

# Scholarship Plans As a Security Why Can't Johnny's Parents Read

Robert H. Scott Jr.

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## SCHOLARSHIP PLANS AS A SECURITY: WHY CAN'T JOHNNY'S PARENTS READ?

In 1961 the Florida legislature authorized the operation of cooperative scholarship plans.<sup>1</sup> Offering a novel method of financing college education, these plans have experienced rapid growth.<sup>2</sup> Three such plans are presently operating in Florida,<sup>3</sup> and increasing numbers of people are investing money in them.<sup>4</sup> In addition, this development has spread to other states; similar plans have been established in Louisiana, Tennessee, Pennsylvania, Delaware, and Iowa.<sup>5</sup> With this expansion has come a serious need for investor protection. What form this protection should take and by whom it should be supplied are problems which deserve immediate attention.

### I

#### A DANGEROUS INVESTMENT

Scholarship plans purport to help participants finance higher education. A purchaser of a plan initially pays the "Sponsor"<sup>6</sup> an administrative fee and a sales load. He also agrees to open a savings account in a federally insured bank or savings and loan association,<sup>7</sup> into which he deposits a specified amount either in a lump sum or in monthly installments. He must maintain this account intact for a specified period of time, during which the earnings are irrevocably

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<sup>1</sup> FLA. STAT. ANN. §§ 617.50-81 (Supp. 1969).

<sup>2</sup> From 1962 through 1966, one trust fund sold approximately 9500 plans. The Trust Fund Sponsored by the Scholarship Club, Inc., SEC Investment Co. Act Release No. 5524, at 6 n.11 (Oct. 25, 1968) [hereinafter cited as SEC Release].

<sup>3</sup> The American College Foundation, the Episcopal School Foundation College Award Program, Inc., and the Scholarship Club, Inc. are all registered with the Florida State Treasurer pursuant to FLA. STAT. ANN. § 617.532 (Supp. 1969).

<sup>4</sup> As of December 1967, the trust fund of the Scholarship Club aggregated \$95,624.82. Brief for Applicant at 39, The Trust Fund Sponsored by the Scholarship Club, Inc., SEC Investment Co. Act Release No. 5524 (Oct. 25, 1968) [hereinafter cited as Applicant's Brief].

<sup>5</sup> Green, *Scholarship Funds, New Approach to Saving for College, Ensnared by Wary Regulators*, Wall St. J., Dec. 27, 1968, at 22, col. 1, discusses the recent expansion of the scholarship plans and reports that one plan has hopes of going nation-wide. In examining anticipated growth, the article points to one plan operating in Canada since 1961 which has 37,000 subscribers and over \$23 million in deposits.

<sup>6</sup> In Florida the "Sponsor" must be a non-profit corporation. FLA. STAT. ANN. § 617.50(3) (Supp. 1969).

<sup>7</sup> SEC Release, *supra* note 2, at 2; Episcopal School Foundation College Award Program, Regulation § 2B (Rev. Nov. 1967) [hereinafter cited as CAP Regs.].

assigned to a trust set up by the Sponsor. The money assigned to the trust fund will be invested in securities.<sup>8</sup> One plan requires an administrative fee and sales load totaling \$160.<sup>9</sup> Under this plan the purchaser deposits either \$1,600 on which earnings amounting to \$564 should accrue over a period of eight and one-half years,<sup>10</sup> or monthly installments of \$227.27 on which earnings amounting to \$566 should accrue over a period of eleven years.<sup>11</sup>

When the purchaser opens the savings account, he designates a beneficiary.<sup>12</sup> If the purchaser makes all of the required payments, and if the beneficiary successfully enters college, the money in the savings account is returned to the purchaser and may be employed to offset the cost of the first year. The beneficiary then receives from the trust fund money to help pay for all or a part of the cost of the remaining three years.<sup>13</sup>

The purchaser assumes the risk of forfeiture upon either his or the beneficiary's disqualification. For example, he can withdraw his money from the savings account at any time, but if he does so prior to the beneficiary's entrance into college, the beneficiary is no longer eligible for an award and the purchaser automatically forfeits the earnings assigned to the trust fund. Similarly, if the purchaser fails to make all the payments under an installment plan, or if the designated beneficiary does not enter college or fails to complete the first year of study, then disqualification occurs and the assigned earnings are forfeited.<sup>14</sup> The earnings thus relinquished supplement the scholarships given to eligible beneficiaries.

Forfeiture by some persons is essential for the satisfactory operation of the scholarship plans as presently organized. The funds have an

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<sup>8</sup> SEC Release, *supra* note 2, at 2; CAP Regs., *supra* note 7, at § 2D.

<sup>9</sup> This amount must be paid by purchasers of the Scholarship Club's plan. SEC Release, *supra* note 2, at 4 n.4. The plan offered by the Episcopal School Foundation College Award Program entails a "membership fee" of \$175. The Trust Fund Sponsored by the Episcopal School Foundation College Award Program, Inc., SEC Hearing Examiner's Initial Decision, Admin. Proceeding File No. 3-1374, at 3 (Oct. 24, 1968) [hereinafter cited as ESFCAP Initial Decision].

<sup>10</sup> SEC Release, *supra* note 2, at 4 n.4.

<sup>11</sup> *Id.* at 3, 4 n.4.

<sup>12</sup> The purchaser can select any child as beneficiary whether kin or not. See, for example, the Episcopal School Foundation College Award Program, CAP Regs., *supra* note 7, at § 1E.

<sup>13</sup> SEC Release, *supra* note 2, at 3; CAP Regs., *supra* note 7, at § 10C.

<sup>14</sup> These are the conditions of forfeiture generally adopted by the Scholarship Club. SEC Release, *supra* note 2, at 2-3. The Episcopal School Foundation College Award Program has adopted substantially the same conditions. CAP Regs., *supra* note 7, at §§ 5A, 15.

extremely conservative investment policy, investing primarily in municipal bonds, time deposits or United States government securities.<sup>15</sup> The return from these securities alone could not meet a significant portion of college expenses of the participating beneficiaries. The real inducement to purchase a scholarship plan is not the investment performance of the fund, but the possibility of a substantial profit through the forfeiture of others.

The necessity for forfeiture may pressure the Sponsor into structuring the plan to encourage it. Strict payment schedules could precipitate the forfeiture of an installment plan purchaser who is but a few days late in meeting his monthly obligation. A temporary setback in high school could disqualify a beneficiary for failure to make satisfactory progress toward college entrance. Once in college the beneficiary could be required to maintain a high average.

Yet for those who feel the need to finance college on the installment basis, the loss through forfeiture would be a severe hardship. A purchaser whose beneficiary fails to qualify for an award may lose over \$600 assigned to the trust fund plus interest on this money.<sup>16</sup> The possible effect of forfeiture plus the inherent reliance upon loss for the plan's successful operation poses the real danger that incidences of disqualification may be so numerous and so complex as to result in an unconscionable risk for the investor.<sup>17</sup>

Another danger created by the essential part forfeiture plays in the plans is that they will be sold intentionally to those most likely to lapse in their payments or whose children enjoy the least opportunity to succeed in college. Assuming a specific intent to encourage forfeiture, such would be the case where a ten-year installment plan is sold to elderly grandparents; or where a plan is sold to parents whose child, due to economic and social factors, has little chance to complete high school; or where a plan is sold to someone in such severe financial

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<sup>15</sup> Such has been the policy of the Scholarship Club. SEC Release, *supra* note 2, at 4. The fund assets of the Episcopal School Foundation College Award Program are kept in "cash interest-bearing savings accounts." ESFCAP Initial Decision, *supra* note 9, at 4.

<sup>16</sup> The maximum forfeiture under the Scholarship Club's plan, as it now stands, would be approximately \$600 plus the \$160 sales load. Under the Episcopal School Foundation College Award Program the forfeiture could exceed \$660 plus the \$175 "membership fee." See ESFCAP Initial Decision, *supra* note 9, at 4.

<sup>17</sup> Although this danger does exist it has not yet materialized. The Episcopal School Foundation College Award Program allows 30 days to cure default upon notice thereof. CAP Regs., *supra* note 7, at § 5C. Also, the Florida statute requires that the requisite scholastic achievement cannot exceed that of the institution attended. FLA. STAT. ANN. § 617.52(g) (Supp. 1969).

straits that the odds of his completing ten years of payments would be slim. Such also would be the case where a plan is sold to parents with a retarded child.<sup>18</sup>

The most troublesome aspect of the plans, however, is the difficulty and uncertainty in choosing a method of distributing the scholarship awards. Two unknowns must be taken into account in order to determine the amount of any scholarship: the number of beneficiaries who will qualify and the total assets which the trust fund will have available for distribution. These variables make uncertain the award which eligible beneficiaries will receive. Past performance does not provide a basis for estimating future profits; the plans are a recent phenomenon,<sup>19</sup> and the average one runs at least eight to ten years.<sup>20</sup> As a result, no money to date has been paid to any student and no exact figure can be promised.<sup>21</sup> In fact, a purchaser of a scholarship plan may be instructed that possibly the award will not be sufficient to cover the entire cost of three years of college education.<sup>22</sup>

These unknowns, however, do not make it impossible for the Sponsors to arrive at definite plans by which the available funds will be allocated among those who are eligible.<sup>23</sup> Yet in formulating such plans the Sponsors must seek to avoid certain dangers. The most serious is the possibility that *no* method of distribution will produce an equitable award. Although no amount may be technically promised, the purchaser, willing to assume the substantial risk of forfeiture, necessarily anticipates a considerable profit from his investment. Contemplating the expense of three years' college education, the plan itself is geared to encourage this expectation. Yet, because of the unknown

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<sup>18</sup> Brief for SEC at 12, *The Trust Fund Sponsored by the Scholarship Club, Inc.*, SEC Investment Co. Act Release No. 5524 (Oct. 25, 1968), cites one instance where a plan actually was sold to a parent with a mentally deficient child.

<sup>19</sup> The Scholarship Club, for example, was organized in 1961, and the Episcopal School Foundation College Award Program began operation in 1965.

<sup>20</sup> C.S.T. Foundation, however, which has been operating in Canada since 1961, has experienced an annual drop-out rate of over 10%. Green, *Scholarship Funds, New Approach to Saving for College, Ensnared by Wary Regulators*, Wall St. J., Dec. 27, 1968, at 22, col. 1.

<sup>21</sup> Yet the Episcopal School Foundation College Award Program, while guaranteeing no specific amount, did represent that anticipated scholarships should provide \$1,500 or more per year for three years. ESFCAP Initial Decision, *supra* note 9, at 7.

<sup>22</sup> This is the practice to be followed by the Scholarship Club. SEC Release, *supra* note 2, at 5-6.

<sup>23</sup> The Scholarship Club has yet to formulate such a plan. *Id.* at 6. The Episcopal School Foundation College Award Program has devised a plan based on the year of anticipated college entrance. CAP Regs., *supra* note 7, at § 10C. The Florida statute requires that a plan of distribution be submitted to the State Treasurer. FLA. STAT. ANN. § 617.55(2)(c) (Supp. 1969).

forfeiture rate,<sup>24</sup> the plan can offer no assurance that the award will be satisfactory. It is possible that there will be few forfeitures and, therefore, the returns may be relatively small. Low returns are a risk assumed in all investment schemes, but where there may be an *implied* assurance of one amount (*i.e.*, cost of three years of college),<sup>25</sup> a lower return cannot be justified.

A subsidiary problem in this area concerns the possibility of inconsistent scholarships. In some years the trust funds may realize sufficient earnings to provide satisfactory awards, while in other years they may not. The danger exists, therefore, that the distribution will be disproportionate. Any mechanical formula, for instance, which classified the beneficiaries by year of anticipated college entry and divided annually among the actual scholarship recipients of that class the available funds, could produce a large variance in yearly allocations. This might prove misleading for a purchaser induced to enter a plan on the basis of past performance.

## II

### THE TOTAL PROHIBITION APPROACH

One argument for prohibiting the plans is based on the fear that they will fail to realize adequate awards. Yet this is not a foregone conclusion and the mere risk of such a result does not qualitatively distinguish the scholarship plans from most unquestionably legitimate investments. Other aspects of the scheme do. The amount of the award essentially depends upon chance.<sup>26</sup> The purchaser is "gambling" that the number of forfeitures will be high. The success of his investment rests not upon a lawful business enterprise, but upon the misfortune of other purchasers.<sup>27</sup>

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<sup>24</sup> The Scholarship Club testified before the SEC that the method of distribution was not an "actuarial problem." SEC Release, *supra* note 2, at 6. The Florida statute suggests otherwise. FLA. STAT. ANN. § 617.55(3)(b) (Supp. 1969). In any event the plans have not been operating long enough to gather sufficient information to estimate a reliable rate of forfeiture.

<sup>25</sup> See note 21 *supra*.

<sup>26</sup> "Chance" has been defined as the "attempt to attain certain ends, not by skill or any known or fixed rules, but by the happening of a subsequent event, incapable of ascertainment or accomplishment by means of human foresight or ingenuity." *United States v. Rich*, 90 F. Supp. 624, 627 (E.D. Ill. 1950), quoting 17 R.C.L. 1223. Chance, of course, would be eliminated if the rate of forfeiture became ascertainable. It is also possible that the investment of fund assets may in the future become a significant source of income.

<sup>27</sup> An argument can be made that the scholarship plans are actually lotteries. A lottery is any scheme that entails consideration, prize and chance. *FCC v. American*

The concomitant problem of forfeiture is even more disturbing. Although the investor might fully realize the nature of the risk, it remains highly questionable whether the possibility of such loss is acceptable under any circumstances. Besides the general argument of unconscionability,<sup>28</sup> Congress, in the Investment Company Act of 1940,<sup>29</sup> has specifically prohibited such forfeitures,<sup>30</sup> evidencing an intent to outlaw the operative fact of the scholarship plans.<sup>31</sup> This strongly suggests that the risk assumed by the scholarship plan investor exceeds that normally associated with an investment and contravenes public policy.

Perhaps the most fundamental policy argument against these plans is that they will operate, in effect, to enrich one class at the expense of another. It is inevitable that the poor, uneducated purchaser whose children may lack the requisite motivation will suffer a high rate of forfeiture. At the same time, however, plans will be sold to purchasers of more able means who would be able to afford sending their children to college without assistance. Beneficiaries of this class, for whom college may very well be the natural extension of education, will likely qualify for an award. The situation will result, therefore, where those most in need will find themselves financing college education for those who actually do not require a "scholarship."<sup>32</sup>

The arguments in support of prohibiting the plans, although persuasive, have not been heeded. Florida has legalized and encouraged the scheme,<sup>33</sup> and the other states in which the scholarship plans have been established have also refused to take repressive action. This implies a belief that the speculative and future benefits from the plans outweigh the obvious and immediate dangers. Such a position is justified, however,

Broadcasting Co., 347 U.S. 284 (1954). Yet the fact that the amount of the scholarship may depend on chance is not necessarily controlling. Qualification for an award has nothing to do with chance. The beneficiary must complete the first year of college. The purchaser, exercising judgment in selecting a beneficiary whom he feels will be scholastically successful, must make all payments.

<sup>28</sup> See, e.g., UNIFORM COMMERCIAL CODE §§ 2-302, 2-719(3).

<sup>29</sup> 54 Stat. 789 (1940), 15 U.S.C. §§ 80a-1 to -52 (1964).

<sup>30</sup> 54 Stat. 829 (1940), 15 U.S.C. § 80a-27(c)(1) (1964).

<sup>31</sup> S. REP. NO. 1775, 76th Cong., 3d Sess. 19 (1940).

<sup>32</sup> Elimination of the plans could be effected with little trouble. The states could declare the plans illegal on the grounds of public policy. Such action would be upheld as a reasonable exercise of the police power. Most states outlaw lotteries as do certain federal statutes. A determination that the plans were lotteries, therefore, would also bring about the demise of the scholarship plans. *But see* note 27 *supra*. Another alternative is created by the federal securities laws under which the SEC, at its discretion, is empowered to prohibit the selling of such plans to the public. *See* pp. 785-88 *infra*.

<sup>33</sup> FLA. STAT. ANN. §§ 617.50-.81 (Supp. 1969).

only if adequate investor protection exists. In turn, this depends upon the applicability of federal securities regulation to the scholarship plans.

### III

#### SEC REGULATION

In October 1968, in *The Trust Fund Sponsored by the Scholarship Club, Inc.*,<sup>34</sup> the SEC held that a Florida trust fund offering scholarship plans was an "investment company" subject to the Investment Company Act of 1940.<sup>35</sup> The Commission also held the scholarship plans to be securities, since by definition an investment company is an issuer of "securities."<sup>36</sup> Although arguments were made against holding funds to be investment companies,<sup>37</sup> and against calling the plans securities,<sup>38</sup> the SEC, motivated by the obvious need for investor

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<sup>34</sup> SEC Release, *supra* note 2.

<sup>35</sup> 15 U.S.C. §§ 80a-1 to -52 (1964).

<sup>36</sup> Section 3(a) of the Act defines an "investment company" as an issuer which:

(1) [I]s or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

15 U.S.C. § 80a-3(a) (1964).

The SEC did not discuss the status of the trust fund, but only noted that the question as to its being an "issuer" had not been raised. SEC Release, *supra* note 2, at 4 n.5.

<sup>37</sup> The applicant in this hearing argued: that it did not issue "face-amount certificates" as defined in § 2(a)(15) of the 1940 Act because it was not obligated to pay a stated and fixed sum of money at maturity; that all of its assets were cash items and therefore did not involve "investment securities" as defined in § 3(a)(3) of the 1940 Act; and that it does not engage primarily nor does it propose to engage primarily in the business of investing, reinvesting, or trading in securities because its investment is secondary to its primary purpose of providing funds for college expenses. As a result, concluded the applicant, it did not fall within the definition of an investment company found in §§ 3(a)(2), (3), or (1) of the 1940 Act. See Applicant's Brief at 52-66.

<sup>38</sup> In his article, *The Economic Realities of a "Security": Is There A More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367 (1967), Coffey developed a practical test by which to determine the existence of a "security." He combined the expectation of profit from an enterprise managed solely by others (SEC v. Howey Co., 328 U.S. 293 (1946)) with the risk of loss from the enterprise (SEC v. Joiner Corp., 320 U.S. 344 (1943)). The scholarship plans would not necessarily meet these requirements. The real profit comes not from the investment of fund earnings, but from the forfeiture of other purchasers. Conversely, the real risk stems from the possibility that the forfeiture rate will be low, or that the purchaser himself may forfeit. In this respect, then, there is no genuine risk of loss or expecta-

protection and perhaps by the absence of alternatives,<sup>39</sup> turned a deaf ear to those appeals and found coverage.<sup>40</sup>

Making the federal securities law applicable to scholarship plans solves some of the problems they raise. The Securities Exchange Act of 1934<sup>41</sup> mitigates the danger that these plans will be sold to those most likely to forfeit. The SEC has recently promulgated a "suitability rule" pursuant to section 15 of the 1934 Act<sup>42</sup> which will assure regulation of all sellers of the scholarship plans. Under this rule a broker, before recommending a security, must have grounds for believing that the security is suitable on the basis of information furnished by the customer after reasonable inquiry.<sup>43</sup> The rule will not apply to those sellers who are NASD members,<sup>44</sup> but this organization has its own self-imposed suitability rule which is identical with the Commission's.<sup>45</sup>

However, the SEC is best able to deal with the scholarship plans under the Investment Company Act of 1940.<sup>46</sup> Holding the trust fund to

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tion of profit from the *enterprise*. Any profit or loss that does arise from the enterprise may be so small and unimportant that the courts will be quick to look through it to discover the real nature of the transaction.

<sup>39</sup> If the scholarship plans were held not to be securities, and the trust fund not to be an investment company, then it is possible that investors would enjoy no statutory protection at all. There is no assurance that the states would apply Blue Sky Laws were the SEC to find federal securities laws inapplicable, and state insurance regulation would be inadequate. *See Comment, The Expanding Jurisdiction of the Securities and Exchange Commission: Variable Annuities and Bank Collective Investment Funds*, 62 MICH. L. REV. 1398, 1407-08 (1964). The only alternative, which the states might reject, would be to declare the plans illegal.

<sup>40</sup> SEC Release, *supra* note 2, at 4. The Commission did not discuss the arguments raised in applicant's brief concerning its status as an investment company, nor was it disturbed by the possibility that the plans were not securities. *See* note 36 *supra*.

<sup>41</sup> 15 U.S.C. §§ 78a to hh-1 (1964).

<sup>42</sup> 15 U.S.C. § 78o (1964).

<sup>43</sup> The rule states:

Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer or associated person.

17 C.F.R. § 240.15b10-3 (1968).

<sup>44</sup> The National Association of Securities Dealers was created under the Maloney Act, 15 U.S.C. § 78o-3 (1964), which sought to encourage strict ethical standards among brokers. Mundheim, *Professional Responsibilities of Brokers-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 446. The NASD is the only such organization to have registered with the Commission. SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH 62 (1966). As such it is exempt from the SEC suitability rule which applies only to brokers who are not members of a national securities association.

<sup>45</sup> CCH MANUAL OF THE NASD, RULES OF FAIR PRACTICE, Art. III, § 2 (1968).

<sup>46</sup> 15 U.S.C. §§ 80a-1 to -52 (1964).

be an investment company makes mandatory certain provisions of that Act which, unless exempted under section 6(c),<sup>47</sup> put the trust fund out of business. Most notable is section 27(c)(1) of the 1940 Act<sup>48</sup> which requires that periodic payment plan certificates<sup>49</sup> issued by an investment company may not be sold unless they are redeemable securities.<sup>50</sup> The scholarship plan, held by the SEC to be periodic payment plan certificates,<sup>51</sup> are certainly not redeemable.<sup>52</sup> To require redeemability under section 27(c)(1) would have destroyed the essence of the plan.

The SEC did grant the necessary exemptions, but only on the condition of fair and adequate disclosure of the operation of the plan and its related risks. The result of such action, however, may go beyond the mere disclosure of the plan as now contemplated by the Sponsor. Since a section 6(c) exemption is granted only where "necessary or appropriate [to] the public interest and consistent with the protection of investors,"<sup>53</sup> the SEC may require the plan, *as disclosed*, to conform to its conception of a safe investment. Using the section 27(c)(1) exemption for leverage, the SEC may attempt substantive regulation of the scholarship plans which exceeds a bare examination of the information contained in the

<sup>47</sup> Section 6(c) enables the Commission to exempt any person, security, or transaction from any part of the Act if:

such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter.

15 U.S.C. § 80a-6(c) (1964).

<sup>48</sup> 15 U.S.C. § 80a-27(c)(1) (1964).

<sup>49</sup> A periodic payment plan certificate is defined in § 2(a)(26) of the 1940 Act to mean:

(A) [A]ny certificate, investment contract, or other security providing for a series of periodic payments by the holder, and representing an individual interest in certain specified securities or in a unit or fund of securities purchased wholly or partly with the proceeds of such payments, and (B) any security the issuer of which is also issuing securities of the character described in clause (A) of this paragraph and the holder of which has substantially the same rights and privileges as those which holders of securities of the character described in said clause (A) have upon completing the periodic payments for which such securities provide.

15 U.S.C. § 80a-2(a)(26) (1964).

Applicant Scholarship Club made an unsuccessful argument that the scholarship plans did not fall within this definition. SEC Release, *supra* note 2, at 8-9.

<sup>50</sup> A redeemable security is defined in § 2(a)(31) of the 1940 Act to mean:

[A]ny security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.

15 U.S.C. § 80a-2(a)(31) (1964).

<sup>51</sup> SEC Release, *supra* note 2, at 9.

<sup>52</sup> Applicant argued that the scholarship plans were redeemable since the trust fund was obligated to pay an award when the beneficiary qualified. Their arguments, however, did not overcome the possibility of forfeiture. *Id.* at 8-9.

<sup>53</sup> See note 47 *supra*.

registration statement. For example, the Commission noted that it would have jurisdiction to "consider the adequacy and accuracy of the disclosure to be made in the Security Act prospectus and in sales literature to be used . . ." which must include "some description of a *feasible* and *fair* plan of distribution . . ." <sup>54</sup> It is possible, therefore, that if the incidences of forfeiture are not reasonable, or if the plan of distribution is neither realistic nor equitable, the SEC may either refuse to accept the registration statement or may reconsider the 1940 Act exemptions. The result in both cases would be the same—prohibition of selling the plans, as now structured, to the public.

Two specific exemptions were made contingent upon the existence of satisfactory "disclosure." <sup>55</sup> One, exemption from the redeemability requirement, was granted provided there was "a full disclosure of the features of the plans with respect to the forfeiture provisions and their consequences." <sup>56</sup> The other dealt with section 23(b) of the 1940 Act <sup>57</sup> which would have prohibited the trust fund from selling its plans below current net asset value. Because of the difficulty of determining the net asset value of the scholarship plans, and since under section 23(b)(2) the plans could be sold below net asset value with the consent of a majority of the plan holders, this exemption was temporarily granted. The Commission added, however, that this uncertainty as to the value of the plan was

another reason why a full and meaningful disclosure of the plan, including a description of a specific method for determining the amounts of distributions to beneficiaries, is of the utmost importance. <sup>58</sup>

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<sup>54</sup> SEC Release, *supra* note 2, at 6 (emphasis added).

<sup>55</sup> The SEC also granted an exemption from §§ 16(a), 18(i), 27(a)(3), 26(a)(2)(A) and (B) of the 1940 Act. It denied applicant an exemption from § 30(d). *Id.* at 7-11.

<sup>56</sup> *Id.* at 9. On the day before this decision the Episcopal School Foundation College Award Program sought an exemption from the same provision in a proceeding before the hearing examiner. In this case, however, the exemption was denied on the grounds that:

To grant applicant's request for exemption from the provisions of Section 27(c)(1) would serve only to perpetuate the incidence of forfeitures which the Congress decried. It is not enough to say, in respect of forfeitures, that the investor is aware of the risk he takes. To whatever extent and under whatever conditions full disclosure may be the *sine qua non* of the federal securities laws, here the Congress specifically excluded forfeitures from any periodic payment plan as adverse to the national public interest and the interest of investors.

ESFCAP Initial Decision, *supra* note 9, at 34.

This indicates that the question may be open for reconsideration in the near future.

<sup>57</sup> 15 U.S.C. § 80a-23(b) (1964).

<sup>58</sup> SEC Release, *supra* note 2, at 10.

## IV

## THE NECESSITY FOR FURTHER REGULATION

Federal regulation alone may not adequately protect the purchaser of a scholarship plan. The danger of unethical selling practices survives the Commission's disclosure requirements since any quantity or quality of disclosure may be ineffective.<sup>59</sup> Likewise, although the suitability rules provide some protection for the buyer, they do not affect the broker who sold scholarship plans without recommending them.

To insure full protection the seller must have an affirmative duty in all cases to sell plans only to purchasers who understand the risk. It must be the seller's obligation, therefore, to determine before sale whether the purchaser in fact realizes the amount of money which may be forfeited and is aware of the circumstances under which such loss will occur. This will require on the seller's part a reasonable inquiry of a prospective purchaser concerning his appreciation of the plan. The seller may be compelled to explain the plan in detail, calling attention to forfeiture and its consequences. This will not be necessary, however, if the purchaser has previously studied the plan and understands the nature and extent of the risk which he must assume. In this respect it is not sufficient that the purchaser is given an opportunity to read a prospectus. The purchaser must in fact read and comprehend the prospectus, or acquire the same knowledge of the plan from some other source. To assure such understanding, the seller may find it necessary to review the rate schedule, the different instances of forfeiture, and the uncertainty inherent in the method of distribution in all cases. Considering the plans' reliance upon personal misfortune, however, such a duty is not excessive.

There are other problems, unresolved by the SEC, which require appropriate state action. One is the method of distribution of the scholarship awards. The Commission held that disclosure of a "feasible and fair plan of distribution" was required.<sup>60</sup> Whether the Commission would have jurisdiction to regulate directly the allocation of assets in

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<sup>59</sup> The number of interested purchasers of a scholarship plan who actually bother to study the registration statement may be negligible. It should also be noted that under § 5(b)(2) of the 1933 Act, 15 U.S.C. § 77(e) (1964), a prospectus need not be sent to an investor before the security is sold if no offer to sell a plan has been made through the instrumentalities of interstate commerce.

<sup>60</sup> SEC Release, *supra* note 2, at 6.

this situation is arguable.<sup>61</sup> In any event this problem seems to be more appropriately left to state control. Any attempt to assure the most equitable system of awards will demand a constant and thorough examination of each fund's performance. Such surveillance over a growing number of scholarship plans could greatly burden the SEC. Moreover, the factors which should influence any distribution may tend to be local in nature—social and economic standards, cost of education, number and character of participants in the plan, and rate of forfeiture. A state should be able to develop an expertise in this area, and might create an agency or department devoted to the regulation of the scholarship plans.<sup>62</sup> This would especially be important now, during the experimental stage of the plans' development.

Under section 27(c)(1) of the 1940 Act,<sup>63</sup> the SEC has the power either to prohibit forfeiture or to supervise its occurrence. Hence, the Commission could allow a plan exemption from this section on the condition that forfeiture be limited to certain situations or that the amount of loss must not exceed a stated maximum. The Commission did not expressly do this in *The Trust Fund Sponsored by the Scholarship Club, Inc.* And it should not, since self-restraint on the part of the SEC will allow a state, which is potentially better suited to guard against the specific dangers of forfeiture, to regulate in that area.<sup>64</sup> In the future it may be possible to estimate the assets necessary to offer satisfactory scholarships. If so, then the state can adjust the risk assumed by the investor to correspond to the anticipated needs of the trust fund. If such an estimate is not possible, or if it develops that the trust funds do not realize enough profits to pay full scholarships, then the state can always reconsider elimination of the plans. In any event the state can and should regulate forfeiture so that it does not become confiscatory or unreasonable. Here a balance must be reached between the obvious effect of forfeiture and the potential benefit to be derived from the plan.

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<sup>61</sup> As indicated, the Commission could control the allocation of fund assets indirectly by refusing to grant the scholarship plans the necessary exemptions from the 1940 Act or by holding up the registration statement until the plan of distribution was acceptable. A more direct supervision of the distribution of earnings, however, would not appear to be authorized by any specific provision of the 1940 Act.

<sup>62</sup> Under the Florida statute the state treasurer as the *ex officio* insurance commissioner is authorized to regulate the operation and administration of the scholarship plans. FLA. STAT. ANN. § 617.52(1) (Supp. 1969). Under the suggested scheme of control a plan national in scope should be required to "qualify" in each state in which investors were sought.

<sup>63</sup> 15 U.S.C. § 80a-27(c)(1) (1964).

<sup>64</sup> The arguments for allowing a state to regulate the distribution of awards would also be applicable here.

The necessity for appropriate state control to complement the federal securities statutes has yet to generate adequate legislation. States into which the scholarship plans are now expanding<sup>65</sup> have done nothing to counteract the potential dangers untouched by federal regulation. Although the Florida legislature has promulgated numerous regulations dealing with the scholarship plans,<sup>66</sup> investor protection is not complete. The Florida statute requires a fair and reasonable method for distributing awards<sup>67</sup> and advance approval of the plan by the State Commissioner.<sup>68</sup> However, it does not contain specific standards for the permissible incidence of forfeiture nor does it offer guidance for the Commissioner in his examination of the distribution of awards. On these crucial points the legislature has failed to take a definitive position, leaving too much to the discretion of one man. Investor protection in this situation necessarily remains speculative.

Adequate regulation of scholarship plans requires state action; the SEC alone cannot effectively protect the investor. Future action by the Commission should be premised on the existence or non-existence of such essential supplemental state control.<sup>69</sup> Only in this way will the Commission avoid decisions that are adverse to the public interest and to the interest of investors.

*Paul D. McGonville*

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<sup>65</sup> See p. 779 *supra*.

<sup>66</sup> FLA. STAT. ANN. §§ 617.50-.81 (Supp. 1969).

<sup>67</sup> *Id.* § 617.55(3)(b).

<sup>68</sup> *Id.* § 617.55(2)(c).

<sup>69</sup> The Commission's decision in *The Trust Fund Sponsored By The Scholarship Club, Inc.* only related to the *status* of the fund. Scholarship plans, of course, will not be offered to the public until the SEC approves the registration statement. Assuming that the SEC grants similar exemptions under the 1940 Act to other funds offering scholarship plans, the requirement of registration statement approval may be its only means of regulation. What the SEC can accomplish through the registration statement, however, is uncertain. See pp. 785-88 *supra*.

## FUTURE ADVANCES AND FILING UNDER ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

In many financing arrangements, a debtor receives several loans, all secured by the same collateral, from a single creditor. The debtor may partially repay the initial loan before obtaining another advance, or the collateral may adequately secure all loans. This type of financing, commonly known as future advance lending, can be effected in three ways under Article 9 of the Code.<sup>1</sup> The lender (*L*) may commit himself in the security agreement to extend further credit. But financing agencies generally desire to control the timing and amount of further loans and will not promise future advances. Accordingly, in the second method, the security agreement will contain an optional future advance clause providing for additional loans only at *L*'s discretion. Finally, the security agreement may be limited to the first loan, possibly because the parties did not contemplate additional advances. This approach may require execution of another agreement when *L* makes a second advance.<sup>2</sup>

If *L* follows the Code's "perfection" steps when he makes the first loan,<sup>3</sup> he obtains priority over the debtor's other creditors, at least to the extent of the initial advance.<sup>4</sup> However, assuming both that *L* uses

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<sup>1</sup> All Uniform Commercial Code [hereinafter cited as UCC] citations are to the 1962 Official Draft unless otherwise specified.

<sup>2</sup> See *Safe Deposit Bank & Trust Co. v. Berman*, 393 F.2d 401 (1st Cir. 1968). But see 5 UCC REP. SERV. 2 (1968) (editor's comment); note 48 *infra*.

<sup>3</sup> To obtain maximum protection for his advance, a creditor must follow five steps. Section 9-204(1) requires that the debtor have rights in the collateral, that the parties agree that the collateral shall be subject to a security interest in favor of the lender (in the terminology of the Code, the parties agree that the security interest shall "attach"), and that the creditor give value as defined by § 1-201(44) to the debtor. At this point the parties have created a security interest.

To enforce the security interest against the debtor or third parties, the lender must take possession of the collateral or the borrower must sign a security agreement containing a description of the property. UCC §§ 9-203(1)(a), (b). Although this step is not required to perfect a security interest, if it does not occur the interest will be worthless. See 1 P. COOGAN, W. HOGAN & D. VAGTS, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 3.02, at 170 (1968) [hereinafter cited as COOGAN, HOGAN & VAGTS].

The creditor then perfects the security interest by filing a financing statement or by taking possession of the collateral. UCC § 9-302.

<sup>4</sup> Once perfected, the security interest defeats not only the claims of all unsecured creditors who become lien creditors after the date of perfection, but also all subsequently perfected security interests. UCC §§ 9-301(1)(b), 9-312(5)(a), (b).

This rule is subject to the general exception that if a purchase-money security interest is perfected within ten days from the time the debtor receives possession of the goods, or, in the case of inventory, if the holder of a perfected purchase-money interest has notified other secured parties who have security interests in the inventory, then the purchase-money interest receives priority. *Id.* §§ 9-312(3), (4).

one of the optional agreements when he makes the first loan and that he contemporaneously files a financing statement to perfect his security interest, *L*'s rights as against other creditors for the second loan depend on whether the subsequent advance creates another security interest and, if so, whether *L* must refile to obtain maximum protection for the second loan.

Some authorities maintain that optional future advances create new security interests;<sup>5</sup> others contend that the first loan produces one security interest which secures all subsequent advances.<sup>6</sup> Adoption of the single security interest approach eliminates the refiling question; to receive maximum protection for a loan, the related security interest must be perfected.<sup>7</sup> Each loan forms part of the same security interest, and the initial filing perfects that interest. If this viewpoint prevails, *L*'s priority for all loans dates from the time of the filing and not from the time of the advance. The initial filing protects all loans against the claims of both unsecured creditors who become lien creditors

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<sup>5</sup> See 1 COOGAN, HOGAN & VAGTS, *supra* note 3, § 3.20, at 239-40, § 21.06(1) (b), at 2207-08. Adherents to the multiple security interest approach rely mainly on §§ 9-204(1) and 1-201(37). The former states that a security interest cannot attach until value is given. Thus they argue that no security exists with respect to a subsequent advance until that advance is made. Also, under § 1-201(37), a security interest "secures payment or performance of an obligation," from which the multiple security interest proponents contend that each time a debtor becomes obligated to repay the lender—which would be each time he receives an advance—a new security interest arises. Finally they maintain that the multiple interest approach in the area of optional future advances is consistent with the general structure of Article 9 which adopts this same viewpoint in other fields; e.g., after-acquired property.

<sup>6</sup> See 2 G. GILMORE, SECURITY TRANSACTIONS IN PERSONAL PROPERTY § 35.6, at 938 (1965). Professor Gilmore argues that the initial loan satisfies the value requirement of § 9-204(1), and that nothing in the Code suggests that the second loan creates a security interest when value has previously been given. This view has received judicial recognition. See *Friedlander v. Adelphi Mfg. Co.*, 5 UCC REP. SERV. 7 (N.Y. Sup. Ct. 1968). However, the court implied that had the lender extended additional credit only for the purpose of depriving the judgment creditor of his right to collect the judgment, the lender would have been acting in bad faith and would not receive priority for his subsequent advance. *Id.* at 11. Since the lender probably is not under a duty to act in good faith towards another creditor, at least under the language of the Code (see §§ 1-203 & 1-201(19)), perhaps the court was merely reiterating a pre-Code rule. In some jurisdictions, a lender did not receive priority for his optional future advances if he had actual knowledge of an intervening creditor. See 2 GILMORE, *supra*, § 35.4, at 927. However, example 4 in comment 4 to § 9-312 clearly indicates that a lender receives priority for his advances even if he knows that other parties have intervened. Cf. *Bloom v. Hilty*, 427 Pa. 463, 471, 234 A.2d 860, 863-64 (1967). One commentator has analyzed the views of Mr. Coogan and Professor Gilmore and further discussion here would be unproductive. See Ege in 2 COOGAN, HOGAN & VAGTS, *supra* note 3, §§ 21.09-17, at 2217-42. The language of the Code adequately supports either approach, and both have considerable merit. See 2 GILMORE, *supra*, § 35.6, at 938-39.

<sup>7</sup> UCC § 9-303, Comment 1.

after the filing<sup>8</sup> and other secured creditors who perfect subsequent to the filing.<sup>9</sup>

However, if optional future advances create new security interests, refiling may be crucial to *L*'s attempts to protect his additional loans. His future advances may be subordinate to the claims of other creditors unless he re-perfects. Furthermore, if *L* must record again to retain a protected status, he cannot utilize the first-to-file rule as to subsequent advances. Under this rule, if the filing which perfects a security interest occurs before another financing statement is filed covering the same collateral, the first filer obtains priority for that interest even if it arose *after* the second filer created his interest.<sup>10</sup>

Several Uniform Laws Comments<sup>11</sup> and many commentators<sup>12</sup> suggest that *L* obtains protection for optional advances without refiling. However, the legislative history of the filing provisions and the language of other relevant Code sections raise serious doubts whether the text of Article 9 supports this viewpoint; a strong argument can be made that *L* should not rely on the original filing.<sup>13</sup>

## I

### FILING UNDER ARTICLE 9

#### A. *Departures from the Uniform Trust Receipts Act and from Initial Drafts of the Code*

A comment to Article 9 states that the Code adopted the filing system of the Uniform Trust Receipts Act (UTRA).<sup>14</sup> Under that Act,

<sup>8</sup> *Id.* § 9-301(1)(b). The term "lien creditor" includes a creditor who has acquired a judicial lien on the debtor's property, an assignee for the benefit of creditors, and a trustee in bankruptcy. *Id.* § 9-301(3).

<sup>9</sup> If the multiple security interest view is followed, *L* will not receive priority for any loans as against unsecured creditors who become lien creditors before the loans are made. *Id.* § 9-301(1)(b). Also, he will be defeated by secured creditors who perfect their interests in a manner other than filing before he makes a further advance. *Id.* § 9-312(5)(b).

<sup>10</sup> *Id.* § 9-312(5)(a).

<sup>11</sup> *See id.* § 9-312, Comment 4, Examples 1, 4, & 5; *id.* § 9-402, Comment 2.

<sup>12</sup> *See, e.g.*, 1 COOGAN, HOGAN & VAGTS, *supra* note 3, § 4.08(4), at 299-300; L. DENNON, SECURED TRANSACTIONS UNDER THE UCC § 5.7, at 40 (1965 ed.); Donnellan, *Notice and Filing Under Article 9*, 29 MO. L. REV. 517, 518 (1964); Kripke, *Article 9 of Uniform Commercial Code—Part II*, 6 PERS. FIN. L.Q. 35, 37 (1952). For a view contrary to these authorities, see Note, *Filing Requirements Under the Montana Uniform Commercial Code*, 25 MONT. L. REV. 228, 240 (1964).

<sup>13</sup> Article 9 expressly eliminates the necessity of refiling for a security interest in the proceeds of the sale of collateral if the financing statement covered proceeds. UCC § 9-306(3)(a). *See also id.* § 9-306(5)(a) (refiling not necessary to perfect a re-attaching security interest in returned goods if the filing has not lapsed).

<sup>14</sup> *Id.* § 9-402, Comment 2.

refiling was unnecessary if the financing statement identified the collateral securing optional advances.<sup>15</sup> A comparison of UTRA filing provisions with their Code counterparts raises the question whether Article 9 adopted this facet of the UTRA.

Section 13(4) of the UTRA provided that

presentation for filing of the statement . . . and payment of the filing fee, shall constitute filing under this act . . . as to any documents or goods falling within the description in the statement which are . . . the subject-matter of a trust receipt transaction . . . .

As this section clearly indicates, one filing was sufficient regardless of the number of loans if the parties limited the transactions to items mentioned in the statement.

Also, section 13(1)(b) required the recorded statement to contain a declaration that the secured party intended to engage in trust receipt transactions. Because the initial filing indicated that several security interests might be created, refiling each time a security interest arose would be superfluous—the existence of that interest was already a matter of public record. By expressly requiring the lender to declare that he intended to engage in many transactions, section 13(1)(b) further indicated that subsequent loans did not require another filing.

Early versions of Article 9 contained language similar to that found in section 13(4) of the UTRA. Under section 8-404 of the October 1949 draft, presentation to the filing officer and payment of the filing fee constituted filing “as to any collateral falling within the description in the statement.”<sup>16</sup> This provision remained unchanged until the Spring 1951 draft.<sup>17</sup> Also, comment 1 to section 8-302 of the October 1949 revision stated that “[o]nce filed, the notice is effective for the period stated . . . , and no further filing need be made for individual transactions . . . .”<sup>18</sup> These early versions clearly allowed one filing to perfect several security interests in collateral described by the financing statement.

The statement required by the present Article 9 need not contain a similar declaration of intent. Section 9-403(1) now provides that “presentation for filing of a financing statement and tender of the filing fee or acceptance of the statement by the filing officer constitutes filing

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<sup>15</sup> See 2 GILMORE, *supra* note 6, § 15.2, at 468.

<sup>16</sup> The drafters did not intend any substantive change from the UTRA when they altered the language in this revision. See UCC § 8-404, Comment 1, of the October 1949 draft.

<sup>17</sup> See *id.* § 9-404(1) of the Spring 1950 draft and *id.* of the September 1950 revision.

<sup>18</sup> Similar language is found in comment 1 to § 7-107 and comment 2 to § 7-410 of the May 1949 draft. Section 8-302 became § 9-302, but this phrase in the comment was eliminated when the section was revised.

under this Article." This section does not imply that one filing suffices for all transactions involving collateral identified by the statement. Rather, it simply indicates the steps necessary for an effective filing and is silent with respect to the extent of effectiveness.

However, three other sections of the present Code may support the view that one filing perfects several security interests.

## B. Current Code Provisions

### 1. Advance Filing: Section 9-303(1)

One referee in bankruptcy held that, where the parties filed when they created a security interest, the Code's advance filing sections<sup>19</sup> permitted them to use the initial filing to perfect a later security interest created under a new agreement.<sup>20</sup> Under section 9-303(1), a financing statement on file can perfect a security interest arising after the date of the filing. And since the parties filed before they created the second interest, the initial filing perfected this new interest by virtue of section 9-303(1).<sup>21</sup> Although a literal reading of the statute might appear to support the referee, his approach suffers from two defects.

First, the legislative history of both sections indicates that they were not designed to deal with whether one filing may perfect several interests. Rather, they were drafted to resolve the lender's problem of protecting a loan before it was made.<sup>22</sup> Some chattel mortgage statutes required filing of the mortgage instrument itself.<sup>23</sup> Accordingly, financing institutions simply assumed that the transaction had to occur before the documents could be filed.<sup>24</sup> To mitigate the dangerous time gap between creation and filing, some statutes contained "grace period" provisions which granted maximum protection to an unrecorded mortgage for a short time.<sup>25</sup> But the UTRA, instead of offering a grace period, allowed a lender to file prior to the time he created an interest.<sup>26</sup> A question remained, however, whether such filing was effective.<sup>27</sup> Section 9-402(1) continues the UTRA concept of advance filing, and

<sup>19</sup> UCC §§ 9-402(1), 9-303(1).

<sup>20</sup> *In re Merriam*, 4 UCC REP. SERV. 234 (S.D. Ohio 1967) (referee's opinion).

<sup>21</sup> *Id.* at 236.

<sup>22</sup> Suppose *L* knows on March 1 that sometime during this month he will enter into a financing arrangement with *D*. To avoid delay between the creation of a security interest and its perfection, *L* will want to file as soon as possible, optimally before he extends credit. But will a March 1 filing perfect an interest arising on March 15? See UCC § 9-302, Comment 2 of the Spring 1950 draft.

<sup>23</sup> See UCC § 9-302, Comment 2 of the Spring 1950 draft.

<sup>24</sup> See 1 GILMORE, *supra* note 6, § 16.6, at 496-97.

<sup>25</sup> See 1 GILMORE, *supra* note 6, § 16.6, at 498.

<sup>26</sup> Section 13(1)(b) of UTRA. See also UCC § 9-312, Comment 4, Example 1.

<sup>27</sup> See UCC § 9-312, Comment 4, Example 1.

section 9-303(1) corrects the UTRA defect by expressly rendering advance filing effective. These provisions were inserted only as a substitute for the grace period approach;<sup>28</sup> they were not intended to determine whether one filing perfects several interests.<sup>29</sup>

Second, to use section 9-303(1) in support of the view that one filing perfects several interests requires the presumption that a filing retains its capacity to perfect after once being employed for this purpose.<sup>30</sup> For example, if *L* files on March 1, and creates one security interest on March 15 and another on April 1, does the recorded statement perfect both the March 15th and the April 1st interests? The Code draftsmen failed to resolve this problem;<sup>31</sup> and where priorities are concerned, it is unsafe to rely upon unsupported assumptions.<sup>32</sup>

## 2. *The Financing Statement: Section 9-402(1)*

One court stated that because the parties can record a financing statement rather than a copy of the agreement, subsequent loans do not require re-filing.<sup>33</sup> This assertion ignores three problems.

First, nothing in the financing statement required by section

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<sup>28</sup> See 1 GILMORE, *supra* note 6, § 16.6, at 498.

<sup>29</sup> See UCC § 9-302, Comment 2 of the Spring 1950 draft.

<sup>30</sup> The necessity of this presumption is demonstrated by the following syllogism: (1) A financing statement must be filed to perfect all security interests, UCC § 9-302(1); (2) *L* can file before a security interest attaches, *id.* § 9-402(1); (3) that security interest is automatically perfected when it arises, *id.* § 9-303(1); (4) therefore § 9-302(1) merely states that to perfect a security interest, a financing statement must be on file; (5) therefore when a second interest arises, and there is a filing on record, that filing perfects the second interest; (6) thus one filing perfects several interests.

However, to derive step 5 from step 4, one must assume the result, *i.e.*, that one filing does perfect several interests. Without this assumption, step 4 suggests only that the initial filing perfects a security interest arising thereafter; and this premise alone does not imply that the filing perfects all later created interests.

<sup>31</sup> Since this problem only arises if the multiple security interest theory prevails, the draftsmen may not have foreseen the single-multiple interest dispute.

<sup>32</sup> The confusion surrounding § 9-303(1) results from the similarity between the advance filing problem and the question of whether one filing covers several interests. A majority of security interests will arise after the parties first file. Thus these concepts are related in two ways. If Article 9 prohibited the automatic perfection provided by § 9-303(1), one recording could not perfect several interests. But even with this procedure, it does not necessarily follow that one filing is sufficient.

And if the Code were silent with respect to automatic perfection and expressly allowed one filing to perfect many interests, then automatic perfection would naturally result. But merely because the ability to perfect several interests inherently includes the automatic perfection procedure does not necessarily suggest that the converse is true.

*But see* 2 F. HART & W. WILLIER, *FORMS AND PROCEDURES UNDER THE UCC* § 91A.08, at 9-69 (1968).

<sup>33</sup> The court in *Household Fin. Corp. v. Bank Comm'r*, 248 Md. 233, 235 A.2d 732 (1967), reached this conclusion in deciding whether a financing statement was a recorded lien or evidence of obligation.

9-402(1) justifies the conclusion that one filing suffices. Under the Code, the filed statement need contain only the following items: names and addresses of the parties; their signatures; and a description of the collateral.<sup>34</sup> If new security interests require refiling only when the recording is misleading, then of course one recording suffices for all future advances. But this section does not state that the test of refiling turns on the accuracy of the statement. Section 9-402(I) may suggest that the truth of the statement controls refiling in such other areas as after-acquired property or products of collateral, but it does not imply that this test applies to optional future advances. Since the Code expressly allows a financing statement to cover after-acquired property or products, refiling may not be necessary for security interests created by the addition of property already identified by the recording. Otherwise, no reason exists for permitting the lender to specify on the statement that it covers these items. But because the Code does not expressly permit the inclusion of optional future advances on the financing statement, one cannot infer that section 9-402(1) intended to eliminate refiling for interests created by subsequent loans.<sup>35</sup>

Second, a statement complying with the minimum requirements of section 9-402(1) does not state on its face whether the lender has more than one interest.<sup>36</sup> Since a creditor would file a statement only if he

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<sup>34</sup> UCC §§ 9-402(1), (3). A survey of official forms reveals that most of them require only the items specified in § 9-402. California's official form has a space for the amount of the debt, but this provision is optional. See, e.g., 2 HART & WILLIER, *supra* note 32, § 91A.04, at 9-40 to 9-62.

<sup>35</sup> Since Article 9 allows the parties to file a copy of the agreement (UCC § 9-402(1)), and since the agreement can contain an optional future advance clause (*id.* § 9-204(5)), the inference that the test of refiling turns on the accuracy of the filing appears applicable to optional future advances when agreements are recorded. And since refiling does not appear necessary when agreements are recorded, arguably it is also unnecessary when the financing statement is filed. Otherwise, inconsistent results would be produced. But the statute does not indicate that optional future advance clauses are permitted in the agreement in order to prevent others from being misled when searching the files. The absence of express permission to include such clauses in the financing statement suggests that they are not allowed in agreements in order to prevent others from being misled. Rather, the sole purpose of permitting the agreement to contain such clauses was to validate the future advance interest. See 2 COOGAN, HOGAN & VAGTS, *supra* note 3, § 21.06(1)(b), at 2209; UCC § 9-204, Comment 8. Even if the multiple security interest approach prevails, permitting the inclusion of optional future advance clauses still serves some function—they eliminate the necessity of executing supplemental agreements with each loan.

<sup>36</sup> Depending on the type of property involved, a financing statement might imply that several interests exist. In accounts receivable or inventory financing, the collateral constantly changes. Each time the debtor acquires new accounts or inventory, a new security interest arises. UCC §§ 9-204(1), (2)(d). If the statement mentions this type of collateral, it may suggest to a knowledgeable financing institution that the lender has or expects to have several interests. But if the security arrangements involve some other

has or intends to have a security interest, the filing indicates that he may have an interest. But beyond that, the filed statement is neutral with respect to the number of security interests which have been or may be created.<sup>37</sup>

Finally, section 9-402(1) does not support the contention that one filing is sufficient. This section sets forth the formal requirements of a financing statement<sup>38</sup> and was designed to inform filing officers when to accept statements and to aid courts in ascertaining which statements constitute a proper filing.<sup>39</sup> The section was never intended to imply that one filing is sufficient.

### 3. "Effectiveness" Argument: Section 9-403(2)

Section 9-403(2) states that a filed statement "is effective for a period of five years from the date of filing" unless the statement provides for a shorter period. Because the parties may file before a security interest arises, and since that interest is perfected when it attaches, "effective" might mean the ability to perfect. Thus a filed statement arguably is effective for the purpose of perfecting every interest created during the five year period. Although section 9-403(2) does not expressly reject this possibility, the use of the word "effective" in other

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property, such as the equipment of the debtor or his personal car, which does not turn over frequently, the statement on its face implies that the lender has or expects to have only a single interest.

Although there may be some merit in distinguishing between financing arrangements on the basis of the collateral involved, except for a single statement in comment 2 to § 9-402, there is no indication that the drafters intended this result. By including all types of security arrangements under one statute, and because all appear to be subject to the same rules, save for a few specific exceptions (e.g., compare § 9-312(3)(b) with § 9-312(4)), the inference is that all arrangements are to be treated the same with respect to the necessity of refiling. See comment 2 to UCC § 7-410 of the May 1949 draft.

<sup>37</sup> Mr. Coogan raises the question whether the financing statement would perfect security interests in the same *kinds* of collateral as that described in the statement if the interests were created under later agreements. He suggests that the parties include a statement of intent indicating whether more than one transaction is intended. 1 COOGAN, HOGAN & VAGTS, *supra* note 3, § 6.04, at 498.

Here the question is whether the financing statement will perfect many security interests in the same collateral described by the statement. The two questions are basically identical, for the quality of notice as to the property impaired is the same in each case.

<sup>38</sup> The title of this section is "Formal Requirements of Financing Statement; Amendments." Section captions are part of the Code, and not mere surplusage. UCC § 1-109; see comment to § 1-109; comment 1 to § 9-402.

<sup>39</sup> See comment 5 to § 9-402. Moreover, "[p]art 4 deals, in an *adjective* sense, with the *procedure* of filing, whereas part 3 deals, in a *substantive* sense, with the effect of filing or failing to file." Kupfer, *Article 9 of the Uniform Commercial Code—Part IV*, 6 PERS. FIN. L.Q. 96 (1952) (emphasis in the original). Comment 1 to § 9-302 states that "[p]art 4 . . . deals with the mechanics of filing: place of filing, form of financing statement and so on."

parts of this subsection demonstrates that the term does not mean the ability to perfect.

"Effective" clearly refers to a filing which maintains the perfected status of a security interest over a period of time.<sup>40</sup> If "effective" means the ability to perfect as well as the ability to maintain the interest as perfected, "ineffective" should logically mean not only that an interest would become unperfected, but also that a filed statement could no longer perfect interests. However, when the effectiveness lapses, section 9-403(1) states only that "the security interest becomes unperfected." This provision does not equate an ineffective filing with one lacking the ability to perfect; thus the term "effective," as used in section 9-403(2), refers only to a filing which can maintain the perfected status of a security interest. Even though one effect of a filed statement is to perfect an interest, nothing suggests that the drafters intended "effective" to mean the ability to perfect.<sup>41</sup> Rather, they directed their attention only to the problem of establishing an appropriate length of time during which the security interest was to remain perfected.<sup>42</sup>

Sections 9-403(2) and 9-402(1) and the advance filing provisions do not resolve whether one filing perfects several interests created by future advances. At best the Code is silent on this issue, thereby placing the optional future advance lender in a dilemma. If he refiles, he is protected against unsecured creditors who become lien creditors after the time of filing. But this second filing may bar the application of the first-to-file rule to the extent of subsequent advances, causing defeat by intervening secured creditors. By attempting to utilize this rule and not refile, the lender runs the risk that his new security interests may be unperfected. Finding himself in either of these two positions, an optional future advance lender might profitably advocate a liberal construction of the advance filing provisions. Because the Code never expressly states that one filing is insufficient, he could urge a court to assume that the automatic perfection provided by section 9-303(1) applies to both the initial security interest and subsequent ones. And he could support this position by demonstrating that refile is un-

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<sup>40</sup> UCC § 9-403(2). See also comment 3 to this section.

<sup>41</sup> The term "effective" as used in a preceding section, § 9-402(5), means the ability to perfect, but this section was added to the official text in 1957, five years after § 9-403(2) was drafted. Also, this term as used in § 9-402(4) does not mean the ability to perfect, but rather the time that a security interest becomes perfected. See § 9-306(5)(a), in which the same word means that the period has not expired. See also Kupfer, *supra* note 39, at 96, and UCC § 9-302, Comment 1.

<sup>42</sup> The comment to § 7-411 of the May 1949 draft states that "[n]o reason is apparent why the holders of long-term obligations . . . should be required to re-file, on penalty of losing their liens, periodically during the life of the obligation."

necessary from a practical standpoint; the single filing gives adequate notice of the property impaired. But this approach does not guarantee success. Some courts, to avoid adopting a presumption that one filing is adequate, have emphasized the nature of the security agreement giving rise to the future advance.

## II

### THE JUDICIAL APPROACH TO THE PRIORITY PROBLEM

One court implied that only advances under a security agreement containing a future advance clause are protected by the original filing.<sup>43</sup> This implication is correct only if the court was referring to an agreement containing a binding future advance provision. However, since Article 9 allows a lender to include an optional clause in his agreement,<sup>44</sup> the court probably would also grant priority to loans made under this type of agreement while withholding protection from advances extended through separate agreements. If so, the court's distinction is invalid;<sup>45</sup> the only distinction should be between agreements binding the lender and those that do not.

If optional future advances create new security interests, Article 9 requires identical treatment of loans under optional future advance agreements and loans under agreements limited to a single advance. Priority depends on perfection, and the perfection rules do not distin-

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<sup>43</sup> *In re Rivet*, 4 UCC REP. SERV. 1087 (E.D. Mich. 1967) (referee's opinion).

<sup>44</sup> UCC § 9-204(5).

<sup>45</sup> Example 4 to comment 4 of § 9-312 perhaps supports Referee Bobier's position, but the relevant portion of this example is so vaguely drafted that it is difficult to draw any conclusion from it. Moreover, it indicates that the second advance under the original agreement creates a new security interest, and if this interest is automatically perfected when made, then a separate interest under a new agreement is automatically perfected when made—the filing provisions accord equal treatment to both types of agreements. See note 46 *infra*. Under the 1952 version, the Referee might have been correct, for § 9-312(2) provided:

A secured party who has a perfected security interest and who makes later advances to the debtor on the same collateral and under the same security agreement takes priority as to the later advances from the time when his security interest was originally perfected.

However, this section was substantially revised and the relevant part of § 9-312 now states that

priority between conflicting security interests in the same collateral shall be determined as follows: (a) in the order of filing if both are . . . perfected by filing, regardless of which security interest attached first . . . and whether it attached before or after filing . . . .

UCC § 9-312(5)(a).

There is no suggestion in this section that the first-to-file rule applies only to security interests created under one agreement.

guish between security interests on the basis of the agreement creating them.<sup>46</sup> An optional future advance clause in the security agreement merely eliminates the need for executing supplemental agreements with each advance; each loan automatically creates an enforceable security interest. But the enforceability of more than one interest under a single agreement does not necessarily result in the perfection of more than one by a single filing. Equating enforceability requirements with perfection requirements ignores the Code's distinction between them.<sup>47</sup>

Also, if a court applies the single-security interest theory to loans made under an agreement containing an optional clause, it should accord the same treatment to advances extended through separate agreements.<sup>48</sup>

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<sup>46</sup> If the automatic perfection provided by § 9-303(1) allows one filing to perfect several interests, it fails to differentiate between these two types of agreements. This section states that if a security interest arises under an agreement which was executed after the parties filed, that security interest is perfected. Also, if a security interest arises under an agreement which existed at the time of filing, that security interest is perfected. See 2 HART & WILLIER, *supra* note 32, § 91A.08, at 96-98.

If § 9-402(1) provides a test for determining whether the lender must refile in order to receive protection for his loans, there might be some rational basis for treating these arrangements differently. In accounts receivable or inventory financing, the debtor will usually need periodic loans. The security agreement may commonly contain an optional future advance clause in order to eliminate the necessity of executing supplemental agreements with each loan. The collateral described by the financing statement indicates that several transactions are contemplated (*see* note 36 *supra*); thus one filing provides adequate notice that many security interests are intended. This situation presents the clearest case for allowing a lender to receive priority for all of his advances without the necessity of refiling. The single filing alerts others to the possibility that several security interests may be created, and since many loans are made in this type of financing arrangement, the lender would be substantially burdened if he had to refile with each advance. However, a future advance clause can be used in any financing arrangement; and if these two types of collateral are not involved and unless the parties indicate that several transactions are contemplated, the financing statement suggests that the lender has only one interest.

Assuming that the term "effective" in § 9-403(2) means the ability of a filed financing statement to perfect several interests, there is no reason for not applying this meaning to both types of agreements.

<sup>47</sup> Under the Code, enforcement procedures are governed by § 9-203 and perfection methods are found in § 9-302. See also 1 COOGAN, HOGAN & VAGTS, *supra* note 3, § 4.04(1), at 279-80; 1 GILMORE, *supra* note 6, § 15.2, at 468-69.

<sup>48</sup> For example, *L* executes a security agreement which reads that the debtor grants a security interest "to secure repayment of \$1,000 and any future advances which *L*, in his discretion, may decide to make." *C* uses an agreement which states that the security interest "secures repayment of \$1,000." The following month both *L* and *C* advance another \$1,000 loan, each secured by the same collateral as the first advance.

The single security interest theory holds that the initial loan satisfies the value requirement of § 9-204(1), and nothing in the Code suggests that the second loan creates another interest when value has previously been given. 2 GILMORE, *supra* note 6, § 35.6, at 938. This rationale applies with equal force to both agreements. Concurrence on the extent of

A second court considering the priority problem indicated that it also would distinguish an optional future advance agreement from one limited to a single loan.<sup>49</sup> First, the court reasoned that an agreement without such a clause would weaken the borrower because the lender could refuse to extend additional credit, and no one else would lend money to the debtor since the first lender would have priority for his subsequent advances.<sup>50</sup> This rationale is invalid because an optional

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the security interest when created is irrelevant in determining if a second loan produces a new interest. Section 9-204(1), in setting forth criteria for creating a security interest, does not consider agreement on the scope of attachment; it focuses only on whether the parties agreed that the interest shall attach. *See* 5 UCC REP. SERV. 2 (1968) (editor's comment).

Alternatively, C's second advance accompanied by a promissory note may be thought of as an amendment of the description of the debt in his security agreement. *Id.* However, C may encounter difficulties if he attempts to enforce his security interest beyond the first loan without executing another agreement. Although § 9-203 requires only one agreement to enforce a single interest, § 9-201 states in part:

Except as otherwise provided by this Act a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors.

But the comment to § 9-201 provides that "[t]his section states the general validity of a security agreement." The New York annotations to this section state that "[t]he emphasis here and throughout the Code is on the general effectiveness of a security instrument, whereas older statutory provisions are often phrased in negative terms." From this it may be contended that § 9-201 deals with the question of whether a security agreement is effective at all, and not with the extent to which it is effective. *See* 1 COOGAN, HOGAN & VACTS, *supra* note 3, § 3.04(1), at 279.

Furthermore, since the security interest encompasses the second loan, and since the lender can enforce his security interest without the execution of a second agreement, arguably he can enforce his security interest to the extent of the second loan regardless of the terms of the first agreement. However, perhaps § 9-203 also was not directed toward this problem, for comment 5 states that "[t]he formal requisites stated in this Section are not only conditions to the enforceability of a security interest against third parties. They are in [*sic*] nature of a Statute of Frauds." Here also, it may be contended that this section deals with the question of whether a security interest can be enforceable at all, and that it does not reach the problem of the extent to which it can be enforced. One court faced this issue, and applied § 9-201. *See* case cited note 2 *supra*. The question is quickly resolved under the multiple interest theory, because another agreement must be executed to enforce the interest created.

Suppose C executes another agreement when he makes the second advance; under the single interest theory would this produce a new security interest? Even though a security agreement, under § 9-105(1)(h), is "an agreement which creates or provides for a security interest," arguably the second agreement does not produce a new interest. To analogize from Professor Gilmore's theory, the initial agreement that the security interest shall attach satisfies the agreement requirement of § 9-204(1), and nothing in the Code suggests that the second agreement creates a new interest when the parties have previously agreed that the interest shall attach. Hence, the subsequent agreement is a nullity insofar as the creation of a security interest is concerned.

<sup>49</sup> *Coin-O-Matic Serv. Co. v. Rhode Island Hosp. Trust Co.*, 3 UCC REP. SERV. 1112 (Super. Ct. R.I. 1966).

<sup>50</sup> *Id.* at 1116-17.

future advance clause does not force the lender to make additional loans. Moreover, even if the agreement contained a binding commitment, the creditor could probably refuse to make further loans without fear of suffering legal injury.<sup>51</sup>

Second, the court decided that only contemplated future advances received protection under the original filing, and that the execution of a second agreement indicated an absence of contemplation.<sup>52</sup> Although one authority arguably supports this view,<sup>53</sup> the perfection provisions do not distinguish between planned and unplanned security interests.<sup>54</sup> Moreover, because it may be impossible to divine the parties' plans accurately, introducing their intentions into the priority analysis results in undesirable uncertainty.<sup>55</sup>

The court's final argument for differentiation was grounded in the disclosure requirements of section 9-208. Usually the financing statement contains only the required items.<sup>56</sup> If interested third parties desire more information, they are under a duty to make further inquiries,<sup>57</sup> and section 9-208 provides a method of obtaining additional details. The court implied that if the agreement includes a future advance clause, section 9-208 requires the lender to divulge this fact. Without such a clause in the agreement, the information provided would not reveal whether further advances are contemplated. The court, apparently assuming that the original filing protects additional loans under an optional future advance clause, concluded that, absent such a future advance clause, a potential lender can not determine if

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<sup>51</sup> See 2 GILMORE, *supra* note 6, § 35.4, at 926; J. HONNOLD, LAW OF SALES AND SALES FINANCING 678 (3d ed. 1968).

<sup>52</sup> Coin-O-Matic Serv. Co. v. Rhode Island Hosp. Trust Co., 3 UCC REP. SERV. 1112, 1119-20 (Super. Ct. R.I. 1966).

<sup>53</sup> 2 HART & WILLIER, *supra* note 32, § 91A.08, at 9-68.

<sup>54</sup> Only the advance filing provisions can possibly support this distinction. The argument might run as follows: Unless the parties contemplated the creation of a security interest or the execution of a security agreement, there would be no reason for them to file a financing statement. Thus § 9-402(1) inherently aims at contemplated security interests and agreements. However, since § 9-402(1) allows filing before the parties execute an agreement, if the parties contemplated several agreements, the lender need only file once. Thus merely because the lender executes another agreement does not deprive him of the protection of § 9-402(1).

For an authority who maintains that unanticipated interests created under new agreements receive protection under the original filing, see Mr. Coogan's comments in *Symposium, A Practical Approach to the Uniform Commercial Code for the Practicing Lawyer*, 19 BUS. LAW. 5, 52 (1968).

<sup>55</sup> See *Safe Deposit Bank & Trust Co. v. Berman*, 393 F.2d 401, 404 (1st Cir. 1968). But see 2 HART & WILLIER, *supra* note 32, § 91A.08, at 9-68.

<sup>56</sup> Note 34 *supra*.

<sup>57</sup> See, e.g., *Hartford Accident & Indem. Co. v. State Pub. School Bldg. Auth.*, 26 Pa. D.&C.2d 717, 732 (Co. Ct. 1961).

his loans will be subordinate to later advances of the first creditor. Thus the first creditor in this case should not receive priority for his additional loans.<sup>58</sup> Although this is the best argument for treating each type of agreement differently, it can be attacked on two grounds.

Section 9-208 may not require a lender to disclose whether the agreement covers future advances.<sup>59</sup> If so, neither type of agreement will apprise an interested third party that the creditor may extend future loans.

And, even if the lender reveals that the agreement contains a future advance clause, this information may be worthless. At the time of disclosure, the lender may not contemplate further loans, or he may not know their amount. Thus a potential lender could not in any case determine whether the collateral is sufficient to secure both his loan and any additional credit extended by the first creditor.<sup>60</sup>

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<sup>58</sup> *Coin-O-Matic Serv. Co. v. Rhode Island Hosp. Trust Co.*, 3 UCC REP. SERV. 1112, 1119 (Super. Ct. R.I. 1966).

<sup>59</sup> See, e.g., 1 COOGAN, HOGAN & VAGTS, *supra* note 3, § 6.08(5), at 529; 2 GILMORE, *supra* note 6, § 35.5, at 933. The secured party must act in good faith when disclosing this information. UCC § 1-203. Therefore he cannot deliberately mislead one who seeks further details of the financing arrangement. 2 GILMORE, *supra* note 6, § 35.5, at 933. But perhaps this obligation of good faith applies only to an honest statement of the aggregate amount of indebtedness, and of the collateral securing the loans—the only things mentioned in § 9-208. See HONNOLD, *supra* note 51, at 678; Cohen, *The Future Advance Interest Under the Uniform Commercial Code: Validity and Priority*, 10 B.C. IND. & COM. L. REV. 1, 6 (1969).

<sup>60</sup> Of course, if the debtor has a copy of the agreement, and it contains a future advance clause, a third party may anticipate additional loans. But examining the document may not be worthwhile because it may not specify the amount of subsequent advances, or the third party may have difficulty in determining whether the agreement actually covers future advances. For example, does an agreement which states that the security interest secures repayment of the present loan and "all other indebtedness present or future, due or to become due, now existing or hereafter arising" cover future advances? Section 9-201 provides that a security agreement is effective according to its terms unless the Code otherwise provides. Article 9 does not expressly invalidate this type of clause, and § 9-204(5) does not specifically require that the agreement mention the words "future advances." See 2 GILMORE, *supra* note 6, § 35.5, at 932. But see O. SPIVACK, SECURED TRANSACTIONS 31 (1963 ed.). In *Charles S. Morton Distrib. Co. v. First State Bank*, 114 Ga. App. 693, 152 S.E.2d 599 (1966), a pre-Code case, the court indicated that a similar clause covered future advances. See also *In re Midas Coin Co.*, 264 F. Supp. 193 (E.D. Mo. 1967), citing UCC § 9-201.

Section 9-204(3) of the 1952 version provided that "a security agreement may provide that collateral . . . shall secure any advances made or other value given at any time pursuant to the security agreement." Comment 8 to § 9-204 stated in part that future advances were valid, "provided only that the advance be made pursuant to a term in the security agreement." In 1957 the drafters revised § 9-204(3) which now states that "a security agreement may provide that collateral . . . shall secure all obligations covered by the security agreement." And the relevant portion of comment 8 now reads that future advances are valid, "provided only that the obligation be covered by the security agreement."

Perhaps there is some merit in distinguishing between the types of security agreements employed, but the supporting arguments are unconvincing. Moreover, the lender does not lose any rights by inserting an optional future advance clause in the security agreement,<sup>61</sup> and the borrower does not gain any advantage if the agreement contains such a clause. Since the term optional future advances does not affect the debtor-creditor relationship, the presence or absence of this innocuous phrase should not determine priority.

### CONCLUSION

Article 9 has been highly publicized as providing a filing system under which one recording suffices regardless of the number of agreements involved.<sup>62</sup> Operating under this assumption, a secured lender may fail to examine the files to ascertain if any other secured creditor has intervened between his first and later loans.<sup>63</sup> Moreover, believing that one filing is adequate, a belief not supported by the text of Article 9, he will not refile with each advance. Thus he may have an unperfected security interest, subject to the assault of secured and unsecured creditors alike.<sup>64</sup>

To clarify the law governing commercial transactions, the Code should be amended to state under what circumstances one filing perfects several interests. Since a single filing gives adequate notice of the prop-

Also, § 9-204(5) has been substantially revised. In 1952 this section provided that: [a] security agreement may provide that collateral under it shall secure future advances.

Comment 8 to this section stated in part that "collateral may secure future as well as present advances when the security agreement so provides." Section 9-204(5) now states that:

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.

This change in § 9-204(5) prompted one commentator, emphasizing the word "whether," to conclude that future advances no longer have to be made pursuant to a term of the agreement. Note, *Legislation*, 5 VILL. L. REV. 465, 471 (1960). The relevant portion of comment 8 was not altered. Although this comment fits the 1952 text, it does not conform to the 1962 version which fails to mention collateral. These alterations in §§ 9-204(3) and 9-204(5) suggest that at the most only the obligation to repay additional loans must be mentioned in the agreement, and it need not include the term "future advances."

<sup>61</sup> Under the Code's definition of value, a lender does not give any more value when he executes a security agreement containing an optional future advance clause than when the agreement is limited to the present loan. UCC § 1-201(44)(a).

<sup>62</sup> See sources cited note 12 *supra*.

<sup>63</sup> See *Coin-O-Matic Serv. Co. v. Rhode Island Hosp. Trust Co.*, 3 UCC REP. SERV. 1112 (Super. Ct. R.I. 1966).

<sup>64</sup> See *In re Rivet*, 4 UCC REP. SERV. 1087 (E.D. Mich. 1967) (referee's opinion).

erty impaired, a refileing serves no practical purpose. The only real consideration is whether, as a policy matter, a future advance lender should obtain priority over intervening secured creditors who perfect by filing. One relevant factor is the proper allocation of the burden of examining the filing records; should the first creditor bear it or should intervening lenders? Simplicity suggests that the burden should be on the latter, for then each lender need check the records only once. A contrary rule forces all lenders to investigate the filings with each advance thus expending needless time and energy. These two factors, adequate notice and the burden of examination, point in the direction of requiring only one filing.

Consideration of the debtor's position suggests the opposite conclusion. Giving the first lender priority effectively ties the borrower to him for five years; new lenders would refuse to give him credit for that period. However, this element presents no difficulty if the borrower intends a permanent change of lenders or if he can induce the first and second lenders to enter into a subordination agreement. A different situation exists where the debtor contemplates only a temporary switch of creditors, and the first lender declines to execute a subordination agreement. A debtor, once confronted with the refusal of a creditor both to advance money and to subordinate his interests, will probably not return to the same creditor; accordingly, this case may present no real difficulty. The more common situation is probably where the debtor intends only a temporary change, and the second lender is unaware of the first—either through the debtor's deceit or the second lender's failure to examine the records. And in neither case does the second lender deserve priority over subsequent advances of the first lender; he is solely responsible for his ignorance.

Finally, the future advance lender should receive priority over all creditors for amounts advanced before they became lien creditors or fulfilled the perfection requirements. His refileing serves no purpose in this situation. But to give him priority here, without refileing, while denying him priority over intervening secured creditors would require a major revision of Article 9.

Simplicity, consistency, and the relevant policy considerations all point toward allowing one filing to suffice. And the arguments apply both to agreements containing an optional future advance clause and to agreements limited to a single loan, regardless of whether the parties execute additional agreements with each advance. Therefore, section 9-302(1), which lists several situations in which filing is unnecessary to perfect a security interest, should be amended by adding

the following subsection: "[S]ecurity interests in the collateral described by a filed statement created within five years from the date of filing by advances under a security agreement or agreements."<sup>65</sup>

*Robert H. Scott, Jr.*

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<sup>65</sup> If the amendment were phrased in this manner, the drafters would not be forced to resolve the single interest-multiple interest dispute.

Alternatively, under either type of agreement, the first lender's priority could be limited to funds advanced before a second creditor invokes § 9-208. Accurate risk calculation will encourage the second lender to make advances, and thus the debtor, motivated by lower interest rates or other better terms, could easily change lenders. However, unless the second creditor fulfills his obligation to search beyond the records, the first lender under any type of agreement should receive priority for all loans. Unaware that a rival exists, he can legitimately assume that the collateral suffices to secure his additional advances. Since § 9-208 requires a written statement, the second creditor can readily prove that he used this section.

Adopting this solution would require some revision of Article 9. Although a secured creditor would not worry about refiling in order to protect his loans against potential lenders, he would still be concerned about unsecured creditors becoming lien creditors after he made some advances. Without refiling, a secured creditor may not receive priority over lien creditors for his additional loans. To effectively utilize the § 9-208 approach, the secured creditor would still have to be granted an exemption from refiling.