1-1-1995

The Value of Public-Notice Filing under Uniform Commercial Code Article 9: A Comparison with the German Legal System of Securities in Personal Property

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THE VALUE OF PUBLIC-NOTICE FILING UNDER UNIFORM COMMERCIAL CODE ARTICLE 9: A COMPARISON WITH THE GERMAN LEGAL SYSTEM OF SECURITIES IN PERSONAL PROPERTY

Jens Hausmann
In contrast to the public-notice filing system under U.C.C. Article 9, the modern German law of securities in personal property lacks publicity of security interests. The German courts have developed a mesh of priority rules exhaustively described in this analysis. Despite the costs and risks arising under the formal filing system, the U.C.C. accomplishes a preferable balance of interests involved in secured transactions. It assures certainty to creditors about the priority of security interests in particular assets, whereas the German law comprehensively recognizes the debtor’s interest in the secrecy of the transaction and the need for external capital. Regarding the scene of business financing, the analysis confronts the notorious priority of the floating lien over the supplier’s security for the purchase money with the preference of the supplier under German law. The U.C.C. gives effect to aspects of economy and efficiency, whereas the German law enforces standards of fairness.
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by

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J.D., University of Muenster, Germany, 1990
LL.D., University of Muenster, Germany, 1992

A Thesis Submitted to Graduate Faculty
of The University of Georgia in Partial Fulfillment
of the
Requirements for the Degree
MASTER OF LAWS

ATHENS, GEORGIA
1995
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# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>1</td>
</tr>
<tr>
<td><strong>Part 1:</strong></td>
<td></td>
</tr>
<tr>
<td>Public-notice-filing in the system of secured transactions under U.C.C. Article 9</td>
<td>9</td>
</tr>
<tr>
<td>I. The system of secured transactions under U.C.C. Article 9</td>
<td>9</td>
</tr>
<tr>
<td>II. The media of publicity for security interests</td>
<td>17</td>
</tr>
<tr>
<td>III. Interpretations of the treatment of public-notice-filing and the objectives of the filing system under U.C.C. Article 9</td>
<td>18</td>
</tr>
<tr>
<td>IV. The filing procedure</td>
<td>24</td>
</tr>
<tr>
<td>V. The irrelevance of trivial errors in the financing statement and major sources of inadequacy in filing</td>
<td>27</td>
</tr>
<tr>
<td>VI. The consequences of perfection</td>
<td>31</td>
</tr>
<tr>
<td>VII. The need of perfection to assure priority in the debtor's bankruptcy</td>
<td>33</td>
</tr>
</tbody>
</table>
VIII. The comprehensive preference of the principal financer to the supplier of a business regarding their security interests and remedies ...................... 36

IX. Cross-collateralization as a means of the principal financer to expand the security interest ...................... 46

X. The filing system's overwhelming compliance with the involved interests ............... 48

XI. Conclusions for the public-notice-filing system under U.C.C. Article 9 .............. 82

Part 2:
The German system of securities in personal property.. 84

I. The pledge as the statutory security device ........................................ 85

II. The ordinary non-possessory and secret securities .............................. 99

III. The combinations of security devices in the financing practice - an example of the perfect security interest ............ 135

IV. The conflict of security interests .......... 148

V. The partial compliance of the German system of securities in personal property with the interests involved in business financing and the disadvantages of banks and general creditors ..................... 161
VI. Conclusions for the operation of the
German legal system of securities in personal
property in business financing ........... 180

Final comparison and conclusions .................... 183

I. The advantages of certainty and the risks
and costs under the public-notice-filing
system of U.C.C. Article 9 ..................... 183

II. Economic benefits under the public-notice-
filling system .................................. 184

III. The preferable balance of interests under
the public-notice-filing system in general.. 185

IV. Policies of efficiency and fairness
underlying the different resolutions of the
conflict between principal financer and
supplier and the impact on interstate
commerce between the United States and
Germany ............................................ 188
Introduction

The economic systems of both countries, the United States and Germany, have to deal with significant undercapitalization of businesses. Banks and other financers infusing undercapitalized businesses with external capital seek to protect themselves against debtors getting into default with repayments; by acquisition of a security interest creditors can provide that the particular collateral ensures satisfaction of the secured debt.¹ In both countries personal property,² including primarily chattels and receivables, commonly serves as collateral for security interests.³ The legal systems of the United States and Germany provide regulations for security interests in personal property, which deal differently with the frequent interest of the debtor to conceal the security transaction and his incapability of self-financing from the trade; although in both systems the


²Although the German term "Mobiliarsicherheiten" would be translated literally as 'securities in movables' (as in: Rolf Serick, Securities in Movables in German Law: An Outline (1990)), for the purpose of this thesis the uniform use of the expression 'personal property' will suffice.

³Serick, supra note 2, at 90, with respect to security interests in receivables.
inherent risks arising from ostensible ownership and secrecy in security transactions are recognized and initially were warded off identically.

In the common law system the risk of fraudulent conveyances arising from ostensible ownership due to secret transfers of property has been acknowledged in England as early as 1601. In Twyne's Case the Star Chamber has held that a transfer of ownership without a transfer of possession violated the Statute of Fraudulent Conveyances of 1571.\(^1\) Twyne's Case proclaimed: "Secrecy is a mark of fraud."\(^5\) Consequently, it was held and practiced that any transfer of ownership required publicity. Based upon the public function of possession indicating ostensible ownership in the possessed chattel the publicity of the transfer of ownership needed to be manifested by the transfer of possession.\(^6\) Thus, the United States' legal system required the transfer of possession for any conveyance including those for security purposes.\(^7\) In parallel fashion the German private law initially acknowledged the risk of

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\(^{1}\) 13 Eliz. c. 5.

\(^{5}\) 76 Eng.Rep. 809, 814 (Star Chamber 1601). Defendant Twyne received as a gift virtually all substantial assets — primarily sheep — from his debtor, who remained in possession thereof and was also heavily indebted to another creditor.


fraudulent conveyances due to ostensible ownership, too, and correspondently demanded that transfers of property rights including secured transactions had to be accompanied by transfer of possession. But subsequently both legal systems have abandoned the absolute requirement of a transfer of possession and given effect to the debtor's need to use the collateral to run its business. Today both systems provide security instruments for creditors allowing the debtor to actually possess the collateral. But their approaches to publicity of security transactions and the danger of fraudulent conveyances arising from ostensible ownership due to secrecy of transfers, which are not accompanied by a transfer of possession, differ radically.

The United States requires the publicity of security transactions. As an alternative means of publicity enabling the debtor to remain in possession of the collateral the

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10Stefan A. Riesenfeld, Introduction: Some Comparisons with American Law, Securities in Movables, supra note 2, at 15, characterizes the relationship between these approaches impressively as "belong[ing] to different worlds"; he would "place the German system at one end of the spectrum and the US system at the other."
filing of public notice of security transactions has a tradition tracing back to the end of the past century. Varying from state to state separated pre-code recording systems with different locations to file had developed for different categories of collateral and security instruments. Ultimately there existed separate systems for trust receipts, assignments of accounts receivables, factors' liens and for chattel mortgages and conditional sales. They commonly required filing of the security agreement accompanied by the secured party's affidavit confirming to have closed the secured transaction for value and in good faith. The framers of the Uniform Commercial Code have merged these recording systems into the one uniform system of filing a financing statement at public office notifying of the secured transaction. This system deals unitarily with security interests in personal property and thereby has abolished the previous distinction between forms of security instruments.

But still it bears inefficiencies and incurs significant costs, which make reflecting about the value of public-notice filing appropriate. Besides the relatively moderate filing and searching fees, which are necessary to finance the recording

11 Gilmore, supra note 7, at 466.

1Hereinafter: U.C.C..

13U.C.C. §§ 9-302 (1) and 9-401-08 (1990); 1 Gilmore, supra note 7, at 465 ("one big filing system").

14See infra Part 1 X.B.4..
system itself, plus expenses for preparing the filing, the
costs for litigation on priority issues concerning compliance
with the filing procedure impair the efficiency of secured
financing seriously. Creditors bear the risk of severe losses
arising from subordination to subsequent creditors with a
perfected security interest and lien creditors as especially
the trustee in bankruptcy because of noncompliance with the
system's public filing requirements. In the individual case
these losses seem to be harsh in consideration of their source, the mere failure to comply with procedural details
i.e. by filing not at all required places or by misspellings
of the debtor's name in the financing statement.

In contrast, at least in the area of business financing the
German practice of securities in personal property ultimately
has given up the concept of publicity under the German Civil

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15As White has proved, solely the costs of reported cases on, whether the secured creditor due to perfection of his security interest by filing public notice had obtained priority over the trustee-in-bankruptcy's hypothetical lien under Bankruptcy Code (hereinafter: B.C.) § 544 (a) (1978), amount to at least $ 1 million but perhaps even "more than $ 30 million" per year for the period including 1980 until 1990 (James J. White, Revising Article 9 to Reduce Wasteful Litigation, 26 Loy.L.A.L.Rev. 823, 838 note 22 (1993), having listed 343 reported cases in note 21 at 831-38). This litigation arises because a trustee in bankruptcy (or debtor in possession) can avoid a security interest, if the creditor's filing does not comply with the requirements of Article 9 of the U.C.C..

16Due to the so-called "strong-arm statute" of B.C. § 544 (a); see infra VII..
The BGB lacks a public-notice-filing system entirely. At the end of the last century the hostility towards ostensible ownership and secret security transactions dominated the legislature and judiciary and influenced the drafting of the BGB, which was enacted in 1896. The statutory pledge requiring publicity by transfer of possession or notice, respectively, was established to serve as the exclusive security instrument in personal property. Although already in the early years of the BGB courts were reluctant to invalidate extra-statutory devices that were contractual in nature, the development of non-possessory and secret security instruments flourished in the period of the 1960s to the mid 1970s, when the German post-war economy was booming and in a permanent need for capital and flexible, non-possessory security devices. The legislature has failed to respond to this need and has neither codified laws on securities in personal property requiring publicity by other means than possession i.e. public-notice-filing, nor discouraged the judiciary on its route to acknowledge the extra-statutory security instruments. With academic support the judicial

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18See infra Part 2. I..

19See i.e. Judgment of April 28, 1903, Reichsgericht, II. Zivilsenat, 54 Entscheidungen des Reichsgerichts in Zivilsachen 396, 397-99 (1903) (hereinafter: 54 RGZ 396), acknowledging a transfer of security ownership but requiring some not defined public act executing the transfer; see infra Part 2. II.B.2.b..
practice has shaped the current system of securities in personal property characterized by the lack of publicity.

This thesis examines and compares the filing system under U.C.C. Article 9 and the operation of German securities in personal property lacking publicity overwhelmingly and a notice filing requirement at all. It will attempt to show the extent to which the systems accomplish their purposes and comply with the interests involved in business financing, and thereby will disclose that the filing requirement under U.C.C. Article 9 establishes substantial certainty among creditors regarding encumbrances of potential collateral, but incurs significant costs and particular risks of severe losses, which could be saved under an informal system like the German. This analysis also will reveal, that public-notice filing may enhance economic efficiency and achieves a compromise of the involved interests which generally is favorable to the imbalance occurring under the German law lacking any fundamental policy in this regard. With respect to the contest between the principal secured financer and the supplier of a business the thesis will set forth the system's contrary treatment of priority in the debtor's insolvency as acknowledged by the District Court in Hongkong and Shanghai.

\[20\] The analysis also considers issues of consumer financing where it appears appropriate for illustrative purposes or due to practical relevance.
Banking Corp., Ltd. v. HFH USA Corporation.\textsuperscript{21} The general priority of the principal lender according to the practice in the United States will be confronted with its subordination to the supplier's reservation of title under the German system. The analysis will attempt to explain that the systems differ so radically on this fundamental point of policy because the United States' system tends to stress efficiency aspects, whereas the German practice gives effect to fairness standards.

Part 1: Public-notice-filing in the system of secured transactions under U.C.C. Article 9

I. The system of secured transactions under U.C.C. Article 9

U.C.C. Article 9 provides the legal framework for secured financing and conceptually gives effect to the economy's need to secure debts on a basis of personal property assets. It recognizes a generic security interest. The security interest establishes a property right for the secured party in the collateral, and thus has effectiveness against the debtor and any other creditor having no property right in the collateral. The unsecured general creditor has no property right in the collateral. Pursuant to U.C.C. § 9-203 (1990) the creation of a security interest, or the "attachment", essentially requires (1) that the secured party must either have obtained possession of the collateral upon mutual consent or have closed a security agreement in writing,\(^2\) (2), that the secured party give "value" basically in form of credit or a "binding

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commitment" thereto and (3) that the debtor have any "rights in the collateral." Any type of personal property, including any receivable or intangible, may serve as the collateral of an Article 9 security interest. According to U.C.C. § 9-102 (1) (a) (1990) security interests may also be taken in fixtures.

U.C.C. Article 9 security interests are not limited to security interests in present individual personal property assets. The system enables and encourages encumbrances of basically the debtor's entire present and future personal property. Especially in the setting of business financing it has become common practice of financers to insist in security interests in the debtor's present and future acquired personal property. These so-called "floating liens" provide the lienor with a continuing security interest in the debtor's personal property and thereby make personal property assets available for security purposes which are subject to a rapid turnover like i.e. inventory and accounts. Article 9 recognizes the

23U.C.C. §§ 9-203 (1)(b) and 1-201 (44) (1990).


25Regarding general intangibles public-notice filing is the sole means of perfection except for isolated accounts and certain limited assignments under U.C.C. § 9-302 (1) (c), (e) and (g) (1990); Uniform Commercial Code Official Text - 1990 with Comments (1994) (hereinafter: U.C.C. Official Comment) § 9-302 cmt. 5, at 783.

floating lien in U.C.C. § 9-204 (1) (1990) expressly allowing covenants in security agreements which extent the security interest to collateral acquired by the debtor in future, so-called "after-acquired property clauses." Moreover, the rules of priority among contesting security interests in the same collateral and the operation of the public-notice filing system under U.C.C. Article 9 achieve almost perfect assurance for the floating lienor to obtain the right to prior satisfaction from the after-acquired property in the debtor's insolvency.

The rules of priority fundamentally give effect to a concept based on the timing of security interests. According to U.C.C. § 9-312 (5) (a) (1990) the security interest which is perfected or filed first, gains priority over conflicting security interests. Perfection occurs when the security interest has attached and all requirements for perfection have been fulfilled, U.C.C. § 9-303 (1) (1990). In practice the creditor taking possession or filing a financing statement at public office first, obtains priority. In the setting of

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27U.C.C. Official Comment, supra note 25, § 204 cmt. 1, at 771.

28LoPucki, 80 Va.L.Rev. at 1917. Regarding the preference of the floating lienor over the supplier of a business in detail see infra VIII..

29For details see infra VI.. Other means to perfect a security interest encompass i.e. the notification on a certificate of title, temporary and automatic perfection (See: U.C.C. § 9-302 (1990)).
business financing this is notoriously the principal financer providing the business with the initial credit, taking a floating lien for security and filing public notice first.

The system of secured financing giving priority over general and unperfected unsecured creditors overrides the "principle" of equal treatment of creditors in bankruptcy by per-quota satisfaction from the estate regardless of bilateral agreements of certain creditors with the debtor.\(^{30}\) The secured creditor with priority in the collateral is not limited to per-quota satisfaction and the collateral is deprived from the bankruptcy estate available to satisfy the general creditors. Thus the amount of return payments to general creditors in the debtor's bankruptcy is reduced. The "value" of unsecured - and secured, but unperfected - debts decreases.\(^{31}\) This intervention by U.C.C. Article 9 has been challenged on grounds of unfairness.\(^{32}\) But since contractual creditors can be "aware of


\(^{31}\)Jackson/Kronman, 88 Yale L.J. at 1147; Alan Schwartz, Taking the Analysis of Security Seriously, 80 Va.L.Rev. 2073, 2076 (1994).

\(^{32}\)LoPucki, 80 Va.L.Rev. at 1954-62. LoPucki suggests the "implied contract theory" resting on the reasonable expectations of the voluntary unsecured creditor about prior credit transactions and private disclosure of their terms which previously has been rejected by the court in Ninth District Production Credit Association v. Ed Duggan, Inc., 821 P.2d 788, 793 (Colo. 1991). The court has held that a claim of a supplier for unjust enrichment against a floating lienor would be inconsistent with the concept of priority established under U.C.C. Article 9, even though the
... the risk[s]" arising under the U.C.C. Article 9 priority rules, these creditors - other than "involuntary" i.e. tort claimants and suppliers of businesses33 - are free to negotiate a perfected security interest or refrain from the credit transaction. Moreover, it has been observed that based on a "zero-sum hypothesis" the general creditor grants credit on an unsecured basis in return for a higher interest rate reflecting the risk of a reduction of the debt's value due to subsequent debts reducing the quota of the initial credit or even gaining priority according to U.C.C. Article 9.34 Read it the other way, the security reduces the interest rate.35

Accordingly the current debate about the doctrines behind the so-called "puzzle of secured debt"36 focuses on economic

supplier reasonably did not foresee the prior security interest.

33See infra X.C.3..


35Schwartz, 80 Va.L.Rev. at 2079-80, states that the unsecured lender is induces to "raise [the] ... interest rate."

efficiency considerations. For economic reasons the present system has been challenged in several respects. But especially regarding the initial financer of a business commonly insisting on a floating lien and thus obtaining first priority in basically all of the debtor's personal property, the secured financer's priority over other creditors has been justified as an incentive for the principal creditor to "monitor" and "counsel" the debtor, which ultimately also benefits the other creditors. The principal lender entering into the business relationship with the debtor on a

37Jackson/Kronman, 88 Yale L.J. at 1148; Scott, 80 Va.L.Rev. at 1802.

38See only: Alan Schwartz, A Theory of Loan Priorities, 18 J.L.Studies 209, 211, 249-54 (1989), and Alan Schwartz, Security Interests and Bankruptcy Priorities: A Review of Current Theories, 10 J.L.Studies 1, 10, 33-34 (1981), basically favoring a debtor-based security system awarding strict priority to a limited number of first-in-time financers over all subsequent creditors without the need for public notice; White, 26 Loy.L.A.L.Rev. at 830-41, suggesting priority of unperfected security interests over lien creditors and the repeal of U.C.C. § 9-301 (1)(b) (1990); LoPucki, 80 Va.L.Rev. at 1959, 1964-65, demanding to limit the binding effect of security agreements to unsecured third-party creditors to reasonably expectable security interests and thereby to require an implied assent to the subordination.

39Which is a comprehensive security interest in the business' present and after-acquired assets and also secures future advances, see infra VIII..

40Jackson/Kronman, 88 Yale L.J. at 1156-57, 1161; Scott, 80 Va.L.Rev. at 1796-97; similarly: George G. Triantis, Secured Debt Under Conditions of Imperfect Information, 21 J.L.Studies 225, 241-55 (1992), finding that secured transactions reduce information deficits in the financing economy; refused by: Schwartz, 10 J.L.Studies at 10, 15, 33.

41Scott, 80 Va.L.Rev. at 19796-97; refused by: Schwartz, 10 J.L.Studies at 10, 15, 33.
secured basis "signals" to the trade that he has verified the debtor's creditworthiness and is going to police his commercial activity."^2 Consequentially the subsequent creditors are enabled to make a better informed credit decision. Giving priority to the "signaling" principal financer also is deemed to resolve the problem of "freeriding" by unsecured creditors in the financing market."^3 Furthermore, the subordination encourages the later secured creditor to consider the credit decision well and thereby minimize inefficient "overlending" to debtors facing insolvency."^4

Another approach for the justification of secured transactions rests on the impact of subsequent debts on the initial credit. Subsequent debts reduce the recoverable quota of earlier credit in the debtor's bankruptcy"^5 and induce the debtor to engage in increasingly risky projects endangering return payment on the senior credit, because risky operations with a small chance of high returns become efficient when the

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"^2The medium for the secured creditor's "signal" is provided by the system of filing public notice under U.C.C. Article 9; Scott, 80 Va.L.Rev. at 1796, 1801; see infra III..

"^3Saul Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 Yale L.J. 49, 71 (1982).

"^4Kanda/Levmore, 80 Va.L.Rev. at 2142.

"^5Schwartz, 80 Va.L.Rev. at 2076; even though on the other hand the subsequent debt may enable a profitable project increasing the debtor's revenue and ultimately the chance of return payment in the ordinary course of business, the "reduction-in-bankruptcy-share effect" supersedes in practice (at 2077-78).
expenses for credit accelerate. The assurance of prior satisfaction of the senior credit in the debtor's bankruptcy provides useful protection against both the loss of value of the initial debt and the "risk alteration" and therefore encourages financers to be the first and principal creditor of a business other than under a pure per-quota system. Thus the impact of potential subsequent credit has been held to justify the acknowledgment of security interests and first-in-time priority under U.C.C. Article 9.

The problem of "risk-alteration" is illustrated by: Kanda/Levmore, 80 Va.L.Rev. at 2108-11.

Kanda/Levmore, 80 Va.L.Rev. at 2113.

Kanda/Levmore, 80 Va.L.Rev. at 2113. Other more general efficiency arguments rest i.e. on the acknowledgment of an overall and "general" increase of efficiency in credit transactions (Paul M. Shupack, Solving the Puzzle of Secured Transactions, 41 Rutgers L.Rev. 1067, 1122-24 (1989)); on an accelerating effect of security on the speed of credit decisions (Kripke, 113 U.Pa.L.Rev at 948); on the extension of credit for the troubled debtor due to the availability of transferring security interests in personal property (James J. White, Efficiency Justifications for Personal Property Security, 37 Vand.L.Rev. 473, 508 (1984)), which may increase the chances for return payment to unsecured creditors in ordinary course of the debtor's business; on the assessment that a secured transaction establishes a "bargain" of "special treatment for important financial interests in exchange for the obligation to provide public notice of prior claims" (Scott, 80 Va.L.Rev. at 1831); on the opinion that secured transactions economically do not differ from other commercial transactions like sales, which are encouraged by the state (Steven L. Harris/Charles W. Mooney, Jr., A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously. 80 Va.L.Rev. 2021, 2037-41 (1994); rejected by: Schwartz, 80 Va.L.Rev. at 2081-87).
II. The media of publicity for security interests

U.C.C. §§ 9-302 (1) and 9-401 (1990) provide that in order to perfect a security interest a financing statement generally can be filed as an alternative means of publicity to transfer of possession according to U.C.C. § 9-305 (1990). Security interests in account receivables and general intangibles must be perfected by filing since both are not manifested in writing which could be subject to delivery. The U.C.C. acknowledges further methods of publicity with respect to security interests in motor-vehicles and collateral possessed by a bailee. Regarding the first, publicity is established by notification of the security interest on the certificate of title unless the motor-vehicle is held as inventory. On regard to the second, a possessory security interest, a pledge in nature, may be established in collateral in the possession of a third-person bailee by notification of the security interest to the bailee. This notification replaces the

49U.C.C. § 9-302 (1990) contains a catalogue of further, but "less important"(White, 26 Loy.L.A.L.Rev. at 826) exemptions of perfection by public-notice-filing such as temporarily perfected security interests in proceeds arising from the disposal of the collateral and money or instruments not constituting part of chattel paper, which cannot be perfected by filing at all, but must be handed over, U.C.C. §§ 9-302 (1)(b) and 9-304 (1),(4)-(6) (1990).


collateral's delivery. Accordingly, U.C.C. § 9-305 states that transfer of possession is deemed to have occurred upon the bailee's receipt of the notification. Because the notification manifests the debtor's "relinquishment ... of control over the disposition of the collateral," it is required that the debtor notify the bailee.

III. Interpretations of the treatment of public-notice-filing and the objectives of the recording system under U.C.C. Article 9

In the academic debate the public-notice-filing system has increasingly been appraised under economic and efficiency criteria correspondent to the approach to explain the entire system of security interests under U.C.C. Article 9. Accordingly, it has been held that the public-notice-filing system serves as the medium for the secured creditor to communicate information about the existence of prior credit to the debtor and the principal lender's intent to "monitor" and "counsel" the debtor; it thereby reduces expenses for investigations and policing efforts on the part of subsequent

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54In re Peter Kontaratos, 10 B.R. at 970; In re David A. Crabtree, 48 B.R. 528, 533 note 12 (E.D. Tenn. 1985); in contrast, Gilmore has held notification by either the secured party or the debtor sufficient, 1 Gilmore, supra note 7, at 440.
creditors using the recording system.\(^{55}\) This aspect of efficiency has been acknowledged especially with respect to an asset-based system of security interests since the creditor seeking information without notice would have to employ expensive inquiries regarding specific assets.\(^{56}\) On the other hand the public-notice-filing system in connection with the first-in-time priority rule under U.C.C. Article 9 enables the principal creditor of a business to "stake his claim" in exchange for the foresaid monitoring and counselling services,\(^{57}\) which seems to discourage principal lenders from monitoring the debtor's cash-flow and engagement in risky business activities.\(^{58}\) Moreover, it has been stated that the public-notice-filing system is "only justifiable", if it incurs lower interest rates than a system of private disclosure would.\(^{59}\) Under a private disclosure system the presumably lower degree of accuracy in the signaled information\(^{60}\) would increase the risk of a shortfall and thus

\(^{55}\)Scott, 80 Va.L.Rev. at 1801, 1831; Kanda/Levmore, 80 Va.L.Rev. at 2128; Jackson/Kronman, 88 Yale L.J. at 1158-61; Schwartz, 18 J.L.Studies at 218-24.

\(^{56}\)Whereas in a debtor-based system only a review of the debtor's accounting books would suffice, Kanda/Levmore, 80 Va.L.Rev. at 2128.

\(^{57}\)Kanda/Levmore, 80 Va.L.Rev. at 2104-05; Robert E. Scott, A Relational Theory of Secured Financing, 86 Colum.L.Rev. 901, 932-33 (1986).

\(^{58}\)Schwartz, 10 J.L.Studies at 10.

\(^{59}\)Schwartz, 18 J.L.Studies at 218-24, and Schwartz, 80 Va.L.Rev. at 2085; Scott, 80 Va.L.Rev. at 1831-32 note 144.

\(^{60}\)Scott, 80 Va.L.Rev. at 1831.
induce the creditor to calculate a higher premium for the risk on the interest rate.\textsuperscript{61} But on the other hand it has been considered that the debtor would have an incentive to full and accurate disclosure to minimize the interest rate.\textsuperscript{62} Basically law and economics regard the public-notice-filing system as a vehicle of information about prior credit, which to be reasonable has to be overall more efficient than a competing system of private disclosure.\textsuperscript{63}

The public-notice-filing system due to its characterization as a medium to communicate information about prior credit and the debtor's creditworthiness has been held to be "principally for the benefit of those creditors who are subject to the limitations of the first-in-time principle"\textsuperscript{64} since they are enabled to make a sophisticated credit decision. In contrast, others see it as the necessary means to operate the first-in-time priority rule under U.C.C. Article 9, which thereby has become a "pure race" filing system merely "designed" to prefer

\textsuperscript{61}Regarding the mechanism of the risk premium in the interest rate see supra I..

\textsuperscript{62}Scott, 80 Va.L.Rev. at 1832 note 144; Schwartz, 80 Va.L.Rev. at 2084-85, therefore denying an "improv[ement of] ... loan pricing" by the current public-notice filing system under U.C.C. Article 9.

\textsuperscript{63}Scott, 80 Va.L.Rev. at 1831; Kanda/Levmore, 80 Va.L.Rev. at 2128-29; Schwartz, 18 J.L.Studies at 218-24.

\textsuperscript{64}Scott, 80 Va.L.Rev. at 1801.
secured creditors, who are enabled to "sort out" their property interest against contesting creditors.\textsuperscript{65}

All of these approaches basically focus on the observation of the social effects of the filing system's current operation. They do not expressly consider that it has been initiated to establish a compromise between the various interests of the secured creditor, the general creditors and also the debtor and his customers. They are concerned by secured transactions, as the history and development of secured transactions, as set forth above, indicates.\textsuperscript{66} Accordingly the public-notice-filing system under U.C.C. Article 9 follows basically three policies: It is determined to establish certainty for the secured party regarding the acquisition of the security interest having priority in a potential conflict of security interests.\textsuperscript{67} In continuation of the pre-code filing systems it also pursues to protect transferees against misrepresentation and fraudulent conveyances by the debtor after the security transaction due to ostensible ownership. Additionally, it is


designed to facilitate public-notice-filing under former filing systems. Within these policies the system has been laid out to impair contravening interests, especially those of the debtor, only as much as necessary to achieve its foresaid directives.

Certainty regarding the perfection of the security interest and protection of the potential transferee shall be achieved by public notice of the collateral's encumbrances in the filing records. The reasonable searcher of records shall be "alerted" of the senior security interest in the collateral. The protection of third parties is limited to this cautionary function; the recording system only requires the filing of a financing statement and is not intended to provide full disclosure of the secured transaction. Correspondently it assigns the burden of additional investigation and ultimately the risk of the debtor's misrepresentation upon request for further information to the potential transferee.

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81 Gilmore, supra note 7, at 463-65.

8See; McDonnell, supra note 9, at 6C.03[1][a] - 35, defining and evaluating the debtor's and sometimes the creditor's "privacy" interests affected by the disclosure through the recording system.


U.C.C. Official Comment, supra note 25, § 9-402 cmt. 2 at 824; Biggins, 490 F.2d at 1308.

72Baird, 12 J.L.Studies at 61.
In the drafting of U.C.C. Article 9 this limited imposition of due diligence upon the third party was selected rather than a proposal to eliminate the public-notice-filing requirement. The competing approach would have shifted the burden of due diligence to the already secured party obliging it to monitor and assure that the debtor disclosed the security transaction to potential transferees of the collateral; the subsequent transferee deceived by misleading statements should have been granted relief by the availability of recovery of losses sustained in good faith from the secured party violating its "policing duty."  

The triggering idea for the present filing system under U.C.C. Article 9 has been the replacement and "unification" of various formerly separated filing systems for trust receipts, chattel mortgages, chattel sales etc.. Thereby a centralized filing system on the state level was suggested instead of local filing. Beside the unification of filing systems the entire procedure of filing itself was intended to be

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73Baird, 12 J.L. Studies at 59-90.

741 Gilmore, supra note 7, at 465; see supra Introduction.

75But U.C.C. Article 9 is not intended to decide the controversy and abandon local files as manifested by the alternative proposals in U.C.C. § 9-401 (1) (1990); U.C.C. Official Comment, supra note 25, § 9-401 cmt. 1, at 819.
facilitated by a limitation of the information needed to be filed.\footnote{U.C.C. Official Comment, supra note 25, § 9-402 cmts. 3, 9 at 825-26; 1 Gilmore, supra note 7, at 465; Baird, 12 J.L.Studies at 59; see also U.C.C. § 9-402 (8) (1990) stating that "minor errors [in the financing statement] which are not seriously misleading" are considered irrelevant to perfection of the security interest. \textit{Schwartz}, 80 Va.L.Rev. at 2084-84, expresses concerns about the impact of excessive facilitation neglecting the system's "signaling" function and leading to "asymmetric" information and ultimately "social inefficien[cy]" in the credit market.}

IV. The filing procedure

The procedure of proper filing is regulated in U.C.C. §§ 9-401-03 (1990). It requires that the secured party files a financing statement containing the information listed in U.C.C. § 9-402 (1) (1990) at the office determined according to the particularly adopted alternative in U.C.C. § 9-401 (1) (1990). Instead of a separate financing statement similar to the sample in U.C.C. § 9-402 (3) (1990) the secured party may file a copy of the security agreement provided that it contains the minimum information required for a financing statement and is signed by the debtor, U.C.C. § 9-402 (1) sentence 5 (1990).

The financing statement must show the debtor's name, his address and signature, the secured party's name and address, and it must identify the collateral, U.C.C. § 9-402 (1)
(1990). Since the debtor's name is the criterion for the filing system's index, "seriously misleading" changes in the debtor's name require an amendment statement, U.C.C. § 9-407 (7) sentence 2 (1990). In addition to the debtor's individual name the secured party may file the financing statement under the debtor's trade name. The debtor's address also serves his identification. His signature manifests his assent to the filing of public notice. The showing of the secured party's name and address shall enable the searcher to "reach" the secured party for further inquiry. The collateral is adequately identified in the financing statement, when its description is reasonable, U.C.C. § 9-110 (1990). Considering the purpose of the filing system, such a description requires that the prudent searcher be alerted to undertake additional inquiry to find out the precise collateral. Thus, less strictly than the description of the collateral in the security agreement, the financing statement merely must


78*Argumentum ex U.C.C. § 9-403 (4) (1990); In re Excel Stores, Inc., F.2d 961, 963 (2d Cir. 1965).

79McDonnell, supra note 9, at 6C.05[6]-90.


81Biggins v. Southwest Bank, 490 F.2d 1304, 1308 (9th Cir. 1973).
indicate the category of collateral,\(^{82}\) i.e. accounts receivables,\(^{83}\) equipment\(^{84}\) or inventory.\(^{85}\)

The financing statement must be filed at the proper office depending on the alternative of U.C.C. § 9-401 (1) (1990) adopted by the particular state. Under this provision the location of filing orientates at the place of the collateral and the place of the debtor. Due to lack of consent among the drafters of U.C.C. Article 9, whether a statewide or a local system was preferable, they have provided three alternative proposals in the code, which fundamentally rest on filing at the office of the Secretary of State and differ regarding the extent of local filings. Ultimately the third proposal requires beside single central and local filings also double filings, consisting of a central plus a local filing in the county of the debtor's place of business or his residence, if he either has solely one place of business statewide, or if his place of business is located out of the state of his residency, respectively.\(^{86}\)

\(^{82}\)U.C.C. Official Comment, supra note 25, § 9-402 cmt. 1, at 924.

\(^{83}\)In re Varney Wood Products, Inc., 458 F.2d 435, 438 (4th Cir. 1972).

\(^{84}\)United States v. Crittenden, 600 F.2d 478, 481 (5th Cir. 1979).

\(^{85}\)Argumentum ex In re Katz, 563 F.2d 766, 769 (5th Cir. 1977).

\(^{86}\)Regarding failure to file at the proper location see infra V.
The filing is effective as soon as the filing officer has accepted the financing statement or the secured party has presented the statement and the filing fees to the officer, whatever is earlier, U.C.C. § 9-403 (1) (1990). The consecutive indexing of the financing statement by the filing officer is beyond the secured party's influence and responsibility and therefore not necessary to "constitute" filing.\(^7\)

V. The irrelevance of trivial errors in the financing statement and major sources of inadequacy in filing

In consideration of the filing system's limited purpose to merely caution searchers checking the records\(^8\) a financing statement fundamentally meeting the requirements as set forth above will not be invalidated for containing "minor errors which are not seriously misleading," U.C.C. § 9-402 (8) (1990). To determine whether any incorrectness is trivial in this sense, it has to be examined, whether the particular defect under the circumstances of the individual case bars the "reasonably prudent" searcher from recognizing and allocating

\(^7\)U.C.C. Official Comment, supra note 25, § 9-407 cmt. 1, at 834; In re Royal Electrotype Corporation, 485 F.2d 394, 396-97 (3rd Cir. 1973); In re Smith, 10 U.C.C. Rep. Serv. 730 (W.D. Okl. 1971)

\(^8\)See supra III..
the security interest and the affected collateral." If the defect turns out to be insurmountable by reasonable efforts, the error has to be considered grave and prevents the security interest from perfection." If on the contrary the financing statement as filed meets the foresaid standard despite the incorrectness, the error is deemed irrelevant."

Considering the described standard, an element of the financing statement being extremely sensitive towards errors is the debtor's name. Since the financing statement is indexed pursuant to this feature, particularly in a computerized system, any misspelling typically causes the statement being untraceably recorded in the filing system. But, to illustrate the complexity of issues concerning the adequacy of filings containing errors, if the statement is filed under the debtor's regular used trade name instead of his legal name, the mistake exceptionally may not be seriously misleading due to the particular circumstances in the individual case. The irrelevance of an error may also be inferred, if the debtor's exact name is indicated somewhere else on the financing

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91In re Glasco, Inc. 642 F.2d at 796; National Cash Register Company v. Mishkin's 125th St., Inc., 317 N.Y.S.2d at 439.

92In re Glasco, Inc., 642 F.2d at 796.
statement\textsuperscript{93}, i.e. in the debtor's legible signature,\textsuperscript{94} so that the filing officer would have been induced to either ask for the correct name or double-index the financing statement. On the other hand, apparently "slight" errors like the mere adding of a "Co." in a corporate name have been regarded as significant in the sense of U.C.C. § 9-402(8) (1990) since according to the official administration of the records a search would disclose only statements "found under the exact name listed" and any probability of incidental findings has to be considered speculative.\textsuperscript{95}

Besides errors in the debtor's name a further major source of inadequacy of filings focuses on filings at the wrong or not at all required places. Considering that an austere standard is applied regarding the correctness of the filing's location to protect the searcher who hardly can be supposed to find a statement at the improper office,\textsuperscript{96} the misplacement of a filing commonly rests on factual\textsuperscript{97} or legal\textsuperscript{98} problems


\textsuperscript{95}In re Raymond F. Sargent, 8 U.C.C. Rep.Serv. 583, 592 (D.Me. 1970).

\textsuperscript{96}McDonnell, supra note 9, at 6C.06[2][b] - 123-24.

\textsuperscript{97}I.e. an important factual issue relates to the determination of the debtor's residency, when he is moving. In the context of dual filing see: Uniroyal, Inc. v. Universal Tire & Auto Supply Co., 557 F.2d 22 (1st Cir. 1977).
regarding the application of the particular proposal. Apart therefrom difficulties might occur in interstate commerce regarding the determination of the applicable state law governing the security interest due to the separate filing systems in each state and the inconsistency of the adopted proposals of U.C.C. § 9-401 (1) (1990) among the states. A failure to file at the right place can only be cured pursuant to U.C.C. § 9-401 (2) (1990) regarding any collateral as to which the filing has been proper, if it was made in good faith, and regarding the entire collateral against anyone having knowledge of the misplaced financing statement.

Both of the foresaid major sources of noncompliance with the filing procedure contribute significantly to the extensive volume of litigation on the issue of whether an asserted security interest has been perfected or not. Moreover, since these exemplary mistakes in the filing procedure typically render the filing inadequate to perfect the security interest, they set forth significant risks for the filing secured party

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9°I.e. of primary legal concern is the disparity among courts regarding the definition of a corporation's place of business; in some jurisdictions the courts rest on the declaration in the certificate of incorporation (National Cash Register Co. v. K.W.C., Inc., 432 F.Supp. 82, 87 (E.D.Ky. 1977)), while in others they stress the prime area of business operation (In re Carmichael Enterprises, Inc., 334 F.Supp. 94, 102-03 (N.D. Ga. 1971), affirmed per curiam, 460 F.2d 1405 (5th Cir. 1972)).

to sustain severe losses in the debtor's bankruptcy due to the treatment as a general creditor limited to per-quota satisfaction from the estate.  

VI. The consequences of perfection

Once the required steps have been taken as set forth above, proper filing is constituted and the attached security interest is perfected, U.C.C. § 9-303 (1990).  

Perfection gives the secured party a priority right regarding satisfaction of the secured debt from the collateral in a conflict between competing security interests and accordingly binds third parties holding a security interest in the same collateral. Upon the debtor's default with payment, the secured party having first priority is entitled to exercise the rights under U.C.C. §§ 9-501 et seq. (1990), especially

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100 Regarding trustees scrutinizing filings for any failure to comply with the filing procedure and the effect of an unperfected security interest in the debtor's bankruptcy see infra VII. and X.B.2.


103 These rights emerge from the secured transaction. Therefore they are also available to unperfected secured parties vis-a-vis the debtor (See: U.C.C. Official Comment, supra note 25, § 9-501 cmt. 1, at 836).
to repossess the collateral without a judgment\textsuperscript{104} and either retain it for the debt\textsuperscript{105} or sell it and account the proceeds on the debt's balance.\textsuperscript{106} If the secured creditor intends to buy the collateral, the liquidation must be executed by public sale.\textsuperscript{107}

The determination of first priority and the solvation of a conflict between contesting security interests in the same collateral is governed by priority rules. Generally they determine that the earlier security interest prevails over the later,\textsuperscript{108} that a later perfected security interest gains priority over an earlier unperfected\textsuperscript{109} and that among contesting perfected security interests the one, which is filed or perfected first whatever is earlier, is prior over the later.\textsuperscript{110} Although these principles are subject to several exemptions,\textsuperscript{111} the fundamental consequence of a filing of

\textsuperscript{104}U.C.C. § 9-503 (1990).
\textsuperscript{105}U.C.C. § 9-505 (2) (1990).
\textsuperscript{107}U.C.C. § 9-504 (3) (1990).
\textsuperscript{109}Argumentum ex U.C.C. §§ 9-301 (1)(a) and 9-312 (5)(a), which "impl[y]" that a perfected security interest is prior to an unperfected (Henry J. Bailey III/Richard B. Hagedorn, Secured Transactions in a Nutshell 231 (3rd ed. 1988)).
\textsuperscript{110}U.C.C. § 9-312 (5)(a) (1990).
\textsuperscript{111}Regarding the priority of a lien creditor, particularly the trustee in the debtor's bankruptcy see infra VII. and regarding the purchase money security interest see infra
public notice first in time is the priority over competing creditors in the collateral and the assurance of substantial recovery of the secured credit not limited to the per-quota satisfaction of a general or an unperfected or subsequently perfected secured creditor in the debtor's bankruptcy.\(^{112}\)

Since perfection commonly is constituted by public-notice filing, in a conflict of security interests the order of priority can be verified accurately from the public files. There is no need to rely on the debtor's or any other statements and records as it would be, if i.e. the date of the security interest's creation were the decisive criterion. Thus, the filing system under U.C.C. Article 9 provides the first-to-perfect priority rule with operative clarity and certainty in potential conflicts between perfected security interests.\(^{113}\)

VII. The need of perfection to assure priority in the debtor's bankruptcy

In the debtor's bankruptcy a security interest enjoys priority when it has been perfected before the petition for

\(^{112}\)See infra VII..

\(^{113}\)Baird, 12 J.L. Studies at 64-65.
bankruptcy. While the general creditors usually are limited to share the proceeds of the estate after its closing, the creditor holding a perfected security interest may obtain relief of the automatic stay on certain grounds during the pendency of the bankruptcy proceeding. The automatic stay generally bars any attempts of creditors to collect the debt including the effort to perfect a security interest. The trustee in bankruptcy may "abandon" the collateral at the secured party's request or if it is "burdensome ... or of inconsequential value ... to the estate." Consecutively the perfected secured creditor can liquidate it pursuant to U.C.C. §§ 9-501 et seq. (1990). In practice the abandonment seems to be worth of consideration primarily, when the secured debt exceeds the value of the collateral.

If the trustee decides to keep the collateral to use or sell it in the ordinary course of business pursuant to B.C. § 363, he is obliged to provide for "adequate protection" of the

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114 With respect to some security interests the secured party has a limited grace period to perfect after the petition for bankruptcy; B.C. §§ 362 (b)(3), 546 (b), providing an exemption of the automatic stay under B.C. § 362 (a).

115 I.e. the lack of adequate protection; B.C. § 361.

116 B.C. § 362 (a).

117 B.C. § 554 (b).

118 B.C. § 554 (a).

119 See supra VI.
security interest. A lack of adequate protection gives rise for the perfected secured creditor to request relief of the automatic stay. Ultimately, if the trustee liquidates the collateral, the perfected secured creditor has a right to vindicate the proceeds deducting the trustee's costs in the amount of the secured debt's open balance plus interest and reasonable expenses. If the proceeds are insufficient to satisfy the secured creditor, he becomes a general creditor regarding the remaining balance.

But due to the so-called "strong-arm" clause in B.C. § 544 (a) the privileges of priority sketched above are only available to a secured creditor whose security interest is perfected in time. This regulation provides the trustee in bankruptcy with the powers of a creditor holding an executional lien - on behalf of the general creditors he is representing - and correspondently he is authorized to "avoid" any transfer of interest in the collateral as a lien creditor could. Since a lien creditor prevails in a conflict with any security

120 B.C. § 361.
121 B.C. § 362 (d)(1).
122 B.C. § 506 (c).
123 B.C. § 506 (b).
124 B.C. § 506 (a).
125 B.C. § 702.
126 This regulation is acknowledged in U.C.C. § 9-301 (1) and (3).
interest unperfected at the time of the lien's creation, U.C.C. § 9-301 (1)(b) (1990), the trustee may set aside any security interest, which is unperfected,127 especially improperly filed, and thereby basically demote the unperfected secured creditor to a general creditor for the purpose of the bankruptcy proceedings.128

Due to his power under the "strong-arm" clause and his task to "collect ... the property of the estate"129 the trustee is induced to scrutinize whether security interests with asserted priority have been perfected properly and particularly have been filed accurately. Therefore the compliance with the filing procedure has become an issue of extensive litigation especially in connection with bankruptcy proceedings.130

VIII. The comprehensive preference of the principal financer to the supplier of a business regarding their security interests and remedies

The code provides the supplier with several remedies in the event of the debtor's default with payment arising from the

127Or not perfected in time.

128Baird/Jackson, supra note 99, at 478.

129B.C. § 704 (1).

130Regarding the empirical results of White's studies on "wasteful" litigation on these issues see supra Introduction and infra X.B.4..
sale under U.C.C. Article 2. In addition, U.C.C. Article 9 generally enables the supplier of a business with inventory or equipment to acquire a security interest for the purchase price in the sold goods, the purchase money security interest.\textsuperscript{131} Under common law\textsuperscript{132} sellers could secure the purchase money effectively by retaining title in the sold goods. The concept of conditional sales allowed the delivery and the buyer taking possession of the goods subject to the seller's retained title which was to pass over to the buyer upon full payment of the purchase money.\textsuperscript{133} Since the seller retained its rights and had not acquired them derivatively from the debtor, the conditional sale was not held to constitute a fraudulent conveyance by the debtor.\textsuperscript{134} Upon the debtor's default with payment of the purchase money, the seller was entitled to repossess the goods.\textsuperscript{135} Courts gave the

\textsuperscript{131}U.C.C. § 9-107 (a) (1990). A purchase money security interest may also acquire any person giving credit to enable the debtor to purchase the goods, U.C.C. § 107 (b) (1990).

\textsuperscript{132}Which governed title retention until legislation integrated conditional sales into the system of security interests in personal property primarily by Conditional Sales Acts.

\textsuperscript{133}1 Gilmore, supra note 7, at 71; Baird/Jackson, supra note 99, at 40.

\textsuperscript{134}Baird/Jackson, supra note 99, at 41.

\textsuperscript{135}Alternatively the seller could seek a judgment for payment of the purchase price. But the seller was barred from repossessing the goods and receiving a judgment for the open balance of the purchase price (R. Braucher & R. Riegert, Introduction to Commercial Transactions 397-98 (1977)).
seller's retained rights priority over a contesting floating lien and thereby made the conditional sale an attractive security device for suppliers of businesses. The courts refused to give effect to the after-acquired property clauses in the lien agreements on grounds of fairness stating that the enforcement of these provisions would frequently cause "gross injustice." But remarkably, it was held a mere "technicality" irrelevant under aspects of equity that the after-acquired property clause could not attach the lien to the property retained by the seller and not vested to the debtor, yet.

Under the U.C.C. the purchase money creditor may obtain priority over the business' principal financer, who already holds a perfected security interest in the debtor's present and future property for his loans to the business, the floating lien. As far as the purchase money security interest gains priority over previously perfected security interests, the first-to-perfect priority rule is displaced. This exception in favor of the later perfected security interest has been justified at least on three grounds: First, the purchase of supply and consequentially the security for the purchase money are required by the debtor to run his business


137Pennock v. Coe, 64 U.S. (23 How.) 117, 121 (1860). Regarding the argument of nemo dat, quod non habet, see infra Part 2 IV. A..
and ultimately make return payments to the earlier creditors;\textsuperscript{138} second, the other creditors benefit from the later purchase money creditor monitoring the debtor;\textsuperscript{139} third, with respect to goods not designed for resale, thus other than inventory, the later purchase has been held not to lead to a problem of "risk-alteration" affecting the earlier credit.\textsuperscript{140}

But in practice the general availability of priority has turned out to be effective only until the delivery of the collateral to the debtor, thereafter the availability has remained to be at most a theoretical under the code. Before the debtor has obtained possession of the goods, the supplier is protected sufficiently by the remedies under Article 2 of the U.C.C. in the event of the debtor's default with payment. Accordingly, the supplier has rights to withhold delivery\textsuperscript{141} and to stop delivery, when the goods have already left the supplier's sphere for shipment.\textsuperscript{142} These remedies are "similar" to a security interest for the purchase money without the requirement of a written security agreement or the filing of

\textsuperscript{138}Scott, 80 Va.L.Rev. at 1833.

\textsuperscript{139}Levmore, 92 Yale L.J. at 56-57.

\textsuperscript{140}Kanda/Levmore, 80 Va.L.Rev. at 2139. Regarding "risk alteration" see also supra I..

\textsuperscript{141}U.C.C. §§ 2-609 (1), 2-702 (1) and 2-703 (a) (1990).

\textsuperscript{142}U.C.C. § 2-705 (1990). Besides default with payment these remedies apply also to the buyer's repudiation of the contract and wrongful rejection of the goods.
a financing statement.\textsuperscript{143} The floating lien does not prevail over these rights of the supplier since it has not attached to the goods free of the latter. The opinions hold that the floating lienor does not qualify as a good faith purchaser under U.C.C. § 2-403 (1) (1990) because the debtor has not obtained possession, yet,\textsuperscript{144} which could establish the basis for the debtor's ostensible ownership and the lienor's good faith.

After delivery has occurred, the supplier encounters both statutory and practical difficulties in achieving priority over a floating lien. If the collateral of the purchase money security interest is other than inventory, in the context of business financing primarily equipment, the supplier has to perfect and file a financing statement within ten days after delivery to assure priority.\textsuperscript{145} In contrast priority of the purchase money security interest in inventory requires that perfection occur at the time of delivery and that the holders of conflicting security interests in the collateral,.

\textsuperscript{143}U.C.C. Official Comment, supra note 25, § 9-113 cmt. 1, at 764.


especially the floating lienor, have received written notice of the purchase money security interest from the supplier within five years before the debtor obtains possession of the inventory, U.C.C. § 9-312 (3) (1990). These restrictions on the availability of priority to purchase money security interests in inventory have been designed to protect other creditors, usually floating lienors, with a conflicting security interest and making "periodic advances against incoming ... inventory;" upon notification the lienor can prepare himself for fraudulent requests by the debtor for advances, when the latter already has given a purchase money security interest designed to defeat the floating lien.\(^{146}\)

Another statutory disadvantage for the supplier of inventory\(^{147}\) in the contest with the floating lienor follows from U.C.C. § 9-312 (3) (1990). Regarding the proceeds of the collateral's resale the purchase money security interest's priority may only cover "identifiable cash ... received on or before delivery" to the debtor's customer. "Cash proceeds" are defined in U.C.C. § 9-306 (1) (1990) and especially do not extend to accounts. The exclusion of accounts from the priority of the purchase money security interest disadvantages the supplier because the rapid turnover of the inventory in

\(^{146}\)U.C.C. Official Comment, supra note 25, § 9-312 cmt. 3, at 801-02.

\(^{147}\)This restriction does not apply to the seller of equipment since it is not designed for resale (U.C.C. Official Comment, supra note 25, § 9-312 cmt. 3, at 802).
the debtor's business routinely is accomplished on an account basis. Correlatively, the exclusion prefers the floating lienor significantly, who routinely extends the lien to present and future accounts.

In practice a serious obstacle to the supplier's acquisition of a prior purchase money security interest also results from the usage of negative pledge clauses in the financing business, which basically are recognized in U.C.C. § 9-311 (1990) acknowledging that the alienation of the debtor's rights in the collateral may be prohibited contractually. By these covenants the principal financers prohibit their debtors to transfer any right in the collateral including any purchase money security interest, which would deprive the secured lien of its priority status. Although the negative pledge clause does not abrogate the debtor's power to transfer his interests in the collateral, it rather operates as a promise on the part of the debtor not to cooperate in the creation of any interest jeopardizing the priority of the financer's lien. Breach of the negative pledge clause will constitute a default


149 Sometimes the purchase money security interests are excluded from the negative pledge clause, as in the provision of concern in Kelly v. Central Hanover Bank & Trust Co., 11 F.Supp. 497, 502 note 2 (S.D.N.Y. 1935), reversed 85 F.2d 61 (2d Cir, 1936).

150 Chadron Energy Corp. v. First Nat. Bank of Omaha, 379 N.W.2d at 748.
under the debtor's security agreement with the principal lienor.\textsuperscript{151} Upon such default the lien creditor is entitled to call the loan, seek payment of the accelerated balance\textsuperscript{152} and ultimately obtains the right to take possession of the - typically substantial - collateral actually covered by the lien. In light of these potential consequences of an offense against the negative pledge clause, the clause operates as a useful tool for the floating lienor to prevent prior purchase money security interests against their borrowers. Considering all of these obstacles to a purchase money priority, purchase money financers prefer an intercreditor agreement under which the floating lienor agrees to subordinate its interest. The express subordination is the only way the supplier can be assured of priority. But it requires the consent of the floating lienor.

Furthermore, in a conflict with the floating lienor the supplier also loses protection under U.C.C. Article 2 after delivery of the goods. When the debtor has obtained possession, the supplier generally has a right to reclaim the

\textsuperscript{151} Redding v. Rowe, 678 P.2d 337, 338 (Wash.Ct.App. 1984); United Independent Insurance Agencies, Inc. v. Bank of Honolulu, 718 P.2d 1097, 1102 (Haw.Ct.App. 1986). In case of the creditor's shortfall it also gives rise for compensation of damages for breach of the promise, which is obviously is less important in the debtor's insolvency (see: Ray D. Henson, Secured Transactions under the Uniform Commercial Code 193 (2nd ed. 1979)).

\textsuperscript{152} Independent Insurance Agencies, Inc. v. Bank of Honolulu, 718 P.2d at 1102; LoPucki, 80 Va.L.Rev. at 1926.
goods upon the debtor's default with payment of the purchase price.\footnote{U.C.C. §§ 2-507 (2), 2-511 (3) and, expressly for the buyer's insolvency, 2-702 (2) (1990); U.C.C. Official Comment, supra note 25, § 2-507 cmt. 3, at 128. The right for reclamation is subject to various modifications and restrictions by the trustee in the debtor's bankruptcy, ultimately even the refusal of repossession, B.C. § 546 (c), (d).} But the remedy of reclamation is subject to the rights of a good faith purchaser under U.C.C. § 2-403 (1) (1990).\footnote{U.C.C. § 2-702 (3) (1990).} Based upon this authority the floating lienor constantly has been recognized as a good faith purchaser for value\footnote{Value is assumed to be given according to U.C.C. § 1-201 (44)(b) (1990) already by the initial grant of credit or an extension thereof. Any separate additional credit specifically related to the supply with the goods is not required. (Lavonia Manufacturing Company v. Emery Corporation, 52 B.R. 944, 946, 41 U.C.C. Rep.Serv. 1172 (E.D.Pa. 1985).} taking the security interest in the goods free of the supplier's right to reclamation.\footnote{Lavonia Manufacturing Company v. Emery Corporation, 52 B.R. at 946; Trust Company Bank v. The Gloucester Corporation, 643 N.E.2d at 18; Stowers v. Mahon (In re Samuels & Co.), 526 F.2d 1238, 1243-44 (5th Cir. 1976) (en banc), cert. denied 429 U.S. 843 (1976).} Although the applicability of the good-faith-purchaser clause with respect to the right of reclamation\footnote{In contrast to the rights to withhold or stop delivery.} seems to rest on the debtor's possession indicating ostensible ownership, the lienor's knowledge of the supplier's remedy does not impede his qualification as a good faith purchaser.\footnote{Stowers v. Mahon, 526 F.2d at 1243-44; Teton International v. First National Bank of Mission, 718 S.W.2d 838, 841}
remedy by showing circumstances of bad faith on the part of the financer, which are subject to an extremely high standard rarely met in practice.\textsuperscript{159}

The supplier is unable to circumvent the preference of the floating lienor by a reservation of title in goods delivered. U.C.C. § 2-401 (1) (1990) states that the retention of title merely reserves a security interest without a security agreement, which is subject to the foresaid restrictions. This feature of United States' law provides one of its principal contrasts to the German system which enforces title retention similarly to the pre-code common law.\textsuperscript{160}

This overall subordination of the supplier's security for the purchase price, especially for inventory under the floating lien ultimately results from the binding effect of the security agreement between the debtor and the lienor on the supplier. Although such binding effect of security interests on third-party creditors has been subject to academic

\textsuperscript{159}Mere efforts by the principal financer to extend the collateral of his security interest do not suffice unless they are accompanied by i.e. collusive conduct or fraudulent misrepresentation concerning the debtor's financial situation. See: E.A. Miller, Inc. v. South Shore Bank, 539 N.E.2d 519, 523 (Mass. 1989).

\textsuperscript{160}See infra Part 2 II.A., IV.B.,C..
criticism, the courts have enforced the policy of U.C.C. Article 9 to prefer the principal lender over the supplier and to encourage accounting and inventory financing as manifested by the foresaid principles. Consequentially, the courts have rejected suppliers' restitutitional claims for unjust enrichment of the principal financer.

IX. Cross-collateralization as a means of the principal financer to expand the security interest

U.C.C. § 9-204 (3) (1990) gives effect to clauses in the security agreement, which provide that the security interest in the particular collateral in addition to the debtor's present credit shall also expand to certain future debts or liability of the debtor to the secured party. These covenants generally effect that the initial security interest under its status of priority continues to secure future advances as long as the financing statement is filed, despite of any competing security interests intermediately perfected. But there exist

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161 Julian B. McDonnell, The Floating Lienor as Good Faith Purchaser, 50 S.Cal.L.Rev. 429 (1977). LoPucki, 80 Va.L.Rev. at 1959, 1964-65, suggests for the revision of U.C.C. Article 9 to bind the third-party creditor only to security agreements between the debtor and other creditors, which were reasonably foreseeable, so that it can be deemed to have assented to his subordination.


163 U.C.C. § 9-312 (5) and (7) (1990); First National Bank of Grayson v. Citizens Deposit Bank and Trust, 735 S.W.2d 328,
some exceptional limitations on the continuation of priority, i.e. regarding the security interest in advances made after an interfering judgment lien had attached.\textsuperscript{164}

The cross-collateralization clause commonly is part of a floating lien and employed by financers expecting to extend their loans or to provide new credit to the debtor before the initial credit will be paid off entirely and therefore aim to ensure priority of the security for these advances. Generally cross-collateralization clauses have been upheld by courts in the setting of business financing.\textsuperscript{165} The covenants in the security agreement merely must cover the advances, which the security interest is designed to secure, but neither must

\textsuperscript{164}U.C.C. § 9-301 (4) (1990) stating that the expanded security interest only prevails regarding advances made not later than 45 days after the judgment lien's attachment or without knowledge thereof or pursuant to a commitment entered into without knowledge of the lien; U.C.C. Official Comment, supra note 25, § 9-301 cmts. 7-8, at 780. Regarding the protection of an intervening buyer of collateral see U.C.C. § 9-307 (3) (1990).

\textsuperscript{165}I.e.: In re Public Leasing Corporation, 488 F.2d 1369, 1378 (10th Cir. 1973); In re Riss, Tanning Corporation, 468 F.2d 1211, 1213 (2d Cir. 1972); Ex parte Chandler, 477 So.2d 360, 362-63 (Ala. 1985). Whereas in the area of consumer financing covenants in the context with cross-collateralization, which consolidate the debts, determine per-rata crediting of payments on all open debts and thereby ultimately avoid any possibility of release of the initial collateral except for full payment of the accelerated debt, have been subject to judicial scrutiny under the aspect of unconscionability; i.e.: Williams v. Walker-Furniture Co., 350 F.2d 445, 447, 450 (D.C.App. 1965).
indicate the amount of the future advances\textsuperscript{166} nor need to be disclosed in the financing statement.\textsuperscript{167} Thus, other creditors of the debtor basically have no access to information about the amount of the open debt and the exact expansion of the security interest; in this respect they depend on private inquiry and disclosure.\textsuperscript{168}

X. The filing system's overwhelming compliance with the involved interests

In consideration of the comparison with the German legal system on securities in personal property it has to be determined, in how far the public-notice-filing system under U.C.C. Article 9 accomplishes its purposes and complies with the interests affected by secured transactions. These are the interests of the parties involved in the transaction, the debtor and the secured party, and the interests of third persons, the prospective secured creditors, the general creditors and the buyers of the collateral.

\textsuperscript{166}As it was required under several common law jurisdictions, U.C.C. Official Comment, supra note 25, § 9-204 cmt. 5, at 772.

\textsuperscript{167}U.C.C. Official Comment, supra note 25, § 9-204 cmt. 5, at 772; First National Bank of Grayson v. Citizens Deposit Bank and Trust, 735 S.W.2d at 331.

\textsuperscript{168}Henson, supra note 151, at 184.
A. The limited accomplishment of the debtor's interest in secrecy of the security transaction

Pursuant to the filing system's purpose to avoid secret transfers of non-possessory security interests the system interferes with the debtor's interest to conceal the entire security transaction itself. But this infringement of the debtor's secrecy interest is outweighed by the advantages emerging from the ability to use the collateral which due to the filing system replacing the transfer of possession is the sole and mandatory means of public notice of the secured transaction. Furthermore the filing system enables the debtor's principal financer to "stake his claim" by filing notice of his lien first and thereby to limit the risk of a shortfall in the debtor's insolvency. This risk-reducing effect of the filing system is reflected in the interest rate of the credit due to a deduction of the risk premium contained in the interest rate. Thus, ultimately the debtor obtains his principal credit for a lower interest rate.

Whereas within the scope of the filing system's rationale the debtor's legitimate interest to keep the conditions of the

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See supra Introduction and III..

See supra Introduction and II. and III..

Kanda/Levmore, 80 Va.L.Rev. at 2104-05, 2113.

Regarding the mechanism of the interest rate influenced by security see: Schwartz, 80 Va.L.Rev. at 2076-78, 2084-85.
transaction, like the amount of original credit or subsequent advances and the interest rate, secret from trade is comprehensively complied with under U.C.C. Article 9. The financing statement does not disclose any business secrets and details of the existing security interest except for the identification of the parties and the collateral.173

B. The advantages for and the burdens on the secured party

Once the availability of a non-possessory security interest and the limitation of a legitimate secrecy interest are accepted, the assessment of advantages and disadvantages of the filing system for the parties of the security transaction focuses on the person of the secured party.

1. The certainty to acquire a security interest with priority in a potential conflict with other security interests

The filing system's principal advantage for the secured party results from its correlation with the first-to-perfect priority rule. The possibility to verify the filing date and due to the priority rule the superior rank of the security interest by simply referring to the filing records creates

173McDonnell, supra note 9, at 6C.07[1] - 128-30, provides a detailed list of potential information covered by the debtor's secrecy interest and not disclosed in the statement.
certainty regarding the priority in a potential conflict of security interests. Accordingly the secured party having filed notice of its security interest first is assured to gain priority against any conflicting security interests and to be entitled to seek satisfaction of the secured debt from the liquidation of the collateral in the debtor's insolvency. This certainty applies particularly to the principal financer of a business, who can "stake his claim" through the filing system and neither has to fear any "risk alteration" nor any devaluation of his claim by later debts of the business and in practice even no priority of subsequent purchase money security interests in the business' after-acquired equipment or inventory or accounts proceeds therefrom. This advantage makes the secured party ultimately being the primary beneficiary of the filing system and outweighs any of the following disadvantages to him.

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174 Trust Company Bank v. The Gloucester Corporation, 643 N.E.2d at 19; 1 Gilmore, supra note 7, at 465; Baird, 12 J.L.Studies at 55, 60, 64-65; White, 80 Va.L.Rev. at 2096.

175 Baird, 12 J.L.Studies at 55, 64-65.

176 Kanda/Levmore, 80 Va.L.Rev. at 2104-05; Baird, 12 J.L.Studies at 55, 65.

177 Schwartz, 80 Va.L.Rev. at 2076-78.

178 Especially by avoiding cooperation of the debtor regarding the perfection of a purchase money security interest of the supplier due to the usage of a negative pledge clause; see supra VIII.

179 Baird, 12 J.L.Studies at 55.
2. The risks of non-perfection and severe losses due to failure to comply with the formal requirements under U.C.C. Article 9

The formalities of the filing system under U.C.C. Article 9 routinely do not impose severe obstacles to perfection of the security interest and despite that certain "minor" errors in the filing of public notice are considered irrelevant. But there remains the inherent risk of the formal requirements, that they are seriously disobeyed particularly due to misspellings in the debtor's name and misplacement of the filing, so that the security interest has not been perfected. The volume of litigation indicates the factual risk of erroneous filing endangering perfection of the security interest, even if the chance of a serious failure to comply with the foresaid filing procedure is drastically limited by the current version of U.C.C. Article 9.

A major factor for the relevance of proper filing arises from the "strong-arm" clause\textsuperscript{180} and the priority of lien holders over earlier unperfected security interests\textsuperscript{181} authorizing the trustee in the debtor's bankruptcy to set aside earlier security interests, when they are inadequately filed. The

\textsuperscript{180}B.C. § 544 (a).

\textsuperscript{181}U.C.C. § 9-301 (1)(b) (1990).
reported cases\textsuperscript{182} initiated by the trustee in bankruptcy, in which the security interest turned out to be unperfected, give an estimation about the risk of non-compliance with the filing procedure in practice.\textsuperscript{183}

Nevertheless, acknowledging that a risk is determined by the ratio of the probability of a loss and the expected sum of a loss in case of its occurrence\textsuperscript{184}, it can be stated, that in the individual case the small possibility of erroneous filing may increase to a significant risk on the part of the secured party. A credit requiring a perfected security interest frequently amounts to a considerable volume and in the event of inadequate filing the unperfected secured creditor merely receives per-quota satisfaction like a general creditor in the debtor's bankruptcy instead of the proceeds from the liquidation plus per-quota payment of the remaining balance.\textsuperscript{185}

Overall, under the present filing system the secured party

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\textsuperscript{183}As proposed by White, 26 Loy.L.A.L.Rev. at 830-41, a repeal of U.C.C. § 9-301 (1)(b) (1990) and the lien's, including the trustee's hypothetical lien's, priority over earlier unperfected security interests would reduce the risk of inadequate filing significantly. But the repeal would also effect a serious reduction of public disclosure in the practice of secured financing which would harm the overall valuable balance of interests and particularly the certainty about the priority status of creditors' security interests.

\textsuperscript{184}The probability-cost ratio.

\textsuperscript{185}See supra VII..
bears the - relatively small - risk of disobeying filing requirements, which may cause the security interest's ineffectiveness and consequentially severe losses.

3. The deterioration of the interest in secrecy

Sometimes secured parties share the debtor's interest to conceal the security transaction or certain terms of it from trade, in particular from competitors\(^\text{186}\) or different clients.\(^\text{187}\) This interest is deteriorated by the filing system as far as it concerns the mere fact of the secured transaction; with respect to certain terms of the transaction, including the total credit outstanding, the interest rate and the purpose of the financing, the secrecy interest is protected correspondently to the debtor's interest.\(^\text{188}\)

4. The facilitation interest and the costs for the secured party under the regime of the public-notice filing system

From a perspective merely considering the costs and inconveniences connected with public-notice filing the secured party has a strong interest in the facilitation of the filing


\(^{187}\)McDonnell, supra note 9, at 6C.03[1][a] - 35.

\(^{188}\)See supra I..
requirement.\textsuperscript{189} Although the filing fees themselves are relatively moderate,\textsuperscript{190} the costs increase to some significance, when the secured party wants to ensure itself about the first priority of its security interest. In that case due to delays in the indexing process of probable prior filings the secured party has to request a search of its financing statement indicating no earlier contesting statement.\textsuperscript{191} This double-check causes additional costs for the filing creditor. In addition, there incur expenses either in-house or due to engagement of external counsel for the preparation of the filing.\textsuperscript{192} Preparation particularly encompasses the determination of the proper place of filing. Primarily in the context of interstate commerce this task frequently is complicated and thus costly to resolve due to the existence of separate filing systems in each state and the inconsistency of state legislation under the current filing system. In contrast to a centralized federal filing system

\textsuperscript{189}McDonnell, supra note 9, at 6C.03[1] - 38; Harris/Mooney, 80 Va.L.Rev. at 2021.

\textsuperscript{190}Report of the Uniform Commercial Code Article 9 Filing System Task Force to the Permanent Editorial Board's Article 9 Study Committee (May 1, 1991), (hereinafter: Task Force-Report), in appendices to: Permanent Editorial Board (PEB) Study Group Uniform Commercial Code Article 9, Report (December 1, 1992), (hereinafter: PEB-Report), p. 23. I.e. in Louisiana they amount to $ 15,-- per standard form of a financing statement and to $ 30,-- per non-standard form plus additional charges for attachments and further debtors listed, Task Force-Report, Appendix I at p. 49.

\textsuperscript{191}Task Force-Report, p. 20.

\textsuperscript{192}White, 26 Loy.L.A.L.Rev. at 830-31.
which would render a filing effective nationwide, the current decentralization causes problems regarding both the determination of the proper state to file initially and the need for any refiling, i.e. when the collateral is moving.¹⁹³ As mentioned above, within the applicable filing system it may vary from state to state, whether filing at the local county office, the state office or even dual filing is required in the individual case.¹⁹⁴

But as far as these costs and inconveniences are inherent in public-notice filing any interest to avoid them is superseded by the purpose and the advantages of the system to the secured party assuring the acquisition of a prior status for the security interest.¹⁹⁵ Therefore any less expensive way to determine priority, especially by relying on the date of the security interest's attachment, would establish at least both the dependence on the parties' records for finding out about priority and the temptation of contesting creditors to

¹⁹³These problems are illustrated by Baird/Jackson, supra note 99, at 239-46.

¹⁹⁴See supra IV., V.. But this impairment of the filing creditor's facilitation interest must not be overrated in the evaluation of the filing system for the purpose of this comparative analysis. The PEB will address this issue in the revision of U.C.C. Article 9; see: PEB-Report, p. 90, Task Force-Report, p. 24. Nevertheless, it remains to be seen in how far harmonizing including federalizing tendencies will succeed in the revision process.

¹⁹⁵See supra 1.,2..
manipulate their agreements and advance the relevant dates.\textsuperscript{196} Only cumulative and concealed costs\textsuperscript{197} arising from inefficiencies in the technical operation of the filing system, i.e. from delays in the indexing process\textsuperscript{198} and from insufficient computerization,\textsuperscript{199} are not balanced by the superior need for certainty of priority. In this context it is sufficient to note that the PEB plans to simplify the filing procedure and to improve the efficiency of the entire filing system within the revision of U.C.C. Article 9.\textsuperscript{200}

But inherent in the requirement of public-notice filing to obtain priority over conflicting security interests, especially in the debtor's bankruptcy, the secured party may sustain significant costs due to litigation merely concerning the issue of perfection and proper filing, which could be saved under a system of securities in personal property lacking a notice-filing requirement. As mentioned previously, White has examined the costs of litigation on issues of

\textsuperscript{196}McDonnell, supra note 9, at 6C.03[1]-38.

\textsuperscript{197}Which are "enormous" according to the Task Force-Report, p. 23.


\textsuperscript{199}PEB-Report, p. 88.

perfection challenged by the trustee in the debtor's bankruptcy intending to set aside unperfected security interests under the "strong-arm" clause. Considering certain variables he has appraised the overall costs of litigation on these issues between "not less than millions per year" and perhaps in the area of $30 million per year during the period including 1980-90.\footnote{26 Loy.L.A.L.Rev. at 838 and note 22.} A substantial part of these costs incurred to the creditors claiming to have a perfected security interest due to adequate filing of public notice.\footnote{202}{202\textsuperscript{2}}

Therefore, it can be concluded that the filing system gives rise to the secured party's interest to facilitate filing and particularly to minimize the risks of improper filing and the costs arising from both litigation and filing itself including preparation of the latter. But this interest basically is outweighed by the advantage of certainty regarding the

\footnote{202}{202\textsuperscript{2}}Beside the secured creditor's interest to minimize the risk of failure to obtain priority and consequentially to sustain severe losses, its interest to avoid litigation costs supports White's proposal of a policy subordinating the lien creditor and particularly the trustee in bankruptcy to the earlier unperfected secured party (26 Loy.L.A.L.Rev. at 830-41). Additionally, this proposal would save filing fees and expenses for preparing the financing statement at least with respect to the volume of filings designed to defeat the trustee in bankruptcy, which would become superfluous under this policy. But as mentioned above (supra 2. note 183) this proposal would reduce disclosure and jeopardize the balance of interests and the valuable certainty established under the public filing system.
priority of the security interest.\textsuperscript{203} Moreover, any further facilitation of filing must be proceeded cautiously for efficiency reasons because excessive granting of security could jeopardize the filing system's "signaling" function regarding the debtor's creditworthiness and ultimately would increase the risk premium reflected in interest rates.\textsuperscript{204}

C. The accomplishment of the third persons' interests

The filing system under U.C.C. Article 9 complies with its basic purpose to protect third persons against fraudulent conveyances in the course of ostensible ownership due to the availability of non-possessory security interests.\textsuperscript{205} It fundamentally accomplishes or at least balances the interests of third persons affected by the security transaction.

1. Compliance with and obstacles to the prospective secured creditor's interests in general

The creditor, who intends to give credit to the debtor on a secured basis after a previously perfected security transaction by another creditor, basically needs certainty about the existence of the prior encumbrance of the potential

\textsuperscript{203}See supra 1..

\textsuperscript{204}Schwartz, 80 Va.L.Rev. at 2084-85.

\textsuperscript{205}Regarding this purpose see supra Introduction and I.
collateral. With respect to this interest the prospective secured party is concerned about a dependable disclosure of prior security transactions and the accuracy of the filing records and search reports. Regarding the searching process it is interested in a simple, prompt and inexpensive way to obtain comprehensive\textsuperscript{206} information from the files.\textsuperscript{207} In a second step after having obtained knowledge about the perfection of a prior security interest from the records, the prospective secured creditor may depend on further information about the security transaction such as the initial amount of the secured debt, the expansion of the security interest to advances and their amount, the interest rate and eventually the volume of repayments to determine the actual balance of the security interest in the collateral. Thereupon the creditor would be able to appraise the collateral's value for a subsequent security interest or for the purpose of bargaining a termination or subordination statement from the prior secured party.

\textsuperscript{206}McDonnell, supra note 9, at 6C.07[3][b] - 133-34, 37; Scott, 80 Va.L.Rev. at 1831; implicitly: Kanda/Levmore, 80 Va.L.Rev. at 2128-29.

\textsuperscript{207}Regarding these interests and the filing system's compliance with them it is irrelevant, whether the prospective secured creditor checks the files before or, as Baird, 12 J.L. Studies at 65-66, assumes, after the decision about the credit has been made. In this thesis it is supposed that the search occurs before the decision.
a. The overwhelming compliance with the prospective secured creditor's interest in certainty about the priority of conflicting security interests

The filing system under U.C.C. Article 9 vastly complies with the foresaid interest of the probable secured creditor in obtaining certainty about the rank of the considered security interest in a potential conflict. Searching the files the prospective creditor may easily verify, whether the potential collateral is subject to any prior security interest. Thereby the probable secured party is protected against misrepresentations by the debtor regarding the encumbrance of the prospective collateral. These functions can be achieved best by a public system of notice filing since it assures a higher degree of accuracy than any private disclosure system could.208 Thus, the records of the U.C.C. Article 9 filing system appropriately give sufficient information to furnish the searcher with certainty about the encumbrances of a prospective collateral with prior security interests.

208 Baird, 12 J.L. Studies at 61-62.
b. The limited disclosure of the secured transaction in the filing records: A balance between the prospective secured creditor's disclosure interest and the debtor's secrecy interest

In protection of the debtor's secrecy interest the financing statement lacks any information about the terms of the secured transaction, including any expansion to advances, and repayments on the secured debt need not be filed.\(^{209}\) Therefore the searcher cannot obtain all the information he needs for his credit decision merely and directly from the records. To this extent the interest in the complete disclosure of the security transaction\(^{210}\) is not accomplished by the filing system. But the search of the files will "alert" the prospective secured creditor to inquire for further information.\(^{211}\) It will also provide the searcher with the prior secured party's name and address enabling further investigation and thereby facilitates inquiry significantly. Consequentially, it saves costs in comparison to a system based on private investigation.\(^{212}\)

\(^{209}\)See supra A..

\(^{210}\)McDonnell, supra note 9, at 6C.07[3][b] - 133-34, 37; Scott, 80 Va.L.Rev. at 1831; implicitly: Kanda/Levmore, 80 Va.L.Rev. at 2128-29.

\(^{211}\)See supra III. and V..

\(^{212}\)Kanda/Levmore, 80 Va.L.Rev. at 2128.
If the prior creditor refuses to provide the prospective creditor with sufficient information, according to U.C.C. § 9-208 (2) (1990) the former may be compelled to approve or correct a "statement of account" prepared and submitted by the debtor. This statement indicates the "aggregate amount of unpaid indebtedness as of a specified date", U.C.C. § 9-208 (1) (1990). Generally it gives adequate notice to the prospective secured party about the present value of a potential collateral for its purposes of acquiring a security interest. The prospective secured creditor cannot demand a "statement of account" from the senior creditor directly. On the occasion of negotiating the subsequent credit it must stipulate that the debtor will submit such a request.\(^\text{213}\) The prospective creditor's bargaining power usually forces the debtor to follow such a demand. If the debtor refuses, the prospective creditor is sufficiently warned to refrain from the security transaction.\(^\text{214}\) Therefore it can be held that the restrictions of the disclosed information in the financing statement partially are compensated by the prospective secured creditor's ability to indirectly force a "statement of account" from the prior secured creditor.

\(^{213}\)U.C.C. Official Comment, supra note 25, § 9-208 cmt. 2, at 777. The senior creditor thereby is protected against insincere or abusive requests from trade, McDonnell, supra note 9, at 6C.07[3][a] - 133.

But even after obtaining a "statement of account" especially with respect to prior floating liens of principal financers, there remains some risk regarding subsequent advances which are secured by the prior lien due to cross-collateralization, but have not been considered in the statement.\textsuperscript{215} In this respect the disclosure interest may not be accomplished by the public-notice-filing system under U.C.C. Article 9. But in case of a recognized prior extended security interest covering advances, the probable secured creditor is sufficiently alerted to draw back from the credit transaction, if it cannot obtain a termination or subordination statement from the prior creditor, particularly from the principal financer, regarding any subsequent extensions of the secured credit.\textsuperscript{216} Therefore any remaining risk of subsequent advances secured by the prior security interest ultimately rests on the searcher's unreasonableness and thus is acceptable.

Correlating to the limitation of disclosure in the financing statement to the names and addresses of the parties to the secured transaction and the identification of the type of collateral, the searcher in his own interest is expected to undertake further inquiries regarding details of the security transaction.\textsuperscript{217} From this perspective the limitation of

\textsuperscript{215}See supra A..

\textsuperscript{216}McDonnell, supra note 9, at 6C.07[3][b] - 139.

\textsuperscript{217}See supra III..
disclosure detriments the facilitation interest digesting the completeness of information about the secured transaction directly from the records.

But as set forth above the restriction of disclosure and the correlating duty to inquire are designed to limit the deterioration of the debtor's and the prior creditor's secrecy interest. The publicity of the secured transaction and therefore the public-notice-filing system under U.C.C. Article 9 in the first instance serve the prevention of fraudulent conveyances. Any infringement of the contracting parties' legitimate interest in the secrecy of their relationship reaching further than necessary to accomplish this precautionary rationale is disproportionate and has to be avoided. Correspondently, as far as publicity of the secured transaction and disclosure in the financing statement would not anymore serve to "alert" the searcher of the security interest's existence, but would solely simplify the search, the disclosure would be disproportionate. In the light of the U.C.C.'s rationale the searcher's facilitation interest in a financing statement disclosing details of the secured transaction therefore is outweighed by the secrecy interest. The limitation of disclosure and the correspondent duty to inquire thus balance the disclosure interest of the searcher

\[\text{See supra A., B.3..}\]

\[\text{See supra Introduction and III..}\]
on the one hand and the secrecy interest of the debtor and the prior secured creditor on the other without leaving significant space for further facilitation of the search by extended disclosure in the financing statement.

Comprehensive disclosure in the records has been advocated for considerations of economy and efficiency due to savings in expenses for searches and investigations. But the intervention with the legitimate privacy interest of the parties to the prior security interest cannot be justified by reasons of efficiency to third-party searchers or society; moreover, conceded an economic analysis would be appropriate, the detriments of public access to trade secrets contained in secured transactions can hardly be estimated and may produce severe economic losses. Overall the duty of further inquiry imposes acceptable restraints on the searcher’s interest in complete notice of the security interest; the prospective secured party’s interest in comprehensive disclosure is not - at least not seriously - infringed by the filing system under U.C.C. Article 9.

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220 As argued with respect to a debtor-based filing system: Kanda/Levmore, 80 Va.L.Rev. at 2128.
c. The partial insufficiency of the filing system to comply with the prospective secured party's interest in accuracy and facilitation of searches

Beside the immanent necessity for the prospective secured creditor to pay the "minimal" costs of search reports,\(^\text{221}\) which are considered to be less than under a system of private investigation,\(^\text{222}\) numerous inherent deficiencies of the filing system under U.C.C. Article 9 impose burdens and risks on him. These deficiencies adversely affect his interest in obtaining accurate and prompt information and not being misled by search reports.

(i). The burden of improper indexing and wrongful search reports

One major factor impairing the prospective secured creditor's interest in accurate information about prior security interests arises from U.C.C. § 9-303 (1) (1990) determining that a security interest is perfected, when the secured party has fulfilled all requirements on his part. Consequentially, after filing any mistake,\(^\text{223}\) delay\(^\text{224}\) or omission by the filing

\(^{221}\)Task Force-Report, p. 23.

\(^{222}\)Kanda/Levmore, 80 Va.L.Rev. at 2128; see also supra b..

\(^{223}\)See i.e. In re Royal Electrotype Corp., 485 F.2d 394, 396 (3rd Cir. 1973); Walker v. Tennessee State Bank (In re Williams), 112 B.R. 913 (Bankr.E.D.Tenn. 1990).
officer to index the financing statement properly does not hinder perfection.\textsuperscript{225} Thus, once the senior security interest has been filed appropriately, it obtains priority in a potential conflict regardless of any failures occurred in the filing office. Consequentially the searcher bears the risk of improper indexing and misleading search reports not indicating the prior security interest, which are caused by deficiencies in the filing office.\textsuperscript{226}

In several jurisdictions this policy of U.C.C. Article 9 preferring the first filing creditor's over the searcher's certainty interest seems to be balanced by the right to compensation for the damages sustained by the filing officer's negligence.\textsuperscript{227} Others have adopted statutes limiting or even exempting the officer from liability.\textsuperscript{228} But even if under certain circumstances the officer can be held liable personally, he appears to be a rather unattractive defendant considering the substantial amount of credit regularly

\textsuperscript{224}PEB-Report, p. 88; Task Force-Report, Appendix II at p. 59, indicates that indexing delays vary from state to state and range from 1-3 days in the majority of states up to 30 days.

\textsuperscript{225}U.C.C. Official Comment, \textit{supra} note 25, § 9-407 cmt. 1, at 834.


\textsuperscript{227}See i.e.: Borg-Warner Acceptances Corporation v. Secretary of State, 731 P.2d 301 (Kan. 1987).

\textsuperscript{228}See i.e.: Kentucky: Commercial Code § 9-407 (3); Nebraska: Commercial Code § 9-411 (1).
involved in secured transactions for which notice is filed. Thus, in practice the mislead creditor not obtaining priority for his security interest has to bear the losses sustained due to failure in the filing office.

(ii). The burden to determine trivial errors in the financing statement and minor changes in the debtor's name

Furthermore, the prospective creditor searching the files bears the burden of detecting trivial errors in the financing statement. This is especially difficult in those cases, when the error relates to the debtor's name and therefore passes through to the record's index.\(^{229}\) It is expected from the searcher to make "reasonable" efforts to determine "minor errors which are not seriously misleading" since a financing statement defective to that extent does not impede perfection of the security interest.\(^{230}\) Although the criterion of 'reasonableness' is rather indefinite at its borderline and therefore bears some uncertainty regarding its range, it restricts the searcher's burden and risks arising from the 'minor-error'-exception. Thus, these burden and risks ultimately must be considered acceptable. Correspondently, the searcher has to cope with changes in the debtor's name which are not "seriously misleading" and therefore do not require

\(^{229}\)See supra V.

\(^{230}\)U.C.C. § 9-402 (8) (1990); see supra V.
the filing of an amendment statement from the senior secured creditor.\textsuperscript{231} The searcher may have to strengthen his efforts to locate the file under prior names.\textsuperscript{232}

(iii). The need to determine the proper place of filing

Especially in interstate commerce the prospective secured creditor needs to determine the proper place of filing to start the search. In this respect the searcher faces the same problems as the secured creditor, who must determine the proper place to file his financing statement.\textsuperscript{233} The separate filing systems in each state require to determine the appropriate recording system for potential filings. Within the proper state's recording system the offices competent to hold the file may vary from state to state depending on the particularly adopted alternative of U.C.C. § 9-401 (1) (1990) including any amended versions.\textsuperscript{234} The lack of uniformity in state legislation in this aspect complicates the search and impedes the searcher's interest to have simple access to the records.\textsuperscript{235}


\textsuperscript{233}See supra V.B.4..\textsuperscript{234}See supra II..\textsuperscript{235}But similarly to the deterioration of the filing creditor's facilitation interest this impairment of the searcher's interest must not be outweighed due to the pendency of the revision process of U.C.C. Article 9
(iv). The burden to identify the assignee of a security interest

The searcher also bears the burden to find out the assignee of a security interest to obtain further information or even a termination or subordination statement from the prior secured party because assignments of security interests are not subject to a filing requirement; pursuant to U.C.C. § 9-405 (1990) a disclosure of the assignment in the records merely is discretionary.\(^\text{236}\) It has been indicated rightly that the searcher may be misled by the former holder of the security interest, the assignor, stating the discharge of the security interest and failing to give notice of the assignment; the searcher relying on this information risks to acquire a subordinated security interest since the earlier security interest of the assignee continues to be perfected under its priority status.\(^\text{237}\)

\(^{236}\)U.C.C. Official Comment, supra note 25, § 9-405 cmt. at 832.

\(^{237}\)McDonnell, supra note 9, at 6C.07[3][d] - 142.
2. The general subordination of the supplier's security for the purchase price to the floating lien of the principal financer of a business

The principal financer of a business routinely is the first creditor to file a financing statement of his security interest, which typically is both extended to the debtor's after-acquired property including the practically important accounts proceeds and expanded to secure also future advances. Thereby the public-notice filing system serves to assure the notorious priority of the principal financer's floating lien over security interests of subsequent creditors of the business particularly the suppliers' purchase money security interests as far as they extend to accounts proceeds from the resale of goods.\(^{236}\) The principal financer additionally is preferred to the supplier in various other ways by U.C.C. Article 9 and ultimately also prevails with respect to the supplier's statutory right to reclamation upon the debtor's default with payment of the purchase price.\(^{239}\) The overall subordination of the supplier to the principal financer in practice, as acknowledged in U.C.C. Article 9 and enforced by the courts, rests on general economic considerations of

\(^{236}\)See *supra* VIII.. An exception may apply to suppliers having obtained a judgment lien and taken appropriate steps in the execution procedure.

\(^{239}\)See *supra* VIII..
efficiency.\textsuperscript{240} According to this policy particularly inventory financing is regarded as a less valuable method of business financing.\textsuperscript{241} The subordination of the supplier's security interest or remedy for default minimizes the devaluation of the financer's earlier loan caused by the later debt for the purchase price.\textsuperscript{242} It also reduces the impact of any "risk alteration" on the first credit. The problem of "risk alteration" arises from the efficiency of an engagement in risky but - if successful - highly profitable business activity, when the break-even has increased due to the accelerated credit or external capital, respectively, in the course of the purchase of supply.\textsuperscript{243} The assurance of an overall priority thus reduces the risk premium contained in interest rates for the business' principal loan.\textsuperscript{244} It also encourages first-in-time lending to businesses,\textsuperscript{245} which ultimately increases economic activity including sales and revenue of suppliers in general. Furthermore, the

\textsuperscript{240}Trust Company Bank v. The Gloucester Corporation, 643 N.E.2d at 19.

\textsuperscript{241}Which is manifested by the restriction of the priority of purchase money security interests in inventory to cash proceeds received on or before delivery of the goods, U.C.C. § 9-312 (3) (1990). Riesenfeld, supra note 10, at 20; Kanda/Levmore, 80 Va.L.Rev. at 2139.

\textsuperscript{242}See: Schwartz, 80 Va.L.Rev. at 2076-78.

\textsuperscript{243}See: Kanda/Levmore, 80 Va.L.Rev. at 2113, 2115, 2139-41.

\textsuperscript{244}See: Schwartz, 80 Va.L.Rev. at 2084-85.

\textsuperscript{245}See: Kanda/Levmore, 80 Va.L.Rev. at 2113, stating that priority of later creditors ultimately would prevent initial lending.
subordination of the supplier can be claimed to increase the supplier's need to monitor the debtor and avoid inefficient "overlending" to debtors facing insolvency for the benefit of an efficient distribution of financial resources.\textsuperscript{246}

Giving effect to these private and social economic considerations, U.C.C. Article 9's policy to prefer the principal financer ignores the inherent unfairness of the supplier's subordination. Due to the priority of the floating lien the supplier basically is compelled to either do business with the debtor on an unsecured basis or refrain from trading. The supplier of a business virtually has no device to secure payment of the purchase price. While the principal financer always is assured of substantial satisfaction, the supplier typically is limited to per-quota payment in the debtor's bankruptcy.\textsuperscript{247}

This result cannot be justified on the ground that the supplier may find out the prior financers from the records and contact them to negotiate a subordination agreement, a guarantee for payment of the purchase price or at least to seek an evaluation about the debtor's financial situation and creditworthiness with respect to the prospective sale transaction. By these means the supplier can improve the

\textsuperscript{246}Kanda/Levmore, 80 Va.L.Rev. at 2142.

\textsuperscript{247}Further aspects of unfairness are considered infra Final comparison and conclusions.
assurance of payment at least by recovery from the financer. But for many supply transactions any of these means are inefficient taking into account the amount of the purchase price and the probability of a shortfall. Furthermore, these assurances are only available to suppliers with substantial bargaining power requiring both to be a supplier of goods necessary for the operation of the debtor's business and to have limited competition in the market. Less important suppliers, presumably the vast majority, cannot obtain such assurances from the principal financer. Since these suppliers can hardly be expected to refrain from trade at all, they have no alternative than to bear the burden of a shortfall without effective security. Thus, it can be concluded that the supplier especially of inventory is deteriorated substantially in his interest to do business on a secured basis due to his overall subordination to the principal financer's floating lien for reasons of economic growth and efficiency in general and for the benefit of the principal financer in particular.248

248Especially with respect to the practically important subordination of the inventory supplier regarding the accounts proceeds of a resale, the inherent unfairness of the current regime cannot be overcome by proposals to limit the binding effect of security agreements only to third party creditors, who reasonably could foresee the prior security interest (LoPucki, 80 Va.L.Rev. at 1959, 1964-65; see supra I.) It can be inferred that principal creditors will continue to extend their liens routinely to accounts proceeds and if necessary will disclose this interest i.e. in a financing statement, so that the prudent supplier will be able to expect the prior security interest and thus will be bound to the lien agreement without any change of the current situation.
3. Limited compliance with the disclosure interest of voluntary general creditors and aspects of efficiency

The system of public-notice filing apparently is of no value for "involuntary" creditors such as tort claimants\(^{249}\) since their claims do not emerge from a credit decision, which could rest on the information provided by such system. Moreover, the filing system detrains the involuntary creditors since it is essential for secured creditors to obtain priority over the general creditors in the debtor's bankruptcy. It thereby establishes the legal tool for secured creditors to deprive the estate from assets at the expense of involuntary creditors.\(^{250}\) Under the foresaid definition the supplier of a business also must be considered an "involuntary" creditor. In practice the supplier is compelled to sell goods on an unsecured basis due to the preference of the floating lien notoriously held by the business' principal financer. The

\(^{249}\)LoPucki, 80 Va.L.Rev. at 1897.

\(^{250}\)Regarding these involuntary claimants it is rightly suggested to give them priority over secured creditors under a revised U.C.C. Article 9 since the current regime—in combination with the corporate limitation of liability enables a comprehensive limitation from involuntary, namely tort liability, whereas a subordination of the principal financer's security interest would encourage the financer to induce the debtor to refrain from tortious activity (LoPucki, 80 Va.L.Rev. at 1913-14, 1963) and avoid "excessive precautions" by "potential victims" (Schwartz, 80 Va.L.Rev. at 2085-86). Critical also: James J. White, Efficiency Justifications for Personal Property Security, 37 Vand.L.Rev. 473, 502-08 (1984); David W. Leebron, Limited Liability, Tort Victims and Creditors, 91 Colum.L.Rev. 1565, 1650 (1991).
supplier can neither "stake his claim" through the filing system nor can meaningfully use the information provided in the records for the credit decision.

Consecutively, it must be asked, whether the public-notice filing system under U.C.C. Article 9 communicates sufficient information for the voluntary creditor to make a sophisticated decision about the award of credit on an unsecured basis. Baird holds that general creditors granting credit without obtaining a security interest hardly check the public files and base their credit decisions on search reports; that they give credit on the general appraisal of the debtor's assets and the assumption that the debtor will pay his debt; therefore the filing system would be of no interest for general creditors.\textsuperscript{251} This assessment appears correct as far as consumer and marginal credit transactions are concerned, when the costs of searching the files exceed any economic relation to the risk of potential losses arising from the debtor's insolvency.

But in the arena of business financing even general creditors usually rely at least indirectly on the filing records, when they grant credit of some substance. Before the credit decision they typically obtain information to determine the financial situation of the debtor from credit reports or

\textsuperscript{251}Baird, 12 J.L.Studies at 55, 60.
financial journals, both of which rest on searches of filing records.\textsuperscript{252} Therefore, at least for the scope of business financing it can be stated, that with some modifications voluntary general creditors basically share a disclosure interest with probable secured creditors.

The scope of the disclosure interest is determined by the general creditor's expectation of return payment in the ordinary course of the debtor's business.\textsuperscript{253} Whereas in the debtor's bankruptcy the general creditor only receives per-quota satisfaction from the estate. A well considered credit decision therefore can only minimize the risk of a "bad" credit,\textsuperscript{254} if it is based on information concerning the probability of the debtor's bankruptcy. Such information encompasses details of major secured transactions, primarily the principal financer's lien, which typically are of crucial relevance for the occurrence of bankruptcy and thus for the assessment of the risk of a shortfall with the unsecured credit. These details concern among others the amount of credit and available creditlines to the debtor, the duration

\footnotesize
\textsuperscript{252}LoPucki, 80 Va.L.Rev. at 1936; See: Theodore N. Beckman & Ronald S. Foster, Credits and Collections: Management and Theory 330-31 (8th ed. 1969), reflecting on the practice of Dun & Bradstreet, Inc..

\textsuperscript{253}LoPucki, 80 Va.L.Rev. at 1931, 1938 ("Cash-flow surfer").

\textsuperscript{254}Since the avoidance of "bad" credit minimizes inefficient distribution of financial resources, full disclosure of secured transactions also is suggested under general economic aspects (LoPucki, 80 Va.L.Rev. at 1957-58).
of the credit, the interest rate, the flow of return payments, default regulations and the financer's policy on calling the loan. Since this information is not provided by the U.C.C. recording system and therefore is hardly available for the preparation of credit reports, the general creditor's interest in comprehensive disclosure of details about the security transaction is not accomplished completely by the filing system.

But partially, as far as the mere fact of the security transaction and the debtor's need for external capital are shown by the files, the system complies with the disclosure interest; and regarding the terms and repayments of the credit the impaired disclosure interest is outweighed by the debtor's secrecy interest. Additionally, it has to be considered that any impairment of the filing process and thus of the possibility to assure priority, especially of the principal financer's floating lien, bears the risk to diminish the availability of credit extensions. These advances uphold the debtor's cash-flow, may at least delay - if not avoid - bankruptcy and ultimately increase the probability of return

\[255\] See: LoPucki, 80 Va.L.Rev. at 1951.

\[256\] LoPucki, 80 Va.L.Rev. at 1951.

\[257\] Which to this extent is protected by U.C.C. Article 9. See supra A., B.1.b..
payments on the unsecured credit in the ordinary course of business for the benefit of the general creditor.\textsuperscript{258}

4. The assurance for the buyer to acquire the purchased property unencumbered

U.C.C. Article 9 protects the buyer of personal property against the acquisition of ownership encumbered with a security interest comprehensively. In the first instance U.C.C. § 9-307 (1990) prevents a buyer in ordinary course against the continuation of security interests after the purchase. By operation of law such a buyer acquires ownership free of any security interest; he does not need to check the filing system in the following situations: If the purchase occurs in the ordinary course of the seller's business, the buyer acquires ownership free of any security interest regardless of his knowledge about it.\textsuperscript{259} The purchaser of consumer goods subject to a perfected, but not yet filed security interest obtains ownership free of encumbrances, if he has no knowledge of the security interest and purchases

\textsuperscript{258}Whereas Schwartz, 80 Va.L.Rev. at 2077-78, stresses and finally rests on the detrimental effect of secured credit depriving assets of the bankruptcy estate.

\textsuperscript{259}U.C.C. § 9-307 (1) (1990). Only knowledge i.e. of any violations of the security agreement is harmful, since an acquisition in the ordinary course of business requires good faith on the part of the buyer and ignorance regarding "a violation of ... a security interest of a third party, U.C.C. § 1-201 (9) (1990); U.C.C. Official Comment § 9-307, supra note 25, cmt. 2, at 794.
"for value" and for private purposes, U.C.C. § 9-307 (2) (1990). However, any buyer "takes [the collateral] free of a security interest", as far as it secures future advances incurring after a certain period of time after the purchase. The buyer's preference over the secured creditor's interest in the continuation of his security has been reasoned on the ground that the sale in the ordinary course of the debtor's business is foreseeable for the earlier creditor and does not affect the secured debt since the proceeds typically enhance the debtor's assets or at least provide an equivalent substitute for the collateral.

If the buyer is not protected under U.C.C. § 9-307 (1990), he can detect any security interest publicly filed by searching the filing records. In this regard the buyer is in the same position as the prospective secured creditor; both aim to make sure that the subject to acquisition is not already encumbered with a security interest. Therefore the considerations set forth above apply correspondently.

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\[^{260}\text{Which is to be determined by either the senior secured creditor's knowledge of the sale or 45 days after the purchase, whatever is earlier, U.C.C. § 9-307 (3) (1990).}\]

\[^{261}\text{Kanda/Levmore, 80 Va.L.Rev. at 2129-30, stressing the lack of "risk alteration".}\]

\[^{262}\text{McDonnell, supra note 9, at 6C.07[3][b] 133-40, examines the disclosure interests of "Prospective Buyers and Financers" together in one chapter.}\]
XI. Conclusions for the public-notice-filing system under U.C.C. Article 9

In compliance with its purposes the public-notice-filing system under U.C.C. Article 9 protects subsequent transferees searching the records against the risk of fraudulent conveyances, which arises from ostensible ownership due to the lack of a transfer of possession, by alerting the searcher of the existence of a prior security interest. It also creates certainty for the secured creditor, who has filed a financing statement first, to acquire a right for prior satisfaction of its secured debt from the collateral in a potential conflict of security interests.

Following these rationales the filing system denies the legitimacy of the debtor's interest to conceal the security transaction and his need for external capital entirely. But it recognizes the secrecy interest regarding details of the transaction. Correspondent to its merely 'alerting' function it does not provide disclosure of details and thus avoids disproportionality of the secrecy interest's infringement. In this respect the alerted searcher is expected to inquire further and is impaired in the interest to obtain complete information about the secured transaction directly from the records. Therefore, it can be concluded that the filing system under U.C.C. Article 9 vastly accomplishes its purposes and in
their light balances the interests involved in security transactions.

But it has to be noted that the risk of failures in the indexing process and in search reports caused by the filing officer is allocated solely to the searcher. Moreover, typically for an administrative system, it bears risks of severe losses for the filing secured party arising from noncompliance with formalities and it incurs significant costs. These costs are charged for filing and for search reports but primarily arise from litigation about the adequacy of filing especially caused by the trustee in bankruptcy setting aside unperfected security interests. Finally, for private and social economic reasons U.C.C. Article 9 and the filing system give effect to a policy generally preferring the floating lien of the principal financer of a business to the supplier's security for the purchase price.
Part 2: The German system of securities in personal property

In contrast the German financing practice supported by the judiciary has developed a system of securities in personal property giving up the initial concept of publicity characteristic for the property law in the BGB.\(^{263}\) Similarly to the development in England and the United States the framers of the BGB feared the consequences of secrecy in security transfers.\(^{264}\) Therefore they incorporated the pledge indispensably requiring public notice of the transaction as the sole statutory security device in personal property, BGB §§ 1205-96.

But in the practice of modern business financing the pledge is hardly of any relevance\(^{265}\) due to the primarily post-war development of non-statutory security devices.\(^{266}\) So far the common non-statutory means for securities in personal property

\(^{263}\)Regarding the concept of publicity see Fritz Baur, Lehrbuch des Sachenrechts 29-31 (13th ed 1985).

\(^{264}\)Serick, supra note 2, at 26; see also supra Introduction.

\(^{265}\)Peter Buelow, Recht der Kreditsicherheiten an Sachen, Rechten und Personen, cmts. 334, 335, at 97-98 (3rd ed. 1993).

\(^{266}\)See supra Introduction.
are the transfer of ownership or the assignment of claims\(^{267}\) for security purposes, primarily operating as the banker's instruments, and the supplier's reservation of title.\(^{268}\) In a more recent development the charge factoring has obtained a firm position in the arena of security instruments for business financing. For the purpose of appraising the value of public-notice-filing under U.C.C. Article 9 in comparison with the German legal system it is therefore necessary - but also sufficient - to analyze, how these security instruments operate and comply with the involved interests in practice.

I. The pledge as the statutory security device

Although the pledge has only a minor practical impact in the area of business financing, it is necessary to see how it works to understand both the economy's need for the non-statutory security devices and their operation in the German reality of financing. Especially with reference to the pledge and its deficiencies to serve as the common security device in business financing, the parties' interests determining the purpose of the non-statutory security instruments, become

\(^{267}\)Although the "Forderungsabtretung" has been translated as "assignment of debts", i.e. Serick, supra note 2, at 52, in the analysis the assignment of "Forderungen" literally refers to "claims" or "accounts receivables", if the claims are for money payment.

\(^{268}\)Serick, supra note 2, at 123.
apparent and therefore will be set forth in context with a survey on the pledge.

Moreover, the pledge still plays some role in the area of private consumer financing, when the debtor can give up possession of the collateral for a limited period of time, in practice primarily regarding jewelry, paintings and other luxury goods. \(^{269}\) Particularly banks usually employ the pledge to secure debts against their private clients. Pursuant to their standard terms governing the relationship between the bank and the client any chattel kept in the safe deposit box at the bank is pledged to secure any debt against the client arisen and arising from the relationship. \(^{270}\)

A. The pledge - an overview

The purpose of the pledge is to give the creditor a right to satisfy due debts by realization of the collateral, which can be either a chattel, BGB § 1204 (1), or a right or claim against a third person, BGB §§ 1274-96. Accordingly, the

\(^{269}\) Buelow, supra note 265, cmt. 334 at 97-98. In 1994 financing firms other than banks took 1.4 million pledge interests amounting to a turnover of German marks 550 million (Florian Kolf, Leihaeuser Fuer den Winter Abschied vom Hinterhofimage: Das Geschaeft mit dem Pfand wandelt sich, 49 no.13 Wirtschaftswoche 72 (1995).

\(^{270}\) Standard terms [Allgemeine Geschaeftsbedingungen]-banks no. 19 (2), hereinafter: AGB-Banken; Standard terms-savings banks no. 21, hereinafter: AGB-Sparkassen; Buelow, supra note 265, cmt.335, at 98.
pledge interest in a chattel is effected, when the parties have at least informally agreed on the foresaid, the to-be-secured debt either has already emerged or can be specified, the collateral has been handed over to the creditor in execution of the agreement and the pledgor owns the collateral. The pledge interest in rights or claims, including accounts receivables, against third parties is created according to the regulations for the transfer of the particular right or claim, BGB § 1274 (1), thus regularly by assignment; additionally, BGB § 1280 provides a requirement to give notice of the pledge to the third party debtor. Once the pledge is effected the pledgee is entitled to realize the collateral upon the debtor's default and certain obligational rights and duties similar to a bailment arise between the parties.

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271 BGB §§ 1205 (1), 1204.

272 If it is a future or conditional debt, BGB § 1204 (2).

273 BGB §§ 1205, 1206.

274 Otherwise the creditor may only acquire the pledge interest in good faith pursuant to BGB § 1207.

275 BGB § 398. Note: Bearer instruments like bearer shares and bearer checks are pledged like chattels by transfer of possession, BGB § 1293.

276 BGB §§ 1215-17. Buelow, supra note 265, cmt. 367, at 105.
The pledge interest is strictly accessory to the secured debt.\textsuperscript{277} Consequentially, when the secured debt extinguishes the pledge interest does so, too, BGB § 1252. The pledgee is obliged to retransfer possession of the collateral to the pledgor, BGB § 1223 (1). The pledge interest cannot be upheld by an exchange of debts.\textsuperscript{278} Furthermore the pledge can be transferred only by assignment of the secured debt, which then by operation of law drags the pledge interest behind.\textsuperscript{279}

When the debt has become due, the pledgor is entitled to discharge the debt and redeem the pledge, BGB § 1223 (2). Simultaneously the pledgee's right to realize the pledge arises, if the debtor does not perform, § 1228 (2) sentence 1. Generally realization is carried out by public auction pursuant to a precisely regulated procedure.\textsuperscript{280} The pledgee is entitled to the proceeds of the collateral's liquidation up to the amount of his debt. To this extent the debt extinguishes,

\textsuperscript{277}Palandt/Bassenge, Bürgerliches Gesetzbuch, BGB Ueberbl v § 1204 cmt. 2, at 1290 (54th ed. 1995).

\textsuperscript{278}Judgment of Oberlandesgericht Karlsruhe, OLG 15, 393, cited at: Palandt/Bassenge, supra note 277, BGB § 1204 cmt. 7, at 1293. Exceptions apply for certain surrogates, BGB § 1210; a listing is provided in: Palandt/Bassenge, supra note 277, BGB § 1210 cmt. 1, at 1295.

\textsuperscript{279}BGB §§ 1250, 401, 398.

\textsuperscript{280}BGB §§ 1233-40, 1245. The parties may agree upon other means of realization, BGB § 1245, such as the private sale (Palandt/Bassenge, supra note 277, BGB § 1245 cmt. 1, at 1304).
regarding excessive proceeds the pledgor as the former owner of the collateral becomes entitled by subrogation, BGB § 1247.

B. The requirement of publicity

The pledge indispensably is public in nature and hostile towards secrecy. The BGB provides various means to make the pledge public. Different from the publicity requirements—particularly the public-notice-filing and transfer of possession—under U.C.C. Article 9, the publicity of the pledge under the BGB does not perfect a valid security interest, but is a prerequisite for the pledge's validity itself.

1. Publicity by transfer of possession

The general rule for the creation of pledge interests in chattels requires a transfer of possession of the collateral consisting of both the pledgee's acquisition of actual possession and the complete relinquishment of the pledgor's possession, BGB § 1205 (1). The transfer serves to clarify the factual situation of control over the collateral to anybody having an interest, especially prospective junior creditors

281U.C.C. §§ 9-302 (1) (a) and 9-305.

282Judgment of June 24, 1911, Reichsgericht, VI. Zivilsenat, 77 Entscheidungen des Reichsgerichts in Zivilsachen 202, 208 (1912); Palandt/Bassenge, supra note 277, BGB § 1205 cmt. 4, at 1293.
and transferees of the collateral interested in the transferor's right to dispose. Therefore the grant of joint possession is only sufficient, if the pledgor factually becomes excluded from any control over the collateral without cooperation of the pledgee.\textsuperscript{283}

2. The transfer of constructive possession and notice to the actual possessor

The pledge interest may be effected by transfer of constructive possession, which requires the assignment of the claim for restoration\textsuperscript{284} and similarly to U.C.C. § 9-305 sentence 2 the pledgor's notice to the actual possessor, BGB § 1205 (2). But differently from the correspondent notice under the U.C.C. it has been held under the BGB that purpose of the notice requirement is not only the "manifestation of ... the relinquishment of control"\textsuperscript{285} over the collateral, but to assure the actual possessor, that the pledgor will respect

\textsuperscript{283}BGB § 1206, so-called 'qualified joint possession'. Judgment of Jan. 24, 1983, Bundesgerichtshof, VIII. Zivilsenat, 86 Entscheidungen des Bundesgerichtshofes in Zivilsachen, 300, 308 (1983). I.e. for the perfection of a pledge interest in the content of a safe deposit box locked with two different keys it is sufficient that the pledgor hands over one key to the pledgee. The pledgor is hindered to reach the collateral without help of the pledgee (See: Palandt/Bassenge, supra note 277, BGB § 1206 cmt. 2, at 1294).

\textsuperscript{284}BGB § 870.

\textsuperscript{285}See supra Part 1 II..
the pledge in future. Therefore it is indispensable that the pledgor gives notice; neither the possessor's actual knowledge about the pledge nor the pledgee's notice are sufficient.

It is noteworthy that this transfer is far less apparent to the public and third persons than the transfer of actual possession. But since there remains no position of possession at all with the pledgor indicating ostensible ownership, the public has no legitimate interest to abandon this form of creating a pledge interest. Whereas the grant of constructive possession to the pledgee, if designed to leave actual or intermediate possession with the pledgor, does not disclose the lack of the pledgor's entitlement in the collateral and therefore is not available.

3. The notice of the pledge in a claim to the third-party debtor

Correspondent to the pledge interest in a chattel by transfer of constructive possession the pledge in a claim generally requires limited public notice. The pledgor has to give notice

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\(^{287}\) 89 RGZ at 289-90; Palandt/Bassenge, supra note 277, BGB § 1205 cmt. 10, at 1294.

\(^{288}\) Buelow, supra note 265, cmt. 349, at 101. Which is in contrast to the transfer of ownership pursuant to BGB § 930.
of the pledge to the third party debtor, BGB § 1280. But separate notice is a superfluous formality, when the pledgee is the debtor of the pledged claim at the same time\(^{289}\) or if any alternative means of publicity are specifically provided for the assignment of the claim and the creation of the pledge.\(^{290}\)

C. The pledge in the debtor's insolvency

In the insolvency of the pledgor the pledge entitles the pledgee to seek so-called 'separate satisfaction' from the collateral, which means that he may seek satisfaction from the proceeds of the collateral's liquidation prior to general creditors\(^{291}\). Among several valid pledge interests in the same collateral the order of satisfaction is determined by priority in the time of perfection; the previously created interest

\(^{289}\)Judgment of Bundesgerichtshof, LM BGB § 610 Nr. 1, cited at: Palandt/Bassenge, supra note 277, § 1280 cmt. 1, at 1312.

\(^{290}\)Palandt/Bassenge, supra note 277, BGB § 1280 cmt. 1, at 1312. An alternate means of publicity is i.e. the delivery of the savingsbook necessary for the transfer of the claim for the account's balance, BGB § 952.

\(^{291}\)"Abgesonderte Befriedigung". Bankruptcy Act (hereinafter: KO), §§ 48, 127; Act on Composition Proceedings (hereinafter: VerglO) § 27 (1); Buelow, supra note 265, cmts. 467, 474, 476, at 126-28. The pledgee has the same right in the judicial execution against or the insolvency of a third-person possessing the collateral, Code of Civil Procedure (hereinafter: ZPO) § 805.
obtains priority over subsequent pledges and therefore authorizes to prior satisfaction.\(^{292}\)

D. The pledge's incapability to comply with the needs in trade

In fact the pledge has not been accepted as a regular security instrument by the German financing economy. Due to its formalities, its publicity and its requirement of transfer of possession it has turned out to be incapable to meet the needs of economy.

1. The interest to keep the debtor in possession of the collateral

It is well established that the pledge's failure in practice can be traced back primarily to its incapability to comply with the parties' interest to leave or to get the debtor in possession of the collateral and allow him to use it.\(^{293}\)

Equipment and inventory are needed to run the business-debtor's enterprise, sales of collateral enable return-payments and finally, the profitability of the business is


\(^{293}\)Serick, supra note 2, at 79; Baur, supra note 263, at 547; see also supra Introduction.
relevant for the future of the relationship between the parties. On the other hand possession of encumbered chattels and consequentially their storage and maintenance annoy the creditor, who generally has no appropriate facilities at his disposal. Overall the parties are interested in the availability of a non-possessory security device. Since the pledge at least requires the complete loss of possession on the debtor's part, it cannot comply with this interest at all.

2. The interest in secrecy about the security transaction and the debtor's need for external capital

Due to the lack of empirical studies it is not entirely clear, whether and - if so - to what extent the rejection of pledging chattels is affected by an interest of the debtor in hiding the security transfer and the need for external capital. The spectrum of opinions concerning the impact of the debtor's secrecy interest reaches from a denial of such interest to the assessment that this interest is of major relevance for

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294 While consumer credits are designed to enable the consumer-debtors to use the goods, before they can raise the purchase money; Baur, supra note 263, at 547.

295 Baur, supra note 263, at 547.

296 See supra B. 1..

297 Serick, supra note 2, at 79; Adams, Oekonomische Analyse der Sicherungsrechte - Ein Beitrag zur Reform der Mobilliersicherheiten 170 et seq., cited at: Serick, supra note 2, at 80 note 5.
the refusal to employ the pledge.\textsuperscript{298} The existence of the foresaid secrecy interest is challenged on the ground, that German businesses always have been severely undercapitalized and thus there is no reason to trust legitimately in a business being free of loans and encumbrances and owning all chattels in possession; therefore the debtor had no serious interest in the secrecy of the security transfer.\textsuperscript{299}

These observations, true or not, are based on the existence of secret security instruments enabling the debtor to possess the collateral and thereby not disclosing his undercapitalization. If the pledge were the only available security instrument in personal property, the trade had no reason to assume the goods in possession of the business were encumbered to secure external capital. Thus the foresaid considerations cannot explain the development of the non-statutory security devices. Furthermore, even in case the debtor lacks an interest to conceal a shortage of capital and any encumbrances of assets, the business-debtor apparently has a strong interest to keep the precise ratio of capitalization as well as details about credits and securities confidential with respect to competitors, customers, suppliers and other creditors. Although the pledge does not disclose details of the security transaction except for the creditor's identification, the

\textsuperscript{298}Baur, supra note 263, at 547-48.

\textsuperscript{299}Serick, supra note 2, at 79.
transfer of possession indicates the debtor's need for financial aid and supports conclusions concerning the capitalization quota of the business. Therefore the pledge in chattels is not an effective security instrument to assure the debtor's secrecy interest.

Overall it can be concluded, that in practice the debtor's secrecy interest affects the rejection of the pledge in chattels and must be considered as a major factor for the development of alternative secret security devices. The impact increases, when exceptionally the secrecy interest is shared by the financer, who might prefer to conceal either the business-relationship with the debtor at all or at least the particular security transfer.

Whereas it is unanimously held, even confirmed by the Bundesgerichtshof,\(^{300}\) that the debtor has a serious interest in the confidence of a security interest in a claim against a third-party debtor since simultaneously the debtor is creditor of the encumbered claim. Employing the pledge as security device the debtor would be required to disclose its own urge for credit to its debtor by notice of the pledge according to BGB § 1280.\(^{301}\) The notice would adversely affect the debtor's


\(^{301}\) Serick, supra note 2, at 80-81; Baur, supra note 263, at 547.
reputation and would impose a severe hazard to the future of the commercial relationship with its debtor; any consecutive credit transactions would become uncertain. Thus, the pledge neither is able to meet the debtor's need for secrecy, when an account receivable is designated to serve as security.

3. The interest in using future accounts receivables for security purposes

Serick, whose name indivisibly is connected with the development of the German law on securities in personal property, persuasively addresses the practical impossibility to pledge future accounts receivables as a "main objection" against the pledge in the financing economy. Since the validity of the pledge in an account receivable requires notice to the third-party debtor, BGB § 1280, neither can notice be given effectively nor the pledge be created before the debt has emerged. Therefore, parties, who are interested in making future accounts receivables useful for security purposes, need security devices other than the pledge.

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302 Any meaningful impact on the current credit transaction is hardly imaginable.

303 Serick, supra note 2, at 82.

304 Serick, supra note 2, at 83.
4. The interest in freedom of formalities and in the possibility to exchange the secured debt

Formalities set forth another major disadvantage of the pledge. Besides the formalities assuring publicity and the procedural requirements for the collateral's realization the impossibility to exchange the secured debt is a concise example with noteworthy practical impact. The strict accessoriness of the pledge bars an exchange of the secured debt and the continuation of the pledge securing a different debt after the initially secured debt has been discharged.\textsuperscript{305}

To secure a different debt a new pledge interest must be created. This necessity not only is annoying, but it also bears the loss of the initial pledge's priority status and the hazard of an intermediate disposal of the collateral by the pledgor.\textsuperscript{306}

Whereas it is in the best interests of the parties - in the example primarily of the financer\textsuperscript{307} - to be able to assimilate the security interest to the particular needs of the parties in the individual situation. Hence, the parties' interest to be free of formalities regarding the creation of the security

\textsuperscript{305}BGB § 1252; see supra A..

\textsuperscript{306}Judgment of Oberlandesgericht Karlsruhe, OLG 15, 393, cited at: Palandt/Bassenge, supra note 277, BGB § 1204 cmt. 7, at 1293.

\textsuperscript{307}But this interest may correspond with the debtor's in a lasting relationship with the financer.
interest also has to be considered influential to the rejection of the pledge and the employment of less formal security instruments in practice.\textsuperscript{308}

II. The ordinary non-possessory and secret securities

The needs of the financing economy set forth above have caused the employment of the constitutum possessorium for security purposes.\textsuperscript{309} This institute is codally recognized in the statutes governing the transfer of ownership in chattels, BGB § 930. It enables the debtor to use the collateral, while the creditor holds the title under fiduciary restrictions.

Two kinds of non-possessory securities in chattels have developed: The reservation of title securing purchase money and the transfer of security ownership primarily securing loans. Parallel to the latter the assignment of claims for security has gained a tremendous role in practice. These modern securities have in common, that they do not require publicity. In improving the securities and searching for protection against the risks resulting from the lack of publicity the financing economy has developed a number of amendments to the ordinary non-possessory securities. The judiciary has been challenged to draw the lines and establish

\textsuperscript{308}\textit{In dictum:} Serick, supra note 2, at 78.

\textsuperscript{309}Serick, supra note 2, at 27; Buelow, supra note 265, cmt. 865, at 236.
subtle rules resolving conflicts between securities, which particularly result from the lack of publicity. The examination of these aspects and the hypothetical consequences of secrecy in security transfers requires a basic understanding of the securities’ creation and operation.

A. The seller’s reservation of ownership

In both a macro- and a micro-economic sense, reservation of ownership is designed to increase sales by giving an incentive for sales on a credit basis.\textsuperscript{310} It serves as a security for the seller in two ways:\textsuperscript{311} First, it secures the seller for the purchase money, when he transfers the goods to the buyer before full payment and thus waives his right to refuse performance until counter-performance is effected, BGB § 320. Second, it also secures the seller’s claim for restoration arising upon repudiation of the purchase contract.

The only statute expressly addressing the reservation of ownership, BGB § 455, provides a rule of interpretation.\textsuperscript{312} Accordingly, the seller retaining ownership is deemed to have reserved a right to repudiate the purchase contract upon the buyer’s default with payment. Due to the express

\textsuperscript{310}Palandt/Putzo, supra note 277, BGB § 455 cmt. 2, at 506.

\textsuperscript{311}Palandt/Putzo, supra note 277, BGB § 455 cmt. 2, at 506, cmt. 27, at 509.

\textsuperscript{312}Palandt/Putzo, supra note 277, BGB § 455 cmt. 1, at 506.
acknowledgment of retention of ownership in this statute the legality of this security instrument never has been contested seriously, although its prerequisites and technique have not been addressed explicitly in the statutes.

1. The features of reserved ownership

When the buyer does not pay the purchase price upon delivery of the purchased good, the seller may in consent with the buyer secure his purchase money by transferring absolute ownership under the 'suspensive condition' of full payment. Correlatively he reserves absolute ownership under the 'restoratory condition' of full payment. The buyer receives actual possession of the good, while the seller retains constructive possession.

313[Eigentumsuebertragung unter "aufschiebender Bedingung"], BGB §§ 929 sentence 1, 158 (1). Palandt/Bassenge, supra note 277, BGB § 929 cmt. 27, at 1127.

314[Rueckbehalt von Eigentum unter "aufloesender Bedingung"], BGB § 158 (2). Palandt/Bassenge, supra note 277, BGB § 929 cmt. 27, at 1127.

315If constructive possession is transferred pursuant to BGB § 931, he becomes constructive possessor on the first level possessing for the seller as the constructive possessor on the second level.

316Judgment of Bundesgerichtshof, LM BGB § 1006 Nr. 11, cited at: Palandt/Bassenge, supra note 277, BGB § 929 cmt. 27, at 1127.
Upon full payment the seller loses its ownership automatically to the buyer ex nunc.\textsuperscript{317} The buyer's acquisition of absolute ownership solely depends on his conduct without any chance of interference by the seller. Therefore the buyer has obtained an 'inchoate title'\textsuperscript{318} in the chattel.\textsuperscript{319} At least the inchoate title can be subject to subsequent transfers, i.e. in performance of resales, without assent of the seller.\textsuperscript{320} Moreover the inchoate title can be encumbered,\textsuperscript{321} which is of particular interest, when its value increases in the course of payments on the purchase price.

2. The absence of publicity

The reservation of ownership lacks any publicity. Since the buyer obtains possession of the goods, he becomes the

\textsuperscript{317}Palandt/Bassenge, supra note 277, BGB § 929 cmt. 32, at 1127.

\textsuperscript{318}[''Anwartschaftsrecht''], as translated in: Serick, supra note 2, at 43.


\textsuperscript{320}Palandt/Bassenge, supra note 277, BGB § 929 cmt. 45, at 1129. A contractual restriction of this right does not affect the validity of the transfer in relation to the subsequent purchaser, BGB § 137 sentence 1; it merely can give rise to internal remedies against the buyer for compensation, BGB § 137 sentence 2, which regularly are worthless, when the buyer does not pay the purchase price.

ostensible holder of unencumbered ownership.\textsuperscript{322} Due to the lack of any requirement of public notice the seller's reservation of ownership and the security interest in the goods may remain a secret among the parties. No subsequent purchaser of the goods or creditors of the buyer needs to become aware of the security interest and the buyer's restriction regarding the entitlement to transfer absolute ownership. But as a consequence of the buyer's ostensible ownership, they may acquire absolute ownership in good faith, BGB §§ 932-35.\textsuperscript{323}

3. The operation of the reserved ownership as a security instrument

The way the reserved ownership operates as a security device is rather complicated. Since the seller retains absolute ownership, he has a latent restitutory claim \textit{in rem} for return of the collateral against the possessing buyer.\textsuperscript{324} In defense the buyer can assert to have a right to possess the collateral, BGB § 986, based upon both the purchase agreement\textsuperscript{325} and the inchoate title.\textsuperscript{326} These defenses

\begin{thebibliography}{9}
\bibitem{Note1} BGB § 1006 (1) BGB.
\bibitem{Note2} See \textit{infra} IV.C.. Regarding the impact of this hazard on the seller's interest to be assured of his security see \textit{infra} V.C.2.b..
\bibitem{Note3} \textit{[Sachenrechtlicher Herausgabeanspruch]}, BGB § 985.
\bibitem{Note4} BGB § 433 (1) sentence 1. Palandt/Bassenge, supra note 277, BGB § 929 cmt. 40, at 1128.
\end{thebibliography}
extinguish, when the seller pursuant to BGB § 455 repudiates the purchase agreement for the reason of the buyer's default with payments or any other breach of contract. The purchase agreement changes into a 'restitutory relationship obligational in nature.' It therefore no longer constitutes a right to possess. Simultaneously, the inchoate title expires because the condition for the acquisition of absolute ownership cannot occur since payment is not owed any longer. Thus the seller can seek the return of possession of the collateral in rem pursuant to BGB § 985 under the following preferences over general creditors.

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327 54 BGHZ at 217.

328 [Schuldrechtliches Rueckgewaehrschuldverhaeltnis]. BGB §§ 346 sentence 1, 455. Judgment of May 16, 1984, Bundesgerichtshof, VIII. Zivilsenat, 37 pt. 3 Neue Juristische Wochenschrift 2937, 2937-38 (1984). The obligatory claim for repossession emerging from this relationship does not give the seller prior security over other creditors. The seller merely obtains the status of a general, unsecured creditor in the buyer's insolvency. Thus, the claim is inferior to the claim for return in rem arising from the reservation of title, BGB § 985, and therefore will be disregarded in this examination.


330 See infra 4.a.,b.
4. The ordinary reservation of ownership in judicial execution and insolvency

Regarding the operation of reserved ownership in judicial execution and insolvency it has to be distinguished:

a. The seller's right to severance and release in the judicial execution against the buyer by a third-party creditor

When a different creditor of the buyer enforces a judgment against the latter and seizes the collateral, the reserved ownership entitles the seller to seek severance and release of the collateral.\textsuperscript{331} The enforcing creditor may avoid severance and extinguish the seller's reserved ownership by payment of the open purchase price to the seller, unless the buyer opposes the payment.\textsuperscript{332} Upon acceptance of payment, the seller would have been satisfied for the purchase money. Therefore the condition of full payment for the transfer of absolute ownership is deemed to have occurred and the seller has lost reserved ownership and its right to vindication of the

\textsuperscript{331}ZPO § 771. 54 BGHZ at 218-19. Since by nature the reservation of title is nothing else but absolute ownership, it constitutes a right, which impedes a disposal of the collateral by the debtor in judicial execution pursuant to ZPO § 771.

\textsuperscript{332}BGB § 267. Buelow, supra note 265, cmt. 651, at 169.
collateral, if the seller rejects the payment although the buyer has not opposed to it. In contrast, upon the buyer's opposition the seller may reject the creditor's payment at his discretion. Therefore, in practice the enforcing creditor regularly also attaches the inchoate title to seize the buyer's right to oppose the payment. Over all it can be concluded that the reserved ownership provides complete security for the seller in the judicial execution of a different creditor against the buyer since he receives either full payment or release of the collateral.

b. The reserved ownership in the buyer's insolvency

In the buyer's bankruptcy, analogously in composition proceedings, the administrator is entitled to elect either to execute the purchase agreement completely or not to perform it at all. If he decides to execute the agreement, he has to

333BGB § 162 (1). An exception from this rule may apply, if the seller has a legitimate interest to refuse the creditor's offer to pay (Palandt/Bassenge, supra note 277, BGB § 929 cmt. 52, at 1130).


pay the open purchase money in total; \(^{337}\) consequentially the condition occurs and the collateral becomes part of the estate. Thus, in practice the administrator prefers performance, when the balance of the purchase price is relatively small. \(^{338}\)

Similarly to the abandonment of the collateral by the trustee in bankruptcy under B.C. § 554 (a), \(^{339}\) the administrator may choose to deny performance particularly, when the debt exceeds the market value of the collateral. Upon the refusal of performance, the buyer's inchoate title extinguishes and the seller is entitled to severance and retransfer of the collateral from the estate. \(^{340}\) In countermove the seller has to return any received payments to the estate \(^{341}\) deducting his expectation interest. \(^{342}\) Additional damages of the seller, i.e. consequential damages arising from non-performance, are treated like ordinary debts in bankruptcy. To this extent the

Zivilsachen 203, 205-06 (1968).

\(^{337}\)KO § 17, [Masseschuld], Palandt/Heinrichs, supra note 277, BGB § 929 cmt. 57, at 1130.

\(^{338}\)Buelow, supra note 265, cmt. 654, at 170.

\(^{339}\)See supra Part 1 VII..

\(^{340}\)KO § 43, [Aussonderung]. Serick, supra note 2, at 42.

\(^{341}\)BGB §§ 323 (2), 812 (1).

seller faces only per quota satisfaction.\textsuperscript{343} Therefore, the seller is not completely secured against any losses arising from the transaction.

c. The buyer's rights in the seller's judicial execution and insolvency

In the judicial execution against the seller the inchoate title gives the buyer a right for severance and retransfer of the seized goods.\textsuperscript{344} Also in the seller's insolvency\textsuperscript{345} the administrator is entitled to elect between execution and non-performance of the purchase agreement. Upon the demand for execution, the buyer has to pay the due purchase price pursuant to the agreement. Consequentially he obtains absolute ownership and becomes entitled to have the goods severed and repossessed.\textsuperscript{346}

It might be profitable for the estate to prefer non-performance. In that event the buyer is obliged to retransfer the goods, if they are still in his possession; the

\textsuperscript{343}KO § 26 sentence 2. 15 BGHZ at 336.


\textsuperscript{345}Including bankruptcy and composition proceedings.

\textsuperscript{346}KO § 43. Buelow, supra note 265, cmt. 655, at 170.
administrator may liquidate the goods by resale for market value, while he has to compensate the buyer for the lost expectation interest only per quota from the estate.\textsuperscript{347} This choice is advisable, when the resale price is higher than the prospective payment on the buyer's compensation claim.

B. The bank's security ownership

In contrast to the seller retaining his initial right in the collateral, the bank giving credit by a loan needs to seek security for repayment by means of a derivative acquisition of assets for security purposes. In the area of securities in personal property one major legal instrument is the transfer of security ownership in chattels.

1. Customary law as the legal basis of security ownership

The transfer of security ownership has not been considered in written law. Therefore the development \textit{praeter legem} of security ownership in variation of the codal pledge still is sharply criticized\textsuperscript{348} as a circumvention of the regulations on

\textsuperscript{347}KO § 26 sentence 2. Buelow, \textit{supra} note 265, cmt. 655 at 170.

\textsuperscript{348}Baur, \textit{supra} note 263, at 546-48, 550; Schubert, \textit{Die Entstehung der Vorschriften des BGB ueber Besitz und Eigentumsuebertragung} 163 (1966), showing that the draftsmen of the BGB intentionally refused to implant the security ownership into the code, cited at: Baur, \textit{supra} note 263, at 547 note 1.
the pledge, especially the public notice requirement, and a violation of the 'numerus clausus of the rights in rem.' Nevertheless, the security ownership is unanimously recognized to be legitimate on the basis of customary law.

2. The components of the security transaction

The security ownership is characterized by the principle of abstraction. In contrast to the pledge the security ownership itself is abstract from the secured debt, and the security ownership's two elements, the security agreement and the transfer of ownership are abstract from each other. Therefore, generally the invalidation of one transaction does not necessarily cause the ineffectiveness of the other.

a. The security agreement - the transfer's causa

The security agreement between the creditor and the 'security giver,' usually and for the purpose of this article the

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349["Numerus clausus der Sachenrechte"].

350 The prerequisites of customary law are fulfilled, since precise standards have been established in society and are applied in the judicial practice; Serick, supra note 2, at 25, 108; Baur, supra note 263, at 548.

351 Which is accessory to the secured debt; see supra I.A..

352 Palandt/Heinrichs, supra note 277, BGB § 930 cmts. 12, 15 at 1133.

353["Sicherheitengeber"].
debtor\textsuperscript{354} is not statutorily regulated as a certain category of contract; it is an agreement \textit{sui generis} pursuant to BGB § 305, the statutory manifestation of the doctrine of freedom of contract.\textsuperscript{355} Although in practice the security agreement regularly is in writing, it does not require any specific form.\textsuperscript{356} Frequently the parties combine the security agreement with the contractual basis of the secured debt, i.e. the contract for a loan,\textsuperscript{357} but legally both agreements must be considered to be separate.\textsuperscript{358}

The security agreement serves as the causa for the transfer of security ownership\textsuperscript{359} and obligationally connects the secured debt with the transfer of ownership. At least implicitly it obliges the debtor to transfer security ownership since the parties have entered into the agreement on the basis of such

\textsuperscript{354}The examination of the situation, where a third party provides the collateral and transfers security ownership would require a reflection of the internal relationship between the security giver and the debtor, which is either agency, BGB §§ 662-76, gift, BGB §§ 516, 518 (2), or in lack of an agreement \textit{negotiorum gestio}, BGB §§ 677-85. Such an analysis would not relate to the operation of security ownership itself and therefore is omitted in this thesis.

\textsuperscript{355}Serick, supra note 2, at 28.

\textsuperscript{356}Palandt/Bassenge, supra note 277, BGB § 930 cmt. 14, at 1133.

\textsuperscript{357}This combination is a common practice in the area of bank loans, Baur, supra note 263, at 567.

\textsuperscript{358}Baur, supra note 263, at 561. Regarding the abstract relationship see supra 2..

\textsuperscript{359}Palandt/Bassenge, supra note 277, BGB § 930 cmt. 14, at 1133.
transfer. But the security agreement's primary relevance arises from the significant fiduciary duties, which it imposes upon the creditor to restrict his powers emerging from his acquisition of formal ownership in the collateral. Therefore the agreement is considered to be 'unilateral' in nature.

Since the security agreement governs the entire internal relationship between the parties, they may regulate a variety of issues arising under the security transfer, such as the determination of the secured debt or debts, duration and termination issues, duties to maintain and insure the collateral, certain extensions of the security interest and primarily the maturity and procedure of realization of the security interest.

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360 Palandt/Bassenge, supra note 277, BGB § 930 cmt. 14, at 1133.


362 Palandt/Bassenge, supra note 277, BGB § 930 cmt. 14, at 1133.

b. The transfer of ownership and the lack of public notice

The transfer of security ownership, the disposal in rem itself, regularly follows BGB §§ 929 sentence 1, 930. Therefore the parties must agree upon the transfer of ownership and create a constitutum possessorium pursuant to BGB § 930, which serves as a surrogate for the requirement of the public transfer of actual possession according to BGB § 929 sentence 1. Both agreements concerning the transfer of ownership and the constructive possession can be informal. The constitutum possessorium usually is created by the security agreement since it at least implies that the debtor is going to possess the collateral for the creditor as the owner. Therefore, in practice the transfer of ownership merely requires an additional agreement about the transfer of ownership itself.

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364 BGB § 929 sentence 1 reads as follows: "The transfer of ownership in a chattel requires that the owner deliver the chattel to the transferee and that both agree that ownership shall pass over."

365 Palandt/Bassenge, supra note 277, BGB § 930 cmt. 15, at 1133.


367 A frequent issue concerns the description of the collateral. At least it needs to be determinable by anybody on the sole ground of the agreement without consideration of external circumstances (Judgment of Jan. 13, 1992, Bundesgerichtshof, II. Zivilsenat, 45 pt. 2 Neue Juristische Wochenschrift 1161 (1992)). I.e. the determination of a certain inventory as a whole includes sufficiently defined collateral (Buelow, supra note 265,
According to the language of BGB § 930 the requirement of a constitutum possessorium is sufficient to replace the indefinite public transfer of actual possession. But it is still controversially discussed,\(^\text{368}\) whether in the light of the 'publicity principle in property law'\(^\text{369}\) the transfer by constitutum possessorium needs to be accompanied by some indefinite public act executing the transfer.\(^\text{370}\) Some older judgments were based on this idea indicating the need of circumstances which give public notice of the security ownership in the particular collateral.\(^\text{371}\) But the opinions neither have defined these circumstances and nor have imposed serious requirements for them. Anyway, such an act would give at least some kind of public notice about the security transfer. It therefore would be inconsistent with the purpose of developing security ownership as an alternative security device to the pledge to allow secrecy in secured transactions.\(^\text{372}\) Thus, the call for such a public act to create

\[^{\text{cmt. 866, at 237}}.\]

\[^{\text{368}}\text{See: Buelow, supra note 265, cmt. 899, at 247.}\]

\[^{\text{369}}\text{"Prinzip der Publizitaet im Sachenrecht". This principle is expressed in BGB § 1006, according to which it is rebuttably assumed that the possessor of a chattel owns it.}\]

\[^{\text{370}}\text{"Ausfuehrungshandlung"}, Buelow, supra note 265, cmt. 899, at 247.}\]


\[^{\text{372}}\text{See supra I.D.2.}\]
security ownership has to be rejected.  

Correspondently, recent judgments do not rest on a public act required to execute the transfer of security ownership. Hence, there does not exist any public notice requirement to create security ownership; the parties may keep the transaction and the creditor's security interest entirely secret.

3. The fiduciary character of the security ownership

As a consequence of the transfer of ownership the creditor formally becomes 'unlimited owner of the right' in the collateral. Therefore, considering the transfer of ownership itself, the creditor obtains "more legal power ... than he needs for purposes of security." The purpose of security would only require the acquisition of a right to realize the collateral upon maturity similar to the pledge, a 'partial right of ownership.' Thus, according to the security agreement or at least its purpose, the debtor only is obliged

\[373\text{Buelow, supra note 265, cmt. 899, at 247.}\]


\[375\text{"Inhaber des Vollrechts"}, Serick, supra note 2, at 23. BGB § 903 sentence 1 allows the owner to treat and dispose of the subject to his ownership as he likes to.}\]

\[376\text{Serick, supra note 2, at 86.}\]

\[377\text{"Teilrecht"}.\]
to transfer such a partial right of ownership being sufficient to secure his debt.\textsuperscript{378}

Therefore the security agreement restricts the creditor's excessive legal powers arising from his ownership by imposition of fiduciary duties requiring him to exercise these rights merely upon maturity.\textsuperscript{379} Since the restriction is only effective \textit{inter partes} and does not affect the creditor's powers in relation to any third person,\textsuperscript{380} the creditor is able to validly dispose of the collateral in violation of his fiduciary duties.\textsuperscript{381} But just like any other act infringing the debtor's right to restore his absolute ownership in the collateral upon discharge of the secured debt, the disposal causes an obligation to compensate the debtor for sustained damages on the ground of 'breach of contract.'\textsuperscript{382}

\begin{flushleft}
\textsuperscript{378}Serick, supra note 2, at 86.
\textsuperscript{379}Buelow, supra note 265, cmt. 862, at 235.
\textsuperscript{380}Serick, supra note 2, at 32.
\textsuperscript{381}Buelow, supra note 265, cmt. 862, at 235. Exceptions arise from the policing doctrines under unconscionability, BGB § 138 (1), and violation of good faith, BGB § 242, i.e. in case of a collusive transfer.
\textsuperscript{382}['"Positive Vertragsverletzung"'], Buelow, supra note 265, cmt. 862, at 235.
\end{flushleft}
4. The debtor's obligational right for retransfer of absolute ownership upon full payment

As a major difference to reserved ownership, the debtor, who has transferred security ownership, does not retain inchoate title in the collateral. Upon full payment he does not acquire absolute ownership automatically unless otherwise agreed upon by transfer of ownership under restitutory condition. Especially in the banking practice the transfer of security ownership typically is not made subject to the restitutory condition of full payment.\(^{383}\)

The security agreement merely imposes at least implicitly an obligational duty on the creditor to retransfer absolute ownership, when the secured debt has extinguished. Typically, the retransfer merely requires consent since the debtor still is in possession of the collateral, BGB § 929 sentence 2. The latter can avoid a delay of the retransfer\(^ {384}\) by offering payment against the creditor's assent to the retransfer.\(^ {385}\)


\(^{384}\)I.e. resulting from controversies about the precise amount due or the legitimacy of any setoffs.

\(^{385}\)Palandt/Bassenge, supra note 277, BGB § 930 cmt. 15, at 1134. The creditor's waiver of his rights under the security ownership is deemed to be an assent to the retransfer (Judgment of Bundesgerichtshof, BGH Warn Nr. 10, cited at: Palandt/Bassenge, supra note 277, BGB § 930 cmt. 15, at 1134).
5. The realization of the collateral

The realization of the collateral is governed by the security agreement.386 Absent of any regulations in the agreement, the statutes about the pledge apply correspondently as far as the fiduciary duties in the internal relationship between the parties are concerned.387 In relation to third parties acquiring the collateral in the course of its liquidation, there is no need for an analogy since the creditor formally owning the collateral is entitled to transfer ownership.388

a. Maturity of the security ownership

Usually maturity of the security ownership occurs, when the secured debt is due.389 After a warning and the expiration of an adequate time limit for payment390 the creditor is entitled

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388See supra 3.; Palandt/Bassenge, supra note 277, BGB § 930 cmt. 17, at 1134.

389BGB § 1228 (2) analogously. Palandt/Bassenge, supra note 277, BGB § 930 cmt. 18, at 1134.

390BGB § 1234 (1) analogously. Palandt/Bassenge, supra note 277, BGB § 930 cmt. 18, at 1134.
to seek delivery of the collateral pursuant to BGB § 985 and to liquidate it consecutively.\textsuperscript{391} The debtor's defensive right to possess the collateral under the security agreement has extinguished.\textsuperscript{392}

b. The procedures of realization

If the security agreement fails to determine, how the collateral shall be liquidated, the creditor has the choice between a 'private sale' by a commercial broker\textsuperscript{393} and a public auction analogously to BGB §§ 1233-40.\textsuperscript{394} The creditor is entitled to the proceeds of the collateral's liquidation in an amount equivalent to the open debt plus any costs incurred by the liquidation. The creditor has to transfer exceeding proceeds to the debtor.\textsuperscript{395} Upon the debtor's consent the


\textsuperscript{392}Regarding the operation of the owner's latent right for restitution under BGB § 985 and the legitimate possessor's defense under BGB § 986 see supra A.3..

\textsuperscript{393}['Freihaendiger Verkauf'], BGB § 383.

\textsuperscript{394}Palandt/Bassenge, supra note 277, BGB § 930 cmt. 19, at 1134, additionally mentioning the enforcement of a money judgment based on the secured debt, which is necessary to satisfy the outstanding credit completely when the collateral's proceeds will not be sufficient.

\textsuperscript{395}Palandt/Bassenge, supra note 277, BGB § 930 cmt. 20, at 1134.
creditor alternatively may realize the collateral either by using the collateral and benefiting from it\textsuperscript{396} or by retaining it for the market value;\textsuperscript{397} the debtor's assent to either one at the creditor's discretion usually is provided in a forfeiture clause in the security agreement.\textsuperscript{398}

6. The security ownership in judicial execution and insolvency

In the judicial execution against the debtor, the security ownership entitles the creditor to have the attached good severed and handed over, as long as he is not completely satisfied for the secured debt, yet.\textsuperscript{399} The debtor has a correspondent right in case of the collateral's seizure in the course of enforcement against the creditor; this right expires upon maturity authorizing the collateral's realization.\textsuperscript{400}

In the debtor's bankruptcy or composition proceeding, the fiduciary restrictions of the security ownership have an

\textsuperscript{396}Nutzungsziehung].

\textsuperscript{397}Selbsteinbehalt].

\textsuperscript{398}BGH, 33 pt. 1 NJW at 227-28.


\textsuperscript{400}Judgment of June 28, 1978, Bundesgerichtshof, VIII. Zivilsenat, 72 Entscheidungen des Bundesgerichtshofes in Zivilsachen 141, 146 (hereinafter: 72 BGHZ 141).
external effect in the conflict with the other creditors.\textsuperscript{401} They transform the formal ownership into a pledge-like security interest as follows:\textsuperscript{402} Pursuant to KO § 43, VerglO § 26 (1) the owner has a right to have his goods severed from the estate and delivered. But when ownership is transferred for the limited purpose of security, it is treated like a pledge in the insolvency proceeding. Accordingly, security ownership entitles the secured creditor to seek separate satisfaction of his claim from the collateral pursuant to KO §§ 48, 127 (1),\textsuperscript{403} VerglO § 27.\textsuperscript{404} Thus, generally he has only priority in the proceeds of the collateral's liquidation executed by the administrator. But in bankruptcy alternatively, the creditor is entitled to claim release of the collateral for the purpose of realization and separate satisfaction.\textsuperscript{405}

\textsuperscript{401}Serick, supra note 2, at 33-34: "Quasi-real effect".

\textsuperscript{402}Serick, supra note 2, at 34, calls it the "principle of conversion".


\textsuperscript{404}Judgment of Nov. 17, 1959, Bundesgerichtshof, VIII. Zivilsenat, 31 Entscheidungen des Bundesgerichtshofes in Zivilsachen 174, 176-77 (1960); Baur, supra note 263, at 563.

\textsuperscript{405}Due to the pledge-like right to realize the collateral without prior judgment, KO § 127 (2) in combination with BGB §§ 1235, 383 (3) analogously; Judgment of Nov. 23, 1977, Bundesgerichtshof, VIII. Zivilsenat, 31 pt. 1 Neue Juristische Wochenschrift 632, 633 (1978). Proceeds exceeding the open amount of his secured debt have to be transferred to the estate (Baur, supra note 263, at 563). Thus after the collateral's release the administrator has
In defense the contesting creditors may avoid the security transfer on the basis of being executed after the debtor has suspended payments and therefore deemed to be collusive to the disadvantage of the general creditors; they also may assert the security being a bulk transfer and thus causing an assumption of liabilities by operation of law; eventually they may claim unconscionability of the transfer.

In the creditor's insolvency three situations have to be distinguished: If the secured debt has been satisfied, it is well established that the debtor is entitled to have the collateral severed from the estate and released, although the debtor does not own the collateral. The debtor's obligational right for restoration upon payment, which emerges from the security agreement, obtains "quasi-real effects." If the debt has not been satisfied completely yet, before maturity the debtor formally has a right for severance, but the administrator is entitled to retain possession of the seized collateral pursuant to the purpose of the security

the right to demand its realization from the secured creditor, KO § 127 (2).

406 [Konkursanfechtung], KO §§ 29-42.
407 BGB § 419, Commercial Code [Handelsgesetzbuch] (HGB) §§ 25 (1) sentence 1, 28 (1) sentence 1.
409 72 BGHZ at 145-46.
410 Serick, supra note 2, at 33-34.
agreement; after occurrence of maturity the administrator is entitled to realize the collateral and only is obliged to transfer proceeds to the debtor, which exceed the secured debt deducting the liquidation costs.\textsuperscript{411}

7. The basic differences with reservation of ownership

The following basic differences between security ownership and the reservation of title become relevant primarily in the conflict of the business supplier's and the financer's security interests and secondarily for combinations of securities perfecting the particular creditor's security interest:\textsuperscript{412} First, it has to be noted that the reservation of title sets forth a security interest in a collateral originally owned by the seller; in contrast, the security ownership exists in a collateral provided by the debtor and therefore is derivative in nature. Consequentially and second, the seller retains absolute ownership; whereas the financer acquires ownership, which is already fiduciary restricted for security and liquidation purposes. Third, the buyer obtains inchoate title in the purchased good and becomes automatically absolute owner upon full payment; whereas the transferor of security ownership usually receives only an obligational claim for restoration. Finally, causa for the reservation of title

\textsuperscript{411}Palandt/Bassenge, supra note 277, BGB § 930 cmt. 24, at 1134; Baur, supra note 263, at 566.

\textsuperscript{412}The combinations are analyzed infra III..
is the purchase contract which also creates the secured debt; whereas the security ownership obligationally is based on the security agreement which is 'unilateral' in nature and thus bars the application of KO § 17 authorizing the administrator in bankruptcy to choose whether the contract shall be executed.\textsuperscript{413}

III. The assignment of claims for purposes of security

Parallel to the development of security ownership, the financing practice and the judiciary have made the fiduciary relationship available for the assignment of claims for security purposes. As Serick states, the security assignment\textsuperscript{414} "has become a major and indispensable security device in the German credit business."\textsuperscript{415} Although the security assignment is not specifically regulated in the statutes, its legitimacy is well established; rightly, since the draftsmen of the BGB explicitly acknowledged its legitimacy by referring to it in the statutes of limitations.\textsuperscript{416}

\begin{flushleft}
\textsuperscript{413} Judgment of July 9, 1986, Bundesgerichtshof, ZIP 1986, 1059, 1061, cited at: Serick, supra note 2, at 46 note 9. Regarding the operation and effect of that choice see supra II.A.4.a.,c..

\textsuperscript{414}[Sicherungsabtretung].

\textsuperscript{415}Serick, supra note 2, at 90.

\textsuperscript{416}[Verjahrungsvorschriften], BGB § 223 (2). In contrast, Serick, supra note 2, at 25, relies on customary law.
\end{flushleft}
1. The elements of the security transaction

Correspondent to the transfer of security ownership, the assignment of claims including accounts for security purposes requires both a security agreement and the disposal of the claim, the assignment itself. Both can be informal and combined.\(^\text{417}\) The security agreement regulates the internal relationship between the creditor and the debtor. Besides the debtor's obligation to assign a claim against a third party for security, it especially may contain rules concerning the realization of the assigned claim. At least it implicitly imposes fiduciary duties upon the creditor prohibiting any disposal or collection of the assigned claim before the debtor's default with performance on the secured debt.\(^\text{418}\) In this respect the security agreement may obtain an external effect, when the parties stipulate a pactum de non petendo for the benefit of the third-party debtor.\(^\text{419}\) It also establishes the creditor's obligation to reassign the claim upon

\(^{417}\) Palandt/Heinrichs, supra note 277, BGB § 398 cmts. 20-22, at 460.

\(^{418}\) Palandt/Heinrichs, supra note 277, BGB § 398 cmt. 22 at 460.

extinguishment of the secured debt, unless an automatic retransfer by means of a conditional assignment is agreed upon.

The creditor acquires the claim serving as security by the debtor's disposal, the assignment, BGB § 398. The assignee becomes formal creditor of this assigned debt with all rights of a creditor. Correspondent to the security ownership, the fiduciary duties arising from the security agreement limit his rights only inter partes and do not invalidate any disposal interfering with the agreement; they merely establish the debtor's compensation claims for breach of contract. Ultimately, the creditor merely is entitled to realize his security interest by collection of the assigned account receivable upon the debtor-assignor's default with performance of the secured debt unless otherwise provided in the security agreement.

\footnote{The reassignment may be implied in the payment upon the secured debt (Judgment of Nov. 21, 1985, Bundesgerichtshof, VII. Zivilsenat, 39 pt. 1 Neue Juristische Wochenschrift 977 (1986).}

\footnote{Judgment of Feb. 11, 1960, Bundesgerichtshof, VII. Zivilsenat, 32 Entscheidungen des Bundesgerichtshofes in Zivilsachen 67, 71 (1960).}

\footnote{See supra B. 3. regarding the security ownership.}

\footnote{Palandt/Heinrichs, supra note 277, BGB § 398 cmts. 21, 22, at 460.}
2. The necessity of the debtor's power to assign the claim and the strict priority rule governing conflicts of assignments

Finally, the debtor must be authorized to assign the claim to the creditor. Generally, this power emerges from the debtor's position as creditor of the to-be-assigned claim. If the debtor has assigned the claim previously, he is not its creditor any longer and therefore has lost the authority to assign it. Thus, the subsequent assignment to the creditor is void regardless of good faith on the part of the latter. This strict rule of priority resolves conflicts among contesting assignments.

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*Pursuant to BGB § 399 limited exceptions apply, when the assignment is prohibited either contractually, codally or because of the nature and purpose of the claim, i.e. the right to certain information against a bank (Judgment of Feb. 28, 1989, Bundesgerichtshof, XI. Zivilsenat, 42 pt. 2 Neue Juristische Wochenschrift 1601, 1602 (1989)).

The impossibility of good-faith acquisitions of debts in contrast to chattels and land results from the lack of publicity manifested by possession. Therefore vested rights exceptionally can be acquired in good faith by assignment, when the document is delivered to the assignee, BGB § 405 (Karl Larenz, Lehrbuch des Schuldrechts Erster Band Allgemeiner Teil 576-77 (14th ed 1987)).

3. The advisability of notice to the third-party debtor

Although one major reason for the preference of the security assignment to the pledge in claims is the absence of the requirement to inform the third-party debtor about the security interest,\(^{27}\) the creditor is advised to insist on giving such notice in certain exceptionally risky transactions. Due to the nature of these transactions, the creditor is usually in the stronger bargaining position and therefore should be able to overcome the debtor's secrecy interest and withstand any demand for a waiver of the right to give notice.

BGB §§ 407-08 provide mandatory\(^{28}\) rules for the assignment to protect the debtor of the assigned claim against the consequences of an erroneous performance for the benefit of his ostensible creditor being either the initial creditor or any ostensible assignee, who is party to a subsequent and therefore void assignment by the assignor. Pursuant to BGB § 407 (1) payment to the assignor is deemed to discharge his debt, unless the debtor had actual\(^{29}\) knowledge of the

\(^{27}\)BGB § 1280. See supra I.D.1.b..

\(^{28}\)Because of this purpose the debtor of the assigned claim can waive these rights, whereas the parties of the assignment are bound to them.

\(^{29}\)Negligent ignorance is not sufficient to forfeit the protection under this rule (Palandt/Heinrichs, supra note 277, BGB § 407 cmt. 6, at 468).
assignment. This rule applies correspondently, when the debtor performs for the benefit of a subsequent, but ostensibly entitled assignee, BGB § 408 (1).\(^{430}\) Although the disadvantaged first assignee has a right to recourse against the assignor\(^{431}\) or the ostensible assignee,\(^{432}\) respectively, who received performance, he carries the burden of either of the parties' insolvency.\(^{433}\)

This risk may increase in case of a security assignment, when it is indicated that the assigning debtor suffers a significant shortfall of capital. The creditor should seek protection against ultimately not recoverable erroneous and collusive payments or false setoffs directed to the assigning debtor or the ostensible assignee.\(^{434}\) Therefore the creditor is advised to give the third-party debtor written notice of the assignment. Then the creditor is able to evidence the latter's knowledge and can avoid the consequences of §§ 407 (1), 408.\(^{435}\)

\(^{430}\)According to the strict priority rule the subsequent assignment is void and therefore the senior assignee has not become creditor (Palandt/Heinrichs, supra note 277, BGB § 408 cmt. 1, at 469).

\(^{431}\)Arising from breach of contract and BGB § 816, unjust enrichment (Palandt/Heinrichs, supra note 277, BGB § 407 cmt. 3, at 468).

\(^{432}\)Arising solely under BGB § 816, unjust enrichment.


\(^{434}\)As it was the case in: 102 BGHZ at 69, 77.

\(^{435}\)102 BGHZ at 74.
Thus, the creditor is assured against the discharging effect of misled payments to the assigning debtor or ostensible assignees and can collect the assigned debt from the third-party debtor. Hence, it can be concluded that although public notice is not required to create security interests in debts, practice may need and will employ restricted notice in appropriate situations.

4. The security assignment in judicial execution and insolvency

The creditor is entitled to oppose and claim the discontinuation of the judicial execution in the assigned account receivable by other creditors of the assigning debtor.\footnote{ZPO § 771. Wolfgang Grunsky, Sicherungsuebereignung, Sicherungsabtretung und Eigentumsvorbehalt in der Zwangsvollstreckung und im Konkurs des Schuldners, 24 Juristische Schulung 497, 501 (1984).} Whereas in the latter's insolvency, the creditor, like a pledgee, can only seek separate satisfaction from the proceeds of the claim's collection prior to general creditors in the ordinary course of the insolvency proceeding.\footnote{KO § 48. Judgment of Bundesgerichtshof, ZIP 1986, 720, 722, cited at: Kuhn/Uhlenbruck, Konkursordnung, KO § 48 cmt. 24 at 819 (11th ed. 1994). Conflicts between opposing assignments are resolved pursuant to the strict priority rule, see supra 2.} On the other hand, the assigning debtor also has a right for discontinuation of the judicial execution against the creditor.
in the assigned claim.\textsuperscript{438} But this right extinguishes upon maturity of the security interest,\textsuperscript{439} regularly the assigning debtor's default with performance on the secured debt. In the creditor's insolvency the assigning debtor is entitled to oppose the collection of the assigned account receivable until maturity.\textsuperscript{440}

5. Future claims as subject to security interests

As a major improvement in comparison with the pledge, the security assignment is not limited to present claims, but enables the parties to employ accounts receivables arising in future for security purposes. The parties merely assign the prospective claim in advance; no notice requirement similar to the notice of the pledge\textsuperscript{441} imposes an obstacle to the creation of the security interest. The legitimacy of an anticipated assignment follows the argumentum a fortiori ex BGB § 185 (2) sentence 1.\textsuperscript{442}

\begin{itemize}
  \item \textsuperscript{438}ZPO § 771. Palandt/Heinrichs, supra note 277, BGB § 398 cmt. 23, at 460458.
  \item \textsuperscript{439}BGHZ at 146.
  \item \textsuperscript{440}KO § 43. Palandt/Heinrichs, supra note 277, BGB § 398 cmt. 23, at 460.
  \item \textsuperscript{441}BGB § 1280. Regarding the practical impossibility to pledge debts arising from the notice requirement see supra I.D.3..
  \item \textsuperscript{442}Judgment of June 22, 1989, Bundesgerichtshof, III. Zivilsenat, 108 Entscheidungen des Bundesgerichtshofes in Zivilsachen 98, 104 (1990); Buelow, supra note 265, cmts. 954, 955, at 264-65. BGB § 185 (2) sentence 1 provides that
The still lasting controversy,\(^{443}\) whether the creditor-assignee acquires the claim directly upon its emergence\(^{444}\) or subsequently to an intermediate acquisition by the assigning debtor,\(^{445}\) is of marginal practical relevance. Even if the assigning debtor acquires the account receivable intermediately and therefore in his insolvency the claim becomes attached to the estate, the creditor can seek separate satisfaction from the account prior to general creditors\(^{446}\) and subsequent assignees.\(^{447}\)

6. Bulk assignments for security purposes

Banks usually are not content with the assignment of an individual claim as security for loans; they only accept certain secure accounts receivables, i.e. claims for tax refunds or purchase money arisen from a perfected transfer of land.\(^{448}\) In practice banks usually insist on ‘bulk assignments’

an unauthorized disposal becomes valid, when the disposing party acquires the subject of the disposal.


\(^{445}\)[Durchgangserwerb]. Larenz, supra note 425, at 585.

\(^{446}\)KO § 48, VerglO § 27 (1).

\(^{447}\)32 BGHZ at 370.

\(^{448}\)Serick, supra note 2, at 91.
by their clients for purposes of security. These assignments cover all of their present and future claims against the debtor emerging from a typically broadly defined relationship, i.e. all accounts receivables arising in the debtor's business. Bulk assignments are subject to judicial scrutiny and certain restrictions in conflicts with other securities because of their totality in range endangering subsequent creditors.

7. Charge factoring as a means of security

Coming from the United States factoring is a relatively new instrument rapidly increasing its share in the German market of business financing. The Bundesgerichtshof following Serick has categorized factoring into 'outright factoring'

\[449\] "Globalzession"]. Palandt/Heinrichs, supra note 277, BGB § 398 cmt. 25, at 460.

\[450\] Kuhn/Uhlenbruck, supra note 437, KO § 43 cmt. 20, at 727.

\[451\] See infra IV.D..

\[452\] Turnover in 1985: German marks 8.8 billion. In 1986: German marks 10.6 billion. Figures from: Serick, supra note 2, at 92.


\[454\] Eigentumsvorbehalt und Sicherungsuebertragung, Bd. IV § 52 III, cited at: 69 BGHZ at 257.

\[455\] "Echtes Factoring". 
and 'charge factoring.'\textsuperscript{456} Outright factoring reflects a mere sale of accounts receivables; thus the factor takes the risk of collecting the assigned accounts receivables from the third-party debtor.\textsuperscript{457} For this reason there is no limitation on the validity of bulk assignments to an outright factor, since other creditors are in a similar position, as if the assignor had collected the accounts receivables itself.\textsuperscript{458}

In distinction thereof only charge factoring is designed to serve as a security device.\textsuperscript{459} The debtor assigns its claim against a third-party debtor to the creditor, the factor, only 'on account;'\textsuperscript{460} the secured debt discharges, when the third-party debtor pays to the factor. But if the third-party debtor becomes insolvent, the factor still is entitled to enforce its claim against the debtor. Thus, ultimately the debtor is exposed to the risk of the third-party debtor's insolvency, the creditor actually obtains a second debtor and thereby is secured for satisfaction of its claim against the debtor.\textsuperscript{461}

\textsuperscript{456}['Unechtes Factoring'].
\textsuperscript{458}69 BGHZ at 258.
\textsuperscript{460}['Erfuellungshalber'], BGB § 364 (2).
\textsuperscript{461}82 BGHZ at 61-62, 65.
Since charge factoring is different from the security assignment only with respect to the order of collection, charge factoring is treated like a security assignment in practice; the rules for security assignments are applied analogously, including the limitations on the validity of bulk assignments. Therefore the comments on security assignments in this thesis relate to charge factoring as well.

III. The combinations of security devices in the financing practice - an example of the perfect security interest

In practice the simple security instruments often do not meet the particular needs of the parties, particularly the needs of the business financer. Therefore, neither suppliers nor banks are content with the plain reservation of title or security ownership, respectively. They combine security devices to extend and expand their plain security interests. This chapter introduces the common practices of 'extension' and 'expansion' in the German financing economy. It will show that various supplements to the simple security interests in the first instance are designed to assure continuation of the

462 In so far see supra 6. and infra IV.D., 82 BGHZ at 56; Rolf Serick, "Befremdliches" zur Behandlung der Barvorschusstheorie beim Factoring-Geschaeft?, 34 pt. 1 Neue Juristische Wochenschrift 794, 796-98 (1981); against an analogy in every aspect: Palandt/Heinrichs, supra note 277, BGB § 398 cmt. 37, at 462.

463 ["Verlaengerung"].

464 ["Erweiterung"].
creditor's security interest and protection against the hazards arising from the lack of publicity.

A. The extension of the security interest

1. The purpose and relevance of a security interest's extension

The extension of a security interest is defined as the continuation of the security interest in certain surrogates of the initial collateral,"65 when the creditor has lost ownership in the latter for some reason."66 It is designed and employed to enable credit transactions with commercial debtors on the basis of securities in raw materials and inventory."67 Suppliers of these goods, who are willing to sell and do business on a credit basis, face their customers' need to transfer ownership in the purchased goods. In the ordinary course of business the retailer needs to resell the inventory goods and the manufacturer needs to process the raw materials and to sell the finished products. The resale requires a transfer of ownership to the ultimate purchaser and the processing will by operation of law cause the processor's

"65I.e. any proceeds from its resale.

"66I.e. because the debtor processes or sells it. Buelow, supra note 265, cmts. 997, 1219, at 279, 358.

"67Serick, supra note 2, at 47-59; Buelow, supra note 265, cmts. 997-1034, at 278-91.
acquisition of ownership, BGB § 950. However, the supplier would lose reserved ownership in the collateral and merely obtain compensation claims for breach of contract and tort. But these claims lack any security function. An extension of ownership compensates this loss by continuing the security interest in the surrogate of the collateral, basically the finished products of processed raw materials and the proceeds of the resale, the claim for the purchase price.

The extension of ownership sufficiently secures the supplier, selling inventory goods and raw materials on a credit basis and allows the debtor to process and sell them. But the extension of the security interest is not limited to the supplier's reservation of title; banks can and do extend security ownership in the debtors' inventories and raw materials, too. In contrast to the financing of supply in raw materials and inventory of businesses, the extension of security interests is of no or only marginal relevance in the area of consumer financing, because the consumer is deemed to be the ultimate user and owner of the collateral. For the same

468 See infra 2.a..


470 Although the bank's security interest in the initial collateral is subordinated to the supplier's reserved ownership, see infra IV.B.. Serick, supra note 2, at 50-52.
reason security interests in business equipment usually are not extended. 471

2. The components of an extension of a security interest

Technically, the extension of a security interest may consist of a 'processing clause' 472 authorizing the debtor to process the collateral and assuring that the creditor's security interest continues in the finished product, a selling clause empowering the debtor to sell the collateral in the ordinary course of business combined with an advance security assignment of the claim for payment of the resale price and finally a power to collect that claim.

a. The processing clause

The following model of a processing clause provides: 473

'8. Processing Clause. (1) The Bank authori[z]es the borrower until further notice in the ordinary course of business to process or procure the processing of the

471 Serick, supra note 2, at 47-59, and Buelow, supra note 263, at 278-91, correspondently limit their analyses to the extension of security interests in inventory and raw materials.

472 ['"Verarbeitungsklausel"'].

473 No.8 of the 'Area Security Contract for Warehouses with Changing Contents and Capital Goods' of the Deutsche Bank AG, unpublished no. 11-011 1178, as translated in: Serick, supra note 2, at 48-49.
goods given as security. The processor therein acts as the gratuitous agent of the Bank as producer, so that the Bank retains or acquires the ownership, sole, joint or inchoate, in the products at all times and at each stage of the process (§ 950 BGB).

(2) If, notwithstanding the above, the Bank should at any stage of the process lose ownership, sole, joint or inchoate, and the borrower obtain such rights, such rights are to vest in the [B]ank immediately the borrower acquires them. In such a case also the borrower holds the goods in question for the Bank. Should the rights acquired by the security-giver be merely rights to call for ownership in the goods, sole, joint or inchoate, he hereby assigns such rights to the Bank.'

If the collateral consists of raw materials or primary products, the debtor needs to be authorized to process the collateral. The processing causes both the processor's acquisition of ownership in the finished product⁴⁷ and, pursuant to BGB § 950 (2), the extinguishment of the rights in the processed materials including the reserved or security

⁴⁷BGB § 950 (1), unless the value of processing is significantly lower than the value of materials, which has been assumed when the value of processing made 40 % of the product's total value; Judgment of Bundesgerichtshof, WM 1972, 188, cited at: Buelow, supra note 265, cmt. 1027, at 289. If the value of processing remains below this rate, the owners of the processed materials become co-owners per quota, BGB §§ 947-48.
ownership of the creditor and an inchoate title of the debtor. Thus, the debtor would infringe the creditor's ownership by processing the collateral and would risk liability for breach of contract\(^{475}\) and tort\(^{476}\) without the authorization provided by the processing clause as set forth above.

The power to process needs to be accompanied by the determination, that the debtor processes the goods on behalf and "as the ... agent"\(^{477}\) of the creditor. The parties thereby agree upon the creditor being the processor and thus directly becoming owner of the finished product pursuant to BGB § 950 (1).\(^{478}\) The creditor avoids a transit acquisition of the debtor, which would bear the risk of an intermediate seizure of the finished product by other creditors.\(^{479}\) The creditor's rights in the finished product, the surrogate of the raw materials and processed goods, correspond to those, which he

\(^{475}\)[Positive Vertragsverletzung].

\(^{476}\)BGB § 823 (1).

\(^{477}\)Supra No. 8 (1) of the sample clause.

\(^{478}\)20 BGHZ at 163-64. A minority of scholars are of the opinion that the processor has to be determined according to the factual situation in life; the debtor must be regarded as the processor and original owner of the finished product since the debtor carries the economical risk of processing and selling it; the processing clause only creates a derivative acquisition of security ownership by an anticipated transfer (Palandt/Bassenge, supra note 277, BGB § 950 cmt. 11, at 1144). This opinion ultimately imposes the risk of an intermediate insolvency of the debtor and attachment of the finished product upon the secured creditor.

\(^{479}\)Buelow, supra note 265, cmts. 885, 1025, at 242, 288.
had in the initial collateral. Therefore his ownership is restricted by the fiduciary duties under the security transaction.

In this respect it is noteworthy, that the supplier's reservation of ownership in the original collateral mutates to security ownership in the surrogate.\(^{480}\) Retention of ownership in the surrogate is impossible; the supplier's ownership is initially restricted by the purposes of security, when the surrogate comes into existence. But in variation of the simple security ownership and corresponding to the retention of title, this substitutive type of security ownership is subject to the restitutory condition of full payment, so that the debtor acquires an inchoate title in the finished product. This modification of general security ownership in the surrogate results from an anticipated transfer of inchoate title to the debtor.\(^{481}\) This transfer at least can be inferred from the extension of the initial reservation of ownership and the extension's purpose being only to continue the original

\(^{480}\)Serick, supra note 2, at 66, 133.

\(^{481}\)BGB §§ 929 sentence 2, 158 (1). Ruediger Nierwetberg, Die Rechtsposition von Lieferant und Produzent nach Verarbeitung im verlaengerten Eigentumsvorbehalt, 36 pt. 3 Neue Juristische Wochenschrift 2235, 2236 (1983). A continuation of the debtor's original inchoate title in the surrogate, as suggested by Werner Flume, Der verlaengerte und erweiterte Eigentumsvorbehalt, 3 Neue Juristische Wochenschrift 841, 844 (1950), must be rejected, since the inchoate title has extinguished pursuant to BGB § 950 (2) (Buelow, supra note 265, cmt. 1028, at 289).
security interest in the surrogate but not to increase or decrease the parties' rights.

b. The authorization to sell the collateral

The selling clause empowers the debtor to sell the collateral regardless of whether it is the original or the finished product, and to transfer ownership in its own name in the ordinary course of business, BGB § 185 (1). Thus, the debtor need not disclose the security transfer to its customers. Whereas without the assent of the creditor formally owning the collateral, the debtor could not transfer ownership validly and thus would face liability to its customers for breach of contract; the debtor finally would be hindered to use the collateral for the operation of its business, which would be contrary to the purpose of the extension of the security interest.462 Therefore, the selling clause is an essential of every extension of a security interest463 and at least is implied in any purchase transaction under reservation of title, when the goods apparently have been purchased for the purpose of resale.464

462See supra 1..

463Buelow, supra note 265, cmts. 1008-08, at 282-83.

464Palandt/Putzo, supra note 277, BGB § 455 cmt. 13, at 507.
The power's limitation to sell the collateral only in the ordinary course of business is designed to protect the creditor against detrimental transfers, primarily fraudulent and dumping sales. Frequently subsequent buyers of the collateral prohibit the assignment of the purchase money. A sale under this condition would be beyond the ordinary course of business since the anticipated assignment of the purchase money to the creditor would be void and ineffective under the prohibition, BGB § 399, and the creditor would be stripped off the security interest without any compensation. But within the boundaries of the ordinary course of business the debtor is free in his calculations; to this extent the creditor is barred from any interference with the debtor's business.

c. The accessory assignment of the purchase money and the power to collect

In the course of the sale of the initial or substitutive collateral the creditor loses ownership. But on the other hand

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486 See infra c..


488 Buelow, supra note 265, cmt. 1010, at 283.
the sale establishes the claim for the purchase money. This surrogate replaces the goods sold as the collateral of the security interest. Thus, the parties agree upon the assignment of the purchase money for security purposes, the so-called 'accessory assignment.' Typically they anticipate the assignment in the initial security transaction to assure, that the creditor acquires the claim directly upon its emergence without prior transit acquisition by the debtor. The parties may limit the assignment to the amount of the secured debt plus an adequate risk markup.

Usually the creditor authorizes the debtor revocably to collect the purchase money in its own name on behalf of the creditor, BGB § 185 (1). Correlatively to this power, the security agreement or the purchase contract, respectively, obliges the debtor to collect the purchase money and pay it to the creditor in the amount of the secured debt. For example,

489["Anschlusszession"]; see the sample clause infra.

490See: Judgment of May 23, 1958, Bundesgerichtshof, VIII. Zivilsenat, 27 Entscheidungen des Bundesgerichtshofes 306 (1958); supra II.C.5..


492Serick, supra note 2, at 56-57; Buelow, supra note 265, cmt. 1004, at 281.

493Buelow, supra note 265, cmt. 1005, at 281.
the accessory assignment and collection clause of the Deutsche Bank AG states:

'10. Accessory Assignment. (1) The borrower hereby assigns, as security for the purposes of this contract, all present and future claims arising out of the sale of secured goods. Such claims, if not already transferred to the Bank, are to vest on the conclusion of this contract, at latest, as soon as they arise...

(2) The borrower is until further notice authorized by the Bank to collect the debts so assigned to the Bank in the ordinary course of business...'

B. The expansion of the security interest

A security interest is expanded, when it secures additional debts on different bases than the primary credit. Alternatively, the parties could create several security interests for each additional debt arising out of their relationship. Apart from the inconvenience of this procedure, the creditor would face the risk of the security interest


"Buelow, supra note 265, cmt. 998, at 279; Serick, supra note 2, at 48, 58-59.
lapsing upon payment on the particular secured debt. The debtor would be entitled to the collateral, which therefore could be subject to attachment and seizure by other creditors. The secured creditor would finally lose the collateral for security purposes.\footnote{\textsuperscript{96}}

The expansion of the initial security interest can prevent this loss.\footnote{\textsuperscript{97}} The collateral initially secures and continues to secure other debts having emerged since the security interest has been created, even after the initial debt has extinguished.\footnote{\textsuperscript{98}} Therefore the creditor, who expects further claims against the debtor arising from a particular relationship, i.e. the supplier for his service charges and the bank for subsequent loans or overdrafts, is advised to stipulate an expansion of the security interest covering also any additional debts, which emerge for other reasons than the debt initially secured. Accordingly, the expansion clause embodied in security agreements by the Deutsche Bank AG\footnote{\textsuperscript{99}} reads as follows:

\footnote{\textsuperscript{96}}This objection is made against the statutory pledge; see \\textit{supra} I.D.4...

\footnote{\textsuperscript{97}}Buelow, \\textit{supra} note 265, cmt. 1035, at 292.

\footnote{\textsuperscript{98}}Serick, \\textit{supra} note 2, at 58-59.

\footnote{\textsuperscript{99}}No.1 of the 'Area Security Contract for Warehouses with Changing Contents and Capital Goods' of the Deutsche Bank AG, unpublished no. 11-011 1178, as translated in: Serick, \\textit{supra} note 2, at 49.
'1. (1) The transfer is made in order to secure all existing and future claims against the borrower, even if subject to condition or term, which may be vested in any branch of the Deutsche Bank.'

It has to be noted, that the foresaid clauses are only models, which in practice are employed in amended or altered versions. The Deutsche Bank AG as many other financing businesses and suppliers combine both the extension and expansion clauses to create the perfect security interest for their particular needs. The expansion and extension of security ownership or reservation of title enable the creditor to assure a continuing security interest in the debtor's present and future personal property securing current and advanced debts. Therefore, especially in the setting of business financing creditors combine and incorporate these covenants in the security agreements.\(^5^0^0\) Primarily the so perfected security ownership of the bank resembles significantly the floating lien as employed by business financers in the United States. Routinely the extended and expanded security ownership of banks covers virtually all of the debtor's personal property assets.\(^5^0^1\) Similarly to the floating lien, the extension of

\(^{5^0^0}\)See i.e. the 'Area Security Contract for Warehouses with Changing Contents and Capital Goods' of the Deutsche Bank AG.

\(^{5^0^1}\)But if the liquidation value of the collateral exceeds the secured debt disproportionally, the secured transaction may be voidable for unconscionability ["Uebersicherung"] (Judgment of June 22, 1989, Bundesgerichtshof, III.
security ownership assures continuation of the security interest in after-acquired property of the debtor, i.e. in inventory or accounts. The expansion clause accomplishes that the security ownership also secures future debts, particularly advances and overdrafts, corresponding to the cross-collateralization notoriously implemented in the lien agreement under the U.C.C..

IV. The conflict of security interests

The conflict of security interests is formatively influenced by the lack of publicity in the area of security interests. In the effort to resolve the conflicts, the courts recognize a set of rules which basically give effect to the security interest created first. But these rules also contain two exceptions, the subsequent acquisition of security interests in chattels in good faith and the subsidiarity of certain advance transfers, primarily bulk assignments. The third relevant restriction in practice, the subordination of a transfer of security ownership in advance to reservation of title, ultimately results from the underlying principles of the first-to-create rule of priority and therefore does not in theory set forth an exception from this axiom. The following examination will focus on conflicts of securities in the area of business financing, but will also provide an excursion on

Zivilsenat, 108 Entscheidungen des Bundesgerichtshofes in Zivilsachen 98, 107-09 (1990)).
conflicts of security interests in motor-vehicles, the dominant consumer product serving as collateral in the modern German practice of consumer financing.\textsuperscript{502}

A. Priority of the security interest created first - the primary axiom

In a conflict of opposing security interests in the same collateral, the primary axiom awards priority to the security interest that has been created first. This rule reflects nothing else but the consequence of the legal situation in rem with respect to the collateral; \textit{nemo dat, quod non habet:}\textsuperscript{503} "A person cannot in general transfer a better title than he himself possess."\textsuperscript{504} After the first security transaction the debtor is no longer entitled to transfer ownership in the chattel or to assign the claim for security purposes again. Either he has lost this right because of the prior transfer or

\textsuperscript{502}See \textit{infra} C.4.; Serick, \textit{supra} note 2, at 109, and Palandt/Bassenge, \textit{supra} note 277, BGB § 932 cmt. 13, at 1136, both limiting their analysis on securities in the area of consumer financing to motor-vehicles serving as collateral.


\textsuperscript{504}R. M. Goode, \textit{Legal Problems of Credit and Security} 19 (1982). The tradition of this primary axiom of priority goes back to the Roman \textit{digesta} 50, 17, 54 (\textit{Ulpian}) (Liebs, \textit{supra} note 503, no. 65, at 132). This principle also governs the concept of priority in the British system of securities in personal property (Goode, \textit{id} at 19).
assignment or he never has obtained such a right because the seller retained ownership.

Neither does the power to transfer ownership arising from the extension of the simple security interest cover a subsequent secured transaction, since the transfer for security purposes goes beyond the ordinary course of business.\(^{505}\) Due to the lack of the debtor's entitlement, the subsequent transfer or assignment therefore 'misses' the collateral\(^{506}\) and has no legal effect.\(^{507}\)

B. The subordination of the transfer of security ownership in advance

In practice banks often stipulate transfers of ownership in a business' inventory or part thereof for security purposes, so-called 'area security contracts.'\(^{508}\) Since the inventory changes, the security transaction encompasses not only present assets but also goods and raw materials becoming part of the inventory in future. With respect to their anticipatory

\(^{505}\) Judgment of March 30, 1988, Bundesgerichtshof, VIII. Zivilsenat, 104 Entscheidungen des Bundesgerichtshofes in Zivilsachen 129, 132-33 (1989); see supra III.A.2.b..

\(^{506}\) "Geht ins Leere".

\(^{507}\) 32 BGHZ at 370, regarding security assignments; Buelow, supra note 265, cmts. 892, 1129, at 244, 329-30.

\(^{508}\) "Raumsicherungsverträege"; see supra III.B..
element, such transactions doubtlessly are valid.\textsuperscript{509} But in the event of a conflict with the supplier's reservation of title in parts of the debtor's inventory, the advanced security transfer to the bank is subordinated.\textsuperscript{510} As long as the debtor has not acquired full ownership in the collateral from the supplier because the price has not been paid in full, the debtor has not acquired absolute ownership and therefore is not entitled to execute the security transfer, yet. Thus, the bank has not obtained security ownership.\textsuperscript{511} The bank merely has acquired the debtor's inchoate title in the collateral for security purposes,\textsuperscript{512} which is inferior to the full ownership of the supplier.\textsuperscript{513} Therefore, although the advanced transfer of security ownership to the bank was entered into previously, it is defeated by the contesting supplier's reservation of title. To this extent the primary axiom that the security

\textsuperscript{509} Similarly to the United States, in Germany disputes frequently arise concerning whether the collateral is sufficiently described. See i.e. Judgment of Jan. 13, 1992, Bundesgerichtshof, II. Zivilsenat, 45 pt. 2 Neue Juristische Wochenschrift 1161, 1161-62 (1992).

\textsuperscript{510} The subordination is not limited to 'area security contracts', but applies to any advanced transfer of security ownership contested by reservation of title.

\textsuperscript{511} An acquisition in good faith is excluded, since the bank does not obtain actual possession; in this respect see infra III.2.; regarding the typical lack of good faith see infra III.3..

\textsuperscript{512} Palandt/Bassenge, supra note 277, BGB § 930 cmt. 2, at 1132, § 929 cmt 45, at 1129.

\textsuperscript{513} Regarding the possibility to raise the inchoate title to full security ownership by satisfying the supplier for the purchase money and thus reacting to the subordination in the conflict of securities see infra V.D.1.
interest created first prevails in the conflict of securities, is restricted. This general preference of the supplier's reservation of title to the bank's anticipated security ownership corresponds to the priority of the supplier's title retention over the floating lien under the pre-code common law in the United States.\textsuperscript{514}

C. The priority of subsequent acquisitions of security ownership in good faith and the limitations on this exception to the general priority rule

Regarding the conflicts of security interests in chattels the primary axiom of priority is breached by the validity of subsequent acquisitions in good faith pursuant to BGB §§ 932-35, when the debtor has lost or never has obtained the right to transfer security ownership in the collateral. But the availability of this exception is restricted drastically by various limitations.

1. The validity of subsequent \textit{bona fide} acquisitions in general

The validity of subsequent acquisitions in good faith is based on the publicity of possession, which grants ostensible

\textsuperscript{514}See \textit{supra} Part 1 VIII.
ownership to the possessor.\textsuperscript{515} Therefore, because of lack of publicity by possession, claims generally cannot be acquired from the assignor in good faith after a previous assignment.\textsuperscript{516} According to BGB §§ 932-34 the defect of a subsequent transfer of security ownership caused by the lack of the debtor's right to transfer ownership will be cured, when the debtor transfers possession of the chattel to the transferee and the latter acts in good faith.\textsuperscript{517}

2. The limitation on \textit{bona fide} acquisition of security ownership without transfer of actual possession

Typically the subsequent transfer of security ownership also is designed to create a non-possessory security interest. Thus, since the debtor remains the actual possessor of the collateral, the subsequent acquisition of security ownership in good faith is governed by BGB § 933.\textsuperscript{518} Accordingly, the

\textsuperscript{515}BGB § 1006. Judgment of June 11, 1953, Bundesgerichtshof, IV. Zivilsenat, 10 Entscheidungen des Bundesgerichtshofes in Zivilsachen 81, 86 (1953); Soergel/Muehl, Buergerliches Gesetzbuch Band 5 Sachenrecht BGB § 932 cmt. 6, at 326 (11th ed. 1978).

\textsuperscript{516}See supra II.C.2. Larenz, supra note 425, at 576.

\textsuperscript{517}BGB § 935 imposes a negative precondition: The chattel must not been stolen or otherwise deprived from the real owner or the legitimate actual possessor, respectively. Since the debtor as the legitimate actual possessor deliberately gives up possession in the course of the subsequent transfer, BGB § 935 never gives rise to an issue in the conflict of security interests.

\textsuperscript{518}Buelow, supra note 265, cmt. 937, at 256.
bona fide acquisition is not valid until the debtor has handed over the collateral. In practice this regularly does not occur, before the debtor is in default with performance to the subsequent creditor and the security agreement authorizes the realization of the collateral. When the subsequent creditor then takes actual possession in accordance with the security transaction and still acts bona fide - particularly regarding the lack of any foregoing security interests in the collateral -, the subsequently created security ownership becomes valid\textsuperscript{519} and ousts the senior security interest.

These strict limitations for subsequent acquisitions of security ownership in good faith cannot be evaded by a temporary transfer of actual possession; the transfer must be designed to last permanently.\textsuperscript{520} Although this issue is subject to some litigation,\textsuperscript{521} the foresaid restriction of the transfer of actual possession usually prevents subsequent bona fide acquisitions of security ownership. Thus in practice the enforcement of the senior security interest in the collateral

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\textsuperscript{519}BGB § 933. Judgment of Bundesgerichtshof, WM 1956, 527, cited at: Buelow, supra note 265, cmt. 937, at 256 note 178.


\textsuperscript{521}Because it has to be decided by scrutinizing each case on its individual facts.
is only rarely interrupted by other creditors claiming to have acquired security ownership subsequently in good faith.\textsuperscript{522}

3. The limitation on good faith regarding goods typically subject to reserved ownership

The second major limitation on subsequent acquisitions for security purposes concerns the element of good faith. Good faith is excluded, when the transferee's lack of knowledge is due to gross negligence on his part, BGB § 932 (2). Accordingly, the transferee has a duty to inquire whether the transferor is the owner of the prospective collateral, when the reasonably prudent transferee considering his individual knowledge and experience seriously is induced to suspect a lack of the transferor's ownership.\textsuperscript{523} Especially in the area of business financing, serious doubts concerning the transferor's ownership in the collateral are suggested to the bank or any other professional financer, when the collateral typically is subject to reserved ownership like equipment, inventory and raw materials and the subsequent transfer is executed within the regular financing period. Therefore the bank or financer, who intends to accept security ownership in chattels as security for loans to a business, has to investigate, whether the prospective collateral is subject to

\textsuperscript{522}\textit{Buelow, supra note 265, cmt. 937, at 256.}

\textsuperscript{523}\textit{Judgment of Bundesgerichtshof, WM 1978, 1208, cited at: Palandt/Bassenge, supra note, BGB § 932 cmt. 10, at 1136.}
the supplier's reservation of ownership. If the bank fails to undertake appropriate\textsuperscript{524} efforts to inquire the transferor's entitlement and closes the transfer, it forfeits the protection under BGB §§ 932-34 and cannot assert to have acted in good faith.\textsuperscript{525}

Neither can the bank invoke the merchant's ostensible power to transfer ownership in the ordinary course of his business pursuant to HGB § 366.\textsuperscript{526} Any transfer of ownership for security exceeds the ordinary course of business and thus apparently is not covered by any extension of a security interest.\textsuperscript{527}

\textsuperscript{524}I.e. obtaining a confirmation of ownership from the transferor is not sufficient (Judgments of Bundesgerichtshof, LM BGB § 932 Nr. 29 and WM 1978, 1028, both cited at: Palandt/Bassenge, \textit{supra} note 277, BGB § 932 cmt. 10, at 1136).


\textsuperscript{526}Which is to distinct from good faith in the debtor's ownership itself. A power to transfer ownership i.e. could have been provided by a selling clause in connection with the execution of a security interest.

4. Excursion: The publicity of the certificate of title limiting subsequent acquisitions of motor-vehicles in good faith

In the area of consumer financing, motor-vehicles represent the type of chattel commonly preferred as collateral by financers. Apart from the fact that motor-vehicles often represent a substantial part of the debtor's total assets,\textsuperscript{528} a main reason for this preference appears to be provided by the particular certainty regarding the priority in a conflict of security interests in motor-vehicles. This clarity in practice ultimately is caused by the public function of the motor-vehicle's certificate of title.\textsuperscript{529} The certificate of title only has to show the 'keeper of the motor-vehicle,'\textsuperscript{530} who normally, but not necessarily is the owner.\textsuperscript{531} Nevertheless, an unbroken line of authorities has established the rule that the certificate of title has a 'negative bona fide effect' for the acquisition of ownership.\textsuperscript{532} According to

\textsuperscript{528}In this respect the German scene does not differ from households in the United States. Regarding the substantial value of motor-vehicles to private households in the U.S. see: Albany Discount Corporation v. Mohawk National Bank of Schenectady, 269 N.E.2d 809, 811 (N.Y. 1971).

\textsuperscript{529}["Kraftfahrzeugbrief"].

\textsuperscript{530}["Kraftfahrzeughalter"].


\textsuperscript{532}["Negative Gutglaubenswirkung"]. Judgment of March 11, 1991, Bundesgerichtshof, II. Zivilsenat, 44 pt. 2 Neue Juristische Wochenschrift 1415, 1416 (1991) (hereinafter:
the customary standards not the possession of the motor-vehicle solely, but the possession of the vehicle together with the possession of the certificate of title identifies the owner. Thus the transferee lacks good faith, when he does not receive possession of the certificate of title from the transferor.

As a practical consequence the diligent secured party usually possesses the certificate of title and therefore is protected against a subsequent acquisition of ownership including security ownership in the motor-vehicle. On the other hand the diligent transferee refrains from the transaction, when the transferor cannot provide the certificate of title. Hence, the possession of the certificate of title establishes publicity of the entitlement in the particular motor-vehicle which the certificate is issued for; it avoids conflicts of security interests between diligent creditors; and finally, in case of

BGH, 44 pt. 2 NJW 1415).

533 Soergel/Muehl, supra note 515, BGB § 932 cmt. 18, at 330.

534 BGH, 44 pt. 2 NJW at 1416. A number of courts have held, that an exception thereof applies, when the transfer concerns a new vehicle from an authorized dealer of the manufacturer (Oberlandesgericht Duesseldorf, NJW-RR 1992, 381; Oberlandesgericht Karlsruhe, NJW-RR 1989, 1461; both cited at: Palandt/Bassenge, supra note 277, BGB § 932 cmt. 13, at 1137). Whereas the Oberlandesgericht Hamm, Judgment of Jan. 13, 1964, 5. Senat, 17 pt. 2 Neue Juristische Wochenschrift 2257 (1964), correctly has found, that in this case only the good faith in the merchant's power to dispose the goods in the ordinary course of his business is protected pursuant to HGB § 366, in contrast to good faith in the debtor's ownership.
a conflict it prefers the diligent creditor possessing the certificate of title.

D. The inferiority of the bulk assignment to the subsequent extended reservation of title

To the disadvantage of banks, the courts have perforated the principle of priority with respect to bulk assignments to the financer. By now it is well established that a bulk assignment for security purposes is unconscionable and therefore void, if and in so far as it refers to claims, which customarily are subject to anticipated assignments to a supplier in the course of extension of his reserved ownership. The courts have considered that suppliers typically reserve ownership and require its extension for security of the purchase money; therefore the debtor, who needs to obtain goods and raw materials to run his business, has no choice but to execute the subsequent anticipatory assignment to the supplier knowing that he is not entitled to because of his previous bulk assignment to the bank. Thus the bank foreseeably compels the debtor to breach his contract with the supplier, when it

535BGB §§ 134, 138 (1). Judgment of April, 18, 1991, Bundesgerichtshof, IX. Zivilsenat, 44 pt. 3, Neue Juristische Wochenschrift 2144, 2147 (1991); Judgment of March 7, 1974, Bundesgerichtshof, VII. Zivilsenat, 27 pt. 2 Neue Juristische Wochenschrift 942-43 (1974). For other purposes and the assignments of other debts the bank may save the validity of the bulk assignment by expressly excluding debts from the assignment, which are usually subject to the supplier's expansion of reserved ownership, [Dingliche Teilverzichtsklausel].
demands a bulk assignment to secure the credit for the business.\footnote{Judgment of Oct. 13, 1987, Bundesgerichtshof, VI. Zivilsenat, 41 pt. 1 Neue Juristische Wochenschrift 263, 264-65 (1988).}

This 'breach-of-contract'-doctrine\footnote{"Vertragsbruchlehre"}, Buelow, supra note 265, cmt. 1137, at 333. has been challenged by scholarly literature advocating a sharing of the assigned purchase money and its proceeds among the assignees per quota calculated on the amounts of the secured debts.\footnote{Peter Finger, Verlaengerner Eigentumsvorbehalt und Globalzession, 25 pt. 2 Juristenzeitung 642, 644 (1970); Buelow, supra note 265, cmts. 1146-50, at 336-38.} This 'sharing'-theory\footnote{"Teilungslehre". Buelow, supra note 265, cmt. 1146, at 336.} lacks any statutory basis and therefore must be rejected.\footnote{Esser, 135 ZHR 320, 330 (1971), cited at: Buelow, supra note 265, cmt. 1150, at 337 note 35.} The better reasons support the strict preference of the supplier's extended reservation of ownership. The supplier's security interest is designed to secure the present debt of a single transaction, the purchase of certain goods; whereas the bulk assignment to the bank is made prophylactically to secure all debts, present and future, arising from a continuous or recurrent relationship. Since as a matter of fact the bulk assignment to the bank is made at the beginning of the relationship with the bank and thus often at the starting point of the debtor's business operations, the
bank's security interest would almost always gain priority over subsequent advance assignments to suppliers in operation of the strict first-to-create axiom of priority; the supplier would be barred from the possibility to acquire sufficient security for the purchase money; thus, the supplier's extended reservation of title would be 'devalued'; 541 undue hardships would be imposed on the supplier, primarily when day-to-day transactions with the debtor are involved, which are executed on the basis of standard terms without actually stipulating any securities. All of which is to say that German law would become the same as the law under the U.C.C. on this subject.

V. The partial compliance of the German system of securities in personal property with the interests involved in business financing and the disadvantages of banks and general creditors

An evaluation of the German system of securities in personal property and its basic avoidance of publicity of security transfers requires clarification about its ability to comply with the interests involved in security transactions in the area of business financing. The following attempt to make a conclusive statement on this issue considers the interests of the debtor, his customers, his supplier, his bank and his general creditors.

541["Entwertet"]. Buelow, supra note 265, cmt. 1133, at 331-32.
A. The complete compliance with the debtor's interest to use the collateral and conceal the security transaction

In modern business financing the debtor's interest to use the collateral for business purposes can be fully complied with by the creation of a *constitutum possessorium* and the employment of processing and selling clauses connected with the extension of the security interest. Accordingly, the debtor may obtain or retain actual possession of the collateral and be authorized to process and sell it.

Additionally, as set forth above the development of reserved ownership and security ownership as well as the security assignment enable the parties to keep the security transaction entirely secret. In contrast to the statutory pledge the modern security devices lack a requirement of public notice. Exceptionally in limited, extremely risky transactions the creditor might prefer to disclose a security assignment to assure against the discharging effect of performance by the third-party debtor to the debtor or a subsequent ostensible assignee. In cases like these, the debtor's interest in secrecy is inferior to the creditor's interest to limit the risks resulting from the debtor's insolvency.

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542 See *supra* III.C.3.
B. The full protection of the debtor's customers

The debtor's customers purchasing the collateral are protected completely against failures to acquire the full ownership in the purchased good without any encumbrances in three ways: First, the selling clause, which is at least implied in the commonly extended security transaction regarding inventory goods and raw materials, empowers the debtor to transfer ownership in the ordinary course of his business. Thus, normally the debtor's customer, who purchases the collateral, acquires full and absolute ownership due to the extension of the security interest.

Second, if the debtor lacks authority to transfer ownership in the collateral,543 the debtor's customer is protected in its good faith in the debtor's ownership and primarily the debtor's ostensible power to transfer ownership in the ordinary course under HGB § 366. The resale to the customer usually belongs to the ordinary course of the debtor's business. The protection under HGB § 366 takes into account that good faith in the merchant's ownership may be precluded because of the transferee being seriously induced to suspect,

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543 I.e. because the security interest exceptionally has not been extended and extension cannot be inferred from the purpose of the security transaction.
that the good is subject to financing and a security interest, especially reservation of title.\textsuperscript{544}

Third, however, when the security interest consists of reservation of title or conditional security ownership, in minimum the subsequent purchaser acquires inchoate title in the good. Any intended transfer of ownership includes the inchoate title\textsuperscript{545} as a 'minus identical in character,'\textsuperscript{546} which the debtor is entitled to transfer.\textsuperscript{547} In apparently critical situations the subsequent purchaser knowing about the security interest may protect itself and decide to make a repayment on the secured debt for the purchased good directly to the secured creditor, BGB § 267 (1), to meet the condition for - ultimately the purchaser's - acquisition of full ownership.\textsuperscript{548} Although the debtor may oppose to the direct payment, the creditor is not bound to the opposition, BGB § 267 (2). The creditor still can - and for his own benefit usually will - accept the payment at his discretion.\textsuperscript{549} The purchaser then can


\textsuperscript{545}Palandt/Bassenge, supra note 277, BGB § 930 cmt. 2, at 1132, referring to the 'area security contract'.

\textsuperscript{546}["Wesensgleiches Minus"].

\textsuperscript{547}Any contractual prohibition is void in relation to the debtor's customer, BGB § 137 (1); see supra II.A.1..

\textsuperscript{548}See supra II.A.4.a..

\textsuperscript{549}Palandt/Heinrichs, supra note 277, BGB § 267 cmt. 5, at 313.
set off his claim against the debtor for recourse\textsuperscript{550} against his debt for payment of the resale price to the latter.

C. The comprehensive satisfaction of the supplier's interest in a firm security for the purchase price

Obviously the supplier reserves ownership for the purpose of securing the claim for the purchase money. But apart from this dominant security interest it must be considered, that the reservation of title generally is designed to increase sales;\textsuperscript{551} it sets forth a security device, which due to its non-possessory and secret nature attracts the debtor to purchase goods on a credit basis. These general and hardly measurable benefits for the supplier must be taken into account and may justify the supplier's exposure to the remaining limited degree of uncertainty and risk in the operation of reserved ownership.

\textsuperscript{550}Arisen from the discharge of the secured debt and based on either commission (BGB §§ 662, 670), BGB §§ 677, 683, 670 or unjust enrichment (BGB § 812), depending on the internal relationship to the debtor (Palandt/Heinrichs, supra note 277, BGB § 267 cmt. 7, at 313; Palandt/Thomas, id, BGB § 812 cmt. 62, at 904).

\textsuperscript{551}See supra II.A..
1. The certainty of acquiring a perfect security interest by reservation of ownership

A primary goal of the reserved ownership is the certainty for the supplier to obtain a perfect security interest. Referring to the security transaction the supplier is the original owner of the collateral and retains ownership. Therefore the supplier does not face the risk of prior security transfers in the collateral or any other lack of the debtor's right to transfer the security interest, which immanently goes along with a derivative acquisition of security ownership. Even an advanced transfer of security ownership from the debtor to the bank cannot harm the supplier; it would be ineffective, since the debtor does not acquire full ownership, which it could transfer to the bank.552

2. The minor risk of losing the security interest

On the other hand, the possibility of a subsequent acquisition of ownership in good faith pursuant to BGB §§ 932-35 exposes the supplier to a minimal risk of losing his security interest in the course of subsequent transfers of the collateral by the debtor. This risk is limited to a few exceptional situations. Against losses in standard situations the supplier either is protected by law or can protect itself by extension of the

552 Regarding the possibility for the bank to acquire inchoate title and be secured thereby see infra D.1..
reserved ownership. Overall the German law on securities in personal property comprehensively accomplishes the supplier's particular interest to be assured of an effective security for the purchase money.

a. The extension of reserved ownership providing substitution for the ownership in the initial collateral

The supplier may allow the debtor to transfer ownership in the collateral, either the initial inventory or the substitutive finished product, and in consideration make the debtor assign the claim for payment of the resale price in advance.553 By this extension of the reserved ownership the supplier assures the continuation of his security interest in case of prospective transfers of the collateral in the ordinary course of the debtor's business. The courts have upheld the supplier's protection by the anticipated assignment in the conflict with a previous bulk assignment by the debtor to the bank including the claim for the resale price. They have constantly given effect to the subsequent assignment to the supplier554 and thus enforced the supplier's protection against the loss of the security interest to the bank financing the debtor.

553 For details see supra III.A..

554 See supra IV.C..
b. The restrictions on subsequent acquisitions in good faith

Subsequent transfers of equipment or of security ownership in inventory or raw materials are normally not covered by extension of reserved ownership and therefore generally have to be feared by the supplier. The debtor typically does not purchase equipment for the purpose of reselling it, so that reserved ownership in equipment usually is not extended.\(^{555}\) The subsequent transfer of security ownership by the debtor is not within the ordinary course of business and therefore not governed by the rules of extension.\(^{556}\) To this extent the supplier may completely lose the security interest by a subsequent acquisition in good faith. But the courts have limited the possibility of such a loss drastically.

The first serious limitation on acquisitions in good faith arises from the statutory requirement of a transfer of actual possession, BGB §§ 932-34. Thus, any subsequent transfer of security ownership will not be valid, until the debtor hands over the collateral to the subsequent transferee. With respect to a subsequent transfer of security ownership the delivery

\(^{555}\)See supra III.A.1.

\(^{556}\)See supra III.A.1. I.e. the extension in no. 10 of the standard terms of the Deutsche Bank AG expressly authorizes only the "sale of [the] secured goods" (supra III.A.2.c.).
normally will not happen before the suspension of payments by the debtor.\textsuperscript{557}

Goods such as business equipment are typically subject to reservation of title. With respect to such assets, the courts have constantly held that the transferee must seriously consider a lack of entitlement to transfer ownership on the part of the debtor. Therefore the transferee has a duty to undertake adequate inquiries regarding the debtor's entitlement and reserved ownership in the goods.\textsuperscript{558} In practice there arise issues regarding, whether goods are typically subject to reservation of title or the debtor presumably is at least empowered to transfer ownership in the ordinary course of business, HGB § 366. However and although these issues may turn out to the detriment of the supplier, the general acknowledgment of the subsequent transferee's duty to inquire contributes to the protection of the supplier against subsequent transferees being unaware of its interest and acquiring ownership. Especially banks which are about to take security ownership, can neither rely on the absence of reservation of title nor HGB § 366 and the presumption of the debtor's authority to execute the security transfer because the transfer for security purposes is not in the ordinary course of the debtor's business. Overall it can be concluded,

\textsuperscript{557}See supra IV.C.2..

\textsuperscript{558}See supra IV.B.3..
that both restrictions impose serious obstacles to subsequent acquisitions of absolute and security ownership in good faith which would oust the supplier's security interest because the extension clauses do not apply.

If reserved ownership is extended, the supplier only loses security unforeseeably when the debtor delivers the collateral to the transferee. With respect to a competing creditors taking possession of the collateral for security purposes, this situation will rarely occur in practice, before the debtor's suspension of payments. Additionally, a loss of security requires that either the collateral typically must not be subject to reservation of title at the time of the subsequent transfer or adequate inquiries regarding the debtor's rights in the collateral must not have indicated the existing security interest and the restriction regarding the debtor's entitlement in the goods.

Therefore, the risk for the supplier to lose the security interest is limited to extraordinary situations and is of minor practical relevance. Any harm, which nevertheless might occur to the supplier, can be regarded as justified by the general gain in sales in assenting to sell on a credit basis and to employ the non-possessory and secret security device of reserved ownership. Accordingly, it seems appropriate to

\[^{59}\text{See supra II.A.1.}\]
impose the burden on the supplier to monitor both the debtor's possession of the collateral and his financial situation, when the supplier wants to eliminate even marginal risks to the retained title. The supplier must be alert to the need to repossess in time, before a different creditor takes possession at the debtor's suspension of payments.

D. The disadvantages of the bank in the conflict of securities and the imposition of due diligence on the bank as a compensation for the lack of publicity of security transfers

The courts systematically have shifted the risks arising from the lack of publicity in security interests to the bank. The bank's subordination to the supplier's security interest gives some certainty in the area of business financing. Often hardships for the banks are avoided because they have secured loans additionally i.e. by land charges. The present system of securities in personal property partially also serves for the benefit of the banks since they neither have to take possession of the collateral as under the statutory pledge nor have to take the costs and risks connected with the need to comply with formalities of filing public notice of the security transaction.
1. The general subordination of the bank's security interest to the supplier's reservation of title

The bank's general subordination to the supplier's security interest emerges from the nature of the supplier's reservation of ownership. Since the supplier initially owns and merely retains ownership in the collateral, when he enters into the security transaction, the bank cannot derivatively acquire security ownership from the debtor as the 'entitled person,' until the supplier has received payment of the purchase money and the condition for transfer of absolute ownership has been met. Thus, any transfer of security ownership in goods being subject to reserved ownership usually can only effect the acquisition of inchoate title in the collateral. An acquisition of full ownership for security purposes in good faith is precluded, since both the bank typically does not obtain actual possession of the collateral and a diligent inquiry would have alerted the bank to the reservation of ownership and the debtor's lack of right to transfer security ownership. Therefore, in the conflict with the supplier's reservation of title the bank's security interest regularly is ineffective.

560["Berechtigter"].

561 Regarding the subordination of advanced transfers of security ownership in particular see supra IV.B..

562 See supra B.
But as a 'minus' to security ownership, the bank has acquired the supplier's inchoate title for security purposes. The bank may raise the inchoate title to full security ownership.\textsuperscript{563} It may pay the purchase money owed by the debtor to the supplier, BGB § 267. Thereby the bank discharges the debtor's secured debt, so that the condition for the debtor's acquisition of full ownership under the sales contract occurs. Due to the anticipated security transfer to the bank, finally the bank obtains security ownership in the collateral.\textsuperscript{564} Consequentially, the bank can seek satisfaction from the collateral. But this procedure is only appropriate, when the balance of the purchase money is smaller than the expected proceeds from the liquidation of the collateral. Nevertheless, the disadvantage of the bank's security ownership may diminish severely in the individual case.

Another facet of the general subordination of the bank's security interest results from the axiomatic invalidity of advanced assignments of expected claims for payment of the resale price contained in the bulk assignment to the bank.\textsuperscript{565} Accordingly the bank's security interest is defeated in the conflict with the supplier's extension of reserved ownership

\textsuperscript{563}See supra IV.B. for the advanced transfer of security ownership in particular.

\textsuperscript{564}See BGB 185 providing that a disposition lacking the transferor's power becomes effective upon his acquisition of the disposed right.

\textsuperscript{565}See supra IV.C..
regardless of priority in the creation of the security interests.

2. The burden of due diligence as a balance for the lack of publicity

As a factual consequence of the bank's strict subordination to the supplier's security interest the bank bears the burden to balance the lack of publicity in the system of securities in personal property. In its own interest to acquire an adequate security interest it has to investigate the rights in a prospective collateral typically subject to reserved ownership. It must diligently check the debtor's records regarding the existence of reserved ownership and, if it has detected any, the amount of payments made on the purchase price. The latter is necessary to find out the balance due and to determine the value of the debtor's inchoate title in the prospective collateral, so that the bank is able to decide, whether an acquisition of the inchoate title enabling the foresaid procedure will provide adequate security.

Moreover, especially when payments are not sufficient to achieve the break-even for the acquisition of the prospective collateral for security purposes, the bank may seek a 'release

566 BGH, 11 pt.2 NJW at 1486.
statement from the supplier, who might have an interest in the debtor receiving the credit. This release statement basically resembles the subordination agreement employed by purchase money lenders in the United States. In practice being the sole means to assure the bank for the acquisition of the security interest, the release statement creates limited publicity of the prior security interest. However, since this limited publicity is a mere reflex of the bank's diligence, it can be concluded that the lack of a public notice requirement for the creation of reserved ownership is to the debit of the banks, which have to undertake diligent efforts to assure the perfection of the security interest.

3. The risk of losing the security interest

Apart from the subordination in the conflict with the supplier's reservation of title, the bank is at risk of losing its security interest to subsequent transferees of the collateral. Significantly more than the supplier, the bank is exposed to the risk of subsequent acquisition of security ownership in good faith by different creditors. Unlike the duty to investigate the rights in goods which are typically

567["Freigabeerklärung"].


subject to reserved ownership, generally there does not exist any such obligation with respect to prior security ownership in the prospective collateral. This principle has only been displaced, when the transferee actually knew either about the particular senior credit or that the debtor was deeply in debt. Therefore the subsequent transferee more likely acts in good faith regarding the prior security interest of the bank than the supplier's reservation of title.

Furthermore, in contrast to the supplier, who retains original ownership and therefore is immune to subordination according to the primary axiom of priority, the bank is subject to this principle in the conflict with other creditors claiming to have acquired security ownership in the collateral. Therefore, the bank unlike the supplier is exposed to the inducement for subsequent creditors to gain priority


571 Judgment of Bundesgerichtshof, LM BGB § 932 Nr. 26, cited at: Palandt/Bassenge, supra note 277, BGB § 932 cmt. 11, at 1136.


573 Buelow, supra note 265, cmt. 934, at 255.

574 See also supra C.1..
fraudulently, i.e. by backdating the documents of their security transactions.\textsuperscript{575}

4. The transformation of security ownership in the debtor's insolvency

A minor disadvantage for the bank results from the principle of transformation\textsuperscript{576} which does not apply to reserved ownership. In the debtor's insolvency the bank cannot demand to have the collateral severed and transferred.\textsuperscript{577} Like a pledgee it is basically limited to the right to prior satisfaction from the proceeds of the collateral's liquidation by the administrator within the pending insolvency proceeding.

5. The limited value of the bank's right to demand additional and effective securities at any time provided in the AGB-Banken no. 19 (1) and AGB-Sparkassen no. 21 (4)

The banks try to avoid potential conflicts of securities to limit losses resulting from the subordination to the supplier's reservation of ownership and the risk of losing the security interest to subsequent creditors by incorporating

\textsuperscript{575}As it was the case in: Judgment of Jan. 24, 1983, Bundesgerichtshof, VIII. Zivilsenat, 86 Entscheidungen des Bundesgerichtshofes in Zivilsachen 300 (1983).

\textsuperscript{576}See supra II.B.6..

\textsuperscript{577}Like an unrestricted owner can, who is not bound by the fiduciary duties of a security agreement.
clauses in their standard terms, which give them the right to demand further and effective securities from the debtor, AGB-Banken no. 19 (1) and AGB-Sparkassen no. 21 (4). Such a clause is valid\(^{578}\) and can protect the bank, when it recognizes the ineffectiveness of its present security interest in time and the debtor is able to provide a different collateral sufficient to secure the credit. But in the practically relevant case, when the additional security transfer under this clause is closed during the debtor's crisis, it is too late: the transfer is avoidable pursuant to KO § 30 no. 2.\(^{579}\)

E. The lack of publicity affecting the subsequent general creditors

Furthermore, the lack of publicity works to the detriment of the general creditors of the debtor, who omitted to secure their claims. The security interest of either the supplier or the bank removes the collateral from the pool of the debtor's assets serving to satisfy the general creditors. The BGB's initial concept of publicity in the area of security transfers\(^{580}\) was intended to protect subsequent general creditors against erroneous appraisals of the debtor's assets


\(^{579}\) 33 BGHZ at 394-95.

\(^{580}\) See supra Part 2.
caused by ignorance of any part thereof being subject to a security interest. This principle of publicity in securities has been contravened and in practice almost completely ousted by the recognition of the non-possessory and secret security transfers. Since their creation only requires internal - and informal - agreements between the secured party and the debtor, the subsequent general creditor need not notice the security transfer and the loss of the debtor's assets being available for his satisfaction. Therefore the general creditor may provide the debtor with credit based on an erroneous assessment of the debtor's capacity to satisfy this debt for return payment.

Although available, credit reports are of comparatively little help since they generally reveal only the debtor's performance in the past, pending insolvency or other major judicial proceedings and the status of certain limited assets publicly disclosed. These reports rest on court and bankruptcy records and an appraisal of some of the debtor's assets as far as they are recorded at public office, i.e. in the commercial and the land and title registers, or otherwise published, i.e. in balance sheets of certain business entities. They cannot and do not consider the current status of encumbrances of personal property due to security transactions.

581 Pignora tacita; Baur, supra note 263, at 549-50.
In an effort to avoid harsh results for the general creditors, courts have invalidated security interests in extreme cases, when the secured party has acquired excessive and opaque security interests "consciously putting up with the not remote danger that unaware creditors subsequently sustain damages".\textsuperscript{582} Nevertheless, since the exception recognized by the courts only applies in rare situations, the subsequent general creditors also have to be considered as the bereaved of the lack of publicity in the modern German system of securities in personal property.\textsuperscript{583}

VI. Conclusions for the operation of the German legal system of securities in personal property in business financing

In the area of business financing the German legal system is characterized by the lack of publicity. In deviation from the pledge as the sole statutory means for a security interest in personal property the practice has developed a system of security instruments based on constructive possession allowing the debtor to use the collateral. Neither the judiciary or the


\textsuperscript{583}Baur, supra note 263, at 549-50, bases his considerations implicitly on the same opinion.
legislature have created a public-notice requirement substituting the transfer of possession. Thus, the German law on securities in personal property completely realizes the debtor's interest in both the ability to use the collateral and the secrecy of the security transaction. Consequently, the secrecy causes the debtor's ostensible ownership and uncertainty among creditors regarding the priority among conflicting security interests.584

In a far reaching response to the uncertainty the courts have established a mesh of rules subordinating various security interests to others generally to the disadvantage of banks; besides the complete protection of the collateral's final resale buyers only the suppliers of a business can be sure to acquire a perfect security for the purchase money, if they extend their reservation of title. The courts thereby have responded to the what they see as unfair advantages of the banks. These advantages spring from being first secured creditor and having the power to stipulate or dictate security agreements with the debtor. The priority rules do not help the banks. The bank must investigate the rights in the prospective collateral, and must regularly rely on the debtor's statements regarding the closing dates of even informal security transactions. The bank faces the risk of subsequent

584Since the German law does not require perfection to gain priority in a conflict, the issue of priority and the uncertainty concerns the security interests' validity.
transferees acquiring the collateral in good faith due to ostensible ownership or being tempted to deprive the financer of his security interest fraudulently.

Overall it can be concluded, that the German legal system comprehensively gives effect to the debtor's secrecy interest and the supplier's interest to be assured of a perfect security for the purchase money. The banks either are subordinated to other creditors, especially suppliers, and therefore have not acquired a valid security interest or at least have to bear the burden of diligent inquiry and uncertainty regarding a potential conflict of security interests.
Final comparison and conclusions

I. The advantage of certainty and the risks and costs under the public-notice-filing system of U.C.C. Article 9

In contrast to the German laws on securities in personal property the public-notice-filing system under U.C.C. Article 9 in combination with the first-to-file priority rule establishes certainty and predictability among competing secured creditors. But this advantage for the secured creditors has its price. Secured creditors face the risk of failing to comply with the formal requirements of proper filing and thus of sustaining severe losses due to mere per-quota satisfaction in the debtor's bankruptcy like any general creditor. The impact of improper filing under the system gives rise to a significant volume of litigation solely concerning the issue of compliance with the filing requirements. Most of the litigation emerges from trustees in bankruptcy challenging the adequacy of the particular filing under the "strong-arm" power. Additionally, there incur some costs linked to the filing procedure itself, the filing fees and expenses for the preparation of the financing statement and its filing. In addition, the searcher of the records bears the risk of trivial errors in the financing statement by the
senior creditor and of mistakes in the indexing process and search reports caused by the officer in the filing office, which may mislead the searcher. The searcher consequentially may grant credit to the debtor without discovery of a prior security interest. The searcher also has to pay some moderate fee for the search report.

Such costs linked to the bureaucracy of the filing system encompassing losses due to noncompliance with formalities, mistakes by officers, litigation costs as well as filing and searching fees and expenses do not incur under the informal German legal system of securities in personal property. But creditors basically depend on the debtor's representations regarding prior securities without the possibility of simple and accurate verification through a public recording system. In part the priority rules reduce the exposures which creditors would otherwise face from the secret and informal system. In light of these priority rules, creditors are normally disappointed only in the event of misrepresentation, when the creditor itself has not employed due diligence in its inquiry, or when a subsequent creditor or purchaser of the collateral qualifies as good faith transferee.

II. Economic benefits under the public-notice-filing system

From an overall economic perspective, the first-to-file priority rule and its core element, the public-notice filing
system, seem to be more efficient than the informal German system of securities in personal property. The assurance of priority to the first creditor, who "stakes his claim" by filing a financing statement, has been held to encourage financers to provide businesses with initial credit and thereby to increase economic activity. Moreover, financers have an incentive to monitor and counsel debtors in financial matters by providing external capital, which improves effective financial management of businesses. Since the financer "signals" his information about the debtor's creditworthiness through the public-notice-filing system to the credit market, subsequent creditors generally are supposed to be able to make a sophisticated credit decision and thereby to minimize inefficient distribution of financial resources by "overlending" to debtors facing insolvency. In contrast, the uncertainty about priority under the informal German system presumably at least causes hesitation towards credit decisions paralyzing economic initiatives.

III. The preferable balance of interests under the public-notice-filing system in general

This comparison also has revealed that the public-notice-filing system under U.C.C. Article 9 generally gives effect to a compromise of the involved interests superior to the German

585Kanda/Levmore, 80 Va.L.Rev. at 2142.
legal system lacking any defined policy in this regard at all. Basically the public-notice-filing system serves and creates certainty among creditors and transferees regarding the existence of a perfected security interest in the collateral and thereby overcomes the risks of the debtor's ostensible ownership including fraudulent conveyances. In combination with the first-to-file priority rule the certainty extends to the priority over conflicting security interests in the same collateral particularly in the debtor's insolvency.

In so far as this certainty is impaired by the consequences of noncompliance with the filing system's formalities rendering the creditor unsecured in the debtor's bankruptcy, this inherent risk of an administrative system is satisfactorily allocated to the filing secured party according to the principle of causal responsibility. The other significant impairment of certainty concerns the searcher's burden to bear the risk of misleading mistakes by the filing officer. The only - but not compelling - explanation for this allocation of risks rests on the secured party's legitimate reliance on the correct procedure in the filing office and the searcher's basic responsibility for the result of his investigations and his nearness to the debtor's representations in his credit transaction.

By establishing the general certainty in trade the filing system surmounts the debtor's interest to conceal the entire
security transaction and its need for financial aid. But on the other hand under U.C.C. Article 9 the filing creditor is not forced to disclose any trade secrets contained in the terms of the transaction; since to this extent the secrecy interest is protected, the system generally avoids disproportionate infringements of interests.

In contrast, the German legal system gives only limited effect to the trade's certainty interest. It factually prefers the debtor's secrecy interest comprehensively. Since the debtor's interest to hide the security transaction itself and its shortfall of capital ultimately aims to mislead the trade, this interest is not as compelling as the trade's certainty interest, which initially was assured under the BGB and thus can be called legitimate. Therefore the imbalance of interests under the German legal system is disproportionate. Publicity of security interests and the public-notice-filing system under U.C.C. Article 9 in particular accomplish a compromise of interests clearly preferable to the operation of the German legal system on securities in personal property.
IV. Policies of efficiency and fairness underlying the different resolutions of the conflict between principal financer and supplier and the impact on interstate commerce between the United States and Germany

But in the important conflict between principal financers and suppliers of a business the German courts have developed a system of priority under aspects of fairness, which is favorable to the practice according to the principles of the U.C.C.. Under German law the floating lien of the principal bank of a business is overall subordinated to the supplier's reservation of title, which is notoriously extended to the proceeds arising from the resale of the goods. In establishing this principle, the courts have considered that under the primary axiom of first-to-create priority the banks would always prevail over subsequent creditors seeking security since the banks are routinely the first creditors of the business. Moreover, the banks generally tend to be oversecured by collateral significantly exceeding the amount of credit in value; in addition to securities in personal property they typically are also secured by land charges. Thus, for security purposes the banks are - at least substantially - secured without a prior security in the goods transferred by the supplier and in the proceeds thereof. In contrast, the supplier has nothing else but the delivered goods possibly serving as security for the purchase money. Thus, for security purposes the supplier virtually depends on the
priority of the retained ownership in the delivered goods in contrast to the bank.

Furthermore, the banks ultimately also benefit from the supply of goods since it is necessary to run the debtor's business and thereby to enable return payments plus interest, the banks' profit, from the debtor's cash-flow. It appears unfair to let the banks share from these benefits of the supply transactions and not only leave the risk of default with payment of the purchase price solely with the supplier, but also take the goods and proceeds for own security purposes. Because of the interest which the principal financer receives from the business' cash-flow for its loan and its investment of external capital in the business, the principal financer basically has a stake in the business much like a joint venturer. Therefore it seems unfair to prefer the bank over suppliers in the event of the business' failure. This would deliberate the bank substantially from the consequences of such failure at the expense of the far less engaged supplier.

In addition, a binding effect of the bank's security agreement with the debtor on the supplier depriving the latter of the ability to secure the purchase money would contravene with the fairness principle in contract law prohibiting contracts, which harm third parties.586 Unfairness under this aspect

586 Judgment of Nov. 12, 1980, Bundesgerichtshof, VIII. Zivilsenat, 78 Entscheidungen des Bundesgerichtshofes in
especially results from the bank's knowledge that the business debtor will and must engage in supply transactions to run the business.\textsuperscript{587} Since eventually the bank acquires a security in the inventory prior to the security of subsequent creditors upon payment of the purchase money to the supplier, and therefore inventory financing is not entirely useless for the bank, it seems adequate to overall subordinate the bank's lien to the supplier's reservation of title under the criterion of fairness.

In contrast, the principles under the U.C.C. preferring the principal lienor over the supplier do not give effect to these considerations of fairness. They fundamentally rest on private and social efficiency. The demotion of the retention of title to the reservation of a security interest, the notification requirement for the priority of a purchase money security interest in inventory, the exclusion of accounts proceeds from the scope of priority of such interest, the acknowledgement of negative pledge clauses and the attachment of the floating lien to the delivered goods free of the supplier's right to reclamation all work to prevent the supplier from obtaining any security for the purchase money prior to the floating lien. This policy of general subordination of the supplier


\textsuperscript{587}Courts basically police the banks' security agreements on grounds of unconscionability pursuant to BGB § 138 (1) because of knowingly endangering third party creditor's interests; see supra Part 2 IV.D..
cannot be considered fair for the reason that the supplier is free to bargain for assurances or subordination statements from the floating lienor since the supplier typically lacks sufficient bargaining power to do so.

The United States' policy rather has been justified on grounds of economic efficiency. The assurance of priority to the principal lender can be considered to give an incentive to the credit market to be the first financer of a business and thereby increase economic activity. It also may reduce the risk premium reflected in the interest rate and compensate the principal financer for monitoring and counselling the debtor for the benefit of the credit market receiving the lienor's information about the debtor's creditworthiness through the filing system. Upon this information subsequent creditors can make sophisticated credit decisions and individually and socially avoid wasteful distribution of financial resources.

The U.C.C.'s resolution of the conflict between floating lienor and supplier appears as a novelty to the vast majority of German lawyers. In German legal culture the "economic analysis of law" has commonly been rejected at least in so far as it declares overall social efficiency to the maxim of law in private, including commercial, transactions. They are entered into for the benefit of the parties, but not of an
entire market or society. The assurance of fairness and equity rather than efficiency generally are regarded as the prior tasks of law.

The ignorance of German lawyers and businessmen about the impact of efficiency criteria on the concept of security interests in personal property under the U.C.C. and on the overall inferiority of the supplier's security for the purchase money in particular turned out to be disastrous in *Hongkong and Shanghai Banking Corp., Ltd. v. HFH USA Corporation.* In this case a German supplier sold and shipped machinery under reservation of ownership to his customer in the United States. A financing statement had not been filed until the supplier became aware of the buyer's financial difficulties. At the time of the filing the grace period for filing after delivery had already expired, so that the

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589 Other objections concern the facts that markets do not operate optimally and that participants in the market frequently not only act for other purposes than economic gain (Roth, supra note 588, at 11-12).


591 805 F.Supp. at 139-45.

592 U.C.C. § 9-312 (4) (1990). The court acknowledged, that the debtor had obtained possession upon arrival and storage
purchase money security interest could not defeat the priority of the floating lien of the debtor's principal financer.

The New York court has refused to enforce a choice-of-law clause in the sales contract providing that German law and thereby the German principles for the reservation of title shall govern the sale. It has recognized the preference of the supplier's reservation of title to the floating lien under German law vis-a-vis the priority of the floating lien under the U.C.C.. The floating lienor would have been subordinated to the supplier, if German law were applicable. Thus, the floating lien would lose its priority status which it enjoyed under United States' law. Since the lienor was not party to the sales contract, this result would have violated public policy. The court has stated that the enforcement of the reservation of title according to the German laws would have offended the "fundamental purpose of ... U.C.C.'s Article 9: 'to create commercial certainty and predictability by allowing third party creditors to rely on the specific perfection and priority rules that govern collateral within the scope of Article 9.'" Remarkably, Hongkong and Shanghai Banking

of the machinery in the free trade zone in Buffalo, New York, (805 F.Supp. at 144).

593 805 F.Supp. at 140.

594 805 F.Supp. at 140.

Corp., Ltd. highlights the principal differences between the German and the United States' legal systems on securities in personal property.