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AN ASSIGNMENT OF ACCOUNTS RECEIVABLE AS A SECURITY DEVICE

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An assignment of accounts receivable is a popular security device. The lender agrees to extend credit to the borrower and he demands security. The borrower agrees to pledge the accounts on his books to secure the loan. He furnishes the creditor with a formal list of the accounts. He agrees to furnish additional lists at specified times in the future. It is assumed by both that if the debtor does not pay when the loan matures the creditor can reach the accounts. Apparently the debtor can carry on business as usual and the creditor is protected against the debtor’s insolvency. There are no papers to be filed. Accounts receivable are “intangibles.” Subsequent creditors, it is asserted, are not “misled” by any “reputed ownership” in the debtor.

This appears to be an ideal security device for creditor and debtor. It seems to carry with it no burdens and few risks. But the Supreme Court of the United States has enunciated the doctrine of “unfettered use.” The creditor must be careful. A mere “assignment” will not protect him if his debtor defaults.

All assignment cases are not alike. There are professional lenders and there are non-professional lenders. There are banks which carry the debtors’ regular commercial accounts. And there are professional finance companies whose business is money-lending but who do not carry their debtors’ bank accounts. Among the debtors there may be retail distributors, manufacturers and jobbers. The accounts may be large or small, many or few. They may arise by reason of sales out of stocks of goods regularly made in the course of trade, or by reason of special orders to be filled in time according to particular specifications. The accounts assigned may be those presently on the books;

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1 Little has been written on assignment of accounts. Many of the cases are difficult to analyze. Frequently the opinions do not disclose what there is in the records to indicate how the various transactions between debtors and creditors have been carried out. The courts are not objective about “unfettered use.” Consequently the citations in this article cannot always be precisely in point with the text. But the schemes suggested in the text do represent more than hypotheses. They represent what are believed to be predictions that are logically and functionally acceptable and based upon the propositions declared in the few leading cases.


4 The word “assignment” is used both legally and descriptively throughout the text. It should appear from the context how it is used each time.
or a series of advances may be contemplated, or a series of renewals, and the parties may bargain about future accounts.

The leading case is *Benedict v. Ratner*. There the creditor was a non-professional lender. At least he was a private individual, a relative of one of the persons interested in the borrowing firm. The debtor already owed the creditor $15,000 when the new agreement was made. The creditor agreed to advance another $15,000, and eventually did so. The debtor gave the creditor its notes and also gave him a list of the accounts then on its books. The debtor agreed to furnish additional lists of new accounts at specified monthly intervals. And the debtor did furnish these additional lists. In the meantime the debtor collected some of the accounts and put the proceeds back into the business. The lists of new accounts were accepted in place of the old ones. Just before the petition in bankruptcy was filed against the debtor, demand was made upon him by the creditor to pay over the proceeds from collections. Some money was paid to the creditor.

There was a dispute between the trustee in bankruptcy and the creditor. The trustee wanted to get the money that had been paid to the creditor and the creditor wanted a decision by the bankruptcy court that the unpaid accounts belonged to him. The Court decided against the creditor on both contentions. The creditor had permitted "unfettered use" by the debtor of the proceeds derived from collections. As to restoring to the trustee what had been paid over before bankruptcy, the Court decided that it made no difference whether the creditor knew or had reason to believe that the debtor was insolvent when the proceeds were paid. He would have to account in any event because this was a fraudulent conveyance as a matter of law. The Court felt that a New York court would have so decided and this was a New York case.

A mere agreement between the lender and the borrower that the accounts outstanding shall "belong to" the creditor is not enough to give the creditor any security interest. Perhaps it does suggest to him that his debtor has assets in the form of accounts receivable, but it gives him no interest in the accounts. Nor would the delivery to him of a formally executed list of accounts outstanding be any more effective. That is what the creditor probably did have in the *Ratner* case. The debtor also must recognize the creditor's dominant interest in the proceeds from the accounts.

What acts on the part of each are sufficient to indicate that the debtor does recognize that dominant interest and that the creditor is demanding protection for it? A mere stamping of the debtor's books

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5 *Benedict v. Ratner*, supra, note 3.
with a statement of the creditor's claim would not be sufficient. The creditor's collecting the accounts and then paying any surplus to the debtor or making new loans and taking new assignments is adequate. But that would carry with it considerable burden to the creditor. It is the kind of burden which a professional financing company might be willing to carry for a prescribed fee. The debtor's collecting and depositing the proceeds into a separate account to which the creditor only has access would be enough, but the debtor might have to reach a part of the fund and use some of the proceeds to stay in business.

Must the bargain in any event cover only present accounts outstanding? The accounts may be potential, as for example where a contractor borrows from a bank to complete a job with the builder and assigns to the bank the retained percentages held by the builder under the terms of the building contract. Other persons may claim a security interest in the same fund, and while the lender's interest may be subordinated to that of another claimant, nevertheless, the assignment is effective. Future accounts may be assigned to replace old ones. That happens in bank cases. It may happen in other situations. Providing the bank or other creditor does not permit the proscribed "unfettered use" of the proceeds derived from collections on the old accounts the new assignment is effective to give the creditor a security interest in the new accounts. In some instances the accounts may arise out of the sale of merchandise in which the creditor has had a specific lien. The assignment of these future accounts without additional con-

7 Cf. In re Bernard & Katz, 38 F. (2d) 40 (C.C.A. 2d, 1930). In this case the court was trying to distinguish the facts from those in the Ratner case. The court seemed to be concerned about the matter of returned stocks covered by accounts already assigned. The court examined the record to discover whether the debtor had immediately substituted new accounts for the old ones affected by the returns. Obviously that could not be the only factor to discover with respect to the matter of "unfettered use." But the court did call attention to the difference in the case at hand as compared with the Ratner case in that in the instant case the creditor had reserved the power to collect the accounts. It is not disclosed in the opinion whether the creditor did make collections regularly.
8a A bank, as a creditor, can control a separate account without too much inconvenience to the debtor. As the proceeds are collected the debtor deposits them in a special account at the bank. The bank can permit withdrawals from this account as the debtor substitutes new security in the form of accounts receivable for the accounts already collected. Compare this with the statement in the text infra.
11 These bank cases and stocks of goods cases will be considered in detail in the paragraphs that follow.
consideration may be effective if the creditor insists on recognition of his dominant interest in the proceeds as collected.

This recognition by the debtor of the creditor's dominant interest in the accounts means payment of the proceeds by the debtor to the creditor as the accounts are collected. It means payment of all the proceeds to cut down the original indebtedness in whole or in part, or it may mean, in some instances, the substitution of other security, perhaps new accounts, under circumstances which indicate that the creditor is choosing, that he is deciding whether to keep the proceeds, to accept the additional security, or to make another loan.

The debtor may be a manufacturer or a processor. He owes a distributor of raw materials on an open account. Any subsequent assignment of accounts outstanding to secure the claim is a preference and that follows regardless of any conduct on the part of both indicating recognition of the creditor's dominant interest in those subsequent accounts. But the manufacturer may borrow from a finance company to pay the open account and to pay for more deliveries, and to secure the loan he may assign to the lender the accounts then on his books. The manufacturer may even get additional deliveries from the distributor by reason of an assignment to the latter of all or some outstanding accounts to secure the general balance between them. So long as the debtor pays over the proceeds as he collects them to the finance company or to the distributor, there is no "unfettered use." There are two important questions to consider. Have payments on the accounts been made to the debtor? Has he in turn purported to discharge so much of the indebtedness with his own creditor as he has agreed to pay out of each account? If he has done so then the creditor's claim to any unpaid accounts will not be affected adversely by the debtor's subsequent bankruptcy.

But suppose the creditor, the finance company or the distributor, permits the debtor to use the proceeds as collected without paying anything to the creditor to discharge any part of the balance between them. Suppose the creditor permits the debtor to so use the proceeds until the indebtedness matures. Or suppose the account between the two is an open account which is already due or that the creditor is a finance company and holds the debtor's demand note. No demand is made for payment or settlement. The creditor, until maturity, or after taking the note, accepts periodically new lists of accounts in place of those which the debtor has collected. The creditor would be permitting "unfettered use" of the proceeds. The case would be like Benedict v. Manufacturers Finance Co. v. Armstrong, 78 F. (2d) 289 (C.C.A. 4th, 1935). Manufacturers Finance Co. v. Armstrong, supra, note 12; In re Gotham Can Co., 48 F. (2d) 540 (C.C.A. 2d, 1931). See Irving Trust Co. v. Finance Service Co., 63 F. (2d) 694 (C.C.A. 2d, 1933). Irving Trust Co. v. Finance Service Co., supra, note 14.
Ratner. The creditor would be unprotected if the debtor were adjudged a bankrupt.

The creditor may undertake to make a series of advances to the debtor to enable him to carry labor costs and expenses of operations over a period of stress. Again the creditor may be a finance company or a distributor who has been selling his own product through the debtor. In any event he bargains with the debtor that in return for these advances which shall be made from time to time the debtor shall assign to the creditor the accounts arising from the sales of the debtor's stock in the immediate course of business.16 The proceeds as collected may have to be used in the debtor's business or new advances will have to be made by the lender. How can the creditor control the use of the proceeds and protect his interest in the accounts if the debtor is thereafter adjudged a bankrupt? That in the beginning the accounts are future accounts is not material. Perhaps the creditor will have to bargain for an assignment of all of the debtor's accounts, but this is a "continuing" transaction.17 It would seem that the proceeds will have to be paid to the creditor as collections are made with the creditor making new advances as the debtor needs them and crediting the debtor with the payment of the older loans. Perhaps it is sufficient if the parties arrange to set-off the payment of the proceeds against the new advances. Money is in the hands of the debtor. The creditor is informed about collections and new accounts. He can choose whether he shall carry the debtor or demand the proceeds. That is not "unfettered use."18

A professional lender, a finance company, or a non-professional lender, a private individual, for example, lends money to a broker to let him pay a manufacturer or wholesaler for goods to be delivered directly to the broker's customers.19 His customers are buying on thirty days credit. The credit accounts are listed and the list is sent to the lender. Notice of the assignment is given to each customer. If the

17 See In re Evansville Broom Co., note 16. Where the first advance is made and no accounts are assigned and bankruptcy intervenes before the debtor does business to create the accounts the creditor is obviously unsecured. However, if the accounts do arise subsequently and if a list is sent to the creditor but bankruptcy intervenes before any proceeds are collected the creditor's "equitable lien" may be recognized. In neither case has there been any "unfettered use." It is difficult to discover from the few cases available just what does amount to a "continuing transaction." Cf. Greey v. Dockendorff, 231 U.S. 513, 34 Sup. Ct. 166, 58 L.ed. 339 (1913) and Petition of Post, 17 F. (2d) 555 (C.C.A. 1st, 1927).
18 See Chapman v. Emerson, 8 F. (2d) 353 (C.C.A. 4th, 1925); In re Vanity Fair Shippers, 4 F. Supp. 83 (S.D. N.Y. 1933). The suggestion in the text which these cases illustrate is pertinent with respect to all of the cases considered where the creditor is willing to continue the loan.
proceeds are remitted through the lender and if he accounts in turn to the borrower the case is easy. The creditor assumes the burden of supervision but he does protect himself. If the accounts are paid by the customers to the broker it is the same problem. Does he pay over to the creditor? Is there a series of payments and a series of new loans? Or does the creditor let the indebtedness stand at some more or less fixed sum and does he perfunctorily accept new lists of new accounts as the debtor collects the old ones and continues to carry on business?

A manufacturer or a jobber may sell goods or raw materials to a storekeeper or processor on consignment. The shipper may also bargain for security in the accounts arising from re-sales by the debtor. Local filing statutes may affect the preservation of the security interest in the physical goods. But suppose the creditor does comply with the filing statutes. Does he have any interest in the re-sale accounts which he can enforce against the debtor's estate if the debtor is adjudged a bankrupt? He does have a security interest in the stock of goods. The accounts are future accounts but his "equity" will be recognized. His interest will be protected providing he has not permitted "unfettered use" of the proceeds from re-sales. Payment must be made by the debtor as he collects the proceeds. But he may want to keep his stock up to normal. He wants to check off payments against new shipments of goods. This creditor is not a banker. He must insist on payment by the debtor as the latter collects. The creditor may be willing to send additional shipments on consignment.

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21 Kemp-Booth Co. v. Calvin, 84 F. (2d) 377 (C.C.A. 9th, 1936); In re Burkhardt, 14 F. Supp. 12 (W.D. Mich. 1935). Cf. Midwest Production Co. v. Doerner, 70 F. (2d) 195 (C.C.A. 10th, 1934) and the Uniform Chattel Mortgage Act, Sections 17 and 19, Sturges, Cases on Credit Transactions (2d ed. 1936) Appendix. By filing a copy of the mortgage where the security is to cover a stock of goods to be sold in trade the creditor is protected with respect to future acquisitions and accounts from sales. The matter of paying proceeds as collected would still be important. (1936) 20 Marq. Law Rev. 199. It is to be noted also that where goods sold out of stock are returned and the accounts covering the sales have already been assigned and the parties have agreed that the debtor shall hold the returned goods for the debtor until a resale can be effected, the creditor has no interest in the goods which he can assert against a trustee in bankruptcy if he has not filed a copy of the agreement setting forth his claim in compliance with the local filing statutes. In re Bernard & Katz, 38 F. (2d) 40 (C.C.A. 2d, 1930); Irving Trust Co. v. Lindner & Bro., Inc., 264 N.Y. 165, 190 N.E. 332 (1934).
22 The solution as proposed in the text is consistent with the result in the Ratner case and other cases in which the courts have purported to follow the leading case, although in no one of the cases is the situation quite the same as that considered in the text.
23 If a number of shipments may be sent, sale on consignment becomes burdensome. The shipper may not want to file too often. But see Wis. Stat. (1937) § 241.26. Perhaps after the first shipment is made and the first accounts arise by reason of re-sales the creditor will be willing to carry the debtor on an open account and to take substituted accounts as security. The matter of "unfettered use" would be important. Perhaps there can be control of the proceeds by the creditor without frequent payments and new consignments. See the text above and footnote 18.
The bank cases are different from all the others. At least that is true where the bank carries the debtor's commercial deposit. Any loan by the bank to its client goes to build up the latter's bank account. After the loan is made the client is a debtor. The bank holds his short term paper, a thirty-day, a sixty-day or a ninety-day note. The debtor's accounts outstanding are pledged to secure the note. The debtor agrees to assign future accounts. Proceeds from collections are deposited in the commercial account. The bank can reach any balance in this account through set-off if the debtor is adjudged a bankrupt. But the bank cannot expect the debtor to keep the balance always at a level sufficient to cover the loan. Nor can the bank expect the debtor to carry his business overhead and to discharge the loan by maturity out of the proceeds from collections. If the note is in fact discharged on the books by reason of drafts drawn by the debtor and charged to the account, the probability is that the debtor will have to borrow again from the bank. The discharging and borrowing would perhaps be a matter of bookkeeping but even that can be burdensome.

Is it sufficient if the bank requires a new note every 30 or even every 90 days? Must the bank also insist that the debtor make reports periodically of outstanding collections and furnish statements of new accounts? Is the bank thereby in a position to control the use of the proceeds from collections? The bank is in a position different from that of the finance company, the lending jobber or the private individual. The bank has some control over the proceeds by reason of the fact that it can refuse to honor checks drawn upon the account unless the proceeds are used to reduce the indebtedness. It would seem that the bank can carry the debtor by taking new accounts and accepting renewals providing it does insist on daily or weekly reports of collections and assignments. By reason of the information which the bank thus gets, together with the bank's control of the debtor's deposits, it is in a position to make a choice between accepting or refusing to accept the substituted security and between continuing or refusing to continue the loan with the debtor. The bank can decide when the note matures whether it should renew or cut down or demand liquidation of the account. The bank's books would show a discharge of the old loan every time a renewal was accepted and the books would also show each renewal as a new loan. But that would entail much less bookkeeping and routine work than the other scheme of always paying up, before maturity, perhaps, by withdrawals, as proceeds from collec-

tions are put into the deposit, with the bank crediting the account with the proceeds of each new note. There will still be the probability that the bank may abuse its discretion even where it does have detailed information of the debtor’s deposits and new accounts receivable. If there is any suggestion that renewals are allowed perfunctorily that might support a finding that the bank has permitted “unfettered use” of the proceeds from the accounts.\(^2\)

To put these unenforceable assignment cases into the fraudulent conveyance category is unreal and unnecessary. Yet that is what the court did in the *Ratner* case. The payment of the proceeds to the creditor after the period of “unfettered use” by the debtor was not merely a preference, it was a fraudulent conveyance. The trustee did not have to begin a plenary suit to get back any payments. He did not have to show that the creditor had known anything about the debtor’s financial status. With respect to the unpaid accounts, of course, the assignee in a case like this is in the position of an unsecured creditor. But as to the proceeds paid over to him before bankruptcy he is worse off. He must pay back absolutely.

There is some reason to distinguish between the kind of case where a creditor permits a debtor to keep a stock of goods encumbered by a recorded or filed mortgage, out of which stock the debtor may sell and collect the proceeds without paying off the loan before maturity, and the kind of case like this where the creditor permits the debtor to use the proceeds from the assigned accounts as the debtor sees fit. Before the *Ratner* case even the New York federal courts hesitated to line up the assignment cases with the stocks of goods cases. They did not like to carry over the doctrine of “reputed ownership” to intangible accounts. They chose rather to enforce the security in the accounts even against the trustee.\(^2\) Perhaps they feared the anomalous result, that a creditor who had bargained for security in assigned accounts and had permitted the debtor to use the proceeds as he collected them would be worse off than if he had not bargained for security at all.

The doctrine of “unfettered use” is not the same as that of “reputed ownership.” The Supreme Court has conceded that. The doc-


\(^{28}\) In re Hub Carpet Co., 282 Fed. 12 (C.C.A. 2d, 1922), the *Ratner* case in the intermediate appellate court; In re Michigan Furniture Co., 249 Fed. 978 (S.D. N.Y. 1918). Cf. Petition of Post, 17 F. (2d) 555 (C.C.A. 1st, 1927), in which the Circuit Court of Appeals for the First Circuit apparently chose to repudiate the doctrine of “unfettered use” as a test to determine whether the creditor had an effective security device. The creditor was protected against the estate in bankruptcy. The court felt that the decision in the *Ratner* case rested on the New York decisions rather than any general proposition of commercial law.
trine of "unfettered use" is plausible when it is used to determine whether a creditor ought to be secured. If a creditor permits a debtor to make "unfettered use" of the proceeds from the accounts the creditor is merely trusting to the debtor's promise to pay the debt in the future. But to classify the payment of proceeds to the creditor where there has been "unfettered use" as a fraudulent conveyance is unwise. Any subsequent unsecured creditor of this same debtor, as a plaintiff in an action against the debtor as a defendant, could reach through garnishment any proceeds paid over to the creditor, where the court decides that the security device is not merely ineffective, but that the conduct of the parties with respect to the debtor's business makes payment a fraudulent conveyance as a matter of law. The lien thus acquired could be preserved by the trustee for the benefit of the estate providing the petition in bankruptcy were filed within four months after the unsecured creditor had begun his garnishment action. It is conceivable then that the trustee may be able to reach back beyond the four-month period to get proceeds paid to the assignee. Perhaps this smacks of academic criticism because the debtor is not likely to have been insolvent over such a long period of time that the trustee will ever have the chance to reach back beyond the four-month period. No other creditor may have begun a garnishment proceeding. Payment of the proceeds so long ago might indicate that the creditor had not permitted any "unfettered use." Nevertheless, these suggestions indicate that it is unwise to talk "fraudulent conveyance" in assignment cases. Nor is it necessary to do so to relieve the bankrupt's estate from the burden of the agreement where the creditor has permitted "unfettered use" of the proceeds. There is one type of case where the criticism is not academic. That is where the trustee tries to get back the proceeds for the estate where payments were made during the four months before the filing of the petition in bankruptcy.

The doctrine of "unfettered use" seems consistent with the trend of decisions in Wisconsin. There is some reason to suppose that the Wisconsin court might talk "fraudulent conveyance" along with "unfettered use." Certainly the doctrine of "reputed ownership" finds favor in Wisconsin. The chattel mortgage filing statute is construed to protect the subsequent unsecured creditor of the common debtor where a mortgagee has not filed a copy of his mortgage. And in those cases

where the chattel mortgage covers stocks of goods to be sold in trade
the creditor who has complied with the special filing statutes may find
himself unprotected as against subsequent general creditors where he
has permitted the debtor to sell from the stock without immediately
cutting down the indebtedness.\textsuperscript{32} In these cases, too, the creditor's posi-
tion is worse than had he not bargained for security, but the courts feel
that he has permitted the debtor to mislead creditors when the debtor
is apparently able to dispose of the stock as he sees fit. Most courts
which have had an opportunity to consider it have used the doctrine
of "unfettered use" to determine whether a creditor is secured or
un-
secured. Even the federal courts in New York have refused to treat
the payment of proceeds to a creditor like the one in the \textit{Ratner} case
as anything more than a preference.\textsuperscript{33}

\textsuperscript{32} Morley-Murphy Co. v. Jodar, 220 Wis. 302, 264 N.W. 926 (1936); Vanden
Wymelenberg v. Badger Furnace Co., 220 Wis. 473, 265 N.W. 718 (1936);
Ross v. State Bank of Trego, 198 Wis. 335, 224 N.W. 114, 73 A.L.R. 225
(1929); (1936) 20 MARQ. LAW REV. 199.
\textsuperscript{33} In \textit{re} Borok, 50 F. (2d) 75 (C.C.A. 2d, 1930); Walradt v. Miller, 45 F. (2d)
686 (C.C.A. 2d, 1930); in accord, J. W. Fales & Co. v. O. H. Seiple Co., 171
Wash. 630, 19 P. (2d) 118 (1933).