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*

INTRODUCTION

The economic systems of both the United States and Germany have to deal with significant undercapitalization of businesses. Banks and other financers seek to protect themselves by acquiring security interests in collateral to satisfy the secured debt in case of default. In both countries, personal property, primarily chattels and receivables, commonly serves as collateral. The legal systems of the United States and Germany provide regulations for security interests in personal property, each system dealing in different ways with debtors’ concealment of the existing security transaction in order to obtain additional funding. The difference is in their approaches to the requirement of publicity of the secured transactions and the problem of ostensible ownership.

In the United States, the Uniform Commercial Code (UCC)\(^1\) has merged the common law recording systems into one uniform system requiring the secured lenders to file a financing statement at a designated public office.

* The author is a partner at the law firm of Dr. Hallermann & Partner in Münster, Germany. The author would like to thank Professor Julian McDonnell of the University of Georgia School of Law for his valuable comments on earlier drafts of this article and Ms. Jeong-Hwa Lee and Mr. Jonathan Ware for their help. He also would like to express his gratitude to Professors Dr. Werner Merle of the University of Potsdam and Gabriel Wilner of the University of Georgia for their support of the author's post-doctorate studies.

\(^1\) U.C.C. (1977).
The UCC deals unitarily with all security interests in personal property, thereby abolishing the previous distinction between various forms of security instruments. However, it still contains inefficiencies and involves significant costs of compliance. Besides the relatively moderate filing and searching fees, which are necessary to finance the recording system itself, there are expenses for preparing the filing. If the creditors fail to meet the filing requirements, they risk severe losses to subordinate their security interests to those of subsequent creditors whose security interests are correctly perfected and of lien creditors such as the trustee in bankruptcy. In contrast, at least in business financing, the German Civil Code (BGB) lacks a public-notice-filing system entirely.

This article examines and compares the filing system under the U.C.C. Article 9 and the operation of German securities in personal property. It will attempt to show the extent to which the systems accomplish their purposes and deal with the conflicting interests involved in business financing. This article will reveal that, despite its costs, the UCC public-notice filing enhances economic efficiency and achieves a more balanced compromise of the conflicting interests than the German system, which lacks any fundamental policy in this regard. It will also compare the UCC’s treatment of the principal secured financer vis-a-vis the supplier of inventory and the German system’s contrary treatment of the inventory financer.

PART 1: PUBLIC-NOTICE-FILING IN THE SYSTEM OF SECURED TRANSACTIONS UNDER U.C.C. ARTICLE 9

I. SECURED TRANSACTIONS UNDER U.C.C. ARTICLE 9—OVERVIEW

U.C.C. Article 9 provides the legal framework for secured financing in the United States and conceptually gives effect to the economy’s need to secure debts in personal property assets. The security interest establishes a property right for the secured party in the collateral against the debtor and against any other creditor having no property right in the collateral. The creation of a security interest, or “attachment”, essentially requires (1) that the secured party either take possession of the collateral upon mutual consent or obtain a security agreement in writing; (2) that the secured party give “value” basically in form of credit or a “binding commitment” thereto; and (3) that
the debtor have "rights in the collateral."³

U.C.C. Article 9 security interests are not limited to security interests in present and tangible personal property assets, but the debtor's entire present and future, tangible and intangible personal property may serve as collateral.⁴ Especially in business financing, it is a common practice for financers to insist on 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 such as inventory and accounts receivable and thereby make personal property assets available for security purposes which are constantly changing.

The UCC rules of priority are fundamentally based on the timing of security interests. According to U.C.C. § 9-312(5)(a), 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.⁵ In other words, the creditor taking possession or filing a financing statement at public office first, obtains priority.⁶

The secured creditor with priority in the collateral is not limited to per-quota satisfaction, and the collateral is exempted from the bankruptcy estate which is used to satisfy the general creditors. This exemption of secured property results in a reduction of the debtor's property available for the general creditors.⁷ This intervention by the U.C.C. has been challenged on grounds of unfairness⁸ overriding the axiom of equal treatment of creditors in bankruptcy.⁹

However, since contractual creditors can be "aware of . . . the risk[s]"

³ U.C.C. § 9-203.
⁵ U.C.C. § 9-303(1).
⁶ Depending on the type of collateral and the circumstances, the security interest can also be perfected by notation on the certificate of title or by temporary or automatic perfection provisions under the Code. UCC § 9-302.
⁸ See LoPucki, supra note 4, 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. Id.
⁹ See Jackson & Kronman, supra note 7, at 1147.
arising under the U.C.C. Article 9 priority rules, these creditors—other than "involuntary" creditors such as tort claimants, but also suppliers of businesses—are free to negotiate a perfected security interest or refrain from the transaction. The general creditor may also grant credit on an unsecured basis in return for a higher interest rate which reflects the probability that subsequent debts may reduce the quota of the initial credit, thus the debt's value, or that they may gain priority over the prior debt. Read the other way, the security reduces the interest rate.

Despite criticism based on economic reasons, the priority of the initial principal financer who has secured his interest by a floating lien has been justified as an incentive for the principal creditor to "monitor" and "counsel" the debtor, which ultimately also benefits other creditors. The principal lender entering into the secured transaction with the debtor "signals" to the markets that he has verified the debtor's creditworthiness and is going to police his commercial activity. Consequentially, the priority rule encourages subsequent creditors to consider the credit decision well and


11 See Schwartz, supra note 7, at 2079-80 (stating that the unsecured lender is induced to "raise [the] . . . interest rate").

12 See Alan Schwartz, A Theory of Loan Priorities, 18 J.L. STUDIES 209, 211, 249-54 (1989) [hereinafter Loan Priorities]; see also Alan Schwartz, Security Interests and Bankruptcy Priorities: A Review of Current Theories, 10 J.L. STUDIES 1, 10, 33-34 (1981) [hereinafter Current Theories] (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); James J. White, Revising Article 9 to Reduce Wasteful Litigation 26 LOY. L.A. L. REV. 823, 830-41 (1992) (suggesting priority of unperfected security interests over lien creditors and the repeal of U.C.C. § 9-301(1)(b) (1990)); Lopucki, supra note 4, 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).

13 Jackson & Kronman, supra note 7, at 1156-57, 1161; Scott, supra note 10, 1796-97. See also 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).

14 Scott, supra note 10, at 1796-97.

15 Id. at 1796, 1801.
thereby minimize inefficient "overlending" to debtors facing insolvency.\footnote{Hideki Kanda & Saul Levmore, Explaining Creditor Priorities, 80 VA. L. REV. 2103, 2142 (1994).}

Giving priority to the "signaling" principal financer also resolves the problem of unsecured creditors "freeriding" in the financing market.\footnote{Saul Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 YALE L.J. 49, 71 (1982).}

The impact of subsequent credit is also considered to justify the first-in-time priority rule under U.C.C. Article 9.\footnote{Id. Other general efficiency arguments rest on the acknowledgment of an overall and "general" increase of efficiency in credit transactions. See, e.g., 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, see Kripke, supra note 10, at 948; on the extension of credit for the troubled debtor due to the availability of transferring security interests in personal property, see James J. White, Efficiency Justifications for Personal Property Security, 37 VAND. L. REV. 473, 508 (1984) (this 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," see Scott, supra note 10, at 1831; on the opinion that secured transactions economically do not differ from other commercial transactions like sales, which are encouraged by the state, see 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), which is rejected by Schwartz, supra note 7, at 2081-87.}

Subsequent debts reduce the recoverable quota of earlier credit in the debtor's bankruptcy\footnote{Schwartz, supra note 7, at 2076. The "reduction-in-bankruptcy-share effect" supersedes in practice, 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. Id. at 2077-78.} and induce the debtor to engage in increasingly risky projects endangering return payment on the senior credit. Therefore, 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."\footnote{The problem of "risk-alteration" is illustrated by Kanda & Levmore, supra note 16, at 2108-11.} It encourages financers to be the first and principal creditors of a business other than under a pure per-quota system.\footnote{Id. at 2113.}
II. PUBLIC-NOTICE-FILING AND THE OBJECTIVES OF THE RECORDING SYSTEM UNDER ARTICLE 9

Filing a financing statement\textsuperscript{22} is an alternative means to perfect a security interest and to publicize the transfer of possession.\textsuperscript{23} The public-notice-filing system serves as a 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 creditors using the recording system.\textsuperscript{24} This is especially true for the asset-based security interests, since the creditor would otherwise have to employ expensive inquiries regarding specific assets.

On the other hand, the first-in-time priority rule in the public-notice-filing system has been criticized for enabling the principal creditor to "stake his claim"\textsuperscript{25} and may even discourage him from monitoring the debtor's cash-flow and risky business activities.\textsuperscript{26} The public-notice-filing system is generally considered to be a vehicle of information about prior credit whose worth depends on its efficiency when compared to the system of private disclosure.\textsuperscript{27}

While some consider the public-notice-filing system to be "principally for the benefit of those creditors who are subject to the limitations of the first-in-time principle,"\textsuperscript{28} others see it as the necessary means to operate the Article 9 first-in-time priority rule, which is a "pure race" filing system.\textsuperscript{29}

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

\textsuperscript{22} U.C.C. §§ 9-302(1) and 9-401.
\textsuperscript{23} U.C.C. § 9-305. U.C.C. § 9-302 contains a catalogue of further, but "less important" (White, \textit{supra} note 12, at 826) exemptions of perfection by public-notice filing.
\textsuperscript{24} Jackson & Kronman, \textit{supra} note 7, at 1158-61.
\textsuperscript{26} See \textit{Current Theories, supra} note 12, at 10.
\textsuperscript{27} Scott, \textit{supra} note 10, at 1801; Kanda & Levmore, \textit{supra} note 16, at 2128-29; \textit{Loan Priorities, supra} note 12, at 218-24.
\textsuperscript{28} Scott, \textit{supra} note 10, at 1801.
various interests. The public-notice-filing system under U.C.C. Article 9 basically follows three policies: to establish certainty for the secured party in a potential conflict of security interests; to protect transferees against misrepresentation and fraudulent conveyances by the debtor; and to facilitate the uniform public-notice-filing system.

The goal of protecting potential transferees is achieved by requiring public notice of the collateral’s encumbrances. The reasonable searcher of records will be “alerted” of the senior security interest in the collateral. The protection of third parties is limited to this cautionary function, however, because the recording system only requires the filing of a financing statement which does not fully disclose the details of the secured transaction. As a result, it assigns the burden of additional investigation and ultimately the risk of the debtor’s misrepresentation upon request for further information to the potential transferees.

III. THE FILING PROCEDURE

The secured party must file a financing statement containing the information listed in U.C.C. § 9-402(1) at the designated public office. The secured party may file a copy of the security agreement instead of the financing statement provided it contains the minimum information required for a financing statement and is signed by the debtor.

The financing statement must show: (1) the debtor’s name, (2) the debtor’s address and signature, (3) the secured party’s name and address, and the description of the collateral. The secured party’s name and address will enable the searcher to “reach” the secured party for further inquiry.
The description of the collateral must be reasonable. Since the purpose of the filing system is merely to alert the prudent searcher, it is sufficient to simply indicate the category of collateral, e.g., accounts receivable, equipment, or inventory.

The financing statement must be filed at the proper public office depending on the version of U.C.C. § 9-401(1) adopted by the particular state. The location of filing depends on the place of the collateral and the place of the debtor. 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, whichever is earlier.

IV. ERRORS IN THE FINANCING STATEMENT

In consideration of the filing system's limited purpose to merely caution reasonable searchers, a financing statement fundamentally meeting the requirements as set forth above will not be invalidated for containing "minor errors which are not seriously misleading." To determine whether any incorrectness is trivial in this sense, one must examine whether the particular defect under the circumstances of the individual case bars the "reasonably prudent" searcher from discovering the prior security interest. If the defect turns out to be insurmountable by reasonable efforts, the error will be considered grave and prevent the security interest from being perfected. If on the contrary the financing statement as filed meets the aforesaid standard despite the incorrectness, the error will be deemed irrelevant.

An element of the financing statement where crucial errors often occur is

39 U.C.C. § 9-110.
40 Biggins, 490 F.2d at 1308.
41 U.C.C. § 9-402 cmt. 1.
43 United States v. Crittenden, 600 F.2d 478, 481 (5th Cir. 1979).
44 Argumentum ex In re Katz, 563 F.2d 766, 769 (5th Cir. 1977).
45 U.C.C. § 9-403(1).
46 U.C.C. § 9-402(8).
49 In re Glasco, Inc. 642 F.2d at 796; National Cash Register Company, 317 N.Y.S.2d at 439.
the debtor's name. Since the financing statement is indexed under the
debtor's name, any misspelling, particularly in a computerized system,
typically causes the statement to be recorded in unexpected places of the

Besides errors in the debtor's name, another frequent mistake involves
filings at wrong places. The misplacement of a filing commonly may occur
due to incorrect determination of the debtor's residency or place of
business.\footnote{Some courts look to the place of incorporation (Nat'l Cash Register Co. v. K.W.C., Inc., 432 F. Supp. 82, 87 (E.D. Ky. 1977)), while others stress the principal place 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)).} Difficulties might also occur in interstate commerce regarding
the determination of the applicable state law due to the separate filing
systems in each state and lack of uniformity.

V. CONSEQUENCES OF PERFECTION

Perfecting the security interest gives the secured party a priority right over
the collateral in a conflict between competing security interests. Upon the
debtor's default, the secured party having first priority is entitled to exercise
the rights through the procedure set forth in the U.C.C.\footnote{U.C.C. §§ 9-501 et seq. The secured creditor can repossess the collateral without a
judgment and retain it in satisfaction of the debt, or sell the collateral and apply the proceeds
to the debt. The unperfected secured parties have the same rights against the debtor (see
U.C.C. § 9-501 cmt. 1).}

The determination of first priority and the solvation of a conflict between
perfected security interests is governed by the priority rules in the U.C.C.
Generally, the security interest perfected or filed first prevails over the later
perfected security interests,\footnote{U.C.C. § 9-315 (5).} and a perfected security interest gains priority
over an unperfected security interest regardless of when it was created.\footnote{Argumentum ex U.C.C. §§ 9-301 (1)(a) and 9-312 (5)(a).}

Although these principles are subject to several exceptions, the fundamental
rule is that the first to file the financing statement or to perfect the security
interest by other means than filing such as possession of collateral gets
priority over other competing secured interests in the same collateral. The
secured party with priority can satisfy its loan first and is not subject to the per-quota satisfaction in the debtor's bankruptcy.

While the general creditors are usually limited to sharing the proceeds of the bankrupt estate after its closing, the perfected secured creditor may be relieved from the automatic stay on certain grounds during the pendency of the bankruptcy proceeding.55

The privileges of priority are only available to a secured creditor whose security interest is perfected before the petition of bankruptcy has been filed.56 The trustee in bankruptcy is empowered to set aside any security interest which is unperfected, improperly filed, or not perfected on time. The trustee can demote the unperfected secured creditor to the same status as a general creditor for the purpose of the bankruptcy proceedings. Due to this power and his task to "collect . . . the property of the estate,"57 the trustee has incentive to scrutinize whether the security interests with asserted priority have been perfected properly. Therefore, the issue of compliance with the filing procedure has been subject to extensive litigation, especially in connection with bankruptcy proceedings.58

VI. PREFERENCE OF THE PRINCIPAL FINANCER TO THE INVENTORY FINANCER

Article 9 priority rules generally subordinate the interests of the inventory financer to those of the principal financer. Article 9 generally enables the supplier of inventory or equipment to acquire a security interest for the purchase price in the goods, the purchase money security interest.59

Under the U.C.C., the purchase money creditor theoretically may obtain priority over the debtor's principal financer who holds a floating lien in the debtor's present and after acquired property. In this regard, the first-to-perfect priority rule is displaced. This exception in favor of the later per-

55 B.C. §§ 554, 361, 362(d)(1).
56 "Strong-arm clause". B.C. § 544(a).
57 B.C. § 704(1).
58 The costs of litigation incurred by the secured creditors (during the period from 1980 to 1990) in obtaining priority over the trustee in bankruptcy's hypothetical lien amounted to at least $1 million and perhaps even "more than $30 million" per year. White, supra note 12, at 838 n.21-22 (listing 343 reported cases). 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..
59 U.C.C. § 9-107(a).
fected security interest has been justified on at least three grounds: first, the
debtor must be able to obtain inventory financing in order to run his business
and ultimately make payments to the earlier creditors; second, the other
creditors benefit from the later purchase money creditor monitoring the
debtor; third, with respect to collateral other than inventory, the later
purchase does not lead to "risk-alteration" affecting the earlier credit.

However, this exception is available only when the supplier provided
written notice to other secured creditors before the inventory is delivered to
the debtor. Accordingly, the inventory supplier can withhold or stop
delivery, and the floating lien does not prevail over the security rights of
the inventory supplier, since the interest does not attach until the debtor takes
possession of the goods.

Once delivery has occurred and the debtor has possession of the goods, the
inventory supplier encounters both statutory and practical difficulties in
achieving priority over a floating lien. Here, Article 9 makes a distinction
between the supplier of business inventory and the supplier of goods other
than inventory. The holder of the purchase money security interest in
collateral other than inventory, primarily equipment, must file a financing
statement within ten days after the delivery to maintain priority over other
secured creditors. In contrast, the supplier of inventory must perfect the
security interest before the goods are delivered to the debtor, and other
secured parties, especially the floating lienor, must have received written
notice of the supplier's purchase money security interest within five years
before the debtor obtains possession of the inventory. These restrictions
on the priority of the purchase money security interests in inventory have
been designed to protect other secured creditors making "periodic advances
against incoming . . . inventory," typically floating lienors. Upon notify-
ation by the supplier of inventory the lienor can prepare himself for fraudulent
requests by the debtor for advances.

Another statutory disadvantage for the supplier of inventory follows from
the exclusion of accounts from the priority of the purchase money security

---

60 Scott, supra note 10, at 1833.
61 Levmore, supra note 17, at 56-57.
63 U.C.C. §§ 2-609(1), 2-702(1) and 2-703(a).
64 U.C.C. § 9-312(4). A purchase money security interest in consumer goods is perfected
automatically without filing according to U.C.C. § 9-302(1)(d).
65 U.C.C. § 9-312(3).
66 U.C.C. § 9-312 cmt. 3.
interest.\textsuperscript{67} Since the rapid turnover of the inventory in the debtor's business routinely results in accounts receivable, this exclusion significantly favors the floating lienor, who routinely extends the lien to present and future accounts, to the disadvantage of the inventory supplier.

Another serious obstacle for the supplier's priority results from the common usage of negative pledge clauses in the financing business. A negative pledge clause does not abrogate the debtor's power to transfer his interests in the collateral,\textsuperscript{68} but it operates as a debtor's promise not to jeopardize the priority status of the financer's lien. A breach of the negative pledge clause will constitute a default under the security agreement with the principal financer.\textsuperscript{69} Upon such default, the creditor is entitled to accelerate balance of the loan\textsuperscript{70} and ultimately to take possession of the collateral. Considering these potential consequences, the clause operates as a useful tool for the floating lienor to avoid priority of purchase money security interests. Therefore, inventory financiers often demand a subordination agreement from the floating lienor.

The supplier generally has a right to reclaim the goods upon the debtor's default.\textsuperscript{71} But the remedy of reclamation is subject to the rights of a subsequent good faith purchaser.\textsuperscript{72} The U.C.C. has recognized a subsequent secured party as a good faith purchaser for value,\textsuperscript{73} who takes the security interest in the goods free of the supplier's right to reclamation.\textsuperscript{74} The subsequent secured party's knowledge of the existing security interest does

\textsuperscript{67} U.C.C. § 9-312(3), § 9-306(1).

\textsuperscript{68} Chadron Energy Corp. v. First Nat'l Bank of Omaha, 379 N.W.2d 742, 748 (Neb. 1986).


\textsuperscript{70} Independent Ins. Agencies, 718 P.2d at 1102; LoPucki, supra note 4, at 1926.

\textsuperscript{71} U.C.C. §§ 2-507(2), 2-511(3), 2-702(2).

\textsuperscript{72} U.C.C. § 2-403(1); U.C.C. § 2-702(3).

\textsuperscript{73} Value is assumed to be already given, according to U.C.C. § 1-201(44)(b), 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 Mfg. Co. v. Emery Corp., 52 B.R. 944, 946, 41 U.C.C. Rep. Serv. 1172 (E.D. Pa. 1985).

not impede his qualification as a good faith purchaser.\textsuperscript{75}

The supplier cannot circumvent the preference of the floating lienor by a reservation of title in goods delivered. The retention of title merely reserves a security interest without a security agreement, which is subject to the aforesaid priority rules.\textsuperscript{76} This feature of the U.C.C. is one of the major differences from the German system, which gives priority to title retention.

Despite various criticisms,\textsuperscript{77} the courts have consistently enforced the policy of the U.C.C. to prefer the principal lender over the supplier and have rejected suppliers' restitutonal claims for unjust enrichment of the principal financer.\textsuperscript{78}

VII. CROSS-COLLATERALIZATION AS A MEANS TO EXPAND THE SECURITY INTEREST

U.C.C. § 9-204(3) allows the security interest in a particular collateral to expand to certain future debts or liability of the debtor to the same secured party. These covenants commonly are part of a floating lien and have the effect of continuing the priority of the initial secured interest to future advances, as long as the financing statement is filed.\textsuperscript{79} There are some

\textsuperscript{75} \textit{In re} Samuels & Co., 526 F.2d at 1243-44; Teton Int'l v. First Nat'l Bank of Mission, 718 S.W.2d 838, 841 (Texas Ct. App. 1986). Mere efforts by the principal financer to extend the collateral of his security interest do not suffice unless they are accompanied by collusive conduct or fraudulent misrepresentation concerning the debtor's financial situation. E.A. Miller, Inc. v. South Shore Bank, 539 N.E.2d 519, 523 (Mass. 1989).

\textsuperscript{76} U.C.C. § 2-401(1).

\textsuperscript{77} Julian B. McDonnell, \textit{The Floating Lienor as Good Faith Purchaser}, 50 S. CAL. L. REV. 129 (1977). \textit{See}, LoPucki, \textit{supra} note 4, at 1959, 1964-65 (proposing revision of U.C.C. Article 9 to bind 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 this subordination).


limitations on the continuation of priority, e.g., priority cannot be continued in advances made after an interfering judgment lien has attached. The amount of the future advances needs to be disclosed in the financing statement, and thus, other creditors have no access to information about the amount of the debtor's debt. In this respect they depend on private inquiry and disclosure.

VIII. TREATMENT OF COMPETING INTERESTS IN THE U.C.C. PUBLIC FILING SYSTEM

A. Debtor's Interest in Keeping the Secured Transaction Secret

The public filing system purports to avoid secret transfers of non-possessory security interests, and thus interferes with the debtor's interest in concealing the security transaction. However, the public filing system replaces the need to transfer possession and allows the debtor to continue to use the collateral. The filing system also enables the debtor's principal financer to "stake his claim" by filing notice of his security interest first, thereby limiting the risk of a shortfall in case of the debtor's insolvency. This risk-reducing effect of the filing system is reflected in the reduced interest rate of the credit. Thus, the debtor ultimately benefits from the filing system.

Moreover, the filing system does not require disclosure of details of the transaction in the financing statement. 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.

---

80 U.C.C. § 9-301; U.C.C. § 9-301 cmts. 7-8.
81 U.C.C. § 9-204 cmt. 5; First Nat'l Bank of Grayson v. Citizens Deposit Bank & Trust, 735 S.W.2d at 331.
83 Kanda & Levmore, supra note 16, at 2104-05, 2113.
84 Regarding the mechanism of the interest rate influenced by security, see Schwartz, supra note 7, at 2076-78, 2084-85.
85 McDonnell, supra note 77, provides a detailed list of potential information covered by the debtor's secrecy interest and not disclosed in the statement.
B. The Advantages for and the Burdens on 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 certainty regarding the priority in a potential conflict of security interests. This certainty applies particularly to the principal financer of a business who can "stake his claim" through the filing system and does not have to fear any "risk alteration" or any devaluation of his claim by debtors' subsequent debts. This advantage makes the secured party ultimately the primary beneficiary of the filing system, outweighing any disadvantages of the filing system.

2. Risks of 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 do not routinely impose severe obstacles to perfection of the security interest, and certain "minor" errors are considered irrelevant. However, there errors, such as misspellings in the debtor's name and misplacement of the filing, which seriously mislead subsequent searchers may prevent the security interest from being perfected. Often a secured party's perfected interests are challenged by the trustee in bankruptcy who is authorized under the "strong arm clause" to set aside earlier security interests that are inadequately perfected.

Even though the possibility of erroneous filing is small, it may represent a significant risk for an individual secured party in terms of the sum of the

---

86 Trust Co. Bank, 643 N.E.2d at 19; Gilmore, supra note 30, at 465; Baird, supra note 29, at 55, 60, 64-65; White, supra note 30, at 2096.
87 See Kanda & Levmore, supra note 16, at 2104-05; Baird, supra note 29, at 55, 65.
88 Schwartz, supra note 7, at 2076-78.
89 Baird, supra note 29, at 55.
90 B.C. § 544(a).
91 U.C.C. § 9-301(1)(b). For an estimation of the risk of non-compliance, see the reported cases initiated by the trustees in bankruptcy. White, supra note 12, at 831-35 n.21.
loss. A credit need requiring a perfected security interest frequently amounts to a considerable sum of money, and the secured creditor may be limited to per-quota satisfaction in the debtor's bankruptcy due to erroneous filing. Overall, the secured party under the present filing system bears a relatively small risk of misfiling, which may cause 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\(^9\) or other clients.\(^9\) The filing system exposes the mere existence of the secured transaction, and the details of the terms of the transaction, such as the total credit outstanding, the interest rate, and the purpose of the financing, may be kept secret.

4. Cost of Filing Under the Public-Notice Filing System

From a perspective of the costs and inconveniences related to the public-notice filing, the secured party has a strong interest in fulfilling the filing requirement.\(^9\) The filing fees themselves are relatively insignificant,\(^9\) but additional costs do add up when the secured party seeks to ensure the first priority of its security interest. The usual delays in the indexing process necessitates a double-check into the possibility of prior filings by another party,\(^9\) causing additional costs for the filing creditor. Also, the preparation for the filing requires assistance of an attorney, increasing the cost of filing.\(^9\) The task of determining the proper place of filing in the context of interstate commerce is frequently complicated because of separate filing


\(^{96}\) *Task Force Report*, *supra* note 95, at 20.

systems in each state and the inconsistencies of state legislation. A centralized federal filing system would effectuate a filing nationwide, but the current decentralized system makes it difficult to determine the proper state for initial filing and requires refiling when the collateral moves to another state. This is inherent in any requirement of public-notice filing to obtain priority over conflicting security interests, especially in the debtor’s bankruptcy. The secured party may also sustain significant costs of litigation concerning the issue of perfection and proper filing. One study has estimated the overall costs of litigation on these issues to be in the area of $30 million per year during the period of 1980-90.98

However, these costs and inconveniences are inherent in a public-notice filing system and are outweighed by the advantages of the system in securing a priority status. Any less expensive way to determine priority, especially by relying on the date of the security interest’s attachment, would result in having to depend on the parties’ own records for determination of priority and would give incentive to competing creditors to manipulate their agreements and advance the relevant dates.99 The Drafting Committee plans to simplify the filing procedure and to improve the efficiency of the entire filing system with the revision of U.C.C. Article 9.100

C. Third Persons’ Interests Against Fraudulent Conveyances

The filing system under U.C.C. Article 9 attempts to protect third persons against fraudulent conveyances which may be caused by ostensible ownership and the availability of non-possessory security interests.

1. Compliance with and Obstacles to the Prospective Secured Creditor’s Interests in General

The creditor who intends to make a secured loan to a debtor who has previously granted a security interest to another creditor needs to inquire about the extent of the prior encumbrance of the potential collateral. The

98 White, supra note 12, at 838 n.22.
99 McDonnell, supra note 77, at § 6C.03[1]-38.
100 Steven O. Weise, Report: Initial Meetings of Article 9 Drafting Committee (1994), at 3; UCC Article 9 Revisions-Report: Third Meeting of Drafting Committee (October 20, 1994), at 3; Fred H. Miller, Plus The Revision of UCC Article 9 Conference on Consumer Finance Law, 47 CONSUMER FIN. L.Q. REP. 257 (1993).
prospective secured party's major concern is the accuracy of the filing records and search reports and a prompt and inexpensive searching process to obtain necessary information from the files. After having obtained knowledge about the prior perfected security interest, the prospective secured creditor may also need further information about the security transaction such as the amount of the secured debt, including advances, the interest rate, and the amount of repayments, in order 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.

The filing system under U.C.C. Article 9 provides a prospective secured creditor the certainty of the order or priority in a potential conflict. By searching the files, the prospective creditor may easily verify whether the potential collateral is subject to any prior security interest and protect itself from misrepresentations by the debtor regarding the encumbrance on the prospective collateral. The searcher cannot obtain all the necessary information on the terms of the existing secured interests, but the search will "alert" the prospective secured creditor to inquire further. The financing statement provides the searcher with the prior secured party's name and address, enabling further investigation. This costs less than in a system based on private investigation.

The prospective secured creditor is entitled to obtain an approval or a correction of a prepared "statement of account" from the prior secured creditor, which discloses the "aggregated amount of unpaid indebtedness". A "statement of account" cannot be demanded from the senior creditor directly; instead, the prospective creditor must stipulate that the debtor will submit such a request. The prospective creditor's bargaining power usually forces the debtor to comply with such a demand. If the debtor refuses, the prospective creditor is sufficiently warned to refrain from

---

101 McDonnell, supra note 77, at 133-34, 37; Scott, supra note 10, at 1831; Kanda & Levmore, supra note 16, at 2128-29.
102 McDonnell, supra note 77, at 133-34, 37; Scott, supra note 10, at 1831; Kanda & Levmore, supra note 16, at 2128-29.
103 Kanda & Levmore, supra note 16, at 2128.
104 U.C.C. § 9-208.
105 Id. cmt. 2. The senior creditor thereby is protected against insincere or abusive requests from trade. McDonnell, supra note 77.
the security transaction.\textsuperscript{106} Therefore, the limited information in the financing statement is partially compensated by the prospective secured creditor’s ability to extract a “statement of account” from the prior secured creditor. There remains the risk of subsequent advances granted by the prior floating lienor; however, the prospective secured creditor is sufficiently alerted to draw back from the transaction, if it cannot obtain a termination or subordination statement from the prior creditor regarding any subsequent extensions of the secured credit.\textsuperscript{107}

But the publicity of the secured transaction and the public-notice-filing system under U.C.C. Article 9 were originally designed to merely prevent fraudulent conveyances. Any infringement of the contracting parties’ legitimate interest in the secrecy of their relationship reaching further than necessary to accomplish this precautionary purpose is therefore considered disproportionate and has to be avoided. In light of this, the searcher’s interest in obtaining more comprehensive information from the financing statement is outweighed by the secrecy interest of the debtor and his existing creditor. The searcher’s interest on the one hand and the interests of the debtor and the prior secured creditor on the other are balanced by the notice function of the financing statement and the searcher’s duty to inquire.

A more comprehensive disclosure in the records has been advocated for reasons of economy and efficiency, since it would reduce the expenses for searches and investigations.\textsuperscript{108} However, the interference with the legitimate privacy interest of the parties cannot be sufficiently justified by reasons of efficiency to third-party searchers. Moreover, the availability of public access to trade secrets contained in secured transactions will be immeasurably detrimental and will probably produce severe economic losses.

2. Prospective Secured Party’s Interest in Accuracy and Facilitation of Searches

In addition to the cost of accurate searches,\textsuperscript{109} there are other inherent deficiencies in the Article 9 filing system which impose burdens and risks.

\textsuperscript{106} See In re Cushman Bakery, 526 F.2d 23 (1st Cir. 1975), cert. denied, 425 U.S. 937 (1976).
\textsuperscript{107} McDonnell, supra note 77, at 139.
\textsuperscript{108} See Kanda & Levmore, supra note 16, at 2128.
\textsuperscript{109} These costs are considered to be less than under a system of private investigation. Kanda & Levmore, supra note 16, at 2128.
on the prospective creditor who plans to lend credit to a debtor who has previously granted a security interest to another party.

First, in interstate commerce the prospective secured creditor is responsible for determining 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.

Another major factor impairing the prospective secured creditor's interest in accurate information about prior security interests arises from U.C.C. § 9-303(1), which provides that a security interest is perfected when the secured party has fulfilled all requirements on his part. Consequently, any mistake, delay or omission by the filing officer in indexing the financing statement does not hinder perfection and priority. In several jurisdictions, however, the searcher is entitled to compensation for the damages sustained by the filing officer's negligence, while others have adopted statutes limiting or even exempting the officer from liability. A filing officer is a rather unattractive defendant, however, considering the substantial amount of credit regularly involved in secured transactions. Thus, in practice, the searcher bears the risk of loss resulting from filing officers' mistakes, such as improper indexing and misleading search reports.

Furthermore, the prospective creditor searching the files bears the burden of detecting trivial errors in the financing statement, including misspellings in the debtor's name, by the prior secured creditor. Accordingly, he has to cope with changes in the debtor's name that are not "seriously misleading" and therefore do not require the filing of an amendment statement by the senior secured creditor. The searcher is expected to make "reasonable" efforts to determine minor changes in the debtor's name and "minor errors which are not seriously misleading" and do not impede perfection of

111 PEB Report, supra note 95, at 88; Task Force Report, supra note 95, Appendix II at 59, (indicating that indexing delays vary from state to state and range from one to three days in the majority of states up to 30 days).
114 See, e.g., Kentucky Commercial Code § 9-407 (3); Nebraska Commercial Code § 9-411(1).
the security interest.\textsuperscript{117} Although the standard of "reasonableness" is rather indefinite and therefore bears some uncertainty regarding its range, it does restrict the searcher’s burdens and risks arising from the "minor-error" exception.

3. \textit{Subordination of the Inventory Supplier’s Security Interest to the Floating Lien of the Principal Financer}

The principal financer of a business is routinely the first creditor to file a financing statement of his security interest, which typically extends to the debtor’s after-acquired property, including the accounts receivable, and which is often expanded to secure future advances. The public-notice filing system serves to assure the notorious priority of the principal financer’s floating lien over the security interests of subsequent creditors of the business, particularly the inventory supplier’s purchase money security interests in inventory for accounts receivable resulting from the sale of the inventory. The principal financer is preferred to the inventory supplier in various other ways by Article 9 and also prevails over the inventory supplier’s statutory right to reclaim the goods upon the debtor’s default.

The overall subordination of the inventory supplier’s interest to that of the principal financer in practice rests on general economic considerations of efficiency.\textsuperscript{118} According to this policy, inventory financing is regarded as a less valuable method of business financing.\textsuperscript{119} 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 inventory purchase price.

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{120} The assurance of an overall priority thus reduces the risk premium contained in the interest rates for the business’ principal loan.\textsuperscript{121} It also encourages first-in-time

\textsuperscript{117} U.C.C. § 9-402(8).
\textsuperscript{118} Trust Co. Bank, 643 N.E.2d at 19.
\textsuperscript{119} Kanda & Levmore, supra note 16, at 2139.
\textsuperscript{120} Kanda & Levmore, supra note 16, at 2113, 2115, 2139-41.
\textsuperscript{121} See Schwartz, supra note 7, at 2084-85.
lending to businesses,\textsuperscript{122} which ultimately increases economic activity, including sales and revenue of suppliers in general. Furthermore, the subordination of the supplier's interest increases the supplier's need to monitor the debtor and avoid inefficient "overlending" to debtors facing insolvency.\textsuperscript{123}

However, in 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 is compelled either to do business with the debtor on an unsecured basis or to refrain from trading. The supplier of a business inventory virtually has no device to secure payment of the purchase price. Typically he is limited to per-quota payment in the debtor's bankruptcy, while the principal financer always is assured of the first priority in substantial satisfaction.

This result cannot be justified by the argument that the supplier can contact the prior financers 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 argument goes, the supplier can improve the assurance of payment at least from the financer. But for many inventory transactions none of these means are satisfactory, due to the considerable amount of the purchase price and the probability of a shortfall. Furthermore, these assurances are only available to suppliers with substantial bargaining power. A vast majority of less powerful suppliers cannot obtain such assurances from the principal financer. Since these inventory suppliers can hardly be expected to refrain from trade altogether, they have no alternative other than to bear the burden of the risk of default without effective security. Thus, it can be concluded that the supplier's interest to do business on a secured basis is significantly reduced 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.\textsuperscript{124}

\textsuperscript{122} See Kanda & Levmore, \textit{supra} note 16, at 2113 (stating that priority of later creditors ultimately would prevent initial lending).

\textsuperscript{123} \textit{Id.} at 2142.

\textsuperscript{124} The proposals to limit the binding effect of security agreements only to third party creditors, who reasonably could foresee the prior security interest, cannot overcome the aforesaid unfairness of the current regime since the notorious extension of principal liens to
4. Limited Compliance With the Disclosure Interest of Voluntary General Creditors and Aspects of Efficiency

The system of public-notice filing is apparently of no value for "involuntary" creditors such as tort claimants since their claims do not emerge from a voluntary credit decision which could rest on the information provided by such system. Moreover, the filing system works to the detriment of the involuntary creditors. It establishes the legal tool for secured creditors to obtain priority in the debtor's bankruptcy and thereby to deprive the estate of assets at the expense of involuntary creditors. The supplier of a business inventory can be considered an "involuntary" creditor, since, in practice, he is compelled to sell goods on an unsecured basis due to the priority of the floating lien routinely held by the business' principal financer.

It must also 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 unsecured credit. One commentator holds that general creditors granting unsecured credit rarely check the public files and base their credit decisions on search reports. Instead, 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. This assessment appears to be 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.

future accounts proceeds has to be considered foreseeable for subsequent creditors in the practice of business financing. LoPucki, supra note 4, at 1959, 1964-65.

125 Id. at 1897.

126 Regarding these involuntary claimants, it is rightly suggested to give them priority over secured creditors under a revised U.C.C. Article 9. The current regime—in combination with the corporate limitation of liability—enables a comprehensive limitation from involuntary, namely tort, liability. In contrast, a subordination of the principal financer's security interest would encourage the financer to induce the debtor to refrain from tortious activity and avoid "excessive precautions" by "potential victims." LoPucki, supra note 4, at 1913-14, 1963; Schwartz, supra note 7, at 2085-86. See 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).

127 Baird, supra note 29, at 55, 60.
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. They use the information from credit reports or financial journals, both of which rest on searches of filing records, to determine the financial situation of the debtor.\footnote{LoPucki, \textit{supra} note 4, at 1936; see Theodore N. Beckman & Ronald S. Foster, \textit{Credits and Collections: Management and Theory} 330-31 (8th ed. 1969) (reflecting on the practice of Dun & Bradstreet, Inc.).}

The scope of the general creditor's disclosure interest is determined by his expectation of return payment in the ordinary course of the debtor's business.\footnote{LoPucki, \textit{supra} note 4, at 1931, 1938.} Since a good credit decision must consider the risk of "bad" credit being lost in the debtor's bankruptcy,\footnote{The minimization of inefficient distribution of financial resources suggests full disclosure of secured transactions also under general economic aspects. \textit{Id.} at 1957-58.} the creditor must consider 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. These details include the amount of credit and available credit lines to the debtor, the duration of the credit, the interest rate, the flow of return payments, default regulations, and the financer's policy on calling the loan.\footnote{See LoPucki, \textit{supra} note 4, at 1951.} Since this information is not provided by the U.C.C. filing system, the general creditor's interest in comprehensive disclosure of details of the secured transaction is not completely accomplished by the filing system.\footnote{\textit{Id.}}

However, the system partially satisfies the disclosure interest by disclosing the existence of the security transaction and the debtor's need for external capital. Thus, the unsatisfied disclosure interest regarding the terms and repayments of the credit is outweighed by the debtor's secrecy interest under this system. Additional requirements impairing the priority of the principal financer's floating lien may diminish the availability of future credit extensions. These advances are necessary to uphold the debtor's cash-flow and increase the probability of return payments on the unsecured credit in the ordinary course of business, which will benefit the general creditor.
5. Assurance for the Buyer to Acquire the Purchased Property Unencumbered

Section 9-307 protects a buyer purchasing personal property "for value" in ordinary course by discontinuing the security interests in the collateral. By operation of law, such a buyer acquires ownership free of any security interest; he does not need to check the filing system. This has been justified on the ground that the sale in the ordinary course of the debtor's business was foreseeable for the earlier creditor, and that it 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.133

If the buyer is not protected under Section 9-307, 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 be acquired is not already encumbered with a security interest.

IX. CONCLUSIONS FOR THE PUBLIC-NOTICE-FILING SYSTEM UNDER U.C.C. ARTICLE 9

The public-notice-filing system under U.C.C. Article 9 protects subsequent transferees searching the records against the risk of fraudulent conveyances, which arise from ostensible ownership due to the absence 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.

To this extent, the filing system denies the legitimacy of the debtor's interest to conceal the security transaction and his need for external capital, while recognizing the secrecy interest regarding the details of the transaction. The filing system merely performs a 'notice' function and thus avoids disproportional infringement of the secrecy interest. The alerted searcher is expected to inquire further. Therefore, it can be concluded that the filing system under U.C.C. Article 9 vastly accomplishes its purposes and provides a good balance between the conflicting interests in security transactions.

It must be noted, however, that the risk of failures in the indexing process and in search reports caused by the filing officer is allocated solely to the

133 Kanda & Levmore, supra note 16, at 2129-30 (stressing the lack of "risk alteration").
searcher, and the filing secured party bears the risk of severe losses arising from noncompliance with filing formalities. Further significant costs arise primarily from litigation about the adequacy of filing, which are often initiated by the trustee in bankruptcy in order to set aside unperfected security interests. Finally, the filing system gives effect to a policy generally preferring the floating lien of the principal financer of a business to the inventory supplier’s security interests in the purchase price, primarily for private and socio-economic reasons.

PART 2: THE GERMAN SYSTEM OF SECURITIES IN PERSONAL PROPERTY

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. Similar to the United States, the framers of the Bürgerliches Gesetzbuch (BGB) feared the consequences of secrecy in security transfers. Therefore, they incorporated the pledge as the sole statutory security device in personal property which requires public notice of the secured transaction. However, the pledge is hardly of any relevance in the practice of modern business financing, primarily due to post-war development of non-statutory security devices for securities in personal property. These devices include the transfer of ownership or the assignment of claims ("Forderungen") for security purposes, which primarily operate as the banker's instruments, and the supplier's reservation of title. More recently, the charge factoring has gained a firm position in business financing. The following sections will analyze how these security instruments operate.

I. THE PLEDGE AS THE STATUTORY SECURITY DEVICE

The pledge has only a minor practical impact in modern business financing; however, the pledge still plays some role in the area of private

---

134 ROLF SERICK, SECURITIES IN MOBABLES IN GERMAN LAW: AN OUTLINE 26 (1990).
135 BGB §§ 1205-96.
136 PETER BÜLOW, RECHT DER KREDITSICHERHEITEN AN SACHEN, RECHTEN UND PERSONEN, cmts. 334, 335, at 97-98 (3d ed. 1993).
137 In the analysis the assignment of "Forderungen" literally refers to "claims" or "accounts receivable", if the claims are for money payment.
consumer financing, when the debtor can give up possession of the collateral such as jewelry, paintings and other luxury goods for a limited period of time. Particularly, banks often employ the pledge to secure debts against their private clients. They regularly provide pledge clauses in their standard terms governing the relationship between the bank and the client.

The pledge interest becomes effective when the following requirements are met: (1) the parties have agreed that the creditor will be entitled to satisfy due debts by realization of the collateral, (2) debt to-be-secured is specified, (3) the collateral has been handed over to the creditor in execution of the agreement, and (4) the pledgor owns the collateral. The pledge interest is strictly accessory to the secured debt. Consequently, when the secured debt extinguishes the pledge interest is also extinguished, and the pledgee is obliged to retransfer possession of the collateral to the pledgor. When the debt becomes due and the debtor does not perform, the pledgee’s right to realize the pledge arises. The pledgee is entitled to dispose of the collateral—usually in a public auction, and keep the proceeds up to the amount of the debt.

In the insolvency of the pledgor, the pledge entitles the pledgee to seek so-called ‘separate satisfaction’ ("Abgesonderte Befriedigung") from the collateral, which means that he may seek satisfaction from the proceeds of the collateral’s liquidation prior to general creditors. Among several

---


139 BGB §§ 1205(1), 1204.

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

141 BGB §§ 1205, 1206.

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


144 BGB § 1252.

145 BGB § 1223(1).

146 BGB § 1228(2).

147 Bankruptcy Act §§ 48, 127 [hereinafter KO]; Act on Reorganization Proceedings § 27(1) [hereinafter VerglO]; Bülow, supra note 136, 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 § 805 [hereinafter ZPO].
valid pledge interests in the same collateral, previously created interest obtains priority over subsequent pledges.\(^\text{148}\)

A. The Requirement of Publicity

The pledge is public in nature and hostile towards secrecy. The BGB provides various means to make the pledge public. In contrast to the publicity requirements, \(i.e.,\) the public-notice-filing and transfer of possession\(^\text{149}\) 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.

The general rule for the creation of pledge interests in chattels requires a transfer of possession of the collateral, the pledgee’s acquisition of actual possession and the complete relinquishment of the pledgor’s possession.\(^\text{150}\) The transfer serves as notice\(^\text{151}\) to prospective junior creditors and transferees of the collateral interested in the transferor’s right to dispose. Therefore, the grant of joint possession is only sufficient when the pledgor factually becomes excluded from any control over the collateral without consent of the pledgee.\(^\text{152}\)

The pledge interest may become effective by transfer of constructive possession. It requires the assignment of the claim for restoration\(^\text{153}\) and notice to the actual possessor.\(^\text{154}\) The purpose of the notice requirement is not only to “manifest . . . the relinquishment of control over the disposition of the collateral,”\(^\text{155}\) but also to assure the actual possessor that the pledgor


\(^{149}\) U.C.C. §§ 9-302 (1)(a) and 9-305.

\(^{150}\) BGB § 1205(1).


\(^{153}\) BGB § 870.

\(^{154}\) BGB § 1205(2).

\(^{155}\) In re Peter Kontaratos, 10 B.R. 956, 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. GILMORE, supra note 30, at 440.
will respect the pledge in the future.\textsuperscript{156} Therefore, it is indispensable that the pledgor gives notice, since neither the possessor’s actual knowledge about the pledge nor the pledgee’s notice are sufficient standing alone.\textsuperscript{157}

This constructive transfer is far less apparent to the public than the transfer of actual possession. The constructive possession of the pledgee does not disclose the lack of the pledgor’s entitlement in the collateral if the pledgor is in actual possession of the collateral.\textsuperscript{158}

II. THE ORDINARY NON-POSSESSORY AND SECRET SECURITIES

Due to the needs of debtors and creditors, particularly in the arena of business financing, two kinds of non-possessionary security interests in chattels have developed without expressive regulation: the reservation of title to secure purchase money, and the transfer of “security ownership” (“Sicherungsgegzentum”). “Security ownership” is the means of “security interests” available under German Law to secure loans and credit other than purchase money. Instead of chattels, claims can also be used as collateral by assignment for security purposes. To protect against the risks resulting from the lack of publicity inherent in non-possessionary security instruments, the financers have developed a number of variations, and the judiciary has been challenged to draw the lines and establish subtle rules resolving conflicts between securities.

A. Seller’s Reservation of Ownership

Reservation of ownership is designed to increase sales by allowing sales on a credit basis.\textsuperscript{159} Under the statute,\textsuperscript{160} the seller retaining “security ownership” is deemed to have reserved a right to repudiate the purchase contract upon the buyer’s default. Since the statute expressly acknowledges retention of ownership, the legality of this security instrument has never been contested seriously. Reserved ownership serves as a security for the seller


\textsuperscript{157} 89 RGZ at 289-90; Palandt, supra note 143, BGB § 1205 cmt. 10, at 1294.

\textsuperscript{158} Bülow, supra note 136, cmt. 349, at 101 (in contrast to the possibility to transfer ownership and remain actual possessor in to BGB § 930).

\textsuperscript{159} Palandt, supra note 143, BGB § 455 cmt. 2, at 506.

\textsuperscript{160} BGB § 455.
in two ways: first, it secures the seller for the purchase money when he transfers the goods to the buyer before full payment; second, it secures the seller’s claim for restoration arising upon repudiation of the purchase contract.

1. Features of Reserved Ownership

When the buyer does not pay the full purchase price upon delivery of the purchased good, the seller may condition the transfer of absolute ownership upon full payment. He reserves absolute ownership under the restorative condition of full payment. The buyer obtains inchoate title ("Anwartschaftsrecht") and receives actual possession of the good, while the seller retains constructive possession until the payment is completed.

The reservation of ownership lacks publicity. Since the buyer obtains possession of the goods, he becomes the ostensible holder of unencumbered ownership. 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 in trade.

2. 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 in rem for return of the collateral against the possessing buyer. The buyer’s right to possess the collateral is extinguished upon default of payment or other breaches of contract. The seller can then seek the return of possession of the collateral. This right is prior to other creditors seizing the collateral.

---

161 Id.
162 BGB § 320.
163 BGB §§ 929 S. 1, 158(1). PALANDT, supra note 143, BGB § 929 cmt. 27, at 1127.
164 BGB § 158(2). PALANDT, supra note 143, BGB § 929 cmt. 27, at 1127.
165 Judgment of Bundesgerichtshof [BGH], LM § 1006 Nr. 11, (as cited by Peter Bassenge in PALANDT, supra note 143, BGB § 929 cmt. 27, at 1127).
166 BGB § 1006(1) BGB.
167 BGB § 985.
168 ZPO § 771. 54 BGHZ at 218-19.
3. Reservation of Ownership in Buyer's Insolvency

In case of buyer's bankruptcy, or in reorganization ("Vergleichs-verfahren")\(^\text{169}\) composition proceedings,\(^\text{170}\) the administrator is entitled to elect either to execute the purchase agreement completely or not to perform it at all.\(^\text{171}\) If he decides to execute the agreement and pay the remainder of the purchase price (Masseschuld), the collateral becomes part of the estate. Similarly to the abandonment of the collateral by the trustee in bankruptcy under the U.S. Bankruptcy Code,\(^\text{172}\) the administrator may instead 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 ("Aussonderung") and retransfer of the collateral from the estate [Aussonderung].\(^\text{173}\) Additional damages of the seller, such as consequential damages arising from non-performance, are treated like ordinary debts in bankruptcy. To this extent the seller faces only \textit{per quota} satisfaction.\(^\text{174}\) Therefore, the seller is not completely secured against any losses arising from the transaction.

B. Security Ownership

In contrast to the seller's retention of title in the collateral, a bank giving a loan must seek security for repayment by means of a derivative acquisition of assets. The most common device is the transfer of "security ownership" in chattels. Since it is not expressly allowed in the statute, it is criticized in the academic literature as a circumvention of the regulations on the pledge, especially the public notice requirement, and a violation of the 'numerus clausus of the rights in rem' ("Numerus clausus der Sachenrechte"). Nevertheless, the security ownership is widely used and unanimously recognized to be legitimate.\(^\text{175}\)

\(^{169}\) See supra note 147 and accompanying text.
\(^{172}\) B.C. § 554(a).
\(^{173}\) KO, supra note 147, § 43. Serick, supra note 134, at 42.
\(^{174}\) KO, supra note 147, § 26 S. 2; 15 BGHZ at 336.
\(^{175}\) 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 134, at 25, 108.
1. Components of the Security Transaction

The security ownership is abstract from the secured debt, and the two elements of security ownership, the security agreement and the transfer of ownership, are abstract from each other. Therefore, invalidation of one transaction does not necessarily invalidate the other.

a. Security Agreement

The security agreement between the creditor and the 'security giver' ("Sicherheitengeber"), the debtor, is not statutorily regulated as a distinct category of contract. Although the security agreement is usually in writing, it does not have to conform to a specific form. Frequently, the parties combine the security agreement with the contractual basis of the secured debt, such as a contract for a loan, but legally these agreements are considered to be separate.

The security agreement provides the causa for the transfer of ownership—the transfer in rem. It also governs the relationship between the parties. It regulates 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 the maturity and procedure of realization of the security interest.

b. Transfer of Ownership and Lack of Public Notice

In order to transfer security ownership, the parties must create a constitutum possessorium which serves as a surrogate for the transfer of actual possession. The constitutum possessorium is usually created by the security agreement and implies that the debtor is going to possess the collateral on behalf of the creditor. Agreements concerning the transfer

176 Helmut Heinrichs in PALANDT, supra note 143, BGB § 930 cmts. 12, 15 at 1133.
177 Peter Bassenge in PALANDT, supra note 143, BGB § 930 cmt. 14, at 1133.
178 Id. at 1133.
180 BGB § 930.
181 BGB § 929, S 1.
of ownership and the constructive possession can be informal.

The requirement of a constitutum possessorium is legally sufficient to replace the indefinite public transfer of actual possession. However, controversy continues as to whether, in light of the 'publicity principle in property law' ('Prinzip der Publizität im Sachenrecht'), the transfer by constitutum possessorium needs to be accompanied by some public act. Some older judgments indicated the need for public notices of the security ownership in some circumstances, but these opinions have not defined these circumstances or imposed serious requirements for them. Whereas recent judgments do not call for a public act in executing the transfer of security ownership, the parties may keep the security transaction entirely secret.

2. The Fiduciary Character of the Security Ownership

As a consequence of the transfer of ownership the creditor formally becomes the 'unlimited owner of the right' ('Inhaber des Vollrechts') in the collateral. Therefore, the creditor obtains "more legal power . . . than he needs for purposes of security." The purpose of security is to acquire a right to realize the collateral upon maturity, a partial right of ownership which is similar to a pledge. Thus, the debtor is only obliged to transfer such a partial right of ownership sufficient to secure his debt.

Therefore, the security agreement tries to restrict the creditor's excessive legal powers, requiring him to exercise the owner's rights only upon maturity. Since the restriction is only effective between the debtor and the creditor and does not affect the creditor's powers in relation to a third party, the creditor is able to validly dispose of the collateral in violation of his fiduciary duties. However, in such cases, the debtor has the right to

---

183 BGB § 930.
184 BÜLOW, supra note 136, at 247.
187 Id. at 86.
188 Id. at 86.
189 BÜLOW, supra note 136, at 235.
190 BÜLOW, supra note 136, at 235. Exceptions arise under the policing doctrines of unconscionability, BGB § 138 (1), and violation of good faith, BGB § 242.
be compensated for sustained damages on the ground of breach of contract.\textsuperscript{191}

3. The Debtor's Obligational Right for Retransfer of Absolute Ownership Upon Full Payment

Contrary to the reserved ownership, the debtor, who has granted security interests, does not retain inchoate title in the collateral; that is, the debtor does not regain absolute ownership automatically upon full payment unless otherwise agreed. Especially in banking practices, the transfer of security ownership does not regularly provide for automatic reversion of ownership upon full payment.\textsuperscript{192} The security agreement merely imposes on the secured creditor an implicit duty to retransfer ownership when the secured debt has been satisfied. The retransfer typically requires a mere consent, since the debtor is still in possession of the collateral.\textsuperscript{193} The debtor can achieve an immediate retransfer by conditioning the payment on the retransfer of the full title.\textsuperscript{194}

4. Realization of the Collateral

The realization of the collateral is governed by the security agreement.\textsuperscript{195} Absent 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.\textsuperscript{196}

The security interest usually matures when the secured debt is due.\textsuperscript{197} After a notice and expiration of a certain time period for payment,\textsuperscript{198} the

\textsuperscript{191} Id. at 235.
\textsuperscript{193} BGB § 929 sentence 2.
\textsuperscript{194} PALANDT, supra note 143, BGB § 930 cmt. 15, at 1134.
\textsuperscript{197} BGB § 1228 (2) analogously. PALANDT, supra note 143, BGB § 930 cmt. 18, at 1134.
\textsuperscript{198} BGB § 1234 (1) analogously. PALANDT, supra note 217, BGB § 930 cmt. 18, at 1134.
creditor may seek delivery of the collateral and to liquidate it consecutively. The debtor’s defensive right to possess the collateral then is extinguished.

If the security agreement does not provide how the collateral shall be liquidated, the creditor may choose a ‘private sale’ ("Freihändiger Verkauf") by a commercial broker or a public auction. The creditor is entitled to the proceeds for the amount of remaining debt plus any costs incurred by the liquidation. The creditor must transfer excess proceeds to the debtor. Alternatively, the creditor may, with the debtor’s consent, use the collateral and gain benefit from it, or retain it for its market value. These options are usually provided in a forfeiture clause in the security agreement.

5. The Security Ownership in Judicial Proceedings and Insolvency

In a judicial proceeding against the debtor, the secured creditor can acquire a right to seize the collateral to satisfy the secured debt. In bankruptcy proceedings, the fiduciary restrictions on the security party have the effect of transforming the party’s security ownership into pledge-like security interests. The secured creditor in bankruptcy proceedings can seek separate satisfaction of his claim from the collateral. He can elect to claim release of the collateral for the sole purpose of realization and separate satisfaction of the debt.

---

199 BGB § 985.
201 BGB § 383.
202 BGB §§ 1233-40.
203 Peter Bassenge in PALANDT, supra note 143, BGB § 930 cmt. 20, at 1134.
204 BGH, 33 NJW at 227-28.
G. Basic Differences With Reservation of Title

The following basic differences between security ownership and the reservation of title become relevant in the conflict of security interests of lenders and suppliers of businesses: First, the reservation of title sets forth a security interest in a collateral that was originally owned by the seller. In contrast, the security ownership in a collateral is granted by the debtor and therefore is derivative in nature. Second, the seller who reserved title retains absolute ownership; whereas the lender's security ownership is restricted by fiduciary duties to security and liquidation rights. Third, the buyer obtains inchoate title in the purchased good and automatically becomes absolute owner upon full payment, whereas the transferor of security ownership usually receives only an obligational claim for restoration.

III. THE ASSIGNMENT OF CLAIMS FOR PURPOSES OF SECURITY

Parallel to the development of security ownership, the assignment of claims for security purposes—security assignment—"has become a major and indispensable security device in German credit business." The security assignment is not specifically regulated in the statutes, but its legitimacy is well established. Even the draftsmen of the BGB explicitly acknowledged its legitimacy by referring to it in the statutes of limitations.

A. The Elements of the Security Transaction

As in the transfer of security ownership, the assignment of claims for security purposes requires both the transfer of the claim—the assignment—and a security agreement. Both can be achieved informally and simultaneously. The assignment gives the creditor all the rights as the formal assignee and creditor of this assigned debt. The security agreement limits these rights between the creditor and the debtor, and contains rules concerning the realization of the assigned claim. It implicitly imposes fiduciary duties upon the creditor and prohibits any disposal or collection of

208 SERICK, supra note 134, at 90.
209 BGB § 223 (2). In contrast, SERICK, supra note 134, at 25, relies on customary law.
210 Helmut Heinrichs in PALANDT, supra note 143, BGB § 398 cmts. 20-22, at 460.
211 BGB § 398.
the assigned claim before the debtor's default unless otherwise provided. As in the security ownership transfers, the fiduciary duties limit the creditor's rights only *inter partes* and do not invalidate any transfers by the creditor that are in violation of the agreement; they merely establish the debtor's right to compensation for breach of contract. The security agreement also establishes the creditor's obligation to reassign the claim upon extinguishment of the secured debt back to the debtor, unless the agreement provides for automatic retransfer by means of a conditional assignment.

**B. Strict Priority Rule for Competing Assignments**

In order for the debtor to assign a claim, he must have the right to assign the claim to the creditor. If the debtor has previously assigned the claim, he has lost the authority to assign it. Thus, the subsequent assignment to the creditor is void regardless of good faith on the part of intended assignee. This strict rule of priority resolves conflicts among contesting assignments.

**C. The Advisability of Notice to the Third-Party Debtor**

A major reason for the preference of the security assignment to the pledge is the absence of the requirement to inform the account debtor ("Drittschuldner"); however, the creditor is wise to insist upon giving such notice in certain exceptionally risky transactions. The account debtor paying his debt in good faith to his ostensible creditor, who typically is his initial creditor, is protected from having to make a duplicate payment to the assignee of the account. Upon such payment, the assigned account is extinguished and

---

212 Palandt, *supra* note 143, BGB § 398 cmts. 21, 22 at 460. 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. (Dietmar Willoweit, *Einwendungen des Drittschuldners aus dem Sicherungsvertrag zwischen Zedent und Zessionar*, 27 NJW 974, 976-78 (1974)).


216 BGB §§ 407-08.
the creditor loses his security interest since he cannot seek payment from the account debtor any longer. This rule does not apply when the account debtor has actual knowledge\(^{217}\) of the assignment. Therefore, a written notification to the account debtor of the assignment will serve as evidence of the latter's knowledge.

**D. The Security Assignment in Judicial Execution and Insolvency**

The secured creditor is entitled to demand the discontinuation of the judicial execution on the assigned accounts receivable by other creditors of the debtor-assignor.\(^ {218} \) In case of the debtor's insolvency, however, the creditor can only seek separate satisfaction from the proceeds in the ordinary course of the insolvency proceeding, though his claim is given priority over the claims of other unsecured creditors.\(^ {219} \)

**E. Future Claims as Subject to Security Interests**

A major improvement from the pledge is that the security assignment is not limited to present claims, but applies also to accounts receivable arising in future.\(^ {220} \) The debtor can assign the prospective claim in advance without any notice. Due to the availability of future claims for security, lenders typically insist on "bulk assignments" ("Globalzession") for security covering all of the debtor's present and future accounts arising in some broadly defined relationship, i.e. the debtor's business.\(^ {221} \)

---

\(^ {217} \) Negligent ignorance is not sufficient to forfeit the protection under this rule. Helmut Heinrichs in PALANDT, supra note 143, BGB § 407 cmt. 6, at 468.


\(^ {219} \) KO § 48. GEORG KHUHN & WILHELM UHLENBRUCK, KONKURSORDNUNG, KO § 48 cmt. 24 at 819 (11th ed. 1994).

\(^ {220} \) Argumentum a fortiori ex BGB § 185 (2) sentence 1. Judgment of June 22, 1989, BGH III. Sen. Z., 108 BGHZ 98, 104 (1990). BGB § 185(2) S. 1 provides that an unauthorized disposal becomes valid, when the disposing party acquires the subject of the disposal.

\(^ {221} \) SERICK, supra note 134, at 91; PALANDT, supra note 143, BAB § 398 cmt. 25.
F. Charge Factoring as a Means of Security

Factoring is a relatively new instrument rapidly becoming popular in the German financing market. There are two categories of factoring: outright ("echtes") factoring and charge ("unechtes") factoring. Outright factoring is a mere sale of accounts receivable, in which the factor assumes the risk of collecting the assigned accounts receivable from the account debtor ("Delkredererisiko"). There is no limitation on the validity of bulk assignments to an outright factor.

Charge factoring is designed to serve only as a security device. The debtor assigns his claim against the account debtor, but if the account debtor becomes insolvent, the creditor is still entitled to enforce his claim against the debtor-assignor. Since charge factoring is different from the security assignment only with respect to the order of collection, it is treated like a security assignment in practice. The same rules for security assignments are applied analogously, including limitations on the validity of bulk assignments. Therefore, the comments on security assignments in this article are relevant to charge factoring as well.

IV. COMBINATIONS OF SECURITY DEVICES—AN EXAMPLE OF THE PERFECT SECURITY INTEREST

This chapter introduces the common practices of "extension" ("Verlängerung") and "expansion" ("Erweiterung") of security interests in the German financing market. Simple security instruments alone often do not meet the needs of the parties, particularly the needs of the business financier. Therefore, neither inventory suppliers nor commercial lenders are content with the reservation of title or security ownership by themselves. They combine various security devices to extend and expand their security interests.

---

222 69 BGHZ at 257.
224 82 BGHZ at 61-62, 65.
225 82 BGHZ at 56.
A. Extension of the Security Interest

The extension of a security interest is the continuation of the security interest in the substitutes of the initial collateral when the creditor has lost ownership in the latter for some reason.\textsuperscript{226} It is designed to continue the security interest in constantly changing collaterals such as raw materials and inventory.\textsuperscript{227} Suppliers of these goods, who are willing to sell them on credit, face their customers’ need to transfer valid ownership in the ordinary course of business. The retailer needs to resell the inventory, and the manufacturer needs to process the raw materials and sell the finished products. The retailer in the ordinary course of business must transfer true ownership to the ultimate purchaser. 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.\textsuperscript{228}

The extension of a security interest may consist of two special clauses: a ‘processing clause’ ("Verarbeitungsklausel") which authorizes the debtor to process the collateral and ensures that the creditor’s security interest continues in the finished product, and a “selling clause” that empowers the debtor to sell the collateral in the ordinary course of business and authorizes the collection of payment from the resale.

\textit{a. The Processing Clause}

The processing of inventory causes, by operation of law, both the processor’s acquisition of ownership in the finished product and the extinguishment of the rights in the processed materials\textsuperscript{229}, including any security interest therein. Thus, the debtor who intends to process the collaterals must obtain authorization by his creditor, which is typically accomplished by a so-called processing-clause.\textsuperscript{230}

\textsuperscript{226} BÖLOW, \textit{supra} note 136, at 279, 358.
\textsuperscript{227} SERICK, \textit{supra} note 134, at 47-59.
\textsuperscript{228} Judgment of March 3, 1956, BGH IV. Sen. Z., 20 BGHZ 159, 163-64 (1956) [hereinafter: 20 BGHZ 159].
\textsuperscript{229} BGB § 950.
\textsuperscript{230} The following is an example of a processing clause:
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, \textit{supra} note 134, at 48-49.
The power to process needs to be accompanied by the agreement that the debtor processes the goods on behalf of and "as the... agent" of the creditor. The creditor, therefore, becomes the owner of the finished product. The creditor's rights in the finished product stem from the rights he had in the initial collateral. Hence, his ownership continues to be restricted by the fiduciary duties as a security holder.

b. The Selling Clause

The selling clause allows the debtor to sell the collateral regardless of whether it is the original or the finished product, and to transfer ownership in the ordinary course of business. In the absence of the selling clause, the debtor could not validly transfer ownership without the assent of the creditor. Therefore, the selling clause is essential to the extension of a security interest and is implied in any purchase transaction with reservation of title, when the goods are purchased for the purpose of resale.

The operation of the selling clause is limited to the ordinary course of business in order to protect the creditor against fraudulent transfers and

8. Processing Clause. (1) The Bank authorizes the borrower until further notice in the ordinary course of business to process or procure the processing of the 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 Bank immediately [as] 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.' Id.

231 Id.

232 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, supra note 143, 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.

233 BGB § 185(1).

234 BÜLOW, supra note 136, cmts. 1008-08, at 282-83.

235 PALANDT, supra note 143, BGB § 455 cmt. 13, at 507.
dumping sales.\textsuperscript{236} Within the boundaries of the ordinary course of business, however, the creditor is barred from interfering with the debtor's business.\textsuperscript{237}

c. The Accessory Assignment of the Purchase Money and the Power to Collect

In the course of the resale of the inventory in the ordinary course of business, the creditor loses ownership of the collateral. Instead, the creditor may also collateralize the proceeds from the sale. This assignment of right to the proceeds from the debtor-assignor to the creditor is called "accessory assignment." ("Anschlusszession")\textsuperscript{238}

Usually, the creditor authorizes the debtor to collect the proceeds on behalf of the creditor.\textsuperscript{239} Then under the security agreement or the purchase contract the debtor is obligated to collect the proceeds and pay it to the creditor in the amount of the secured debt.\textsuperscript{240}

B. Expansion of the Security Interest

A security interest can be expanded to secure other subsequent debts in addition to the primary debt.\textsuperscript{241} The initial collateral continues to secure

\begin{itemize}
\item\textsuperscript{236} Judgment of Bundesgerichtshof, WM 1969, 1452, cited in Bülow, supra note 136, cmt. 1010, at 283 n.6.
\item\textsuperscript{237} Bülow, supra note 136, cmt. 1010, at 283.
\item\textsuperscript{238} See infra note 240.
\item\textsuperscript{239} BGB § 185(1). Serick, supra note 134, at 56-57; Bülow, supra note 136, cmt. 1004, at 281.
\item\textsuperscript{240} Bülow, supra note 136, cmt. 1005, at 281. The following is an example of the accessory assignment and collection clause:
\end{itemize}

No.10 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 134, at 49. 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 authorize[ed] by the Bank to collect the debts so assigned to the Bank in the ordinary course of business . . . .' Id.

\textsuperscript{241} Bülow, supra note 136, at 279; Serick, supra note 134, at 48, 58-59.
other subsequent debts, even after the initial debt has been extinguished. Therefore, the creditor who expects the lender-borrower relationship with the debtor to continue is advised to stipulate an expansion of the security interest to cover any additional subsequent debts.

The perfected security ownership of the German banks bears significant resemblance to the floating lien employed by the financiers in the United States. As in the floating lien, the extended security assures continuation of the security interest in the debtor’s after-acquired property such as new inventory or future accounts receivable. The expansion clause expands the security ownership to future debts, particularly advances and overdrafts, which is similar to the cross-collateralization notoriously implemented in the lien agreement under the U.C.C..

V. CONFLICTING SECURITY INTERESTS

In the effort to resolve the conflicts between conflicting security interests, the courts have recognized a set of rules which basically give priority to the security interests created first. There are two exceptions: (1) the subsequent acquisition of security interests in chattels in good faith; and (2) the subsidiarity of certain advance transfers, primarily bulk assignments.

A. Priority of the Security Interest Created First—The Primary Axiom

The primary rule for priority among competing security interests is that priority goes to the one that was created first. This rule reflects the axiom: *Nemo plus juris ad alium transferre potest, quam ipse habet.* 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.

---

242 SERICK, supra note 134, at 58-59.

243 An example of the expansion clause is as follows:
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.

244 *Nemo plus juris ad alium transferre potest, quam ipse habet.* DETLEF LIEBS, LATEINISCHE RECHTSSPRICHWÖRTER 10, no. 40, at 129, and no. 63, at 132 (5th ed. 1991).

245 R. M. GOODE, LEGAL PROBLEMS OF CREDIT AND SECURITY 19 (1982). This principle also governs the concept of priority in the British system of securities in personal property. *Id.* at 19.
B. Subordination of the Transfer of Security Ownership

Banks often stipulate transfers of ownership in the debtor’s inventory. Such a transfer is undoubtedly valid; however, in the event of a conflict between the inventory supplier’s reservation of title and this security transfer, the reservation of title is superior. 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 yet entitled to execute the security transfer. Thus, the bank has merely acquired the security interest in the debtor's inchoate title, which is inferior to the full ownership rights of the supplier. This general preference of the supplier’s reservation of title to the bank's anticipated security ownership is similar to the priority of the inventory supplier’s title retention over the floating lien under the pre-code common law in the United States.

C. The Priority of Subsequent Acquisitions of Security Ownership in Good Faith and the Limitations on this Exception to the General Priority Rule

As an exception to the primary rule of priority, subsequent acquisitions of security interest in good faith are valid. However, the availability of this exception is drastically restricted by various limitations.

1. Validity of Subsequent Bona Fide Acquisitions in General

The validity of subsequent acquisitions in good faith is based on the rationale that the debtor’s actual possession created ostensible ownership.

---


247 The subordination is not limited to ‘area security contracts’, but applies to any advanced transfer of security ownership contested by reservation of title.

248 PALANDT, supra note 143, BGB § 930 cmt. 2, at 1132, § 929 cmt 45, at 1129.

249 See supra Part 1 VIII.

250 BGB §§ 932-35.

Therefore, where this ostensible ownership is lacking, subsequent acquisition of security interest cannot be considered to be in good faith.\(^{252}\)

2. The Limitations on Bona Fide Acquisition Exception

Qualifying subsequent *bona fide* acquisition of security interests occurs only when the debtor has handed over the collateral to the subsequent creditor. This does not regularly occur, however, unless the debtor is in default with the subsequent creditor and the security agreement authorizes the realization of the collateral. Only when the subsequent creditor takes actual possession in accordance with the security transaction and still acts in good faith—lacking knowledge of any foregoing security interests in the collateral—will the subsequently created security ownership become valid\(^{253}\) and oust the senior security interest.

These strict limitations cannot be evaded by a temporary transfer of actual possession; the transfer must be intended to be permanent.\(^{254}\) Thus, practically speaking, the priority of the senior security interest in the collateral is only rarely interrupted by subsequent creditors claiming to have acquired security ownership subsequently in good faith.\(^{255}\)

The second major limitation on the good-faith subsequent acquisitions exception is that the transferee’s lack of knowledge must not be due to gross negligence on his part. The transferee has a duty to inquire whether the transferor is the true owner of the prospective collateral, when a reasonably prudent transferee of similar knowledge and experience would suspect a lack of the transferor’s ownership.\(^{256}\) In the world of business financing, the financer who intends to accept security ownership in chattels as security for loans is expected to investigate whether the prospective collateral is subject

---

\(^{252}\) BGB § 935 imposes a negative precondition: The chattel must not have 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. *Id.*


\(^{255}\) Bülow, *supra* note 136, at 256.

to the supplier's reservation of ownership or other prior security interests. If the bank fails to undertake appropriate\textsuperscript{257} efforts to inquire into the transferee's entitlement, it forfeits the protection under the \textit{bona-fide} subsequent transfer exception and cannot assert to have acted in good faith.\textsuperscript{258}

\textbf{3. Certificate of Title in Motor-Vehicles Cases}

In the area of consumer financing, motor-vehicles represent the most commonly preferred collateral. Apart from the fact that motor-vehicles often represent a substantial part of the debtor's total assets,\textsuperscript{259} such preference appears to be owing to the certainty of priority among conflicting security interests in motor-vehicles. This certainty is based on the public nature of the motor-vehicle's certificate of title, Kraftfahrzeugbrief. The certificate of title only shows who the 'keeper of the motor-vehicle Kraftfahrzeughalter' not necessarily who the owner is.\textsuperscript{260} Nevertheless, an unbroken line of authorities has established the rule that the certificate of title has a 'negative bona fide effect', "Negative Gutglaubenswirkung", for the acquisition of ownership.\textsuperscript{261} According to the customary standards, not the mere possession of the motor-vehicle, but the possession of the vehicle together with the possession of the certificate of title, identifies the owner.\textsuperscript{262} Thus, the transferee lacks good faith when he does not receive possession of the certificate of title from the transferor.\textsuperscript{263}

\textsuperscript{257} \textit{i.e.} obtaining a confirmation of ownership from the transferee is not sufficient. Judgments of BGH, LM BGB § 932 Nr. 29 and 1978 WM 1028, both cited in PALANDT, supra note 143, BGB § 932 cmt. 10, at 1136.


\textsuperscript{259} 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{262} BGB § 932 cmt. 18, at 330.

\textsuperscript{263} 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. OLG Duesseldorf, 1992 NJW-RR 381; OLG Karlsruhe, 1989 NJW-RR 1461;
A diligent transferee will refrain 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 for which the certificate is issued. This way, the certificate of title avoids conflicts of security interests, and even in the case of a conflict, it unquestionably prefers the creditor who possesses the certificate of title.

D. Inferiority of the Bulk Assignment to the Subsequent Extended Reservation of Title

Contrary to the priority rules under the U.C.C., the inventory supplier’s extended reservation of ownership is strictly preferred to the bulk assignment to other creditors for reasons of fairness. It is well established that a bulk assignment for security purposes is valid, if it refers to the claims over the inventory that is subject to the supplier’s extended reservation of ownership. The inventory suppliers typically have the purchase money secured by extended reservation of ownership in the goods they supply. In the event of a prior bulk assignment to the lender, the debtor could not validly assign the proceeds again to his inventory supplier. Due to the business debtor’s apparent need for supply, the lender insisting on a bulk assignment, thus, intentionally—at least foreseeably—compels the debtor to breach his contract with the supplier. Therefore, the bulk assignment is deemed unconscionable.

This ‘breach-of-contract’-doctrine (Vertragsbruchlehre) has been challenged by scholars advocating a sharing of the proceeds among the assignees-creditors per quota. This ‘sharing’-doctrine (Teilungslehre) lacks any statutory basis and therefore must be rejected. Moreover, the supplier’s security interest is designed to secure the present debt of a single transaction, i.e., the purchase of certain goods; the bulk assignment to the primary financer is made 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 usually made at the beginning of the debtor’s business operations, the bank’s security interest would almost always be first in time and thus gain priority over subsequent interests of the inventory suppliers under the strict first-to-create priority rule.

(as cited by Peter Bassenge in PALANDT, supra note 143, BGB § 932 cmt. 13, at 1137). Whereas the OLG Hamm, Judgment of Jan. 13, 1964, 5. Senat, 17 NJW 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.
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 secrecy of the secured transactions. Deviating from the pledge system as the sole statutory means for a security interest in personal property, the modern practice has developed a system of security instruments which grant the secured party constructive possession over the collateral but allow the debtor to continue the actual possession of the collateral. Neither the judiciary nor the legislature has created a public-notice requirement similar to the public filing system in the United States. Thus, the German law on secured transactions completely supports the debtor's interest in the continued use of the collateral and in the secrecy of the secured transaction. Consequently, the secrecy causes ostensible ownership problems and uncertainty among secured creditors regarding the priority.

In a far reaching response to such uncertainty, the courts have established a mesh of rules subordinating various security interests to the others, generally to the disadvantage of the banks who are primary general lenders. Complete protection is provided for the suppliers of the inventory who are assured of the right to the proceeds from the sale of the inventory, so long as they obtain an extension of their reserved ownership.

The courts have responded to what they saw as unfair advantages of the banks. These advantages spring from being the first secured creditor and having the power to stipulate or dictate security agreements with the debtor. The priority rules purport to limit these powers of the banks. The bank must investigate the rights in the prospective collateral, and it must regularly rely on the debtor's statements regarding the closing dates of even informal security transactions. The bank faces the risk of subsequent 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 they have to bear the burden of diligent inquiry and uncertainty regarding a potential conflict of security interests.
I. ADVANTAGES AND RISKS UNDER THE PUBLIC-NOTICE-FILING SYSTEM OF U.C.C. ARTICLE 9

Compared to the German laws on secured transactions the public-notice-filing system under U.C.C. Article 9, with its first-to-file priority rule, establishes more certainty and predictability among competing secured creditors. However, this advantage 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 in the case of the debtor's bankruptcy. The question of proper filing gives rise to a significant volume of litigation, especially in bankruptcy settings where the trustee in bankruptcy often challenges the adequacy of a particular filing. In addition to the possible cost of litigation, there are costs involved in the preparation of the financing statement and its filing.

The searcher of the records, the subsequent creditor, bears the risk of being mislead by the trivial errors in the financing statement and from clerical mistakes in the indexing process by the officer in the filing office. The searcher, therefore, may grant credit to the debtor without discovering a prior security interest.

The creditors under the German system do not incur the same costs, but they must depend on the debtor's representations regarding the existence of prior securities without being able to verify the debtor's truthfulness through a public filing system. The priority rules are designed to reduce the risks creditors face in the secretive and informal system. Therefore, creditors are normally disappointed only when the debtor has misrepresented, when the creditor himself has not employed due diligence in its inquiry, or in the event of a subsequent good faith transferee.

II. ECONOMIC BENEFITS OF THE PUBLIC-NOTICE-FILING SYSTEM

From an overall economic perspective, U.C.C.'s first-to-file priority rule and the public-notice-filing system seem to be more efficient than the informal and secretive German system. The assurance of priority to the first creditor who "stakes his claim" by filing a financing statement encourages financers to provide businesses with initial credit and thereby increases economic activity. Moreover, financers have an incentive to monitor and counsel debtors in financial matters, which helps the debtor to effectively
manage business finances. Since the financer "signals" the debtor's creditworthiness through the public-notice-filing system to the credit market, subsequent creditors are generally enabled to make an informed credit decision and thereby minimize "overlending". Contrarily, the uncertainty of priority under the informal German system tends to inhibit credit decisions and thus paralyzes economic initiatives.

III. BALANCE OF INTERESTS UNDER THE PUBLIC-NOTICE-FILING SYSTEM

The public-notice-filing system under U.C.C. Article 9 generally provides a more balanced compromise of the conflicting interests than the German system, which lacks any defined policy in this area. The public-notice-filing system creates certainty of priority among creditors and transferees and thereby overcomes the problems of the debtor's ostensible ownership. Even though the filing secured party bears the risk of both erroneous filing and clerical mistakes, this risk allocation seems adequate since the filing party is the cause for the error or mistake.

Article 9 does not require the filing creditor to disclose any trade secrets contained in the terms of the transaction, but a mere notice of the existence of the transaction. 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 need for certainty, which was initially assured under the BGB. Therefore, the imbalance of interests under the German legal system is disproportionate.

IV. POLICIES OF EFFICIENCY AND FAIRNESS AND THEIR IMPACT ON INTERSTATE COMMERCE IN THE UNITED STATES AND GERMANY

The German courts have developed a system of priority under the principle of fairness in the conflict between principal financers and inventory suppliers. Under German law, the floating lien of the principal lender is generally subordinated to the supplier's reservation of title, which extends to the proceeds from the resale of the goods. In establishing this principle, the courts were concerned that the general rule of first-to-create priority would allow the banks to always prevail over subsequent creditors since the banks

264 Kanda & Levmore, supra note 16, at 2142.
are routinely the first creditors of the business. Moreover, the banks are often exceedingly oversecured, collateralizing debtor's personal property as well as land charges. In contrast, the supplier has nothing else but the delivered goods serving as security for the purchase money. The supplier virtually depends on the priority of the retained ownership in the delivered goods.

Furthermore, the banks ultimately benefit from the supply of goods since they enable the debtor to continue the business and make loan payments to the bank. It would be unfair to let the banks share from these benefits and leave the risk of default with the supplier.

In addition, a binding effect of the bank's security agreement with the debtor depriving the supplier of the ability to secure the purchase money would contradict with the fairness principle in contract law which prohibits contracts that harm third parties. It is especially unfair because the primary lender, the banks, know that the debtor will and must engage in supply transactions to run the business. In contrast, the U.C.C., preferring the principal lienor over the supplier, focuses on economic and social efficiency instead of fairness.

The assurance of priority to the principal lender gives an incentive to the credit market to be the first financer of a business and thereby increase economic activity. It also reduces the risk premium reflected in the interest rate and compensates the principal financer for monitoring and counselling the debtor for the benefit of the credit market, which receives notice of the debtor's creditworthiness through the filing system. Subsequent creditors can, therefore, make informed credit decisions and 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 insofar as it concerns 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.\textsuperscript{267}

The ignorance of German lawyers and businessmen about the impact of the efficiency principle in secured transactions under the U.C.C. and the overall inferiority of the supplier's security interests, in particular, had a disastrous outcome in \textit{Hongkong and Shanghai Banking Corp., Ltd. v. HFH USA Corporation}.\textsuperscript{268} In this case a German supplier sold and shipped machinery under reservation of ownership to his customer in the United States.\textsuperscript{269} A financing statement was not filed until the supplier became aware of the buyer's financial difficulties. At the time of the filing the grace period for filing had already expired,\textsuperscript{270} so that the purchase money security interest could not defeat the priority of the floating lien of the debtor's principal financer.

The New York court refused to enforce a choice-of-law clause in the sales contract which provided that German law, including the reservation of title, shall govern the sale. The court recognized that the floating lienor would have been subordinated to the supplier, if German law were applicable.\textsuperscript{271} The court stated that the enforcement of the reservation of title according to the German laws would have offended the "fundamental purpose of \ldots 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.' "\textsuperscript{272} Remarkably, \textit{Hongkong and Shanghai Banking Corp., Ltd.} highlights the principal differences between the German and the United States' legal systems on securities in personal property.

\footnote{\textsuperscript{267} Other objections concern the facts that markets do not operate optimally and that participants in the market frequently act for other purposes than economic gain. \textsc{Roth}, \textit{supra} note 266, at 11-12.  
\textsuperscript{269} 805 F. Supp. at 139-45.  
\textsuperscript{270} U.C.C. § 9-312(4) (1990). The court acknowledged that the debtor had obtained possession upon arrival and storage of the machinery in the free trade zone in Buffalo, New York. 805 F. Supp. at 144.  
\textsuperscript{271} 805 F. Supp. at 140.  
\textsuperscript{272} 805 F. Supp. at 141 (citing \textit{Carlson v. Tandy Computer Leasing}, 803 F.2d 391, 394 (8th Cir. 1986)).}