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FINANCING DEALERS:
Existing Wisconsin Law and the Uniform Code

CHARLES BUNN*

I

ON MERCHANDISE STOCKS

Some years ago a Wisconsin lawyer put to me this problem:
Client owns a drug store. He is retiring and has arranged to sell
the business to his former manager. The price has been agreed; the
buyer can pay half of it in cash; the balance is to be secured on the
property sold, and paid off in installments over five years. What kind
of effective security can the buyer give?

This led, at once, to questions as to what the property was. "Does
the store own real estate which could be mortgaged?" "No, it is in
a rented building and the rent is about what the property is worth,
so the leasehold would not be valuable as security." "Are there fix-
tures and equipment?" "Yes, but they are not worth enough to be
security." "Are there single large items in the stock that could be
sold on conditional sale and released individually when paid for, like
automobiles?" "No luck. It's a thousand small items. You can't ask
a customer to wait for a release when he buys a tube of toothpaste."
"Is some of the stock in a warehouse, so that negotiable receipts could
be pledged?" "Not much. Most of it is on the shelves or in the cellar."
"Are there accounts receivable? If so, he could assign them". "Only a
few. It's mostly a cash business." "Has the buyer got a house or
other outside property that he could pledge or mortgage?" "He is
using that as far as it will go to raise the cash down payment."

So there we were. The remaining possibility seemed to be a
mortgage on the merchandise itself, with permission to the buyer
to sell items in the ordinary course of business and apply the proceeds
to make replacements, pay expenses and pay off the mortgage debt,
with new merchandise becoming subject to the mortgage in place
of what was sold. A perfectly sensible transaction and the client
thought a perfectly sensible security, but my friend the lawyer had to
tell him it was pretty sour.

*Professor of Law, University of Wisconsin; Chairman, Wisconsin Bar
Association Committee on Uniform Commercial Code.
Why was it sour? This requires a little history.

Before 1887. In this period the law depended wholly on the cases. A mortgage of the sort suggested was ineffective as security for two reasons:

(1) Permission to the mortgagor to sell the mortgaged property and to apply any part of the proceeds to anything except the mortgage debt made the mortgage fraudulent in law, and ineffective against general creditors, and (2) any clause subjecting after-acquired merchandise to the security was ineffective, since one could not mortgage what he did not yet own.

1887-1951. In this period the common law was supplemented by a series of Acts (now 241.14, Statutes).

The first Act, that of 1887, apparently assumed, and correctly so, that a mortgage of a merchant's stock in trade was valid although the mortgagor remained in possession with authority to sell, provided all the proceeds of such sales were to be applied, and were applied, against the mortgage debt. It added the requirement of periodical reports of sales and of additions. If these reports were not filed at the time provided, the mortgage became immediately due and payable, and fifteen days thereafter ceased to be a lien except as between the parties. These provisions remain in force with changes in the time and filing places of the required reports.

The Act of 1913 limited this to cases where the mortgage so provided. This continues in the present law. It is therefore clear that one of the old troubles of the stock-in-trade mortgage no longer exists: an after-acquired property clause is effective if the mortgage is otherwise within the law.

2 Place v. Langworthy, 13 Wis. 704 (1861); Steinart v. Deuster, 23 Wis. 136 (1868); Blakeslee v. Rossman, 43 Wis. 116 (1877); Anderson v. Patterson, 64 Wis. 557, 27 N.W. 541 (1885); see Mortgages on Stock in Trade, 1947 Wis. L. Rev. 453.

2 Chynoweth v. Tenney, 10 Wis. 397 (1860); Mowry v. White, 21 Wis. 422 (1867); see Chattel Mortgages on After Acquired Property, 23 MARQ. L. Rev. 80 (1939). The proposition that after-acquired property cannot effectively be mortgaged seems still to be the law of the State, except in the particular cases where statutes provide otherwise. Wisconsin Valley Trust Co. v. Hotel Wausau, 214 Wis. 317, 251 N.W. 218 (1934); Kohler Improvement Co. v. Preder, 217 Wis. 641, 259 N.W. 833 (1935). Statutes which do provide otherwise are e.g. Wis. Stats. (1951) §182.025 (public utility companies); Wis. Stats. (1951) §241.14 (stock in trade), and Wis. Stats. (1951) §241.145 (2) (factor's lien act).

5 L. 1887, c. 241; Wis. Ann. Stats. (1889) §2316 (b); L. 1895, c. 11; Wis. Stats. (1898) §2316 (b); L. 1913, c. 575; L. 1921, c. 49; L. 1925, c. 4; Wis. Stats. (1925) §241.14; L. 1927, c. 355; L. 1929, c. 525, §2; L. 1931, c. 291, §2; Wis. Stats. (1951) §241.14.

3 L. 1887, c. 241; Wis. Ann. Stats. (1889) §2316 (b); L. 1895, c. 11; Wis. Stats. (1898) §2316 (b); L. 1913, c. 575; L. 1921, c. 49; L. 1925, c. 4; Wis. Stats. (1925) §241.14; L. 1927, c. 355; L. 1929, c. 525, §2; L. 1931, c. 291, §2; Wis. Stats. (1951) §241.14.


5 L. 1895, c. 11; L. 1913, c. 575; Wis. Stats. (1951) §241.14.
None of the Acts say anything about the application of the proceeds of sales to anything except the mortgage debt. In and after 1900 the Court concluded, in view especially of the amendment of 1895, that use of the proceeds to pay for replacements of stock, as well as on the mortgage debt, was probably permitted. But the Court has never gone beyond that. Any permitted application of the proceeds by the mortgagor to anything except renewal of the mortgaged stock and payment on the mortgage debt brought into effect the common law with all its rigor. The mortgage was fraudulent in law, however honest in intention, and ineffective against other creditors.  

This was and is the trouble with any mortgage on a merchant’s stock in trade, except those covered by the Factor’s Lien Act of 1951. The merchant needs to run his business and to live and must somehow pay rent, wages, taxes, heat, light, telephone and his own family’s bills; as well as cost of merchandise and mortgage debt. The mortgage creditor (unless the loan is for a very short period indeed) can hardly avoid knowing that these other things are being paid out of gross sales. If he does know and does nothing about it, he is likely to be held to have consented. And if he has consented his lien is gone. So when such loans were made under the advice of careful counsel, it was common to require the debtor to pay over his gross proceeds every day or every week and loan part of them right back to him on a new mortgage. It is not at all surprising that there was pressure for a change.  

Since 1951. The change came with the Factor’s Lien Act of 1951. By that Act “any person . . . engaged . . . in the business of lending or advancing money on the security of merchandise” may, by agreement, take as security “a continuing lien upon all merchandise of the borrower generally described in such agreement . . . regardless of whether . . . such merchandise . . . shall be in existence at the time of creating the lien . . . and upon any accounts receivable or other proceeds resulting from the sale or other disposition of such merchandise”. Notice of the creation of the lien must, of course, be filed, and thereupon the lien “shall . . . be effectual upon . . . the merchandise from time to time described in the written agreement . . . .

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6 Durr v. Wildish, 108 Wis. 401, 84 N.W. 437 (1900); Ross v. State Bank of Trego, 198 Wis. 335, 224 N.W. 114 (1929); Morley-Murphy Co. v. Jodar, 220 Wis. 302, 264 N.W. 926 (1936); Knapp v. Milwaukee Trust Co., 216 U.S. 545; see Mortgages on Stock in Trade, 1947 Wis. L. Rev. 453.  
7 L. 1951, c. 486; Wis. Stats. (1951) §241.145. The act follows a model enacted in a considerable number of states. A “factor” under it is not the familiar figure who sells another’s goods, but “any person . . . engaged . . . in the business of lending or advancing money on the security of merchandise, whether or not they are employed to sell such merchandise.”  
8 Wis. Stats. (1951) §241.145 (2).  
9 Wis. Stats. (1951) §241.145 (3) and (4).
as against all claims of unsecured creditors of the borrower and as against subsequent liens of creditors . . . .” The agreement also operates “as an assignment of the accounts receivable which will result from the sale and other disposition of the merchandise” as fully as if an assignment had been perfected following each sale. And finally, reversing the existing law on the main point, “failure of the factor to require the borrower to account . . . for the proceeds of merchandise sold or . . . for moneys received on any account receivable resulting from the sale of merchandise” does not invalidate the lien.

The Act follows a pattern which has become familiar in the law of a number of states. Its evident purpose is to make general liens on fluctuating stocks of merchandise secure and this it does, as fully as a State law can, in favor of some people. The strange thing is that the people who can take advantage of it are so limited. They consist of “any person . . . engaged in whole or in part in the business of lending or advancing money on the security of merchandise whether or not they are employed to sell such merchandise.” This includes banks, finance companies and old-fashioned factors who make advances to their clients, but excludes sellers of merchandise, or of the business itself (as in the case with which this paper started) and persons who make an occasional loan but are not in the business of lending. To all such persons the general lien of the Act is denied, and they are left to the rigors of the prior law.

The reasons for the discrimination are not stated in the Act. The Bill was, of course, proposed primarily by the benefited groups, but we do not know why the legislature thought it wise to exclude so many others from its benefits. It may, perhaps, be argued that the exclusion denies the equal protection of the law to the excluded groups. I do not now explore that question, since, if the Act were held invalid, the result would not be to extend the new security to those now excluded from its use but to deny it to everyone. Assuming that the Act is valid, the present situation is that persons in the business of lending money on the security of merchandise can take valid and effective liens on a merchant’s fluctuating stock in trade, even though they permit the debtor to apply the proceeds of

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10 Wis. Stats. (1951) §241.145 (6) and (9). The persons not subject to the lien are purchasers of merchandise in the ordinary course of business (§(5) (a)), like assignees for value of conditional sales contracts or chattel mortgages made by the merchants’ customers (§5) (b), unpaid sellers to the merchants who take chattel mortgages (§5) (c), and holders of specific liens for processing, warehousing or shipping (§6).
11 Wis. Stats. (1951) §241.145 (10) (c).
13 §§(1) (a), (2).
his sales to pay his business and/or personal expenses, but that no one else may do so.

The 1953 legislature has enacted the Uniform Trust Receipts Act. This act will undoubtedly be useful here, as it has been elsewhere, in the financing of dealer’s purchases of automobiles and other like goods which can be separately listed in a trust receipt and accounted for when sold. But it has little practical operation in situations that require a general lien on a fluctuating stock of numerous small items with after-acquired merchandise included. For that one must still look, in Wisconsin, primarily to the Factor’s Lien Act of 1951.

_Under the Uniform Commercial Code._ If the Code should be adopted in Wisconsin, the general lien authorized by the Act of 1951 would be made available, with some variations of detail, to all comers.

Article 9 of the Code deals with Secured Transactions. Its general philosophy, stated as briefly as possible, is that agreed security should, within very wide limits, be legally secure provided others have a reasonable chance to learn that it exists, either from public notice or from possession by the creditor. In particular, the Code approves and validates a general lien on a merchant’s fluctuating stock and gives the parties complete freedom to agree as to how the merchant shall apply the proceeds of his sales. Let us see how this is worked out.

In the first place there is wide liberty of contract.

“Except as otherwise provided by this Act or by other rule of law or regulation, a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors.”

In particular, after-acquired property clauses are effective. Section 9-204 (3) says, with an exception not now material, that

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15 All references to the Uniform Commercial Code herein are to Official Draft, Text and Comments Edition, 1952. A few changes were approved after that print by the American Law Institute and the Conference of Commissioners on Uniform State Laws, and were embodied in the Pennsylvania Act of 1953, but none of these are material on the points covered in this paper. They may be found in a publication of the American Law Institute, “Recommendations of the Editorial Board for changes in the Text and Comments of the Uniform Commercial Code, Official Draft, Text and Comments Edition.” June 1 1953.
16 The literature about the Code is large and growing. For present purposes perhaps the most useful single thing, other than the Text and Comments themselves, is Harold F. Birnbaum, _Article 9-A Restatement and Revision of Chattel Security_, 1952 Wis. L. Rev. 348. Mr. Birnbaum is also the author of a forthcoming book on Article 9, to be published by the American Law Institute.
17 Uniform Commercial Code §9-201.
a security agreement may provide that collateral, whenever acquired, shall secure any advances made or other value given at any time pursuant to the security agreement.”

And it is not improper to permit the debtor to make sales from stock and use the proceeds in any way the parties may agree.

“A security interest is not invalid or fraudulent against creditors by reason of liberty in the debtor to use or dispose of all or part of the collateral . . . or to collect or compromise dispose of proceeds, or by reason of the failure of the secured accounts . . . or to accept the return of goods . . . or to use or dispose of proceeds, or by reason of the failure of the secured party to require the debtor to account for proceeds or replace collateral.”

If this should be enacted much red tape now required will no longer be essential for security. “Business and not legal reasons will determine the extent to which strict accountability, segregation of collections, daily reports, and the like will be employed.”

When a security of this sort is taken notice of it must be filed. The interest is perfected from the time of filing or, if no advance has then been made, from the time of the first advance under the agreement after filing. When goods are sold, it continues as a perfected interest in the proceeds if the agreement and the filed notice so provide. When goods come in under an after-acquired property clause the creditor's interest in them ranks from the same date as on the earlier goods.

The resemblance of all this to the Factor's Lien Act of 1951 is very clear. There are indeed differences in detail, which have been well spelled out by my colleague, Robert Skilton, in a schedule which is reproduced following this article. Only three of these, I think, are of much present moment.

(1) As previously stated, the protection of the Factor's Lien Act is limited to persons in the business of lending money upon merchandise. The Code provisions would be available to anyone.

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17 Uniform Commercial Code §9-205. See the Comment for the reasons for this section.
18 Uniform Commercial Code §9-205, Comment 5.
20 Uniform Commercial Code §9-303, 9-204.
21 Uniform Commercial Code §9-306. The sentence to which this is a footnote is a bald generalization, subject to various qualifications. The section cited contains careful provision for different kinds of proceeds, which are dealt with in different ways: It and the Comment to it should be consulted in detail.
22 Uniform Commercial Code §9-312 (1) and (3). These interests will not be good against buyers of goods from the merchant in the ordinary course of business (§9-307), certain purchasers of chattel paper (§ 9-308), holders in due course of negotiable paper and the like (§9-309) and persons holding liens for services upon the goods themselves, (§9-310). As to conflicts concerning proceeds, see §9-306.
(2) The Code makes substantial and, it is believed, sensible changes in the procedure on default.\textsuperscript{23}

(3) The Code tries, as the Factor's Lien Act does not, to deal with the bankruptcy question that arises when after-acquired property comes in under an existing lien within four months of bankruptcy.\textsuperscript{24}

So far as liens on fluctuating stocks of merchandise are concerned, the decision to enact the Code or not depends mainly therefore on the answer to two questions:

(1) Should such liens, when agreed to by the parties and notified to the world by public filing, be legally effective against other creditors?

(2) If so, should this be in favor only of persons in the business of lending money upon merchandise, or of any lender or seller who takes such a security?

II

ON Accounts Receivable

Financing on receivables has grown to a large extent in the United States.

An old and very respectable form of such financing is by the discount of trade acceptances. Seller ships a carload lot to buyer under contract and draws on him for the price, at 90 days' sight, bill of lading attached. Buyer accepts the draft, gets the bill of lading and receives the goods. The accepted draft comes back to seller or to seller's bank. It is now a trade acceptance, two name paper, eligible for discount and rediscount, and if the names are good is worth very near its face. Sellers to good buyers have been financed by the discount of trade acceptances for years.

The governing law is, of course, that of negotiable instruments. It has been restated, and the statement greatly simplified, by Article 3 of the Code (Commercial Paper), replacing the Negotiable Instruments Law of 1896. Changes in the law itself are few. The most important change at this point, if the Code should be adopted, is that the drawer of the draft will no longer be discharged entirely in all cases if presentment for payment is delayed beyond the proper date without excuse. He will, indeed, not be discharged at all by the delay unless the drawee becomes insolvent during the delay and the drawer "is deprived of funds maintained with the drawee . . . to cover the instrument", and in that case "may discharge his liability by written


\textsuperscript{24} \textit{Uniform Commercial Code} §9-108 (2), and comment thereto. See also Kripke, \textit{The Modernization of Commercial Security}, 16 \textit{Law and Contemp. Problems} 183, 194-195 (1951); Birnbaum, Article 9—\textit{A Restatement and Revision of Chattel Security}, 1952 Wis. L. Rev. 348, 357.
assignment to the holder of his rights against the drawee.” The same rule will apply to the acceptor’s liability if the acceptance is made payable at a bank and is not there presented when it should be, and the bank fails during the delay.\(^\text{25}\) This applies the substance of the old law about drawers of checks to the drawers of all drafts, and to acceptors of drafts payable at banks and makes the rule workable in practice. It ought to make no change in the commercial or banking use of trade acceptances.

Sellers, whose receivables are not merchants’ acceptances but consumers’ notes secured by chattel mortgage or conditional sales contract, also need financing and obtain it in large volume by assignment of the paper that they hold. Here the changes that the Code would make are probably not of major importance. The Code recognizes that in practice assignees of such paper sometimes take possession of it, and sometimes leave it in the possession of the merchant and permit him to make collections. Under the Code the interest of the assignee may be perfected either by possession of the paper or by filing,\(^\text{26}\) but, if it is by filing only, the interest is perfected only against creditors of the assignor and transferees “except a purchaser for new value and in the ordinary course of his business who takes possession of the paper and who does not have actual knowledge that the specific chattel paper is subject to a security interest.”\(^\text{27}\) Under the Code, an assignee of such paper who did not take possession but did file would need to stamp or mark the paper with a clear notice of his interest, so that no one could thereafter take possession of it without notice.

Where the receivables, which are the basis of the financing, consist of open accounts or of sums to become due under an existing contract, the Code makes an important change. Under existing Wisconsin law, such accounts and sums to become due may be assigned without notice either to the account debtor or to anybody else, and if the assignment is in writing and for value it prevails over all subsequent assignees and over every “future attaching, garnishing, judgment, execution, levying or other creditor” of the assignor.\(^\text{28}\)

This is a surprising situation. A business, which borrows on its least liquid assets (plant, fixtures, machinery, etc.) or on its chattel property, must give notice to the world by filing in a public office; but if the financing is on the security of the kind of property that

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\(^{25}\) For the old law: \textit{NIL} §§70, 186; \textit{Wis. Stats.} (1951) §§116.75, 118.62. For the Code provisions, §§3-501(1) (c), 3-502(1) (b) and Comments to both sections.

\(^{26}\) \textit{Uniform Commercial Code} §§9-302 and 9-305.

\(^{27}\) \textit{Uniform Commercial Code} §9-308. See also the Comment to this section, which describes the going practice and the reasons for the provision.

\(^{28}\) L. 1945, c. 206, 528; L. 1949, c. 582; \textit{Wis. Stats.} (1951) §241.28.
leads most directly into cash, current accounts receivable, the transaction may be completely secret. One would think that a bank or merchandise supplier, invited to extend credit to a business, would be more interested in the state of its accounts receivable than in liens on its fixed assets. But as the law stands, he must rely entirely on the business itself for information as to whether its accounts and contract rights have been assigned.

This situation the Code would change. Financing on accounts receivable and contract rights is, of course, contemplated and permitted by the Code and the interest of the secured party can be perfected as fully as on any other kind of property, but it can be perfected only by filing notice in a public office. If the Code should be adopted banks and merchandise suppliers, asked to give credit to a business, could find out from public sources whether or not its open accounts receivable and contract rights had been assigned.

The decision to enact or not enact the Code, so far as receivables financing is concerned, depends mainly on the answer to one question: Should public notice of the assignment of the open accounts receivable and contract rights of a business be required to make the assignment effective against other creditors and later assignees?

30 Uniform Commercial Code §9-302, 9-305, and Comments to both sections.
31 The only argument I have ever heard in favor of secrecy in receivables financing is that it is somehow regarded as an indication of a shaky financial position and may damage the firm's credit unduly if disclosed. I am convinced that if this was ever true, it is not true today.

Trade acceptances have been sold to banks and eligible for rediscount at Federal Reserve Banks for years. Surely the concerns which draw them on their customers and sell them to their banks are not in disrepute.

For the newer, but now very large and reputable financing on assignment of retail customers' paper, the automobile industry is the most conspicuous witness. But it is not the only one. For other industries perhaps a single great example will make the point sufficiently. The Statement of Financial Position of Sears, Roebuck and Co., in its Annual Report for the fiscal year ended January 31, 1953, p. 8, contains this entry on the asset side:

Customers Installment Accounts ............ $669,645,127
Less Sold to Banks ....................... 225,199,223

$444,445,904.

For financing on contract rights the witness is the history of prime contractors and their subcontractors with the government in World War II and since.

For financing on open accounts receivable, consult the great department stores.
### INVENTORY LIENS**

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**Outline prepared by Robert Skilton, Associate Professor of Law, University of Wisconsin.**
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