



The Floating Lien Concept under Article 9 of the U.C.C.: Suggested Improvements for Slovak Secured Transactions Law

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Abstract

This thesis focuses on the comparison of the floating lien concept as a long term financing tool through creation of security interest, description of factors determining the floating lien, under Article 9 UCC together with a purchase money security interest as an alternative financing device effectively used both by credit sellers and lenders.

In contrast, the Slovak charge law which deals with the provision on the floating lien is a very inconclusive and questionable solution, leaving basic conceptual elements of the floating lien completely untouched. In addition to it, question of purchase money security financing is not considered at all.

The comparison aims to point out the advantages of the floating lien together with purchase money security interest, describing in some more details different aspect of purchase money security financing.

Going through these peculiarities of the floating lien and purchase money security interest, we may conclude that the Slovak legislation introducing only a “predecessor of a floating lien coupled with a traditional concept of a limitative title financing bears number of disadvantages, as opposed to the a clear and systematic solution of Article 9, and is therefore unsatisfactory.

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1 Introduction

The adoption of a new secured transactions law in Slovakia has revolutionized the credit market over recent years. Prior to the new law, the limitations and inflexibility of Slovakia's charge law inhibited the needs of business in the growing transitory economy. After the adoption of the new law, many of these problems disappeared almost overnight.

Nevertheless, since newly introduced aspects of charge law dealing with long term financing mechanisms have not undergone gradual development in the area of secured transactions, their subsequent continual progress will depend on the improvement of quality and level of the economic, social and legal environment. While these new aspects of charge law are a step in the right direction, they are only one of the many strong and efficient security devices that should be introduced into Slovak secured transactions law.

The new law presumably intended to embrace and make full use of all categories of charge law. Among the most important of these categories is the concept of the floating lien, which is designed to secure credits in the long run. However, the new law neglected to properly consider the nature of the individual elements upon which the floating lien rests. It also failed to address a principal issue related to floating lien financing, specifically, it failed to incorporate a solution for subsequent alternative financing and to include efficient enforcement mechanisms.

Since the new charge law failed to address many key issues peculiar to the floating lien concept, a number of problems have arisen in practice. A secured party must therefore be very careful to draft provisions in the security agreement which address those issues peculiar to the floating lien. However, even though individual parties can help protect themselves through careful drafting, Slovakia will not be able to solve the gaps in its charge law relating to short term financing and efficient enforcement mechanism unless it adopts mandatory provisions of law. Hopefully, Slovakia will see such provisions in the near future.

In this paper, I shall compare Slovakia's charge law to Article 9 of the United State's Uniform Commercial Code ("UCC"). Article 9 effectively addresses and enables the full use of floating lien in practice and enables debtors to access alternative subsequent financing through a purchase money security interest. The primary purpose of this thesis is to analyze and evaluate the discrepancies and misconceptions of the floating lien in Slovak charge law and to propose solutions based on the United State's experience with its secured transactions law.

I first sketch out the historical development and gradual recognition of the floating lien mechanism in the United States under Article 9. This involves a discussion of the unique concept of creation and perfection of a security interest and the priority system of security interests. Then, after clarifying the floating lien concept through a more detailed discussion, I turn to the concept of purchase money security financing. In

the latter half of this paper, I explore Slovak charge law and, in the process, compare Slovak charge law to Article 9. The paper ends with a short conclusion.

2 U.S. Secured Transactions Law

2.1 History

The industrial revolution led to the expansion of commerce and, consequently, to a need for new sources of financing. With regards to early 19th century security devices, such as a possessory pledge and real estate mortgage, delivery of the collateral to the secured party was the only means of making the security interest enforceable against other creditors or purchasers, was insufficient to provide of collateral needed to secure credits.¹

Another problem arose from the fact that, as the industrial revolution progressed, personal property began to replace real property as the substantial source of many people's wealth. At the time, personal property, unlike real property, could not be easily exploited as an efficient security instrument. The debtor could not simultaneously remain in a possession of collateral arising from personal property and use it in his business since the courts refused to recognize a security interest which remained in the debtor's hands. The solution was a public filing system which was an essential prerequisite to non

¹ See DONALD B. KING ET AL., COMMERCIAL TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE AND OTHER LAWS 756 (5th ed. 1997).

possessory security devices, among which chattel mortgage and conditional sale were the first.²

2.1.1 Recognition of Security Interest over After-Acquired Property

The initial attack and refusal to enforce after-acquired property clauses stemmed from *qui non habet, ille non dat* doctrine, which lays down the principle that one cannot transfer property that he does not own.³ By the end of the 19th century, however, courts began to recognize and validate after-acquired property clauses with respect to chattels, but not with respect to inventory. Courts considered arrangements trying to incorporate after-acquired property clauses regarding inventory as fraudulent and therefore unenforceable against third parties. The courts' were concerned with a number of problems presented by inventory financing. For example, it was unclear how creditors could effectively trace the lien when the bulk of the assets constantly changed their nature as they were processed, manufactured, sold or replaced.⁴ Also, it was unclear how other creditors could be adequately informed of these encumbered liquid assets. Finally, it was unclear whether the debtor should be required to keep a part of his assets free of liens for satisfaction of unsecured creditors.

² See *id.* at 757. See also LOUIS F. DEL DUCA ET AL., SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE AND INTERNATIONAL COMMERCE 4 (2002).

³ See D. Benjamin Beard, *The Purchase Money Security Interest in Inventory: If It Does Not Float, It Must Be Dead!*, 57 TENN. L. REV. 437, 445-46 (1990).

⁴ See *id.* at 463-464. Grant Gilmore on this issue stated: "An alternative way of rationalizing the invalidity of the stock in trade mortgage came to be the idea that there was something wrong-or 'inconsistent' with the nature of a mortgage-in a shifting mass of collateral. The lien had to be 'certain'; if the mortgage security was in a constant state of flux as the mortgagor sold the existing stock and replaced it with new stock, then the required certainty of lien was gone." See *id.* at 464 n.131.

The problems presented by inventory financing were solved by the creation of specialized security instruments, such as trust receipt, factor's lien and field warehousing.⁵ The old theory that the creditor must exercise control of collateral influenced these new financing mechanisms wherein the entruster, the factor, and the lender remained in close touch with the debtor which enabled them to keep an eye on him.⁶

In the 19th century the main controversy revolved around chattels. In 20th century, however, the focus shifted to receivables and intangibles, which began to play an important role in secured transactions. As with security instruments regarding chattels, the courts also required security instruments governing receivables to meet the dominion requirement. Most famously, in *Benedict v. Ratner* the court required the creditor to have an unfettered dominion over the collateral, thus preventing the debtor to dispose freely thereof; the creditor's failure to exercise control resulted in his security interest being fraudulent.⁷ *Benedict v. Ratner* meant in practice that the courts also required creditors to comply with a number of cumbersome and expensive formalities, such as a daily transfer of the proceeds received to the creditor for control even though such an amount was remitted immediately back to the debtor to maintain the agreed volume of loan.⁸ This clearly was very obstructive to lending transactions.

⁵ See GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY, 354 (1965).

⁶ See *id.* at 354-355

⁷ See *id.* at 355

⁸ See Beard, *supra* note 3, at 460-461.

2.2 The Floating Lien Concept

2.2.1 History Background

The concept of a floating lien and its incorporation into Article 9 of the Uniform Commercial Code (UCC) was highly controversial. There existed a strong prejudice against a general continuing lien due to the concern that a “floating or blanket lien on all present and future assets will leave nothing to satisfy the claims of unsecured creditors and will consequently tend to dry up the sources of such credit” and a desire to “protect a necessitous borrower against himself by refusing to allow him to encumber all the property he may ever own in order to secure a present loan.”⁹ The advocates of the floating lien won out, however, and the concept was expressly validated in Article 9. The validation of the floating lien in Article 9 was, in many ways, just a restatement of pre-Code law. As Professor Gilmore points out, even before the adoption of Article 9 it was possible to encumber all debtor’s present and future assets, though under the pre-Code law it “was cumbersome, expensive and tricky; only the most expert lawyers could hope to avoid the many hidden pitfalls.”¹⁰

2.2.2 Elements of Floating Lien

The floating lien is a salient feature of Article 9 in secured transactions law. The concept of the floating lien involves a lien which constantly floats over the assets; the lien

⁹ See Grant Gilmore, *The Purchase Money Priority*, 76 HARV. L. REV. 1333, 1335 (1963).

¹⁰ *Id.*

moves from one item to another as the collateral changes. The term “floating lien” as such is not legally defined in the Code, however the concept is laid out in a number of provisions in Article 9.¹¹ Such provisions include those dealing with: (i) the general validity of security agreement between the parties, against purchasers of the collateral, and against creditors;¹² (ii) the possibility of creating a security interest not only over present property but also over after acquired property;¹³ (iii) the option of securing future advances by current collateral;¹⁴ (iv) the abolition of the *Benedict v. Ratner* rule;¹⁵ and (v) the automatic shifting of the security interest over to proceeds.¹⁶ These elements of floating lien provide the parties with significant leeway in designing and structuring their transaction in order to provide more or less protection to a secured party based upon mutual agreement.¹⁷

2.2.2.1 After-acquired property

Article 9 fully validates a security interest in after-acquired property. A security interest may be created over any type of collateral with the exception of consumer goods and commercial tort claims.¹⁸ Parties are not required to execute an additional security agreement which would cover the newly acquired collateral.¹⁹

2.2.2.2 Future Advances

With regards to the priority of a floating lien creditor, it is important to discuss the

¹¹ See *id.* at 1334 n.1.

¹² See U.C.C. § 9-201(a).

¹³ See U.C.C. § 9-204 (a) & (b), Comment 2 (Rev. 2000).

¹⁴ See U.C.C. § 9-204 (c).

¹⁵ See U.C.C. § 9-205.

¹⁶ See UCC §9-204 (a), Comment 2 (Rev. 2000).

¹⁷ TIBOR TAJTI, COMPARATIVE SECURED TRANSACTIONS LAW 178 (2002).

¹⁸ See U.C.C. § 9-204 (a) & (b).

¹⁹ See U.C.C. § 9-204 (a) & (b), Comment 2 (Rev. 2000).

creditor's priority position over a security interest with respect of future advances.²⁰ Before adoption of Article 9, courts were reluctant to enforce clauses granting creditors such priority. It was common for courts to require the parties to specify the amount of later loan or even the time when they intend to execute the security agreement.²¹ For example, before the state adopted Article 9, , California required the parties to indicate in the financing statement the maximum amount to be secured in order for a senior secured party to have priority. If the parties failed to indicate the maximum amount, then the creditor only had priority as "to all obligatory advances, and as to all optional advances made by the secured party without knowledge of an intervening right."²²

Future advances may cover any antecedent, present or future obligations if parties so agree. This goes in line with after-acquired property clauses. Article 9 ensures the creditor's priority position with respect to future advances and rejects the prior case law that required future advances, to be enforceable, be of the same or similar type of obligation as the previous advances secured by the collateral.²³

2.2.2.3 Abolition of Benedict Rule

As a result of its abolishment of the *Benedict* rule, Article 9 is referred to as a floating lien statute.²⁴ As previously explained, the *Benedict* rule no longer applies and a debtor, who is no longer required to account for proceeds, is free to dispose of collateral.

²⁰ Futures advance clause are also referred to as dragnet or anaconda clauses since their purpose is to cover the largest amount of debt. See R.T. NIMMER ET AL., COMMERCIAL TRANSACTIONS: SECURED FINANCING CASES, MATERIALS, AND PROBLEMS 283 (2d ed. 1999).

²¹ See TAJTI, *supra* note 17, at 181.

²² See Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1182 n.122 (1979). See also CAL. COM. CODE § 9312(7) (West 1964) (amended 1965).

²³ See U.C.C. § 9-204, Comment 5 (Rev. 2000).

²⁴ See GILMORE, *supra* note 5, at 354, 359. The provisions related to policing were repealed both with respect to chattels and intangibles. See *id.* at 358.

Article 9 makes it clear that a failure to account for proceeds does not make the secured party's security interest invalid or fraudulent.²⁵

By repealing the Benedict rule Article 9 does not run leave the creditor unprotected. On the contrary, Article 9 provides a set of detailed rules on filing, perfection and notice which are exactly designed to protect the parties. In order to ease commercial transactions, Article 9 leaves the question of policing of the debtor's affairs by a creditor completely to the parties' mutual agreement.²⁶

2.2.2.4 Proceeds

A security interest in collateral automatically extends to proceeds. Proceeds are to be identifiable and a security interest in them is perfected on condition that the security interest in the original collateral was perfected.²⁷ Thus parties do not need to specifically agree that the proceeds should be also subject to the security interest. What counts for identifiable proceeds are not only direct proceeds, obtained upon the sale or other disposition of collateral usually in form of cash or goods exchanged, but also indirect proceeds obtained from the original proceeds. Therefore transformation of proceeds is irrelevant as long as the proceeds can be identified.²⁸

²⁵ See U.C.C. § 9-205.

²⁶ See U.C.C. § 9-205, Comment 2 (Rev. 2000).

²⁷ See U.C.C. § 9-203(f); U.C.C. § 9-315(a) & (c).

²⁸ See JAMES BROOK, SECURED TRANSACTIONS: EXAMPLES AND EXPLANATIONS 331 (3d ed. 2005).

2.3 Unitary Approach of Article 9

The UCC was drafted in 1952 and by the mid 1960s the UCC with Article 9 became, in principle, valid across the whole country.²⁹

Article 9 favors a more functional than formal approach to secured transactions, and leaves the technicalities of the pre-Code law behind.³⁰ The objective of the Article 9 provisions is to provide a level of certainty and predictability through a number of rules dealing with priority, the perfection of security interests and a public notice filing system to protect third parties in relation to created security interests.³¹

The pre-Code legal landscape was characterized by a number of individual security devices which evolved from the common law and different statutes.³² Examples are the pledge, chattel mortgage, conditional sale or trust receipt.³³ Article 9 replaced most of these security devices. A secured party thus no longer has to fear that courts will invalidate his security transaction on the grounds that he failed to comply with the requirements for individual pre-Code security devices.³⁴

²⁹ See KING ET AL., *supra* note 1, at 759.

³⁰ See *id.*

³¹ 68A AM. JUR. 2D *Secured Transactions* § 2.

³² See GILMORE, *supra* note 5, at 296

³³ See Peter F. Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien,"* 72 HARV. L. REV. 838, 842 (1959).

³⁴ See GILMORE, *supra* note 5, at 333.

Article 9, as a result of departing from individual distinctions of old security devices in the sphere of personal property, developed a new single category of a “security interest.” Unification of the whole approach to secured transactions in respect of personal property brought about a need to adopt a common language to use throughout the Article. Thus the drafters adopted a new vocabulary, irrespective of the transaction. The basic common terms that we can find in the Article are “security interest,” “debtor”, “secured party” and “collateral.”³⁵

2.3.1 Scope of Article 9

Article 9 covers all transactions that purport to create a security interest³⁶ in personal property and fixtures. It also embraces transactions involving an agricultural lien, a sale of accounts, chattel paper, payment intangibles, or promissory notes.³⁷ On the other hand, transactions regulated by federal law, real estate transactions, wage and insurance claims, and landlord liens are not covered by Article 9.³⁸

The underlying test as to whether Article 9 should be applied is whether the nature of the transaction intends to create a security interest. If the answer is yes, Article

³⁵ See *id.* at 302. Before adoption of Article 9, terms were often different depending on the security device. For example, in case of assignment, the parties were termed as “assignor” and “assignee,” rather than the current terms “debtor” and “secured.” See *id.*

³⁶ See U.C.C. § 1-201(35).

³⁷ See U.C.C. § 9-109(a)

³⁸ For more detail, see U.C.C. § 9-109(c)&(d). For example, since the U.C.C. is state law, Article 9 defers to federal law to the extent that the federal law regulates certain issues differently.

9 steps in regardless of the name it may take.³⁹ As a result, Article 9 is an open ended *non numerus clausus* system of security devices.⁴⁰

2.3.2 Creation of Security Interest

For a security interest to come into existence there naturally must be, first and foremost, an agreement between the parties to create the security interest. Article 9, however does not impose on parties the obligation to execute a security agreement in any particular form; the security agreement may be contained in a number of documents and may be also shown by parol evidence.⁴¹

Article 9 requires a security interest to attach and to perfect. Simply put, attachment is a creation of a security interest and makes the security interest enforceable against a debtor whereas perfection requires additional step, such as filing, for the security interest to be enforceable against third parties.⁴²

2.3.2.1 Attachment

The three pre-requisites for the attachment of a security interest are: 1) value has been given by the secured party,⁴³ 2) the debtor⁴⁴ has rights in the collateral or the power to transfer rights in the collateral to a secured party,⁴⁵ and 3) the debtor has

³⁹ See U.C.C. § 9-109, Comment 2.

⁴⁰ See TAJTI, *supra* note 17, at 54.

⁴¹ See U.C.C. § 9-203, Comments 3 & 4.

⁴² See 68A AM. JUR. 2D *Secured Transactions* § 240.

⁴³ Value is usually credit or a binding promise to extend credit, but value may also be any consideration which is sufficient to support a simple contract, See U.C.C. § 1-204 & Comment.

⁴⁴ “Debtor” under U.C.C. § 9-102(a)(28) includes “a person having an interest, other than a security interest or other lien, in the collateral, whether or not the person is an obligor.”

⁴⁵ See U.C.C. § 9-203(b)(2), Comment 6 (explaining that a debtor does not have to have a full ownership in collateral and that limited rights are sufficient).

authenticated⁴⁶ a security agreement that provides a description of the collateral. There are other alternatives besides authentication of the security agreement. These alternatives include: (1) possession of the collateral by a secured party; or (2) if the collateral is investment property, a deposit account, electronic chattel paper or a letter-of-credit right, the secured party has “control” of the collateral.⁴⁷

2.3.2.2 Description of Collateral

The collateral in an authenticated security agreement must contain a sufficient description. A description is deemed sufficient if collateral is indicated through a specific listing, category, or type, such as equipment or inventory. Under Article 9, a generic description of a collateral, such as “all debtor's assets” or “all the debtor's personal property,” is insufficient.⁴⁸ Such a description is, on the other hand, sufficient for the financing statement.⁴⁹ Also description by type is not permissible when the collateral is consumer goods or a securities account.⁵⁰

2.3.2.3 Perfection

Perfection, as I already mentioned, serves the public notice requirement and makes the security interest good against third parties. Perfection follows attachment or

⁴⁶ The requirement of authentication is broader than a writing requirement. *See* U.C.C. § 9-102[7].

⁴⁷ *See* U.C.C. § 9-203(b) & Comment 4.

⁴⁸ *See* U.C.C. § 9-108.

⁴⁹ *See* U.C.C. § 9-504(2).

⁵⁰ *See* U.C.C. § 9-108(e).

can occur simultaneously with attachment; perfection, however, may never precede attachment.⁵¹

Article 9 lays out four ways in which a security interest may be perfected: (1) through filing;⁵² (2) through possession; (3) through automatic perfection; and (4) through control. Some security interests may be perfected by multiple methods. Meanwhile, some security interests in certain collateral may be perfected only through a particular form of perfection. For example, possession is effective as a perfection mechanism only in respect of certain type of collateral, such as goods, instruments, money or tangible chattel paper.⁵³ Security interest in a deposit account may only be perfected through control.⁵⁴ A security interest is automatically perfected, i.e. without any need to take further additional steps with regard to perfection, in case of purchase money security interest in consumer goods or assignment of accounts and payment intangibles to some extent.⁵⁵ Perfection of a security interest over investment property⁵⁶ is done through either control⁵⁷ or through filing.

The method of perfection deserves great attention because it determines not only the enforceability of the secured party's security interest but also—and more

⁵¹ See U.C.C. §9-308.

⁵² See U.C.C. 9-310. Filing is the principle perfection mechanism.

⁵³ See U.C.C. § 9-313.

⁵⁴ See U.C.C. § 9-312(b).

⁵⁵ See U.C.C. § 9-309.

⁵⁶ Investment property includes security (whether certificated or un-certificated), securities accounts, commodity contracts, etc. See U.C.C. § 9-102(a)[48].

⁵⁷ See U.C.C. § 9-312; U.C.C. § 9-314. "Obtaining 'control' means that the purchaser...has taken whatever steps are necessary, given the manner in which the securities are held, to place itself in a position where it can have the securities sold, without further action by the owner" BROOK, *supra* note 28, at 203. For example, control over certificated security in bearer form is done through a delivery. See U.C.C. § 8-106.

importantly—plays a crucial role in determining priority with respect to competing security interests. I shall later address this issue.

In order to explore the differences between the US and the Slovak approach to the creation and perfection of security interests, I shall first describe the filing, which is the dominant perfection device, in more detail and then move on to discuss the priority issues within Article 9.

2.3.3 Filing

Article 9 allows for the filing of a financing statement⁵⁸ before a security agreement is entered into or a security interest otherwise attaches.⁵⁹ Lenders often take advantage of pre filing and file well before the loan transaction is finalized⁶⁰ since this enables lenders to safeguard their priority position among conflicting perfected security interests.

Filing must be authorized by the debtor, but for this evidence of a security agreement authenticated by the debtor is sufficient.⁶¹

The filing must be done centrally through a “communication of a record”⁶² to the office of Secretary of State in the jurisdiction where the debtor is located.⁶³ Most central

⁵⁸ See U.C.C. § 9-102 [39] (“Financing statement means a record or records composed of an initial financing statement and any filed record relating to the initial financing statement.”). Even though a filing office can reject the financing statement for only a limited number of reasons, written forms provided by Article 9 that are used for filing as safe harbors must be accepted by every filing office. Applicants are not forced by virtue of law to use these forms; however, in order to achieve maximum certainty and avoid the risk of refusal on the basis of form or format, they are well advised to use them. See U.C.C. § 9-520, Comment 2.

⁵⁹ See U.C.C. § 9-509(d).

⁶⁰ See BROOK, *supra* note 28, at 106.

⁶¹ See U.C.C. § 9-509(a)-(b).

⁶² See U.C.C. § 9-516.

⁶³ See U.C.C. § 9-501.

filing may be done electronically, often through the Internet, with a possibility to pay fees with credit cards.⁶⁴

While the financing statement is a rather simple document to fill out, the party must be careful to enter the data correctly. The filing office is not required to check for accuracy of the information or to conduct any further investigation⁶⁵ and failure to fill in information correctly may have a disastrous effect on the later enforceability of the security interest.⁶⁶

The financing statement is very limited in terms of obligatory entries that a party needs to fill in; the statement needs only contain the name of the debtor, the name of the secured party, and the collateral.⁶⁷ Failing to fill in these prerequisites makes the filing ineffective. But to best avoid refusal of the financing statement by the filing office, the statement shall also contain the mailing address of the secured party and the debtor, and indication whether a debtor is an individual or an organization, and its jurisdiction and identification number. However these latter grounds would not render the financing statement ineffective. If the applicant complied with all the requirements set forth by

⁶⁴ Darrell W. Pierce & Dykema Gossett, *What Lawyers Need to Know About UCC Article 9: Secured Transactions 2007, The Article 9 Filing System*, PLI Order No. 10808, 894 PLI/Comm. 25, at 34 (2007).

⁶⁵ See U.C.C. § 9-516(b) & Comment 3.

⁶⁶ See, e.g., U.C.C. § 9-503(a). This section of the U.C.C. calls for the correct indication of the debtor's name, which is the name shown on public records. This is of high importance as the financing statements are indexed according to the debtor's name. See U.C.C. § 9-503, Comment 2. The debtor's name is sufficient only "[i]f a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic, if any, would disclose a financing statement." See U.C.C. § 9-506(c). Thus, if the debtor's name is incorrectly recorded (like a trade name for example) on the financing statement, it will not turn up the right search results. Third parties are protected in such a case and a financing statement is ineffective against them. See *In re FV Steel & Wire Co.* 310 B.R. 390 (Bankr. E.D. Wisc. 2004). As can be seen *In re Tyingham Holdings, Inc.*, 354 B.R. 363 (Bankr. E.D. Va. 2006), the courts apply the requirement of indication of the debtor's name very strictly. Here the debtor's search under "Tyingham Holdings, Inc." did not disclose any search results as the debtor's name was entered without the corporate identifier. See *id.*

⁶⁷ See U.C.C. § 9-502(a).

Article 9 and paid the filing fee, the filing office may not reject its application.⁶⁸ Here, it is important to note that after-acquired property or future advances do not need to be indicated in the financing statement.⁶⁹ For this reason and also due to only limited space for the information to be included in financing statement, parties are encouraged to further investigate the current state of debtor's affairs in order to get the complete and appropriate information.⁷⁰ Fees related to the financing statement are determined by individual states⁷¹ and different states impose different fees regarding the filing of initial financing statements, amendments, termination or searches. However, the introduction of electronic filing has made the whole process much cheaper.⁷²

Lastly, financing statement have limited duration. They are effective only for a period of five years after filing, but this period can be renewed.⁷³

2.4 Priorities

2.4.1 Article 9 Priority System

Article 9 significantly improved priority rules over pre-Code legal rules, which dealt with priority issues in an incoherent manner.⁷⁴

⁶⁸ See U.C.C. § 9-520. This provision is aimed at harmonizing the practices among filing offices. See BROOK, *supra* note 28, at 108.

⁶⁹ A lien creditor is a "creditor that has acquired a lien on the property involved by attachment, levy or the like." See U.C.C. § 9-502, Comment 2.

⁷⁰ See *id.*

⁷¹ See U.C.C. § 9-525.

⁷² For example, in the state of Maryland, filing of financing statement, continuation or termination costs USD 20. See <http://www.sec.state.ma.us/cor/UCC/uccinf.htm#ucc8>. Meanwhile, in Michigan the filing fee is USD 10, and search with a certificated record of a search is USD 6. See http://www.michigan.gov/treasury/1,1607,7-121-1751_2194-6014--,00.html. In California, filing of financing statement, continuation or termination is USD 10, but if done electronically only USD 5, electronic search is charged for USD 10. See http://www.sos.ca.gov/business/ucc/ra_9_ucc_formsfees.htm.

⁷³ See U.C.C. § 9-515(a).

⁷⁴ See Jackson & Kronman, *supra* note 22, at 1144.

The issue of giving priority to certain creditors over others has been the subject of a long debate in the sphere of bankruptcy law and, as with other features of secured transactions, it took a long time until priority was recognized and introduced in the form as it is known today. The reason behind the early reluctance was that it is not justified for a debtor to prefer certain creditors over the others by making various contractual arrangements with creditors. This argument assumes that by such arrangement the claims of other creditors naturally are put aside though every creditor should be afforded equal protection if a debtor goes bankrupt. The principle of equal treatment however did not override recognition of the debtor's power to contractually agree to whether he will give certain creditors preference or not.⁷⁵ Instead, any fears that the value of unsecured creditors' claims will be diminished are allayed by the fact that the unsecured creditors may well be familiar with such consequences and will adopt measures to protect themselves from losses. How? If other collateral is not available, they can ask for higher fees and interest rates in connection with disbursement of the loan. So, as a result, the loan can be obtained without any security but becomes more expensive for a debtor. Moreover, creditors are free to choose their debtors and lay down the conditions under which they will be willing to undertake a loan transaction. They are not forced to enter into anything that bears a risk which they find unacceptable.⁷⁶

Secured lending carries several distinctive advantages for the lender. Upon encumbering the debtor's assets, the creditor is protected by the collateral which serves not only as an incentive for a borrower to repay the credit but also as a limit on the

⁷⁵ See *id.* at 1147.

⁷⁶ See *id.* at 1148-1149.

debtor' potential ability or willingness to take up risky business transactions. For a creditor, on the other hand, the collateral serves as protection in case the debtor encounters a default. On top of that, the lender is granted a priority over other unsecured lenders. Also, the outcome of the secured loan, as previously sketched, should be a more favorable interest rate for the debtor.⁷⁷

Article 9 contains a system of detailed rules on priorities, the general rule being the first-in-time, first-in-right rule.⁷⁸ The application of priority rules depends on the type of collateral (for example, instruments, chattel paper, investment property, deposit accounts or fixtures), and also on the status of a creditor (for example, whether it is perfected or unperfected creditor under Article 9, a PMSI holder or a holder of a possessory artisan's lien).⁷⁹ Along with these priorities rules, Article 9 sets forth exceptions to them, the most important exception being the purchase money security interest.

Under the Article 9 filing system, the preference of secured parties is ranked according to the time of filing rather than the time that the lending transaction was finalized.⁸⁰ So, assuming security interests are both perfected by filing only, regardless of a date of perfection of a junior security interest, the filing of a senior security interest that has not attached yet but was filed earlier than a security interest ranked as second (even though perfected earlier) will defeat the earlier perfected security interest. This is a

⁷⁷ See Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 639-41 (1997).

⁷⁸ See U.C.C. § 9-322, Comment 3.

⁷⁹ See NIMMER ET AL., *supra* note 20, at 254.

⁸⁰ See Jackson & Kronman, *supra* note 22, at 1179.

benefit that a secured party may take advantage of under the Article 9 filing system which, as I already mentioned before, expressly allows for pre-filing (i.e. filing before the security interest attaches). A secured party may well take a priority position in the line of other secured creditors.⁸¹

Nonetheless, we must bear in mind that a security interest may be perfected by means other than filing and that these other means can strike down the prior security interest perfected by filing.⁸² The method of perfecting a security interest in investment property is illustrative. The security interest here can be perfected either by filing or by control, yet perfection by control trumps perfection by filing even if the filing occurred earlier.⁸³

The Article 9 priority system, by developing a number of thorough rules and procedures not based solely on the first-in-time rule, expanded greatly the opportunities for parties to obtain credits that may not be permissible in laws of countries favoring the first-in-time model.⁸⁴ Purchase money security interests are a demonstrative example.

2.4.2 Termination of Security Interest upon Disposition of Collateral

In connection with priority issues it is also important to note that in certain cases

⁸¹ See BROOK, *supra* note 28, at 258

⁸² See U.C.C. § 9-502; U.C.C. § 9-322. See also BROOK, *supra* note 28, at 253, 257-58.

⁸³ See U.C.C. § 9-328 [1].

⁸⁴ See TAJTI, *supra* note 17, at 164.

regarding the disposition of collateral, the security interest ceases to exist. Article 9 sets forth that a security interest continues “upon sale, lease, license exchange or other disposition unless the secured party authorized the disposition free of the security interest.”⁸⁵ A buyer of goods takes collateral free of a security interest if he gives value and has no knowledge of a security interest and security interest is not yet perfected.⁸⁶ Generally, a buyer in the ordinary course of business⁸⁷ also takes goods free of any security interest if the security interest has been created by the buyer’s seller, regardless of perfection of security interest and the buyer’s knowledge of security interest.⁸⁸

These provisions are of the utmost importance for protecting a secured party. Enabling the buyers to purchase the collateral brings funds into the debtor’s balance, from which the debt is paid off. There is therefore incentive to support and encourage a debtor’s sales. However, we must also prevent dishonest buyers and debtors from forming a transaction in such a way that defrauds the creditor. For example, if the debtor sells the goods to the buyer at far below market value and the parties have actual knowledge that the creditor is being defrauded, we are failing to afford the secured party sufficient protection.⁸⁹

⁸⁵ See U.C.C. § 9-315(a).

⁸⁶ See U.C.C. § 9-317(b).

⁸⁷ “Ordinary course of business” means that the sale was of such a nature and performed in such a way that was in the ordinary course of the seller’s business and not of buyer’s affairs. See BROOK, *supra* note 28, at 315. Comment 3 to U.C.C. § 9-320 further provides for who qualifies for the buyer in the ordinary course of business: it someone who buys “in good faith, without knowledge that the sale violates the rights of another person and in the ordinary course.” The revised Article 9 sets forth the objective standard of good faith as opposed to a prior version of Article 9 which promulgated subjective test based only “on the honesty in fact in the conduct or the transaction involved.” The new test requires that a party act not only honestly but also in the “observance of reasonable commercial standards of fair dealing.” See U.C.C. § 9-102 [43]; BROOK, *supra* note 28, at 319.

⁸⁸ See U.C.C. § 9-320(a).

⁸⁹ See BROOK, *supra* note 28, at 317.

2.5 Purchase Money Security Interest (PMSI)

2.5.1 History

The concept of purchase money priority, like the concepts of after-acquired property clauses or future advances, is not completely new to Article 9.⁹⁰ The pre-Code law struggled with the problem of how to enable further financing for enterprises which could avoid prior liens. This problem was solved through adjustment of the title concept under individual security devices, such as conditional sale or a security lease. Due to these adjustments, a secured party directly held title, not a lien on the asset, and, in case of any conflicting interest with the prior financier, it would be protected as the title never passed on to the mortgagor.⁹¹ Nevertheless, problems remained under pre-Code law. For example, it was unclear whether the person lending money to the buyer to acquire goods can have such a purchase money interest. Under the pre-Code law, a lender could not benefit from the conditional sale and the concept of purchase money mortgage was based on the assumption that “the mortgage runs in the first instance directly to the seller.”⁹²

Article 9 attempted to solve these problems in part by abolishing independent security devices and refusing to make a distinction between a title and lien.⁹³ Under Article 9, a lender could possess a purchase money security interest. The old problems

⁹⁰ The first cases dealing with purchase money priority related to industrial mortgages. *See, e.g.*, *US v. New Orleans R.R.*, 79 U.S. (12 Wall.), 362, 364-365 (1871). These cases confirmed the validity of the after-acquired property clause and priority of purchase money interest in mortgages. The validity was formulated as follows: “A mortgage intended to cover after-acquired property can only attach itself to such property in the condition in which it comes into the mortgagor's hands. If that property is already subject to mortgages or other liens, the general mortgage does not displace them, though they may be junior to it in point of time.” *Id.* This rule applied irrespective of whether such an interest was reserved as a title to property under conditional sale, or a purchase money mortgage, a vendor's lien or a bond for purchase money. *See Gilmore, supra* note 9, at 1339-43.

⁹¹ *See Gilmore, supra* note 9, at 1337.

⁹² *See id.* at 1373.

⁹³ *See id.* at 1337.

were viewed as dealing with priority positions and were effectively solved through adoption of rules on purchase money security interests which imposed statutory limitations. These limitations avoided potentially unfair results that could arise from floating liens with regard to future creditors.⁹⁴

2.5.2 Purchase Money Security Interest - General Remarks

A purchase money security interest (PMSI) neutralizes the effect of tying the debtor's assets and provides an escape from the floating lienor's general encumbrance over the debtor's assets.

Article 9 distinguishes between two types of PMSIs. A PMSI is either held by the seller to secure the payment of the purchase price or the PMSI is held by the lender to secure the credit advanced to the debtor to enable him to acquire rights in or to use the collateral. When the PMSI is held by the lender, there is the requirement that the buyer use the credit for the purpose of obtaining the collateral.⁹⁵

Article 9 strictly limits the PMSI only to goods and software.⁹⁶ At the outset it must be said that the PMSI is subject to a number of elaborated rules, depending on the nature of the financed assets, which determine priorities among creditors. Different rules apply to consumer goods, to non-inventory, to inventory, to livestock, or to crops. The easiest mechanism for treatment of a PMSI is in the area of consumer goods, where, out

⁹⁴ See *id.* at 1336-1338.

⁹⁵ See U.C.C. § 9-103(a).

⁹⁶ See U.C.C. § 9-103.

of commercial necessity, the purchase money security interest is perfected automatically without a filing requirement.⁹⁷

A PMSI constitutes an exception to the Article 9 priority rules. The PMSI holder is afforded priority even when his security interest was perfected later in time and a PMSI enjoys a special protection in bankruptcy.⁹⁸

The PMSI requires a close connection between the acquisition of collateral and the obligation secured by the PMSI. While the seller does not seem to have much of a burden, the lender must trace the funds and show that it actually used the funds to obtain the collateral. Therefore, the creation of security interest preceded by unsecured credit does not amount to a PMSI. Unfortunately, Article 9 does not provide any guidance with respect to the kind of proof necessary to prove the correlation between the collateral and the secured obligation; however, it should be sufficient for the lender to show that the loan and sale occurred basically at the same time and that both seller and debtor knew that the loan was a precondition for the sale.⁹⁹ To escape any doubts over how the funds were actually used the transaction may be arranged in such a way that the lender advances the funds directly to the seller.¹⁰⁰

The requirement of correlation between the collateral and the credit is meant to ensure that the debtor uses the loan to acquire something that it debtor did not previously

⁹⁷ Filing is required, however, when the consumer goods are automobiles. *See* U.C.C. § 9-309 & Comment 3.

⁹⁸ *See* Beard, *supra* note 3, at 445.

⁹⁹ K.G. Meyer, *A Primer on Purchase Money Security Interests under Revised Article 9 of the Uniform Commercial Code*, 50 U. KAN. L. REV. 143, 153-54 (2001).

¹⁰⁰ *See* Gilmore, *supra* note 9, at 1373.

own and something that would enrich and bring new value to its assets. Additionally, the correlation requirement ensures that the collateral is identifiable and can be traced. The correlation requirement also protects the security interest of senior creditors by barring the debtor from using the loan for general business purposes, such as indirect costs like wages or salaries.¹⁰¹

2.5.3 Floating Lien and PMSI in Secured Financing

The floating lien is a tool for a long term financing. The after-acquired property clause, which is one of the essential elements of the floating lien, plays an important role when financing assets that rapidly change their nature, are of temporary nature, or are frequently disposed of. This is particularly true of inventory and receivables. Such clauses have a significant impact on cost saving because parties do not need to execute a number of documents each time inventory or receivables change in order to give effect to their ongoing transaction.¹⁰²

To understand better how the floating lien works and why the purchase money security interest is a legitimate restriction, we need to consider and assess this security instrument from several aspects.

A borrower usually has a particular development plan for its business project. By encumbering its assets with a blanket lien, the debtor commits himself to a lender with whom the debtor has an exclusive relationship. This exclusive relationship enables the

¹⁰¹ See Jackson & Kronman, *supra* note 22, at 1175-76.

¹⁰² See *id.* at 1167.

lender to watch closely the borrower's affair and particular development of its project. The borrower, meanwhile, usually receives the necessary financial counseling from the lender, who is motivated to ensure the successful continuation and finalization of the borrower's project. Subsequently, a borrower may benefit from loans disbursed at a cheaper cost if he engages in repetitive commercial transactions with a lender. Due to the ongoing creditor-debtor relationship, the lender knows his debtor and, thus, any expenses related to the screening of the debtor do not come into play. The blanket lien not only makes the monitoring of the debtor's affair easier, but it also serves as a deterrent to any potential misbehavior on the part of a debtor since the general lender has the option to invoke several default remedies, putting quite a lot at stake.¹⁰³

Based on the foregoing analysis, it is appropriate to ask why the PMSI holders are accorded priority over floating lien creditors under Article 9 considering that the floating lien bears the advantages of established exclusivity between parties?

The traditional argument favoring the PMSI is that the PMSI financier adds new funds into the debtor's assets and, therefore, the floating lien financier should not be concerned since the new advance is secured with new collateral and will not affect the senior's lender interests. On the other hand, one can make the counterargument that, assuming the debtor's affairs remain relatively the same, the costs incurred by the lender with respect to further subsequent financing are lower than that of a second junior lender who is not familiar with a debtor yet. Moreover the senior lender does, in reality, care about the PMSI which may trump the senior security interest. After all, the principal

¹⁰³ See Beard, *supra* note 3, at 488.

incentives for floating lien financing are to obtain exclusivity with respect to financing and, consequently, obtain the ability to supervise the project.¹⁰⁴

Two possible arguments may, however, be put forward in support of PMSI priorities. The first deals with the creditor's conservatism, which arises a lack of incentive to further finance the debtor when new business opportunities arise since the return of profits is calculated in advance. The creditor, who is wary of risky new projects, has incentives that are simply incompatible with those of a debtor, who may be more eager to engage in risky projects in to hopes of further expanding its business. So, if the creditor will not finance the new project, the debtor's project will stagger and remain unaccomplished. Even though the debtor may escape this impasse by finding a second financier who will refinance the first loan and undertake the financing of the new project, this is a costly solution. It is a costly solution since the debtor not only incurs expenses related to finding a willing financier, but also has to pay costs related to termination of the old loan, such as prepayment fees, and the fees associated with the administration of a new loan. A possible solution is offering the second lender a purchase money priority through which a debtor would be able to take up the new project that may bring new value to the firm.¹⁰⁵

The second reason favoring PMSI derives from the assumption that a purchase money holder may well benefit the firm. For example, a PMS financier may have specialized knowledge and skills in particular financing, sale and servicing of specific

¹⁰⁴ See Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 961-62 (1986).

¹⁰⁵ See *id.* at 962.

assets; a bank, in contrast, might lack familiarity and the requisite expertise. Also, a credit seller may often decrease the costs related to overseeing the debtor's use of the assets since the credit seller has regular contact with a debtor when servicing or providing additional support with respect to use of these assets.¹⁰⁶

A trade creditor, active in one part of an industry and having knowledge in this industry, will be much better equipped to assess the debtor's warranties and business affairs when applying for a credit. So, for what may be in case of a large lender, such a bank, a long and expensive procedure to obtain the necessary information, will be routine for a trade seller, who can readily access and easily obtain accurate information.¹⁰⁷ This will benefit both types of creditors and the first creditor will avoid the monitoring costs.

If we assume that the PMSI creditor would not be afforded priority, his claims would be ranked behind those of a general lender. It is therefore likely that the monitoring costs of a PMSI lender would be rather high since, as a junior lender, it would seek to monitor the behavior of both the debtor and the senior (or general) lender. . Meanwhile, the senior lender, who has a floating lien over the debtor's assets, will not feel compelled to heavily monitor the new collateral obtained by the debtor since the new collateral gives new value to the debtor's overall assets. The second junior lender, on the other hand, will be aware of its second ranking and will have an imminent interest in ensuring that the debtor's affairs go well so that, in case the debtor gets into trouble, the debtor's assets are sufficient to cover the junior lender's second ranked claim. The junior

¹⁰⁶ See *id.* at 963.

¹⁰⁷ See Jackson & Kronman, *supra* note 22, at 1161.

lender will consequently monitor not just the collateral which the debtor obtained through the junior lender but also the collateral obtained through the senior lender. Moreover such an arrangement runs the risk of collusion; for example, when undertaking a risky investment, the senior lender and the debtor could collude to defraud a junior lender.¹⁰⁸ However, giving a purchase money priority to a junior lender splits the monitoring costs among the creditors. In so doing, it ensures that no lender bears additional costs and that the debtor can benefit from a junior lender who will be willing to extend credit at a cheaper rate since he is secured.¹⁰⁹

However, the PMSI not only benefits the debtor and the junior lender; the general creditor also benefits from the PMSI holder's presence. If the new advances result in the debtor's growth, this growth will benefit not only the PMSI holder but also a senior general lender who was unwilling to extend the credit for a transaction that it considered too risky. If the debtor's project fails, however, the senior creditor's funds are not endangered since they remained secured by the collateral given in present and after-acquired property, excluding the PMSI. A senior creditor may be expected to rely on the assumption that these sources will be sufficient when entering into the loan transaction.¹¹⁰

Finally, it is important to note that a general creditor's security interest in after-acquired property may not be at the mercy of a PMSI holder without the general creditor's consent. If the contract between the debtor and the senior contractor contains negative covenants which prohibit or limit the occurrence of purchase money security

¹⁰⁸ See *id.* at 1169-70

¹⁰⁹ See *id.* at 1171

¹¹⁰ See Beard, *supra* note 3, at 493.

interests, the senior creditor may hold a debtor to such a contractual stipulations. Therefore, even though negative covenants are only *in personam* security devices, they nevertheless may play an important role in business transactions.¹¹¹

At this point, I will depart from general remarks on purchase money security financing. Instead, the next section will demonstrate the precision with which Article 9 deals with respective purchase money security interests. I will do so by briefly describing some characteristics of purchase money security interests in inventory and equipment as well some common rules regarding purchase money security interest and priorities.

2.5.4 Distinct Characteristics in Certain Types of PMSI Financing and PMSI Priorities

2.5.4.1 PMSI in equipment

A PMSI in equipment¹¹² enjoys priority when there are conflicting security interests in the same goods or their identifiable proceeds provided that the PMSI was perfected when the debtor obtained possession or within 20 days thereafter.¹¹³ “Identifiable proceeds” is a broad term that encompasses not only proceeds in the form of money or accounts but also proceeds in the form of tangibles where the goods are exchanged instead of sold.

In the past, the issue of obtaining physical possession raised problems and the interpretation what exactly constitutes a possession varied. These problems arose when the possession of goods occurred before the debtor decided to buy on a credit. This was

¹¹¹ See Meyer, *supra* note 99, at 171.

¹¹² See U.C.C. § 9-102(a)[33] (“Equipment means goods other than inventory, farm products, or consumer goods”).

¹¹³ See U.C.C. § 9-324(a).

often the case when a possession was with a lessee or bailor, when goods were to be tested, or where the debtor took possession of goods gradually rather than all at once. Article 9 attempts to solve these problems by laying out that the 20 day period to begin to commence as of the moment when the goods become collateral, that is, when the goods become subject to a security interest. It follows that the 20 day period should begin to run when a creditor has a security interest in the collateral which has attached, that is, when the debtor has rights in collateral, the value has been given, and an authenticated security agreement has been entered into.¹¹⁴

2.5.4.2 PMSI in inventory

The requirements for an inventory¹¹⁵ purchase money financier are very strict for reasons that I will soon explain.

An inventory PMSI financier, in order to ensure his priority over a general financier, needs to inspect public filings and give an authenticated notice to the creditor who has a perfected security interest in the debtor's inventory. The notice must be given within the time period of 5 years before the debtor receives the collateral; it must state that the PSMI financier has or expects to acquire a PMSI in the inventory of the debtor

¹¹⁴ In addressing the issue of taking possession, the drafters of revised Article 9 addressed resolved the ostensible ownership problem with respect to transferred collateral by adopting what was in effect the test articulated in *Citizen's National Bank of Denton v. Cocknell*, 850 S.W.2d 462 (1993). Comment 3 of U.C.C. § 9-324 states that the "buyer takes possession...when, after an inspection of the portion of the goods in the debtor's possession it would be apparent to a potential lender to the debtor that the debtor has acquired an interest in the goods takes as a whole." Prior to the revised version, the courts generally held that possession did not occur until all components were at the debtor's possession. *See, e.g., In re Vermont Knitting Co., Inc.*, 98 Bankr. 184 (D. Vt. 1989). *See also* BROOK, *supra* note 28, at 278-79.

¹¹⁵ "Inventory means goods, other than farm products, which:

- (A) are leased by a person as lessor;
- (B) are held by a person for sale or lease or to be furnished under a contract of service;
- (C) are furnished by a person under a contract of service; or
- (D) consist of raw materials, work in process, or materials used or consumed in a business."

See U.C.C. § 9-102 [48].

and the notice must describe the inventory. Additionally, the PMSI must be perfected before the debtor receives possession of the collateral. If these requirements are met, the PMSI holder has priority not only with respect to the PMSI inventory but also to identifiable cash proceeds¹¹⁶ received by the debtor on or before delivery of the inventory to a buyer.¹¹⁷ A notice to a secured party with a prior security interest is effective for 5 years; this time limitation is of significant importance when the parties maintain their business relationships for an extended period or if a junior financier has floating lien over the inventory.

One may ask why PMSI holders are treated differently with respect to their security interests. Why does a PMSI financier of equipment not have to file before the debtor obtains possession or notify prior creditors? The reason for setting out different rules stems from the nature of transactions and the need to protect certain creditors more than others.

For example, conditional sales of equipment tend to be carried out by non-professionals and possession by the debtor is a “business necessity.”¹¹⁸ Therefore, if the law imposed the same requirements as in inventory financing, it would be quite burdensome and would chill the ease of commercial transactions.¹¹⁹ Meanwhile, a

¹¹⁶ “Cash proceeds” means proceeds that are money, checks, deposit accounts, or the like. *See* U.C.C. § 9-102(a)(9). Here the definition of proceeds is narrower than with regards to proceeds in the non-inventory setting. For example, in the inventory setting, an account is defined as “a right to payment of a monetary obligation, whether or not earned by performance ... (vii) arising out of use of a credit or charge card or information contained on or for use with the card.” U.C.C. § 9-102(a)(2). Deposit account or investment property are outside of definition of accounts. *Id.* It is important to note that if cash proceeds are deposited in the bank having a control of the deposit account, the bank defeats the priority of the PMSI holder. *See* U.C.C. § 9-327.

¹¹⁷ *See* U.C.C. § 9-324(b)

¹¹⁸ *See* Coogan, *supra* note 33, at 863-64.

¹¹⁹ *See id.*

businessman is less likely to enter into a series of transactions for equipment as opposed to inventory, which is constantly changing and constantly needs to be renewed.¹²⁰ In the case of equipment financing, “[t]he prior filer will tend to be less dependent than the inventory financier upon receiving notice that some of the equipment coming into his debtor’s possession is subject to a PMSI.”¹²¹ Also, unlike PMSI holders in inventory, PMSI holders in equipment transactions are usually sellers. Their prime incentive is to attract the customers for their business and be as efficient as possible. For sellers, the requirement to file notice, with its additional paperwork, would inhibit their ability to be flexible and their ability to quickly serve customers.¹²²

As far as an inventory financing is concerned, Article 9 requires notification in order to protect a prior creditor who is expected to make advances against newly acquired inventory. Without this protection, a debtor could easily defraud a secured party by drawing new credit lines despite the fact that he has already given a security interest in the inventory to another creditor. The notification requirement informs the prior creditor about additional financing and the prior creditor can protect its security interest by ceasing to provide further advances to the debtor.¹²³

Thus, looking back at all the requirements that of a PMSI holder must comply with in order to safeguard his prior position, it may seem that the PMSI holder is under quite a heavy burden with regard to monitoring the debtor once the debtor receives the possession of collateral for the funds that were advanced to him for this particular

¹²⁰ See *id.* at 864.

¹²¹ *Id.*

¹²² See BROOK, *supra* note 28, at 276-277.

¹²³ See Beard, *supra* note 3, at 461

purposes. We must however bear in mind that, since Article 9 allows for the pre-filing of a financing statement before the lender releases any funds, a lender can effectively avoid the necessity of tracing the exact time of possession.

2.5.4.3 Conflicting interest of PMSI holders

When there is a competing security interest in the same collateral, Article 9 resolves the conflict differently depending on the parties involved in the conflict. If the conflict is between the seller and the lender, Article 9 resolves the conflict in favor of the seller.¹²⁴ In all other cases, where only lenders are involved, the first-to-file rule or first-to-perfect rule applies.¹²⁵ As regards conflicts between PMSI holders, buyers not in ordinary course of business, or lien creditors, Article 9 gives priority to those PMSI holders with interests perfected by filing “before or within 20 days after the debtor receives delivery of the collateral.”¹²⁶

3 Slovak Charge Law

3.1 Background

To begin with, unlike Article 9 of UCC, which contains a uniform set of rules governing secured transactions of personal property, Slovak secured transactions law does not favor a unitary approach and, therefore, does not possess one single category of “security interest.” Instead, security instruments in Slovak law are scattered in a number of provisions which, following the duality of the legal system, are found in both the Civil and Commercial Code. The new secured transactions law, effective as of 1 January

¹²⁴ U.C.C. § 9-324(g)(1).

¹²⁵ U.C.C. § 9-324(g)(2).

¹²⁶ U.C.C. § 9-317(e).

2003,¹²⁷ brought a change only with respect to a charge law; other categories of security instruments which also serve to create a security interest have not been reformed. The reform law sought to enhance the secured transactions environment in order to foster the development of Slovakia's transitory economy. Despite significant improvement and new opportunities in financing, the reform law left open a number of issues, which has given rise to questions and various interpretations mainly among legal practitioners.

For purpose of this comparative analysis, a security interest involving a floating lien interest or a purchase money security interest is functionally identical to what is known as a "charge" in Slovak law.

3.2 How Was the New Law Born?

The European Bank for Reconstruction and Development ("EBRD") considered the inaccessibility of credit due to an insufficient and inflexible secured transaction environment in Central and Eastern European countries one of the key obstructions to economic development and growth at the beginning of the transformation process. This was an impetus for the "Project on Secured Transactions," which came to existence in 1992.¹²⁸ The EBRD and the Notarial Central Registry of Charges ("NCR") were directly involved in the implementation of the new secured transactions law.¹²⁹ The EBRD

¹²⁷ The law was introduced by the Act No. 526/2002 Coll. amending the Act No. 40/1964 Coll., the Civil Code ("CC"); the last amendment to the CC was done by the Act No. 568/2007 Coll. which became effective 1 January 2008.

¹²⁸ See LEGISLATIVE INTENT OF COMPLEX CHANGES OF LEGAL REGULATION ON CHARGES (PROPOSAL), available at [http://www.rokovania.sk/appl/material.nsf/0/500A3C6C126691F3C1256A2A0043B150/\\$FILE/Zdroj.html](http://www.rokovania.sk/appl/material.nsf/0/500A3C6C126691F3C1256A2A0043B150/$FILE/Zdroj.html) (last accessed 30 March 2008).

¹²⁹ See REVIEW OF THE FUNCTIONING OF THE CHARGES REGISTER IN THE SLOVAK REPUBLIC, EBRD, July 2006, at 3.

Model Law was inspired largely by US law, specifically Article 9 of the UCC. However, there are also traces of English law in some of the concepts.¹³⁰

3.3 Pre-reform Law

3.3.1 General remarks

Prior to the enactment of the new reform, Slovak law generally recognized, in the sphere of charges that could be created over personal property, only the possessory pledge. The call for reform was mainly driven by the industry, which was particularly concerned with the limited sources to finance Small and Medium Enterprises (“SME”). The new reform law had the objective of boosting SME financing which in turn would have a positive effect on employment growth.¹³¹ The deficiencies in the old law forced banks as principal lenders to use alternative security devices in financing, such as security of obligation though transfer of a legal title. This security device, however, could be used only if the title to a specific asset was vested with the debtor and not with a third person.¹³² Hence this rather limited alternative could not substitute for the advantages of

¹³⁰ Specifically, English law influenced the adoption of the term “charge” as a single security right which can be created over essentially any type of asset that qualifies as collateral, including after-acquired property and shifting assets. Further influence of English law can be seen in the exemption of title financing from secured transactions and the inclusion of an option to sell charged enterprise as a pool of assets constituting a going concern. EBRD Model Law was a product that to embrace solutions evolved in common law secured transaction adopted to countries with civil law system. *See* TAJTI, *supra* 17, at 328.

¹³¹ SME in OECD countries represent 95% of all businesses and their share in employment is approximately 60-70%, in Slovakia the portion of SME businesses, in 2001, was as high as 99% out of all businesses with the share in employment of 59,2%,. *See* ANALYSIS OF SME DEVELOPMENT, MINISTRY OF ECONOMY, *available at* <http://www.economy.gov.sk/pk/1160-2002-010/ma.htm>, (last accessed 30 March 2008).

¹³² Amendment to the CC by the Act. 568/2007 Coll., effective as of 1 January 2008 allows also a third party to create such a security interest.

charge law, which is far more flexible since it is based on a concept of a granting purely a security interest, rather than a title.¹³³

3.3.2 Drawbacks of Possessory Pledge

Prior to the adoption of the reform law, the statutory wording of the Civil Code did not provide a clear distinction between the creation and the perfection of a charge. The prior law required the parties to execute a written agreement and to undertake one of three actions to create a charge over movables. The charge could be created by: (1) handing in a thing to a chargeholder; (2) by marking the creation of a charge in the deed certifying the legal title to the collateral, an action which is also necessary to dispose of a thing; or (3) by giving a thing to a third party for custody.¹³⁴ The creation of a charge mentioned under (2) was particularly problematic as the deed which was a prerequisite for the disposal of a thing enabling a creation of a non-possessory charge was hard to find.¹³⁵ Consequently, the parties were essentially left with the other two possibilities for creation of a charge. This clearly was causing a lot of troubles in practice as it presented borrowers with a shortage of financing options.

It is interesting how the courts tackled this barrier to a possessory pledge. Despite a clear statutory provision calling for either the creditor to have possession of a pledge or a third party to have the collateral in custody, the High Court adopted a flexible

¹³³ See Justification Report to the Amendment of the Act Introducing new charge law, available at [http://www.rokovania.sk/appl/material.nsf/0/13B6A11FF0BFB2E7C1256B8A0035AA49/\\$FILE/Zdroj.html](http://www.rokovania.sk/appl/material.nsf/0/13B6A11FF0BFB2E7C1256B8A0035AA49/$FILE/Zdroj.html) (last accessed 15 March 2008).

¹³⁴ See § 151b (3) CC prior to the amendment of the Act No. 526/2002 Coll.

¹³⁵ Not even a technical car certificate could qualify for the creation of a charge as this was not a prerequisite of a transfer of a legal title to a car. See Peter Vojčík, *Nová právna úprava záložného práva v Slovenskej republike*, BULLETIN SLOVENSKEJ ADVOKÁCIE (Jan. 2003), available at <http://www.sak.sk/blox/cms/sk/zone1/bulletin/archiv/id1/id1/id2/lbtnFolderOpen> (last accessed 15 March 2008).

interpretation of how a possessory pledge is created and, at the same time, allowed the charger to use the collateral in his business. The brief reasoning of the High Court argued that the law did not speak of “actual” or “real” delivery of the collateral to the creditor or a custodian, but rather just of pure delivery.¹³⁶ The brief and poor reasoning of the High Court completely failed to address the issue of ostensible ownership.

While High Court decisions possess strong persuasive value, lower courts do not always follow them in practice. *Decision of the Regional Court in Košice* was a case of a lower court overlooking a High Court decision. The court here held that the law required that the collateral be delivered to a creditor or a third party; however, it seems that the claim was denied not solely on the grounds of failing to comply with delivery requirements of possessory pledge but in conjunction with rejection to recognize the charge over changing pool of assets – livestock.¹³⁷

¹³⁶ The case concerned bankruptcy proceedings. The holding of the case was that a “plaintiff as a creditor shall be entitled for a separate satisfaction from the proceeds of sale of movables also in the case, if assets specified in the charge agreement has been henceforth used by a charger based on its agreement with a creditor.” A regional court first denied the claim stating that the charge had not come into existence since the movables were not handed over to the chargeholder. The plaintiff appealed, arguing “that the parties in the agreement declared that the movables were handed over to the chargeholder” and that “[t]he law does not set forth that there must be an actual delivery of the charged movables.” The High Court, siding with the plaintiff, reasoning that the manner of delivery agreed on by the parties was not excluded by the law. What is more, the High Court said: “Lastly if the quoted legal provision permits the possibility of delivery a thing instead of a creditor to other party, it would be incorrect not to enable the use of a thing (assets) to a charger, especially, when a charger needs them to meet his production plan which may help him to pay off the debt.” See *Decision of High Court 3Obo 180/2001*.

The foregoing High Court decision was followed subsequently in another bankruptcy case. First the claim for a separate satisfaction was denied by the bankruptcy trustee with respect to movables charged in 1998; in so doing, the court reasoned that the charge was not created validly. Even though the decision does not discuss why the charge over movables had not come into existence, since the bankruptcy trustee relied on the previous decision of *High Court 3Obo 180/2001*, we may assume that similar reasons were involved even in this case. Thus the claim for a separate satisfaction was admitted. See *Decision of Regional Court in Banská Bystrica, 35Cbi/42/2005*.

¹³⁷ The plaintiff filed a claim for a separate satisfaction in bankruptcy proceedings from a collateral among which were also movables – livestock. The claim for satisfaction based on the charge over livestock was denied by the bankruptcy trustee, who reasoned that the charge is invalid since the cattle were not handed over to the creditor. The plaintiff argued that the law only anticipates the collateral to be delivered. The

3.4 Floating Lien Scheme in Slovak Law, How Does it Differ from Article 9?

In order to assess and examine the policy of the floating lien under Slovak law, it is necessary to outline some new rules and changes that have been introduced by the reform law, starting from the creation and perfection of a charge through a conceptual analysis of distinct elements upon which floating lien rests. This discussion will include the recognition of after-acquired property clause, future advances and finally the concept of proceeds.

3.4.1 Creation and Perfection of a Charge

The reform law draws a sharp distinction between the creation of a charge and the perfection of a charge, both being a condition of enforceability of a charge not only against third parties but also against a charger. The concept of attachment, found in Article 9, makes a collateral security interest enforceable against a debtor does not have its equivalent in the Slovak charge law.

plaintiff also pointed to, among other opinions, to the *High Court decision 3Obo 180/2001* on this matter. The court, unlike the High Court, was of the opinion “that an actual handover or indication of a creation of a charge in the deed certifying the legal title and necessary for disposition of the asset and the asset must be indicated in such a way that it would be clear that such an asset is charged.” The court said that indication of a charge on the inventory of livestock is not sufficient because the record in question is not necessary for a disposition of these assets. Therefore the court found the charge agreement to be invalid. The court did not address the issue what kind of a record could be sufficient in order to create a valid charge. The court went on with its reasoning and addressed the issue of the collateral. It held that a subject to charge may only be in individually determined and identified thing. Besides even if the charge at issue was valid, this would only cover the animals which at the time of execution of a charge agreement were owned by the debtor and not the animals which were subject to ownership of the debtor in different periods. (This would mean only animals subject to charge in 1993). The court was of the opinion that the plaintiff did not prove that the livestock at issue was under debtor’s title at the day of the declaration of bankruptcy and therefore the claim of the plaintiff for a separate satisfaction from the sale of animals was considered unauthorized. See *Decision of the Regional Court in Košice, 3Cb/552/2002*.

Generally, a charge is created by a written agreement, with the exception of a possessory pledge where no written agreement is required.¹³⁸ Failure to comply with this formal requirement makes the whole agreement invalid *ab initio*.¹³⁹ The written agreement must contain signatures of both parties to the agreement. In comparison, US law under Article 9 sets forth the requirement that an agreement be authenticated by the debtor. Article 9 does not, however, call specifically for an authentication on the part of a creditor.

In Slovak law, the charge is generally perfected by registration with the Notarial Central Registry of Charges (“NCR”).¹⁴⁰ Other forms of perfection include taking possession or registering with the specific asset based registry where the law so provides.¹⁴¹ Since a charge is generally created by a written agreement, absent such agreement, the charge is a nullity; this prevents any pre-registration of a charge with the NCR before the execution of a charge agreement. In contrast, Article 9 explicitly allows for pre-filing.¹⁴²

Registration with the NCR, like in the US filing system, is the central perfection mechanism of charge, but, in addition, it is also a principal priority determinant.¹⁴³

¹³⁸ See § 151b (1) CC, a charge may also be created by approved heirs agreement, by a decision of administrative body or by operation of law. Also charge to specific properties, such as real estate, securities and most of intellectual property rights, is regulated by separate laws. Application of these specific laws on creation of charge to provisions contained in CC follows *lex specialis, lex generalis rule*.

¹³⁹ See § 40 (1) CC.

¹⁴⁰ See § 151e (1) CC.

¹⁴¹ See § 151e (2)-(3) CC. For example, real property is registered with land registries, trademarks, patents, utility designs and semiconductor topography with Intellectual property Office, securities with Central Depository of Securities, ownership interest with Commercial Registry, ships or aircrafts with Ships or Aircraft registries

¹⁴² See U.C.C. § 9-509(d).

¹⁴³ Unlike in the US where we can see an elaborated priority system based on various policy considerations to prefer certain creditors over the others, this is not the case of Slovakia, where registration of charge with

3.4.2 Collateral

The reform law substantially extends what may qualify as collateral. Collateral is understood very broadly and the charge may also be created over, for example, an enterprise or a pool of assets that is constantly changing. The essential condition to qualify as collateral is that the asset subject to charge is transferable.¹⁴⁴

3.4.3 Parties to Charge Agreement

The law requires that a charge be created over a thing, right or intangible asset over which a charger has legal title.¹⁴⁵ The charger needs not be the debtor who owes the payment or the other obligation.¹⁴⁶ Unlike the former statutory wording, which allowed parties to create a charge with the consent of the person having the legal title,¹⁴⁷ the current statutory wording is silent on this issue and presumably does not foresee a broader ability to create a charge than is found in Article 9, which requires the debtor to have rights in the collateral.

From the wording of other provisions on charge law it seems that the reform law did not intend someone else other than the owner to create a charge. The justification report also mentions that a charge may only be created by a person having a legal title to

NCR is a key priority factor. Example may be illustrated on a possessory pledge, although the law permits perfection by possession, the later charge created over same collateral if registered with NCR trumps over the earlier possessory pledge. *See* § 151k (2) CC. Same applies to charges created by state organs, e.g. a tax lien, which no longer are granted preference and are ranked with other charges according to time of registration. *See* § 151k (1) CC.

¹⁴⁴ *See* § 151d CC. Some laws provide specifically that certain assets may not be subject to a charge, such as state owned assets, the creation of a second charge over securities, etc.

¹⁴⁵ An example of an intangible asset is intellectual property or an ownership interest in a limited liability company. *See* KAROL PLANK, *OBČIANSKE PRÁVO S VYSVETLIVKAMI*, 1. zväzok, at 268b (1996).

¹⁴⁶ Compare a definition of a “debtor” in U.C.C. § 9-102(a)(28).

¹⁴⁷ *See* § 151d (1) CC prior to the novel law. This approach was approved by the courts. *See Decision of High Court File No. sp.zn. 4 Obo 248/97* (stipulating that a charge may be created by a person who is not an owner of the collateral but who has the consent of the owner).

the collateral.¹⁴⁸ Even though this does not seem to cause any difficulties in practice, the law did not resolve properly the duties imposed separately on a charger as owner and debtor.

Under the law, a charger must fulfill far more duties with respect to collateral than third persons, among which is the debtor. For example, only the charger has the obligation to register the charge. Also, in terms of use of collateral, the law speaks only of obligations pertaining to a charger, who must refrain from any acts—beyond ordinary use—that could reduce the value of the collateral.¹⁴⁹ But what if collateral is in possession of a third party, such as a debtor based on a lease contract? It remains to be seen how the courts will face such issues and whether they will adopt a broad interpretation with respect to who is authorized to create a charge and what obligations then follow.

3.4.4 Future Advance Dilemma

One of key principles upon which the floating lien rests is the option to secure an obligation that will arise in future. Even though the securing of a future obligation was not a novelty introduced by the reform laws, absent a broad understanding of collateral and after-acquired property clauses, it could not have been fully exploited.

Slovak law, *per se*, does not put any limitation on type of claim that may be secured.¹⁵⁰ It can be a monetary or non-monetary claim, the value of which is specified

¹⁴⁸ See Comment to §151d CC in justification report to the Act introducing new charge law.

¹⁴⁹ See § 151i (1) CC.

¹⁵⁰ Prizes from stakes and gambling and loan provided for this purpose are not legally enforceable unless covered by the Act on Gambling 171/2005 Coll., as amended. See §§ 845-846 CC.

or identifiable any time during the existence of the charge.¹⁵¹ The claim may be antecedent, present, future or conditional.¹⁵² In contrast to US law, which allows for pre-filing before the security agreement is executed or a loan actually released, Slovak law takes the opposite approach; in Slovakia, the parties first must make a security agreement and then register a charge. Since a registration of charge is often, in practice, a precondition for advancement of the credit by a creditor, we should address the securing of future claims.¹⁵³

Slovak law requires the charge agreement to specify the claim and the collateral. The collateral may be specified individually, in terms of volume, or in any other identifiable manner¹⁵⁴ and a claim shall be specified in such a matter that its value shall be determinable any time during the existence of a charge.

The law presents a hurdle in that it also calls for the parties to specify the maximum value of principal up to which the claim shall be secured in case the charge agreement does not specify the *value* of the secured claim.¹⁵⁵ In practice, this provision presents a number of difficulties when it comes to registering a charge with the NCR and when the lender subsequently disburses additional advances of the credit. Consequently, practitioners, in an effort to achieve some flexibility, differ in their interpretations and practices.

¹⁵¹ See 151c (1) CC.

¹⁵² See 151c (2) CC. Even though the law does not explicitly articulate of a possibility to secure an antecedent debt, the definition of the claim that can be secured clearly speaks in favor of this option.

¹⁵³ GUIDE FOR TAKING CHARGES IN THE SLOVAK REPUBLIC, EBRD, Feb. 2003, at 12.

¹⁵⁴ See 151b (2) & (4) CC.

¹⁵⁵ See 151b (3) CC.

It is not quite clear what the law means by the value of the secured claim. On one hand, the law requires the claim to be identified; therefore, one might interpret the question of value to mean that the value of the claim should be at any time identifiable and the exact sum of the secured claim should not be requisite as long as the value of claim is identifiable. Indeed, the justification report makes clear that when the value of the claim changes during the validity of the charge agreement, it shall be possible to determine the current value of the claim at any time during the existence of a charge in order to comply with requirements on identifiability of the legal act laid down in the Civil Code.¹⁵⁶ Obviously if parties enter into a charge agreement providing for the securing of future obligations and, subsequently, the parties execute a new amendment to the credit agreement, the value of the claim is clearly identifiable if it is revealed by the exact amount of the loan being disbursed.

The other interpretation of value may be to require the parties to specify in the agreement the sum of the claim. But what if the parties enter into a credit agreement and simultaneously execute a charge agreement, without foreseeing any future indebtedness or without specifying the upper credit limit? The solution adopted by Article 9 is that, if the charge agreement provided for securing a future obligation in respect of the same collateral, then the future advance is automatically covered by the same collateral.

Problems also arise with respect to the NCR. The registration forms pertaining to charge require the parties to specify the amount of the claim. So the dilemma is, when the parties amend a credit agreement to increase the credit limit, are the parties under an obligation to re-register the amount of the claim with the NCR? If so, such a requirement

¹⁵⁶ See Comment to § 151b CC in justification report introducing new charge law.

is cumbersome and expensive since registration with NCR naturally involves fees which are not low.

The possible requirement that parties re-register the amount of the claim with respect to future advances is an unnecessary requirement. The situation is reminiscent of a period in the history of US history secured transactions law where parties were required to specify the maximum amount of the claim. Noticing the problems presented by this approach, Gilmore formulated his unitary view on the creation of a security interest.¹⁵⁷ Slovakia should take a similar approach. Therefore, in Slovakia, any later amendment extending credit covered by the earlier charge agreement should not be viewed as new charge that required the parties to re-register with the NCR. The amendment is only the extension of credit that was secured initially by the collateral. There is no further reason why, each time they extend the credit, the parties should run to the NCR to register the current increased amount of the claim. Moreover, the registration form contains, in addition to the column where it calls for a registration of exact amount, a space where the parties can describe the claim; the parties can use this space to fill in that the collateral secures also future advances. This should serve as adequate notice to the creditors. Clearly, it provide even greater protection than the US filing system, which does not

¹⁵⁷The creation of a security interest was a hot debate between two American legal scholars, who advocated a multiple or unitary theory on perfection of security interest. The debate was driven by a need to clarify the priority position of a judgment lien creditor. Coogan favored the multiple theory, which posited that each advancement of subsequent credit gives a rise to a new security interest. Therefore, by making additional advancement to the debtor, the lender accumulates number of security interests. Gilmore, however, favored the unitary theory. In Gilmore's view, the value requirement forms the essence and once value is given with the first advance, no further steps are required. Under the unitary theory, the initial security interests automatically extend to cover subsequent loans. The argument against the unitary view was that making subsequent advances on the loan will eventually eat up the whole collateral without leaving anything for satisfaction of other creditors. Gilmore, however, argued that, even though such a squeeze out caused by future advances is possible, future advances augment the debtor's assets. See Stephen Knippenberg, *Future Nonadvance Obligation: Preferences Lost in Metaphor*, 72 WASH. U. L.Q. 1537, 1542-44 (1994).

require the sum of the claim to be specified at all and does not require the parties to indicate the presence of a future advance or after-acquired property clauses. Finally, if the collateral acquired under an after-acquired property clause does not need to be specified and registered with NCR each time when the charger obtains a title to it, which is clearly not feasible when it comes to a collateral over pools of assets, I do not see any reason why this should be a requirement in the case of future advances. If the contrary view were adopted, this would impose great inflexibility and an unfair burden on the debtor to pay fees each time the credit is extended (assuming the parties do not indicate the highest secured amount of claim).

3.4.5 After-acquired Property

The new law explicitly permits the creation of a charge over after-acquired property.¹⁵⁸ Creation of a charge over after-acquired property is not limited to specific types of assets but is extended to any property that may qualify as collateral; therefore, even property that is registered in the specific asset based registries, like real estate or securities, can be subject to a charge over after-acquired property.

A charge over after-acquired property is perfected upon acquisition of a legal title to collateral.¹⁵⁹ While a charge needs to be perfected through filing with the NCR, this does not cause any problems. Problem may arise, however, when a charge can only be perfected by registration with the specific asset based registries.

The explicit and clear statutory wording of the Civil Code provides that such a charge shall be perfected upon the acquisition of a legal title. However since the

¹⁵⁸ See § 151d (4) CC.

¹⁵⁹ See § 151f (2)-(3) CC.

individual laws that regulate legal rights to these specific properties have not been amended to reflect and complement the new Civil Code provisions on charge law, a charge over after-acquired property regarding these assets does not work in practice.

Specific registries are not technically equipped to monitor the acquisition of a legal title in a way that would enable them to immediately tie a charge to the newly registered acquisition. Moreover, a charge over after-acquired property is not even registered with these registries, but only with the NCR. The solution would be either to require parties to register a charge over after-acquired property with specific registries or to interconnect the NCR with specific registries. Next, even if a specific registry could somehow manage to register the charge over the after-acquired property upon acquisition of a legal title, there needs to be another public register where creditors can check for charges according to the name of the charger; otherwise, creditors would have to rely solely upon the charger's disclosure as regards to after-acquired property.

Moreover, the issue may become even more complicated if we consider the individual types of properties that are registered in these asset based registries. For example, some areas still have not transferred all of the old, hard-copy real estate records into electronic form. Without an electronic database, it is extremely difficult to monitor the assets.

Nevertheless, it will be interesting to see how the courts resolve these discrepancies in law when parties claim to possess conflicting security interests in the charged property that is registered with specific asset based registries, based on after-acquired property clauses.

3.4.6 Proceeds

The broad concept of proceeds as adopted by Article 9 addresses not only direct proceeds but also indirect proceeds, i.e., “proceeds from proceeds.” The automatic extension of a security interest to proceeds from collateral, which is recognized in Article 9, is not addressed at all in Slovak charge law.

Charge under Slovak law extends automatically only to collateral components, fruits, attachments and appurtenances,¹⁶⁰ subject to the parties’ contrary agreement.¹⁶¹ Parties may, by way of contractual stipulation, agree specifically on an extension of a charge to proceeds but, taking into consideration that proceeds are not defined in the charge law, a chargeholder would have to be very careful when drafting such clauses or he might see his charge slowly disappear. In comparison, Article 9 provides a big comfort to creditors by including these provisions directly in the statute.

The concept of proceeds needs to be looked at also from the perspective of the disposition of the collateral from which proceeds actually come from. Article 9, by abolishing the *Benedict* rule, gave debtors wide discretionary power to dispose of collateral and proceeds.¹⁶² And, to protect the creditor’s equity, Article 9 automatically shifts a security interest onto proceeds. As I explained in a previous section on US law, it is important to give a debtor a free hand in the disposition of collateral in the ordinary course of business since sales bring fresh funds into the debtor’s estate and the debtor can continue on in its transaction, striving for profits which later will be used to pay off the loan.

¹⁶⁰ See § 121(3) CC. Appurtenances include interest, default interest and the costs of enforcement. *Id.*

¹⁶¹ See § 151d (2) CC.

¹⁶² See U.C.C. § 9-205.

The concept of the disposition of collateral is much less developed in Slovak charge law. Slovak law only addresses the use of collateral, not really its disposition. It stipulates that a charger is entitled to use the collateral in a usual manner and is obliged to refrain from anything that could reduce the value of collateral besides its ordinary use.¹⁶³ Interestingly, the law here speaks only of an obligation on the part of a charger, who, however does not have to be the person using the collateral. The collateral may be in hands of a debtor pursuant to an agreement.

In the realm of the floating lien, particularly in terms of inventory and receivables financing, it is a basic precondition that a charger can dispose of collateral. The law sort of implies a right of a charger to dispose of collateral when it states that an acquirer of collateral takes the collateral free of charge if the charger transferred the collateral in the ordinary course of business and within the scope of his business but it does not address this issue as clearly as Article 9.

3.5 Registration

With the new reform law, Slovakia also introduced a Notarial Central Registry (NCR). The NCR is important for two reasons: it fulfils the public notice requirement for protection of other creditors, and it is essential for determining priority among chargeholders.

The NCR may be said to be a success. According to the World Bank, upon enactment of the new charge law approximately 70 percent of new business credits were

¹⁶³ See § 151i(1) CC.

secured by movables and receivables.¹⁶⁴ Registration of charges with the NCR is growing. While at the launch of reform in 2003 there were 10,553 charges registered, in 2005 there were 15,347 new charges entered with the NCR and in 2007 23,316 charges.¹⁶⁵ EBRD ranks Slovakia as one of the top major reform countries with respects to secured transaction among the CEE countries, Baltic States, South Eastern Europe, and Commonwealth of Independent States.¹⁶⁶

Many of the features of NCR registration procedures are very similar to those in the US. For example, the NCR, as with US filing offices, does not certify the legal existence of the charge. It is not a specific asset based registry where the legal right and existence of collateral is certified; instead, it has only an informative role.¹⁶⁷ A notary is not under obligation to verify the validity of a charge agreement; rather, the applicant is responsible for ensuring that his application for registration of a charge contains all the data set forth by the law.¹⁶⁸ A notary's duty is only to verify the identity of the applicant and to determine whether the application form contains all the details laid down by the law.¹⁶⁹ Therefore a creditor himself should always inspect the respective security arrangements undertaken by his potential charger to get a clear and accurate picture of his contractual undertakings. This is also advisable since the NCR form does not usually

¹⁶⁴ See Rado Baťo, *Svetová banka: Uľahčiť podnikanie sa najviac snažilo Slovensko Najväčšie výhody Slovenska – Zákonník práce a záložné právo*, TREND (Sept. 9, 2004), available at <http://ekonomika.etrend.sk/38248/slovensko/svetova-banka-ulahcit-podnikanie-sa-najviac-snazilo-slovensko> (last accessed 15 March 2008).

¹⁶⁵ See complete statistics available at <http://www.notar.sk/DotNetNuke/bfontsize2V%c5%a1eobecn%c3%a9inform%c3%a1cie/Inform%c3%a1cie/%c5%a0tatistikaZP/tabid/251/Default.aspx> (last accessed 30 March 2008).

¹⁶⁶ See REGIONAL SURVEY OF SECURED TRANSACTIONS, EBRD (2003).

¹⁶⁷ See justification report introducing new charge law.

¹⁶⁸ See § 6 (1) & 7(5), decree No. 607/2002 Coll. on Notarial Central Registry of Charges

¹⁶⁹ See § 73f (2) Act No. 323/1992 Coll. on Notaries.

contain all the information that may be of importance to the creditor when advancing the loan. This follows the same pattern as the US structure of filing.

On the other hand, the Slovak law requires the parties to provide a lot more data in the NCR form than U.S. law requires. For example, in contrast to obligatory entries in US filing which are narrowed to a description of collateral and an identification of parties, the Slovak law also requires a specification of claim and a statement of the value of the claim, which, as previously discussed, is quite disputable in terms of future advances. Furthermore, Slovak law requires the parties to register the beginning of enforcement of a charge.¹⁷⁰ Registration of enforcement is crucial for the chargeholder to foreclose on the collateral since a chargeholder may only start foreclosure on the collateral 30 days after the registration of enforcement with the NCR.¹⁷¹

The introduction of the NCR has produced other benefits. Since the NCR is publicly accessible, information may be searched online for free and the applicant may register a charge in any notary's office¹⁷² irrespective of its residence. Also, the registration is done within minutes. Unfortunately, unlike in the US, online registration is not yet available. But there are advantages with registering a charge with the NCR that the US system does not share. For example, registration with the NCR is of unlimited duration; unlike in the US, the parties do not have to renew the registration every five years.

¹⁷⁰ See § 73d Act No. 323/1992 Coll. on Notaries.

¹⁷¹ See § 151m (1) CC.

¹⁷² See § 3, decree No. 607/2002 Coll. on Notarial Central Registry of Charges

What remains a problem with registering with the NCR are the registration fees. At the launch of the reform the registration fees were based on a degressive scale and were calculated in terms of the percentage of the amount of the secured claim.¹⁷³ At most, registration fees could be SKK 14,700.¹⁷⁴ According to a review by the World Bank, the costs for creation of a charge in Slovakia amounted to 20.1 % of GNI (2003). In comparison, the costs in Albania were 0.3% of GNI, in UK 0.1%, and in Holland there were no expenses at all.¹⁷⁵

The substantial cost for creation of a security interest in the past was often due to the requirement that the parties execute a notarial deed, which forms a separate execution title and allows the parties to avoid litigation. The trend in using notarial deeds has rapidly decreased and banks are trying to find cheaper security devices, for example, in form of bills of exchange in blank.¹⁷⁶ The total costs for creation a security interest are also affected by the fees banks charge for the preparation and administration of credit paperwork.¹⁷⁷

As of 1 January 2005, the fees for registration of a charge were decreased. Currently they are no longer calculated in terms of percentages but are based on fixed sums according to the amount of the secured claim. The current fees vary from SKK

¹⁷³ The Act No. 748/2004 Coll. introduced a lower fee scale. The amendment became effective as of 1 January 2005; the current exchange rate EUR/SKK is approximately: 1/33.

¹⁷⁴ See Rado Baťo & Martina Kláseková, *Registrácia záložného práva môže zlacnieť*, *Ministerstvo financií chce vymeniť právnu istotu veriteľov za jednoduchosť vzniku záložného práva*, TREND (Oct. 18, 2004), available at <http://firmy.etrend.sk/39923/financny-sektor/registracia-zalozneho-prava-moze-zlacniet> (last accessed 15 March 2008).

¹⁷⁵ See *id.* See also *supra* note 72 to compare US filing fees.

¹⁷⁶ See Baťo & Kláseková, *supra* note 173.

¹⁷⁷ See *id.*

1,000 – 5,500.¹⁷⁸ According to EBRD 2006 review, the registration fees are among the highest in the region.¹⁷⁹

It must be pointed that the registration of charge may result in very high fees in certain situations. Since the fees are based on the value of the secured claim, the higher the value of the claim, the higher the fee. But imagine a hypothetical in which the parties amend their charge agreement so as to extend the present collateral without increasing the value of the claim. In order to be enforceable, the charge is subject to registration and to the same fee scale as was the original charge agreement regardless of whether the amount of secured claim remained the same. This may indeed cause unfair results to a charger who will likely be the one to bear the whole portion of costs.

3.6 PMSI as a Counterbalance to Floating Lien Missing

The PMSI in Article 9 restricts the expansive power of the floating lien not only with regards to future creditors but also with regards to the debtor who does not find himself in a deadlock if he needs to find further financing.

The concept of PMSI as such is completely missing in Slovak law. The debtor's alternative financial sources are therefore rather limited. When all of the debtor's assets are encumbered with a blanket lien, the debtor is forced to remain with the original lender the whole time including both current credit relations and also future ones. If the creditor is unwilling to engage in further financing, the debtor has few, if any, alternatives. As I discussed in the earlier sections on the PMSI under Article 9, the debtor in such a

¹⁷⁸ See Act No. 31/1993 Coll. appendix, item J (1).

¹⁷⁹ See REVIEW OF THE FUNCTIONING OF THE CHARGES REGISTER IN THE SLOVAK REPUBLIC, EBRD, July 2006, at 9.

situation is basically left with two possibilities: either he gets his loan bought out by a junior lender which will amount to prepayment fees of a termination of an earlier loan, or he can find an unsecured creditor who will likely only lend at a much higher interest rate.

The last alternative for a debtor is to obtain collateral using the mechanism of title financing. This alternative brings with it a series of disadvantages. First, retention of title means that the title remains with the seller; thus, following the *nemo plus iuris doctrine*, a buyer may not freely dispose of the collateral. This is different than the case of a security interest or charge where a debtor generally keeps title to collateral. Second, as was an issue under the pre-Code law before adoption of Article 9, retention of title by the seller was not an option when the lender was financing the acquisition of collateral, but only when the seller financed acquisition of the collateral under a conditional sale security device.

If Slovak law were to introduce the concept of the PMSI, it would first need to restructure the concept of the floating lien to provide the freedom to dispose of collateral in the ordinary course of business, a freedom to which the whole concept of proceeds is very akin.

4 Conclusion

The quality of secured transactions law contributes to the enhancement of creditors' protection and enforceability of creditor's claims. The credit environment naturally does not depend solely on the quality of secured transactions law, nonetheless flexibility of secured transactions law and availability to create an efficient security

interest is the first condition in obtaining the credit. The credit environment have a significant impact on the growth of economy and employment and vice versa. Therefore paying attention to quality of secured transaction law deserves a great attention.

As I described and pointed out throughout this paper the Article 9 UCC with its detailed, comprehensive and clear rules presents a workable solution supporting widely the credit environment. A secured party under Article 9 is afforded a great level of protection of its security interest as Article 9 addressed properly the issues inherent both to long term and short term financing and developed a unique mechanism of a floating lien concept with purchase money security interest.

In contrast, Slovakia, even though the enactment of new charge law definitely was well received and meant an overall success, some of principal factors pertaining to a concept of a general continuing lien, such as e.g. continuity of charge over to proceeds or registering claims in respect of future advances in public registration notice system, have been quite neglected. Slovak charge law completely disregarded to consider the issue of alternative subsequent financing. Despite the fact that many aspects of a secured transaction may be solved by parties through contractual covenants. The contract law has its limitations too. Therefore there is a need to incorporate certain provisions directly in the law.

This work limited the analysis to *only* some aspects of secured transactions law, mainly to comparison of creation of security interest in the US and Slovakia, to a floating lien concept under Article 9, together with a purchase money security interest and its much less developed counter part in Slovak charge law. It also addressed briefly, in the

comparative perspective, the priority rules and filing and registration system as a public notice giving requirement.

Considering that US and Slovakia stand on different legal systems and have different economies, the solution for changes in the Slovak secured transactions law probably could not be seen in the adoption of all concepts known under Article 9 in their entirety, but nevertheless much of the underlying principles could be well adapted into Slovak legislation, too.

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