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SECURITY INTERESTS UNDER PLEDGE AGREEMENTS

THE extent to which security law in responding to the needs of business practice must reconcile conflicting commercial forces is illustrated by the doctrinal history of the pledge. Both parties to a credit transaction frequently desire, for reasons of expense or business expediency, that the security res be retained by the borrower. On the other hand, third persons may demand notice of the lender's security interest in order to guide their course of dealing with the debtor.¹ The search for a mean proves particularly difficult when the parties avail themselves of the pledge device. Once borrower and lender select its simple formula in order to avoid the requirements surrounding such alternative devices as the chattel mortgage and conditional sale, the courts respond to the demand of third persons for notice by compelling the lender to take possession of the property as a condition precedent

1. The common law has developed no security device exactly comparable to the Roman Law *hypotheca* which arose from a debtor's possession of the res. See Stone, *The "Equitable Mortgage" in New York* (1920) 20 Col. L. Rev. 519-20.

to a completed pledge.² Both contracting parties, however, press for relaxation of these possession requirements. The resulting interaction has produced two doctrinal responses: a fluid concept of possession by the pledgee in a completed pledge; and a law of "non-possessory" or "equitable" pledge.

Since equitable and completed pledges lead to different legal consequences, classification of the transaction in one or the other category is often of vital importance to the parties. When the pledge is completed by delivery of the res to the lender, his security interest generally is enforceable against all the world, and upon maturity of his debt he may follow a definite collection procedure against the pledged property.³ When there is insufficient delivery and the pledge is merely equitable, however, the lender holds a security interest enforceable only under certain conditions and one which may be subordinated to claims of bona fide purchasers, some creditors of the borrower, and his trustee in bankruptcy, receiver, or assignee for the benefit of creditors.

POSSESSION IN THE COMPLETED PLEDGE

Persistent ambiguities of definition characterize the concept of possession as the dividing line between completed and equitable pledge. So adaptable has this term become that in most instances the lender's security interest is sustained within the expanded pledge formula without resorting to the law of non-possessory pledge. Although the decisions form broad categories based upon various meanings of "possession", in many cases that concept is significant only as a convenient fiction adopted to sustain the particular transaction when there has been an ostensible minimum notice to third parties of the security interest.⁴

When delivery of pledged goods is difficult or impossible because of their bulky nature, the courts aid the parties to the security arrangement by accepting various schemes of constructive delivery⁵ as substitutes for a physical surrender of the res.⁶ In relaxing possession requirements, the courts express an intention to protect third parties who may have relied upon the borrower's apparent ownership of the pledged property. This policy in the bulky goods cases requires not only that the property hypothecated be identified and the pledgee assume control, but also that the pledgee take

2. For the sake of clarity in terminology, the noun "pledge" will be used to indicate a security interest. The verb "pledge" will be used to designate the acts necessary to create the security interest. This terminology is suggested by *RESTATEMENT, SECURITY* (Tent. Draft No. 1, 1937) § 1, comment *a*.

3. *JONES, COLLATERAL SECURITIES AND PLEDGES* (3d ed. 1912) c. XVI.

4. In the last analysis it can be said that most courts using the pledge-law idiom of "possession" and "delivery" are thinking only in terms of notice to third parties.

5. "Constructive delivery" is used to mean something less than a physical removal by the pledgee. In many cases, however, the term is apparently limited to delivery by means of title documents. See *Gibson v. Stevens*, 8 How. 384, 399 (U. S. 1850).

6. See general discussion in *RESTATEMENT, SECURITY* (Tent. Draft No. 1, 1937) § 6, comment *a*.

further steps to notify the business world of his security interest. Although such a standard is announced in many decisions, other courts frequently recognize a valid constructive delivery where the acts of the parties accomplish little toward conveying actual notice to third persons. For example, the initialing of goods—stamped on piled lumber⁷ or painted on stacked iron⁸—and their segregation in a remote corner of the borrower's yard is often sufficient compliance.⁹ Or storage in the borrower's distant warehouse, where third parties are unlikely to discover the goods, may constitute a good delivery.¹⁰ This relaxation of the possession requirement is carried over into other circumstances where the goods are more or less immobilized. Thus liquor stored on the borrower's premises, but formally in a governmental bonded warehouse, may be constructively delivered since manual delivery is impossible.¹¹ Although some authority exists to the contrary,¹² it seems clear that once a court finds a constructive delivery the lender's interest emerges as a completed pledge. But when the goods are not deemed bulky, or the acts are held not sufficient as notice to third parties, the security interest of the lender is reduced to an equitable pledge.¹³

Delivery of the property to a third party as agent or bailee of the pledgee is everywhere sufficient to perfect the lender's pledge interest.¹⁴ Although most courts profess to uphold such arrangements only when there is an overt assumption of possession by the third party pledgeholder,¹⁵ frequently the acts sustained seem to give insufficient actual notice to third parties. In many cases the court apparently limits its inquiry to a determination of whether or not the pledgeholder is in actual control of the res, and does not enforce the usual publicity requirements.¹⁶ Frequently the property is already

7. *Ward v. First Nat. Bank*, 202 Fed. 609 (C. C. A. 6th, 1913).

8. *American Pig Iron Storage Warrant Co. v. German*, 126 Ala. 194, 28 So. 603 (1900).

9. See also *Israel v. Woodruff*, 299 Fed. 454 (C. C. A. 2d, 1924) (delivery of "orders" for potatoes stored on three lighters, apparently with no notice to third parties, held sufficient); *First Nat. Bank v. Harkness*, 42 W. Va. 156, 24 S. E. 548 (1896) (oil delivered by instructing permanent watchman to "hold for" pledgee).

10. *Grand Ave. Bank v. St. Louis Union Trust Co.*, 135 Mo. App. 366, 115 S. W. 1071 (1909).

11. *Taney v. Penn Nat. Bank*, 232 U. S. 174 (1914).

12. See language in *RESTATEMENT, SECURITY* (Tent. Draft No. 1, 1937) §6, comment *a*, at pp. 21-22.

13. *Sequeira v. Collins*, 153 Cal. 426, 95 Pac. 876 (1908).

14. *JONES, COLLATERAL SECURITIES AND PLEDGES* (3d ed. 1912) §10. Where the third party is a dummy corporation, however, no pledge interest is created. *Hamilton Ridge Lumber Sales Corp. v. Wilson*, 25 F. (2d) 592 (C. C. A. 4th, 1928).

15. *Irving Trust Co. v. Commercial Factors Corp.*, 68 F. (2d) 864, 866 (C. C. A. 2d, 1934).

16. *Manufacturers' & Traders' Nat. Bank v. Gilman*, 7 F. (2d) 94 (C. C. A. 1st, 1925) (delivery of marine engines to borrower's general manager as pledgeholder); *First Nat. Bank v. Harkness*, 42 W. Va. 156, 24 S. E. 548 (1896).

in the possession of a warehouseman or carrier,¹⁷ and where a document of title is involved some opinions regard the pledge as complete without notification to the holder that a security interest exists.¹⁸ There is important statutory modification, however, since both the Uniform Warehouse Receipts Act and the Uniform Bills of Lading Act require notice of the pledge to the carrier or warehouseman before the security interest of the lender is complete.¹⁹ Prior to such notification, the lender appears to be an equitable pledgee, although his status in this situation seems to have no relation to the usual requirement for protecting third parties: apparent ownership in the equitable pledgor.

As applied in the much used field-warehousing arrangement, the pledgeholder device presents the small manufacturer or dealer with a ready source of cheap operating credit.²⁰ Institutionally, the warehouse company isolates a quantity of goods in a leased portion of the borrower's plant, marks the segregated items and part of the building as in its possession, chooses an employee of the borrower to act as its agent, and issues warehouse receipts to the borrower.²¹ The latter then pledges the receipts to a bank or to its materialmen in order to obtain credit. The goods, however, are left upon the borrower's premises, easily available for processing, exhibition, or sale, when released by the pledgee. In a transaction of such informality, the line between perfected and equitable pledge is necessarily difficult to draw. How far borrower and lender may go toward rendering the agreement a mere formality that gives no notice to third parties is "a question of more or less"²² and the subject of much litigation. Factors usually considered by the courts are whether or not there is a locked enclosure, who pays the agent's salary, whether a formal lease exists, whether the borrower substitutes freely, and whether there are sufficient signs both inside and outside

17. If the res is already in the possession of the pledgee, as collateral security for another loan, or for another purpose, no additional delivery is required to create a pledge. *Ingram v. Mandler*, 56 F. (2d) 994 (C. C. A. 10th, 1932); JONES, *COLLATERAL SECURITIES AND PLEDGES* (3d ed. 1912) §§ 25, 36.

18. *Gibson v. Stevens*, 8 How. 384 (U. S. 1850); *Bank of Newport v. Hirsch*, 59 Ark. 225, 27 S. W. 74 (1894).

19. UNIFORM WAREHOUSE RECEIPTS ACT § 42; UNIFORM BILLS OF LADING ACT § 33.

20. Field-warehousing seems to be favored by many banks as a security device for a broad area of commercial activity. See Miller, *Field-Warehousing* (Feb. 1941) 35 *MID-WESTERN BANKER* 9; Tuttle, *New Borrowers Made Eligible For Loans To Finance Operations* (1940) 57 *BANKERS MONTHLY* 554.

21. See general discussion in (1931) 19 *CALIF. L. REV.* 333. There is a well established maxim that a party cannot be his own warehouseman. See *Mechanics Trust Co. v. Dandridge*, 18 Ky. L. REP. 625, 37 S. W. 288 (1896).

22. "Whether enough has been done to give a right of any kind in certain property is a question of more or less." Justice Holmes in *Sexton v. Kessler & Co., Ltd.*, 225 U. S. 90, 98 (1912).

of the building.²³ An apparently sympathetic judiciary refrains from establishing a single confining formula.

Other commercial necessities lead to further changes in traditional pledge concepts of possession and delivery. In many cases where there is a proper initial surrender of the pledged property, the parties desire its return to the pledgor for the performance of a specified undertaking. Again responding to the actualities of business many courts hold that a return of the res for a temporary and limited purpose does not destroy the security interest of the lender²⁴ except as against a bona fide purchaser from the pledgor.²⁵ While this doctrine is applied particularly to the return of pledged notes for renewal or collection,²⁶ and to the return of chattels for sale or processing,²⁷ the rule is stated generally to include all limited returns benefiting the pledgee's interest or the security res. But if the returned goods are mixed with the pledgor's general property,²⁸ or returned unconditionally to him,²⁹ the security interest of the lender becomes an equitable pledge until timely repossession. Although few of the opinions show a detailed inquiry into the duration of the special return,³⁰ it is apparent that the permissible time may vary from a few days for collection of a note to many months for liquidation of a large block of securities.³¹ In cases where the property

23. *Pittman v. Union Planters Nat. Bank & Trust Co.*, 118 F. (2d) 211 (C. C. A. 6th, 1941); *McCaffey Canning Co., Inc. v. Bank of America*, 109 Cal. App. 415, 294 Pac. 45 (1930); *Philadelphia Warehouse Co. v. Winchester*, 156 Fed. 600 (C. C. D. Del. 1907).

24. RESTATEMENT, SECURITY (Tent. Draft No. 1, 1937) § 11(2). A pledge is not destroyed by the pledgor's wrongful repossession. *American Pig Iron Storage Warrant Co. v. German*, 126 Ala. 194, 28 So. 603 (1900).

25. A bona fide purchaser from the pledgor in possession defeats the lender's security interest. *Schumann v. Bank of California*, 114 Ore. 336, 233 Pac. 850 (1925); *Atlanta Guano Co. v. Hunt*, 100 Tenn. 89, 42 S. W. 482 (1897). But *cf.* *Clare v. Agerter*, 47 Kan. 604, 28 Pac. 694 (1892) (bona fide mortgagee). A purchaser with notice, however, takes subject to the pledge. *Stockyards Nat. Bank v. First Nat. Bank*, 249 Fed. 421 (C. C. A. 8th, 1918).

26. *Bundy v. Commercial Credit Co.*, 202 N. C. 604, 163 S. E. 676 (1932); *Ainsworth v. Kruger*, 80 Mont. 468, 260 Pac. 1055 (1927) (pledgor held as "trustee" during special return).

27. *S. J. Marx Co.'s Trustee v. Marx*, 223 Ky. 339, 3 S. W. (2d) 644 (1928); *Darragh v. Elliotte*, 215 Fed. 340 (C. C. A. 6th, 1914).

28. *Sneeden v. Nurnberger's Market*, 192 N. C. 439, 135 S. E. 328 (1926). In many of these special return cases, the pledgor executes a trust receipt. Most courts, however, merely apply conventional rules governing special returns and do not permit the trust receipt to change the legal result. *Canal-Commercial Trust & Savings Bank v. New Orleans, T. & M. Ry. Co.*, 161 La. 1051, 109 So. 834 (1926).

29. *In re A. E. Fountain, Inc.*, 282 Fed. 816 (C. C. A. 2d, 1922).

30. *White & Williams v. Platt*, 5 Denio 269 (N. Y. Sup. Ct. 1848), is a typical case.

31. The pledgee's possession for seven months has been held a proper limited return where a large number of notes were to be collected. *Williams v. Hall*, 30 Ariz. 581, 249 Pac. 755 (1926).

is to be returned immediately, and for a substantial length of time, original delivery seems little more than a doctrinal rite.³²

Since the limited return cases presuppose a completed pledge, the pledgee prevails over all creditors of the pledgor, prior or subsequent to the return. When an attaching creditor of the pledgor defeats the lender in the case of an attempted limited return, the pledge has been held equitable not because of the apparent ownership doctrine but because the terms of the return give the borrower too general a dominion over the res.³³ In protecting bona fide purchasers, however, the courts recognize the irrelevancy of the purpose of the return as a deterrent to third party reliance on apparent possession and subordinate the pledgee's claim. While the reason for the difference in treatment accorded bona fide purchasers and creditors presumably rests on the unexpressed premise that possession does not remain in the borrower for a period long enough to mislead creditors, the usual judicial indifference to the time element casts doubt upon the validity of this assumption. By the Uniform Trust Receipts Act,³⁴ however, lien creditors are allowed to defeat the interest of the pledgee in the special return cases after ten days. Although this provision is consistent with the strict security-law tradition of protecting creditors of the borrower, such a short period necessarily will curtail the commercial flexibility of the pledge device and its adoption may be expected to drive many of the transactions now treated as special returns into the equitable pledge class.

A number of complications in terminology arise from the hypothecation of choses in action, since there is some reluctance to apply the term pledge to such an assignment.³⁵ The trend, however, is toward labelling the transaction a pledge when the chose in action is represented by an "indispensable instrument" — a document possession of which is necessary to enjoyment of the right.³⁶ Assignments of book accounts or other intangibles, incapable of being exclusively represented by a single document, have on the other hand also been classified as pledges.³⁷

32. Professor Hanna suggests dispensing with original delivery in this case. Hanna, *Trust Receipts* (1929) 29 *Col. L. Rev.* 545, 553-54.

33. A few opinions seem to disregard the commercial function of the special purpose doctrine in allowing even an unlimited return to a pledgor as "agent", "custodian", or "bailee" of the lender. These courts, however, reach the opposite decision if the pledgor is merely in "possession". *Rose v. Coble*, 61 N. C. 517 (1868). The Restatement group accepts the same distinction. *RESTATEMENT, SECURITY, EXPLANATORY NOTES* (Tent. Draft No. 1, 1937) p. 82.

34. *UNIFORM TRUST RECEIPTS ACT* § 3(3).

35. See *Benedict v. Ratner*, 268 U. S. 353 (1925); *In re Pusey, Maynes, Breish Co.*, 122 F. (2d) 606 (C. C. A. 3d, 1941).

36. This term is suggested in *RESTATEMENT, SECURITY* (Tent. Draft No. 1, 1937) § 1, comment *e*.

37. *Savage Tire Sales Co. v. Stuart*, 61 Mont. 524, 203 Pac. 364 (1921); *American Exch. Nat. Bank v. Fed. Nat. Bank*, 226 Pa. 483, 75 Atl. 683 (1910).

Both groups of assignments of choses in action pose delivery problems. When the chose is represented by a so-called indispensable instrument, such as a bond, or insurance policy, some opinions recognize manual delivery of the document as sufficient to create a pledge interest in the recipient.³⁸ In most cases, however, the physical handing over must be supplemented by a written assignment,³⁹ power of attorney,⁴⁰ or indorsement,⁴¹ and, in the case of stock shares and insurance policies, by registration upon the books of the issuing company.⁴² The Uniform Stock Transfer Act, for example, permits manual delivery of an indorsed certificate, but stipulates that an undorsed certificate must be accompanied by a power of attorney.⁴³ Insufficient delivery forces these transactions into the equitable pledge category.

When the pledged chose in action is, like book accounts, not represented by an indispensable instrument, the courts abandon the idiom of possession and delivery; the manner in which the borrower deals with the pledged chose in action is the measure of the lender's security interest.⁴⁴ Hence, when accounts receivable are assigned⁴⁵ the important consideration is not the type of delivery, although a minimum surrender of account books or a written assignment is usually required as an indication of intent, but whether or not the borrower treats the accounts assigned as if he recognized the dominant security interest of the lender. And where the pledgor exercises full dominion over the accounts, using the proceeds generally in his business, this "unfettered use" conclusively imputes fraud to the transaction and dissolves the pledge.⁴⁶ Once such an arrangement is termed fraudulent, the lender is stripped of even an equitable pledge interest. But collections by the debtor as agent for the pledgee or other acts of limited jurisdiction are held compatible with a recognition of the creditor's security interest.⁴⁷ Compliance with the un-

38. *Stout v. Yaeger Milling Co.*, 13 Fed. 802 (C. C. E. D. Mo. 1882) (insurance policy); *Taft v. Bowker*, 132 Mass. 277 (1882) (savings bank book); see corporate stock gift cases collected in BALLANTINE, CORPORATION LAW AND PRACTICE (2d ed. 1930) § 146, n. 18.

39. The older authorities are collected in JONES, COLLATERAL SECURITIES AND PLEDGES (3d ed. 1912) §§ 142, 145, 152.

40. See *Nisbit v. Macon Bank & Trust Co.*, 12 Fed. 686, 690 (C. C. S. D. Ga. 1882).

41. See *Crowder v. Terhorst*, 107 Ind. App. 288, 21 N. E. (2d) 141 (1939).

42. See general discussion in BALLANTINE, CORPORATION LAW AND PRACTICE (2d ed. 1930) § 147 and cases cited.

43. UNIFORM STOCK TRANSFER ACT § 1. The indorsement must be in blank or to a specified person.

44. See GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES (rev. ed. 1940) §§ 531-33.

45. This security device is common in factoring arrangements. See Danziger and Steffen, *The Rebirth Of The Commercial Factor* (1936) 36 COL. L. REV. 745, 754-65.

46. *Benedict v. Ratner*, 268 U. S. 353 (1925).

47. See discussion in Miller, *An Assignment of Accounts Receivable as a Security Device* (1937) 22 MARQ. L. REV. 28, 29-30.

fettered use test established in *Benedict v. Ratner*⁴⁸ apparently gives the pledgee a claim superior to that of an attaching or levying creditor, and in most jurisdictions one superior to the rights of a subsequent assignee.⁴⁹

THE NON-POSSESSORY OR EQUITABLE PLEDGE

When a court declines to extend the elastic concept of possession in the pledgee to a particular fact situation, the security interest held by the lender against the borrower becomes an equitable pledge.⁵⁰ By definition, possession fails only when there is no notice to third parties of the lender's security interest. Factually, an equitable pledge most frequently arises when for reasons of business convenience the debtor remains in control of the pledged property and the circumstances do not fall within the constructive delivery, bulky goods, or special return categories. But apart from the situation in which parties seeking to create an immediate pledge fail to meet delivery requirements, equitable pledges arise in other types of transactions. An attempted hypothecation of property not owned by the borrower, or not yet in existence, will create a non-possessory pledge interest in the lender as soon as it is acquired or produced.⁵¹ Moreover, the pledge interest is equitable when a security contract stipulates the future pledging of a particular chattel or chose in action.⁵² On the whole, these and a few other transactions⁵³ produce the bulk of equitable pledge litigation.

In many of the debtor-in-possession cases, however, the courts face a categorization problem, since the surrounding circumstances and the ambiguous phraseology of the agreement frequently suggest that either a pledge or a chattel mortgage might have been intended by the parties. Traditionally,

48. 268 U. S. 353 (1925).

49. *Salem Trust Co. v. Manufacturers' Finance Co.*, 264 U. S. 182 (1924). In the case of a second assignment, however, a few courts adhere to the English rule of *Dearle v. Hall* [3 Russ. 1 (Ch. 1823)] that the first assignee notifying the debtor perfects his security interest. American authority for this English view is collected in GLENN, *FRAUDULENT CONVEYANCES AND PREFERENCES* (rev. ed. 1940) § 527, n. 40.

50. On the general problem, see RESTATEMENT, SECURITY (Tent. Draft No. 1, 1937) § 10; Glenn, *The "Equitable Pledge", Creditors' Rights, and the Chandler Act* (1939) 25 VA. L. REV. 422; Comment (1937) 37 COL. L. REV. 621.

51. *Hurley v. Atchison, T. & S. F. Ry. Co.*, 213 U. S. 126 (1909) (pledge of unmined coal); *Commonwealth Trust Co. v. RFC*, 120 F. (2d) 254 (C. C. A. 3d, 1941) (pledge of pig iron prior to manufacture).

52. *National Bank of Commerce v. Moody*, 90 S. W. (2d) 279 (Tex. Civ. App. 1935); *Bogard v. Tyler's Adm'r*, 119 Ky. 637, 55 S. W. 709 (1900).

53. Frequently a contractor offers the owner or surety all raw material and equipment located upon the particular job as security for his completion of the contract work. Subsequent insolvency of the contractor often finds these parties holding an incomplete security interest. *In re P. J. Sullivan Co., Inc.*, 254 Fed. 660 (C. C. A. 2d, 1918). An incomplete security interest is also produced by returned goods in the pledged accounts receivable cases. *Goldstein v. Rusch*, 56 F. (2d) 10 (C. C. A. 2d, 1932).

the distinction is based upon a formalism: whether title passes to the lender. When title does pass by the agreement, the lender's interest is held a chattel mortgage, but it is termed a pledge when a merely "special" property is conveyed.⁵⁴ Unless the parties indicate which security device they intend, explicitly or by clear implication from the nature of their agreement, classification by intent exposes judicial intuition to a severe test.⁵⁵

The security interest arising from an incomplete contract of pledge is commonly designated an "equitable lien" or "equitable interest" in the res.⁵⁶ Historically it was enforced by the chancellor. And because of its origin in equity the interest of the pledgee out of possession was not recognized in suits at law by many early American courts, even as between the contracting parties.⁵⁷ On the other hand, some contemporary courts have ignored not only its equitable origins but also its equitable terminology, and decide the particular case by determining which party is entitled to possession of the hypothecated property.⁵⁸ Other courts, maintaining that the pledge is based upon possession, enforce the lender's security interest by means of the tortious fiction that possession lies where the contract has placed it, at least as between the parties to the agreement.⁵⁹

Ostensibly the equitable pledge must attach to an identified res as designated by the parties at the time of their contract,⁶⁰ but this rule is seldom strictly applied. Where, for example, a certain number of securities or notes are pledged as collateral, the identification requirement is often ignored. Without destroying the interest of the equitable pledgee, a pledgor-bank often retains and exercises a right of substitution and replacement over the

54. For discussion on a completely verbal level, see (1932) 7 NOTRE DAME LAWYER 230; see also *In re German Publication Society*, 289 Fed. 509, 510 (S. D. N. Y. 1922) ("the whole matter floats nebulously in that fog, 'the intent of the parties,' out of which the courts are so apt to evoke what they most want.")

55. The attitude of the late Justice Holmes seems a model in judicial method. Maintaining that a court should construe the conduct of the parties as adopting whatever device, consistent with the facts, was best fitted to accomplish the desired results, he was willing to assume that any correct verbal formula had been employed. *Sexton v. Kessler*, 225 U. S. 90, 96-97 (1912).

56. Such terminology is used by most courts. *Johnson v. Burke Manor Bldg. Corp.*, 48 F. (2d) 1031, 1034 (C. C. A. 7th, 1931); *James Freeman Brown Co. v. Harris*, 88 S. C. 558, 560, 70 S. E. 802, 803 (1911). See generally 4 POMEROY, EQUITY JURISPRUDENCE (5th ed. 1941) §§ 1233-37; Britton, *Equitable Liens—A Tentative Analysis of the Problem* (1930) 8 N. C. L. REV. 388.

57. *Morganstein v. Commercial Nat. Bank*, 125 Ill. App. 397 (1906); *Young v. Kimball*, 59 N. H. 446 (1879).

58. *Hamilton Ridge Lumber Sales Corp. v. Wilson*, 25 F. (2d) 592 (C. C. A. 4th, 1928); *Murdock v. Murdock*, 300 Pa. 280, 150 Atl. 599 (1930).

59. *Nobles v. Christian & Craft Groc. Co.*, 113 Ala. 220, 20 So. 961 (1896); see JONES, COLLATERAL SECURITIES AND PLEDGES (3d ed. 1912) § 28.

60. *In re Magrill*, 22 F. (2d) 757 (C. C. A. 5th, 1927); see *In re Herkimer Mills Co., Inc.*, 39 F. (2d) 625, 628 (N. D. N. Y. 1930).

collateral segregated as security for governmental deposits⁶¹ or for loans from other banks.⁶² A similar relaxation occurs when the borrower pledges fungible goods. Under such circumstances the pledgor is permitted to make substitutions without destroying the lender's interest.⁶³ The Uniform Sales Act adopts this policy by permitting a vendee's interest to become affixed to a specified quantity of fungible goods.⁶⁴ Many courts, however, adhere strictly to the identification requirement, upon the theory that an in rem right to possession demands an identified res. But in these jurisdictions if the description is sufficiently vague, the security interest of the non-possessory pledgee may attach to an entire body of goods.⁶⁵ Upon occasion a court may employ various conceptual aids in order to reach an equitable decision and yet formally preserve the identification requirement. For example, where a pledgor by his own wrongdoing intermixes the res with other goods so that ascertainment becomes impossible, the court may preserve the equitable lien as between the parties by estopping the borrower from denying that any particular goods were intended to be pledged.⁶⁶

In awarding possession of the res to the equitable pledgee seeking to perfect his security interest by suit against the borrower, the courts appear to be applying the traditional equitable remedy of specific performance.⁶⁷ But instead of treating the cases in the light of that doctrine, most opinions merely repeat the maxim "equity regards as done that which ought to be done."⁶⁸ But in the minority of courts, which frankly label their decree one for specific performance, it is bottomed on the inadequacy of the legal remedy.⁶⁹ When an equitable pledgee attempts to perfect his right to possession of the res prior to maturity of his claim, the possessory decree is based upon the fact that damages at law are nominal and therefore inadequate.⁷⁰ After maturity and where the debtor is insolvent the decree has been granted, absent bankruptcy, because damages collectible are necessarily

61. *Burrowes v. Nimocks*, 35 F. (2d) 152 (C. C. A. 4th, 1929).

62. *Chapman v. Johnson*, 261 S. W. 470 (Tex. Civ. App. 1924).

63. See RESTATEMENT, SECURITY, EXPLANATORY NOTES (Tent. Draft No. 1, 1937) p. 66.

64. UNIFORM SALES ACT § 6(2).

65. *Hopkins v. National Shawmut Bank*, 293 Fed. 884 (C. C. A. 5th, 1923), *cert. denied sub nom. Eventually v. Equitable Trust Co.*, 263 U. S. 722 (1924).

66. *Union Trust Co. v. Trumbull*, 137 Ill. 146, 27 N. E. 24 (1891).

67. For a statement that the decree is not one of specific performance, see Glenn, *The "Equitable Pledge", Creditors' Rights, and the Chandler Act* (1939) 25 VA. L. REV. 422, 424.

68. This theory has received its clearest statement in 4 POMEROY, EQUITY JURISPRUDENCE (5th ed. 1941) § 1235; see *Hook v. Ayers*, 80 Fed. 978, 982 (C. C. A. 7th, 1897).

69. See 4 POMEROY, *op. cit. supra* note 68, § 1401 *et seq.*

70. See RESTATEMENT, SECURITY, EXPLANATORY NOTES (Tent. Draft No. 1, 1937) p. 75.

inadequate.⁷¹ Another theory supporting recovery of the hypothecated property by the equitable pledgee, apparently distinct from specific performance, is premised upon the doctrine that a court of equity will not countenance an unjust enrichment on the part of a borrower attempting to retain possession of the res.⁷² Whichever principle of enforcement is applied, the courts in the equitable pledge cases have shown a high degree of freedom from doctrinal rigidities.

The types of claims held by third parties, however, present the crucial problems on enforceability of equitable pledges. The interest of the equitable pledgee is everywhere valid against the borrower⁷³ and the fact that third parties exist who have extended credit in reliance upon the apparent ownership of the pledgor in possession is usually regarded as irrelevant in an action between the parties to the security contract. But where the equitable pledgee faces a general creditor with a matured claim, the courts occupy the position of referee in a race for possession between the lender, attempting to perfect his security interest, and the creditor, seeking a lien by attachment or levy.⁷⁴ A bona fide purchaser for value from the equitable pledgor, however, obtains the res free of the lender's security interest.⁷⁵ On the other hand, a purchaser with actual notice of the interest of the equitable pledgee, or with notice of facts calling for reasonable inquiry, takes subject to his claim.⁷⁶ While the effect of notice upon creditors has rarely been litigated, there is some authority that in this situation the creditor's claim will be subordinated to the interest of the pledgee.⁷⁷ But in general the opinions do not examine the basis for credit extension and the usual common law rule seems a presumption that all third parties have relied upon the equitable pledgor's possession of the res. Moreover, the courts are not uniform in their holdings where the pledgor undergoes insolvency administration with the hypothecated property among the apparent assets of the estate. If a clash of possessory rights occurs between the equitable pledgee and a receiver

71. *Sullivan v. Tuck*, 1 Md. Ch. 59 (1847). Where the debtor is not insolvent, after maturity the decree is based upon the inadequacy of damages computed upon the future ability of the borrower to repay and upon a future value for the property. *Ibid.*

72. See GLENN, *FRAUDULENT CONVEYANCES AND PREFERENCES* (rev. ed. 1940) §§ 522-23.

73. *National Bank of Commerce v. Moody*, 90 S. W. (2d) 279 (Tex. Civ. App. 1935).

74. *People's Bank v. Continental Supply Co.*, 213 Ky. 44, 280 S. W. 458 (1929); *Gamson v. Pritchard*, 210 Mass. 296, 96 N. E. 715 (1911); *Parshall v. Eggert*, 54 N. Y. 18 (1873).

75. *Robertson v. Wade*, 17 Tenn. App. 457, 68 S. W. (2d) 487 (1933) (bona fide mortgagee); *Mosher v. Smith*, 67 Me. 172 (1877).

76. *Murry v. Central Bank*, 226 Mo. App. 400, 40 S. W. (2d) 721 (1931).

77. See GLENN, *FRAUDULENT CONVEYANCES AND PREFERENCES* (rev. ed. 1940) § 292a. For the effect of statutory notice from an inscription upon a document of title, see *Taplinger v. Northwestern Nat. Bank*, 101 F. (2d) 274 (C. C. A. 3d, 1938), *overruling In re Fell*, 16 F. Supp. 987 (E. D. Pa. 1936).

or assignee for the benefit of creditors, the lender gains the res only in the rare case where the court equates the interest of the insolvency officer with that of the borrower and subjects it to the same equities.⁷⁸ Most courts, however, regard the assignee or receiver as holding the insolvent's estate for the benefit of all creditors. Having rights superior to those of the equitable pledgor, he thus prevails over the pledgee.⁷⁹

Much of the equitable pledge litigation arises in the federal courts during bankruptcy liquidation or reorganization. Prior to the Chandler Act of 1938, when the parties contracted to pledge before the four-month preference period but perfected the agreement within that time, a majority of bankruptcy courts refused to find a preference, even though the trustee represented intermediate general creditors who had relied upon the borrower's apparent ownership.⁸⁰ To preserve the pledgee's equitable lien these courts adopted the fiction that delivery related back to the origin of the agreement.⁸¹ Although a substantial number of courts refused to apply the relation back rationale,⁸² it was frequently employed not only in the equitable pledge cases, but also in the equitable lien cases in general.⁸³ When the equitable pledgee failed to take possession before adjudication, however, most cases awarded the res to the trustee as part of the debtor's estate, relying upon the 1910 amendment⁸⁴ which armed him with the rights of an attaching or levying creditor.⁸⁵ The trustee was unable to use this amendment in combatting the relation back doctrine since it apparently conferred no rights upon him prior to adjudication. Moreover, since the trustee's title was not perfected until adjudication, prior to 1938 creditors had little protection during the period between the filing of the petition and adjudication.⁸⁶

78. *Union Trust Co. v. Trumbull*, 137 Ill. 146, 27 N. E. 24 (1891) (assignee); *Chapman v. Johnson*, 261 S. W. 470 (Tex. Civ. App. 1924) (receiver) *semble*.

79. *Casey v. Cavaroc*, 96 U. S. 467 (1877) (receiver); *Copeland v. Barnes*, 147 Mass. 388, 18 N. E. 65 (1888) (assignee).

80. *Johnson v. Burke Manor Bldg. Corp.*, 48 F. (2d) 1031 (C. C. A. 7th, 1931); *Massachusetts Trust Co. v. MacPherson*, 1 F. (2d) 769 (C. C. A. 1st, 1924).

81. The cases are collected in 3 COLLIER, BANKRUPTCY (Moore's ed. 1941) § 60.37, n. 51. This fiction was also adopted when federal jurisdiction was invoked under the National Banking Act. REV. STAT. § 5242 (1875), 12 U. S. C. § 91 (1934), *Burrowes v. Nimocks*, 35 F. (2d) 152 (C. C. A. 4th, 1929).

82. The authorities are reviewed in *In re New York & Baltimore Inland Transp. Co.*, 276 Fed. 145, 150-51 (D. Del. 1921), *aff'd sub nom. Hayes v. Gibson*, 279 Fed. 812 (C. C. A. 3d, 1922), *cert. denied*, 259 U. S. 581 (1922).

83. *Thompson v. Fairbanks*, 196 U. S. 516 (1905) (chattel mortgage on after-acquired property).

84. As re-enacted into the Chandler Act, the 1910 amendment is found in 52 STAT. 881 (1938), 11 U. S. C. § 110(c) (Supp. 1939).

85. See generally 4 REMINGTON, BANKRUPTCY (4th ed. 1935) § 1547.

86. See discussion in Glenn, *The "Equitable Pledge", Creditors' Rights, and the Chandler Act* (1939) 25 VA. L. REV. 422, 438.

Inspired by critics of this "chaotic jumble", the Chandler Act amendment to Section 60 clearly aimed at destroying the concept of relation back as a means of circumventing preference rules.⁸⁷ The simple prophylactic adopted is the dating of the transfer either as of the time when it is so far perfected that no bona fide purchaser can acquire further rights from the debtor, or, if not so perfected, then immediately prior to the filing of the petition. The various preference elements must be ascertained as of this time.⁸⁸ Moreover, the trustee's title to the bankruptcy estate is now dated as of the filing of the petition.⁸⁹ Although eventually the amendment may end the era of secret liens in bankruptcy, many courts have not construed the new section to achieve the results intended by its drafters. One fundamental misconception is embodied in a number of recent decisions declining to treat the transfer as one for an antecedent debt when the transaction is perfected at some time subsequent to its inception and within the four-month preference period.⁹⁰

While the simplicity of the pledge device preserves it from detailed legislative control, a few special statutes are aimed at the non-possessory arrangement. By Section 3 of the Uniform Trust Receipts Act, the equitable pledge is validated for ten days against all creditors, with or without notice, to the extent that the lender gives new value under the security contract. But purchasers for value and without notice continue under the Act to gain a right in the res superior to the security interest of the equitable pledgee even within the ten-day period. Section 230 of the New York Lien Law, designed for the protection of banks in their extensive brokers' day loan transactions, validates non-possessory pledges and unrecorded mortgages or liens for a single day, if the property consists of stocks or bonds. But the broad language of Section 230 has recently been held to include all pledges, mortgages, or liens upon stocks or bonds.⁹¹ In general, however, the rules surrounding the completed and equitable pledge are developed exclusively in the case law.

PROTECTION OF CREDITORS

Over the entire field of security law no consistent policy for the protection of the borrower's creditors from an incomplete security interest exists in either statute or case law. Within a single jurisdiction whether lien credi-

87. The leading criticism of old Section 60 is found in McLaughlin, *Amendment of the Bankruptcy Act* (1927) 40 HARV. L. REV. 341, 387-90.

88. For a complete discussion, see 3 COLLIER, BANKRUPTCY (Moore's ed. 1941) § 60.38.

89. 52 STAT. 879 (1938), 11 U. S. C. § 110(a) (Supp. 1939).

90. *Adams v. City Bank & Trust Co.*, 115 F. (2d) 453 (C. C. A. 5th, 1940), *cert. denied*, 312 U. S. 699 (1941). For a strong condemnation of these decisions, see 3 COLLIER, *op. cit. supra* note 88, § 60.39 at pp. 911-16.

91. *Sammet v. Mayer*, 108 F. (2d) 337 (C. C. A. 2d, 1939).

tors, all creditors, or no creditors will be protected under local recording acts or case law may depend upon the type of security device used.⁹² Although in the pledge situation only attaching or levying creditors of the borrower prevail over the security interest of the equitable pledgee, frequent dicta add confusion by suggesting that the facts are examined to discover if creditors actually relied upon the apparent ownership of the borrower,⁹³ as if such reliance were a prerequisite to a favorable decision.⁹⁴ The problem of what classes of creditors should be protected and what remedy they should be afforded seems merely a particular aspect of a general need for an orderly collection procedure when the debtor does not undergo insolvency administration. While federal bankruptcy law is designed to distribute the debtor's assets under judicial supervision insuring fairness to both secured and unsecured creditors, there is no adequate formula when the debtor avoids a formal insolvency proceeding. But since most of the equitable pledge cases involving the interests of third parties are decided during a bankruptcy administration of the debtor's estate, the private collection cases have only a secondary importance. Moreover, if there is undue depletion of the debtor's assets by private collection the debtor may be forced into bankruptcy, and recent attachments or perfections of security interests may be vulnerable as preferences or fraudulent conveyances. But in spite of the relative infrequency of private collection, the conflict between an equitable pledgee and a single general creditor seems to bear reexamination in the light of a need for reform in private collection procedure.⁹⁵

In formulating a policy for the protection of creditors dealing with the equitable pledgor, the courts are faced with the double problem of choosing which creditors are to be protected and what type of remedy is to be offered

92. In New York, for example, the interest of the lender upon an equitable mortgage of land is good against all creditors of the mortgagor, in the absence of bad faith or collusion. See Stone, *The "Equitable Mortgage" in New York* (1920) 20 COL. L. REV. 519, 523, n.20. But the security interest of the equitable chattel mortgagee is subordinate to the claims of mere general creditors in existence during the period of the non-recordation. The state cases are reviewed in *In re Shay's Estate*, 157 Misc. 615, 285 N. Y. S. 379 (Surr. Ct. 1935). When pledge or conditional sale devices are used, however, only the lien creditor is protected. *Baker v. Hull*, 250 N. Y. 484, 166 N. E. 175 (1929) (conditional sale).

93. See *Swetnam v. Edmund Wright Ginsberg Corp.*, 37 F. Supp. 546, 550 (S. D. N. Y. 1941); *In re Smith-Flynn Comm. Co.*, 292 Fed. 465, 472 (C. C. A. 8th, 1923).

94. Most opinions, however, presume that third parties were deceived in their credit transactions. See *Casey v. Cavaroc*, 96 U. S. 467 (1877); *Gretzinger v. Arehart*, 193 N. E. 714 (Ind. 1935).

95. For a suggested reform in the collection procedure for general creditors, see Sturges, *A Proposed State Collection Act* (1934) 43 YALE L. J. 1055. Based upon a policy of preventing the burdening of a debtor beyond his ability to pay, this plan allows creditors to share in the debtor's property in the order in which credit has been extended.

them. At the outset it is clear that the security interest of the equitable pledgee cannot be upheld against all creditors, since the foundation of pledge law rests on the premise that possession by the lender is deceptive to third parties.⁹⁶ But the other extreme — protecting all bona fide creditors of the pledgor — might prove a sound solution. If all creditors are protected, it is possible to provide a more substantial remedy than the common law race of diligence. For if the courts are to penalize secret liens, it would seem that a substantial sanction should be employed against the holder as a preventive measure; and more important, that the relief granted the creditor should be something adequately recompensing him for his loss from the deception. A more positive policy against secret liens would thus add to the security of general credit extensions.

In constructing a stronger policy against secret liens the legislature could establish a reasonable time for the taking of possession, during which the pledge interest of the lender could be perfected. Upon its termination, presuming reliance by third parties, the statute would dissolve his security interest. Although the strongest sanction against the equitable pledgee in this situation involves subordination of his debt to claims of creditors, such a penalty seems unnecessarily harsh. By preserving his underlying debt and reducing him to the status of a general creditor, the lender would be permitted to employ customary collection methods, without, however, any advantage from his unperfected security interest.⁹⁷ Although in enforcing his claim the demoted equitable pledgee would again be involved in a race for possession with other general creditors, he would compete upon an even basis by using court process upon maturity of his debt. Adoption of a fixed possession time would also protect all creditors of a debtor undergoing local or federal insolvency administration, since the asset would become a part of the estate if the specified period had passed.

Apparently no state at present offers as strong a remedy to creditors as the statutory period for possession. The operation of any such plan, however, would not seem to threaten serious impairment to the commercial utility of the pledge device since the current flexibility of the possession concept validates the great majority of transactions as completed pledges. Moreover, under this liberality in imputing possession to the pledgee, it would seem reasonable to demand strict compliance with the remaining simple and easy procedures.⁹⁸ And in those cases where an equitable pledge has

96. The generalization against secret liens had an early expression in *Twyne's Case* [3 Co. 80b (K. B. 1602)] where a vendor's retention of possession was held to constitute a "badge of fraud" voiding a sales transaction.

97. This is roughly the theory of the New York chattel mortgage recording act, N. Y. LIEN LAW § 230.

98. Such an argument is outlined in RESTATEMENT, SECURITY (Tent. Draft No. 1, 1937) § 10, comment *b* at p. 32.

proved inevitable, the parties could be expected to use some other form of security.

While the common law method of collection presents obvious administrative advantages, on the whole it would seem inadequate as a solution to the security law policy of protecting third parties. Furthermore, the race of diligence between equitable pledgee and general creditor is consistent with traditional common law policies to allow a debtor to dispose of his own assets until prevented by a lien or by insolvency administration, and to force general creditors into a race of diligence as between themselves. But as a remedy it offers only the right to vie for possession of the res with an equitable pledgee who holds a security interest by definition secret and often enforceable without the cumbersome and expensive court action required of the general creditor. Furthermore, even this remedy is available only to the creditor with a matured claim.⁹⁹ In general, the common law collection procedure seems to fail both in substantially recompensing creditors and in sufficiently penalizing secret liens.

Between the extremes of statutory possession time on the one hand and the common law collection process on the other lies an examination of the basis for credit extension in order to isolate the particular group of creditors actually injured by the secret lien, with a view to providing those parties with a stronger remedy. Clearly the usual judicial policy of offering equal protection to all creditors can be no more valid than its premise—that all credit is extended by relying upon the chattels and choses in action that comprise a portion of the debtor's property. Actually, however, credit is not extended so simply. Account is taken of the reports of general and special credit agencies, information from informal exchanges and from credit interchange bureaus, the debtor's statements, business references, and personal acquaintance.¹⁰⁰ The assumption of many opinions that the creditor walks through the debtor's establishment and extends his credit upon the basis of visible assets in finished goods and raw materials is clearly an oversimplification. And since many general credit transactions are based upon something other than assets of the debtor capable of being pledged, it seems reasonable for the courts to protect only those third parties actually deceived by the particular secret lien. Although proof of reliance by such "estoppel creditors" necessarily would be difficult, they might be required to establish the bases used in extending credit, and, so far as possible, the extent of their reliance. In administering such a plan, however, it would be necessary to avoid decisions based upon an incomplete causation theory since many of

99. See *Hensley v. Minehan*, 29 Ga. App. 251, 114 S. E. 647 (1922) (attachment not issued until debt matured).

100. For general discussion, see CHAPIN, *CREDIT AND COLLECTION PRINCIPLES AND PRACTICE* (3d ed. 1939) Pt. II; BECKMAN, *CREDITS AND COLLECTIONS IN THEORY AND PRACTICE* (3d ed. 1938) Pt. II.

the factors prompting credit extension at some point depend upon the assets of the debtor.¹⁰¹ While perhaps not insuperable, these problems of proof stand as major objections to adoption of the "estoppel creditor" scheme of protection.

Under such a plan, those third parties who extended credit in reliance upon the borrower's apparent ownership might be given a right in the res superior to the security interest of the equitable pledgee. Administratively, allowance could be made for intervention by creditors in a possessory action by the lender, with a right to recover the property from the equitable pledgee in the original cause. Moreover, if the debt of the relying creditor is not matured, the property might be held in custody of the court until the time when the rights concerned could be fixed.¹⁰² Again it is clear, however, that procedural complications under this system would be greater than under the present collection process, or under the proposed statute creating a possession time. On the whole it would seem that either the "estoppel creditor" or the common law theories are inferior to the statutory period as a solution, since the latter protects all third parties without promising serious interference with business uses of the pledge as a security device.

CONCLUSION

By repeatedly refusing to recognize a static conception of possession in the lender, the courts render the pledge device fully adaptable to the business needs of the contracting parties. Although frequently an arrangement is held a completed pledge when it is at least doubtful that the surrounding conditions offer adequate notice to third persons, the chief need for reform arises when there is admittedly no warning of the lender's security interest. Under these circumstances where the claim of the general creditor and the security interest of the lender are before the court, it appears that at least some—and perhaps all—creditors might be accorded more positive preference over the equitable pledgee than they can obtain through a common law race of diligence. The slight extent to which such a rule would curtail the commercial usefulness of the pledge seems more than offset by the added security given general credit transactions. Although a strong sanction in effect means the end of the equitable pledge, it seems but a reasonable extension of the present policy of lending protection to third parties who rely upon the apparent ownership of the equitable pledgor.

101. This problem is discussed in Comment (1925) 34 YALE L. J. 891, 895-96.

102. Most of the administrative problems are similar to those met in Sturges, *A Proposed State Collection Act* (1934) 43 YALE L. J. 1055.