Commercial Law: Priorities of "Future Advances" Under Previously Perfected Security Interests and Article 9 of the U.C.C.

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NOTES

PRIORITIES OF "FUTURE ADVANCES" UNDER PREVIOUSLY PERFECTED SECURITY INTERESTS AND ARTICLE 9 OF THE U.C.C.

Future advances financing is a useful credit device for both lender and debtor; and as such, is an important feature of Article 9 of the Uniform Commercial Code (hereinafter "UCC" or "Code"). Briefly, future advances lending calls for a lender to advance future installments of a loan, established either by a pre-determined schedule or at the discretion of the lender, and based on a security interest perfected at the time of the original installment.

Typically, future advances financing is used where a lender requires security for its loan and valuable property is legally available for use as collateral, and the collateral is sufficient to secure all or most of the advances. The lender, however, is unwilling to lend or the borrower is not in need of the entire contemplated amount at the onset, so they prefer to establish a line of credit. This allows closer supervision of the loan and more rigid policing of the collateral by the creditor, but the debtor pays no interest on the unused portions of the installments and postpones the incurrence of interest until the advances are actually made.

Future advances financing has been used with varied success in commercial transactions for many years. The drafters of the UCC, however, wished to reverse the "vaguely articulated prejudices against future advance agreements" which developed at common law and under chattel mortgage statutes. The desire of the drafters notwithstanding, confusion exists as to the relative priorities established under the filing provisions of the Code between creditors where the financing statement fails to indicate that the original security agreement is intended to cover future advances, and future advances are contemplated or have been made. The result is reluctance by lenders to extend credit. Loans may not be made when

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1. UNIFORM COMMERCIAL CODE (hereinafter "UCC"). The American Law Institute, National Conference of Commissioners on Uniform State Laws, 1972 Official Text. The U.C.C. was adopted in Wisconsin by the Laws of 1963, ch. 158 and is now found at Wis. STAT. ch. 401-409. Article 9 of the U.C.C. is found at Wis. STAT. ch. 409 and most revisions found in the 1972 Official Text were adopted by the Laws of 1973, ch. 215.


adequate collateral is available, or the original creditor is given
great leeway in establishing terms of a second loan.

Typically, this situation arises where the initial creditor lends
funds on a particular asset or class of assets for what he believes
to be a single loan. Funds are advanced and a proper financing
statement is filed in compliance with local filing requirements, but
no provisions are made for future advances. Before the debt is
repaid in full, however, additional funds are advanced or the loan
is refinanced with the intention that the original collateral form the
security for the new advances. No new financing statement is filed,
however. Between the time of the original loan and the refinancing,
a second creditor has lent money to the same debtor, creating a
perfected security in the same collateral. If the debtor becomes
insolvent, and the collateral proves insufficient to repay the loans,
both parties will claim priority. Neither the UCC comments or
judicial decisions aid in determination of the proper outcome. Wis-
consin is among the majority of jurisdictions in not having decided
this issue.

A lender in a jurisdiction without controlling authority con-
fronts a similar problem. No lender realistically expects the law to
apprise him of the business risks he faces in loaning funds in a
particular situation, but no business risk can intelligently be evalu-
ated unless a lender is fully apprised of the legal risks, and this the
UCC fails to do. The attorneys for each creditor can find support-
ing cases, and can only advise their respective clients that the law
is unsettled on this point. The original lender fears the original
financing statement will not secure later payments. The second
creditor, on the other hand, fears later advances by the original
creditor will preclude assertion of rights in the collateral. The per-
son seeking the loan, therefore, might have sufficient collateral to


5. The following cases have dealt with future advances in Wisconsin: John Miller Supply
Co. v. Western State Bank, 55 Wis. 2d 385, 199 N.W.2d 161 (1971); In re Glaue, 6 U.C.C.
Rptr. 876 (E.D. Wis. 1969); In re Zwicker, 8 U.C.C. Rptr. 924 (W.D. Wis. 1971); Barth
Brothers v. Billings, 68 Wis. 2d 80, 227 N.W.2d 673 (1975).

6. Wis. Stat. § 409.204 was amended by Laws of 1973, ch. 215 to conform to U.C.C.
1972 Official Text. Prior to that it read:

When Security Interest Attaches; After-Acquired Property; Future Advances

(1) A security interest cannot attach until there is agreement (subsection (3) of
Section 1-201) that it attach and value is given and the debtor has rights in the
collateral. It attaches as soon as all of the events in the preceding sentence have taken
place unless explicit agreement postpones the time of attaching.

(2) For the purposes of this section the debtor has no rights
justifies a loan, but not be able to secure one from either lender. While this might be a difficult situation for the second creditor, it is an intolerable situation for the person seeking the loan. The Code itself, however, offers no answer.

The Code unquestionably endorses future advances financing. Section 9-204(3) states:

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

The official comment to this section indicates that collateral "may secure future as well as present advances when the security agreement so provides." For a valid loan of this type, the parties need only execute a security agreement that provides for future

(a) in crops until they are planted or otherwise become growing crops, in the young of livestock until they are conceived;
(b) in fish until caught, in oil, gas or minerals until they are extracted, in timber until it is cut;
(c) in a contract right until the contract has been made;
(d) in an account until it comes into existence.

(3) Except as provided in subsection (1) a security agreement may provide that collateral, whenever acquired, shall secure all obligations covered by the security agreement.

(4) No security interest attaches under an after-acquired property clause
(a) to crops which become such more than one year after the security agreement is executed except that a security interest in crops which is given in conjunction with a lease or a land purchase or improvement transaction evidenced by a contract, mortgage or deed of trust may if so agreed attach to crops to be grown on the land concerned during the period of such real estate transaction;
(b) to consumer goods other than accessions (Section 9-314) when given as additional security unless the debtor acquires rights in them within ten days after the secured party gives value.

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

It now reads:

409.204 After-acquired property; future advances. (1) Except as provided in sub. (2), a security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral.

(2) No security interest attaches under an after-acquired property clause to consumer goods other than accessions under s. 409.314 when given as additional security unless the debtor acquires rights in them within 10 days after the secured party gives value.

(3) Obligations covered by a security agreement may include future advances or other value whether or not the advances or value are given pursuant to commitment (s. 409.105(1)).

History: 1973c.215.

7. U.C.C. § 9-204, Comment 5.
advances. The creditor must also file a financing statement with the Secretary of State and the county Register of Deeds, but, in accord with the "notice filing" objective of the Code, no specific information, other than reservation of the right to future advance secured by the named collateral, is required. Thus, it is fairly simple for the lender to enter a secured transaction providing for future advances. Nevertheless, some lenders have attempted to secure their future without making an exact compliance with the simple requirements of the Code. Later, the creditor may learn the price of his error.

The principal cases in this area holding a financing statement which fails to indicate the loan is secured by future advances, and is filed by the original creditor, will not give it priority over a secured creditor lending funds and taking a security in the identical collateral are: Coin-O-Matic Service Co. v. Rhode Island Hospital Trust Co., Safe Deposit Bank and Trust Co. v. Berman. In Re Merriman and In Re Rivell are the leading cases holding to the contrary.

In Coin-O-Matic the debtor secured an automobile with a loan for its purchase which was assigned to defendant trust company. The debtor then borrowed money from plaintiff, Coin-O-Matic, who took a security in the same vehicle. The trust company subsequently refinanced the original loan, cancelled the original security agreement, and took a new note from the debtor. The original financing statement was not terminated, and the debtor owed money to the defendant trust company at all times. The debtor then went bankrupt. Priority was granted to the second creditor, Coin-O-Matic. The court rejected defendant trust company's argument that the express provision for future advances in section 9-204(5) is merely permissive. The court reasoned that such a rule would stymie commercial transactions and create a great deal of uncertainty for other creditors as to the existence of future advances. The court found only one security agreement contemplated by only one loan, and without express provisions in the

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10. 393 F.2d 401 (1st Cir. 1968).
14. Laws of 1963, ch. 158, § 409.204(5) (now Wis. Stat. § 409.204(3)).
agreement, a filed financing statement could not act as an umbrella for future advances to the detriment of other creditors. The original creditor, therefore, lost his priority.

*Safe Deposit Bank and Trust Co. v. Berman,*\(^{15}\) similarly holds that the original creditor fails in his claim for priority. On June 26 the plaintiff bank and the debtor entered into a loan agreement. On July 30, a substantial sum was lent on a note providing for a "security interest in accounts receivable, contract rights, etc., under agreement dated 6-26-63; also in equipment, etc., under security agreements dated 5-6-63 and 7-30-63."\(^{16}\) The July agreement was intended "to secure payment of the Total Debt . . . and also any and all liabilities of the debtor to secured party under this agreement or said note or notes or any renewals or extensions thereof."\(^{17}\) The security interest was perfected and later advances were made upon notes with the same language found in the July note. The initial note, meanwhile, had been paid off in September.

When the debtor went bankrupt, the bank attempted to argue that either the perfected July security agreement covered future advances or that each note for each advance constituted a security agreement in itself. The court did not agree. It held that the original agreement had provided for renewals or extensions of the July note but not for future advances. The court found no merit to the bank's argument that language on the notes would properly cover the deficiency in the security agreement. It felt that to hold otherwise would create unneeded confusion in commercial financing and supported its ruling by finding, as the court in *Coin-O-Matic* did, that the agreement contemplated only one loan and to hold any other way would unfairly harm subsequent creditors who relied upon the repayment of the original loan. In this case the intervening creditor was not a second secured creditor, but a trustee in bankruptcy, although that fact should make no legal difference. A trustee in bankruptcy takes the power of a secured creditor as of the date of the filing of the petition in bankruptcy.\(^{18}\) Presumably, an intervening judgment creditor could also take advantage of the *Coin-O-Matic* rule.

*Coin-O-Matic, Safe Deposit Bank* and supporting cases\(^{19}\) pay

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15. 393 F.2d 401 (1st Cir. 1968).
16. *Id.* at 402.
17. *Id.*
particular attention to the mechanics of the various Code provisions. The Code requirement for a properly perfected security agreement is not particularly burdensome, and provides, as was pointed out by a Florida court, for flexibility in shaping credit arrangements to fit a particular situation. A security agreement may provide for a line of credit or for a single loan. It may also call for a security in specific collateral, a class of collateral, or for a security on each of a debtor’s assets. Provision is also made for a second or third credit agreement securing the same assets, but for each credit arrangement the provisions of the Code that relate to that particular agreement must be complied with to advise a subsequent creditor of the debtor’s status. When those requirements are not met, the *Coin-O-Matic* rule voids the security. The requirements are not complicated, and the burden is not onerous. The penalty for failure to comply, therefore, is not harsh.

*In re Rivet,* and the cases that follow hold otherwise. These cases take a much more philosophical view of the application of Article 9 in this situation, and view the entire pattern of subsequent loans perfected by the original financing statement as a continual debtor-creditor relationship. This diverges from the more mechanical application of specific Code provisions.

The leading case in support of this proposition, and the case apparently most in accord with the revision committee of the UCC, is *In re Rivet.* In that case the court overruled a lower court. A lender filed a single financing statement and subsequently made four additional loans, making each prior note and mortgage as “refinanced and included in the new note.” The lower court held that section 9-204 was not complied with because the original security agreement filed did not provide for future advances, nor was a new financing statement with each succeeding loan. The referee in bankruptcy disregarded the creditor’s “notice filing”

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21. *In re Sanelco,* 7 U.C.C. Rptr. 65 (M.D. Fla. 1968).
22. *Id.*
27. *Id.* at 375.
argument and ruled that in light of the available alternatives for securing the later loans, which were not complied with, the later loans were unsecured. The district court reversed holding that, while the later loans were technically not future advances in the absence of an express security agreement provision, the “first to file” rule was invoked by the filing of the initial financing statement. The court found an agreement, value, and attachment for each subsequent loan. Therefore, despite the haphazard order of perfecting, a valid security interest had been created. Since the Code merely provides for a notice filing system, it is incumbent upon prospective creditors to look beyond the financing statement for information. A single security interest was created and the lender had priority as to all four subsequent loans.

*In re Merriman* involved a very similar fact situation and the same result as *In re Rivet* was obtained. There the court placed particular emphasis on a continuous creditor-debtor relationship. As such, the court pointed out, no prospective lien holder could have been misled by the arrangement. The collateral had not been changed nor had the parties sought any change in their relationship. In essence, this court also relied on the notice filing aspect of perfection under the UCC.

The fundamental concept on which *In re Rivet* was grounded is the Code’s system of notice filing. The burden of investigation is placed on the subsequent creditor. A financing statement is deemed sufficient to cover any later loans even where the original security agreement did not contemplate any later loans. The rule of *Rivet* has been characterized as the “better rule.” Indeed, in the Preliminary Draft Number 2 of the UCC, the Review Committee for Article 9 addressed itself to the problem of priorities when subsequent loans are secured by an earlier financing statement and concluded that *Rivet* more accurately reflected the intent of Article 9 than *Coin-O-Matic* and *Merriman*. The Committee emphasized the notice filing aspects of the Code and the fact that section 9-402(1) expressly allows for the filing of a financing statement where there is no security agreement and that section 9-204, which outlines future advances requirements, is limited to security agree-

32. 4 U.C.C. Rptr. 234.
ments and does not include financing statements.\textsuperscript{33}

Unfortunately, as unquestionable as the Review Committee's logic might be, in reality it introduces an entirely new dimension to secured credit financing that, apparently, was not even considered by the Committee. A subsequent creditor will be most reluctant to lend funds on an agreement that takes security in a previously encumbered asset. As long as the original creditor has even one dollar remaining in the asset, it is possible for him to loan up to the full loan value of the collateral and preempt any creditor who takes a junior security in the same collateral. This also makes it more difficult to ferret out the various loans and potential loans, of course, which can only increase the initial amount of money tied up in loan service. This will be of a relatively insignificant amount for large commercial borrowers, but of a more meaningful amount for the small business. More importantly, the \textit{Rivet} rationale inevitably ties the debtor to the original creditor should he wish to borrow more money on the same collateral, even if the funds are available at better rates elsewhere.

A prudent investor will be most reluctant to lend money where a valid financing statement covers the collateral that will form the basis of the security in the second loan for fear of losing its security in the collateral by a future loan by the original creditor. For example, A enters into a perfected security agreement with B whereby B will lend $25,000 to A and take a security in X, B's principal asset. Later A seeks to borrow $10,000 from C for capital expansion and has repaid $20,000 of his original loan to B. B also wishes to make the second loan to A but at substantially higher interest rates. B, therefore, refuses to partially terminate his security interest in X. Under the "better" \textit{Rivet} rationale, C could not lend A the $10,000 and perfect a security interest in X, and B later lend A another $20,000 ($5,000 still remains to be paid on the original loan). A would have a security interest in the first $25,000 of X or the full amount. C would then be an unsecured creditor. This development clearly upsets the normal debtor-creditor relationship and places the final decision as to which creditor will make the second loan not in the hands of the debtor, but, for all practical purposes, in the hands of the original creditor. The resulting role reversal was not bargained for or perhaps even contemplated. The result, however, is clear.

\textsuperscript{33} U.C.C. Preliminary Draft \#2, p. 1094.
Moreover, this can also be used as a device for maintaining artificially high interest rates. In a market of declining interest rates, the original high interest rate lender effectively precludes a partial refinancing of the original loan by a second creditor seeking a security interest in the original collateral. Unless the second creditor has sufficient funds to cover the entire value remaining on the original he faces the same prospect of being frozen out of his security interest as the second creditor did in the example above. Again, the original creditor is given substantial control over the debtor's later decision — control, it might be pointed out, that was never bargained for. This situation clearly works to the benefit of the large commercial lenders, lenders experienced in the field of secured loans. This is not a situation where different notes are reissued covering the same collateral and the same agreement without any further advances of funds. In this situation the debtor who cannot fully repay his original loan, thereby forcing a termination of the original financing statement, might wish a second loan or a partial repayment at lower interest rates than offered by the original lender, but no prudent creditor could take a security in the collateral without fear of losing its security interest.

The further advantage of the rule in *Coin-O-Matic* not found in *In re Rivet* is that it is self-regulating, but maximizes the loan potential of an asset. Under *Coin-O-Matic* a debtor can never borrow more than 100% of the value of its collateral but should have no legal problem finding a lender willing to take a security in the unsecured portions of the asset should the original creditor be unwilling to make the subsequent loan. If A, in the above example, should borrow $25,000 from B, securing the loan with asset X which is worth $25,000, and A repays $10,000 of the original loan, he is only in a position to borrow an additional $10,000 from B or C. Under the rule in *Rivet*, A could borrow $10,000 from C securing the loan with a junior lien on X. A could still borrow $10,000 from B and give security to B for 100% of the loan. Under *Coin-O-Matic*, B would be an unsecured creditor, for all practical purposes, as to the amount of the second loan.

As the situation stands today, a jurisdiction is free to choose between the *Coin-O-Matic* line of cases or the "better rule" of *In re Rivet*. It is submitted that the Article 9 Review Committee's endorsement of *In re Rivet* was not based on the practical effect

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34. Which distinguishes it from 292 Minn. 277, 194 N.W.2d 775 (1972) at note 31, supra.
the Rivet rule would have vis-à-vis the debtor-original creditor relationship when the second loan (or refinancing) is bargained for. With a little thought of the unwarranted and unbargained for control this places at the disposal of the original creditor, who may never even have intended any subsequent loans, the "better rule" may be the rule in Coin-O-Matic rather than In re Rivet. The burden placed on the original creditor is not onerous and the cost is nominal. The bargaining position of the debtor in relation to the original creditor is restored to what it should be, a choice among competitors. In short, even without official sanction, the rule in Coin-O-Matic may prove to be a better policy decision. One thing is quite clear, however, and that is whichever position is adopted, either legislatively or judicially, it is a situation that calls for resolution.

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