafter cited as U.C.C.] (All section references not otherwise identified are to the Uniform Commercial Code, 1962 Official Text.)

3 It may be pointed out, and perhaps it should be emphasized, that the collateral in *Portland* did not fall below the amount of the loan at any time during the four months preceding bankruptcy. See Exhibit E attached to Stipulation admitted as Exhibit 39 on May 27, 1966, in the record of evidence, *In re* Portland Newspaper Publishing Co., No. B 64-3282, D. Ore., Feb. 9, 1966.

4 It is difficult for me to see why certain academic bankruptcy specialists continually favor unsecuring every secured loan by any interpretation of any applicable statute that will achieve that end. Perhaps it is in part an effort to infuse a certain aura of esoterica into a rather commonplace part of the law. It serves no social purpose to upset secured credit transactions, when the inevitable result is simply more expensive credit, for secured credit there must be to keep our economy moving; some necessitous borrowers just cannot get unsecured loans. It serves no purpose of any kind to engage in excessive legalisms in order to thwart the will of Congress and the legislatures of almost every state. To engage in such is lacking in justification when the Commercial Code in no way contravenes the Bankruptcy Act or the policy underlying it.

It is clear that the hypothesized transaction meets the requirements of the Code for a perfected, enforceable security interest. That is, the security interest attached when the parties made their agreement, the debtor had rights in the collateral, and the secured party advanced funds;[5] it was perfected by filing.[6] The security interest was not impaired by the secured party's failure to exercise any dominion over the collateral,[7] and the Code recognizes a continuing security interest in changing collateral.[8]

In what circumstances may a valid security interest be denied enforcement as a preference? Eight elements must co-exist before a preference exists: there must be (1) a transfer (by way of security) of (2) the debtor's property (3) to a creditor (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,[9] and (8) the creditor must have had reasonable cause to believe that the debtor was insolvent when the transfer was made.[10]

The pro-Bankruptcy Act (and anti-Code) argument usually takes the position that as each new account arises, it is a new transfer when that account becomes subject to the pre-existing security agreement, and, subject to other elements of a preference being found to be present, accounts arising within four months of bankruptcy are voidable preferences.[11] To some extent this argument relies on the Code's stipula-

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5 See U.C.C. § 9-204(1).

6 See U.C.C. § 9-302(1).

7 See U.C.C. § 9-205. This section may be said to repeal the rule of Benedict v. Ratner, 268 U.S. 353 (1925); at all events it eliminates any possible basis for the rule. According to Referee Snedecor, this "section *may* serve to displace" this rule. See *Portland*, 4 CCH INST. CRED. GUIDE ¶ 98483 at 89072 (1966). (Emphasis added.) That it *does* displace the rule is beyond question, for the Supreme Court in *Benedict* merely purported to state a rule of New York law, which many states have never recognized or have abolished by statute.

8 See U.C.C. §§ 9-204(3), (4).

9 Bankruptcy Act. § 60a, 11 U.S.C. § 96(a) (1964).

10 *Id.* § 60b, 11 U.S.C. § 96(b) (1964). The basic problem which the preference provisions of the Bankruptcy Act were designed to meet is the situation where a creditor senses impending doom and grasps security to which he was not previously entitled, thereby diminishing the bankrupt's estate to the detriment of other creditors. This is not the kind of problem involved in the *Portland* case.

11 These critics admit, as does Referee Snedecor, that the parties could reach exactly the same result provided by the Code by the more expensive and laborious means of revolving credit.

> Admittedly if Rose City had retained in its agreement the policing provisions . . . and had insisted upon their observance, it might have avoided the preference chal-

tion that a debtor has no rights in an account until it comes into existence[12]—a provision which could easily be dropped from the Code—and of course a security interest cannot attach (or be perfected) before the debtor has rights in the collateral.[13] This is a perfect example of

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> lenge. Requirements such as these are insisted upon by sophisticated lenders. They require that all checks, drafts, cash and other remittances in part or full payment of any collateral be deposited in a cash collateral account over which the secured party alone shall have power of withdrawal. . . . It is usually agreed that once each week the secured party will apply the whole or any part of the collected funds in the cash collateral account against the principal or interest of the advances made against the collateral, and new loans similarly are made upon the assignment of new accounts. This revolving credit arrangement enables the secured creditor to keep his financial finger on the business pulse of the debtor. Thus a sound and healthy business relationship may be maintained between creditor and debtor.

Portland, 4 CCH INST. CRED. GUIDE ¶ 98483 at 89071 (1966). It requires no intellectual sophistication or legal legerdemain to see that where the debtor is allowed to retain collections instead of paying them over to the secured party, the secured party is constantly giving new value to the debtor, just as much as if he had taken the money with one hand and given it back with the other. As old accounts are paid down, collateral is released, and new accounts come under the security agreement for new value. Section 9-108 says no more than this. To the argument that these substitutions must be strictly "contemporaneous," it may be said that the concept is in fact a practical impossibility, as those who think in terms of events must realize and as those who do not go behind shibboleths will not. The courts have not been so impractical as the Code's critics. See Henson, *supra* note 1, at 251.

12 U.C.C. § 9-204(2)(d). See *Portland*, 4 CCH INST. CRED. GUIDE ¶ 98483, at 89076 (1966).

13 U.C.C. §§ 9-204(1), 9-303(1). Professor King seems to feel that these sections *create* the problem, basically because of the concept of attachment. See King, *Section 9-108 of the Uniform Commercial Code: Does It Insulate the Security Interest from Attack by a Trustee in Bankruptcy?*, 114 U. PA. L. REV. 1117 (1966). While the concept of attachment is perhaps not an essential one, neither is it new. Under our old chattel mortgage law, for example, we could have had a mortgage "valid between the parties"—*i.e.*, it had "attached"—but invalid as to third parties because there was no recording—*i.e.*, it was not "perfected." The Code provisions at issue here present no difficulty unless one conceptualizes secured transactions in terms of specific mortgages of specific things. To read the Code as Professor King and other pro-bankruptcy specialists do, means that accounts and inventory cannot be financed without being vulnerable in bankruptcy unless a revolving credit plan is established; this attitude is insupportable as a social policy or as a legal policy. Professor King suggests that the concept of attachment could be eliminated from the concept of perfection so that "the security interest in after-acquired property could be considered perfected at the time the financing transaction and filing occur without any need to wait for the debtor to acquire the property. There would then be no problem with the section 60(a) four-month period or antecedent debt element." King, *supra* at 1132. It seems to me that this would unleash a new barrage of complaints about the Code stating a rule contrary to fact—that is, how can you have today a perfected security interest in an account that may arise next year?—although this concept does have some case support.

Leaving metaphysics to one side, the Code handles the conceptual problem satisfac-

the "mortgage mentality" at work; this is the closed mind that can conceive of no security interest more modern than the old-fashioned real estate mortgage, preferably covering only dirt.

The simple answer to this so-called problem is in section 9-108 which provides:

> 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.

It was unfortunate draftsmanship to include the word "deemed" in this provision. It provides a peg on which to hang the standard objection that this provision is contrary to fact. This provision simply recognizes the standard bankruptcy doctrine that there is no preference when new property is substituted for other property in a secured transaction.[14] The security interest continues and relates back to the original perfection. There is no objection whatsoever to this relation back.

This kind of relation back was not condemned—it was not even involved—in *Corn Exchange Bank v. Klauder*,[15] a case which seems to be frequently mis-cited in writings about the Code and the Bankruptcy Act. The *Klauder* case involved a perfectly simple collision between an accounts receivable financer and a trustee in bankruptcy, at a time when

torily if one accepts certain basic premises. There is no solution to these problems unless one is willing to accept the necessity of the kind of financing we are concerned with and the statutory provisions which now make it feasible, or any other provisions which may later be used. Any language is capable of more than one interpretation.

14 Where collateral, such as inventory or accounts, is constantly changing, it seems to me that the collateral can be analogized to, *e.g.*, the Mississippi River. See Henson, *supra* note 1, at 233-34. In the ordinary usage of English, we think we know what we mean when we say, "Mississippi River," even though that river is not the same at any two moments in time. Similarly, when we speak of inventory or accounts of a named debtor we think we know what we are talking about even though that collateral is constantly changing, in tangible or intangible ways. When the collateral changes, we trace the original security interest into the proceeds back into substituted collateral, and so on, so that the security interest is continuous and continuously perfected. See U.C.C. § 9-306(2). This is not a new concept. See Henson, *supra* note 1, at 248-52.

15 318 U.S. 434 (1943). For an example of the mis-citing of *Klauder* see *Portland*, 4 CCH INST. CRED. GUIDE ¶ 98483, at 89075-77 (1966).

section 60a of the Bankruptcy Act deemed a transfer to take place when no bona fide purchaser from the debtor and no creditor could have acquired rights in the property superior to the transferee. Under Pennsylvania law at that time, an assignee of accounts was required to notify the account debtor, in order to prevail against a subsequent good faith assignee who had given such notice. If no notice was given, and none was in this case, then the transfer was clearly vulnerable under the Bankruptcy Act. Of course, the state law was changed to make the assignment effective when noted on the assignor's books,[16] and the Bankruptcy Act was subsequently amended to incorporate a lien creditor test in place of the bona fide purchaser test.[17] What was apparently disturbing the *Klauder* court was secret liens,[18] which are impossible under the Code.

In cases decided before the Code was ever dreamed of, as well as in cases arising since it has been effective, courts have recognized continuing security interests covering after-acquired collateral, without even discussing the preference question, when the secured transactions were carried out in accordance with applicable law. Two pre-Code cases[19] were dismissed by the *Portland* referee with the observation that the facts did not disclose that the property in issue was acquired within four months of bankruptcy.[20] This is true, but on the other hand, nothing indicated that it was not acquired within four months of bankruptcy; and, particularly when we are dealing with inventory, it would appear only common sense to assume that some inventory was received within four months of bankruptcy. A certain number of changing-collateral cases are not treated as preference cases, but this does not mean that the issue could not have been raised; it merely indicates that it was not raised.[21] The cases may be taken to be ambiguous on the point, or they may be taken to support the proposition that

16 See Corn Exchange Bank v. Klauder, *supra* note 15 at 436, n.6.

17 See, *e.g.*, MacLachlan, *Preference Redefined*, 63 HARV. L. REV. 1390 (1950); Kupfer, *The Recent Amendment of Section 60a of the Bankruptcy Act*, 24 REF. J. 86 (1950).

18 See Corn Exchange Bank v. Klauder, 318 U.S. 434 *passim* (1943). This same problem of secret liens was important in Benedict v. Ratner, 268 U.S. 353 (1925).

19 Mason v. Citizens' Nat'l Trust & Sav. Bank, 71 F.2d 246 (9th Cir. 1934); Joe Heaston Tractor & Implement Co. v. Claussen, 59 N.M. 486, 287 P.2d 57 (1955).

20 *Portland*, 4 CCH INST. CRED. GUIDE ¶ 98483, at 89078 (1966). For a different version of what these cases involved, see Henson, *supra* note 1, at 250-51.

21 While referees or judges are responsible for what they decide and are entitled to the ensuing praise or blame, it must be remembered that some cases are argued and briefed inadequately by counsel; the issues raised may be a matter of chance; and the fact situations often leave much to be desired.

at least some bankruptcy courts see it as their duty to enforce security interests in accordance with the state law creating them.

Three Code cases have involved collateral which surely must have changed within four months of bankruptcy, and yet the security interest was properly upheld with no question of a preference being raised: *In re Goodfriend*,[22] *In re United Thrift Stores, Inc.*,[23] and *In re Platt*.[24] The first two cases involved inventory and the third involved inventory and accounts. All were in bankruptcy. In the first two cases the referees were reversed by the district court, while in the third, the opinion was by Referee Hiller, who is generally and rightly recognized as the foremost Code authority among our referees. Interestingly enough, in the *Platt* case Referee Hiller explicitly enforced section 9-501(5) of the Code, which states that when the secured party reduces its claim to judgment the lien of the levy relates back to the date the security interest was perfected. This, of course, is an implicit enforcement of section 9-108.[25]

If any reasonable reconciliation of section 9-108 of the Code and section 60a of the Bankruptcy Act can be made, then of course there is no conflict between the two unless somebody wishes to make one. With two possible alternatives, it seems strange that some referees prefer to find invalid, in bankruptcy, a provision in an act sponsored by the American Law Institute and the National Conference of Commissioners on Uniform State Laws, especially when that act has been passed by the legislatures of 47 states, by Congress for the District of Columbia, and by the Virgin Islands. Is this attitude tolerable? It is here submitted that it is not.

It is not the two statutes which are in conflict but rather a modern statute which meets the needs of the modern world versus the anti-secured transaction attitude of some referees and bankruptcy specialists. Probably not one bankruptcy case on review or appeal has ultimately been decided adversely to the intentions of the Code's sponsors, but reviews and appeals are expensive and time-consuming. They would also be needless if all referees would follow the plain provisions of the Code.

We can find exemplified in the *Portland* case the attitude that the

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22 4 CCH INST. CRED. GUIDE ¶ 98977 (1964).

23 242 F. Supp. 714 (D.N.J. 1965), *aff'd*, 363 F.2d 11 (1966).

24 4 CCH INST. CRED. GUIDE ¶ 98448 (1966), *vacated on other grounds*, 4 CCH INST. CRED. GUIDE ¶ 98323 (E.D. Pa. 1966).

25 The lien of the levy related back approximately four years. The collateral, being inventory and accounts, was constantly changing during this period.

Code simply must not be upheld because its provisions make legitimate secured transactions invulnerable.

> According to these Code sections a merchant by a simple signed agreement, regardless of form, may create a general floating lien for present and future advances on inventory and accounts receivable including future acquisitions. With such an agreement in existence the secured party may leave the merchant in complete control of his business and funds and yet be protected against the claims of other creditors, except purchase money security interests, by filing . . . a financing statement . . . . There is no requirement that it contain any information concerning the limit of the credit to be extended, the amounts advanced or to be advanced or the terms of payment.[26]

Admittedly the referee has grasped the idea of just what the Code does, although it would not have been so shocking to him, perhaps, if he had given some thought to the Uniform Trust Receipts Act.

> Unless the financing statement shows a maturity date of the obligation secured, it remains effective for the five years as notice to the world that the secured party may have a floating lien on the merchant's inventory and receivables. All other creditors must carry the burden of ascertaining from time to time the status of his security interests . . . . It would appear that the secured party is not concerned over the amount of unsecured credit extended to the debtor.[27]

It is not immediately obvious why "all other creditors" need to "carry the burden of ascertaining" the limits of the security interest involved, since they need not become creditors at all. But if they do, they are creditors with notice. Since the secured party has given public notice of his interest, surely there is no reason for him to be concerned with the amount of unsecured credit extended to his debtor—at least from a legal point of view; from the viewpoint of his interest in seeing the business continue in operation, his concern might be very real.

[26] *Portland*, 4 CCH INST. CRED. GUIDE ¶ 98483, at 89072 (1966). The kind of transaction condemned by the referee was found not to be fraudulent as to creditors who had notice of the financing of inventory because of public recording and who, therefore, must be held to assume a risk at their peril in Etheridge v. Sperry, 139 U.S. 266 (1891). This old case is cited merely to show that some current ideas have respectable antecedents. There is, however, no reason why current commercial law should be saddled with commercial concepts of an agrarian economy of the last century, when such concepts do not accord with modern legislation and the needs of a modern society.

[27] *Portland*, *supra* note 26 at 89073.

> The old-fashioned method of operating a business on the strength of equity capital and unsecured bank credit based upon the financial integrity of the debtor seems to be giving way to the modern trend of financing business operations in reliance upon a floating lien on current assets with little or no regard for equity capital. Added to this is the more recent development of leasing, instead of owning, plant and equipment. These methods leave the daily suppliers and employees in a perilous position. The instant case furnishes a dramatic illustration in which the priority labor claims amount to nearly $43,000. Employees furnished the labor to publish and deliver the newspapers that gave rise to the receivables in controversy. The moneys advanced by the creditors claiming security long since had been dissipated in operating losses. If these floating liens are valid, the wage claimants may receive not more than fifteen per cent on their claims out of the free assets.[28]

This is the nub of the case. These transactions must be found to be invalid so that the erstwhile employees may get more money. But put in terms of a social problem, it is not quite so simple in the *Portland* case. The wage claimants were strikers who started the defunct newspaper in competition with their former employers, while Rose City Development Company, Inc., the principal Code secured party involved, happened to be a corporation formed by 88 labor unions to provide a building for the strikers to use. Moreover, part of the funds Rose City had lent on a secured basis perhaps went to pay the strikers-employees whose work generated the accounts, which secured the capital that may have paid the workers. Which came first, the chicken or the egg? And why should financing patterns authorized by statute have to meet the personal approval of a referee in bankruptcy?

Ultimately the referee found he was "reminded of Hamlet's plaintive lines:

> The time (law) is out of joint; O cursed spite,
> That ever I was born to set it right!
> Nay, come; let's go together."[29]

Any comment on this adulterated quotation would be superfluous.

It is demonstrable that if every secured transaction were invalidated in bankruptcy and the secured parties became general creditors, it

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28 *Ibid.*
29 *Ibid.*

would make very little financial difference to general creditors in the average case.[30] (It would make a considerable difference to the secured parties involved, of course.) However, it does seem reasonable that such a result should be by act of Congress rather than by the whim of a referee.

Billions of dollars are outstanding in loans against accounts, and these loans are both legal and necessary. It was undoubtedly loans by friendly persons which kept the Portland newspaper going as long as it did. That some security was necessary to obtain the loans is self-evident. The debtor in *Portland* could never have qualified for an unsecured bank loan, which the referee thought a desirable business practice; nor could the debtor have acquired a place to publish the paper free and clear of mortgage debt, which the referee also approved, as a cushion for claims. Times have changed and so have social policies;[31] so has the law.

Because bankruptcy courts provide the ultimate test for many secured transactions, it is very important that referees be attuned to the law as it is and that they interpret it properly, whatever their personal preferences may be. If the antipathy of so many referees toward secured transactions continues to result in their invalidation, until review or appeal brings the just result, then the referee system as we know it must be re-examined[32] and perhaps abolished.

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30 See Henson, *supra* note 1, at 253.

31 There is a concomitant problem at the other end of the scale. A considerable number of referees are failing the lowest economic stratum of our society, which needs protection the most, by an antipathy toward the use of Chapter XIII. Even though Chapter XIII is widely used in some sections of the country, it is not used, except on rare occasions, in many districts. While no one wants to encourage the payment of debts to unscrupulous merchants and purveyors of unnecessary services, it should be readily apparent that if ignorant consumers have gone through perhaps needless bankruptcies they can be trapped a minute later under the heavy vise of the credit laws in some states and they can have no more such relief for six years, which gives creditors a field day. The importance of this problem can scarcely be over-estimated. Some consumers need to be saved from themselves, and the referees could help a great deal in this area. The reasons given for opposing the more frequent use of Chapter XIII are difficult to fathom and impossible to accept. Perhaps an old Moroccan saying illustrates the problem.

> You tell me you are going to Fez.
> Now, if you say you are going to Fez,
> That means you are not going.
> But I happen to know that you are going to Fez.
> Why have you lied to me, you who are my friend?

Quoted in BOWLES, THE SPIDER'S HOUSE 55 (1955).

32 The ever-rising cost of bankruptcy administration is in itself a problem of the first magnitude that demands corrective action. See Henson, *supra* note 1, at 253.

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