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Why Benedict V. Ratner?

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WHY *BENEDICT v. RATNER*?

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The rule of *Benedict v. Ratner*[1] is discussed in some Virginia circles as often as the weather; past efforts to effect changes in each have been comparable. There is now reasonable prospect of abolishing the rule through adoption of the Uniform Commercial Code in Virginia.[2] It may be appropriate, therefore, to discuss the rule again; its abolition might be an impelling reason for adopting the Code.

The rule of *Benedict v. Ratner*, taking its name from the decision of the Supreme Court of the United States in that case,[3] is substantially this: If a person impresses a lien on his property as security for a debt to another, and if the debtor reserves or is permitted to exercise power or dominion over the property that is inconsistent with the avowed purpose of the transfer—for example, if the debtor assigns his accounts receivable to secure a debt, but collects the proceeds of the accounts and commingles them with his own funds—the lien is illusory and void. Such reservations of power are sometimes referred to as "unfettered dominion" in the debtor-lienor.

The desire of lenders' counsel to avoid loss of clients' liens on personal property by virtue of the application of *Benedict v. Ratner* is a major cause of long and complicated loan agreements. Under accepted practice, a loan agreement governing accounts receivable financ-

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[1]286 U.S. 353 (1925).

[2]§ 9-205 of the Uniform Commercial Code, infra note 20, abrogates the rule of Benedict v. Ratner. The Virginia Advisory Legislative Council was directed by the 1962 Session of the General Assembly of Virginia to study the desirability of adopting the Code, in whole or in part, and report to the Governor and General Assembly by October 1, 1963. The VALC has made a favorable report and the Code has been introduced at the 1964 Session of the General Assembly of Virginia.

[3]Supra note 1. At least to Virginia lawyers, the rule should be known as that of Lang v. Lee, 24 Va. (3 Rand.) 410 (1825), rather than Benedict v. Ratner, since the rule was announced by the Virginia Supreme Court of Appeals in the Lang case one hundred years before the opinion of the United States Supreme Court in the Benedict case. Nevertheless, the Virginia court has not received credit or discredit for the rule, and it will be referred to in accordance with common parlance as that of Benedict v. Ratner. For a discussion of the origin and development of the rule in Virginia, see Brasfield, Reservation of Dominion over Property Given as Security, 49 Va. L. Rev. 192 (1963).

ing (where notification to the account debtors is not contemplated) contains provisions that: (1) require the borrower to deliver all remittances to the lender, promptly and in kind—that is, deliver all checks and cash received by the borrower in payment of the assigned accounts without commingling the remittances with the borrower's funds; (2) require the borrower to obtain the lender's consent to the granting of credits or adjustments on assigned accounts, and require the borrower to separate all returned goods covered by assigned accounts from other goods on hand and to mark the returned goods as being pledged to or held in trust for the lender, pending release in consideration of an assignment of additional accounts or a payment by the borrower; (3) require the borrower to mark his books of accounts so as to reflect the assignment; and (4) give the lender the right to hold the remittances as security for the loan or to apply them to repayment of the loan, or provide for revolving credit (effected by the lender's release of the proceeds of the accounts in his hands from time to time upon the substitution of other accounts receivable).

It may be observed that these provisions of the loan agreement as outlined in the preceding paragraph contemplate a higher degree of dominion in the lender than has been required by the decisions. The Court of Appeals for the Fourth Circuit in one case applying Virginia law[4] sustained the lien on accounts receivable despite failure to deliver the proceeds in kind and despite the commingling of proceeds with the borrower's funds. The court found that the borrower's duty to apply all remittances to the curtailment of the note at the end of each sixty day period was sufficient to avoid a holding of unfettered dominion in the borrower, even though the borrower had the use of the moneys collected during the interim. The advised lender may be reluctant, however, to require only that degree of dominion required by lenders who have prevailed in decisions involving attack upon their liens under *Benedict v. Ratner*. Dominion in the lender, or absence of undue dominion in the borrower, is a factual determination; and risk is involved in relying upon a decision that upheld the lien despite commingling of proceeds by the borrower,[5] or in attempting to extract the permissible minimum of dominion

[4]Parker v. Meyer, 37 F.2d 556 (4th Cir. 1930).

[5]Parker v. Meyer, supra note 4 (holding that the lien was valid despite borrower's retention of proceeds for 60 days), may be contrasted with the statement of the same court in Manufacturers Fin. Co. v. Armstrong, 78 F.2d 289 (4th Cir. 1935) (control of proceeds by borrower for 6 days suggests unfettered dominion). The contrast might be explained by the fact that Virginia law was applied in Parker and North Carolina law in Armstrong. But the leniency of Parker has been

from the decided cases. More impelling, perhaps, should be the desire of creditors to avoid the necessity of litigation to establish the validity of their liens, particularly since our jurisprudence has not advanced to the point of permitting damages for mental anguish suffered during the course of litigation.

Until the rule of *Benedict v. Ratner* is abrogated, borrowers should be reconciled to agreeing that they will deliver remittances in kind, that they will be subject to restrictions on their freedom to grant credits or adjustments and to deal with returned goods, and that they will mark books. The advised lender may accept no less, while admitting (if pressed) that the restriction on granting credits and the requirements of segregating returned goods and book-marking are not expressly required by Virginia statute or decision.

The lender has borne only one of two burdens when he provides for the necessary dominion in the loan agreement. The right to exercise dominion will not suffice, if the requisite dominion is in fact not exercised.[6] The exercise of dominion, "policing" of the loan, is the more difficult of the two; and policing practices are probably less standard among lenders than are loan agreement provisions. The practices of the accounts receivable financing companies in New York, as described by a company representative, are as follows:

> "No. 1 [These companies] make at least monthly audits against the books of their assignors.
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> "No. 2 [They] verify the accounts by making test checks of the fact that the amounts are still outstanding, very much as ... the department stores do, by making test checks.
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> "No. 3 [They] check the collections very carefully. By looking at the borrower's periodic balance sheet—you see, we do ask for financial statements—[they] can tell from the way a man's business is operated, whether indeed he is converting the proceeds of assigned accounts, and the minute they learn about that, they will do no further business with him."[7]

It appears, then, that these financing companies have been able to chart the course to be followed, to assure requisite dominion over

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questioned by other courts. See Irving Trust Co. v. Finance Serv. Co., 63 F.2d 694, 696 (2d Cir. 1933), cert. denied, 289 U.S. 763 (1934).

[6]"It does not follow, however, that an assignment of accounts is good and enforceable in the hands of the assignee because it is cast in a form recognized as sufficient to convey title by statute or by the decisions of the courts; for the rights of the parties are to be determined by what they actually do rather than by the provisions of a contract which they disregard in giving effect to the transaction." Mount v. Savings & Loan Corp., 192 F.2d 286, 290 (4th Cir. 1951).

[7]New York Law Revision Commission, Communication and Study Relating to Assignments of Accounts Receivable, Leg. Doc. No. 65(k), app. V, p. 285 (1945).

the assigned receivables, and have substantially resolved their problems under the rule of *Benedict v. Ratner.*[8] If a chart can be so simply drawn, it may be asked why so many lenders fail to exercise the requisite dominion; or fail to exercise the degree of dominion that would discourage trustees in bankruptcy and others from litigating the issue.[9] One probable cause of this litigation is the failure of lenders to carry out dominion rights and practices, as provided for in loan agreements and established by management. Accounts receivable companies may be expected to have adequate personnel and equipment to carry out policing activities. This is often not true of other lenders who customarily lend on an unsecured basis, or under security devices that are unaffected by *Benedict v. Ratner.* The result is failure to exercise the requisite dominion.

Liens may be imperiled not only through failure to carry out policing activities, as has been suggested, but also because lenders are unaware that the rule of *Benedict v. Ratner* may be applicable in certain cases. Two examples will be given, involving factor's liens and mortgage warehousing.

A lender or factor[10] may advance money secured by a continuing

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[8]It may be noted that, in the description of the practices followed by the accounts receivable financing companies in New York, no reference is made to practices with respect to returned goods and credits or adjustments, or to bookmarking. The following comments of the New York Law Revision Commission, supra note 7, relate to the necessity of following those practices in New York:

> "The 1943 amendment of section 45 [of the Personal Property Law of New York] added a clause expressly stating that the exercise of dominion over returned goods by the assignor of accounts receivable shall not invalidate the assignee's lien on other accounts, and that the assignor's conduct in granting credits and adjustments on an assigned account shall not invalidate the lien on the balance of such account, 'irrespective of whether the assignee shall have consented, or acquiesced in, such acts of the assignor.'" Id. at 161.
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> "It seems to be assumed that, apart from statutes, marking of the books is not necessary to the assignment, or effective either in itself or to make a transfer by specific assignment of named accounts more effective. It has been urged, however, that as a practical matter such marking makes it impossible for a subsequent assignee of the accounts marked to be a purchaser without notice." Id. at 22-23.

[9]In Virginia alone, at least twenty-four cases involving the rule of Benedict v. Ratner have reached the highest court. These are in addition to the many federal bankruptcy cases arising in Virginia. "Lawyers representing banks and other major financial institutions on the frontiers of new forms of financing have told the writer that their biggest single perennial problem is the rule of Benedict v. Ratner." Kripke, The Modernization of Concepts Under Article 9 of the Uniform Commercial Code, 15 Bus. Law 645, 652 (1960).

[10]The definition of a "factor" includes persons who finance a manufacturer in his purchase, manufacture and sale of goods. See Va. Code Ann. § 55-143 (Repl. Vol. 1959).

lien upon goods to be manufactured and also upon the accounts receivable and proceeds arising out of the sale of finished goods. The factor may duly record notice of the factoring agreement and be content to look exclusively to the security of the unfinished goods, which he deems ample to protect him in the event of insolvency. But if he permits the borrower to commingle the proceeds of the accounts with his general funds and use them for general business purposes, the entire lien may be subject to attack. In decisions applying *Benedict v. Ratner* to different factual situations, liens have been held invalid as to all security where the lender's exercise of dominion was only over part of the security.[11] This prompts the question whether the failure of the factor to exercise dominion over the accounts or proceeds would operate to vitiate the lien on the unfinished goods remaining in the borrower's possession. Apparently, this question remains undecided in Virginia.[12]

Benedict v. Ratner may be applicable to "mortgage warehousing" transactions. Many mortgage companies, having made loans evidenced by mortgage notes, enter into agreements to sell the mortgage notes to long-term investors. To obtain funds until the sale is effected, it is a common practice for the mortgage company to enter into a "mortgage warehousing" transaction—that is, to obtain a temporary loan, usually from a bank, evidenced by the mortgage company's note secured by the mortgage notes. It is contemplated that, when the sale to the long-term investor is later effected, the mortgage company will pay off its promissory note and thereby obtain the bank's release of the mortgage notes, for delivery to the long-term investor. If, in accordance with common practice, the bank permits the mortgage company to collect and retain the installments on the mortgage notes during the interim, *Benedict v. Ratner* may be applicable. Since the pledge to

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[11]See Brasfield, supra note 3, at 195.

[12]That the lien on the remaining unfinished goods may be invalid, unless a statutes abrogates the Benedict v. Ratner rule as to tangible personalty, is indicated in Manchester Nat'l Bank v. Roche, 186 F.2d 827 (1st Cir. 1951). In Roche the lien on accounts receivable under a factoring agreement was held invalid because the lender failed to perfect his lien by asserting dominion prior to four months before the borrower's bankruptcy. The court upheld the lien upon the merchandise remaining in stock, but specifically pointed to a New Hampshire statute qualifying the Benedict v. Ratner rule so as to make it inapplicable to the lien on the tangible personal property. Presumably, similar considerations are applicable to tangible personal property under trust receipts. It should be remembered that the rule adopted by the court in Benedict v. Ratner had already been recognized by state law as applying to liens on tangible personal property. Ratner argued, without success, that the rule as to tangibles should not be extended so as to make it applicable to intangibles. See Benedict v. Ratner, supra note 1, at 362.

the bank purports to cover all payments made on the notes, the bank should be concerned about possible attack of its lien because it failed to exercise the required dominion over the pledged mortgage notes.

Whether or not there is agreement on retaining the rule of *Benedict v. Ratner* in force, there should at least be agreement that the punishment exacted for failure to exercise the requisite dominion is extremely severe. Even if a lender mends his ways and commences the exercise of his dominion rights at some time after the loan is made, his lien may be subject to avoidance as a preferential transfer if the borrower's bankruptcy ensues within four months after the lender begins to exercise dominion. Since the lien is perfected at a time subsequent to the making of the loan, the lien secures an antecedent debt and therefore may be avoidable as a preference.[13]

With a view to determining whether the punishment fits the crime, we should consider arguments in support of *Benedict v. Ratner.* One supporting argument has been summarized as follows: "[T]he rule of *Benedict v. Ratner,* requiring the assignee to maintain the integrity of the collections made by the assignor is nothing but the manifestation of sound business practice, and ... any other rule would make for a great deal of sloppiness in the procedures of handling assigned accounts."[14] The rule as announced by the court was not grounded, however, upon the policy of forcing the lender to adopt practices conceived to be in his interest. To support the rule on this basis is to engage in legal paternalism.

If *Benedict v. Ratner* is not to be maintained in force so as to require a lender to adhere to wise business procedures, the question remains whether the rule is necessary in the interest of other creditors. If other creditors should urge the retention of the rule to prevent the secrecy of the lien, a recording or public notice requirement should be the more direct and satisfactory answer.[15] Unsecured creditors might urge the continuance of the rule on another ground: that it tends to force the lender to apply the proceeds of assigned accounts to the orderly liquidation of the loan so that subsequently acquired accounts may be available to satisfy the claims of general creditors. Whether general creditors would be so benefitted, however, is problematical. It may be preferable from their standpoint that the borrow-

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[13]See, e.g., Manchester Nat'l Bank v. Roche, supra note 12.

[14]New York Law Revision Commission, supra note 7, at 257.

[15]There is no statutory recording or public notice requirement in Virginia for assignments of accounts receivable except when such assignments involve a factor's lien as required by Va. Code Ann. § 55-145 (Repl. Vol. 1959), or a trust receipt transaction as required by Va. Code Ann. § 6-562 (1950).

er apply the proceeds of the assigned accounts to the operating needs of his business or to the purchase of unencumbered assets, instead of using the proceeds to curtail the secured loan. Moreover, in the case of revolving credit, where the proceeds of collected accounts are released from time to time upon the assignment of new accounts, the accounts collected while the revolving credit is in force need not be applied to the liquidation of the loan in order to avoid the impact of *Benedict v. Ratner.* It may be suggested that the benefit of the rule to unsecured creditors is in the nature of a windfall since, by a rule of law, assets intended to benefit a secured creditor are made available to unsecured creditors.

In short, it appears that *Benedict v. Ratner* stems from a common law concept or postulate divorced from the considerations of sound business practices, secrecy of liens, or the protection of unsecured creditors. The lien in *Ratner* was held invalid because of the reservation of dominion inconsistent with the purported disposition of the title and creation of the lien.[16] Other decisions stemming from common law postulates have been changed or modified by statute in Virginia.[17] To suggest that the legislature should change the *Benedict v. Ratner* rule does not necessarily imply that the common law postulate was improperly applied in deciding the case.

Promptly after the decision in *Corn Exch. Nat'l Bank & Trust Co. v. Klauder,*[18] holding that the assignment of accounts receivable without giving notice to the account debtors was incomplete and therefore avoidable as a preference by a trustee in bankruptcy, legislation was enacted in Virginia that reversed *Klauder* and precluded attack on the assignment on the ground of failure to notify.[19] It is surprising that the exposure of lenders under *Benedict v. Ratner* (more subtle but no less devastating than *Klauder*) did not prompt them to seek statutory change in Virginia long ago. In any event, change of the rule apparently can be made most effectively by adoption of the Uniform

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[16]"It [the rule] rests not upon seeming ownership because of possession retained, but upon a lack of ownership because of dominion reserved. It does not raise a presumption of fraud. It imputes fraud conclusively because of the reservation of dominion inconsistent with the effective disposition of title and creation of a lien." Benedict v. Ratner, supra note 1, at 361.

[17]For example, the postulate that a gift over, following a gift in fee simple, is void for repugnancy has been made inapplicable to a gift over following a life estate with full power of disposition in the life tenant. See Va. Code Ann. § 55-7 (Repl. Vol. 1959), changing the rule of May v. Joynes, 61 Va. (20 Gratt.) 693 (1871).

[18]318 U.S. 434 (1943).

[19]The Klauder decision was handed down in 1943 and in the following year, Va. Code Ann. § 11-5 (Repl. Vol. 1956) was enacted into law.

Commercial Code.[20] As has been aptly said: "Several states have enacted statutory provisions making clear that *Benedict v. Ratner* does not apply in limited contexts. But only the Code breaks through the alleged inconsistency of concepts, abolishes the rule forthrightly in broad application, and leaves to the creditor the responsibility, as a matter of business prudence rather than as a matter of law, for policing the preservation of his security."[21]

For another reason—the desirability of uniformity among the states—adoption of the Uniform Commercial Code should be preferable to enactment of a special Virginia statute abrogating *Benedict v. Ratner*. So long as Virginia lenders enter into secured loan transactions that may be affected by the laws of other states—because, for example, they do business with nonresidents—they cannot afford to ignore the applicability of the rule of *Benedict v. Ratner* in other states, even after it has been abrogated in Virginia. Twenty-eight states have adopted the Code; they include the major commercial states of the Union.[22] By adopting the Code, Virginia would add its recommenda-

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[20]Uniform Commercial Code § 9-205 provides:

"A security interest is not invalid or fraudulent against creditors by reason of liberty in the debtor to use, commingle or dispose of all or part of the collateral (including returned or repossessed goods) or to collect or compromise accounts, contract rights or chattel paper, or to accept the return of goods or make repossessions, or to use, commingle or dispose of proceeds, or by reason of the failure of the secured party to require the debtor to account for proceeds or replace collateral."

[21]Kripke, supra note 9, at 652-53.

[22]These states have adopted the Code:

State	*Adoption Date*	*Effective Date*
Alaska	1962	December 31, 1962
Arkansas	1961	January 1, 1962
California	1963	January 1, 1965
Connecticut	1959	October 1, 1961
Georgia	1962	January 1, 1964
Illinois	1961	July 2, 1962
Indiana	1963	July 1, 1964
Kentucky	1958	July 1, 1960
Maine	1963	January 1, 1965
Maryland	1963	February 1, 1964
Massachusetts	1957	October 1, 1958
Michigan	1962	January 1, 1964
Missouri	1963	July 1, 1965
Montana	1963	January 1, 1965
Nebraska	1963	March 1, 1965
New Hampshire	1959	July 1, 1961
New Jersey	1961	January 1, 1963
New Mexico	1961	January 1, 1962
New York	1962	September 30, 1964

tion to the states that have not yet acted. If and when the Code becomes uniform, *Benedict v. Ratner* will have been relegated to the past.

State	*Adoption Date*	*Effective Date*
Ohio	1961	July 1, 1962
Oklahoma	1961	December 1, 1962
Oregon	1961	September 1, 1963
Pennsylvania	1953	Original Version—July 1, 1954
[Pennsylvania	1959	1958 Official Text—January 1, 1960]
Rhode Island	1960	January 2, 1962
Tennessee	1963	July 1, 1964
West Virginia	1963	July 1, 1964
Wisconsin	1963	July 1, 1965
Wyoming	1961	January 1, 1962