RETHINKING SOME U.C.C. ARTICLE 9 PROBLEMS — SUBROGATION; EQUITABLE LIENS; ACTUAL KNOWLEDGE; WAIVER OF SECURITY INTERESTS; SECURED PARTY LIABILITY FOR CONVERSION UNDER PART 5

PROBLEMS OF SOURCES OF LAW RELATIONSHIPS UNDER THE UNIFORM COMMERCIAL CODE — PART III: USING THE PROPOSED APPROACH TO RESOLVE THE METHODOLOGICAL PROBLEM

Steve H. Nickles*

ANNOTATED TABLE OF CONTENTS
(For Part III)

SECTION

<table>
<thead>
<tr>
<th>V. PRINCIPLES OF LAW AND EQUITY NOT DISPLACED UNDER ARTICLE 9</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. The Subrogation Rights of Accommodation Parties, Assignees and Construction Sureties</td>
</tr>
</tbody>
</table>

One of the equitable doctrines most frequently used to supplement the provisions of Article 9 is subrogation. The typical applications of the doctrine vis-a-vis Article 9 are discussed. The focus, however, is on the subrogation rights of a contractor's performing surety.

* Associate Professor, University of Arkansas School of Law (Fayetteville).

This article was submitted in partial fulfillment of the requirements for the degree of Doctor of the Science of Law in the Faculty of Law, Columbia University.

Once again, I express my sincere appreciation to the members of my doctoral committee, Professors E. Allan Farnsworth, Walter Gellhorn, Albert J. Rosenthal and William F. Young, Jr., for their direction, suggestions and encouragement in the preparation of this article. Sometimes, however, their opinions and mine differed with respect to approach, policy and other matters. For these and other reasons, criticism of what follows should be aimed directly and only at me. I alone am responsible for it.

I also thank three of my colleagues each of whom was dean, at one time or another, while I was preparing this article. Without the support of Deans Wylie Davis, Milton Copeland and David Epstein, my work on this project would have been more difficult, less rewarding and unduly prolonged.

In addition, I thank my secretary, Mrs. Beverly Wallace. My work was made easier because of her patience, skill and professionalism.

Finally, and most of all, I thank Kathryn, without whom I could accomplish nothing and nothing would be worth accomplishing.
Frequently the surety does battle with the contractor's financing bank which is an assignee of the contractor's accounts. Each claims priority with regard to contract percentages retained by the owner, progress payments paid to the bank or equipment used by the contractor at the construction site. These and other priority disputes are analyzed.

B. The Equitable Lien as an Alternative to An Article 9 Security Interest ........................................ 41

The parties to a written security agreement must observe certain formalities. A literal application of section 9-203 can result in denying a creditor a security interest despite (1) the debtor's original intention that the creditor have a security interest and (2) a signed writing which the court finds technically insufficient. The discussion centers on the applicability and availability of the equitable liens doctrine in this context.

C. Actual Knowledge of an Earlier Interest as a Factor Affecting Priority ........................................ 72

The conventional wisdom is that section 9-312(5)(a) is a pure-race statute. The first secured party to file or perfect wins, and that party's actual knowledge of an earlier attached interest is immaterial. The discussion demonstrates that most courts and commentators have paid too little attention to pre-Code statutory and common law when construing the section and have failed to scrutinize closely pre-Code law as an aid to the interpretation of section 9-312(5)(a). The discussion shows that a race-notice interpretation is easily possible and clearly desirable when the interests of the debtor are considered and not simply the diligence of the creditors.

D. "Or Otherwise" Authorizations to Dispose of Collateral Resulting in the Waiver of Security Interests ........... 103

A security interest will not continue in the collateral if the secured party authorized the disposition in the security agreement "or otherwise." The discussion considers the extent to which the "or otherwise" language allows the law of waiver and estoppel to supplement Article 9 through section 9-306(2). Caution is urged with respect to finding that a farm products lender has waived his security interest. The courts are encouraged, however, to find waivers by inventory financiers, especially when a lender's claim conflicts with that of an ordinary course buyer whose seller did not create the security interest.

E. Conversion as a Debtor's Remedy under Part 5 of Article 9 .................................................................. 136

The discussion deals with the secured party's liability to the debtor
for conversion of the collateral. Everyone agrees that the secured party is liable for conversion when he wrongfully repossesses the collateral by seizing it at a time or in a manner not permitted by the parties' agreement or by law. Few people ever consider the secured party's conversion liability when he wrongfully forecloses by failing to comply with Part 5 when disposing of the collateral. Even fewer people consider how a conversion theory (used to measure the debtor's "any loss") relates to the more widely accepted approaches to determining the secured party's liability for wrongful foreclosure. The discussion considers all these issues and shows that the conversion theory for determining the secured party's liability for wrongful foreclosure subsumes all others.

VI. EXPERIENCE AS THE LIFE OF THE LAW AND THE KEY TO ITS INTERPRETATION

177

Table of U.C.C. Citations

181

In a recent "commote," Professor Peter Winship concludes that "[t]he Code does not dictate any one particular approach to statutory interpretation."344 He is right; it dictates several approaches. This is the last in a series of three articles dealing with the methodological conflict between the different approaches to interpretation suggested by Uniform Commercial Code sections 1-102(1) and 1-103.345 The principal purpose of the first two articles346 is to establish the existence of the conflict by tracing and analyzing the comparative antecedents of the sections. The ancestors of section 1-103 appear in the commercial codes of England.347 Section 1-102(1) derives from the civil law system of codified law.348

The civilian approach to code interpretation clearly recognizes


Professor Winship explains "commote" as "a portmanteau word (comment-note), with overtones of 'emote' and 'stir up a commote.'" Id. at 844 n.5.

345. All references and citations to the text and comments of the Uniform Commercial Code, hereinafter often referred to simply as the Code or the U.C.C., are to the 1972 Official Text with Comments, unless otherwise indicated.


Since this article is the third in a series, the footnote pagination is continued from the second article.

347. See Nickles Part II, supra note 346, at 197-98.

the existence of sources of law in addition to codified texts, but its strict hierarchical arrangement of these sources just as clearly prescribes that every effort must first be made to reach a decision upon the basis of the rules and principles contained within the four corners of the relevant code. Civilian interpretative methodology applicable to codes reinforces the supremacy of enacted law as the primary source of law and seeks to restrict as thoroughly as possible the need for resort to subordinate sources. The English approach to code interpretation is very different. The tendency is to recognize no hierarchy of sources of law when construing any code and to prefer in doubtful cases resorting immediately to unwritten law for solutions without first seeking them through exhaustive statutory interpretation as is demanded by civilian methodology.

The issue addressed by this series of articles is whether the U.C.C. or supplemental principles of law and equity should be the primary source of law in resolving "doubtful cases." The civilian-section 1-102(1) approach demands that the statute be supreme and that resort to extraneous sources be limited. The English-section 1-103 approach to the interpretation of codes encourages frequent resort to these sources. The conclusion of the first two articles is that neither approach should be applied en bloc to the U.C.C. Both approaches can be used to construe or supplement its provisions and reach a result, but neither should always be used to the complete exclusion of the other. They coexist under the U.C.C., and the problem is deciding which one to use in a particular case or class of cases. The narrow question then becomes how to decide when to apply which approach. And since section 1-103 provides that "[u/nless displaced by the particular provisions of this Act, the principles of law and equity... shall supplement its provisions," the precise issue is how to determine when the Code displaces these principles and thereby precludes resort to them.

Since the publication of the first article in this series, several legal scholars have suggested methods for deciding when courts can legitimately supplement the Code with legal or equitable principles. Professor Summers argues generally "against narrow con-

349. See id. at 24-31.
350. See id. at 16-46.
351. See Nickles Part II, supra note 346, at 190-215.
352. See Nickles Part I, supra note 346, at 3.
353. See id. at 47-48 and Nickles Part II, supra note 346, at 216-25.
construction of section 1-103.”

He believes that the section “imposes a duty on judges to interpret and construe the Code to take account of equities in the particular case, except insofar as equitable principles are ‘displaced.’”

The technique for discharging this duty is for the courts, when deciding whether to apply a Code rule or equitable principle, to consider certain issues in the order of his list.

1. Which specific Code section (or sections), if any, applies or appears to apply?
2. What would be the effect of its application? In particular, would this effect be inequitable as between the parties?
3. If the effect appears inequitable as between the parties, does section 1-103 authorize resort to general equitable principles here? Does the relevant Code section (or sections) displace all such principles?
4. If the specific Code section (or sections) does not displace general equitable principles, which general equitable principle comes into play?
5. How is the applicable general principle to be formulated? Does non-Code law of the jurisdiction reject it? Should this rejection be rejected?
6. If the non-Code law of the jurisdiction does not repudiate the principle, how is it to be applied to avoid an inequitable result as between the parties?

Professor Hillman, on the other hand, recognizes the tension between sections 1-102(1) and 1-103 but sees only a “limited function” for common law and equitable rules. He worries about “over-usage” of section 1-103, and his method is intended to guard against this evil by placing “greater emphasis on Code policy as reflected in section 1-102(1) . . .”

Hillman, therefore, suggests a “priority system” whereby “[c]ourts are asked to look first at the explicit language of the Code, next to the Code’s purposes and policies and, finally, to the common law.” This approach appears simply to mirror the civilian method of true code interpretation which subordinates all other sources to the enacted law, but Hillman denies it. He tries to distinguish his method by expressly recognizing that “[c]ommon law is needed to fill gaps unanticipated by Code drafters and to supplement the Code where the drafters purposefully left gaps. Common law should also be applied when the Code text is hopelessly ambiguous or overly broad and where Code purposes and poli-
cies also conflict or are vague." By allowing some formal role for the common law under the Code, Professor Hillman seeks to differentiate his approach from that of the civil law.

The Summers and Hillman articles are extremely thoughtful and very helpful works. They deserve close study. But problems exist with the approaches they suggest. The Hillman approach is not significantly different in substance from that used in civil law systems for interpreting true codes. Conceding that extraneous sources of law have some role in deciding doubtful cases does not distinguish Hillman's approach because civilian methodology also recognizes a limited function for other sources of law in deciding code cases. Both methods emphasize the supremacy of the statute as the primary source of law, but such an approach is not suitable for application en bloc to the U.C.C. as the first article in this series establishes.

Professor Hillman's approach also suffers from a dependency on broad, vague and often conflicting purposes and policies underlying the Code, especially those detailed in section 1-102(1). He recognizes the problem and tries to ease it by suggesting that their general nature can be particularized by using the Code's text, its legislative history, the Official Comments and by applying literally and analogously other relevant Code sections. An easy and logical way to overcome the problem is to recognize, as Hillman does not, that promoting these purposes and policies is intended to further a broader goal of insuring the orderly conduct of commercial affairs and transactions. And no court can decide whether a particular rule furthers that goal without carefully analyzing the current state of pertinent commercial practices and circumstances. These considerations, which may be termed "commercial realities," do more than amplify the Code's announced purposes and policies. They give them content and direction. But Hillman's approach fails formally to institutionalize relevant commercial realities as factors for the courts to consider.

Another problem with Professor Hillman's approach is his perception that section 1-103 presents an obstacle to an interpretative method which, like his, accounts fully for the Code's purposes and policies. It does not; and, in fact, section 1-103 should be read in concert with section 1-102(1). The drafters certainly did not insert section 1-103 for the courts

364. See id. at 678.
366. See particularly id. at 47-58.
367. See Hillman, supra note 358, at 679.
368. See generally id. at 679-83.
370. See Hillman, supra note 358, at 683-84.
to use as a means of frustrating the policies announced in the immediately
preceding provision or additional ones the Code should promote. Applying
legal and equitable principles by way of section 1-103 can be as effective
a way of promoting them as any other. Necessarily, then, Hillman's
approach also fails to account for the fact that the purposes or policies
underlying the Code may conflict and that in the same case one may be
promoted by finding a rule in the Code and another by supplementing
the Code with a common law rule. Assuming the result would be differ-
ent, which rule should then be applied? The answer in this and other
doubtful cases should depend on which one will more certainly promote
the orderly conduct of commercial transactions, and an analysis of the
commercial realities is required.

Professor Summers' approach is also problematic. First, according to
him, a determination that the effect of applying a Code section would "be
inequitable as between the parties" is a prerequisite to resort to equitable
principles.371 But, as Professor Wasserstrom has aptly demonstrated,
rules of decision must be based on something other than a considera-
tion of the effect of a decision upon the particular litigants before the court.372
An at least equally important consideration is the rule's effect on the class
of cases represented by the one before the court. A more critical problem
with Summers' approach is that it also requires the court to decide
whether the relevant Code section has displaced equitable principles.373
But he concludes that "so far as I can see, there is no formula for making
such determinations."374 The displacement issue, however, is the very
heart of the methodological problem raised by sections 1-102(1) and 1-103
and their derivative approaches.

The approach suggested in this series of articles picks up where Pro-
fessor Summers' leaves off. It establishes a formula of sorts for deciding
when the Code has displaced a legal or equitable rule. And the approach
goes one step beyond Professor Hillman's. It recognizes that a considera-
tion of the Code's purposes and policies is central to the displacement
issue, including those of the Code as a "code" and as a collection of rules
and principles each having its own underlying purposes or policies.375

371. See Summers, supra note 355, at 945.
373. See Summers, supra note 355, at 946.
374. Id. at 939.
375. Professor Hillman's priority system "places heavy emphasis on the Code's purposes
and policies in construing Code sections." Hillman, supra note 358, at 678. He refers ini-
tially and, perhaps, primarily to those listed in U.C.C. § 1-102(1). But these "underlying
purposes and policies" are designed to promote the Code as a "code," i.e., a particular form
of statutory law. See Nickles Part I, supra note 346, at 20-21. When interpreting the Code,
due emphasis should also be placed on the purposes and policies underlying the particular
rules and principles of Code sections potentially relevant to the decision of a case. The
approach suggested in this article does just that. See text accompanying notes 376, 378-380
But it requires that the debate revolve around commercial realities involved in any particular class of cases and not simply over abstract concepts which often are too broad for practical application and so vague as to be in constant conflict. Following an analysis of the commercial realities and relevant purposes and policies, the decision whether to apply a Code or common law rule should depend on which one tends more certainly in any case or class of cases to promote the orderly conduct of commercial transactions. This approach is simply a unification of the different methods suggested by sections 1-102(1) and 1-103 and is designed to emphasize the importance of commercial practices and circumstances in the decision of doubtful cases under the Code. Expressed in the patterned manner of a legislative direction regarding the decision process, here is what it provides:

PURPOSES; RULES OF CONSTRUCTION; SUPPLEMENTARY PRINCIPLES OF LAW APPLICABLE

(1) This Act shall be construed and applied to further the orderly conduct of commercial transactions

(a) by promoting underlying purposes and policies of this Act which are

(i) to simplify, clarify and modernize the law governing commercial transactions;

(ii) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties;

(iii) to make uniform the law among the various jurisdictions; and

(b) by effectuating the purposes and policies of the Act's rules and principles.\(^{376}\)

(2) The purposes and policies referred to in subsection (1) shall be promoted or effectuated either

(a) by liberally construing and applying the provisions of this Act, or

(b) by supplementing its provisions with principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause

whichever method tends more certainly in any particular case or class of cases\(^{377}\) to further the orderly conduct of commercial transactions.

\(^{376}\) Professor Hillman also sees the importance of these purposes and policies. He concedes that the general policies of U.C.C. § 1-102(1) may be vague and useless in the context of particular problems, and he suggests that "courts should more actively seek to determine the underlying purposes and policies of the individual sections under consideration." Hillman, supra note 358, at 680.

\(^{377}\) The phrase "by effectuating the purposes and policies of the Act's rules and principles" is added simply to emphasize an obviously important but sometimes overlooked source of purposes and policies the Code must promote. See note 375 supra and text accompanying notes 378-380 infra.
This approach combines the language of sections 1-102(1) and 1-103, interrelates their methods and incorporates the findings and conclusions of the earlier articles in this series. It unites the two provisions and thereby eases the tension existing between the conflicting methodologies deriving from them. The union establishes an approach to deciding doubtful cases under the Code which resolves the sources of law problem in favor of a hierarchical ranking dependent upon the commercial realities involved in any particular class of cases. The proper source of law to consult in a doubtful case is the one permitting the result most consistent with the broadest and ultimate purpose the Code was designed to achieve. Deciding this issue requires an examination of pertinent commercial practices and circumstances, as well as of the Code's purposes and policies.

This approach also recognizes that among the important purposes and policies to be considered when deciding doubtful cases are those underlying the legal rules and principles comprising the Code's individual sections. These purposes and policies should not be subordinated willy-nilly to those outlined in section 1-102(1), which relate only to the Code \textit{qua} code. The U.C.C. is a "codification"\textsuperscript{378} intended to be uniformly adopted and applied, but any approach to its interpretation must also provide for promoting the intent of its substantive provisions as well as the form which collectively they take. The drafters apparently agree. In their comments to section 1-102, they reiterate the importance of construing the Act "in accordance with its underlying purposes and policies."\textsuperscript{379} They add, however, that "[t]he text of each section should be read in the light of the rule or principle in question, as also of the Act as a whole . . . ."\textsuperscript{380} The approach suggested in this article assumes that the purposes and policies which should be promoted or effectuated in construing the U.C.C. include those underlying the rules and principles which comprise its component provisions.

The principal purpose of this final article in the series is to demonstrate the use of this approach to resolve a sampling of Article 9 doubtful cases. Not everyone will agree that the commercial realities or purposes or policies emphasized in each case are the controlling ones or that the rules and results advocated here more certainly promote the orderly conduct of commercial transactions. But in every case the aim is to illustrate the practical effect of the decision whether to apply a Code section or to supplement it with a common law rule or equitable principle. An approach based primarily on a consideration of the practicalities or realities

\textsuperscript{378} See Nickles Part I, supra note 346, at 19 n.55, 20 n.58 & 21 n.59.
\textsuperscript{379} U.C.C. § 1-102, Comment 1 (emphasis added).
\textsuperscript{380} Id.
involved in commercial transactions is believed to subsume the Hillman and Summers methods and to provide a more workable and predictable solution to the displacement issue under the Code.

The demonstration begins by considering a type of case which is easily resolved under any of the approaches. No need arises to debate purposes or policies or to determine relative equities or to examine commercial realities. Most of the other types of cases considered here are not so easily decided, however, since the source of law to consult, the rule to apply and the result reached may depend upon which methodological approach is adopted.\footnote{381}

SECTION V. PRINCIPLES OF LAW AND EQUITY NOT DISPLACED UNDER ARTICLE 9

A. The Subrogation Rights of Accommodation Parties, Assignees and Construction Sureties

One of the equitable doctrines most frequently used to supplement the provisions of Article 9 is subrogation.\footnote{382} Three hypothetical cases illustrate the typical applications of the remedy. The displacement issue is most easily resolved in the first case. Debtor gets a loan from Bank and executes a promissory note payable to Bank and secured by a security interest in Debtor's personal property. Surety is also a party to the note as an accommodation indorser.\footnote{383} Debtor dishonors the instrument,\footnote{384} and

\footnote{381} For example, compare Summers, supra note 355, at 937-38 with text accompanying notes 574-643 infra, regarding actual knowledge as a factor in determining priority between secured parties under U.C.C. § 9-312(5)(a). Also, compare Hillman, supra note 358, at 690 with text accompanying notes 644-680 infra, regarding conflicts between buyers of farm products and farm lenders.

\footnote{382} "Subrogation is a term describing the equitable remedy by which, where the property of one person is used to discharge a duty of another or a lien upon the property of another, under such circumstances that the other will be unjustly enriched by the retention of the benefit thus conferred, the former is placed in the position of the obligee or lienholder." Restatement of Security § 141, Comment a (1941). See also Restatement of Restitution § 162 (1937). And see generally H. Sheldon, The Law of Subrogation §§ 1-11 (1882).

\footnote{383} The Surety is an accommodation party because he "signs the instrument . . . for the purpose of lending his name to another party to it." U.C.C. § 3-415(1). He "is liable in the capacity in which he has signed . . . ." U.C.C. § 3-415(2), which in this case is that of an indorser. The liability of an indorser is explained in U.C.C. § 3-414(1), and see note 384 infra.

\footnote{384} An indorser’s liability is conditioned upon dishonor of the instrument and any necessary notice of dishonor. See U.C.C. § 3-414(1). "An instrument is dishonored when a necessary or optional presentment is made and due acceptance or payment is refused or cannot be obtained within the prescribed time . . . ." U.C.C. § 3-507(1)(a). And when the instrument is dishonored, "the holder has . . . an immediate right of recourse against . . . indorsers." U.C.C. § 3-507(2). But untimely and unexcused presentment or notice of dishonor will discharge an indorser. See U.C.C. § 3-502(1)(a), and see, e.g., Nevada State Bank v. Fischer, 93 Nev. 317, 565 P.2d 332 (1977).
Surety pays it. Surety has a right of recourse on the instrument against Debtor.\textsuperscript{385} Does he also have recourse against the collateral which secures the note?

Pre-Code law provides a clear answer. "Where the duty of the principal to the creditor is fully satisfied, the surety to the extent that he has contributed to this satisfaction is subrogated . . . to the interests which the creditor has in security for the principal's performance . . . ."\textsuperscript{386} The creditor's interest in the collateral "is kept alive against the principal . . . for the benefit of the surety"\textsuperscript{387} because "equity . . . creates in the surety . . . rights similar to those of the creditor before the duty to him was discharged."\textsuperscript{388} This is accomplished by an "equitable assignment"\textsuperscript{389} to the surety of the creditor's interest in the collateral, which is not dependent upon an express assignment between them.\textsuperscript{390} The assignment results from "a particular application of the broad principle of subrogation" which is enforced whenever the interests of the party making the payment "can only be fully protected and maintained by regarding the transaction as an assignment to him, and the lien of the mortgage kept alive . . . for

\textsuperscript{385} "An accommodation party is not liable to the party accommodated, and if he pays the instrument has a right of recourse on the instrument against such party." U.C.C. § 3-415(5). \textit{See also U.C.C. § 3-603(2)}. \textit{See, e.g.}, Payne v. Payne, 219 Va. 12, 245 S.E.2d 133 (1978). The surety is also subrogated to the creditor's rights against the debtor on the underlying transaction. \textit{See, e.g.}, Warren v. Washington Trust Bank, 19 Wis. App. 348, 575 P.2d 1077 (1978); Ilg v. Andrews, 10 Wis. App. 936, 520 P.2d 1385 (1974).


\textsuperscript{387} \textit{Restatement of Security} § 141, Comment a (1941).

\textsuperscript{388} Id.


\textsuperscript{390} "[T]he duty of the creditor, which the court enforces, does not arise from contract, but is imposed upon him by equity . . . ." L. Simpson, \textit{supra} note 386, at 206-07.

Equity, in effect creates in the surety who has performed, rights similar to those of the creditor before the duty to him was discharged. This is sometimes called an assignment by operation of law. It does not depend upon an actual assignment, however, although where necessary to give the surety procedural or other advantages, the creditor can be required to make an assignment.

\textit{Restatement of Security} § 141, Comment a (1941).

"This equitable result follows, although no actual assignment, written or verbal, accompanied the payment, and the securities themselves were not delivered over to the person making the payment, and even though a receipt was given speaking of the mortgage debt as being fully paid, and sometimes even though the mortgage itself was actually discharged and satisfied of record."

4 J. Pomeroy, \textit{supra} note 389, at § 1211.
his security and benefit.”

Article 9 does not displace the common law in this case. Instead, it perpetuates the notion of “equitable assignment” by specifically recognizing it.

A person who is liable to a secured party under a guaranty, indorsement, repurchase agreement or the like and who receives a transfer of the collateral from the secured party or is subrogated to his rights has thereafter the rights and duties of the secured party.

Those rights include repossessing the collateral from the debtor and disposing of it according to the procedures prescribed in Part 5 of Article 9.

The second case illustrating the use of subrogation as a supplementary principle raises an issue regarding a subrogated party’s rights against a third person having an interest in the collateral. Do his rights include any “priority” which the original secured party could have claimed over other creditors? Suppose, for example, that Debtor buys goods from Seller on credit. Seller retains an Article 9 security interest in the property and perfects it. Debtor then borrows money from Finance Company which takes a perfected security interest in the same property. Some time later Bank agrees to refinance the obligation which Debtor owes Seller. Bank pays Seller the balance owed him, and Debtor grants to Bank a security interest in the goods. Bank perfects. Debtor ultimately defaults under his security agreements with Finance Company and Bank. Which party has priority?

The general Article 9 rule for determining priorities between two perfected secured parties is that “[c]onflicting security interests rank ac-

391. 4 J. POMEROY, supra note 389, at § 1211.
392. U.C.C. § 9-504(5).

cording to priority in time of filing or perfection." Finance Company will note that its security interest was perfected before the Bank's. Bank will argue that it is subrogated to Seller's position and that, by the same priority rule, Seller's security interest would have been prior to Finance Company's. The problem with the Bank's argument is that no provision of Article 9 explicitly provides that one subrogated to the rights of a secured party has thereafter his relative priority with respect to other creditors also claiming the collateral. Section 9-504(5) uses the term "rights," but its definition provides only that they "include remedies." Finance Company can then argue that absent an express assignment of Seller's interest to Bank, Bank must rely on the security interest granted by the Debtor and perfected later than the one held by Finance Company.

The principal problem with Finance Company's argument is the decision and reasoning in French Lumber Co., Inc. v. Commercial Realty & Finance Co., Inc. French financed the purchase of a new automobile through Ware Trust Company which obtained and perfected an Article 9 security interest in it. About four months later, French borrowed money from Commercial. The car served as collateral for the loan, and Commercial perfected a security interest. French defaulted under its security agreement with Ware which then repossessed the car. But persons representing French induced Associates Discount Corporation to refinance. Associates paid the balance owed to Ware and took a perfected security interest in the car. Ware expressly assigned nothing to Associates. When Associates was not paid as agreed, it repossessed the car and sold it at public auction. Both Associates and Commercial claimed the sale proceeds. Commercial asserted priority on the basis of section 9-312(5)(a), and Associates based its priority on the senior position of Ware to which Associates claimed it was subrogated.

The court determined that section 9-312(5)(a), if literally applied,

394. U.C.C. § 9-312(5)(a).
395. "It is frequently held, there being no intervening equities, that one who advances money to discharge a prior lien on real or personal property, and who takes a new mortgage as security, is entitled to subrogation to the prior lien as against the holder of an intervening lien of which the lender was ignorant." 4 J. Pomeroy, supra note 389, at § 1212. See also D. Dobbs, supra note 386, at 251; J. Eaton, supra note 386, at § 255. See generally other authorities cited at note 386 supra.
396. U.C.C. § 1-201(36). "'Remedy' means any remedial right to which an aggrieved party is entitled with or without resort to a tribunal." U.C.C. § 1-201(34).
398. U.C.C. § 9-312(5)(a) provides that
Conflicting security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither filing nor perfection.
would rank Commercial’s security interest prior to Associates’. Therefore, Associates could prevail only by establishing the right to succeed to Ware’s priority over Commercial. The right could have been created by an express assignment of Ware’s security interest to Associates, but none was made. The other possibility was to apply a common law rule under which Associates could acquire Ware’s priority through the doctrine of subrogation.

“The plaintiff, having paid the debts of the defendant out of its funds and taken its mortgage in the mistaken belief that it would have a first lien on the premises, was not officious. In such circumstances equity has given relief by way of subrogation when the interest of intervening lienors were not prejudicially affected.”

The court decided that Associates should prevail on the basis of this pre-Code rule which, it also decided, was not displaced by Article 9. After citing section 1-103, the court said, “No provision of the Code purports to affect the fundamental equitable doctrine of subrogation.” Its reason-

399. See 195 N.E.2d at 509.
400. Citing U.C.C. § 9-302(2), the court said: “A security interest can be “assigned” to another creditor without loss of its priority even if no filing is made. Thus Ware could have made an assignment of its security interest to Associates, and Associates would then have acquired Ware’s priority over Commercial. But no such assignment was made.” 195 N.E.2d at 509. See generally Bruer v. Sanford Atlantic Nat’l Bank, 247 So. 2d 764 (Fla. Dist. Ct. App. 1971); Hillman’s Equipment, Inc. v. Central Realty, Inc., 144 Ind. App. 18, 242 N.E. 2d 522 (1968), see id on other grounds; 253 Ind. 48, 246 N.E.2d 383 (1969).

The court in French Lumber Co. v. Commercial Realty & Fin. Co., Inc., 346 Mass. 716, 195 N.E.2d 507 (1964) failed to discuss one possible qualification to the common law rule which it applied. The subrogee will be given priority over an intervening lien only if he was “ignorant” of it. T. J. POMEROY, supra note 389, at § 121. Could Commercial have argued in French that Associates was not ignorant of its intervening security interest because of the constructive notice supplied by Commercial’s filed financing statement? The better answer is “no.” “It has been held in a few cases that if a lien is properly recorded so that under the recording acts of the jurisdiction it constitutes constructive notice of its existence, one who subsequently acquires rights in the property is not entitled to subrogation on paying off a senior incumbrance, even though in good faith and without actual notice, and though he did not expressly or impliedly assume the payment of the junior obligation.” 2 F. LAWRENCE, supra note 386, at § 651. But this was the minority rule under the common law.

“The weight of authority and of reason rejects the doctrine of constructive notice from the record, and holds that in the absence of some prejudice resulting to the junior lienor from the change of owners of the senior lien, the record alone will not defeat the right of subrogation.” Id. See also Bruer v. Sanford Atlantic Nat’l Bank, 247 So. 2d 764 (Fla. Dist. Ct. App. 1971) (holding that a subrogee’s prior knowledge of an intervening lien is irrelevant in cases involving contractual or conventional—as opposed to legal or equitable—subrogation).
ing must have been that equitable principles are applicable under Article 9 unless some provision specifically displaces them, either expressly or by unquestionable inference.

Better reasons support the conclusion that Article 9 does not displace subrogation as applied to decide priority disputes like the one in *French*. In some cases the Code will resolve the displacement issue by leaving no choice but to use the common law, and one way is by failing to define definitively Code terms. Under the common law the rights of a person discharging a debtor’s obligations to a secured creditor include both subrogation to the creditor’s interest in the collateral and entitlement to the secured creditor’s preference over competing claims.404 “Rights” as used in section 9-504(5) “include remedies,”405 but the definition does not necessarily exclude “priorities.”406 The court in *French* could have defined “rights” to include “priorities.” On that reading section 9-504(5) could then be said to perpetuate expressly an equitable principle, just as in the first subrogation case discussed earlier.407

The same result can be reached using the same approach under another section. Interpret the term “assignment” as used in section 9-302(2)408 by reference to the common law. The courts must look beyond Article 9 for a definition which neither it nor Article 1 provides. In *French* the court assumed without analysis that “assignment” as used in section 9-302(2) meant an “express” assignment. But, by resort to the common law, the term could be defined to include an “equitable assignment” which would have resulted when Associates paid French’s debt to Ware.409 The reason for preferring a creditor in Associates’ position is the same whether the assignment is an express or equitable one. “The other creditors have no ground of objection, since they are thereby placed in no worse position than they would have occupied if the claim had not been paid.”410

The doctrine of subrogation and its ancillary rules continue to supplement Article 9 in cases like *French*, but the better reasons for this con-

404. *See* RESTATEMENT OF RESTITUTION § 162, Comment f (1937).
405. U.C.C. § 1-201(36).
406. One court relying on U.C.C. § 9-504(5) to determine the rights of a subrogee held that he “is subrogated to all the rights and remedies of the bank asserted in this case, including the right of collection on the debt itself, and has the same priority with respect to the perfected security interest as that of the plaintiff bank.” First Nat’l Bank of Sikeston, Mo. v. Jefferson Sales and Distributors, Inc., 341 F. Supp. 659, 671-72 (S.D. Miss. 1971) (emphasis added), aff’d per curiam, 460 F.2d 1059 (5th Cir. 1972).
407. *See* text accompanying notes 382-393 supra.
408. This section provides that “[i]f a secured party assigns a perfected security interest, no filing under this Article is required in order to continue the perfected status of the security interest against creditors of the transferees from the original debtor.” U.C.C. § 9-302(2).
409. *See* 4 J. POMEROY, supra note 389, §§ 1211-1212, and see generally authorities cited at note 386 supra.
410. RESTATEMENT OF RESTITUTION § 162, Comment f (1937).
clusion do not include the absence of a provision specifically displacing them. The doctrine's application should be based on either (1) the direct or analogous application of section 9-504(5) which expressly perpetuates the doctrine or (2) the Code's failure to define operative terms which requires resort to common law rules and equitable principles to give them meaning. In essence, therefore, the language of applicable Code provisions solves the displacement issue in French by expressly perpetuating pre-Code principles or by leaving no choice but to resort to them.

The decision in French to resort to the equitable doctrine of subrogation is also justified because the result furthers the orderly conduct of commercial transactions, which is the most basic goal of the Code and which should be the ultimate basis for resolving doubtful cases. Subordinating a new creditor in Associates' position to intervening ones will discourage refinancing arrangements, but the practice of refinancing is a desirable one which the Code should facilitate. The original creditor is paid without having to repossess the collateral, dispose of it and, as is often the case, sue for a deficiency; depending on the rights of other creditors and subject to the terms of his agreement with the new creditor, the debtor retains the collateral; the chances that intervening creditors will be paid are not worsened and may even be enhanced.\textsuperscript{411} Regardless of the court's reasoning, therefore, the decision on the displacement issue in French is correct because it fosters a practice which may benefit all classes of persons typically involved or, at least, benefit some and not prejudice others.

The third case illustrating the use of subrogation to supplement Article 9's provisions appears most often among the reported decisions. Contractor agrees to build a structure for Owner, either a public or private entity. Their agreement provides that Contractor will furnish a performance or payment bond or both.\textsuperscript{412} Contractor then borrows money from

\textsuperscript{411} Refinancing helps to avert foreclosure, and this may help to insure that the debtor has funds available to pay other creditors. The collateral may, for example, be goods used in the debtor's employment, such as a car. Repossessing the car may leave the debtor no way to commute to his job. Losing his job means losing his salary and, perhaps, the ability to pay anyone. In addition, foreclosure may hurt the debtor's chances of obtaining funds elsewhere to pay his debts. If he applies for a loan the lender will be interested in knowing the debtor's credit history and determining his creditworthiness. The lender may well ask whether the debtor has defaulted on previous obligations and whether he has suffered any foreclosures. Affirmative answers on these questions cannot help the debtor's chances of obtaining additional credit. As a means of averting foreclosure, therefore, refinancing helps to insure that the debtor's financial situation is not worsened and, thereby, that other creditors' chances of being paid are not lessened.

\textsuperscript{412} "Payment" and "performance" bonds are the two standard types of contractors' bonds.

In every case there will be a bond which, in effect, secures the owner against the failure of the contractor to complete the building and otherwise fully perform the contract. This is called a performance bond. There may also be a payment bond
Bank which perfects a security interest in the Contractor's rights to payment under his agreement with Owner,\textsuperscript{413} Contractor ultimately defaults, and Surety completes performance or pays materialmen and laborers. Surety then argues that he is equitably subrogated to the rights of Owner, Contractor or materialmen and laborers,\textsuperscript{414} and he claims any undisbursed payments, usually retained percentages, to which Contractor

under which the surety assumes liability for the payment of labor and material claims and on which the labor and material suppliers have a direct cause of action. Although payment bonds are sometimes used in private construction, they are, in a sense, redundant because under the performance bond the surety will be obligated to pay labor and material claims in order to protect the owner against liens. On the other hand, payment bonds are commonly required by statute for public construction in order to provide a substitute security for the laborers and materialmen who are precluded from asserting a lien on the public improvement. While separate payment and performance bonds are frequently written, it is about as common to include both obligations in a single undertaking.


A performance bond guarantees the owner that the work will be completed. A payment bond guarantees that persons supplying labor and material in connection with the project will be paid. Private owners require payment bonds to protect their property against mechanics' liens; public owners generally do so pursuant to statutory requirements manifesting a venerable policy of protecting the artisans whose labor and materials have gone into public projects.

Contrary to a widely accepted misconception, a surety bond is not an insurance contract; it is a guarantee. As between the surety and the contractor, the latter has the primary obligation. The surety, in executing a bond, expects the contractor to complete the job and pay his suppliers. Hopefully, the contract price will cover both undertakings. If it will not, the surety expects the contractor to make up any loss, if he can.


\textsuperscript{413} Under an earlier version of the Code, the collateral would be classified as a "contract right," i.e., "any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper." U.C.C. § 9-106 (1962 version). The 1972 version eliminates the term, and now the bank's collateral is an "account," i.e., "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance." U.C.C. § 9-106.

\textsuperscript{414} [T]he surety in cases like this undertakes duties which entitle it to step into three sets of shoes. When, on default of the contractor, it pays all of the bills of the job to date and completes the job, it stands in the shoes of the contractor insofar as there are receivables due it; in the shoes of laborers and material men who have been paid by the surety—who may have had liens; and, not least, in the shoes of the government [or other person], for whom the job was completed.

**Nat'l Shawmut Bank of Boston v. New Amsterdam Cas. Co.**, 411 F.2d 843, 845 (1st Cir. 1969). And see, e.g., Cushman, The Surety's Right of Equitable Priority To Contract Balances in Relation to the Uniform Commercial Code, 39 TEMP. L.Q. 239, 239-44 (1966); Withers, Surety vs. Lender: Priority of Claims to Contract Funds, 10 WASHBURN L.J. 356, 359-60 (1971); Notes, 65 COLUM. L. REV. 927 (1965); 69 DICK. L. REV.172, 172-75 (1965). Additionally or alternatively, the surety may assert a claim to retained funds on the basis of an express assignment of the contractor's rights to payment under the contractor's contract with the owner. See text accompanying notes 426-46 infra.
would have been entitled had he fully performed.\textsuperscript{415} Bank also claims the payments by virtue of its perfected security interest. Owner interposes them, and the court must decide which party has priority to the payments, the performing Surety or the financing Bank. The courts agree almost unanimously about which party should prevail,\textsuperscript{416} but the dis-

\footnotesize{\textsuperscript{415} Typically a construction contract calls for the owner to make two types of payments to the contractor.

So-called progress payments are generally made monthly as the work progresses and each payment, depending on the contract, is between eighty and ninety-five percent of the value of labor and materials added during the previous month as determined by the architect. The final payment is made after the building is complete and has been accepted by the owner and equals the difference between the contract price and the total progress payments. Included in the final payment are the so-called retained percentages which have, in a sense, been accumulated by paying the contractor less than one hundred per cent of value in the progress payments.

Rudolph, supra note 412, at 247. Therefore, when the contractor defaults and the surety performs, the assignee-bank and the surety may compete for different types of funds "consisting of either earned but unpaid progress payments in the building owner's possession, progress payments earned by the surety upon completion of the contractual obligations, progress payments already paid to the contractor or his lender, or, most frequently, a retained percentage of the contract price held by the owner as security for the completion of the project and payment of outstanding claims." Note, 27 VAND. L. REV. 389, 391 (1974). As between the surety and the assignee-bank, which party prevails may depend on the type of fund which is the subject of the dispute, because the relative equitable, legal and practical positions of the parties differ with respect to each fund. The discussion which follows in this section of the article generally demonstrates this point.

placement issue has not been so easily resolved in this type of case.

Since the decision in *Prairie State Bank v. United States*, the surety's right to subrogation in this type of case has not been seriously questioned; and prior to the Code's adoption the courts had consistently held that the surety prevailed over the bank. What prompted a reexamination of that result after the enactment of Article 9 is the argument that "the surety's claim against retained funds is a 'contract right' under the Uniform Commercial Code, operating as an assignment of future earnings given to secure performance by the principal, and thus is a 'security interest' required to be filed under the Code . . . ." Since the bank always files a financing statement and the surety usually does not, the bank asserts priority of its security interest on the basis of the first-to-file-or-perfect rule of section 9-312(5)(a). A principal reason often given to reject the bank's argument is that a surety's claim arising under the doctrine of subrogation is not within Article 9 as it reaches only "consensual" transactions intended to create "security interests." The courts have held (1) that the surety's right of subrogation "is not 'created by contract' but rather by the status, resulting from a contract, inhering in a surety, quite independently of the express terms of the contract," (2) that what secures the surety is not a

and *Hartford Accident* cases interpreted Pennsylvania law, but the Pennsylvania Supreme Court has since decided a similar case to the contrary. See *Jacobs v. Northeastern Corp.*, supra herein. 417. 164 U.S. 227 (1896).


419. In re *J.V. Gleason Co.*, 452 F.2d 1219, 1221 (8th Cir. 1971).

420. U.C.C. § 9-312(5)(a) provides inter alia that "[c]onflicting security interests rank according to priority in time of filing or perfection." The bank's argument assumes, however, that neither its interest nor the surety's was automatically perfected without filing. See note 432 infra.

421. Article 9 "applies (a) to any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures . . . ." U.C.C. § 9-102(1). This section's "main purpose . . . is to bring all consensual security interests in personal property and fixtures under this Article, except for certain types of transactions excluded by Section 9-104." U.C.C. § 9-102, Prefatory Comment on Purposes. It also applies "to any sale of accounts or chattel paper," U.C.C. § 9-102(1)(b), but courts have held that the surety does not fit the description of such a buyer. See *Nat'l Shawmut Bank of Boston v. New Amsterdam Cas. Co.*, 411 F.2d 843 (1st Cir. 1969); *Alaska State Bank v. General Ins. Co. of America*, 579 P.2d 1362 (Alaska 1978).

security interest but "the opportunity, on default, to finish the job and apply any available funds against its cost of completion,"423 (3) that the transaction between the surety and contractor was not intended to result in a security arrangement;424 and even (4) that suretyship contracts may be specifically excluded from the scope of Article 9.425 Based on this reasoning, the displacement issue appears as easily resolvable as it is in the other types of subrogation cases already mentioned. Common law rules must determine the relative priorities because the transaction between the surety and the contractor is beyond the scope of Article 9, and none of its priority sections purports to rank the competing claims of a surety asserting subrogation rights and a secured party claiming a secured interest. The Code thereby requires resort to the common law in this type of case.

Many of the contractor's surety-versus-financing bank cases involve another factual element, however, which complicates the displacement decision. A contractor's bond application ordinarily contains language expressly assigning to the surety amounts that become due under the con-

---


425. U.C.C. § 9-104(f) provides that one type of transaction excluded from Article 9 is "a transfer of a right to payment under a contract to an assignee who is also to do the performance under the contract . . . ." The Eighth Circuit cited this section for the proposition that Article 9 "may exempt suretyship contracts" but it has "not been fully considered by either the courts or the commentators." In re J.V. Gleason Co., 452 F.2d 1219, 1224 (8th Cir. 1971). In Canter v. Schlager, 358 Mass. 789, 267 N.E.2d 492 (1971), the court refrained from passing "on the question whether the assignment to the surety . . . was excepted as a 'transfer of a contract right to an assignee who is also to do the performance under the contract . . . ." Id. 267 N.E.2d at 494. Professor Gilmore believes this exclusion does not exempt suretyship contracts even when the contractor expressly assigns to the surety his right to receive payments from the owner. See 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 36.7 (1965). But another author writes that "[w]ith respect to the surety's assignment in the bond application, . . . [s]ince it is not given to secure an extension of commercial credit, it falls outside the general class of transactions with which the Code is principally concerned." Rudolph, supra note 412, at 245. And he directs the reader to examine U.C.C. § 9-104 and its comments. Id. at 245 n.4.
tractor's agreement with the owner. The bank can now argue that the surety's claim to the payments retained by the owner should be based on

426. Here are examples of security paragraphs taken from standardized contracts of indemnity currently used by several leading insurance companies:

Example 1: SECURITY TO SURETY: As collateral security to Surety for the agreement of the Undersigned to repay all loss and expense to Surety, the Undersigned:
1. Convey to Surety, as of the date of execution of any Bond, all rights of the Contractor in, or in any manner growing out of:
   a. Any contract or modification thereof;
   b. Any subcontract and against any legal entity and its surety who has contracted with Contractor to furnish labor, materials, equipment and supplies in connection with any Contract;
   c. Monies due or to become due Contractor on any Contract, including all monies earned or unearned which are unpaid at the time of notification by Surety to the Obligee of Surety's rights hereunder;

6. Agree that this agreement may at any time be completed and filed by Surety in such a manner that it will qualify as a financing statement under the applicable provisions of any statute of any state which has adopted the Uniform Commercial Code, and that Surety may add such schedules to this agreement, describing specific items of security covered hereunder as shall be necessary under such statutes.

[NOTE: "Contract" is defined in this form agreement as "any contract between Contractor and a third party, the performance of which is guaranteed by any Bond for which Surety is surety."]

Example 2: When BOND(S) secure the performance and fulfillment of contracts, PRINCIPAL, with the consent of UNDERSIGNED, agrees that:

(A)(1) The SURETY has the right of Exoneration and Subrogation; and
(2) SURETY'S rights of Exoneration and Subrogation may be enforced as provided by applicable law or, at option of SURETY, as follows:

(a) with respect to each specific contract secured by BOND(S) all money and property representing the consideration for the contract is dedicated for: (i) the performance of the contract; (ii) the payment of obligation(s) to subcontractor(s), laborer(s) and supplier(s) of material(s) and service(s) incurred or to be incurred in the performance of the contract for which SURETY is liable under BOND(S) and, (iii) the satisfaction of the obligations herein and all other indebtedness and liabilities of PRINCIPAL to SURETY;

(b) to partially implement this dedication SURETY may, in its sole discretion, demand that PRINCIPAL Request delivery of the consideration for the contract to a bank designated by SURETY for deposit of the proceeds of the consideration for the contract(s) in an account in the name of PRINCIPAL designated as a "Special Account" and withdrawal(s) from said "Special Account" shall be by check(s), payable to the beneficiaries of this dedication, signed by a representative of PRINCIPAL and by a representative of SURETY;

(c) this dedication may be implemented in any other manner provided at law or in equity;

Example 3: FIFTH: Each of the undersigned does by these presents assign, transfer and convey to the Company, as of the date of execution of any such Bond, in connection with any Contract, for the Company's protection and use and as collateral security for the full performance of the covenants and agreements herein contained and for the payment of any indebtedness or liability of the undersigned to the Company, whether heretofore and hereafter incurred, the following:

(a) All right, title and interest of the undersigned in and to all machinery, equipment, plant, tools and materials which are, on the date of execution of such Bond, or may thereafter be, about or upon the site of the work to be performed under the contract referred to in and guaranteed by such Bond, or elsewhere for the purpose, including as well materials
the express assignment of a contract right or account which by the
parties' agreement creates a security interest and not on an equitable
right of subrogation which arises by law. According to the First Circuit's
opinion in National Shawmut Bank of Boston v. New Amsterdam Casualty Co.,
Inc., this argument is "respectable." And Judge Braucher, a leading
commercial law scholar who wrote the opinion in Center v. Schlager,
admits that "[i]f the surety were claiming the balance due under the con-
tact by virtue of the assignment to it in the contractor's bond applica-
tion, it would be fairly arguable that it was claiming a 'security interest'
in a 'contract right.'"

Assuming that the express assignment does create a security interest
which has not been perfected by filing, the ultimate issue becomes

purchased for or chargeable to said contract which may be in the process of construction or
in storage elsewhere or in transportation to said site;

(b) All rights of the undersigned in, or growing in any manner out of, said contract or
any extensions, modifications, changes or alterations thereof or additions thereto;

(c) All rights, causes of action, claims and demands whatsoever which the undersigned
or any of them may have or acquire in any sub-contract in connection with said contract,
and against any sub-contractor or any person, firm or corporation furnishing or agreeing to
furnish or supply labor, materials, supplies, machinery, tools or other equipment in con-
nection with or on account of said contract, and against any surety or sureties of any such
materialman, subcontractor, laborer or other person, firm or corporation;

(d) All right, title and interest of the undersigned in any to any and all percentages
retained by the obligee under said contract, and any and all estimates, payments, extras,
final payments and other sums that, at the time of abandonment, forfeiture or breach of said
contract or such Bond or of the terms of this agreement or at the time of any advance,
payment or guaranty by the Company for the purpose of avoiding such abandonment, for-
feiture or breach, may be due or may thereafter become due under said contract to or on
behalf of the undersigned.

SIXTEENTH: That this Agreement shall constitute a Security Agreement to the
Surety and a Financing Statement, both in accordance with the provisions of the Uni-
form Commercial Code of every jurisdiction wherein such Code is in effect and may be so
used by the Surety without in any way abrogating, restricting or limiting the rights of
the Surety under this Agreement or under law, or in equity.

427. See note 413 supra.
428. 411 F.2d 843 (1st Cir. 1969).
429. Id. at 845.
431. 267 N.E.2d at 494.
432. The transaction between the contractor and the surety may fall within the broad
scope provision of U.C.C. § 9-102. But see text accompanying notes 421-24 supra. But it has
been suggested that the transaction may be expressly excluded from Article 9's scope under
the specific language of § 9-104(f). It provides that the article does not apply to a "transfer of
a right to payment under a contract to an assignee who is also to do the performance
under the contract ...." See note 425 supra.
433. If Article 9 applies, however, and if the requirements for creating a security interest are
satisfied, perfection may not always require the filing of a financing statement. Perfection
will be automatic in any case where the "assignment of accounts ... does not alone or in
conjunction with other assignments to the same assignee transfer a significant part of the
outstanding accounts of the assignor ...." U.C.C. § 9-302(1)(e). See 2 G. Gilmore, supra
note 425, § 36.7 at 974-75. Determining whether the account(s) assigned represents a signifi-
clear: Is the surety thereby precluded from making a prior claim to the payments on the basis of his right of subrogation and the pre-Code cases giving him priority over the financing bank? The courts have answered, "No." They have determined that Article 9 does not displace the common law in this type of case, and their reasoning is generally the same whether or not the transactions involve express assignments to the sureties.433

The courts first cite historical evidence tending to show that the drafters did not intend to change the relative priorities established under pre-Code law. Section 9-312(7) of the 1952 Official Draft of the Code included the following provision:

A security interest which secures an obligation to reimburse a surety or other person secondarily obligated to complete performance is subordinate to a later security interest given to a secured party who makes a new advance, incurs a new obligation, releases a perfected security interest or gives other new value to enable the debtor to perform the obligation for which the earlier secured party is liable.

The provision was deleted from the uniform version of the Code in 1953 because it was "a complete reversal of the case law not only of the Supreme Court of the United States but also of the highest courts of most of the states" holding that "the surety's rights come first as to the funds owing by the owner unless the surety has subordinated its rights to the bank."434 The Eighth Circuit and other courts interpret the decision to delete the provision as "an intentional recognition of and a desire to preserve the doctrine of subrogation."435 But they have been unwilling or


433. The courts' reasoning on the displacement issue is virtually unaffected by the presence of an express assignment. Most of the courts rely on precedents without distinguishing the cases on the basis of whether or not the contractor expressly assigned to the surety his right to payments. See Alaska State Bank v. General Ins. Co. of America, 579 P.2d 1362 (Alaska 1978) (Rabinowitz, J., concurring). The courts apparently share the view expressed by the Mississippi Supreme Court. "The rights of the surety to subrogation for its losses are founded on equitable principles independent of any assignment of contract proceeds in the application of the contractor. The assignment in a bond application is in aid of an equitable right; it does not create that right." Travelers Indemnity Co. v. Clark, 254 So. 2d 741, 745 (Miss. 1971).


unable to rely solely on this piece of legislative history as the reason for perpetuating the pre-Code rules and the result they dictate.436

The courts have had to overcome the appealing policy argument that requiring sureties to file financing statements would "establish a degree of certainty . . . to the determination of priorities among claimants to construction contract proceeds."437 The bankers contend that applying Article 9 would solve their problem of lack of notice of suretyship arrangements when contractors seek financing from them. The courts' collective response has generally been based on an analysis of the commercial practices and circumstances involved in this type of case. They have analyzed the commercial realities and rely on them as the primary support for their decision that subrogation has not been displaced in this context. Most important to them is the fact that the assignee bank has a right only to those payments actually due the contractor under his agreement with the owner. When the contractor defaults, however, any retained or unpaid balance which the bank claims is not due and payable to him. Absent a surety's involvement, the owner can and will use these funds to complete the project or pay materialmen, and the bank cannot claim them. When a surety does perform, he steps into the owner's or materialmen's shoes and is simply reimbursed with funds to which the bank in the first instance was not entitled whether or not it had prior notice of the suretyship arrangement. The contractor cannot assign to the bank more than he is entitled to receive, and upon default he forfeited the retainage which the bank now claims.438

Some courts also consider that a bank dealing with a contractor ordinarily has or should have sufficient notice of a suretyship arrangement or, at least, the real possibility that one exists. Therefore, an Article 9 filing would be superfluous. In some cases a bank may have actual knowledge

436. In In re Gleason Co., 452 F.2d 1219 (8th Cir. 1971), the court noted the argument made by some that the drafters' decision to delete § 9-312(7) from the 1952 Official Draft of the Code "indicates that they considered the equitable lien to be a security interest." Id. at 1221. One can argue that the deletion simply eliminated a special priority section and did not necessarily mean that the surety's interest is always something other than a security interest. The result is that the priority of a surety's interest will be determined according to Article 9's other priority rules, i.e., U.C.C. § 9-312(5)(a). Therefore, a surety's unperfected interest will be subordinate to a bank assignee's perfected one. The point is simply that the drafter's decision to delete § 9-312(7) from the 1952 Official Draft is susceptible to more than one interpretation. See 2 G. Gilmore, supra note 425, at § 36.7; Notes, 64 Nw. U. L. Rev. 582, 586-87 (1969); 32 U. Pitt. L. Rev. 580, 588, 590 (1971).


that a payment or performance bond has been furnished, and all lenders are presumed to know that in many instances the law requires surety bonds on public construction contracts. A state may even require that bonds covering certain types of construction projects be filed for record. But many courts may also be persuaded by Judge Braucher's reasoning in Canter.

It is possible for parties dealing with a construction contractor to be ignorant of the existence of a surety bond. But it could well be a rational legislative judgment that the practice of furnishing performance and payment bonds in connection with construction contracts is so well known that a requirement of public filing is unnecessary.

After examining these practicalities, the courts generally have agreed with the conclusions reached in Jacobs v. Northeastern Corporation.

None of the purposes or objectives of the Code's filing requirements would be served by holding that the subrogation to the contract balance now due is subject to the filing provisions of Article 9.

...It seems exceedingly clear that filing is not needed to prevent deceiving or misleading the creditors about the state of the contractor's available assets. Filing could in no conceivable way be beneficial to or protective of the general creditors.

What the courts have in essence decided is that the doctrine of subrogation is not displaced in this type of case because applying Article 9 and requiring sureties to file under its provisions would not promote the orderly conduct or commercial transactions. The requirement would

---

440. The Miller Act requires that "[b]efore any contract exceeding $2000 in amount, for the construction, alteration, or repair of any public building or public work of the United States is awarded to any person, such person shall furnish to the United States..." performance and payment bonds. 40 U.S.C. § 270a (1976). State law may impose a similar requirement. For example, Ark. STAT. ANN. § 51-632 (Repl. 1971) provides:

No contract in any sum exceeding $3000 providing for the repair, alteration, or erection of any public building, public structure or public improvement shall be entered into by the State of Arkansas, or any subdivision thereof, any county, municipality, school district, other local taxing unit, or by any agency of any of the foregoing, unless the contractor shall furnish to the party letting the contract a bond in a sum equal to the amount of the contract.

The First Circuit has observed that "even if the bank had no actual notice, it might well be held, at least in a Miller Act case, to constructive notice of the surety's existence." Nat'l Shawmut Bank of Boston v. New Amsterdam Cas. Co., 411 F.2d 843, 847 n.5 (1st Cir. 1969).

442. 267 N.E.2d at 496.
444. 206 A.2d at 54-55.
445. They thereby implicitly reject the argument made by some that the very existence of Article 9 and its provisions for filing and obtaining priority gives the surety an adequate legal remedy. See, e.g., Clark, Suretyship in the Uniform Commercial Code, 46 Tex. L. Rev. 455.
place a burden on the surety without easing the bank's or enlarging the bank's rights.\footnote{Among other practical considerations militating against subjecting the surety's interest to Article 9 and applying the U.C.C. § 9-312(5)(a) first-to-file-or-perfect rule are these:
Such a rule might prove unworkable since the surety and the bank might be unable to arrive at subordination agreements. Despite the fact that such agreements are to their advantage, banks and sureties in the past have been unable to negotiate a settlement.
An additional problem concerns commercial procedures leading to subordination agreements. Whichever party files first has a stronger bargaining position and could abuse its power and limit the other party's contractual freedom. For instance, a surety filing first might refuse to enter into a subordinated agreement with any financing institution except one of its own choosing, thereby forcing the contractor to deal with the surety's preferred bank for his loan. The same problem occurs when the bank files first: the bank may refuse to enter an agreement and thereby prevent the contractor from obtaining surety bonds unless he deals with the bank's preferred surety. Commercial realities do not justify the development of such positions of power.}

The performing surety's rights against a financing bank under pre-Code law are not unlimited, however, and questions may arise about the extent to which particular limitations imposed by the common law may be displaced under Article 9. Consider, for example, the surety's rights based on subrogation to recover the contract payments which have been paid to the assignee bank. The author of a frequently cited article reports that

Occasionally a surety has attempted to recover amounts already paid to the assignee bank. For the most part, these attempts have been unsuccessful. Subrogation avails nothing in these cases since it has generally been held that the owner himself cannot recover such payments from the assignee even though, under the particular facts, the payment could have been recovered had it been made instead to the contractor.\footnote{As Cushman explains, The Surety's Right of Equitable Priority to Contract Balances in Relation to the Uniform Commercial Code, 39 Temp. L.Q. 239, 249 et seq. (1966); Rudolph, supra note 412, at 255.}

The cases generally support the conclusion that the surety usually has
been unable to recover payments received by the assignee, but, except in cases where the United States is the obligor, the reason has not ordinarily been the owner's inability to recover them. Neither the common law nor the U.C.C. is perfectly clear about the right of the owner to recover payments from the contractor's assignee, and "[t]here are almost no cases in which contract debtors have sought refunds or other affirmative recoveries from third party assignees . . . ." As between the assignee-bank and the obligor-owner, the Restatement Second of Contracts provides inter alia that

(2) The right of an assignee is subject to any defense or claim of the obligor which accrues before the obligor receives notification of the assignment, but not to defenses or claims which accrue thereafter except as stated in this Section or as provided by statute.

(3) Where the right of an assignor is subject to discharge or modification in whole or in part by impossibility, illegality, non-occurrence of a condition, or present or prospective failure of performance by an obligee, the right of the assignee is to that extent subject to discharge or modification even after the obligor receives notification of the assignment.

The Comment to this Restatement section explains that

After receiving notification of an assignment, an obligor must treat the assignee as owner of the right and cannot assert against him a defense or claim arising out of a subsequent transaction . . . . Notification, however, does not enlarge the obligor's duty, and the possibility remains that the assigned right will become subject to a defense or to a claim by way of recoupment. The assignee's right is subject to such a defense or claim if it arises from the terms of the contract between the assignor and the obligor.

Undoubtedly, if sued by the assignee, the obligor can assert defensively as a set-off the damages resulting from the obligee's breach. A Restatement illustration confirms the defensive use of the recoupment right.

---

448. A section of the Assignment of Claims Act provides that

In any case in which moneys due or to become due under any contract are or have been assigned pursuant to this section, no liability of any nature of the assignor to the United States or any department or agency thereof, whether arising from or independently of such contract, shall create or impose any liability on the party of the assignee to make restitution, refund or repayment to the United States of any amount heretofore since July 1, 1950, or hereafter received under the assignmet.


449. But cf. United States v. Hadden, 192 F.2d 377 (6th Cir. 1951) (holding that the United States cannot recover payments mistakenly made to an assignee when nothing was owing to the assignee because under general legal principles restitution cannot be had in such cases of mistake). See RESTATEMENT OF RESTITUTION §§ 13-14 (1937). And see text accompanying notes 451-72 infra.


452. id., Comment d.
A contracts to build a structure for B, and becomes entitled to progress payments. A assigns the money due to C, and B receives notification of the assignment. Thereafter, in breach of his contract, A abandons the work. In an action by C against B, B is entitled to recoup damages caused by A's breach.\footnote{Id., Comment d, Illustration 6.}

Assume, however, that payments have already been made by the obligor and received by the assignee pursuant to the assignment. Can the obligor who suffers damages from the obligee's default assert his right of recoupment as an affirmative cause of action against the assignee? The quoted Restatement section and its comment are not as clear on the affirmative use of recoupment. Arguably, however, if the word "claim" as used there is to be literally interpreted and fully contrasted with the word "defense," the answer to the question may be "yes." If it is not, then "claim" as used in the Restatement section is little more than a mere redundancy.\footnote{Of course, "claims" may be used simply to make it clear that the obligor as defendant can assert set-offs and counterclaims, as well as "defenses." See generally Gilmore, The Assignee of Contract Rights and His Precarious Security, 74 Yale L.J. 217, 227-30 (1964). In this sense, a "claim" is different from a "defense" yet both are asserted in a defensive posture. But Professor Corbin believed that "[i]n its broadest sense, no doubt the word "defense" includes the others," i.e., recoupment, set-off and counterclaim. 4 A. CORBIN, CORBIN ON CONTRACTS § 896 (1950). Also, a counterclaim is the assertion of a claim for relief or cause of action which could have formed the basis of a lawsuit brought by the one asserting it. And other rules providing that assignees are subject to claims and defenses of obligors have been interpreted to permit an obligor an affirmative cause of action against the assignee on the basis of such claims. See Vasquez v. Superior Court of San Joaquin County, 4 Cal. 3d 800, 484 P.2d 964, 94 Cal. Rptr. 796 (1971); FTC Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses, 41 Fed. Reg. 20022, 20023 (1976). The Vasquez case and the FTC Rule involve situations much different than the type considered in the text, but they at least suggest the plausibility of the argument that the language "subject to claims" as used in the Restatement and its comment permit the affirmative, as well as defensive, assertion of them. An additional piece of evidence tending to support such an argument is found in the comments to RESTATEMENT (SECOND) OF CONTRACTS § 168 (1973). The only place the drafters make it clear that the assignee is "not subject to affirmative liability" is with reference to claims which are unrelated to the contract assigned to the assignee and which arise before notification to the obligor. See id., Comment c. The drafters' silence on the affirmative liability of the assignee with respect to "claims" arising from the terms of the contract between the assignor and obligor adds to the possibility of interpreting the section to allow such affirmative liability. But see note 466 infra.}

The same question about whether the "claims" to which a party takes subject may be asserted affirmatively as well as defensively may arise under U.C.C. § 3-306. But there "want or failure of consideration, nonperformance of any condition precedent" and so forth are specifically referred to as "defenses," [§ 3-306(c)] while "claims to it" [§ 3-306(a) (emphasis added)] refers only to rights of ownership to or other interests in the instrument itself. See id., Comment 2. Under this section, a counterclaim, set-off or right of recoupment is more clearly characterized as a "defense" only, not a claim which might arguably be asserted as an affirmative cause of action establishing the basis of a lawsuit against the transferee as defendant. But see generally Garner & Dunham, FTC Rule 433 and the Uniform Commercial Code: An Analysis of Current Lender Status, 43 Mo. L. Rev. 199, 227-29 (1978).
claims to which an assignee is subject,\footnote{455}{U.C.C. § 9-318(1) provides that unless an account debtor has made an enforceable agreement not to assert defenses or claims arising out of a sale as provided in Section 9-206 the rights of an assignee are subject to (a) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; and (b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment.}} and it "makes no substantial change in prior law."\footnote{456}{263 Ark. 1, 562 S.W.2d 74 (1978).} \textit{Benton State Bank v. Warren}\footnote{457}{Memorandum to the Supreme Court of Arkansas from the Permanent Editorial Board for the Uniform Commercial Code at 1, Benton State Bank v. Warren, 263 Ark. 1, 562 S.W.2d 74 (1978) [hereinafter Memorandum].} is a case raising "a question of nationwide significance on which there is a dearth of authority in both the decided cases and in writings of teachers and other students of the law; and on which the few decisions which have been found are contradictory."\footnote{458}{Id. \footnote{459}{562 S.W.2d at 76. \footnote{460}{Id.}}}

In its opinion of this case, the Arkansas Supreme Court may have interpreted section 9-318(1) to give the obligor an affirmative cause of action to recover payments made to the assignee. The Warrens, as owners and general contractors, were building an apartment complex. They hired Harps General Contractors to perform concrete, carpentry and heating and air conditioning work. Harps borrowed $60,000 from Benton State Bank which was secured by an assignment of Harps' right to receive progress payments from the Warrens. Several payments were made jointly to Harps and the Bank. Harps eventually breached its contract with the Warrens who then completed the work.

Materialmen unpaid by Harps asserted liens which the Warrens satisfied, and then they sued the Bank to recover the amount they had been required to pay the liens. The question was whether "the Warrens [are] entitled to recover from the bank their payments up to the amount of their net loss."\footnote{459}{Id.}

The court realized that "the equities clearly do not stand entirely in favor of either party . . . but held for the Warrens on the bases of U.C.C. section 9-318(1)(a) and the court's perception of the realities involved.

\begin{quote}
[T]he rights of an assignee (the bank) are subject to all the terms of the contract between the account debtor (the Warrens) and the assignor (Harps) and to any defense or claim arising therefrom. It follows that the bank necessarily took some risk in lending Harps up to 76% of the amount specified in each application for a progress payment. That is, if the Warrens, upon receipt of an application, had discovered that there were outstanding bills for labor and materials, the Warrens, under the subcontract, could have made their check payable jointly to the bank
\end{quote}
and to suppliers of labor and materials. In that situation it cannot be doubted that the bank's interest in the check would have been subordinate to the supplier's primary right to payment. That is so because the bank's rights as assignee were subject to any claim by the Warrens against the bank's assignor, Harps, who was primarily liable to its own suppliers.\footnote{461}

One interpretation of the court's reasoning is simply that if the Warrens had paid suppliers rather than remitting progress payments to the bank, the bank would have had no cause for complaint. The bank's rights as assignee were subject to the terms of the contract between the obligor and obligee. The necessarily implied second step in the court's reasoning is that the bank's rights are no greater simply because the payments had already been made to it. The court interprets section 9-318(1)(a) as providing that the assignee may have to answer for the obligee-assignor's breach whether the assignee sues for payments due under the assignment or is sued by the obligor seeking to recover them.\footnote{462} The court does not interpret the "subject to" language in the section to limit the obligor's right of recoupment to a defensive one.\footnote{463}

\footnote{461} Id.

\footnote{462} The result may be different if the assignee bases his right to keep the payments on a common law right of set-off instead of an Article 9 security interest. See generally Cherokee Carpet Mills, Inc. v. Wornher Bank and Trust Co., 262 Ark. 776, 561 S.W.2d 310 (1978).

\footnote{463} But the overwhelming consensus seems to be that under Restatement (Second) of Contracts § 168 and U.C.C. § 9-318(1), the obligor can assert claims to which the assignor wishes subject only in a defensive posture, unless the assignee has assumed the duty of performance under the contract. Regarding the assumption of duties notion, see U.C.C. §§ 2-210 & 9-217. But see note 466 infra. The treatise writers consistently refer to the right of the obligor to assert claims when he is sued by the assignee. See generally C. Calamari & J. Perillo, The Law of Contracts §§ 18-16—18-17 (2d ed. 1977); A. Corbin, supra note 454, §§ 892-897; J. Murray, Murray on Contracts § 307 (Rev. ed. 1974); S. Williston, A Treatise on the Law of Contracts § 432 (3d ed. W. Jaeger ed. 1960). And see Garner & Dunham, FTC Rule 433 and the Uniform Commercial Code: An Analysis of Current Lender Status, 43 Mo. L. Rev. 199, 227-29 (1978) (regarding affirmative liability of holder of instrument under U.C.C. § 3-306 with respect to breach of warranty claims by maker). The Code's Permanent Editorial Board argued vigorously in a brief filed with the court in Benton State Bank v. Warren, 263 Ark. 1, 562 S.W.2d 74 (1976), that § 9-318 cannot and should not be interpreted to require an assignee to refund what has already been paid to him. See Memorandum, supra note 458, at 4-14. Also, in Shepard v. Commercial Credit Corp., 123 Vt. 106, 183 A.2d 525 (1962), the buyer of goods sold under a conditional sales contract sued the assignee of the contract, Commercial Credit, for what amounted to a breach of warranty by the conditional seller. The precise issue was whether the plaintiffs are entitled to an affirmative judgment against the Commercial Credit Corporation . . . . This question appears to hinge on whether or not there was an assumption by the Commercial Credit Corporation of the liabilities imposed by the contract between the vendor and the plaintiffs. It is a general principle that an assignment of a contract does not cast upon the assignee liabilities imposed by the contract on the assignor, in the absence of an assumption on such liabilities. The assignee of a contract is usually not liable to the other contracting party to the contract assigned unless such liability has been expressly or impliedly assumed by the assignee.

In the absence of assumption of liability it is the well settled doctrine, and we so hold, that
The lone dissenter in Benton State Bank argues that the assignee is accountable for the damages suffered by the obligor only if the assignee seeks to enforce the assignment against the obligor. He argues that the obligor's right of recoupment can only be asserted defensively and not affirmatively. His interpretation of section 9-318(1)(a) is based upon what he thinks is the important commercial reality to be considered in this type case. After quoting the section he reminds the majority that the Code defines "rights" as including "remedies."464

Thus when we look at [U.C.C. § 9-318(1)(a)] with the definition of "rights" superimposed, we then read it as saying "... the [remedies] of an assignee are subject to (a) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; 

Notwithstanding the specific language of the Uniform Commercial Code and its specific definitions, the majority has now interpreted [§ 9-318] to place a liability upon the assignee. The Benton State Bank was not pursuing a remedy as to the accounts in question from which the Warrens could make any defense or claim arising from the pursuit of such remedy. The bank had no need to pursue a right (remedy) against the account debtor because all such accounts had been paid—in fact the bank was no longer an assignee as to those accounts.

The effect of the majority's view is to make every Banker, who has taken an assignment of accounts for security purposes, a deep pocket surety for every bankrupt contractor in the state to whom it has loaned money. Will the majority apply the same reasoning to product liability arising from such transactions under the innumerable warranty provisions? If so, what limitations will be applied to the bank's liability in such situations?465

Assuming the majority was correct in its interpretation of section 9-318(1)(a), it failed, at least consciously, to consider whether this section displaces a traditionally accepted limitation on the right of an obligor to

---

464. 562 S.W.2d at 76. And see U.C.C. § 1-201(36).
465. 562 S.W.2d at 77 (Byrd, J., dissenting). The answer to his question about the warranty liability of the assignee may be found in U.C.C. § 9-317. This section may be consistent with the majority's interpretation of § 9-318. See note 466 infra.
seek restitution from an assignee. The Restatement of Restitution provides that

An assignee of a non-negotiable chose in action who, having paid value therefore, has received payment from the obligor is under no duty to make restitution although the obligor had a defense thereto, if the transferee made no misrepresentation and did not have notice of the defense.\footnote{466}

According to a Comment to this section, the rule presupposes that, had there been no payment, the assignee would have no rights against the payor. . . . The rule is based upon the principle that in determining whether or not one gives value it is immaterial whether he pays value at the time he acquires the title or has paid value at some prior time in order that he might acquire title. It is consistent with the rule that one who pays value for a transfer of property to be made in the future is a purchaser for value thereof if the property is subsequently transferred to him and that he is a bona fide purchaser if, when he receives title, he has no notice of adverse interests.

The rule stated in this Subsection applies, and applies only, to those cases where there was a transaction between the payor and assignor from which a cause of action would have arisen but for failure of consideration, fraud, mistake, duress, the failure of a condition, or a similar defense. Thus the rule applies where a promise has been obtained by fraud or without consideration, or where the promise was conditional and the condition has not been performed. It also applies where there was a mistake common to both of the original parties to the transaction, a mistake for which there might have been rescission or reformation.\footnote{467}

\footnote{466. \textit{Restatement of Restitution} § 14(2) (1937). The court also failed to consider the relevance of U.C.C. § 9-317 providing inter alia that "the mere existence of a security interest . . . does not impose contract . . . liability upon the secured party for the debtor's acts or omissions." The Comment to this section suggests its inapplicability to cases like Benton State Bank v. Warren, 263 Ark. 1, 562 S.W.2d 74 (1976) and the issue raised there. It seems simply to reiterate for the purposes of Article 9 that the secured party does not assume the performance of any duties with respect to the contract which gives rise to the account assigned to it. U.C.C. § 2-210(4) is cross-referenced. Section 9-317 is consistent with the court's interpretation of § 9-318 if § 9-317 relates only to the liability of the assignee beyond the amount of money it receives as a result of the assignment. In other words, the assignee may be liable to the extent of monies it has been paid, but it cannot be liable for more because it did not assume the responsibility of performance under the contract. The Code's Permanent Editorial Board believes U.C.C. § 9-317 was relevant to the decision of Benton State Bank, see Memorandum, supra note 458, at 6, but its relevancy was never directly discussed in the brief. The Board did conclude, however, that "[s]ection 2-210 on \textit{Delegation of Performance}; Assignment of Rights is not significant here, and in any case is only applicable to transactions in goods and not to contracts for services like the present situation." \textit{Id.}

The court also refused to consider the applicability and relevance of Article 3's rules and principles. The Warrens made the progress payments by checks transferred to the bank and Harps as joint payees. In its Memorandum, the Permanent Editorial Board argued that the court "should hold that the checks were negotiable instruments; that the Benton State Bank became a holder of them in due course; and that therefore it held the checks and their proceeds free from all claims on the part of any person, particularly the Warrens (sic)." Memorandum, supra note 458, at 20.

467. \textit{Restatement of Restitution} § 14(2), comment d (1937).}
The rule of this section seems applicable to the Benton State Bank case, and an illustration supplied by the Restatement drafters involves facts strikingly similar to those in the case. A falsely represents to B that he has done work for him to the value of $100 and B gives to A a non-negotiable note for that amount. A assigns this note to C who pays value therefore and has no reason to know of A's fraud. B pays the amount of the note to C. B is not entitled to restitution from C. But the negative implication of the Restatement of Restitution rule is that restitution against the assignee is proper if the assignee had notice of the obligor's defense. Despite the court's failure to consider the rule in Ben-

468. United States v. Hadden, 192 F.2d 327 (6th Cir. 1951), offers some support for the applicability of the section. And see Daniels v. Parker, 209 Or. 419, 306 P.2d 735 (1957). See also Memorandum, supra note 458, at 22-23, where the Code's Editorial Board suggests the relevance of this section and also § 14(1) to the decision in Benton State Bank v. Warren, 263 Ark. 1, 562 S.W.2d 74 (1976). § 14(1) provides

A creditor of another or one having a lien on another's property who has received from a third person any benefit in discharge of the debt or lien, is under no duty to make restitution therefor, although the discharge was given by mistake of the transferor as to his interests or duties, if the transferee made no misrepresentation and did not have notice of the transferor's mistake.

Restatement of Restitution § 14(1) (1937).


470. Farmers Acceptance Corp. v. Delozier, 178 Colo. 291, 496 P.2d 1016 (1972), involves facts very similar to those in Benton State Bank v. Warren, 263 Ark. 1, 562 S.W.2d 74 (1976). The court in Benton State Bank considered Delozier as deciding the precise question facing it. Id., 562 S.W.2d at 76. But the Colorado Supreme Court applied the following rule in Delozier to hold that an obligor could recover payments already made to an assignee. "[W]here the assignor fails to perform the contract, the assignee cannot retain mistaken, or even negligent, payments made to it by the [debtor] unless there has been a subsequent change of position by the assignee." 496 P.2d at 1018-19. This "rule" is attributed to Professor Gilmore. See Gilmore, The Assignee of Contract Rights and His Pecuniary Security, 74 Yale L.J. 217, 235 n.35 (1964). Under it, the assignee is protected only if he subsequently changed his position, and it is, therefore, harsher from his standpoint than the negative implication suggested by Restatement of Restitution § 14(2) (1937). But Gilmore does not assert the statement attributable to him as a "rule" or as a correct or preferable interpretation of law. He simply reports it as the holding in the case of Firestone Tire & Rubber Co. v. Central Nat'l Bank of Cleveland, 159 Ohio St. 423, 112 N.E.2d 636 (1953). In Benton State Bank, the court refrained from saying "whether we would agree with Gilmore's statement in every case, no matter how negligent the account debtor might be or how innocent of fault the assignee might be. The issue is open to some exercise of judgment, for the precise point is not covered by any specific provision in the Uniform Commercial Code." 562 S.W.2d at 76. This is consistent with the Ohio court's view in the Firestone Tire & Rubber Co. case. After stating the rule which Gilmore has summarized as the holding of the case, the court said "this general rule is modified in certain cases to conform to the equitable principles which must be applied." 112 N.E.2d at 642.

The point is, however, that Delozier, Firestone Tire & Rubber Co. (and cases cited therein) and possibly the negative implication of Restatement of Restitution § 14(2) tend to support the proposition that an obligor may in some cases be able to recover payments made to an assignee on a restitution theory, without regard to how the "subject to claims" language of the Restatement (Second) of Contracts §§ 168 or U.C.C. § 9-318(1) is interpreted. This may also be the true theory underlying the court's decision in Benton State Bank or, at least, it may form the basis for an alternative interpretation of the court's holding. But see note 472 infra. The Permanent Editorial Board of the Uniform Commercial Code sug-
ton State Bank, the result of the case is, at first glance, consistent with such an implication. The court determined that "the bank was certainly not an innocent recipient of the progress payments, without notice of possible claims on the part of the Warrens against Harps." But closer analysis suggests that the negative implication of the Restatement of Restitution rule cannot be used to justify the decision in Benton State Bank.

The bank knew that Harps had been compelled to borrow a large sum to pay delinquent federal taxes. It knew that another bank had refused to make the loan. It was in close touch with Harp's financial difficulties and knew, for instance, that shortly before the last progress payment was made at least eleven checks written by Harps on the bank had been dishonored. It had solid reasons for suspecting the truth of Harps' assertions, which the bank forwarded to the Warrens, that all past-due bills for labor and materials had been paid. It was on notice that its endorsements on the progress-payment checks recited that the money was furnished to pay for labor and materials. The president of the bank, a law school graduate, knew that unpaid laborers and materialmen could file liens against the project. He knew that part of the earlier progress payments had been applied by the bank to its own loans to Harps and assumed that additional progress payment money had been used by Harps to meet its payrolls. The question would naturally arise: how had Harps been able to pay its suppliers when it had to borrow against the progress payments to meet its payroll?

Id., 562 S.W.2d at 76-77.

A very significant problem arises when trying to justify a restitution action against an assignee bank in this kind of case on the basis of the negative implication of Restatement of Restitution § 14(2). See note 470 supra and text accompanying it. The problem is raised by language from the opinion in Benton State Bank v. Warren, 263 Ark. 1, 562 S.W.2d 74 (1976), quoted at note 471 supra. The bank acquired the notice referred to there after it gave value.

Harp's owed the bank $60,000 before it started construction for the Warrens. Before it began work, it assigned the right to progress payments to the bank as additional security for that loan. "[A] person gives 'value' for rights if he acquires them . . . as security for . . . a pre-existing claim . . . " U.C.C. § 1-201(4)(b). Also, the bank agreed to make additional loans to Harps on the security of the account. "Whenever Harps submitted an application for progress payment to the bank, the bank would advance money to Harps, as it had agreed to do." 562 S.W.2d at 75 (emphasis added). This suggests that the additional advances eventually made by the bank were pursuant to a commitment by it, a commitment given even before Harps began work for the Warrens. Value was given at that time. See U.C.C. §§ 1-201(4)(a); 9-105(1)(k).

The defense of Restatement of Restitution § 14(2) "is based upon value given to acquire the claim . . . " 3 G. Palmer, The Law of Restitution § 16.7 at 505 (1978) (emphasis in original). Indeed, the commentary to § 14(2) of the Restatement of Restitution states that "[t]he rule is based upon the principle that in determining whether or not one gives value it is immaterial whether he pays value at the time he acquires the title or has paid value at some prior time in order that he might acquire title." Restatement of Restitution § 14, comment d (1937) (emphasis added). If the time when the assignee must be without notice of a defense is the time at which he gives value, then information acquired after the lender in Benton State Bank loaned the money on the security of the account is immaterial under § 14(2) of the Restatement of Restitution.

After all, § 14 is only "a specific application of the underlying principle of bona fide purchaser." Restatement of Restitution § 14, comment a (1937). And the Restate-
Nevertheless, an argument, albeit a tenuous one, exists under one or more common law theories and the Code, at least according to a possible interpretation of Benton State Bank, that the owner-obligor may in some cases recoup payments he has already paid to the assignee-bank. Why cannot the construction surety, who stands in the owner's shoes, also recover them?473 With respect to payments made before the contractor's

ement's provision dealing with the protection of such purchasers clearly provides that the time of innocence is the time at which value was given by the transferee. See id. § 13.

The problem of determining when one must be without notice in order to acquire certain rights and immunities also arises in the context of Article 3. One becomes a holder in due course by taking "the instrument (a) for value; and (b) in good faith; and (c) without notice . . . of any defense against or claim to it on the part of any person." U.C.C. § 3-302(1). It is generally believed that notice acquired after the giving of value does not preclude holder in due course status, at least to the extent that such value, i.e., without notice, has been given. See generally, e.g., Bowling Green, Inc. v. State Street Bank & Trust Co., 425 F.2d 81 (1st Cir. 1970); J. White & R. Summers, Handbook on the Law Under the Uniform Commercial Code § 14-6 at 477 (1972).

The lack of notice of the assignor's breach at the time of giving value, therefore, may protect the assignee from an action for restitution against him. But it will not help the assignee to overcome the obligor's defense assertion of counterclaims and set-offs arising out of the breach if the assignee sues the obligor. The reason is that the restitution action is in the nature of quasi-contract and based upon unjust enrichment. Since the assignee gave value by taking the account as security for a pre-existing claim and also by committing itself to future advances, it was not unjustly enriched by the obligor's payments to it. When the assignee sues the obligor on the basis of the assignment, however, the cause of action is not grounded upon quasi-contract. See generally 3 G. Palmer, supra herein, § 16.7.

Despite this analysis, however, one additional fact present in the Benton State Bank case may still prove the decision correct. If the bank had notice that materialmen were unpaid, then it misrepresented the true facts to the owner-obligors, i.e., the Warrens. The checks sent by them to the bank were "payable jointly to Harps and to the bank and bore this statement above the payees endorsement: 'By endorsement of this check payee acknowledges payment for labor, materials, or both, in connection in construction at the following address . . . ."" 561 S.W.2d at 75. The address given, of course, was the one where the work was being done for the Warrens by Harps. The Warrens' attorney believed this fact to be critical. In the appellee's brief to the court, he argued that the Bank "misrepresented to the Warrens that their money was being properly applied . . . . " Brief for Appellee at 10, Benton State Bank v. Warren, 263 Ark. 1, 562 S.W.2d 74 (1978). He seems to have been inviting the court to decide the case on a fraudulent misrepresentation or other similar theory. And the Code's Permanent Editorial Board concluded that on the basis of the appellee's claim of misrepresentation, "the Benton State Bank may have some liability to the Warrens as a result. But such a liability would be based on other rules of law and not on the provisions of the Code . . . ." Memorandum, supra note 458, at 26-27.

473. The surety ordinarily has two other sets of shoes available to him. See note 414 supra. Seldom, however, does a court discuss the surety's right to recover payments based on subrogation to the rights of materialmen. In American Fidelity Co. v. Nat'l City Bank of Evansville, 266 F.2d 910 (D.C. Cir. 1959), the court conditioned the sureties' right to recover from the assignee on the owner's, i.e., the United States', right to do so because "[i]t goes without saying that the contractor, who had for a full consideration assigned to the bank the progress payments here involved, could not recover them from its assignee, so subrogation to the contractor would avail the sureties nothing . . . ." Id. at 915

[And though] the sureties were subrogated to the rights of the laborers and materials whom they paid . . . the only rights those persons had were to proceed against the contractor and the surety on payment bond which the Government had gratuitously required for their protection. They had no right against the United States, which
default, the answer is simply that the surety never had a right to them. The right to subrogation exists from the date the surety bond is executed, but the surety is not subrogated to anyone's rights until it performs its guarantees after the principal's default. And the surety has no valid claim to any money payable or paid under the contract between the owner and the contractor until he has been subrogated.474 Professor Corbin's treatise supports this conclusion.

As long as the contractor has committed no vital breach, he has a right to payments as provided in the contract; and his assignee will have as good a right to these payments as did the contractor. As long as the contractor is performing as agreed, the owner must pay as agreed; and the surety has no right by subrogation, that the payments shall be with-

had not agreed to pay them and was under no duty to do so. So the sureties obtained nothing by subrogation to the rights of laborers and materialmen except the right to proceed against the contractor. . . . It is apparent that the mechanics and materialmen never had any legal or equitable rights to the proceeds of the contract and so had no right to recover the progress payments from the assignee bank.

Id. at 916 (emphasis added). But cf. Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962), holding that materialmen and a surety subrogated to their position have a prior right to or an equitable lien on, at least, retained percentages held by the government.

We therefore hold in accord with the established legal principles stated above that the Government had a right to use the retained fund to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of the fund; that the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the fund; and that the surety, having paid the laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it.

Id. at 141. And see generally, e.g., Note, 65 Colum. L. Rev. 927 (1965). But compare Bank of Arizona v. Nat'l Surety Corp., 237 F.2d 90, 93-94 (9th Cir. 1956). Aside from the Pearlman decision, the court's reasoning in American Fidelity may not apply in a case where the owner is someone other than a government immune from the claims of liens. Nevertheless, the priority between a materialmen (or a surety subrogated to his position) asserting an equitable lien on or other rights to payments made to an assignee and the assignee who is an Article 9 secured party is not an issue considered here. But cf. F. Farnsworth, W. Young & H. Jones, CASES AND MATERIALS ON CONTRACTS 35-36 (2d ed. 1972).

474. See, e.g., American Cas. Co. of Reading Pa. v. Line Materials Indus., 332 F.2d 393 (10th Cir. 1964); Nat'l Union Fire Ins. Co. of Pittsburgh v. United States, 304 F.2d 465 (Ct. Cl. 1962). In the latter case, the court also noted that at the time the payments were made the surety was not out of pocket one cent. The money in issue was earned prior to default and since the moneys furnished by the Bank to the contractor prior to default were loaned for use in the performance of the contract, it can reasonably be presumed that said moneys were used to pay laborers and material men that plaintiff would have otherwise had to pay.

Id. at 468. And see Town of River Junction v. Maryland Cas. Co., 110 F.2d 278 (5th Cir. 1940).

If payments earned before default are not paid to the assignee, however, the surety prevails as to them. "But for the surety's completion of the work, the obligee on the bond, be he owner or prime contractor, would have been entitled to apply the funds against the cost of completion. It is the surety's performance which frees the funds, and in our view, the surety is entitled to them." American Fire & Cas. Co. v. First Nat'l Bank of New York, 411 F.2d 755, 758 (1st Cir. 1969). Accord, Industrial Bank of Washington v. United States, 424 F.2d 932 (D.C. Cir. 1970). But see Rudolph, supra note 412, at 251-53.
Corbin and the cases recognize, however, that “[a]fter breach by the contractor, the situation changes.” But the courts do not hold that the surety cannot recover post-breath payments from the assignee simply because they are made after that time. One court characterized the surety’s “equitable lien” as a “latent equity” of which a good faith assignee for value and without notice takes free. But the surety’s rights based on subrogation are not properly classified as “latent equities,” and the Restatement Second of Contracts provides that its rule with respect to them does not give priority to an assignee where a surety for the assignor is subrogated to the rights of the obligor. The courts have nevertheless applied a rule similar to a latent equities one in cases where a surety seeks to recover post-breath payments made to the assignee. In order for a surety to recover them, they have required him to prove at least that the assignee had knowledge of the contractor’s breach and, in some cases,

475. 4 A. CORBIN, supra note 454, § 901.
476. Id.
477. The courts sometimes characterize the surety’s rights or remedy upon subrogation as an “equitable lien.” See also, e.g., American Fidelity Co. v. Nat’l City Bank of Evansville, 266 F.2d 910, 914 (D.C. Cir. 1959). More precisely, they say the surety has an equitable lien on the funds due or to become due under the contract. The term was used by the United States Supreme Court in a case where the surety asserted the rights of materialmen. See Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962). Perhaps this results from the fact that materialmen, who are third party beneficiaries of contractor’s surety bonds, may be said to have equitable liens on the contracts funds. Withers, Surety vs. Lender: Priority of Claims to Contract Funds, 10 Washburn L.J. 356, 363 (1971). Whatever reason exists for using the term, the correctness of its use in this context is not an issue considered here. The equitable liens doctrine is fully considered elsewhere in this article but in a completely different context. See text accompanying notes 498-573 infra.
478. Maryland Casualty Co. v. Nat’l Bank of Germantown & Trust Co., 320 Pa. 129, 182 A. 962 (1936). The court relied in part on Restatement of Contracts § 174 (1932) which provides that “[i]f an assignor’s right against the obligor is voidable by someone other than the obligor or is held in trust for such a person, an assignee who purchases the assignment for value in good faith without notice of the right of such person cannot be deprived of the assigned right of its proceeds.”
479. “If the surety claims by subrogation, his claim is not a ‘latent equity’ for the reason that he is being put into the position of the obligated owner, none of whose defenses and counterclaims can be described as ‘latent.’” 4 A. CORBIN, supra note 454, § 901 at 609. For a discussion of third party equities which are properly classified as “latent” and from which an assignee ordinarily takes free, see id. at § 900.
480. Restatement (Second) of Contracts § 175 (1973) provides that

If an assignor’s right against the obligor is held in trust or constructive trust for or subject to a right of avoidance or equitable lien of another than the obligor, an assignee does not so hold it if he gives value and becomes an assignee in good faith and without notice of the right of the other.

The Reporter’s Note explains that “[t]his section is substantially the same as § 174 in the original Restatement.” See note 478 supra. And the commentary cautions that “where a surety for the assignor is subrogated to the rights of the obligor, the assignee does not have priority by virtue of the rule stated in this Section.” Restatement (Second) of Contracts § 175, Comment b (1973).
knowledge of the surety’s claim to the funds.\textsuperscript{481}

In many pre-Code cases, therefore, the surety claiming payments already made to the assignee asserted priority on the basis of an express assignment to it in the bond application of the contractor’s right to payments. The problem with this theory is the common law rule that “a subsequent assignee is entitled to retain assigned moneys which it receives without notice of a prior assignment.”\textsuperscript{482} Assuming it applies,\textsuperscript{483} Article 9 solves the dispute between successive assignees of accounts on the basis of the priority rules in section 9-312(5).\textsuperscript{484} These rules change the result

\begin{quote}
no superior equity in the Surety will appear unless it shows that the money lent by the Bank was diverted, or used for purposes outside the contract, for if the money lent was applied to the payment of labor and materials used in the contract, thereby discharging obligations for which the Surety would otherwise have been liable, the Surety was in no wise injured by the transaction. It cannot have its liability discharged with the Bank’s money and then recover from the Bank money equivalent to that so used for its benefit by the principal. It is fundamental that one seeking in equity to recover money from another must allege and prove injury—not benefit.
\end{quote}

\textit{Id.}\ at 78-79.

\textsuperscript{482} McKenzie v. Irving Trust Co., 323 U.S. 365, 373 (1945). And see Martin v. Nat’l Surety Co., 300 U.S. 588 (1937); Bank of Arizona v. Nat’l Surety Corp., 237 F.2d 90 (9th Cir. 1956); California Bank v. United States Fidelity & Guaranty Co., 129 F.2d 751 (9th Cir. 1942); Aetna Cas. & Surety Co. v. Harvard Trust Co., 344 Mass. 160, 181 N.E.2d 673 (1962); \textit{Restatement (Second) of Contracts} § 174 (1973). Sometimes an assignee bank has prevailed under a different rule providing that the assignee who first notified the obligor prevailed. \textit{See} American Fire & Casualty Co. v. First Nat’l City Bank of New York, 411 F.2d 755 (1st Cir. 1969); Town of River Junction v. Maryland Cas. Co., 110 F.2d 278 (3rd Cir. 1940). And see generally 4 A. CORBIN, supra note 454, § 902 (1951). In one case, however, the surety prevailed over the assignee bank only because of a state statute expressly giving the first assignee, which was the surety, priority over subsequent ones. Aetna Cas. & Surety Co. v. Eastern Trust & Bank Co., 156 Me. 87, 8 A.2d 843 (1960). In another case, the surety lost on an assignment theory because it failed to comply with federal statutes with respect to the assignment from the contractor. \textit{See} Coconut Grove Exchange Bank v. New Amsterdam Cas. Co., 149 F.2d 73 (5th Cir. 1945).

\textsuperscript{483} Despite the express assignment of an account to the surety, Article 9 will not apply if the transaction is found not to be in the nature of or for security, see text accompanying notes 421-424 supra, or if it is expressly excluded from Article 9’s scope, see note 425 supra.

\textsuperscript{484} U.C.C. § 9-312(5) provides inter alia that:

\begin{quote}
In all cases not governed by other rules stated in this section . . . , priority between conflicting security interests in the same collateral shall be determined according to the following rules:
\begin{enumerate}
\item Conflicting security interests rank according to priority in time of filing or perfection.
\item So long as conflicting security interests are unperfected, the first to attach has priority.
\end{enumerate}
\end{quote}
under the common law if (1) both parties are unperfected or (2) the later assignee knows of the earlier assignment at the time it takes its own but is the first to file or perfect and its actual knowledge is deemed immaterial to the resolution of the priority dispute. If the prior assignee files or perfects first, the result under Article 9 is generally consistent with the common law rule if perfection is regarded as giving notice to third parties. Therefore, when a surety claims payments already made to an assignee bank, it can enhance its position by reference to Article 9 only if (1) the surety filed or perfected its security interest first or (2) the bank also failed to file or perfect and the surety's interest was the first to attach. If sureties were to file financing statements—the usual mode of perfection for security interests in accounts—or if the banks ordinarily neglected to do so, the need to discuss the common law rights of a performing surety vis-a-vis

485. In this case the first security interest to attach would have priority. See U.C.C. § 9-312(5)(b). This result is akin to that dictated by a rule which at one time prevailed in this country. "[A]s between successive assignees of the same right whose claims are otherwise equal, the earlier in time is preferred." 4 A. Corbin, supra note 454, § 902 (1951). And see discussion of this rule in American Fire & Cas. Co. v. First Nat'l Bank of New York, 411 F.2d 755, 757 (1st Cir. 1969). But Corbin lists as the first exception to this rule one providing "that, if the second assignee collects the money in good faith and is not a mere donee, he will be allowed to keep the money so received." 4 A. Corbin, supra note 454, § 902 at 617. The rule with its first exception is almost indistinguishable from the one cited and discussed earlier. See text following note 481 supra.

486. Regarding the relevance of a subsequent secured party's actual knowledge of an earlier attached interest in terms of deciding priorities under U.C.C. § 9-312(5)(a), see text accompanying notes 574-543 infra.

487. Where state or federal law provides otherwise, the means of perfecting an interest may be something other than the filing of an Article 9 financing statement pursuant to U.C.C. §§ 9-401 and 9-402. See U.C.C. § 9-302(3)(a). In fact, any part of Article 9's provisions is preempted by federal law "to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property . . . ." U.C.C. § 9-104(a).

With respect to claims subject to the federal Assignment of Claims Act, filing a § 9-402 financing statement in the place prescribed by § 9-401(1) may arguably be inadequate to protect the surety's interest. Filing pursuant to those sections is the general rule under Article 9. See U.C.C. § 9-302(1). But, U.C.C. § 9-302(3) provides:

The filing of a financing statement otherwise required by this Article is not necessary or effective to perfect a security interest in property subject to (a) a statute or treaty of the United States which provides for a national or international registration or a national or international certificate of title or which specifies a place of filing different from that specified in this Article for filing of the security interest

And the Assignment of Claims Act requires the assignee to "file written notice of the assignment together with a true copy of the instrument of assignment with (a) the contracting officer or the head of his department or agency; (b) the officer or the head of his department or agency; (c) the surety or sureties upon the bond or bonds, if any, in connection with such contract; and (d) the disbursing officer, if any, designated in such contract to make payment. 31 U.S.C. § 203 (1976). But the Act "does not establish a national Filing system and therefore is not within the scope of [U.C.C. § 9-302(3)(a)]." U.C.C. § 9-302, Comment 8. The cautious surety will nevertheless comply with the Act to protect fully his claim of priority over that of an assignee bank. It may not be necessary to perfect under the Act as well as under Article 9, but language in some cases gives cause for caution. See, e.g., Coconut Grove

the Article 9 rights of an assignee bank would not so frequently arise regardless of which payments are in contention.

Performing sureties have also claimed that their equitable rights under the common law entitle them to priority over a financing bank’s security interest in the contractor’s goods. A clause frequently appearing in bond applications purports to assign to the surety as collateral in the event of the contractor’s default “all the right, title and interest of the [contractor] in and to all machinery, equipment, plant tools and materials which are now, or may hereafter be, about or upon the site of said work or elsewhere.”488 What are the rights of a performing surety who had not filed an Article 9 financing statement covering a defaulting contractor’s equipment when the equipment is also claimed by a bank holding a perfected security interest in the property? In *Aetna Casualty & Surety Co. v. J.F. Brunken & Son, Inc.*,489 the court decided that the interest asserted by the surety was a security interest subject to the perfection and priority rules of Article 9. The surety had contended that its priority was not based upon Article 9. It argued that “no Uniform Commercial Code filing was required for it to prevail over the secured interests of the two banks”490 because “by performance of its suretyship obligations for and on behalf of [the contractor] an equitable lien arises in favor of [it], which lien relates back to the inception of the suretyship agreement (the bond application date) for the purposes of determining priority.”491

The court interpreted the surety’s argument as a request “to extend the established priority it has been provided by law [under an equitable lien or subrogation theory] in the defaulting contractor’s retained proceeds to the same position in the defunct contractor’s personal property.”492 According to the surety’s submission, “[t]here is no reason . . . for saying that an equitable lien arises and attaches in the case of contract proceeds, but not in a case involving personal property (construction equipment).”493 The surety was arguing, first, that it had an equitable lien on the equipment, second, that this lien was prior to the banks’ perfected security interests and, third, that the lien and its alleged priority were not displaced by Article 9.

The court did not reach the displacement issue because it decided that the surety’s equitable rights upon the contractor’s default do not in-

---

490. *Id.* at 292.
491. *Id.*
492. *Id.* at 293.
493. *Id.*
clude an equitable lien on the contractor's equipment.\textsuperscript{494} The same decision was reached in \textit{In Re Merts Equipment},\textsuperscript{495} involving a dispute between a surety and one in the position of a lien creditor. The court in \textit{Merts} distinguished the case from those giving the performing surety a prior interest in contract proceeds.

[\textit{T}he rationale for according such a lien to the surety does not apply in the case of equipment. Unlike [a case holding that the surety's equitable lien in contract retainages will prevail over an assignee bank's security interest in those funds], in which the right to the contract funds is created by the surety's performance, the equipment in question was fully in the possession of the [contractor] and ownership was not in any way conditioned upon contractual performance. Stated differently, the surety has done nothing with respect to the . . . equipment which raises up in the surety an equity superior to that of later . . . creditors. The equitable lien protects the surety whose performance enables funds to become available, but in the case of equipment the surety is in no better position than any other unsecured creditor. The surety cannot accede to the general assets of the contractor absent some assignment of title or attachment through a perfected secured interest. In conclusion, because no equities arise in favor of the surety with respect to the . . . equipment, the surety stands as general unsecured creditor . . . .\textsuperscript{496}

The court in \textit{J.K. Brunken & Son}, however, went one step further. It also decided or, at least, implied that the surety could not rely on an equitable lien even if one existed in its favor because Article 9 displaces the "doctrine of equitable mortgages."\textsuperscript{497} But is this true? Has Article 9 displaced equitable liens or mortgages and, if so, to what extent? The question is particularly important in the context of section 9-203 dealing with the creation of Article 9 security interests.

B. The Equitable Lien As An Alternative To An Article 9 Security Interest

Professor Gilmore advises against using the term "equitable" with reference to liens.\textsuperscript{498} "There is not the most tenuous semblance of agreement about the word's meaning, or even its principal meaning"\textsuperscript{499} because it is used in many different senses.\textsuperscript{500} One can safely say, however, that the equitable liens doctrine derives from the principle that "equity

\textsuperscript{494} See id. at 294.
\textsuperscript{496} Id. at 298. In Travelers Indemnity Co. v. First Nat'l Bank of Jackson, 368 So. 2d 836 (Miss. 1979), a bank with a perfected security interest and a surety claimed a fund representing the liquidated assets of a construction company. The surety was forced to argue the existence and prior perfection of an Article 9 security interest because none of the funds held by the receiver represented funds to which the surety could be subrogated.
\textsuperscript{497} 357 F. Supp. at 294.
\textsuperscript{498} See generally 1 G. GILMORE, supra note 425, § 7.2.
\textsuperscript{499} 1 G. GILMORE, supra note 425, § 7.2 at 198.
\textsuperscript{500} See generally id. § 7.2 at 198-99.
regards as done that which ought to be done."\textsuperscript{501} Pomeroy's statement and explanation of the doctrine are frequently cited by the courts.

An equitable lien is not an estate or property in the thing itself nor a right to recover the thing,—that is, a right which may be the basis of a possessory action; it is neither a \textit{jus ad rem} nor a \textit{jus in re}. It is simply a right of a special nature \textit{over} the thing, so that the very thing itself may be proceeded against in an equitable action, and either sold or sequestered under a judicial decree, and its proceeds in the one case, or its rents and profits in the other, applied upon the demand of the creditor in whose favor the lien exists.\textsuperscript{502} Remedies in equity, as well as at law, require some primary right or interest of the plaintiff which shall be maintained, enforced, or redressed thereby. . . . The doctrine of "equitable liens" . . . was introduced for the sole purpose of furnishing a ground for the specific remedies which equity confers, operating upon particular identified property, instead of the general pecuniary recoveries granted by courts of law. It follows, therefore, that in a large class of executory contracts, express and implied, which the law regards as creating no property right, nor interest analogous to property, but only a mere personal right and obligation, equity recognizes, in addition to personal obligation, a peculiar right over the thing concerning which the contract deals, which it calls a "lien," and which, though not property, is analogous to property, and by means of which the plaintiff is enabled to follow the identical thing, and to enforce the defendant's obligation by a remedy which operates directly on the thing.\textsuperscript{503}

The doctrine may be stated in its most general form, that every express executory agreement in writing, whereby the contracting party sufficiently indicates an intention to make some particular property, real or personal, or fund, therein described or identified, a security for a debt or other obligation, or whereby the party promises to convey or assign or transfer the property as security, creates an equitable lien upon the property so indicated, which is enforceable against the property in the hands not only of the original contractor, but of his heirs, administrators, executors, voluntary assignees, and purchasers or encumbrancers with notice. Under like circumstances, a merely verbal agreement may create a similar lien upon personal property.\textsuperscript{504}

The earliest use of the equitable lien was presumably to designate

\textsuperscript{501} J. Pomeroy, supra note 389, § 1235 at 697-98.  
\textsuperscript{502} Id. § 1322 at 692.  
\textsuperscript{503} Id. § 1234 at 694-95.  
\textsuperscript{504} Id. § 1235 at 696. Harlan Fiske Stone referred to the equitable lien or mortgage, terms often used interchangeably by the courts and in this article, as a "form of security" which may be classified into the equitable mortgage or lien which is quasi-contractual in its origin and the equitable mortgage which is based on consensus or agreement of the parties to it. The former is based on the duty and power of equity to compel restitution in those cases where the property of one is improved or added to by another, induced by fraud or mistake under such circumstances as to entitle him to equitable relief. In such cases the relief may take the form of a lien imposed by
"interests favored by the law, which 'ought' to be enforced (even though common law precedents were lacking or common law formalities had not been complied with)." With respect to pre-Code security arrangements involving personal property, equitable liens were imposed in cases where a pledge was promised but the property was not or could not be delivered or where a debtor agreed, orally or in writing, to give a chattel mortgage but failed to execute one. If the security arrangement was equity on the property improved on principles analogous to the general right of recovery in quasi-contract.

The latter in the final analysis will be found to be a special application of the doctrine of specific performance or agreements to give security. Equity does not generally enforce contracts either to give or receive a loan of money. . . . Once, however, the lender has made his advance to the borrower relying on the promise of the borrower to give security, equity will give complete relief by compelling specific performance of the promise. There can be no adequate remedy at law, since legal damages would be speculative depending on the future ability of the debtor to pay and the future need and value of the security. Equity will thus compel specific performance of the agreement to give security regardless of its particular form.

Stone, The "Equitable Mortgage" in New York, 20 COLUM. L. REV. 519, 521 (1920). See also, e.g., Tucker v. Prevatt Builders, Inc., 116 So. 2d 437 (Fla. Dist. Ct. App. 1959); McFerran v. Louisville Title Co.'s Receiver, 254 Ky. 362, 71 S.W.2d 655 (1934); Foster v. Falmouth Lumber Co., 96 W. Va. 325, 123 S.W. 50 (1924). This article's primary concern is with the equitable lien or mortgage on the other party or to the parties to it and their intention to create security. For a summary review of the many types of cases in which courts traditionally used the equitable liens doctrine, see Note, 31 COLUM. L. REV. 1335 (1931). For comparisons of the equitable lien remedy with constructive trust, see, e.g., Jennings & Shapiro, The Minnesota Law of Constructive Trusts and Analogous Equitable Remedies, 25 MINN. L. REV. 667 (1941); Lacy, Constructive Trusts and Equitable Liens in Iowa, 40 IOWA L. REV. 107 (1954); Monaghan, Constructive Trust and Equitable Lien: Status of the Conscious and the Innocent Wrongdoer in Equity, 38 U. DETROIT L.J. 10 (1960).

505. 1 G. GILMORE, supra note 425, § 7.2 at 199.

506. "When the property intended to be pledged is incapable of delivery, but the writing sufficiently describes it to make it capable of identification, and the pledge attempted is as security for the payment of certain notes, this is sufficient to create an equitable lien in favor of such pledgee. . . ." In re Cross, 244 F. 844, 848 (N.D.N.Y. 1917), citing Chatawnooga Nat'l Bank v. Rome Iron Co., 102 F. 755 (N.D. Ga. 1900). See also, e.g., In re Pittsburgh Industrial Iron Works, 179 F. 151 (W.D. Pa. 1910); Huntington v. Sherman, 60 Conn. 463, 22 A. 769 (1891); James Bradford Co. v. United Leather Co., 11 Del. Ch. 110, 97 A. 622 (1916); Reordon v. Higgins, 39 Ind. App. 363, 79 N.E. 208 (1906); Davis v. Billings, 254 Pa. 575, 99 A. 163 (1916). See also Restatement of Security § 10 (1941); Glenn, The "Equitable Pledge," Creditor Rights, and the Chandler Act, 25 VIR. L. REV. 422 (1939); Note, 37 COLUM. L. REV. 621 (1937).

unorthodox and informal or its form was unrecognized or inappropriate considering the particular type of collateral or transaction involved, the parties' intent to create security might still be carried out by imposing an equitable lien on the collateral.\textsuperscript{508} Or if the creditor properly used a chattel mortgage, for example, but failed to satisfy the commonly rigid and technical prerequisites to legal validity,\textsuperscript{509} all was not lost. The creditor could assert the "well-recognized, equitable principle that an attempt to make a legal mortgage which fails for want of some solemnity, may yet

\begin{footnotesize}


Cases dealing with the imposition of equitable liens in real estate transactions will be cited throughout this discussion because "the equitable mortgage of personal property should be subject to the same rules as equitable security in land. This is the result reached in England and very generally in the other states of this country . . . ." Stone, supra note 504, at 525.


\textsuperscript{509} The requirements varied between states, but included among them were witnesses to the execution of the mortgage, acknowledgement or attestation by a notary public or other official, verification by affidavit of the parties' good faith or purpose in executing the mortgage and statement by the mortgagor that he had received a true copy of the instrument. See 1 L. JONES, THE LAW OF CHATTAL MORTGAGES AND CONDITIONAL SALES §§ 35-37 (6th ed. R. Bowers 1933). Also, see generally 1 J. GOBEY, A PRACTICAL TREATISE ON THE LAW OF CHATTAL MORTGAGES AS ADMINISTERED BY THE COURTS OF THE UNITED STATES §§ 17-62 (1893).
create a lien valid in equity.”

And agreements to secure creditors by interests in or claims to real and personal property not in esse or “after-acquired” were first enforced in equity and often by the imposition of equitable liens.

---

510. Howard v. McPhail, 37 R.I. 21, 91 A. 12, 15 (1914). For the purpose of the decision in Sayers & Scovill Co. v. Doak, 127 Miss. 216, 89 So. 917 (1921), the court conceded that the mortgage in question was void because the hearse was not properly described therein, and furthermore, that it was not entitled to be recorded because not properly acknowledged, and for the further reason that the acknowledgment was not properly attested by the notary public taking it, and still it was an equitable lien on the hearse because the law is that where an abortive attempt has been made to give a mortgage, still it will be given the effect and operation of a mortgage in equity. . . . The applicable principle is that equity considers that done which ought to be done. [T]his principle applies to writings which are incapable under the law of having the effect of a mortgage because of the absence of a seal; in cases of defective registration; insufficient attestation, and irregular acknowledgment—even when those formalities are made essential by statute as a part of the due execution of the instrument.

Id. 89 So. at 918. See also, e.g., Arkansas Cypress Shingle Co. v. Meto Valley Ry. Co., 97 Ark. 534, 134 S.W. 1195 (1911); Title Ins. & Trust Co. v. California Development Co., 171 Cal. 173, 152 P. 542 (1915); Motor Acceptance Co. v. Finn, 124 Cal. App. 766, 13 P.2d 761 (1932); Fugua v. Trego, 47 N.M. 34, 133 P.2d 344 (1943); Galbraith v. First State Bank & Trust Co., 63 Tex. Civ. App. 179, 133 S.W. 300 (1911); Gilfillan’s Adm’r v. Bixby, 100 Vt. 468, 139 A. 250 (1927); Clarksbury Casket Co. v. Valley Undertaking Co., 81 W. Va. 212, 94 S.E. 549 (1917); Harrigan v. Gilchrist, 121 Wis. 127, 99 N.W. 999, 981 (1904). In addition, see generally Jackson, Morris and Co. v. Rutherford, 73 Ala. 155 (1882); McGuigan v. Rix, 140 Ark. 418, 215 S.W. 611 (1919) (realty); Bell v. Pelt, 51 Ark. 433, 11 S.W. 684 (1889) (realty); Love v. Sierra Nevada Mining Co., 32 Cal. 639, 91 Am. Dec. 602 (1867) (realty); Hall v. Hall, 50 Conn. 104, 111 (1882) (realty); Hanney v. Colwell, 314 Ill. App. 203, 41 N.E.2d 123 (1942) (realty); Whiting v. Eichelberger, 16 Iowa 422 (1866); Charpie v. Stout, 88 Kan. 318, 221 P. 596 (1924) (realty); Abbott v. Godfrey’s Heirs, 1 Mich. 178 (1849) (realty); Burnet v. Boyd, 60 Miss. 627 (1882) (realty); Dunn v. Raley, 58 Mo. 134 (1874) (realty); McQuie v. Peay, 58 Mo. 56 (1874) (realty); McClurg v. Phillips, 49 Mo. 315 (1872) (realty); Hamilton Trust Co. v. Clemen, 163 N.Y. 423, 57 N.E. 614 (1900) (realty); Corman v. Lakely, 80 N.Y. 345 (1880); Payne v. Wilson, 74 N.Y. 348 (1878) (realty); Chase v. Peck, 21 N.Y. 581 (1860) (realty); Spivey v. Grant, 96 N.C. 214, 2 S.E. 45 (1887); Standorf v. Shoichley, 16 N.D. 73, 111 N.W. 622 (1907); New Vienna Bank v. Johnson, 47 Ohio St. 306, 24 N.E. 505 (1890) (realty); Dunlay v. Willis, 95 Va. 606, 29 S.E. 324 (1898) (realty); Atkinson v. Miller, 34 W. Va. 115, 11 S.E. 607 (1890) (realty); Wayt v. Carwithen, 21 W. Va. 516, 520 (1883) (realty). Generally, see also Britton, Equitable Liens—A Tentative Analysis of the Problem, 8 N.C.L. REV. 388, 390 (1929); Cunningham & Tischler, Equitable Real Estate Mortgages, 17 RUTGERS L. REV. 679, 694-701 (1963), Stone, supra note 504, at 522; Note, 12 HARV. L. REV. 140 (1898).

511. The leading English case is Holroyd v. Marshall, 11 ENC. REP. 999 (H.L. 1862). It is quite true that a deed which professes to convey property which is not in existence at the time is as a conveyance void at law, simply because there is nothing to convey. So in equity a contract which engages to transfer property, which is not in existence cannot operate as an immediate alienation, merely because there is nothing to transfer.

But if a vendor or mortgagor agrees to sell or mortgage property, real or personal, of which he is not possessed at the time, and he receives the consideration for the contract, and afterwards becomes possessed of property answering the description in the contract, there is no doubt that a court of Equity would compel him to perform the contract, and that the contract would, in equity, transfer the beneficial interest to the mortgagee or purchaser immediately on the property being acquired.
These few illustrations demonstrate an important use of the equita-

Id. at 1006-07. The American courts often relied upon Helzog to reach conclusions such as these:

At common law a mortgage can operate only on property actually in existence as the time of giving the mortgage, and then actually belonging to the mortgagor, or potentially belonging to him as an incident of other property then in existence belonging to him. . . . A different rule, however, prevails in equity. There, while such mortgage itself does not pass the title to such [subsequently acquired] property, it creates in the mortgagor an equitable interest in it, which will prevail, even against judgment creditors and others, although the mortgagor has not taken possession of the property, and the mortgagor has done no new act to confirm the mortgage. The ground of the doctrine is that the mortgage, though inoperative as a conveyance, is operative as an executory agreement, which attaches to the property when acquired, and in equity transfers the beneficial interest to the mortgagor; the mortgagor being regarded as trustee for him, in accordance with the familiar maxim that equity considers that as done which ought to be done.

Borden v. Croak, 131 Ill. 68, 22 N.E. 793, 795 (1889).

It is well understood that at common law nothing can be mortgaged that is not in existence and does not at the time belong to the mortgagor, for a person cannot convey that which he does not own; but it is now well settled that equity will give effect to a contract to convey future-acquired property, whether real or personal. Equity considers that done which the mortgagor has agreed to do, and treats the mortgage as already attaching to the newly acquired property as it comes to the mortgagor’s hands.

Hickson Lumber Co. v. Gay Lumber Co., 150 N.C. 282, 63 S.E. 104S, 1047 (1909). And equity often gave effect to such contracts by characterizing the mortgagor’s interest as an equitable lien.

It is well settled that an agreement to charge, or to assign, or to give security upon, or to have property not yet in existence, or in the ownership of the party making the contract, or property to be acquired by him in the future, although . . . it creates no legal estate or interest in the things when they afterwards come into existence, or are acquired by the promisor, does constitute an equitable lien upon the property so existing or acquired at a subsequent time, which is enforced in the same manner and against the same parties as a lien on specific things existing and owned by the contracting party at the date of the contract.

United States Fidelity & Guaranty Co. v. Fidelity Trust Co., 49 Okla. 398, 153 P. 195, 199 (1915). On the subjects of equity enforcing after-acquired property clauses and the imposition of equitable liens, also see generally In re Interborough Consol. Corp., 298 F. 334 (2d Cir. 1923), cert. denied, 262 U.S. 752 (1923); Seig v. Greene, 225 F. 955 (8th Cir. 1915); Hill v. Morris, 124 Ark. 132, 186 S.W. 609 (1916); Moulder Holcomb Co. v. Glasgow Cooperage Co., 173 Ky. 519, 191 S.W. 275 (1917); Cheatham v. Tennell’s Assignee, 170 Ky. 429, 186 S.W. 128 (1916); Brady v. Johnson, 75 Md. 445, 26 A. 49 (1892); Adkinson & Bacot Co. v. Varnado, 91 Miss. 825, 47 So. 113 (1908) (reality); Sporer v. McDermott, 69 Neb. 533, 96 N.W. 232, 659 (1903); Steele v. Ashenfelter, 40 Neb. 770, 59 N.W. 361 (1894); Rochester Distilling Co. v. Rasey, 142 N.Y. 570, 37 N.E. 632 (1894); Deeley v. Dwight, 132 N.Y. 59, 30 N.E. 258 (1892); Kribbs v. Alford, 120 N.Y. 519, 24 N.E. 811 (1890); Hellstrom v. First Guaranty Bank, 54 N.D. 322, 209 N.W. 379 (1926); Meridian Oil Co. v. Randolph, 26 Okla. 634, 110 P. 722 (1910); Kenney v. Hurlbut, 88 Or. 688, 172 P. 490 (1918). See also Barnes v. Alexander, 232 U.S. 117 (1914); Thompson v. Fairbanks, 196 U.S. 516 (1905); Gage Lumber Co. v. McEldowney, 207 F. 255 (6th Cir. 1913); Howze v. Dew, 90 Ala. 178, 7 So. 239 (1889) (reality); Apperson & Co. v. Moore, 30 Ark. 56 (1875); Emerson v. E. & N.A. Ry., 67 Me. 387 (1877); Everman v. Robb, 52 Miss. 653 (1876); Leupold v. Weeks, 96 Md. 280, 53 A. 937 (1903); Wright v. Birch’s Ex’r, 72 Mo. 179 (1880); Howard v. Iron & Land Co., 62 Minn. 298, 64 N.W. 896 (1895) (reality); Sporer v. McDermott, 69 Neb. 533 (1903); Chester v. Jumel, 125 N.Y. 237, 251, 252, 26 N.E. 297 (1891); Coats v. Donnell, 94 N.Y. 168 (1883); Winser v. Oumpaugh, 71 N.Y. 113 (1877); McCaffrey v. Woodin, 65 N.Y. 459 (1875); Creech v. Long, 72 S.C. 25, 51 S.E. 614 (1905); Akers v. Rowan, 33 S.C. 451, 12 S.E. 165
ble lien under pre-Code law. It was to protect a creditor’s right in the
developer’s personal property when an attempt to collateralize failed because
of the confusing, restrictive, limited or formalistic nature of the prescribed
security devices.\(^{512}\) Does Article 9 displace this use of the equitable lien?
The drafters say that it does.

An Article 9 security interest is not enforceable until it attaches to the
collateral.\(^{513}\) When the secured party is not in possession, attachment
occurs only if and when “the debtor has signed a security agreement

\(^{512}\) (1890); Paker & Co. v. Jacobs, 14 S.C. 112, 35 S.C. Rpt. 48 (1880); Taylor v. Huck, 65 Tex.
Turnbull, 73 Va. (32 Gratt.) 699 (1880); Horner-Gaylor Co. v. Fawcett, 50 W. Va. 487, 40
S.E. 564 (1901).

Also, see generally Blair, The Allocation of After-Acquired Mortgaged Property Among Rival
Claimants, 40 HARV. L. REV. 222 (1926); Stone, The “Equitable Mortgage” in New York, 20
COLUM. L. REV. 519 (1920); Williston, Transfers of After-Acquired Personal Property, 19 HARV.
L. REV. 557 (1906).

\(^{512}\) The imposition of an equitable lien does not protect a creditor by giving him an
interest in the property. An equitable lien does not create an estate or interest in the prop-
erty although it is often “spoken of as being in the nature of an ‘emcumberance’ upon the
lien is not seeking the thing, but is attempting to gain security for the payment of money.
He does not attempt to assert property in the thing but merely seeks a right to which the
thing is subject.” Note, 5 KAN. CITY L. REV. 207, 208 (1937). According to Stone, an
equitable lien as a form of security for a creditor is “analogous to the hypothec by which the
creditor acquired neither possession nor a legal right in the subject matter of security and
under which his equitable right was a right in personam, by appropriate remedy to compel
the debtor to apply the subject of security to the payment of the debt.” Stone, supra note
504, at 520. It creates “no legal rights but [confers] on the mortgagor the right in equity to
demand of the mortgagor the benefit of the security agreed to be given.” Id. at 525. The
ultimate relief for an equitable lien is “the foreclosure and sale of the property.” Id. at
L. REV. 422, 424-25 (1939). If an equitable lien is successfully asserted on property “then the
court orders that, on failure to pay the claim, the property is to be seized and sold to satisfy
the claim.” Note, 56 DICK. L. REV. 235, 241 (1952). And see RESTATEMENT OF RESTITU-
TION § 161, Comment b (1937). The reason equity comes to the creditor’s aid by the imposi-
tion of an equitable lien is that “it works a fatal change of position for one to get a loan, and
then decline to furnish the agreed security. . . . [T]he purpose of the lender, when he stipu-
lated for collateral, was that he should never be troubled about the borrower’s solven-
cy. ‘Return the money or hand over the agreed security’ is the rule—in other words, ‘resti-
tution of unjust enrichment.’” Glenn, supra herein, at 426. “It is upon the like principle that a
mortgage so defectively or informally executed as not to operate as a legal mortgage or to
cover property intended to be described in it may be made effective as an equitable mort-
gage. Underlying the defective instrument of transfer is the agreement that some specific
property shall be mortgaged and it is this agreement which equity specifically enforces.”
Stone, supra note 504, at 522.

For general and usually brief discussions of the nature of an equitable lien, see, e.g.,
Szlurecki, 297 Ill. 81, 130 N.E. 325 (1921); Hill v. Hill, 345 P.2d 1015, 185 Kan. 389 (1959);
Greer v. American Sec. Ins. Co., 223 Tenn. 390, 445 S.W.2d 904 (1969); Milan v. Milam,
138 Tenn. 686, 200 S.W. 826 (1918). And see generally cases and other authorities cited note
504 supra.

\(^{513}\) See U.C.C. § 9-203(2).
which contains a description of the collateral.\footnote{514} In their commentary to section 9-203, the drafters discuss the nature of this writing requirement and state that a creditor who fails to comply with it cannot assert a right over the collateral based on an equitable liens theory.

The formal requisite of a writing stated in this section is not only a condition to the enforceability of a security interest against third parties, it is in the nature of a Statute of Frauds. Unless the secured party is in possession of the collateral, his security interest, absent a writing which satisfies paragraph (1)(a), is not enforceable against the equitable mortgage or the like.\footnote{515} The theory of equitable mortgage, insofar as it has operated to allow creditors to enforce informal security arrangements against debtors, may well have developed as a necessary escape from the elaborate requirements of execution, acknowledgment and the like which nineteenth century chattel mortgage acts vainly relied upon as a deterrent to fraud. Since this Article reduces formal requisites to a minimum, the doctrine is no longer necessary or useful. More harm than good would result from allowing creditors to establish a secured status by parol evidence after they have neglected the simple formality of obtaining a signed writing.

What of the case, however, in which the parties intended to create a security interest and for some reason the creditor is denied one despite his compliance with the “simple formality of obtaining a signed writing?” In Shelton v. Erwin\footnote{516} the debtor purchased an automobile, and the sale was financed by the seller. The parties executed a bill of sale which described the car, set out the terms of payment and provided that the debtor would properly insure the car. The debtor also "filed an application for Missouri Title showing [the seller] as holder of the first lien and [the debtor] as owner,"\footnote{517} and such a certificate of title was issued. Several months later a dispute arose between the seller and a third party who also claimed the car.\footnote{518} Without addressing a supposed issue of priority, the Eighth Circuit first considered whether or not a security interest attached to the automobile in the seller's favor under section 9-203(1).\footnote{519} The court decided that the seller had no interest in the debtor's property.\footnote{520}

The court did not doubt the purpose of the seller and debtor. They

\footnotesize{\begin{verbatim}
515. U.C.C. § 9-203, Comment 5.
516. 472 F.2d 1118 (8th Cir. 1973).
517. Id. at 1119.
518. Six months after he purchased the automobile, the debtor filed in bankruptcy. The trustee thereafter sought title and possession of the automobile. See notes 520 & 557 infra.
519. If an interest existed, it was perfected under Missouri law requiring the notation of lien on a certificate of title. See 472 F.2d at 1120. But the “question before us in this case is whether a security interest on an automobile was established . . . .” Id. at 1119.
520. The court's decisions on the creation issue and the displacement of the equitable liens doctrine under U.C.C. § 9-203 are the only reasons for discussing the case here. Regarding the ultimate resolution of a priority dispute between one successfully asserting an equitable lien and the bankruptcy trustee, see note 557 infra.
\end{verbatim}}
"clearly intended,"521 "indeed even attempted, to create a security interest in favor of [the seller]."522 But the court held that the parties had failed to satisfy the written "security agreement requirement" of section 9-203(1).523

Although no precise words are required in the Code, the definitions given [of "agreement" and "security agreement"] indicate that there must be some language in the agreement actually conveying a security interest. We fail to find such language in the bill of sale or the title application before us. The notation on the title application that a lien in [the seller's] favor existed is not sufficient. [T]he title application and subsequent Certificate of Title showing [the seller] as lienholder were at best financing statements. . . . Although a financing statement conceivably could create a security interest they usually do not contain the necessary grant of an interest section 9-203(1) . . . requires.524

The court admitted in Shelton that "the result may seem harsh"525 but justified its decision on the basis of

"the necessary technicalities inherent in any law governing commercial transactions. . . . [T]o the extent that the legal significance of documents may be varied and enlarged by other documents evidencing an understanding of the immediate parties to a transaction, we suspect that the law of commercial transactions will not achieve [its] stated purpose. The basis of the trouble here is that appellee [creditor] used an inappropriate form to do what it apparently wished."526

Even though this justification stresses the law's "technicalities" and the type of "form" used by the parties, the Eighth Circuit adopted the view as quoted above from a Code comment that "the doctrine of equitable mortgages is no longer necessary or useful in a commercial transaction since article nine reduces formal requisites to a minimum."527 The decision assumes that more is necessary to create an Article 9 security interest than merely

521. 472 F.2d at 1119.
522. Id. at 1120.
523. Id.
524. Id.
525. Id.
526. Id., quoting Safe Deposit Bank and Trust Co. v. Berman, 393 F.2d 401, 402, 404 (1st Cir. 1968).

complying “with the simple formality of obtaining a signed writing” as the comment suggests. A writing was signed in Shelton, but it was technically and formally insufficient.

Some might argue that Shelton is wrongly decided on the creation issue under Article 9 because section 9-203(1) does not require that a written security agreement express the grant of a security interest. But the majority of courts agree on the necessity of grant language, and most of

528. U.C.C. § 9-203, Comment 5.


Many of these cases decide that a financing statement sufficient under U.C.C. § 9-402(1) is not sufficient as a security agreement under § 9-203(1) because it lacks language of grant. Professor Gilmore, however, disagrees with this decision. Referring to the opinion in American Card Co. v. H.M.H. Co., 97 R.I. 59, 196 A.2d 150 (1963), he wrote:
the others apparently require some clearly expressed language which evidences the parties’ intention to create a security interest. Security agreement” is defined as “an agreement which creates or provides for a security interest,” and even the courts which do not require specific language of grant still look for words apt to create or provide for an agreement or document the making of one. A common denominator for all these

There is no sensible reason for the discrepancies between the formal requisites of § 9-203 and § 9-402. Certainly, nothing in § 9-203 requires that the “security agreement” contain a “granting” clause. The § 9-402 financing statement contained all that was necessary to satisfy the § 9-203 statute of frauds as well as being sufficient evidence of the parties’ intention to create a security interest in the tools and dies. . . . The Rhode Island court gives it an effect reminiscent of the worst formal requisites holding under the nineteenth century chattel mortgage acts.

1 G. Gilmore, supra note 425, § 11.4 at 347-48. See also Weinberg, Toward Maximum Facilitation of Intent to Create Enforceable Article Nine Security Interests, 18 B.C. INDUS. & COM. L. REV. 1, 10-18 (1976). Undoubtedly, however, “[a] substantial number of cases, beginning with the American Card Co. decision . . . , have concluded that a writing must contain a grant or conveyance of a security interest to constitute a security agreement even when the intent to create a security interest is certain.” Id. at 3-4. “[T]he prevailing case law . . . requires” a granting clause for the existence of a security interest.” Note, A Financing Statement as a Security Agreement Under the Uniform Commercial Code, 26 SW. L.J. 626, 628-29 (1972).

531 These courts often recite a rule to the effect that no “magic words” are necessary to create a security interest, only “language . . . in the instrument which when read and construed leads to the logical conclusion that it was the intention of the parties that a security interest be created.” In re Nottingham, 6 UCC Rep. Serv. 1197, 1199 (E.D. Tenn. 1969). And clearly several writings construed together can constitute a “security agreement.” See, e.g., In re Truckers Internat’l Inc., 17 UCC Rep. Serv. 1337 (W.D. Wash. 1975); In re Wambach, 343 F. Supp. 73 (N.D. Ill. 1972), aff’d, 484 F.2d 572 (7th Cir. 1973); Walter E. Heller & Co. v. Salerno, 168 Conn. 152, 362 A.2d 904, (1975). In the absence of granting language, however, the path leading to the conclusion that a security interest was intended must apparently be clear and direct. Practically all decisions reciting and purporting to follow the Nottingham rule or one akin to it to hold that a security interest was created have consistently emphasized words such as “security,” “secured,” “security agreement,” “secured party,” and “security interest” in written documents executed by the parties. See, e.g., Morry Machinery Co., Inc. v. Great Western Industrials Machinery Co., 507 F.2d 987 (5th Cir. 1975); In re Apex-Protein Development Corp., 504 F.2d 1056 (9th Cir. 1974); In re Numeric Corp., 485 F.2d 1328 (1st Cir. 1973); In re Bollinger Corp., 469 F. Supp. 246 (W.D. Penn. 1979); In re Modern Engineering & Tool Co., 25 UCC Rep. Serv. 580 (D. Conn. 1978); Cheel v. Caine & Weiner Co., 335 F. Supp. 1319 (C.D. Cal. 1971); In re Center Auto Parts, 6 UCC Rep. Serv. 398 (C.D. Cal. 1966); Komas v. Small Business Administration, 71 Cal. App. 3d 809, 139 Cal. Rptr. 669 (1977); First Nat’l Bank & Trust Co. In Macon v. Olivetti Corp., 130 Ga. App. 86, 204 S.E.2d 781 (1974); Evans v. Everett, 279 N.C. 352, 183 S.E.2d 109 (1971). These words may not be magic ones, but the courts consistently imply that they are critical to the sufficiency of a § 9-203(1) writing which lacks specific words of grant. Compare, for example, Union Nat’l Bank of Pittsburgh v. Providence Washington Ins. Co., 21 UCC Rep. Serv. 1163 (W.D. Pa. 1977); Crete State Bank v. Lauhoff Grain Co., 195 Neb. 205, 239 N.W.2d 789 with the cases cited above.

532. U.C.C. § 9-105(1).

533. See generally authorities cited note 531 supra. When deciding whether certain documents are sufficient to constitute a “security agreement” under U.C.C. § 9-203(1), most courts completely ignore the Code’s explicit language providing that a parties’ “agreement” may be found “by implication from other circumstances . . .” as well as in their language. U.C.C. § 1-201(3) (emphasis added). But see, e.g., In re Miller, 545 F.2d 916 (5th Cir. 1977); In re Penn. Housing Corp., 367 F. Supp. 661 (W.D. Pa. 1973); In re Carmichael Enterprises, Inc.
decisions is the rule that a security interest is not enforceable when the debtor retains the collateral unless the section 9-203(1)(a) writing contains operative or demonstrable words or language creating, conveying or providing for or evidencing a security interest. A corollary to the rule is that a creditor who wants to become an Article 9 secured party is more likely to succeed in any jurisdiction if the section 9-203(1) writing signed by the debtor contains grant or other language actually conveying a security interest. The existence of this rule and its corollary demonstrate that while the drafters intended to minimize the formal requisites for the creation of a security interest, they failed to eliminate them completely. The effect of such a rule, writes Professor Gilmore, is “reminiscent of the worst formal requisites holding under the nineteenth century chattel mortgage acts.”

The decision in Shelton on the creation issue is a correct one under

334 F. Supp. 94 (N.D. Ga. 1971). And in Cleveland Chair Co. v. United States, 557 F.2d 244 (Ct. Cl. 1977), the court said that U.C.C. §§ 1-201(3) & (37) provide respectively that an “agreement” within the meaning of article 9 may be implied from the circumstances surrounding a transaction, and that a “security interest” within the article is any interest in personalty which an owner transfers to a creditor in order to secure the payment of an obligation. Thus, for article 9 purposes, there may be a common-law implied agreement.

Id. at 246-47 (emphasis added).

534. I G. GILMORE, supra note 425, § 11.4 at 348. The courts were split on the issue of whether words of grant or defeasance were essential to the validity of a chattel mortgage. Compare these authorities:

If the instrument reasonably expresses the intention of the parties to secure a particular debt, indicating the property and conforming to the statutory requirements as to acknowledgement and recording, it should be deemed a chattel mortgage. It is the general rule that if it appears from the instrument that the parties intended it as security, it is a mortgage. This general statement should be limited by the qualification that the instrument must contain a personal grant.


“The general rule is that no special form of writing or words is necessary to effect a chattel mortgage . . . .” S. EAGER, THE LAW OF CHATTEL MORTGAGES AND CONDITIONAL SALES AND TRUST RECEIPTS §§ 31 & 38 (1941). “Whenever it appears that the instrument is intended as security, the debtor has the right of redemption, if seasonably exercised. Words of defeasance are not absolutely necessary to make an instrument a chattel mortgage.” J. CORBETT, A PRACTICAL TREATISE ON THE LAW OF CHATTEL MORTGAGES § 12 at (18) (1899). A number of courts held that words of conveyance were unnecessary to create a valid chattel mortgage. See, e.g., Richards v. Montgomery, 230 Ala. 307, 160 So. 706 (1935); Ellington v. Charleston, 51 Ala. 166 (1874); Weed v. Mirick, 64 Mich. 414, 29 N.W. 78 (1886); Evans v. Everett, 279 N.C. 352, 183 S.E.2d 109 (1971); Marsh v. Wade, 1 Wash. 538, 20 P. 578 (1889). And frequently the courts recited the rule that no particular or prescribed words were necessary to establish a chattel mortgage. See, e.g., Federal Finance Corp. v. Reed, 296 F. 1 (1st Cir. 1924); Mervine v. White, 50 Ala. 388 (1874); Georgia Home Ins. Co. v. Hoskins, 71 Fla. 282, 71 So. 285 (1916); Bascom v. Rainwater, 30 Mo. App. 483 (1888); Harris v. Jones, 83 N.C. 317, (1880). But in most of the cases cited above for the proposition that no words or grant or other particular words are necessary, the parties used such words as “mortgages,” “mortgaged,” “lien,” “collateral security” or the like. Compare them with cases cited supra decided under Article 9.
this rule. But is the Eighth Circuit’s conclusion on the displacement issue also correct? Does section 9-203(1) displace the equitable liens doctrine in cases where the court is absolutely convinced that the parties intended to create a security interest in identifiable and adequately described collateral despite their failure to satisfy the section’s written-security-agreement requirement? This is the issue to be examined here.

A preliminary issue must first be resolved. Under circumstances similar to those involved in Shelton, would a creditor be entitled to an equitable lien as that doctrine has developed under the common law? One writer has argued that “the legitimate functions of the old equitable lien have been taken over by Section 9-203 itself.”535 He and the drafters of Comment 5 to that section apparently take the position that the requirements for establishing both are identical. Admittedly, the equitable liens doctrine is unnecessary and useless under section 9-203 and, therefore, displaced by Article 9 in this context if their position is correct. But it is not.

No writing whatsoever was required to impose an equitable lien under pre-Code law.536 The requirements for an equitable lien under


536. “[A] merely verbal agreement may create an equitable lien upon personal property.” 4 J. Pomeroy, supra note 389, § 1235 at 696. See also, e.g., Slack v. Guneriu, 67 F. 2d 852 (7th Cir. 1933); Jackman v. Newbold, 28 F.2d 107 (8th Cir. 1928); Crosby v. Packer, 22 F.2d 611 (1st Cir. 1927); Great Northern State Bank v. Ryan, 292 F. 10 (8th Cir. 1929); Goodnoough Mercantile & Stock Co. v. Galloway, 156 F. 504 (D. Or. 1906); In re P.B. McChesney & Son, 31 F. Supp. 202 (D. Ky. 1940); Reardon v. Higgins, 39 Ind. App. 363, 79 N.E. 208 (1906); McFerran v. Louisville Title Co.’s Receiver, 254 Ky. 362, 25 S.W.2d 655 (1934); Lee v. Cole, 17 Or. 559, 21 P. 819 (1889); Creech v. Long, 72 S.C. 25, 51 S.E. 614 (1905); Davis v. Childers, 45 S.C. 133, 22 S.E. 784 (1895); Atlanta Nat’l Bank v. Four States Grocer Co., 135 S.W. 1135 (Tex. Civ. App. 1911); Galbraith v. First State Bank & Tr. Co., 133 S.W. 300 (Tex. Civ. App. 1911); Perkins v. Frank, 64 S.W. 236 (Tex. Civ. App. 1901). But for many years the courts also recited the rule that oral chattel mortgages were enforceable, at least as between the immediate parties and others with notice. “At common law a valid mortgage of personality could be made without writing, and this seems to be the uniform holding in the American courts, except where there has been some statutory regulation to the contrary.” Sparkman v. First State Bank of Handley, 112 Tex. 33, 244 S.W. 127 (Tex. Comm. App. 1922). See also, e.g., Border Nat’l Bank v. Coupland, 240 F. 355 (5th Cir. 1917); Todd v. Farmers’ & Merchants’ Bank of Aurora, 195 Iowa 959, 193 N.W. 7 (1923); Bank of Hinton v. Swan, 156 Iowa 715, 137 N.W. 1032 (1912); Cherrydale Inv. Co. v. Dillman, 135 Kan. 699, 11 P.2d 681 (1932); State Bank of Downs v. Abbott, 104 Kan. 344, 179 P. 326 (1919); Dosbaugh Nat’l Bank v. Jelf, 86 Kan. 41, 119 P. 538 (1911); Weil v. Ryus, 39 Kan. 564, 18 P. 524 (1888); Bates v. Wiggin, 37 Kan. 44, 14 P. 442 (1887); Bank of Highland v. Evans-Snider-Buell Co., 9 Kan. App. 80, 57 P. 1046 (1899); Hart County Deposit Bank v. Hatfield, 236 Ky. 725, 33 S.W.2d 660 (1930); Carroll Exch. Bank v. First Nat’l Bank, 50 Mo. App. 92 (1892); Barth v. Ely, 85 Mont. 310, 278 P. 1002 (1929); Reynolds v. Fitzpatrick, 23 Mont. 52, 57 P. 452 (1899); First Nat’l Bank of Decatur v. Young, 124 Neb. 598, 247 N.W. 586 (1933); Reiss v. Argubright, 3 Neb. 735, 92 N.W. 988 (1902); Sheldon v. McFee, 216 N.Y. 618, 111 N.E. 229 (1916); Kearns v. Davis Bros., 186 N.C. 521, 120 S.E. 52 (1923); Moore v. Brady, 125 N.C. 35, 34 S.E. 72 (1899); Thompson v. Irwin, 362 P.2d 460 (Okla. 1961); Crews v. Harlan, 99 Tex. 93, 87 S.W. 656 (1905); Hand v. Lubbock Production
common law and the requisites for a written security agreement under section 9-203(1)(a) are otherwise substantially similar, except in one im-

Credit Ass'n, 466 S.W.2d 438 (Tex. Civ. App. 1971); Yeager v. Laredo Nat'l Bank, 146 S.W.2d 796 (Tex. Civ. App. 1941); Gillett v. Talley, 60 S.W.2d 868 (Tex. Civ. App. 1933); Edwards v. Mayes, 136 S.W. 510 (Tex. Civ. App. 1911); Gillillan's Adm'r v. Bixby, 100 Vt. 468, 139 A. 250 (1927); Mower v. McCarthy, 79 Vt. 142, 64 A. 578 (1906). Often it is difficult to discern, however, whether the courts were enforcing an oral chattel mortgage or imposing a equitable lien arising from an oral agreement. For example, compare Glover v. McGilvray, 63 Ala. 508 (1879) with Morrow v. Turney, 35 Ala. 131 (1859). And see First Nat'l Bank v. Taylor, 69 Kan. 28, 76 P. 425 (1904); Bolton v. Baldwin, 57 S.W.2d 957 (Tex. Civ. App. 1933).

Eventually statutes were enacted requiring chattel mortgages to be in writing, and courts sometimes held, therefore, that equitable liens could not now arise from oral agreements. See, e.g., Palmer v. James, 210 Ala. 641, 99 So. 109 (1924); Dickey v. Vaughn, 198 Ala. 283, 73 So. 507 (1916); Williams v. Davis, 154 Ala. 422, 45 So. 908 (1908); Buffalo Pitts Co. v. Decq, 30 S.D. 384, 138 N.W. 802 (1912). See also, e.g., Mosley v. Dallas Entertainment Co., 496 S.W.2d 237 (Tex. Civ. App. 1973), regarding the enforcement of oral chattel mort-
gage agreements.

But a writing requirement for chattel mortgages did not completely bar oral equitable liens. The Supreme Court of South Dakota held that a statute which necessarily required chattel mortgages to be in writing applied only to a certain class of equitable mortgages, i.e., only to attempts to give chattel mortgages proper, generally known as such. Dorman v. Crooks State Bank, 55 S.D. 209, 225 N.W. 661 (1929). Other courts held that the statute of frauds simply did not bar the enforcement of an equitable lien created by a reservation in a conveyance to secure the purchase price of goods. See, e.g., Putman v. Summerlin, 168 Ala. 390, 53 So. 101 (1910). And some found that a traditional exception to the statute of frauds is satisfied when a lender advances money on the oral promise by the debtor to give security.

It sufficiently appears that the railway company fully performed its part of the agreement. It advanced the money as agreed. Equity will not permit the statute of frauds to be invoked in favor of a party who has not performed his oral undertaking against one who, at his invitation and in reliance upon his promise, has expended money and changed his situation. That would make the statute [of frauds] an instrument of fraud rather than a means to prevent it. It cannot be so employed.

Atchison, Topeka & Santa Fe Ry. Co. v. Hurley, 153 F. 503, 509 (8th Cir. 1907), aff'd, 213 U.S. 126 (1908). Cf. Burton v. Atkins, 199 Miss. 275, 24 So. 2d 355 (1946), holding that a statute of frauds regarding the sale of personal property did not bar a parol chattel mortgage because "when the money is advanced at the time of the mortgage agreement this will be tantamount to a payment in part of the purchase price which will itself take the transaction out of the statute." Id. 24 So. 2d at 355. Oral agreements to give mortgages on real estate were commonly found to create enforceable equitable liens despite statutes of frauds because "they are completely executed by at least one of the parties, and are no longer executory; and secondly, because the statute of frauds by its own terms does not affect the power which courts . . . have always exercised to compel specific performance of such agreements." Sprague v. Cochran, 144 N.Y. 104, 38 N.E. 1000, 1002 (1894). See also Rutherford Nat'l Bank v. H.R. Bogle & Co., 114 N.J. Eq. 571, 169 A. 180 (1933) (realty); "Besides this, it properly may be said that the lien actually decreed results from the operation of the law upon the entire conduct of the parties, and hence is, in terms, excluded from the inhibition of the statute." Foster Lumber Co. v. Harlan County Bank, 1 Kan. 158, 80 P. 49, 50 (1905). See also Edwards v. Scruggs, 155 Ala. 566, 46 So. 850 (1908); Hullum v. Bre-Lew Corp. 93 So. 2d 727 (Fla. 1957) (realty); Charpie v. Stout, 88 Kan. 318, 128 P. 396 (1912); Cole v. Cole, 41 Md. 301 (1875); Baker v. Baber, 2 S.D. 261, 49 N.W. 1064 (1891). But see Bennett v. Harrison, 115 Minn. 342, 132 N.W. 309 (1911); Sleeth v. Sampson, 237 N.Y. 69, 142 N.E. 355 (1923).

Regarding equitable liens or mortgages on reality and the statute of frauds, see also Cunningham & Tischler, Equitable Real Estate Mortgages, 17 Rutgers L. Rev. 679, 681-83,
important respect. Both require (1) an identification of the specific property which (2) the parties have agreed will serve as security. They


537. The courts routinely referred to the requirement that the property sought to be charged with an equitable lien must have been identified, described, specified or designated. For example, "In order . . . that a lien may arise in pursuance of the doctrine, the agreement must deal with some particular property, either by identifying it, or by so describing it that it can be identified . . . ." B. Kuppenheimer & Co. v. Morning, 78 F.2d 261, 264 (8th Cir. 1935) (quoting "section 1235 of POMEROY, EQUITABLE JURISPRUDENCE"). "[T]he property which the lien purports to cover must be specifically designated." In re Goodhue Motor Co., Inc., 28 F.2(402), 404 (D. Md. 1928). "An equitable lien to be valid must relate to some specific property or thing capable of segregation and identification. [An agreement] cannot hold as an equitable lien, [if] the thing or things to which the lien was to attach was not ascertained and is not capable of identification." In re Imperial Textile Co., 255 F. 199, 202 (N.D.N.Y. 1919). "It is . . . true that after-acquired property may be subject to the lien of an equitable mortgage, which attaches as a charge against the particular property, when it comes into being, or the title thereto is acquired by the mortgagor, when the property is sufficiently described in the contract between the parties." Hill v. Morris, 124 Ark. 132, 136, 186 S.W. 609, 610-11 (1916) (emphasis added). "Here the claim is that the mortgage subsequently executed . . . is an equitable mortgage, but to create a lien upon property, such property must have been ascertained and identified, at least with a reasonable degree of certainty, at the time such agreement was made, and to which it owes its existence. 'There must be . . . an identification of the property so that the equitable mortgagee may say, with a reasonable degree of certainty, what it is that is subject to his lien.'" Lee v. Cole, 17 Or. 559, 21 P. 819, 819-20 (1889). For similar statements, see also, e.g., Union Indemnity Co. v. A.D. Drumm, Jr., Inc., 57 Neb. 252, 70 P.2d 767 (1937); Bradley v. Strauss-Frank Co., 414 S.W.2d 504 (Tex. Civ. App. 1967). "[T]he two, apparently, indispensable factual elements are: intent of the parties to give and take security, and the identification of the property." Britton, Equitable Liens—A Tentative Analysis of the Problem, 8 N.C. L. REV. 388, 389 (1929) (emphasis added).

538. A clear statement of this proposition was made by the Court of Appeals of New York:

It may be pointed out that to find an equitable lien it is necessary that an intention to create such a charge appear from the language and the attendant circumstances. Strict proof of such an intention is required. . . . [There must be] "proof that clearly establishes that the [property] would be 'held, given or transferred as security for the obligation' of the contract."

Pennsylvania Oil Products Refining Co. v. Willrock P. Co., 267 N.Y. 427, 196 N.E. 385, 387-88 (1935). Also see generally Cherno v. Dutch American Mercantile Corp., 353 F.2d 147 (2nd Cir. 1965); Jackman v. Newbold, 28 F.2d 107 (8th Cir. 1928); Penn. Lumber Co. v. Wilson, 26 F.2d 893 (4th Cir. 1928); In re Interborough Consol. Corp. 288 F. 334 (2nd Cir. 1923), cert. denied, 262 U.S. 752 (1922); In re Mattoon, 279 F. 530 (2d Cir. 1922); Columbus, S. & H.R. Co. Appeals, 109 F. 177 (6th Cir. 1901); Wood v. Holly Mfg. Co., 100 Ala. 326, 13 So. 948 (1893); Smith v. Rainey, 9 Ariz. 362, 83 P. 463 (1906) (realty); Hill v. Morris, 124 Ark. 132, 186 S.W. 609 (1916); Title Ins. & Trust Co. v. California Development Co., 171 Cal. 173, 152 P. 542 (1915); James Bradford Co. v. United Leather Co., 11 Del. Ch. 110, 97 A. 622 (1916); De Winter v. Thomas, 34 App. D.C. 80 (1909), cert. denied, 215 U.S. 609 (1910); Hibernian Banking Ass'n v. Davis, 295 III. 537, 129 N.E. 540 (1920); Carmichael v. Arms, 51 Ind. App. 689, 100 N.E. 302 (1912); Lambert v. New England Fire Ins. Co., 146 Me. 60, 90 A.2d 451 (1952); Stone v. First Nat'l Bank, 100 Or. 528, 197 P. 304 (1921). These and many other cases support the conclusion reached by one scholar that one of the "indispensable factual elements" necessary to impose an equitable lien is the "intent of the parties to give and take security . . . ." Britton, Equitable Liens—A Tentative Analysis of the Problem, 8 N.C. L. REV. 388, 389 (1929). For additional authority, see generally, e.g., Jamison Coal & Coke Co. v. Ghotra, 143 F.2d 889 (8th Cir. 1944), cert. denied, 323 U.S. 769 (1944); Carson v. Long-
differ with respect to the evidence necessary to demonstrate the parties' intention to use the property as collateral. Section 9-203(1) presumably requires that the security agreement contain some language granting or otherwise conveying an interest in the debtor's property, whereas the equitable liens doctrine imposes no analogous requirement.

According to Pomeroy's statement of the equitable liens doctrine, it requires only a sufficient indication of an intention to make particular and described property security for an obligation. In Westall v. Wood, for example, the creditor paid for building materials which the debtor had promised to use to improve real estate upon which the creditor had a mortgage. The materials were misappropriated by the debtor who claimed to hold them "as his own free from any adverse right." The court imposed an equitable lien on the materials in the creditor's favor despite the lack of a "specific engagement that a lien for the price should attach to the material."

An equitable lien does not of necessity rest exclusively upon an express agreement. It may arise from circumstances of such a nature as to require the presumption upon general considerations of justice as between those conducting commercial transactions according to a reasonable standard of integrity that an equitable lien was meant. Equity looks at the substance and not the form. If the arrangement between the parties interpreted in the light of the conditions in which they were placed, indicates a contemporaneous intention to adjust their rights upon a basis which can be established only by resort to the equitable principle of lien or pledge, then . . . such an intent will be executed.

The irresistible conclusion from the facts disclosed upon this record is that the parties intended that the materials furnished by the lumber company to the defendant should become subject to the lien of the mortgage. . . .


539. See text accompanying notes 529-534 supra.

540. See J. POMEROY, supra note 389, § 1235 at 696. And see cases cited note 523 supra.


542. 99 N.E. at 325.

543. Id.
An equitable lien is based on the finding of an intention to create security which may be inferred from the nature of the transaction and the attendant circumstances. It is not dependent on the form of the parties' contract or an express declaration of an encumbrance or clearly expressed written words conveying, creating or providing for an interest. The
answer, then, is "yes" to the question which asks whether a creditor in
repayment of money, we ought, as between them, to so regard it and treat it as
creating an equitable charge or lien, however artifici ally it may have been expressed." We
fully approve of this interpretation of the transaction. Equity looks at the sub-
stance and not at the form.

Hurley v. Atchison, Topeka & Santa Fe Ry., 213 U.S. 126, 134 (1909) *(emphasis added)*, quoting from the opinion below, 153 F. 503, 507 (8th Cir. 1907). "[T]he courts have gone
far in declaring transactions, not made strictly in the conventional language of a mortgage or pledge,
to be equitable charges in the nature of such mortgage or pledge, when it is necessary to do
so in order to execute the intent and purpose of the parties." Atchison, Topeka & Santa Fe Ry.
"The law does not require that any particular form of words be used; it being sufficient if the
deed shows a clear intention to reserve a lien." Putnam v. Summerlin, 168 Ala. 390, 53 So.
101, 102 (1910).

The form of the contract is immaterial. Though a lien may not be expressed in
terms, equity will imply a security from the nature of the transaction, and give it
effect as such, in furtherance of the agreement of the parties, if there appears an
intention to create a security. . . . Neither is any particular form of words neces-
sary to the reservation of a lien. Any words which manifest an intention to retain
one will be sufficient in a court of equity.

Ala. 516, 520 (1885).

Every instrument intended to secure the payment of money, whatever may be its
form and whatever name the parties may choose to give it, is in equity a mortgage.
Equity requires no particular words to be used in creating a lien if from the instru-
ment evidencing the agreement, the intent appears to give or to charge or to pledge
property, real or personal, as security for an obligation . . . .

Hill v. Morris, 124 Ark. 132, 135-36, 186 S.W. 609, 610 (1916). Equity "does not require
express words to create an equitable mortgage where the intention to create such a lien is evi-
dent." *Hibernian Banking Ass'n v. Davis, 295 Ill. 537, 129 N.E. 540, 542 (1920).*

"Although the conveyance . . . may lack the formal requisites of a mortgage at law, or be
expressed in inapt or untechnical language, equity will look to the substance and give effect
to the intentions of the parties." Parry v. Reinertson, 208 Iowa 739, 224 N.W. 489, 490
(1929) *(realty)*, quoting 41 C.J. 293. "The form of an agreement by which security is given
is unimportant, if the purpose plainly appears. Equity regards the substance, and gives
effect to the intention." Charpie v. Stout, 88 Kan. 318, 128 P. 396, 398 (1912) *(realty)*.

Although the language of the contract does not in terms or words express that a
"lien" is given, or that Coleman & Stockley convey or 'mortgage,' or employ like
expressions to indicate the creation of a lien upon the stock of cattle, yet we think that the
contract . . . in fact, intended to, and does, subject the said stock to a lien
and a charge as clearly as though it were so expressed.

Dunnan v. Coleman, 59 Tex. 199, 203 (1883). *See also, e.g., Beason Trust v. Dolan, 27 F.2d
247 (1st Cir. 1928); Jackson v. Rutherford, 73 Ala. 155 (1882); Arkansas Cypress Shingle Co.
v. Metro Valley Ry. Co., 97 Ark. 534, 124 S.W. 1195 (1911); Ward v. Stark, 91 Ark. 268, 121
S.W. 382 (1909) *(realty)*; Martin v. Schichtl, 60 Ark. 395, 31 S.W. 458 (1895); Bell v. Pelt, 51
Ark. 433, 11 S.W. 684 (1889); Port v. Carpenter, 138 Iowa 553, 114 N.W. 615 (1908). And
for additional authority, see, e.g., G.L. Wilson Bldg. Co. v. Leatherwood, 268 F. Supp. 609
(D.N.C. 1967); Kalmanoff v. Weitz, 8 Ariz. App. 171, 444 P.2d 728 (1968); In re Fried-
lander's Estate, 178 Misc. 65, 32 N.Y.S.2d 991 (1942); Greer v. American Sec. Ins. Co., 223
App. 1967).

A classic case for the imposition of an equitable lien is one involving an instrument the
language of which is insufficient to create a valid legal chattel or real estate mortgage. *See
generally, e.g., Jackson v. Rutherford, 73 Ala. 155 (1882); Arkansas Cypress Shingle Co.
v. Metro Valley Ry. Co., 97 Ark. 534, 124 S.W. 1195 (1911); Bell v. Pelt, 51 Ark. 433, 11 S.W.
684 (1889) *(realty)*; Ståndoff v. Shockley, 16 N.D. 73, 111 N.W. 622 (1907) *(realty).*
Shelton or a similar case is entitled to an equitable lien assuming the doctrine is not displaced by section 9-203. This is the answer in any case where the court is convinced, as the Eighth Circuit was in Shelton, that the parties' intended to create security in property which has been sufficiently described to identify it.

Since their requirements are different, cases like Shelton will arise in which the parties have failed to execute a proper "security agreement" under section 9-203(1) but their demonstrable intentions support the imposition of an equitable lien. These cases present the issue whether or not the equitable liens doctrine is displaced by Article 9 in this context. The answer should depend on whether the orderly conduct of commercial transactions is more certainly promoted by displacing the doctrine or by perpetuating it. Among the commercial realities to be considered is a very basic one: If a case is ripe for the imposition of an equitable lien, then the parties' intention to create security is necessarily clear. A decision to displace the equitable liens doctrine is, therefore, also a decision that the orderly conduct of commercial transactions is more certainly promoted by refusing to give effect to the intentions of the parties. There are realities and policies embodying them such as those noted below which support the displacement of the equitable liens doctrine under section 9-203, but each is answerable with countervailing policy and reasoning. In the final analysis, the decision about whether to perpetuate or displace the doctrine hinges upon the relative weight given the most basic factual reality, i.e., that the parties actually intended to create security.

One argument for displacing the doctrine is that because decisions like Shelton elevate form over substance, they make it easier for a court to decide whether or not a creditor has an enforceable interest in or right over the debtor's property. Judicial convenience, however, is not an over-riding purpose or policy which the Code is designed to promote. An evidentiary purpose may be served by the requirement in section 9-203(1) of a written security agreement\(^\text{547}\) which presumably must contain some language actually conveying an interest or words to that effect.\(^\text{548}\) But a creditor who is denied an Article 9 security interest should not be denied the opportunity to claim an equitable lien simply because he now bears a relatively heavier burden of proof.\(^\text{549}\)

\(^{547}\) "One purpose of the formal requisites stated in subsection (1)(a) is evidentiary. The requirement of written record minimizes the possibility of future dispute as to the terms of a security agreement and as to what property stands as collateral for the obligation secured." U.C.C. § 9-203, Comment 3. Note, however, that the drafters' emphasis is on evidencing the terms and the collateral, not the mere existence of an agreement.

\(^{548}\) See text accompanying notes 529-534 supra.

\(^{549}\) Cf. Alexander v. Ghatlin, 5 Gill. 138 (Md. 1847). There the court discussed the enforceability of an oral agreement to mortgage personal property.

If the contract be as well established, it imposes the same moral and equitable
Another argument for displacing the equitable liens doctrine is that doing so and requiring strict compliance with section 9-203(1) helps to prevent fraud. The section is, after all, in the nature of a statute of frauds. But an equitable lien cannot be imposed absent sufficient evidence indicating the parties' intentions to make specific property security for a debt. Fraud cannot be suspected or perpetrated when the courts simply give legal effect to the parties' contractual intention as demonstrated by the evidence. And the quantum of evidence sufficient to im-

obligation to perform it, when made verbally, as if made in writing, and the legal effect of the terms of the agreement will be the same in the one case as the other. The greater difficulty of proving the precise terms and import of the agreement is necessarily incurred by the party setting it up, and courts of equity have properly required that every agreement shall be clearly and explicitly established, before they will lend their aid to enforce it. Id. at 182 (emphasis added).

Some might argue that a U.C.C. § 9-203 writing containing clear language of grant is important to third parties. According to this argument, a potential secured party, for example, will look to the debtor's "agreement" with the original creditor to determine whether the parties actually created a security interest and, therefore, whether the debtor's property is already encumbered. Such a potential creditor should not have to guess about the existence of an interest, and, therefore, a writing with clear language of grant is necessary and the possibility of an equitable lien being imposed, on the basis of unexpressed or ambiguously expressed intentions, should not exist.

The basic problem with this argument, and the difficulty with assigning much weight to it as a commercial reality, is the Code's lack of a formal mechanism whereby potential creditors can examine and rely on security agreements executed between the debtor and other creditors. It is true, of course, that a filed financing statement is calculated only to give notice of the possibility that a prior interest exists. It is also true that subsequent creditors are expected to look beyond a financing statement to discover the details of a transaction. Article 9, however, does not suggest that the original parties' "security agreement" is the place to look. It recognizes the needs of third parties in this respect but fulfills them by the procedure prescribed in U.C.C. § 9-208. See U.C.C. § 9-208, Comment 2. As a practical matter, arguing that another creditor is not a secured party because of a defective § 9-203 writing will probably not occur to a later creditor until a priority dispute arises between them.

That a later creditor can even make such an argument may not be as clear to some lawyers as it is to the drafters of Article 9. No one seems to dispute their statement that compliance with the requirements for creating a security interest under § 9-203 is "a condition to the enforceability of a security interest against third parties." U.C.C. § 9-203, Comment 5. But that section "is in the nature of a Statute of Frauds." Id. According to Corbin and other authorities, however, "[i]t is nearly always said that the unenforceability of a contract within the statute of frauds can be taken advantage of only by parties to the contract and those in privity with them." 2 A. CORBIN, supra note 454, § 289.

It has been held in very numerous cases that creditors cannot successfully attack the validity of a contract made by their debtor on the ground that the requirements of the statute were not satisfied. Performance as promised in such a contract is not a fraud on creditors; the . . . giving of security will be sustained. Id. § 290. Also see generally 3 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 530 (W. Jaeger 3d ed. 1960); RESTATEMENT (SECOND) OF CONTRACTS § 218 (1973). Nevertheless, even if § 9-203 is viewed only as a statute of frauds section and nothing more, there is an answer to this problem. The later creditor who is a secured party may be considered a transferee of the property, or at least a transferee of an interest therein, against whom the prior contract for security is unenforceable. See generally id. § 220(2).

550. See U.C.C. § 9-203, Comment 5.
551. See cases cited notes 538 & 545 supra.
pose an equitable lien is at least as much as that required to enforce a contract for the sale of goods, i.e., "sufficient to indicate that a contract has been made between the parties" and affording simply a "basis for believing" that a "real transaction" took place between them. A transaction passing title to goods is no less serious an undertaking and no more insulated from the possibility of fraud than one intended to have effect as security.

It can also be argued that displacing equitable liens under section 9-203(1) insures a degree of certainty and clarity in personal property security law. But the objectives of certainty and clarity in the form of parties' transactions should not take precedence over that of giving effect to their clear, albeit inarticularly expressed, intentions, except when necessary to protect the legitimate rights and interests of third parties. And caveats to the equitable liens doctrine and other rules of law with respect to the

---

552. See note 538 supra and text accompanying it.
554. U.C.C. § 2-201, Comment 1.
555. But see Note, supra note 535, at 1284-85.
556. For example, a previously perfected legal interest undoubtedly prevails over a subsequently acquired equitable lien. See, e.g., Aetna Ins. Co. v. Texas Thermal Industries, Inc., 591 F.2d 1035 (5th Cir. 1979); First Security Bank of Idaho v. Crouse, 374 F.2d 17 (10th Cir. 1967). In addition, equitable liens are not generally enforceable against third parties, but only against the debtor's "heirs, administrators, executors, voluntary assignees, and purchasers or encumbrancers with notice." 4 J. Pomeroy, supra note 389, § 1235 at 696. "While an equitable lien . . . may be enforceable against the specific property embraced in the contract in the hands of the contractor and subsequent purchasers and encumbrancers with notice, it may not be enforced against prior incumbrancers or subsequent incumbrancers without notice." Hayes v. Gibson, 279 F. 812, 814 (3rd Cir. 1922). "It is well settled that a party may, by his contract, create a security, charge, or lien against his property which a court of equity will enforce as an equitable lien against him and also against voluntary or voluntary and involuntary claimants under him with notice of the agreement." Powell v. Totten, 93 Ind. App. 442, 162 N.E. 418, 420 (1928) (emphasis added). The receiver is a mere volunteer, with no greater rights than the debtor. He cannot claim any rights as an innocent purchaser for value without notice.

Sayers & Scovill Co. v. Doak, 127 Miss. 216, 89 So. 917, 918 (1921). An agreement that the price of goods should be secured by a mortgage thereon "could have been specifically enforced in equity and constituted an equitable lien upon the property as against [the debtors] and all persons claiming through or under them except bona fide purchasers having no notice of the lien." Husted v. Ingraham, 75 N.Y. 251, 258 (1878) (emphasis in original). "As against the parties themselves and those who purchase with notice, an agreement, intended to effect a transfer of property or to create a lien upon it or an equity in it, though lacking in some legal requisite, will be upheld in equity. . . ." Howard v. McPhail, 37 R.I. 21, 91 A. 12, 14
rights of third parties serve the purpose of protecting the rights and


However, "in many cases state law, while refusing to recognize such lien as against a bona fide purchaser, does give them validity over a subsequent judicial lien obtained by another creditor." 3 pt. 2] J. Moore & L. King eds., COLLIER ON BANKRUPTCY ¶ 60.50 at 1036 (14th ed. 1977). Often recited in older cases is the rule that a prior equitable lien is enforceable "against the judgment or execution creditor, with or without notice; inasmuch as according to well-established principles, a judgment creditor must take the property subject to every liability under which the debtor held it." First Nat'l Bank of Alexandria v. Turnbull, 73 Va. 695, 704 (1880). See also, e.g., Steele v. Allen, 40 Neb. 770, 59 N.W. 361 (1894); Parker & Co. v. Jacobs, 14 S.C. 112 (1880). This rule and its justification are more often recited with respect to the priority of an equitable interest affecting realty. See, e.g., Alston v. Biddle, 252 Ark. 75, 477 S.W.2d 446 (1972); Pullaski Federal S & L Ass'n v. Carrigan, 243 Ark. 317, 419 S.W.2d 813 (1967); Rural Acceptance Corp. v. Pierce, 157 Ind. App. 90, 298 N.E.2d 499 (1973); Apple v. Robb, 54 Ind. App. 359, 130 N.E. 12 (1913); Everist v. Carter, 202 Iowa 498, 210 N.W. 559 (1926); City Nat'l Bank of Marshalltown v. Crane, 135 Iowa 230, 112 N.W. 793 (1907); Ledal Realty Corp. v. Demkin, 141 N.Y.S.2d 686 (Sup. Ct. 1955). But the rule and its reasoning have also been extended to equitable interests affecting personality. See, e.g., In re Haseltine's Will, 280 App. Div. 857, 113 N.Y.S.2d 752 (1952); Bennis v. Conley, 231 N.Y.S. 635 (App. Term 1929). Another often cited rule with respect to the priority of an equitable lien on real estate is that such a lien being a specific one, it prevails over the general lien of a judgment creditor. See, e.g., Wharton v. Wilson, 60 Ind. 591 (1878); Burns v. Burns, 233 Iowa 1092, 11 N.W.2d 461 (1943); Garner v. Union Trust Co. of Md., 185 Md. 386, 45 A.2d 106 (1945); Jackson v. County Trust Co. of Md., 176 Md. 505, 6 A.2d 380 (1939); Caltrider v. Caples, 160 Md. 392, 133 A. 445 (1929); Union Trust Co. v. Briggs, 153 Md. 50, 137 A. 509 (1927); Cook v. Kraft, 60 Barb. 409, 3 Lann. 512 (N.Y. App. Div. 1871); Dwight v. Newell, 3 N.Y. (3d. Ser.) 185 (1849); Springfield v. Powell, 113 Wis. Va. 638, 169 S.E. 459 (1933). This rule has also been extended to personal property priority disputes. See generally, e.g., Union Nat'l Bank of Wilmington v. Topkis Bros. Co., 23 Del. Ch. 59, 2 A.2d 148 (1938); James Bradford Co. v. United Leather Co., 11 Del. Ch. 110, 97 A. 622 (1916). Often, however, the courts give no reason for preferring an equitable lien on personality to the right of a judgment or attaching creditor. See, e.g., J.B. Inderrieden Co. v. Allen, 176 Ill. App. 301 (1913); Blumenfeld v. Seward, 71 Miss. 342, 14 So. 442 (1894).

Other authority suggests that a judgment creditor is subordinate to an equitable lien only if he has notice of it. See generally, e.g., Sky Harbor, Inc. v. Jenner, 164 Colo. 470, 435 P.2d 894 (1968); Royal Ins. Co. v. Simon, 20 Del. Ch. 297, 174 A. 444 (1934); Blumkin v. Ellis, 186 So. 2d 286 (Fla. App. 1966); Humphrey v. Copeland, 54 Ga. 543 (1875); Rutherford Nat'l Bank v. H.R. Bogie & Co., 114 N.J. Eq. 571, 169 A. 180 (1933); Hoagland v. Latourette, 2 N.J. Eq. 254 (1839); Dufur Oil Co. v. Enos, 59 Or. 528, 117 P. 457 (1911). And cf. RESTATEMENT OF SECURITY § 10 (1941) (explaining the priority of the equitable interest acquired by an intended pledgee before the collateral is delivered to him). According to one scholar, this equitable pledge creates an equitable lien. See Glenn, "The Equitable Pledge," CREDITOR'S RIGHTS AND THE CHANDLER ACT, 25 VA. L. REV. 422, 423 (1939). Also cf. Cunningham & Tischler, EQUITABLE REAL ESTATE MORTGAGES, 17 RUTGERS L. REV. 679, 687 (1963) (regarding
interests of deserving adverse claimants. Furthermore, the drafters must

The courts were almost unanimous in holding, however, that purchasers and others took their interests subject to equitable liens about which they knew. Equitable liens are enforceable against purchasers and encumbrancers with notice. See authorities cited supra herein. This maxim raises an interesting and important question regarding the validity of an equitable lien against third parties in light of Article 9's notice-filing system. The ques-
not have been overly concerned about using section 9-203(1) as a means 

tion is this: Will the filing of an Article 9 financing statement give sufficient notice of an 
equitable lien so as to bind a third party purchaser? Suppose, for example, that a creditor 
and debtor intend and attempt to create an Article 9 security interest in debtor's property. 
An Article 9 financing statement is properly filed. Their "agreement," however, is insuffi-
cient under U.C.C. § 9-203 to create a security interest but sufficient under the equitable 
liens doctrine to impose an equitable lien. A second creditor is successful in creating with 
the debtor a valid security interest. A priority dispute arises between the creditors. The first 
one claims an equitable lien, and the other asserts his security interest. The first creditor, 
i.e., the equitable lieni or, will argue, first, that equitable liens are enforceable against pur-
chasers and encumbrancers with notice and, second, that the Article 9 financing statement 
he filed was sufficient to notify the world, including the subsequent creditor, of his equitable 

This argument raises several issues. Two of them are most important. First, must the 
notice that will bind purchasers under the equitable liens doctrine be actual notice or will 
constructive notice suffice? Second, assuming constructive notice is sufficient, does an Ar-
icle 9 financing statement which is filed to give notice of a "security interest" also suffice to 
give constructive notice of an agreement giving rise to an equitable lien but not a "security interest"?

The first question is easily answered by reference to the often cited rule that construc-
tive notice is sufficient as or equivalent to actual notice. See generally United States v. Brady, 
1949); Cowden v. Kress, 202 Cal. App.2d 1, 20 Cal. Rprr. 560 (1962); Crabee v. White, 113 
Corp., 135 Colo. 110, 309 P.2d 616 (1957); Metropolitan State Bank v. Wright, 72 Colo. 106, 
209 P. 804 (1922); People v. Burns, 161 Mich. 169, 125 N.W. 740 (1910); Meisel Tire Co. v. 
Ralph, 164 Misc. 845, 1 N.Y.S.2d 143 (N.Y. Ct. 1937); R-F Finance Corp. v. Summers, 
168 Okla. 179, 32 P.2d 312 (1934); U.S. Zinc Co. v. Colburn, 124 Okla. 249, 255 P. 688 
(1927); First Nat'l Bank v. Atchison, Topeka & Santa Fe Ry. Co., 77 Okla. 93, 186 P. 1086 
(1908); First Nat'l Bank of Washington, Okla v. Haines, 76 Okla. 301, 185 P. 441 (1919); 
436, 94 A.2d 224 (1953); Union State Bank of Wapato v. Warner, 140 Wash. 220, 248 
(1926); Boeringa v. Perry, 96 Wash. 57, 164 P. 773 (1917).

The harder and ultimate question, however, is whether the constructive notice im-
parted by a financing statement includes notice of the equitable lien or facts giving rise to 
one. The answer is probably, "No." Repeated scores of times in the recent cases is the 
maxim that an instrument even though actually filed, gives constructive notice unless such 
effect has been given to it by statute. See generally Central Bank & Trust Co. v. Lee C. 
1946); In re Atlantic Beach Corp., 224 F. 828 (D. Fla. 1917); Hunt v. Douglas Lumber Co., 
41 Ariz. 276, 17 P.2d 815 (1933); Bank of America Nat'l Trust & Sav. Ass'n v. Nat'l Funding 
Corp., 45 Cal. App. 2d 320, 114 P.2d 49 (1941); Arapahoe Land Title, Inc. v. Contract 
Financing Ltd., 28 Colo. App. 393, 472 P.2d 754 (1970); Spencer v. Poole, 207 Ga. 155, 60 
S.E.2d 371 (1950); Gayer v. Union Trust Co. of Indianapolis, 55 Ind. App. 472, 104 N.E. 82 
(1914); Miller v. Greenfield Sav. Bank, 199 Iowa 1039, 203 N.W. 236 (1925); Lundy v. 
O'Connor, 246 Iowa 1231, 71 N.W.2d 589 (1955); Brananma v. Black Tam Mining Co., 446 
S.W.2d 573 (Ky. 1969); Shuster v. Jones, 22 Ky. 568, 58 S.W. 595 (1900); Cadwallader v. 
Clifton R. Shaw, Inc., 127 Me. 172, 142 A. 580 (1920); William Penn Supply Corp. v. Wat-
N.W.2d 33 (1943); Dutton v. Ives, 5 Mich. 515 (1858); Pedersen v. Brantner, 303 S.W.2d 25 
(Mo. App. 1973); Royal Finance Co. v. Schafer, 330 S.W.2d 129 (Mo. App. 1959); Jordan 
v. Pence, 123 Mo. App. 321, 100 S.W. 529 (1907); Kransky v. Hensleigh, 146 Mont. 486, 409 
P.2d 537 (1965); Dorenger v. Selby, 75 Mont. 416, 244 P. 485 (1926); Bell v. Dennis, 43 N.M. 
350, 92 P.2d 1003 (1939); Fleming v. Mann, 23 N.C. App. 418, 209 S.E.2d 366 (1974); 
Carolina Beach Fishing Pier, Inc. v. Town of Carolina Beach, 274 N.C. 362, 163 S.E.2d 363
of infusing clarity and certainty into the law of commercial transactions. They specifically note in their commentary to the section that it does not

(1968), appeal after remand, 277 N.C. 97, 177 S.E.2d 513 (1970); Stanton v. Schmidt, 45 Ohio App. 203, 186 N.E. 851 (1931); Board of County Commrs of Choctaw County v. Schuessler, 358 P.2d 830 (Okla. 1961); Crater v. Wallace, 193 Okla. 32, 140 P.2d 1018 (1943); Cockrum v. Johnston, 11 Okla. 325, 194 P. 210 (1920); Franklin Sav. & Loan Co. v. Riddle, 216 S.C. 367, 57 S.E.2d 910 (1950); Durr v. Doud, 66 S.C. 81, 278 N.W. 539 (1938); Tandy v. Dickinson, 371 S.W.2d 81 (Tex. Civ. App. 1963); Flynn v. Garford Motor Truck Co., 149 Wash. 264, 270 P. 806 (1928); Dame v. Mileski, 340 P.2d 205 (Wyo. 1959). The basic themes of these and similar cases is that the filing of an instrument is constructive notice only when relevant statutes authorize such filing and that the notice it imparts is prescribed by and limited to that which the statutes provide.

Article 9 clearly authorizes the filing of financing statements, but an Article 9 financing statement "indicates merely that the secured party who has filed may have a security interest in the collateral described." U.C.C. § 9-402, Comment 2 (emphasis added). At best, therefore, an Article 9 financing statement gives constructive notice of the mere possibility of an agreement giving rise to a security interest. It does not indicate that in fact any agreement has been made between the parties who caused its filing. In essence, then, the equitable lienor is arguing that the filing of an Article 9 financing statement is equivalent to filing an instrument creating an equitable lien or giving notice of one. But since there is no provision for recording or giving notice of equitable liens under Article 9, and since a financing statement literally gives notice only of the possibility of some agreement creating a security interest, the simple fact of its filing cannot give notice of an equitable lien sufficient to bind third parties. Cf. In re Van Winkle, 49 F. Supp. 711 (W.D. Ky. 1943):

The recording acts do not deal with the creation of liens between the parties, but on the contrary deal only with the question of notice of existing liens on the part of subsequent purchasers for value. Unless the question of notice comes into play, recording is immaterial. There is no statutory provision in Kentucky for the recording of an equitable lien, and it is the accepted rule that the recording of a non-recordable instrument does not operate as constructive notice under the recording statutes. . . . Accordingly, the Insurance Company did not fail to do any act which was required of it by any statutory provision, and even if it had lodged its contract for recording with the County Clerk it would have had no legal effect and would not have bettered its position in any way.


The equitable lienor might argue, however, that third parties are bound not simply by the information contained within the four corners of a recorded instrument. They are also bound by what would have been disclosed had they asked questions which the record suggests. A rule of similar import is often cited by the courts. See generally Tobin v. Kampe, 132 F.2d 64 (8th Cir. 1942); In re Greer College and Airways, 53 F.2d 585 (7th Cir. 1931); F.P. Baugh, Inc. v. Little Lake Lumber Co., 185 F. Supp. 628 (N.D. Cal. 1960); Whatley v. Cuddly, 148 Colo. 362, 366 P.2d 671 (1961); Hull v. Maryland Cas. Co., 79 So. 2d 517 (Fla. 1954); Sapp v. Warner, 105 Fla. 245, 141 So. 124 (1932), aff'd, 105 Fla. 245, 143 So. 648 (1932); McCausland v. Davis, 204 So. 2d 334 (Fla. App. 1967); Strand v. Jones County, 228 Iowa 875, 295 N.W. 477 (1940); Gray v. Brasee, 14 N.Y.S.2d 687 (N.Y. Sup. 1939); Farmers' Merchants' Bank of Walla Walla v. Small, 131 Wash. 197, 229 P. 531 (1924). This argument will also be unsuccessful because, as established above, the financing statement only imparts notice of the possibility of an Article 9 security interest. Logically, therefore, it cannot suggest inquiries about anything else.

A tactic likely to be more successful is to establish that the third party actually discovered the financing statement, asked the debtor its meaning and, therefore, actually learned of an agreement between the first creditor and the debtor to encumber the debtor's property. In this case, the equitable lienor relies not on the constructive notice given by the
displace or "reject, the deeply rooted doctrine that a bill of sale although

record per se but on the actual knowledge which the third party purchaser acquired as a result of searching the records and actually pursuing the inquiries they suggested.

557. For example, creditors of bankrupt debtors who could have but failed to create an Article 9 security interest by complying with U.C.C. § 9-203 and rely instead on the equitable liens doctrine risk having such liens voided by the trustee under § 60 of the Bankruptcy Act [11 U.S.C. §§ 1 et seq. (1970) (act superseded 1978)], more specifically § 60a(6) providing inter alia that

The recognition of equitable liens where available means of perfecting legal liens have not been employed is hereby declared to be contrary to the policy of this section. If a transfer is for security and if (A) applicable law requires a signed and delivered writing, or a delivery of possession, or a filing or recording, or other like overt action as a condition to its full validity against third persons other than a buyer in the ordinary course of trade claiming through or under the transferor and (B) such overt action has not been taken, and (C) such transfer results in the acquisition of only an equitable lien, then such transfer is not perfected within the meaning of [§ 60a] paragraph (2), it shall not suffice to perfect a transfer which creates an equitable lien such as is described in the first sentence of [§ 60a] paragraph (6), that it is made for a valuable consideration and that both parties intend to perfect it and that they take action sufficient to effect a transfer as against liens by legal or equitable proceedings on simple contract . . . .

For a thorough analysis of this paragraph and its effect on equitable liens, see 3 (pt. 2) J. Moore & L. King, COLLIER ON BANKRUPTCY ¶ 60.50 (14th ed. 1977). The means of perfecting an Article 9 security interest include the attachment of one pursuant to U.C.C. § 9-203. See U.C.C. § 9-303(1). If the parties' transaction is within the scope of Article 9, then a means of perfecting a "legal lien," i.e., an Article 9 security interest, may be said to be available. See generally In re Supermercados San Juan, Inc., 575 F.2d 8, 13 n.2 (1st Cir. 1978); Chernoff v. Dutch American Mercantile Corp., 353 F.2d 147 (2d Cir. 1965); Mullins v. Noland Co., 406 F. Supp. 206, 208 n.1 (N.D. Ga. 1975); In re Dean and Jean Fashions, Inc., 329 F. Supp. 663 (W.D. Okla. 1971). But cf. Porter v. Searle, 228 F.2d 748 (10th Cir. 1955).

In Porter the debtor agreed to give a chattel mortgage but never did. The agreement, however, gave rise to an equitable lien under state law, and it withstood the trustee's challenge under § 60a(6). According to the court, "There was no means available to the [creditors] by which they could have converted [the equitable lien] into a legal lien." Id. at 755. Arguably, however, the court was incorrect.

[It] seems clear that the defendants did have means available both to acquire and to perfect a legal lien. The basic intention of the framers of section 60a(6) would seem to require creditors of the bankrupt to acquire legal liens when possible and perfect them by performing any affirmative action required by applicable state law. If the defendants had enforced their legal rights under the sales contract they would have obtained either a legal lien or possession of the goods prior to the four month period before filing of the petition in bankruptcy. This could have been accomplished by refusing to surrender the merchandise until execution of the chattel mortgage, by repossessing of the merchandise within a reasonable time after surrender, or by suit for specific performance on the sales contract. Any of these methods would have procured the necessary chattel mortgage which could then have been perfected by filing.


"If the transaction giving rise to the equitable lien is not (although normally it will be) voidable under § 60, there remain the provisions of §§ 67, 70c and 70e, by virtue of which the trustee may move to strike down such liens." 3 (pt. 2), J. Moore & L. King, COLLIER ON BANKRUPTCY ¶ 60.50 at 1042 (14th ed. 1977). See, e.g., cases cited at note 566 supra regarding trustee asserting lien creditor status.

absolute in form may be shown to have been in fact given as security.”1558 Parol evidence is admissible to show “that a transfer purporting to be absolute was in fact for security.”1559 Here is a case where the drafters envisioned that form is subordinate in terms of legal effect to the parties’ contrary intention. The drafters give no reason for perpetuating the common law rule regarding absolute bills of sales while suggesting the displacement of the equitable liens doctrine. Since the parties’ intention to create security is the critical factor in both kinds of cases,1560 however, why

dealing with preferences, as originally enacted, has no specific paragraph dealing with equitable liens. This omission may be significant because (1) a transfer of personal property is deemed to be perfected “when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee” [Id. § 547e(1)(B)] and (2) “in many cases state law, while refusing to recognize such [equitable] liens as against a bona fide purchaser, does give them validity over a subsequent judicial lien obtained by another creditor.” 3 (pt. 2), J. Moore & L. King, COLLIER ON BANKRUPTCY ¶ 60.50 at 1036 (14th ed. 1977). And see generally id. ¶ 60.50 and note 566 supra. For a general discussion of the validity of liens under various provisions of the new Act, see Levine, An Introduction to the Trustee’s Avoiding Powers, 53 AM. BANKR. L.J. 173 (1979).

Legislation has been proposed, however, which will add to § 547 of the new Bankruptcy Reform Act a provision dealing with equitable liens. The proposal adds to

Section 547(e) of title 11 of the United States Code . . . a new paragraph (4) at the end thereof as follows:

“(4) For the purposes of this section, a transfer of an equitable lien is deemed to be made immediately before the commencement of the case on account of an antecedent debt.” S. 658, 96th Cong., 1st Sess. (1979). Supposedly, “[t]his amendment makes clear that equitable liens are to be treated like other liens and be avoidable by the trustee in bankruptcy.” S. Rep. No. 96-309, 96th Cong., 1st Sess. (1979). The only thing this provision clearly does is to create ambiguity about the treatment and validity of equitable liens under the new Bankruptcy Code, particularly when it is compared to the extensive provisions governing them under the old Act.

Primarily for historical analyses of the validity of equitable liens under federal bankruptcy law the provisions of which dealing with such liens have varied over the years, see generally Glenn, The “Equitable Pledge,” Creditors Rights, and the Chandler Act, 25 VIR. L. REV. 422 (1939); McLaughlin, Amendment of the Bankruptcy Act, 40 HARV. L. REV. 340 (1927); Weintraub & Levin, The Equitable Lien, 30 REF. (NAT’L ASS’N REFEREES IN BANKRUPTCY) J. 92 (1956); Notes 37 COLUM. L. REV. 621 (1937); 32 COLUM. L. REV. 901 (1932); 15 MICH. L. REV. 345 (1916); 14 MICH. L. REV. 339 (1916); 12 MINN. L. REV. 378 (1928); 12 MINN. L. REV. 174 (1927); 5 UTAH L. REV. 272 (1956).


560. In cases where courts are asked to find that an absolute bill of sale was in fact a mortgage, “[t]he question to be determined by the jury is whether the transaction was in substance a mortgage, notwithstanding the form the parties have given it; and this question is to be determined upon the evidence, independently of the form of the instrument and of the form of the transaction . . . The intention of the parties is what must be sought in such cases, and this is not to be determined from the manner in which the parties characterized the transaction, but from a consideration of all the attending circumstances at the time the instrument was executed.” 1 L. JONES, supra note 509, § 24 at 42-43 (emphasis added).
is form important for purposes of clarity and certainty in cases like Shelton but not in the kind of case the drafters suggest in this comment?

The supposed advantages of displacing the equitable liens doctrine under section 9-203(1) do not outweigh the significant and obvious reason for perpetuating it, i.e., to give effect to the parties' clear intentions. Suppose in a case similar to Shelton the dispute is only between the immediate parties: no third party claimant is involved. Suppose also that the debtor testifies in court that he agreed to grant the creditor a security interest. Should the court hold that no enforceable security interest exists and that he cannot at law or in equity be accorded any other claim, right, interest or remedy with respect to the particular property, except an ordinary collection process?

If the issue concerned the enforceability of a contract for the sale of goods, a clear answer would be that provided by section 2-201. Notwithstanding the absence of a writing or the insufficiency of one, a sales contract is enforceable if the one against whom enforcement is sought admits its existence.561 In such a case "no additional writing is necessary for protection against fraud;"562 and the same reasoning supports other exceptions to the statute of frauds for the sale of goods.563 The purpose of the


Article 8's statute of frauds contains a similar provision. See U.C.C. § 8-319(d).

562. U.C.C. § 2-201, Comment 7.

563. Other exceptions to Article 2's statute of frauds include cases of "goods . . . to be specially manufactured for the buyer . . . not suitable for sale to others in the ordinary course of the seller's business" and "goods for which payment has been made and accepted or which have been received and accepted." U.C.C. §§ 2-203(3)(a) & (c). Absent a contract between the parties, why would a seller manufacture a product useable only by the buyer? Or why would a buyer pay for goods or accept them unless he had contracted to buy them? In most cases no other justification is possible, and, therefore, no other evidence is necessary to establish a basis for believing that the offered oral evidence rests on a real transaction. For discussions of U.C.C. § 2-201(3)(c), see, e.g., Notes, 20 Kan. L. Rev. 538 (1962); 10 Wake Forest L. Rev. 613 (1974). For discussions about the development and application of the part performance doctrine in other contexts, see, e.g., Moreland, Statute of Frauds and Part Performance, 78 U. Pa. L. Rev. 51 (1929); Odear, The Statute of Frauds and Possession as Part Performance Thereunder, 18 Ky. L.J. 379 (1930); Comment, Part Performance, Estoppel, and the California Statute of Frauds, 3 Stan. L. Rev. 281 (1951); Notes, 22 Baylor L. Rev. 588 (1970); 7 Ottawa L. Rev. 678 (1975). For discussions concerning U.C.C. § 2-201 generally, see Comment, An Anatomy of Sections 2-201 and 2-202 of the Uniform Commercial Code, 4 B.C. Indus. & Com. L. Rev. 381 (1962); Comment, Changes Wrought in the Statute of Frauds by the Uniform Commercial Code, 48 Marq. L. Rev. 571 (1965); Comment, A Comparison of the Statute of Frauds Sections of the Uniform Sales Act and Uniform Commercial Code in Pennsylvania, 58 Dick. L. Rev. 373 (1954); Notes, 15 Syracuse L. Rev. 532 (1964); 36 Temp. L.Q. 75 (1962). For a thorough analysis of the original English Statute of Frauds enacted in 1677, see Willis, The Statute of Frauds—A Legal Anachronism (pts. 1-2), 3 Ind. L.J. 427, 528 (1928). In large part,
earliest statutes requiring that certain classes of promises be in writing was “to prevent the foisting of an obligation . . . by perjury upon one who had never assented to assume it.” But the courts and legislatures have recognized exceptions to the traditional writing requirement of a statute of frauds when other reliable indicia are present and sufficiently evidence a party’s assent.

Section 9-203(1) makes no exception to the writing requirement when the debtor is in possession of the collateral. Therefore, in the hypothetical case where the debtor admits his agreement to grant a security interest, a literal application of the section would cause injustice because it would be “used as a technical defense against a meritorious claim.”


564. 2 A. Corbin, supra note 454, § 275, at 3.


The principal disadvantage of form requirements—possible injustice in individual cases—is aggravated when the penalty for non-compliance is voidness or enforceability. Parliament decided in 1877 that such an extreme penalty would be imposed. Courts of equity and common law have since mitigated against the penalty by the doctrine of part performance, the imposition of constructive trusts, the fictions of quasi-contract, the main purpose rule, the joint obligor rule, and a variety of other devices, of which promissory estoppel has become a recent favorite. All of these are ingenious and creative but often erratic and undependable, means of escaping an exaggerated statutory penalty. Some of these devices, particularly the doctrines of part performance and promissory estoppel, are employed in situations where acts by the plaintiff pursuant to an oral or insufficiently memorialized agreement provide corrodibing evidence of the existence of the agreement. Other kinds of events could well corroborate the existence of the alleged contract. Id. at 71-73 (emphasis in original). Regarding the use of promissory estoppel to lift the bar of the statute of frauds, see note 568 infra.

566. And U.C.C. § 2-201 with its exceptions to the traditional writing requirement is inapplicable literally to security agreements under Article 9. See 3 S. Williston, A TREATISE ON THE LAW OF CONTRACTS § 511 (3rd ed. W. Jaeger ed. 1960). Also not applicable are other formulations of these exceptions. Cf. In re Carter, 25 UCC Rep. Serv. 1162 (D. Me. 1978). The court in Carter noted that U.C.C. § 9-203 “is universally recognized as a statute of frauds” and then asked, “[d]oes it necessarily follow that the oral agreement by the debtors to grant a new or renewed security interest in favor of Associates must be denied jural effect because it was not signed by the debtors?” Id. at 1170. The court apparently concluded “yes” after observing that neither the part performance doctrine nor the debtor’s admission would dispense with the writing requirement under U.C.C. § 9-203. The court ultimately decided, however, that the requirement of a signed writing was satisfied in this case.

It is possible to argue, however, that the principles implicit in the U.C.C. § 2-201 exceptions are applicable under U.C.C. § 9-203. They were first developed by the courts as ways to avoid fraud and prevent injustice. To the extent that they constitute equitable principles or common law rules, therefore, one can argue for their perpetuation under U.C.C. § 9-203 through § 1-103. This type of argument is unnecessary, however, if the equitable lien doctrine is available to a creditor who has failed to satisfy the requisites for establishing a security interest under U.C.C. § 9-203. Equitable liens have been imposed and enforced despite the parties’ non-compliance with a statute of frauds. See note 536 supra.
based on [a] . . . contract the terms of which are undoubted. In Shelton and the hypothetical case, no one doubts the parties’ intention that the creditor should have a security interest. But in both cases the existence of a security interest is denied because section 9-203(1) requires a writing and presumably one containing formal words of conveyance or language or similar import. The equitable lien doctrine could be invoked in these cases to the extent necessary to avoid injustice by serving not as a substituted means for creating a security interest under Article 9, but

567. 2 A. CORBIN, supra note 454, § 275 at 13.
568. Using equitable doctrines to prevent injustice which would result from the literal application of a statute of frauds is not without precedent under the Code. Promissory estoppel, for example, can sometimes be used in contract cases to defeat the defense of noncompliance with the Statute of Frauds. See RESTATEMENT (SECOND) OF CONTRACTS § 217A (1973). And in Warder & Lee Elevator, Inc. v. Britten, 274 N.W.2d 339 (Iowa 1979), the court concluded that U.C.C. § 2-201 does not purport to eliminate equitable and legal principles traditionally applicable in contract actions. Therefore it does not affect the validity of defenses to application of the rule of evidence which it defines.

If [§ 2-201] were construed as displacing principles otherwise preserved in [§ 1-103], it would mean that an oral contract coming within its terms would be unenforceable despite fraud, deceit, misrepresentation, dishonesty or any other form of unconscionable conduct by the party relying upon the statute. No court has taken such an extreme position. Nor would we be justified in doing so. Despite differences relating to the availability of an estoppel defense, courts uniformly hold “that the Statute of Frauds having been enacted for the purpose of preventing fraud, shall not be made the instrument of shielding, protecting, or aiding the party who relies upon it in the perpetuation of a fraud or in the consummation of a fraudulent scheme.” The estoppel defense, preserved on the same basis as the fraud defense by [§ 1-103], developed from this principle. “The Statute was designed as a weapon of the written law to prevent frauds; the doctrine of estoppel is that of the unwritten law to prevent a like evil.”

We have found no reported decision in any jurisdiction holding that the statute of frauds in the Uniform Commercial Code, defined as it is in [§ 2-201], displaces principles preserved in [§ 1-103]. We do not believe that our legislature intended for it to do so.

as an alternative for giving the creditor a right over the debtor's property and a remedy for enforcing it. It can and should serve that purpose in any case where the parties' intention to create security, however demonstrated, is clear and the property is adequately described.

The principal purpose of contract law is to give effect to the parties' intentions through "the realization of reasonable expectations that have been induced by a promise." This purpose can be promoted under the Code and in the law of secured transactions by perpetuating the equitable liens doctrine. It provides an alternative means of security when a literal application of section 9-203 would frustrate the parties' intentions and dash their expectations on the basis of legal technicalities or formalities. The drafters of Article 9 admitted that the doctrine was useful to escape the formalities of pre-Code chattel mortgages law. They urged its displacement with the enactment of Article 9 only because they believed section 9-203(1) eliminated almost completely the formal requisites to the creation of a security interest. One can argue, therefore, that the drafters may not have intended to abolish the equitable liens doctrine in cases involving the remaining remnants of formality under section 9-203(1) when requiring strict compliance with them would frustrate parties' intentions and dash the creditor's reasonable expectation of having security in the debtor's property. The doctrine was, after all, "liberally extended" under the common law "in order that the intentions of the parties to create specific charges may be justly and effectually carried out." Even the principal architect of Article 9 concedes "that the courts [will] have to continue to find their way through the jungle of 'equitable liens' . . . [because] the Statute of Frauds of § 9-203 will be no more successful than any other Statute of Frauds has ever been in making hard problems go away."
C. Actual Knowledge Of An Earlier Interest As A Factor Affecting Priority

A court may decide that the equitable liens doctrine is displaced under section 9-203(1) to the extent that it cannot be relied upon as an alternative means of enforcing agreements which lack some formal requisite that that section requires. The court has not thereby decided, however, that the doctrine is displaced in all other contexts under Article 9.

Satisfying the attachment requirements under section 9-203(1) also results in satisfying those for imposing an equitable lien. Cases arise in which a creditor may prefer to rely on an equitable lien and not on a validly created security interest attaching under section 9-203(1). The reason is that equitable liens are enforceable not only against the debtor, but also against third party claimants with notice. Therefore, the equitable liens doctrine can possibly be used to supplement (or circumvent) the priority rules of Article 9. The most notable situation involves section 9-312(5)(a), General Insurance Company of America v. Lowry is an example. Edward Lowry and two others were indemnitors on surety bonds issued by General Insurance. During 1972 and 1973, the indemnitors executed cognovit notes payable to the surety. Collateral securing the notes included shares of common stock owned by Lowry in Pico Development Company, an Ohio corporation, but the security interest in the stock was not perfected.

In his dealings with General Insurance, Mr. Lowry was actively represented by his attorney, Jacob Myers, who examined all the documents signed by his client. Myers was a partner in the professional association of Kusworm & Myers Company, and in 1974 Lowry executed a note payable to it for “attorneys fees rendered and to be rendered by both Kusworm & Myers Company, LPA, and Jacob Myers." The note was

interests in property which secure obligations necessarily become Code security interests; that the choice [cannot] be reduced to the simple one between a Code security interest and nothing . . . ." Id. at 345. See also id. § 11.1.

574. See generally text accompanying notes 536-539 supra.

575. See notes 556 & 557 supra.

576. “Conflicting security interests rank according to priority in time of filing or perfection.” U.C.C. § 9-312(5)(a).


578. The shares of stocks were “securities” as defined in U.C.C. § 8-102. For Article 9 purposes, therefore, they were “instruments.” See U.C.C. § 9-105(1)(b). “A security interest in . . . instruments (other than instruments which constitute part of chattel paper) can be perfected only by the secured party’s taking possession . . . .” U.C.C. § 9-304(1). But “[a]t no time were the shares of stock ever delivered to [General Insurance Co.]. . . .” 412 F. Supp. at 13.

579. Id. at 14.
secured by a perfected security interest in 19 shares of stock in the Pico Development Company.

General Insurance subsequently sued Lowry, the other indemnitees, Myers and his professional association asking that they be compelled to deliver to it the Pico stock. The only issue in the case concerned the relative priority of the security interests claimed in the stock by the plaintiff and Kusworm & Myers. Resolving the dispute between non-purchase money security interests is a simple matter if section 9-312(5)(a) is literally applied.

Since this was a security interest in an instrument . . . , and General Insurance never took possession of the Pico stock, the security interest was never perfected . . .

By taking possession of Lowry’s stock pursuant to its 1974 pledge agreement, Kusworm & Myers, LPA, did perfect their security interest. Under § 9-312(5)(a) defendants’ rights in the stock prevail over the plaintiff’s unperfected security interest, even though they had knowledge of the plaintiff’s interest.580

The court refused, however, to tolerate such a result in light of the fact that Myers, as Lowry’s attorney, witnessed the agreement which gave General Insurance a security interest in the stock. “Defendant Myers is not merely a disinterested creditor who attempted to protect his commercial interests.”581 The court believed that Myers’ law firm must be denied priority “[i]f the integrity of the concept of ‘good faith’ is to be maintained.”582 Therefore it held that General Insurance obtained an equitable lien on the Pico stock, as well as a security interest in it. Although a subsequent secured party who knows of an earlier attached security interest may prevail under a literal application of section 9-312(5)(a) by perfecting his interest first, he cannot prevail over an existing equitable lien if he has full knowledge of the agreement giving rise to it.583 General Insurance won the priority dispute because the court resorted to the equitable liens doctrine which it believed not to be displaced by the priority rules of Article 9.584

580.  Id.
581.  Id.
582.  Id.
583.  Defendants Jacob A. Myers and Kusworm & Meyers, LPA, as third party with full knowledge of the agreements [between General Insurance and Lowry] . . . and occupying an attorney-client relationship to first party may not under the circumstances of this case obtain by pledge under the U.C.C. a security interest prior to the equitable lien of second party General Insurance Company of America.

584.  “Although courts should hesitate to invoke equity powers to disturb the operation of a statute, nothing in the Uniform Commercial Code precludes the imposition of an equitable lien in narrowly-circumscribed situations,” 412 F. Supp. at 15 (emphasis added). The court relied upon Klaustermeyer v. The Cleveland Trust Co., 89 Ohio St. 142, 105 N.E. 278 (1913), as authority for imposing an equitable lien in this type of case. The Sixth Circuit in its opinion

HeinOnline -- 34 Ark. L. Rev. 73 1980–1981
The literal result dictated by section 9-312(5)(a) has also been avoided without imposing an equitable lien. In Thompson v. United States, Paul Kapelow and Lester Gross borrowed more than $3 million from John Hancock Mutual Life Insurance Company to build a high-rise apartment building. The loan was secured by a deed of trust covering real and personal property, including after-acquired personal property to be used in the apartment complex. The deed was recorded in the local real estate records. The loan was also guaranteed by the Federal Housing Administration, and the debtors agreed to be bound by an FHA "regulatory agreement" which prohibited them from further encumbering any of the mortgaged property.

While the building was under construction, Kapelow and Gross conveyed their interests to a partnership consisting of Vance Thompson and his adult sons. The Thompson partnership assumed the obligations of the deed of trust and the regulatory agreement. Two years later they defaulted on the installment payments due under the deed of trust note. FHA paid John Hancock, took an assignment of the deed of trust, brought a foreclosure action against the Thompson partnership and had an operating receiver appointed for the apartment building.

Four months after its default, the Thompson partnership granted a security interest in the personal property used in the apartments to the M.D. Thompson & Son Company, of which Vance Thompson was an officer and his wife, adult children and grandchildren were all shareholders. The Thompson corporation was engaged in the business of selling furniture and had sold such goods to the Thompson partnership for use in the apartment building. The Thompson corporation's security interest in the personal property was perfected.

While FHA's foreclosure action was pending in federal court, the Thompson corporation sued in state court to establish a first lien on the personal property in which it had a perfected interest. It based its claim of priority on section 9-312(5). The Eighth Circuit found that the Thompson corporation was the first to perfect a security interest because the deed of trust which gave the FHA a security interest in the property was not a financing statement under section 9-402(1) and was improperly filed under section 9-401. But the court refused to allow the Thompson

affirming the trial court's decision obviously believed this reliance was sound; and it rejected "appellant's argument that the enactment of the Uniform Commercial Code overruled Klausermeyer and eliminated equitable liens in all situations." General Ins. Co. of America v. Lowry, 570 F.2d 120, 122 (6th Cir. 1978).

585. 408 F.2d 1075 (6th Cir. 1969).

586. "The government tried to justify its priority on the basis of U.C.C. § 9-401(2). This section provides that

A filing which is made in good faith in an improper place or not in all of the places required by this section is nevertheless effective with regard to any collateral
corporation to enforce its security agreement against the government. It held that section 1-203\textsuperscript{587} "permits the consideration of the lack of good faith by the Thompson entities toward the government to alter priorities which otherwise would be determined under Article 9."\textsuperscript{588}

By entering into a security agreement with each other, the Thompson partnership and the Thompson corporation were required to exercise good faith in the enforcement of the security agreement on the furniture. To attempt to enforce that security agreement against the government, in our judgment, would be an act of extreme bad faith on the part of those members of the Thompson family who are affiliated with both the partnership and the corporation and particularly on the part of Vance Thompson, who dominated and acted for both business entities. . . . In the regulatory agreement, Vance Thompson and his adult sons, as members of the partnership, had agreed that they would not, without the approval of the FHA Commissioner, encumber any of the mortgaged property or permit the encumbrance of any such property. The execution of the security agreement with the corporation was a breach of the regulatory agreement. The relationship between the Thompson partnership and the Thompson corporation is so close that the corporation must be charged with participation in the partnership's breach of the regulatory agreement.

Under the circumstances of this case, good faith would require the members of the Thompson family and any of its business entities to observe and abide by these contractual agreements, and, under § [1-203] . . . the government was entitled to prevail in respect to this furni-
In both General Insurance and Thompson, the subsequent secured parties which first perfected were denied priority under section 9-312(5) primarily because they lacked good faith. Their knowledge of the pre-existing security interest at the time they took their interests was not by itself the reason for altering the result dictated by Article 9's priority rule. But such knowledge alone was the controlling factor in In Re Davidoff. The debtor, a dentist, granted security interests in his equipment to Bankers Trust Company and then to Herbard Dental Supply Company, Inc. Bankers was the first to file a financing statement but failed to do so in all the places required under section 9-401(1). Herbard's security interest was properly perfected. Herbard's assignee, Dentsply International, Inc., was therefore entitled to priority under section 9-312(5), but the court held for the bank because the debtor had told Herbard that "everything in the office is chattled" and that "the [Bankers Trust Co.] had held the mortgage on that equipment." According to the debtor's testimony, Herbard knew before its security interest attached that "'everything I had is hocked lock, stock and barrel', . . . 'between First National City and Bankers Trust . . . .'"

Citing section 9-401(2), Dentsply argued "that one may knowingly perfect a security interest . . . even when he knows that two other creditors hold security interests in the same property, so long as he does not learn of the fact of improper filing, or see a copy of that which is filed." The court rejected such a narrow reading of section 9-401(2).

589. Id. at 1084-85.
590. In General Insurance Co. of American v. Lowry, 412 F. Supp. 12 (S.D. Ohio 1976), the court emphasized the later secured party's knowledge of the earlier security agreement and that party's position as the debtor's lawyer. See id. at 15. And in Thompson v. United States, 408 F.2d 1075 (8th Cir. 1969), the Eighth Circuit observed about the Thompson corporation that there was more than 'actual knowledge' of the government's interest. Vance Thompson and his children, as partners, assumed the deed of trust and regulatory agreement and they now seek to avoid that obligation through the use of a transaction with the Thompson family.
592. Id. at 442.
593. Id.
594. Id.
595. This subsection is quoted note 586 supra.
596. 351 F. Supp. at 443.
597. The court labeled the theory "novel," id., but concluded "this interpretation of U.C.C. § 9-401(2) is too narrow and literal . . . ." Id. at 442. The courts do not require that the subsequent creditor actually have seen a copy of the misfiled or improperly filed financing statement in order for it to be effective against him under U.C.C. § 9-401(2). They do not require even that he have acquired knowledge of literally all the information contained in such a statement. One author has suggested the possibility of "a trend toward equating 'knowledge of the contents of a financing statement' with 'knowledge of the exist-
but chose to “rely on § 1-103.”598 It reasoned that
“The purpose of the notice-filing statute is to give protection to a credi-
tor by furnishing to others intending to enter into a transaction with the
debtor a starting point for investigation which will result in a fair warn-
ing concerning the transaction contemplated . . . .” Here, the debtor
gave Herbard all that notice and warning which proper filing could
give.599

The court then fashioned and applied a meta-Code rule providing that
“actual notice of an outstanding equity prevents perfecting a security
which will become, by correct filing, superior to such outstanding eq-
uity.”600 In this case it was not notice of an existing security interest cou-
pled with the subsequent secured party’s lack of good faith which
persuaded the court to deviate from Article 9’s priority rule. Instead, the
court here believed that taking a security interest in assets which the credi-
tor knew were already encumbered is, in itself, bad faith.601

In General Insurance, Thompson and Davidoff, the subsequent creditor
had knowledge of the earlier security interest at the time it took its own
but sought to subordinate the earlier one on the basis of the first-to-file-or-
perfect rule in section 9-312(5)(a). In each case the court refused to apply
that rule literally because of the later secured party’s lack of good faith.
General Insurance avoided the rule’s literal result by superimposing the equ-
itable liens doctrine on the section’s priority scheme: the subsequent
creditor’s knowledge and lack of good faith subordinated its security in-

598. Id., quoting Beneficial Finance Co. v. Kurland Cadillac-Olds, Inc., 32 A.D. 2d 643,
599. Id., at 443.
601. “Under the circumstances of this case, it was not good faith to impose a security
interest on assets which the debtor had already said were secured to two named banks.” Id.
at 444.
terest. The same result was reached in Thompson without imposing an equitable lien because the court held that a lack of good faith can by itself alter the priority rules of Article 9. The court in Davidoff agreed but decided that when a creditor takes a security interest in collateral which he knows to be encumbered, he thereby acts in bad faith and cannot attain priority by being the first to file or perfect. The ultimate issue raised by these cases, especially Davidoff, is the extent to which actual knowledge of an earlier attached but unperfected security interest affects the first-to-file-or-perfect rule of section 9-312(5)(a). If the subsequent creditor’s actual knowledge of an earlier interest is material under this section, then there is no need (1) to resort to the equitable liens doctrine as in General Insurance or (2) to find a lack of good faith exceeding actual knowledge

602. "[A]ctual notice embraces all those instances in which positive personal information of a matter is directly communicated to the party, and this communication of information, being a fact, is established by evidence directly tending with more or less cogency to its proof." 2 J. PomeroY, supra note 389, § 593 at 609. But actual notice can be inferred from circumstantial evidence, and, therefore, it is proper to consider "whether the facts proved were sufficient to put the party [to be charged with notice] upon an inquiry, so that, if he went on with the transaction without making any inquiry, his actual receipt of information and consequent notice is a legitimate or necessary conclusion; or whether, on the other hand, he prosecuted an inquiry to such an extent and in such a manner that his actual failure to acquire information is a just inference of fact." Id. § 596 at 616. Therefore,

A purchaser or mortgagee who is put upon inquiry by the facts and circumstances within his knowledge is charged with notice of whatever such inquiry would have imparted. If he abstains from inquiry, whether designedly for the purpose of avoiding knowledge, or negligently, he cannot be regarded as a bona fide purchaser without notice. But the purchaser must first be put upon inquiry before his failure to make inquiry will invalidate his mortgage. Mere want of caution, or mere negligence in making inquiries as to prior encumbrances, is no ground for charging a mortgagee with notice of such encumbrances. When circumstances are shown to exist which would put an ordinary prudent business man upon inquiry as to prior encumbrances, then he is charged with notice of such facts as he could have ascertained upon inquiry . . . ."

1 L. Jones, supra note 509, § 308 at 490. For a thorough analysis of the nature and constitution of actual notice, see 2 J. PomeroY, supra note 389, §§ 595-603. For a similar analysis in the context of chattel mortgage priority disputes, see 2 J. Coby, supra note 509, §§ 603-611, 1 L. Jones, supra note 509, §§ 308-318. For cases decided under statutes making actual notice material in deciding priority disputes [see text accompanying notes 626-637 infra] and discussing the meaning of actual notice and facts sufficient to prove it, see, e.g., Commercial Loan & Mortgage Co. v. Jones, 124 Kan. 649, 261 P. 555 (1927); Brandeis Machinery & Supply Co. v. St. Matthews Finance Co., 228 Ky. 506, 15 S.W.2d 502 (1929); Cable Piano Co. v. Lewis, 195 Ky. 666, 243 S.W. 924 (1922); Security Trust Co. v. Tuiller, 243 Mich. 570, 220 N.W. 759 (1928); Onco Motors Corp. v. Martin, 137 N.J. Eq. 433, 34 A.2d 454 (1946); Farmers' State Bank of Gwinner v. First Nat'l Bank of Forman, 51 N.D. 225, 199 N.W. 961 (1924); Cambridge Production Credit Ass'n v. Patrick, 140 Ohio St. 521, 45 N.E.2d 751 (1943); Strahorn-Hutton-Evans Commission Co. v. Florer, 7 Okla. 499, 54 P. 710 (1898); First Nat'l Bank in Dalhart v. Flack, 222 S.W.2d 455 (Tex. Civ. App. 1949), rev'd, 148 Tex. 495, 226 S.W.2d 628 (1950).

Although they are not synonymous, the concepts of "actual notice" and "knowledge" are used interchangeably in this article because "the effects produced by [notice] are undeniably the same which would result from actual knowledge." 2 J. PomeroY, supra note 389, § 592 (emphasis in original). And see U.C.C. § 1-201(25).
simpliciter on the part of the later creditor as in Thompson.603 The same result would have been reached in each case simply on the basis of the later party's knowledge at the time it took its interest as in Davidoff.

Most courts and commentators believe that section 9-312(5)(a) is a "pure-race" statute and that a later secured party's knowledge of a pre-existing security interest is always immaterial in itself when determining priorities under it.604 Three arguments are typically made to support this belief. The first is that an Official Comment to the section demonstrates that actual notice is irrelevant under it.

A and B make non-purchase money advances against the same collateral. The collateral is in the debtor's possession and neither interest is perfected when the second advance is made. Whichever secured party first perfects his interest (by taking possession of the collateral or by filing) takes priority and it makes no difference whether or not he knows of the other interest at the time he perfects his own.

The result may be regarded as an adoption, in this type of situation, of the idea, deeply rooted at common law, of a race of diligence among creditors.605 But the type of situation envisaged by this comment is unlike that in Da-

603. In neither General Insurance nor Thompson was the later creditor's knowledge of the earlier encumbrance the sole reason for deviating from the priority rule of first to file or perfect in U.C.C. § 9-312(5)(a). See note 590 supra.

These two cases apply the well-known but variously phrased "clog" principle, a term coined by a good friend and colleague with a bent for etymology and lexicography who is the John D. Rockefeller, Sr. of legal gems.

A lack of good faith compounded of actual knowledge and one or more additional lack-of-goodnicks cries out for a handy label. In our acronym-impassioned society, this level of legal inequity should be known as CLOG—compound lack of good faith. In the simple case of Clog v. Unclog, of course, Unclog will always prevail.

Memorandum from Wylie H. Davis to Steve H. Nicules (July 10, 1979).


605. U.C.C. § 9-312, Comment 5, Example 2. This example was relied on in Thompson v. United States, 408 F.2d 1075 (8th Cir. 1970), for example, as partial support for this conclusion: "Generally, notice of a pre-existing, unperfected lien is immaterial under the
In that case the subsequent secured party had knowledge of the

Code." Id. at 1083 n.13. And see also, e.g., Madison Nat'l Bank v. Newrath, 8 UCC Rep. Serv. 1153, 1159 (Md. 1971).

In Nat'l Bank of Sarasota v. Dugger, 335 So. 2d 859 (Fla. Dist. Ct. App. 1976), the court relied on U.C.C. § 9-312, Comment 5, Example 3 to support its conclusions that "[t]he U.C.C. priority scheme is purely a race provision—first in time, first in right," and that "knowledge is irrelevant" under § 9-312(5). Id. 335 So. 2d at 860. See also J. White & R. Summers, supra note 604, § 25-4, at 906 n.4. But this particular illustration dealing with a very limited fact situation is not a sound foundation for a general rule that knowledge is always immaterial under § 9-312(5). The example given is this:

A has a temporarily perfected (21 days) security interest, unfiled, in a negotiable document in the debtor's possession under Section 9-304(4) or (5). On the fifth day B files and thus perfects a security interest in the same document. On the tenth day A files. A has priority whether or not he knows of B's interest when he files, because he perfected first and has maintained continuous perfection of filing.

U.C.C. § 9-312, Comment 5, Example 3. Technically this result is not inconsistent with a rule which makes actual knowledge material under U.C.C. § 9-312(5)(a) because in this example the first secured party was "perfeated" before the subsequent secured party's interest attached. The problem this article considers is one where a first secured party has not filed or perfected before a subsequent creditor, who knows of the earlier interest, causes his own security interest to attach. See note 606 infra. There may be additional reasons why the example quoted above does not necessarily mean that actual knowledge is in all other cases immaterial under § 9-312(5)(a). For example, overriding policy considerations perhaps should control this peculiar type of situation. See generally U.C.C. § 9-304, Comment 4.

In In re Smith, 326 F. Supp. 1311 (D. Minn. 1971), the court relied on another example in the § 9-312 commentary to support its view that knowledge of an earlier interest has no bearing on priorities under § 9-312(5)(a). Comment 5, Example 1 gives this situation:

A files against X (debtor) on February 1. B files against X on March 1. B makes a non-purchase money advance against certain collateral on April 1. A makes an advance against the same collateral on May 1. A has priority even though B's advance was made earlier and was perfected when made. It makes no difference whether or not A knew of B's interest when he made his advance.

But the important point the court overlooks is that in this situation B knew of A's interest when B took his interest because of A's prior filing. Once again, this example does not address the precise issue with which this article is concerned. The problem this article addresses involves the case where A was not perfected when B took and perfected his interest, and B claims he should have priority despite his actual knowledge of A's unrecorded interest. In U.C.C. § 9-312, Comment 5, Example 1, however, A was perfected before B acquired his interest and no issue regarding actual knowledge is raised.

This is not to say, however, that the situation described in Example 1 raises no other problems. Here is a situation, much like Example 1, posed by Professor William F. Young, Jr., of Columbia.

A and B perfect competing security interests in a debtor's machinery—A by filing and B by filing or otherwise—in the order suggested by their names. A claims priority over B not only for his initial advance, but also for one made after B has perfected his interest, both obligations being "covered by" his initial security agreement.

Young, Book Review, 66 Colum. L. Rev. 1571, 1576-77 (1966). This problem involves the priority not only of A's first advance, but also his future advances. A literal interpretation of the first-to-file-or-perfect rule in § 9-312(5) would give priority to A for all his advances. An illustration contained in both the 1962 and 1972 uniform versions of Article 9 also supports this result:

On February 1 A makes an advance against machinery in the debtor's possession and files his financing statement. On March 1 B makes an advance against the same machinery and files his financing statement. On April 1 A makes a further
other interest not only at the time it perfected, but also at the time its

advance, under the original security agreement, against the same machinery (which is covered by the original financing statement and thus perfected when made). A has priority over B both as to the February 1 and as to the April 1 advance and it makes no difference whether or not A knows of B's intervening advance when he makes his second advance.

U.C.C. § 9-312, Comment 7, Example 5 (emphasis added). And under the 1962 Official Text and Comment, see id., Comment 4, Example 4.

Professor Young believes this result “is a bit thick,” and he suggests “that the picture might . . . be softened by reference to meta-Code concepts—factors such as B’s expectations, A’s knowledge, and the voluntariness of the future advance.” Young, supra herein, at 1577. Pre-Code law usually took into account in such cases (such as the ones suggested by Young and the example just quoted) the knowledge of one in the position of A.

Prior to the Uniform Commercial Code the states adopted diverse rules on whether an optional (as opposed to an obligatory) future advance would relate back to take priority from the date of the original security agreement. The majority rule was that optional advances made before the advancing creditor received actual notice of an intervening lien related back to the state of the original security interest. A minority of jurisdictions adopted what was known as the Michigan rule in which, although the prior lien was effective to secure the future advance, the lien was effective only from the date the future advance was made. Intervening encumbrancers took priority over subsequent future advances. Another minority view, based on earlier English precedent, held that optional future advances related back regardless of actual notice of intervening liens “for it was the Folly of the second Mortgagee, with Notice, to take security.”

Kimbell Foods, Inc. v. Republic Nat’l Bank of Dallas, 557 F.2d 491, 503-04 (5th Cir. 1977) (emphasis added), aff’d sub nom., United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979). The Fifth Circuit in Kimbell Foods stated its opinion that “the ubiquitous U.C.C., at least with respect to competing security interests perfected by filing, adopted the third rule.” Id. at 504. But the court emphasized that in the case before it the result would not be different if the first rule, i.e., the actual notice one, were applied. See id.

Before it can be said, however, that U.C.C. § 9-312(5) and § 9-312(7), as added by the 1972 amendments to the uniform Article 9, clearly adopt the third rule listed in Kimbell Foods, courts and commentators should consider the policy arguments more thoroughly than they have so far done. Perhaps the results can and should be softened by considering the commercial realities and by making reference to meta-Code concepts or equitable principles with respect to the effect of actual knowledge in this type of future advances case under the literal language of U.C.C. § 9-312(7).

Even under a literal interpretation of U.C.C. § 9-312(7), however, there is an argument in cases somewhat like Kimbell Foods that the second secured party should prevail over the first. Suppose the facts in U.C.C. § 9-312, Comment 7, Example 5, except when B makes his advance, the debtor owes nothing to A. Under U.C.C. § 9-312(7), A’s priority as to his future advances will be the same as that of his original advance if A’s future advances were made “while a security interest is perfected by filing.” Technically, when A made his future advance, or at least an instant before he made it, his security interest was not perfected. Perfection requires the attachment of a security interest and the taking of the appropriate applicable steps for perfection. U.C.C. § 9-303(1). But until A made the optional future advance to B, he had no attached security interest because no value was outstanding. The original advance had been paid off. Therefore, when A made the future advance it was at a time when A had no interest to perfect, and, therefore, § 9-312(7) literally will not give A the priority which would have been accorded A’s original advance. This argument was made to the Arkansas Supreme Court in Associated Business Investment Corp. v. First Nat’l Bank of Conway, 264 Ark. 611, 573 S.W.2d 328 (1978). See Reply Brief of Appellant at 2-5, Associated Business Investment Corp. v. First Nat’l Bank of Conway, supra. But the court did not mention the appellant’s argument or even cite U.C.C. § 9-312(7) regarding the priority of future advances. In fact, the court failed to cite any portion of § 9-312.
security interest attached and before value was given. The comment to section 9-312 provides only that knowledge at the time of perfection is immaterial and is silent on the effect of knowledge at the time of attachment.\(^{606}\)

The rule deeply rooted in pre-Code law for determining priorities between secured creditors where the later encumbrancer knew of an earlier attached interest at the time he gave value and took his interest was not based on the idea of a pure race of diligence.\(^{607}\) All the authorities agree that under the majority rule a creditor's failure to take possession of his collateral or to record his interest did not subordinate it to a later encumbrancer with notice who does. According to Pomeroy, American courts adopted and followed with "great uniformity" the doctrine established very early by the English courts of chancery that

a notice of some kind, of an existing prior, unrecorded conveyance, oper-

\(^{606}\) Referring to an earlier, but essentially identical, version of U.C.C. § 9-312, Comment 5, Example 2 (see text accompanying note 605 supra). Professor Gilmore observed:

The passage quoted does not, of course, squarely meet the problem we are discussing: that is, the effect of knowledge of the earlier interest at the time the later interest attaches (the Comment talks of knowledge at the time either interest is perfected). The pre-Code rules, which subordinated a later security interest to an earlier unperfected interest known to the later secured party, were presumably referring to knowledge at the time the later party gave value; after both parties were committed, the "race of diligence" took up. The Comment, on examination, turns out to be enigmatic.

2 G. GILMORE, supra note 425, § 34.2 at 900-01.

The issue of the effect of actual notice acquired before the subsequent purchaser has parted with value is the problem addressed in this article. Professor Gilmore's presumption about the pre-Code rules is undoubtedly correct. See 2 J. COBBY, supra note 509, § 607; 1 L. JONES, supra note 509, § 313. See also note 607 infra. And see, e.g., Capital Finance Co. v. Karp, 75 Ohio App. 210, 61 N.E.2d 505 (1945); City of Buffalo v. Easton Boot & Shoe Co., 187 Pa. 30, 40 A. 107 (1898).

607. The "race of diligence" is run only when the parties' equities are equal. See 2 J. POMEROY, supra note 389, §§ 413-415, 519. But in determining

When . . . the different equities simultaneously subsisting with respect to the same subject-matter [are] "equal" . . . or on the other hand, what renders them "unequal," so that one shall have an essential inherent superiority over another . . . the doctrine of Notice plays a most important part. When a person is acquiring rights with respect to any subject-matter, the fact whether he is so acting with or without notice of the interests or claims of others in or upon the same subject-matter is regarded throughout the whole range of equity jurisprudence as a most material circumstance in determining the extent and even the existence of the rights which he actually acquires. In conformity with this view, the general rule has been most clearly established, that a purchaser with notice of the right of another is in equity liable to the same extent and in the same manner as the person from whom he made the purchase. The same rule may be thus expressed in somewhat different language: a person who acquires a legal title or an equitable title or interest in a given subject-matter, even for a valuable consideration, but with notice that the subject-matter is already affected by an equity or equitable claim in favor of another, takes it subject to that equity or equitable claim. On the other hand, a person who acquired a title, and paid a valuable consideration, without any notice of an equity actually existing in favor of another, may by that means obtain a perfect title, and hold the property freed from the prior outstanding equity.

Id. § 591 at 601-02 (emphasis added). And see text accompanying note 608 infra and see also note 609 infra.
This rule applied to chattel mortgages and to other personal property
security devices, including the conditional sale and the trust receipt.

Throughout the United States the doctrine is settled that the registration of an instrument in pursuance of the recording acts operates as a constructive notice to all subsequent purchasers. Whatever be the language of any state statute, the result of a registration—that it should be a constructive notice—is uniformly regarded as the most important object of the entire legislation—the final purpose for which the whole system of recording was established. By this American doctrine, the constructive notice given by registration stands on exactly the same footing, produces the same effects, and is of the same nature as any other species of absolute constructive notice recognized by equity, as, for example, that arising from a lis pendens or from a recital or that operating upon a principal through his agent. In all these instances the notice is a conclusive presumption of the law, and it is immaterial whether or not any information of the prior right was actually brought home to the consciousness of the party affected thereby. As, therefore, the one important and necessary effect of a registration, in pursuance of the American statutes, is to create and impose upon subsequent purchasers a constructive notice of a recorded instrument, it seems to be the natural and inevitable consequence of this view, that any other species of notice, either constructive or actual, should, in the absence of a record, produce the same effect on the rights of a subsequent purchaser. The registration of an instrument is constructive notice; and this result was the main design of the legislation. It is therefore natural, just, and equitable that if a subsequent purchaser has received any other kind of notice, actual or constructive, the same effect upon his rights should be produced as would have followed from the single species of constructive notice occasioned by the statute. . . . [This rationale] dispenses with the notice of fraud as a necessary element, which in very many admitted instances of notice must be a mere figment of judicial logic; it avoids all the inconsistencies which are incidents of that notion; and finally, it accords with the intent and purpose of the recording acts as recognized by the vast majority of American decisions.

Id. at 886-87.

Even before the enactment of chattel mortgage recording acts when the law required the mortgagee to take possession of the collateral, subsequent purchasers from a mortgagor in possession were not protected if they had actual notice of the prior mortgage. See, e.g., Fowler v. Merrill, 52 U.S. 375 (1850), where the Court, citing Le Neve v. Le Neve, supra herein, said

According to some cases, this conduct of [the purchasers in taking the property with notice of an existing mortgage] under such circumstances would seem more fraudulent than any by the [earlier mortgagee in leaving the mortgagor in possession]. [The answer to the complaint by the earlier mortgagee against the subsequent purchasers] should have avowed the want of notice, not only before the sale, but before the payment of the purchase-money. Till the actual payment the buyer is not injured, and it is voluntary to go on or not when informed that the title is in another.

Id. at 395. Of course, before the advent of recording statutes, no practical differences existed between the pledge and the chattel mortgage. “[A] chattel mortgagee, once he takes possession, is a pledgee for all practical purposes.” Glenn, The Chattel Mortgage as a Statutory Security, 25 Va. L. Rev. 316, 317 (1939). Delivery to and continued possession of the collateral by the pledgee were necessary to the validity of a pledge. But in some cases where the property was not delivered to the pledgee, the courts imposed equitable liens on the collateral, see authorities cited note 506 supra and see RESTATEMENT OF SECURITY § 10 (1941), and equitable liens are enforceable against third parties with notice. See notes 556 & 557 supra. Without resorting to the equitable liens doctrine, however, the common law in some instances enforced pledges against third parties who were not bona fide, i.e., without notice, even though the collateral had been returned to the pledgor. See RESTATEMENT OF SECURITY § 11(2), Comment c (1941). Enough has been said here to establish that the equitable doctrine with respect to the sufficiency of actual notice was not simply a statutory rule but a principle of equity or common law rule which arose and existed apart from legislative formulations.
And in most jurisdictions the priority of a purchaser of real estate subject

610. The Uniform Conditional Sales Act (hereinafter cited as U.C.S.A.) expressly conditioned the priority of a subsequent purchaser over an unrecorded conditional sales contract on the purchaser's lack of notice. See U.C.S.A. § 5 (act withdrawn 1943), which is quoted at text accompanying note 628 infra. Under nonuniform statutes providing for the filing or recording of conditional sales contracts

complications sometimes arise as to their proper construction in cases where they have not been complied with but it is claimed that such fact is immaterial due to notice or knowledge of the existence of the contract on the part of one who has dealt with the conditional buyer concerning the property sold. These complications are frequently chargeable to the variant specifications in the collective statutes, for their provisions are by no means uniform as to the conditions under which the rights of third parties are intended to be protected by the recording acts. As a matter of principle, the constructive notice afforded by a record of the contract supplies the effect that actual knowledge of the existence and contents of the contract would produce. By the same principle, the presence of actual notice or knowledge of the contract for all purposes renders superfluous the recording of the contract. Agreeably to the logic of such a situation, if either one of such conditions exist, the other is unnecessary and its presence would neither add to, nor detract from, the rights or liabilities of any interested party. It is correct to say that the constructive notice of the record is a substitute for actual notice, but it is equally appropriate to say that actual notice is a substitute for, and fulfills all the purposes of the constructive notice imparted by a public record.

Consonant with this reasoning, even though the statute, expressly or by implication, makes the contract void as to named persons unless it is filed or recorded, without mentioning the effect of actual notice, nevertheless the conditional vendor's rights will be preserved as against all who have actual notice of those rights.

3 L. JONES, supra note 509, § 1076 at 149-50, 151 (emphasis added). Among the states which enacted statutes requiring the recording or filing of conditional sales contracts prior to the promulgation of the Uniform Conditional Sales Act, it was "well established that only purchasers without notice of the conditional nature of the buyer's interest should be protected." U.S.C.A. § 5, Commissioner's Note (act withdrawn 1943).

But even in the absence of recording acts, some courts held that subsequent purchasers with actual notice of a conditional sales contract took subject to it, although many courts took the position that all purchasers, even good faith ones without notice, acquired no title from a conditional vendee. For a review of the early cases on the rights of purchasers from a conditional vendee, see Harkness v. Russell, 118 U.S. 663 (1886). And see generally Glenn, The Conditional Sale at Common Law and as a Statutory Security, 25 VA. L. REV. 559 (1939).

611. UNIFORM TRUST RECEIPTS ACT § 9(2)(b) (act withdrawn 1943) established the principal rules for determining priorities between the interest of an entruster and that of pledgees, mortgagees and other claimants of security interests created by contract. The subsection provided that

In the absence of filing, the entruster's security interest in goods shall be valid, as against purchasers, save as provided in this Section; but any purchaser, not a buyer in the ordinary course of trade, who, in good faith and without notice of the entruster's security interest and before filing either (i) gives new value before the expiration of thirty day period specified in Subsection 1 of Section 8 or (ii) gives value after said period, and who in either event before filing also obtains delivery of goods from a trustee shall hold the subject matter of his purchase free of the entruster's security interest . . . .

Id. (emphasis added).

In short, those who give new value and receive delivery before filing defeat the entruster's security interest without having to give the entruster thirty days in which to file as do those who give value only. Of course, an absence of knowledge on the part of the purchaser is implicit in both instances.

G. McCOWAN, TRUST RECEIPTS 80 (1947) (emphasis added).
to an unrecor ded mortgage still depends on whether or not the purchase was without actual notice of the unperfected prior encumbrance. Professor Gilmore states the rule succinctly: “Under most pre-Code security statutes, and at common law, . . . the unperfected security arrangement is good against a subsequent ‘purchaser’ (for security or otherwise) if the purchaser has actual knowledge of the earlier interest.”

Clearly, therefore, a common law or pre-Code rule exists to support the decision in **Davidoff**, and the Official Comment quoted above does not control the facts of that case. But the proponents of the pure-race interpretation of section 9-312(5)(a) have a second argument based upon the existence of section 9-401(2). This provision is that “[a] filing made in good faith in an improper place or not in all the places required by this section is nevertheless effective with regard . . . to collateral covered by the financing statement against any person who has knowledge of the contents of such financing statement.” The existence of this section appears to belie the conclusion that section 9-312(5)(a) is anything other than a pure-race statute. The pure-race advocates ask, “If actual notice is relevant under section 9-312(5)(a), why did the drafters include section 9-401(2)?” They conclude that section 9-401(2) is a limited exception to a general rule that actual knowledge is immaterial under section 9-312(5)(a).

The existence of section 9-401(2) is not, however, inconsistent with a

---


613. See text accompanying notes 640-643 infra.

614. 2 G. GILMORE, supra note 425, § 34.2 at 896.

615. See text accompanying note 605 supra.
race-notice interpretation of section 9-312(5)(a).\textsuperscript{616} The Uniform Chattel Mortgage Act\textsuperscript{617} by its express language made actual notice relevant in determining priority between an unrecorded chattel mortgagee and a purchaser of the collateral.\textsuperscript{618} But the Act also contained a provision similar to Article 9's section 9-401(2). It provides that "[w]here an instrument . . . is filed in good faith . . . in an improper filing district or office or in only one of a greater number of filing districts required for particular subject matter, filing shall nevertheless be effective with regard to such subject matter, as against any person who has actual notice of the mortgage."\textsuperscript{619} The reason for including this provision in the Chattel Mortgage Act may have been simply to insure that the actual notice which is effective to subordinate subsequent purchasers includes that of an improperly filed instrument. Similar reasoning can explain the existence of section 9-401(2) if section 9-312(5)(a) is interpreted to make actual notice relevant in determining priorities under it.\textsuperscript{620}

The final and most substantial argument supporting a pure-race interpretation of section 9-312(5)(a) is based on the "silence theory." According to it, the absence of words such as "without actual notice" in section 9-312(5)(a) clearly demonstrates the drafters' intention to displace the common law and pre-Code rule making actual knowledge relevant in deciding priorities. The pure-race advocates argue that the drafters were fully aware of the pre-Code rule and meant to continue it under Article 9 only when a section expressly conditions a subsequent creditor's priority on his lack of actual notice.\textsuperscript{621} The problem with this theory is how to justify attaching so much significance to the drafters' silence about the effect of actual knowledge under section 9-312 when they were vocal

\textsuperscript{616} As used in this article, "race-notice" means that the first person to record his interest gains priority only if he did not know about an earlier unperfected encumbrance at the time his own interest attached or, more precisely, at the time he gave value.

\textsuperscript{617} The Act was approved by the National Conference of Commissioners on Uniform State Laws in 1926. One state, Indiana, adopted it prior to its withdrawal in 1943. See HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 307 (1943).

\textsuperscript{618} "The mortgagee's interest shall be defeated by any purchaser who without notice thereof . . . gives value and obtains delivery of the subject matter or perfects his lien thereon, before the instrument evidencing the mortgage is duly filed." UNIFORM CHATTEL MORTGAGE ACT § 42(1)(a) (act withdrawn 1943) (emphasis added). "Purchaser" included one "taking by conditional sale, lease, mortgage, pledge, and the acquisition of any specific lien, legal or equitable, by contractual acts." \textit{Id.} at § 1. "Notice of the mortgage" meant "knowledge of such facts as would put a reasonably diligent person on inquiry leading to the ascertainment of the mortgagee's interest." \textit{Id.}

\textsuperscript{619} \textit{Id.} at § 56.

\textsuperscript{620} The only reason the drafters give for including U.C.C. § 9-401(2) is to reject "the occasional decisions that an improperly filed record is ineffective to give notice even to a person who knows of it." U.C.C. § 9-401, Comment 5. This justification is not inconsistent with the explanation suggested in the text.

\textsuperscript{621} See generally, \textit{e.g.}, Felsenfeld, \textit{supra} note 604, at 248-51.
about its effect under other major priority sections. Particularly im-

622. In most Article 9 sections which contain an express caveat about knowledge, the effect is to make knowledge a factor in determining priorities. See, e.g., §§ 9-301(1)(c)(d); 9-
301(4); 9-307(2); 9-307(3); 9-308(a). But in several instances the reference to knowledge is
there to indicate the opposite effect, i.e., that knowledge by the subsequent party does not
change the result dictated by the priority rule. See §§ 9-307(1); 9-308(b); 9-312(2). And see
the text immediately following this note and that accompanying note 623 infra.

Earlier versions of Article 9 make knowledge relevant in determining priority between a
secured party and a lien creditor. § 9-301(1)(b) of the 1962 Official Text, for example, pro-
vides that "an unperfected security interest is subordinate to the rights of . . . a person who
becomes a lien creditor without knowledge of the security interest and before it is perfected."
The 1972 Official Text eliminates the element of knowledge as a factor in determining
whether a lien creditor may defeat an unperfected security interest. See § 9-301(1)(b). The
stated reason for the change appears important to the question about the relevance of actual
knowledge in determining priorities under U.C.C. § 9-312(5)(a), but it is not conclusive of
the issue.

The justification for eliminating the knowledge element under § 9-301(1)(b) is that
the former section denied the lien creditor priority even though he had no know-
ledge when he got involved by extending credit, if he acquired knowledge while
attempting to extricate himself. It was completely inconsistent in spirit with the
rules of priority between security interests, where knowledge plays a very minor
role.

Review Committee for Article 9, Reasons for Changes Made in Former Text of Article 9 § 9-301
(Oct. 1970). Here the mechanics tinkering with Article 9 clearly state a general rule that
knowledge is usually immaterial in determining priorities between secured parties. But look
closely at their statement. It can easily be read this way: Since knowledge acquired after the
giving of value plays a very minor role in determining priority between secured parties, it
should also be unimportant in deciding priority between lien creditors and secured parties.
Such a reading helps to explain why the statement refers to the lien creditor’s knowledge at
the time credit is extended by him to the debtor. The statement does not necessarily mean
that knowledge acquired by a subsequent secured party prior to the time of giving value is unim-
portant under § 9-312(5)(a).

Even if this reading is rejected, however, the statement still does not help to explain the
original intent behind the silence of § 9-312(5)(a) with respect to the effect of actual knowl-
dge. The Review Committee’s Reason for Change regarding § 9-301 was written long after
the version of § 9-312(5) which first was silent about the effect of actual knowledge. The
statement may simply have been a reflection of and submission to the pure-race interpreta-
tion of § 9-312(5)(a) which prevails among the courts and other legal writers. See authorities
cited note 604 supra. The Review Committee was apparently more concerned with perpetu-
ating uniform results than it was with examining the theoretical soundness of existing prece-
dents, none of which fully considers the reasons supporting a race-notice interpretation. The
Committee said

it would be a great mistake to introduce serious non-uniformity into any funda-
mental aspect of operations under Article 9. The Code must remain uniform in its
day-to-day impact and operation . . . . Thus the proposed changes must be com-
patible in operating with the existing Code, and the Committee has eschewed amendment
merely for the sake of theoretical improvement where there was no pressing problem illust-
trated by non-uniform amendments or by substantial demand for change.

Review Committee for Article 9, General Comment on the Approach of the Review Committee for
Article 9 (Oct. 1970) (emphasis added). The Committee apparently decided initially to em-
phasize the purposes and policies of the Code qua code when making recommendations for
change. But the approach suggested in this article for deciding doubtful cases under the
Code eschews undue emphasis on the purposes and policies detailed in § 1-102. See text
accompanying notes 378-380 supra. The weight to be given the Review Committee’s dictum
about the relevance of knowledge in determining priority between secured parties must be
measured in light of its deliberate decision to ignore the theoretical soundness of the prece-
important is the express language of section 9-307(1) which provides that "a buyer in the ordinary course of business . . . takes free of a security interest created by his seller . . . even though the buyer knows of its existence." Why did the drafters include the language "even though the buyer knows of its existence" if silence about the effect of actual notice under Article 9 means that it is always immaterial?  

...dent they attempt to perpetuate. Some might argue, however, that the elimination of the knowledge condition from U.C.C. § 9-301(1)(b), aside from the Review Committee's explanation, is by itself an important factor to consider when interpreting § 9-312(5)(a). There now is an inconsistency between § 9-301(b) and § 9-312(5)(a), if knowledge is found to be material in determining priorities under the latter section. If there is an inconsistency, however, that fact is not important in terms of the construction to be given § 9-312(5)(a) in light of pre-Code law. It was not unusual under chattel mortgage statutes, for example, to make actual notice material in deciding the rights of subsequent purchasers but not in determining those of lien, judgment or other creditors. Here are some illustrative statements concerning the interpretation frequently given typical pre-Code statutes:  

We think the law upon this point is established that, as to a purchaser having knowledge of the mortgage lien, he is bound, but as to the judgment creditor such mortgage is actually void, notwithstanding he may have had notice of its existence brought home to him.  


[A] subsequent mortgagee taking a mortgage with actual notice and knowledge of a prior mortgage is not a mortgagor in good faith . . . . But the rule applicable to a mortgagee in good faith, is not applicable to a general creditor. A mortgagee may give credit solely upon the faith of the mortgage security, which, if taken in good faith, is valid. The lien created by it arises from the acts of the parties, while the lien of a levy arises by operation of law. No question of good faith has anything to do with it.  

Houk v. Condon, 40 Ohio St. 569, 574 (1884).  

[In the chattel mortgage act . . . good faith shall be required only of purchasers, mortgagees, etc., of the original mortgagor; but in the case of creditors, the instrument shall be absolutely void as to them, no matter whether they acted in good faith or not in crediting the mortgagee or in seeking to enforce their debts against the mortgaged property.  

[The first section of the [chattel mortgage] act is almost in the exact language of similar statutes in many other states. Such, for instance, as New York, New Jersey, Ohio, Michigan, Nebraska, Minnesota and others; and in all those states, whenever the point has come under decision, it has always been held that good faith was not required of creditors in order to enable them to avoid a chattel mortgage, not filed and deposited as required by the act.  

Brothers v. Mundell, Munzesheimer & Co., 60 Tex. 240, 246 (1883). Good faith was routinely defined to include lack of notice of a pre-existing but unrecorded interest. See notes 629 & 630 infra and text accompanying them. A case contrary to the above is Pattee v. Harbough, 82 Or. 612, 171 P. 221 (1918), but there a statute specifically defined purchaser to include attaching creditors.  

Therefore, to the extent an inconsistency does exist between the materiality of actual knowledge as it affects the priority of subsequent lien creditors and secured parties (if § 9-312(5) is interpreted to make actual notice material), the inconsistency is not original with Article 9. Lien creditors were treated differently under pre-Code law, perhaps for good reason. After all, the committee responsible for explaining the reason for change with respect to U.C.C. § 9-301(1)(b), also had this to say about the lien creditor: "He is not directly part of the Code's system of priorities." Review Committee for Article 9, Reasons for Changes Made in Former Text of Article 9 § 9-312 (Oct. 1970).  

623. The same question can be asked about these sections:
The problem with the silence theory is compounded by Professor Gilmore's admission that "without knowledge" language may have been omitted from section 9-312(5)(a) by mistake and not by design. He suggests that if such a "considerable change" in prior law had been intended, the drafters would have found a better way of accomplishing it than by simply keeping quiet about the effect of a subsequent secured party's knowledge of an earlier interest at the time he takes his own.

Another important factor to consider in evaluating the silence theory is the language of pre-Code statutes governing the recodification of security interests in personal property and the priorities among competing claimants. Some of them expressly provided that only a subsequent purchaser "without notice" is prior to an earlier unrecorded interest. The Uni-

---

A purchaser of chattel paper or an instrument who gives new value and takes possession of it in the ordinary course of his business has priority over a security interest in the chattel paper or instrument . . . which is claimed merely as process of inventory subject to a security interest (Section 9-306) even though he knows that the specific paper or instrument is subject to a security interest.

U.C.C. § 9-308(b) (emphasis added).

A perfected security interest in crops for new value given to enable the debtor to produce the crops during the production season and given not more than three months before the crops become growing crops by planting or otherwise takes priority over an earlier perfected security interest to the extent that such earlier interest secured obligations due more than six months before the crops become growing crops by planting or otherwise even though the person giving new value had knowledge of the earlier security interest.

U.C.C. § 9-312(2) (emphasis added).

---

624. See 2 G. GILMORE, supra note 425, § 34.2 at 898-901. "It is, however, less than crystal clear that this was an intended, deliberate change in policy from pre-Code law, and the argument can be made with some degree of plausibility, that the apparent meaning of the relevant provisions of the Article should be disregarded." Id. at 898. "Neither the text of subsection (5) nor the accompanying Comment is conclusive on whether, with respect to the case of the earlier unperfected interest, the lack of reference to knowledge was by design or inadvertence." Id. at 901. And Professor Gilmore concludes, "No knowledge limitation appears expressly in § 9-312(5)(a), although it is possible that one might be implied." Id. § 36.7 at 975-76.

625. Id. at 901.

626. Here is a sampling of cases decided under statutes which conditioned a subsequent purchaser's priority over an unrecorded chattel mortgage on the purchaser's lack of actual notice. The word "purchaser" is used throughout the text and in this footnote, as it typically was in chattel mortgage recording acts, to include mortgagees as well as buyers. Some of the cases cited here, however, determine the rights of other types of third party claimants, such as lien creditors. But the statutory rules quoted or relied upon in all the following cases require a purchaser to take without notice of an unrecorded chattel mortgage if he is to prevail, and this is why they are cited: United States v. Suring State Bank, 150 F. Supp. 60 (E.D. Wis. 1957); Crooks v. Stuart, 7 F. 800 (D. Iowa 1881); Copeland v. Tennessee Valley Bank, 238 Ala. 364, 191 So. 243 (1939); Finney v. Dryden, 214 Ala. 370, 108 So. 13 (1926); Neely v. Reynolds, 196 Ala. 581, 72 So. 124 (1916); Williams v. White, 165 Ala. 336, 51 So. 559 (1910); Dixie v. Harrison, 163 Ala. 304, 50 So. 284 (1909); Hickey v. McDonald Bros., 160 Ala. 300, 48 So. 1031 (1909); Nolen v. Farrow, 154 Ala. 269, 45 So. 183 (1907); Couch v. Holmes, 151 Ala. 503, 43 So. 858 (1907); Grimmer v. Nolen, 146 Ala. 466, 40 So. 97 (1906); Dearing v. Watkins, 16 Ala. 20 (1849); Bolling v. Carter & Womack, 9 Ala. 921 (1846); Smith & Co. v. Zurcher, 9 Ala. 208 (1846); Albertville Trading Co. v. Brooks, 22 Ala. App. 147, 113 S. 473 (1927); Ragner v. General Motors Acceptance Corp., 66 Ariz. 157, 185 F.2d
form Chattel Mortgage Act is an example. “The mortgagee’s interest shall be defeated by any purchaser who without notice thereof . . . gives

value and obtains delivery of the subject matter or perfects his lien thereon, before the instrument evidencing the mortgage is duly filed. . . ."[627] The Uniform Conditional Sales Act also recognized the importance of notice other than that provided by filing. "Every provision in a conditional sale reserving property in the seller, shall be void as to any purchaser from or creditor of the buyer, who, without notice of such provision, purchases the goods . . . before the contract or copy thereof shall be filed as herein provided, . . ."[628]

Many of the early statutes, however, did not have express language concerning the relevance of a subsequent purchaser's actual notice. Those dealing with chattel mortgages are good examples. Typically they provided that purchasers, including subsequent mortgagees, would take free of an unrecorded prior mortgage but only if the purchase was made in "good faith."[629] Routinely, however, good faith was defined to include

627. **Uniform Chattel Mortgage Act** § 35(1)(a) (act withdrawn 1943). "'Purchaser' means any person taking by purchase and any legal successor in interest of such person." [Id. § 1]. "'Purchase' includes taking by conditional sale, lease, mortgage, pledge, and the acquisition of any specific lien, legal or equitable, by contractual acts." [Id. § 1].

628. **Uniform Conditional Sales Act** § 5 (act withdrawn 1943). "'Purchase' includes mortgage and pledge." [Id. § 1].

629. Here is a sampling of cases decided under recording statutes which conditioned a subsequent purchaser's priority over an unrecorded chattel mortgage on the purchaser's good faith. The word "purchaser" is used throughout the text of this article and in this footnote, as it typically was in chattel mortgage recording acts (see, e.g., 2 J. Cobby, supra note 509, at 611), to include mortgagees as well as buyers of the collateral. Some of the cases cited here, however, determine the rights of other types of third party claimants, such as lien creditors. But the statutory rules quoted or relied on in all the following cases require a *purchaser* to take in good faith in order to prevail over an unrecorded chattel mortgage, and this is why they are cited: Peoples Sav. Bank v. Bates, 120 U.S. 556 (1887); Stewart v. Platt, 101 U.S. 731 (1879); Smith v. Mangels, 73 Ariz. 203, 240 P.2d 168 (1952); Moore v. Chilson, 26 Ariz. 244, 224 P. 818 (1924); Teater v. Good Hope Development Corp., 14 Cal. 2d 196, 93 P.2d 112 (1939); Lemon v. Wolff, 121 Cal. 272, 53 P. 801 (1898); Cardenas v. Miller, 108 Cal. 250, 39 P. 783 (1895); Fette v. Lane, 4 Cal. Unrep. 813, 37 P. 914 (1894); Harms v. Silva, 91 Cal. 636, 27 P. 1088 (1891); Schuch v. Northrup-Jones, Inc., 328 P.2d 279 (1958); Bush v. Bank of America Nation'l Trust & Savings Ass'n, 1 App. 2d 588, 37 P.2d 168 (1934); Fred C. Silverthorn & Sons v. Pacific Fin. Corp., 133 Cal. App. 163, 23 P.2d 798 (1933); Latenser v. Schied, 126 Kan. 490, 268 P. 855 (1928); Farmers' & Merchants' Bank v. Bank of Glen Elder, 46 Kan. 376, 26 P. 680 (1891); Howard v. First Nat'l Bank, 44 Kan. 549, 24 P. 983 (1890); Casner v. Crawford, 4 Kan. App. 687, 46 P. 41 (1896); Security Trust Co. v. Tuller, 243 Mich. 570, 220 N.W. 795 (1928); People v. Burns, 161 Mich. 169, 125 N.W. 740 (1910); Read v. Horner, 90 Mich. 152, 51 N.W. 207 (1892); Kohl v. Lynn, 34 Mich. 360 (1876); Doyle v. Stevens, 4 Mich. 87 (1856); Yethevevill v. Spencer, 3 Mich. 123 (1854); Miller Motor Co. v. Jaax, 193 Minn. 85, 257 N.W. 653 (1934); Griffin v. Minnesota Sugar Co., 162 Minn. 240, 202 N.W. 445 (1925); St. Paul Title Ins. & Tr. Co. v. Berkley, 32 Minn. 497, 55 N.W. 60 (1893); Dyer v. Thorstad, 35 Minn. 534, 29 N.W. 345 (1886); McNeil v. Finnegern, 33 Minn. 375, 23 N.W. 540 (1885); Tolbert v. Horton, 31 Minn. 518, 18 N.W. 647 (1884); Bank of Farmington v. Ellis, 30 Minn. 270, 15 N.W. 243 (1883); Chester State Bank v. Great Northern Ry. Co., 58 Mont. 44, 190 P. 136 (1920); John Caplice Co. v. Beauchamp, 22 Mont. 258, 56 P. 278 (1899); First Nat'l Bank v. Young, 14 Neb. 598, 247 N.W. 586 (1933); State Bank of Lushton v. O.S. Kelly Co., 49 Neb. 242, 68 N.W. 481 (1896); Wagner v. Steffin, 38 Neb. 392, 56 N.W. 933 (1893); Railsback v. Patton, 34 Neb. 490, 52
taking without actual notice of an existing but unperfected interest.630


630. Generally see authorities cited note 629 supra, but here is a representative sampling of opinions about the relationship between good faith and notice: "[T]he words 'mortgagee in good faith' means the same thing as 'mortgagee for a valuable consideration without notice.'" Peoples Sav. Bank v. Bates, 120 U.S. 556, 564 (1887).

The term 'good faith' . . . is borrowed from equity jurisprudence and must be
Section 9-312(5)(a) is similar to the priority sections of most chattel

constituted accordingly. Our courts have frequently held that an unrecorded mortgage
is not void as against a subsequent purchaser or incumbrancer who has actual
knowledge of the previous lien for the reason that he does not acquire his interest
in good faith.
(1934). "[A] subsequent mortgagor with notice of a prior mortgage is not a subsequent
mortgagee in good faith. . . ." Farmers' & Merchants' Bank v. Bank of Glen Elder, 46

To say that a man takes in good faith when he acts with notice . . . would be a
legal solemnism. The object of the statute here is that of all the other registry acts,—
to prevent imposition upon subsequent purchasers and mortgagees, who must
many times govern themselves by appearances. When everything is actually explained
to them, they have the best kind of notice, and must be held to take subject to prior incumbrance.
Howard v. First Nat'l Bank, 44 Kan. 549, 24 P. 983 (1890). "[A]s to subsequent purchasers
and mortgagees notice is equivalent to filing." People v. Burns, 161 Mich. 169, 125 N.W.
740, 742 (1910).

[N]otice of the existence of an unpaid prior mortgage of personal property destroys
the preference which the second mortgagee would otherwise be entitled to claim in
consequence of the omission of the first mortgagor to refile his mortgage within the
period prescribed by statute; that he was not a subsequent mortgagee in good
faith, within the meaning of the statute.
Read v. Horner, 90 Mich. 152, 51 N.W. 207, 209 (1892). "So far as the statute relates to
'subsequent purchasers and mortgagees in good faith,' is to be taken as settled by the decisions
of this court construing the statute relating to chattel mortgages, . . . that a purchaser
with actual notice acquires no preference from the absence of required registration." Dyer
v. Thorstad, 35 Minn. 534, 29 N.W. 345, 346 (1886).

Was the defendant a mortgagee in good faith, within the meaning of the statute,
in view of the fact that he had actual notice of the prior mortgage upon the
property? By force of the statute . . . both want of registration and of transfer of
possession are made to affect the rights of creditors and subsequent purchasers.
The effect of the statute as a registry law is not here involved; and we need only say
that its object and purpose, so far as subsequent purchasers and mortgagees are
concerned, is to protect them against secret or unknown conveyances by reason of
which they, purchasing in ignorance of prior vested rights, might be prejudiced,
. . .—and that under such statutes actual notice of the prior conveyance has gen-

erally, if not always, been deemed to make the fact of non-registration immaterial
want of notice, is an essential element of good faith, or bona fide, as those terms are
used in registry statutes and in equity jurisprudence.

Tolbert v. Horton, 31 Minn. 518, 18 N.W. 647, 648 (1884) (emphatic in original).

A mortgagee who has notice, either actual or constructive, of the rights of another
to a prior chattel mortgage is not a mortgagee in good faith and his lien will be
subordinated to the rights of that other. A mortgagee in good faith is one who
takes a chattel mortgage to secure a debt actually and justly owing to him without
actual or constructive notice of the prior equities against the mortgaged property.

'good faith' as employed in the statute, have been construed by this court as synonymous
with the words 'without notice.'" Osco Motors Corp. v. Martin, 137 N.J. Eq. 433, 45 A.2d
454, 457 (1946).

'[Good] faith' consists in an honest intention to abstain from taking any unconsci-
tenious advantage of another, even through the forms of technicalities of law, to-
gether with an absence of all information or belief of facts which would render the
transaction unconscientious. 'Good faith' has frequently been defined by the decisions
of the courts as synonymous with the words 'without notice' . . .

And see 2 J. COBBEY, supra note 509, § 611; 1 L. JONES, supra note 509, § 312.

HeinOnline -- 34 Ark. L. Rev. 94 1980-1981
mortgage statutes in that it does not expressly provide that a subsequent secured party must be without actual notice of an earlier unrecorded security interest to have priority over it. But it does not, as most chattel mortgage statutes did, express qualify the later creditor's priority on his "good faith." The section is, however, part of an integrated code providing in its first article that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." To pursue seriously the silence theory as supporting a pure-race interpretation of section 9-312(5)(a) requires its advocates to decide (a) whether or not the good faith obligation imposed by section 1-203 extends to the relationship between secured parties dealing with a common debtor's property and (b) if good faith is to be defined, as it was under the chattel mortgage statutes, to require the taking an interest in property without knowledge of an earlier one. If the answers are "yes," then section 9-

631. U.C.C. § 1-203.

632. The Eighth Circuit apparently thought it did in Thompson v. United States, 408 F.2d 1075 (8th Cir. 1969); see discussion of this case at text accompanying notes 585-589 supra. And see General Ins. Co. of America v. Lowry, 570 F.2d 120 (6th Cir. 1978); Central Soya Co. v. Bundrick, 137 Ga. App. 63, 222 S.E.2d 892 (1975). And, according to the Code drafters, "the general policies of this Act... require good faith not only between the parties to the sales contract, but as against interested third parties..." U.C.C. § 2-236, Comment 2 (emphasis added).

Clearly, however, the subsequent secured party owes an obligation of good faith to the debtor. An important question to ask, therefore, is whether there are any considerations which suggest that this obligation owed the debtor, regardless of any owed earlier creditors, is violated by the subsequent creditor lending money on collateral which he knows will not fully collateralize him and the earlier creditor. The concerns and interests of debtors generally should be factors which are considered when evaluating priority rules and deciding how to interpret and apply them. See text accompanying notes 640-643 supra.

633. This issue raises a level question of law. Here are several of them: First, what standard of good faith is to apply, i.e., that prescribed in § 1-201(19), § 2-103(1) or a standard pulled into the Code through § 1-103? For a thorough analysis of the different standards of good faith under the Code, see Summers, "Good Faith" in General Contract Law and the Sales Provision of the Uniform Commercial Code, 54 Va. L. Rev. 195, 219-216 (1968). See also Note, 23 U. Pitt. L. Rev. 754 (1962). Regarding the standard to be applied under Article 9, at least in one particular type of case, see, e.g., Notes, 14 B.C. Indus. & Comm. L. Rev. 343 (1972); 4 Cum-Sam. L. Rev. 168 (1973); 17 U. Miami L. Rev. 524 (1973); 51 N.C. L. Rev. 646 (1973); 4 Rutgers-Camden L.J. 132 (1972).

Second, what types of conduct generally are within the range of activity prohibited by the appropriate standard of good faith, i.e., what is bad faith? For a helpful analysis, but one not dealing directly with the issue raised in the text, see Summers, supra herein, at 220-252. And see generally Eisenhart, Good Faith Under the Uniform Commercial Code—A New Look at an Old Problem, 54 Marq. L. Rev. 1 (1971). It has been argued, however, that for a lack of good faith to affect priority results under U.C.C. § 9-312(5), it must involve "some leading on or other basis for estoppel." Bloom v. Hilty, 427 Pa. 463, 234 A.2d 860, 864 (1967), citing 1 P. Coogan, W. Hogan & D. Wagts, Secured Transactions Under the Uniform Commercial Code 177 n.23 (1967).

Third, if a good faith requirement is imposed under § 9-312(5)(a) because of § 1-203, in what sense is the concept of good faith used in § 1-203, i.e., the performance or the purchase sense? See generally Farnsworth, Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code, 30 U. Chi. L. Rev. 666 (1963). Does it matter?

Fourth, does the answer to the third question depend upon the answers to the first and
312(5)(a) is closely analogous to a great many chattel mortgage statutes which were silent in their express language about the effect of actual notice on priorities but which were interpreted to require that a subsequent purchaser take his interest without knowing of an unperfected one.634

Even if section 1-203 is found not to modify section 9-312(5), a final category of early chattel mortgage statutes must be considered. A few of them did not expressly qualify a subsequent purchaser’s priority on either his lack of actual notice or his good faith.635 But some courts interpreting

second ones, and is the third question completely irrelevant if a good faith requirement and standard are imposed under § 9-312(5)(a) on the basis of principles introduced through § 1-103 and not on the basis of § 1-203? Cf. Seay v. Davis, 246 Ark. 201, 438 S.W.2d 479 (1969),

rehearing denied, 246 Ark. 627, 438 S.W.2d 481 (1969). There a creditor accelerated the

maturity of a promissory note because the maker was late in making a payment. The court first

held that this situation was governed by U.C.C. § 1-208 and that the creditor had no power to

accelerate because he lacked good faith as that section requires. On rehearing, the

creditor argued that the good faith requirement in § 1-208 was applicable only to “whim”

accelerations which was not the case here. The parties’ contract permitted acceleration upon

the debtor’s default and such an event had occurred. The court left that question “open for

future decision” but refused to change its earlier decision. “[E]ven if the appellants are

correct in their construction of the Code the decree [for the debtor] must nevertheless be

affirmed under our prior [pre-Code] decisions. Apart from the Code, ‘... a court of equity

will protect a debtor against an inequitable acceleration of the maturity of the debt’” 438

S.W.2d at 481 (emphasis added). The court said, in effect, that even if the Code does not

impose an obligation of good faith in such a case as this, one should and will be imposed

based upon equitable principles. And what good faith means in such a case will be deter-

mined by pre-Code principles, as well. Generally in accord with Seay is Brown v. Avemco

Investment Corp., 603 F.2d 1367 (9th Cir. 1979).

Fifth, are all these questions immaterial if the analysis focuses on the good faith, or lack

thereof, vis-a-vis the subsequent secured party and the debtor and not that between the two

creditors? See note 632 supra.

634. See notes 629 & 630 supra and text accompanying them.

635. These cases were decided under recording statutes which were silent about the

actual notice or good faith of third party claimants and hold that purchasers and others gain

priority over an unrecorded chattel mortgage even though they know about it: Brandes v.

Barner, 13 F.2d 53 (8th Cir. 1926); Standard Computing Scale Co. v. Adam, 292 F. 344 (9th

Cir. 1923); Dean v. Planters Nat’l Bank of Hughes, 176 F. Supp. 909 (E.D. Ark. 1959); In

re Watson, 99 F. Supp. 49 (W.D. Ark. 1951); Sims v. McFadden, 217 Ark. 810, 233 S.W.2d 375

(1950); Connell v. Robinson, 217 Ark. 1, 128 S.W.2d 5 (1950); Primm v. Farrell-Cooper Lbr.

Co., 210 Ark. 699, 197 S.W.2d 557 (1946); Ruddell v. Rees, 146 Ark. 259, 225 S.W. 316

(1920); Merchants’ & Farmers’ Bank v. Citizens Bank, 125 Ark. 131, 187 S.W. 650 (1916); Franklin

v. Meyer, 36 Ark. 96 (1880); Main v. Alexander, 9 Ark. 112 (1848); Clark v. Baker, 30 Colo. 199, 69 P. 506 (1901); Frank v. Miner, 50 Ill. 444 (1869); Collateral Finance Co. v.

Braud, 298 Ill. App. 130, 18 N.E.2d 392 (1938) (regarding discussion of Ch. 95, § 4, Ill. Rev.

Stat., as it existed prior to 1931); Kahreman v. Dunbar, 152 Ill. App. 34 (1909); Roberts v.

Kingsbury, 71 Ill. App. 451 (1897); People v. Hamilton, 17 Ill. App. 599 (1885); Franklin

Nat’l Bank v. Whitehead, 149 Ind. 569, 49 N.E. 592 (1899); Kennedy v. Shaw, 38 Ind. 474

(1872); Lockwood v. Slevin, 25 Ind. 124 (1866); Chenyworth v. Daily, 7 Ind. 284 (1855);

Lewiston Trust Co. v. Devono, 145 Me. 224, 74 A.2d 457 (1950); Hayden v. Russell, 119 Me.

38, 109 A. 485 (1920); Garland v. Plummer, 72 Me. 397 (1881); Rich v. Roberts, 48 Me. 543

(1860); Sheldon v. Conner, 48 Me. 584 (1859); Connecticut Valley Onion Co. v. Pieclick, 281

Mass. 287, 183 N.E. 526 (1932); Smith v. Howard, 173 Mass. 88, 53 N.E. 143 (1899); Rawlings

v. Bean, 80 Mo. 614 (1883); Wilson v. Milligan, 75 Mo. 41 (1881); Bevans v. Bolton, 31

Mo. 437 (1862); Bryson v. Penix, 18 Mo. 13 (1853); Humphreys Sav. Bank v. Carpenter, 213
these statutes still subordinated the claim of a later purchaser who took his interest with actual knowledge of an earlier unrecorded one.\textsuperscript{636} They

\textsuperscript{636} See note 635 supra and text accompanying.

It should be noted, however, that courts construing statutes which were literally silent about subsequent purchasers' actual notice or good faith were often severely constrained in their interpretations by the clarity and definiteness of the statutory language. Language such as this was not uncommon: "[N]o mortgage of goods, chattels, or personal property shall be valid, as against the rights and interests of any other person than the parties thereto, unless the possession of such goods, chattels, or personal property be delivered to and retained by the mortgagee, or the mortgage . . . be acknowledged and filed as hereinafter provided."\textsuperscript{7} Milburn Mfg. Co. v. Johnson, 9 Mont. 527, 24 P. 17 (1890) (emphasis added). Construing a similar statute the Supreme Court of Nevada said "The language of the statute is plain and unambiguous, and the plain implication is that if possession is not taken, or the mortgage not recorded, it is absolutely void as against all persons except the parties thereto."\textsuperscript{8} Simpson v. Harris, 21 Nev. 353, 31 P. 1009, 1013 (1893). "The language is so plain that no room is allowed for construction."\textsuperscript{9} Id. 31 P. at 1013, quoting Lockwood v. Slevin, 26 Ind. 124, 125 (1867). Many of the earlier "silent" chattel mortgage statutes can be distinguished from U.C.C. § 9-312(5)(a). No one can honestly say that its provisions are so plain with respect to the significance of actual notice that no room for construction is allowed.

The pre-Code "silent" chattel mortgage statutes may also differ in other respects from Article 9. The Arkansas statute, for example, provided literally that a mortgage of real or personal property did not become a lien on the collateral until it was filed.\textsuperscript{10} Ark. STAT. ANN. § 51-1002 (Repl. 1971) (statute limited to real estate mortgages by Ark. Acts 1961, No. 185, § 10-102(3)). But even under a literal reading of Article 9, it is impossible to argue that the attachment of a security interest to collateral is in any way dependent upon its perfection.\textsuperscript{11} See U.C.C. § 9-203.

636. In First Nat'l Bank v. Lawrence, 207 So.2d 907 (La. App. 1968), \textit{not issued}, 251 La. 1082, 208 So.2d 537 (1968), \textit{not dismissed}, 253 La. 54, 216 So. 2d 304 (1968), the court considered the significance of an amendment to the state's chattel mortgage recording act. Prior to 1944 the act provided, inter alia, that "an order to affect third persons without notice theretofore shall be recorded."\textsuperscript{12} Id. at 909 (emphasis in original). After a 1944 amendment, however, "the Statute no longer contained the wording 'without notice.'"\textsuperscript{13} Id. The appellant in the case was a subsequent mortgagee who had acquired
reasoned that the purpose of a registry act was fulfilled when a later credi-
actual knowledge of appellee's earlier but improperly recorded chattel mortgage before it
4 took its interest. The appellant argued that its actual knowledge was immaterial under the
registering act as amended. The court disagreed.

[All of the jurisprudence on this subject since the 1944 amendment has not given
5 the meaning to the deletion from the statute of the words "without notice" that
6 appellant would have us give it. The purpose of the Statute requiring registry and
7 registration is to make third parties aware of the existence of a mortgage so that
8 they will not act to their detriment. Where a person is already possessed of this
9 knowledge, the objective of the registry statute has already been accomplished.

Id. at 910.

Md. CONVEYANCING CODE ANN. Art. 21, § 41 (repealed by the adoption of the U.C.C.,
1963 Md. LAWS, Ch. 538 § 1), provided:

No personal property, of any description whatever, whereof the vendor, mort-
4 gagee or donor shall remain in possession, shall pass, alter or change, or any prop-
5 erty therein be transferred to any purchaser, mortgagee or donee, as against
6 subsequent purchasers, mortgagees, incumbrancers, landlords with liens, pledges,
7 receivers, and creditors who acquired a lien by judicial proceedings on such per-
8 sonal property, unless by bill of sale or mortgage acknowledged and recorded as
9 herein provided . . .

The predecessor of this provision was enacted in 1729 and was construed in Hudson v.
16 Warner & Vance, 2 H. & G. 415 (Md. 1828). The appellant argued that an unrecorded
17 chattel mortgage was void against third parties even though they may have had actual
18 notice. The court rejected the argument.

The act of assembly of 1729, ch. 8, had for its object the suppression of secret sales.
19 By demanding that transfers should be recorded, it was intended, that notice
20 should be given, that no one might be injured or deluded by secret and unknown
21 conveyances.

It's object then, being to protect creditors from prior secret conveyances, any
22 such creditor, who had notice of such an incumbrance, could not be considered as
23 falling in the class of those for whose benefit the act was passed. For when he had
24 notice, how could he be considered as injured by the conveyance? We cannot give
25 the act the narrow construction, which seems to be contended for, that no notice
26 was sufficient to gratify the law, but such as was derived from the registry of the
27 deed; for such a construction would invalidate transfers, which, it is obvious, from
28 the general tenor of the act, it was not the purpose of its framers to disturb, or
29 interfere with. Any other kind of notice of the transfer, which demonstrates the
30 existence of a lien, or the transfer of a right, brought home to the party who seeks
31 to avoid such a lien or transfer, will be sufficient.

Id. at 430-31 (emphasis in original). And see Note, 21 Md. L. REV. 160 (1961) (which discusses
33 1729 Act and subsequent history).

In Fergus County v. First State Bank, 67 Mont. 1, 213 P. 1114 (1923), the court ob-
35 served that:

Section 3861 of the Civil Code of 1895 provided that a chattel mortgage
37 should be void as against creditors of the mortgagor and subsequent purchasers or
38 incumbrancers of the property in good faith unless the property was delivered to and
39 retained by the mortgagee, or, if the property remained in possession of the mort-
40 gagee, it was accompanied by an affidavit of good faith . . . While this statute
41 was in force, this court held that a subsequent purchaser or incumbrancer to
42 successfully assail the validity of a prior mortgage which had not been filed as
43 required by law must have become such purchaser or incumbrancer in good faith.

Id. at 213 P. at 1115 (emphasis added). The court then noted that the statute had been amended
45 to eliminate

the statement that a chattel mortgage should be void as against creditors of the
48 mortgagor and subsequent purchasers and encumbrancers in good faith unless the
49 mortgaged property was delivered to and retained by the mortgagee or accompa-
50 nied by the affidavit of good faith, and simply provided that the mortgage must be
51 signed, acknowledged and have the affidavit of good faith attached thereto.
tor had actual notice even though a prior interest was not recorded in compliance with the statutes. The plain intention of recording acts is

Id. Despite the amendment, however.

Reading this section in connection with the other provisions of the act, it is apparent that the purpose of the act was to designate what mortgages could be filed, and thereby give constructive notice to creditors and subsequent purchasers and incumbrancers in good faith and to such only . . . , and that there was no intent on the part of the Legislature to declare that one who obtained a mortgage upon personal property with actual knowledge of the existence of a prior informal or unfiled mortgage thereon, thereby secured a superior lien.

Id. (emphasis added). And in Hackney v. Bireley, 67 Mont. 155, 215 P. 642 (1923), the Montana Supreme Court quoted this statute: "Every mortgage of personal property made, acknowledged, and filed, as provided by the laws of this state, is thereupon, if made in good faith, good and valid as against the creditors of the mortgagor, subsequent purchasers or incumbrancers from the time it is filed, during its life." Id. 215 P. at 644. The court said that "by the terms of [the above statute] three classes are protected against a mortgage of which they have no notice: Creditors, subsequent purchasers, subsequent incumbrancers." Id. 215 P. at 645 (emphasis added).

In Blevins v. W.A. Graham Co., 72 Okla. 308, 182 P. 247 (1919), the Oklahoma Supreme Court was faced with an issue similar to that in First Nat'l Bank, supra, and Fergus County, supra. The state's chattel mortgage recording statute had at one time provided that an unrecorded chattel mortgage was void against subsequent purchasers and incumbrancers in good faith. A new statute omitted the words "in good faith." The court said

We cannot believe that the Legislature of Oklahoma intended to inaugurate a new policy or to declare that one who knew of an existing incumbrance might ignore it and acquire property free from any lien, if he but paid some consideration to the seller . . . . The purchase of the statute was to give constructive notice to those whose dealings were in good faith, and who had no actual knowledge of the facts.

Id. 182 P. at 248.

As a final example of courts' constructions of "silent" statutes in terms of "good faith" and "actual notice," there is Gooding v. Riley, 50 N.H. 400 (1870). The statute in this case provided "that no such [chattel] mortgage shall be valid against any person except the mortgagor, his executors and administrators, unless possession is delivered, or the mortgage is sworn to and recorded in the manner herein prescribed." Id. at 404. The precise issue in the case was "whether a subsequent mortgagee, with full knowledge of the plaintiff's mortgage that it was made upon full consideration and in good faith, can take advantage of the want of the affidavit prescribed by the statute to the truth and justice of the plaintiff's mortgage." Id. at 403. But the court surveyed the precedents on the issue whether "actual notice will supercede the necessity of a record of personal property mortgages." Id. at 410. The court observed that

In respect to real estate, it is well settled in New Hampshire that a purchaser, with knowledge of a prior conveyance that is valid between the parties, cannot, even at law, avoid it by insisting upon the want of registry or acknowledgement, or even the prescribed number of witnesses. And yet the law, Rev. St., ch. 130 § 4, is explicit, that no conveyance of real estate shall be valid against any person but the grantor and his heirs only, unless the deed be attested, acknowledged, and recorded.

Id. at 404. The court remarked that this was the doctrine with respect to real estate in England and in other American states. And it reasoned that since the chattel mortgage recording act at issue in the case was enacted "long after it had become a settled and well known rule of construction that notice of the conveyance of real estate was equivalent to registration," id. at 411, the same construction should be applied to the chattel mortgage act. "Had it been otherwise, it is inconceivable that the difference should not have been expressed." Id.

And see discussion of Howard v. McPhail, 37 R.I. 21, 91 A. 12 (1914), note 637 infra. In addition, see 1715 N.C. Sess. Laws, ch. 1715 § 11 and its interpretation in Pike v. Armstead,
"to secure subsequent purchasers and mortgagees against prior secret conveyances and fraudulent incumbrances. Where a person had no notice of a prior conveyance, there the registering his subsequent conveyance shall prevail against the prior; but, if he had notice of a prior conveyance, then that was not a secret conveyance by which he could be prejudiced. . . . [H]e can be in no danger when he knows of another incumbrance, because he might then have stopped his hand from proceeding. . . . [I]t would be a most mischievous thing if a person, taking . . . advantage of the legal form appointed by [a registry act] might under that protect himself against a person who had a prior equity, of which he had notice."637

Since the main design of recording acts is to give constructive notice to subsequent parties dealing with the debtor,

It is therefore natural, just, and equitable that if a subsequent purchaser has received any other kind of notice, actual or constructive, the same effect upon his rights should be produced as would have followed from the single species of constructive notice occasioned by statute.638

This same reasoning can be used to interpret section 9-312(5)(a). As

16 N.C. 110 (1827). [This and other North Carolina recording statutes are discussed in Comment, 28 N.C. L. Rev. 305 (1950).]

Similar reasoning can be used to interpret U.C.C. § 9-312(5)(a). Presumably the drafters were aware of the majority rule under chattel mortgage acts, as well as under real estate recording acts, that actual notice was material in determining priority between successive mortgagees of the same collateral. If they clearly intended such a considerable change in the law, as Professor Gilmore dubs it, see text accompanying notes 624 & 625 supra, it is inconceivable that the change would not have been more unambiguously expressed.

637. Howard v. McPhail, 37 R.I. 21, 91 A. 12, 16 (1914) (emphasis in original), quoting Le Neve v. Le Neve, 26 Eng. Rep. 1172 (1748). And see note 636 supra. Howard involved the construction of this statute:

No mortgage of personal property hereafter made shall be valid as to the assignee in insolvency of the mortgagor, or any other person except the parties thereto and their executors and administrators, until possession of the mortgaged property be delivered to and retained by the mortgagee, or the said mortgage be recorded, * * * which said recording or taking and retention of possession as aforesaid shall be made or taken within five days from the date of the signing thereof. Howard v. McPhail, id. 91 A. at 13. The first mortgagee failed to record his mortgage within the five days required by the statute. The second mortgagee took his interest with full knowledge of the first mortgage but claimed priority because of the first mortgagee's delay in recording. The court noted a general principle of equity under which the subsequent mortgagee's actual notice would bind and subordinate him. Then it asked, "Does [the subsequent mortgagee] escape the effect of the equitable doctrine which we are now considering by reason of the language of the statute in question?" Id. 91 A. at 16. The court answered, "No." One of the reasons for this result was the accepted construction of real estate recording acts.

The principle announced in Le Neve v. Le Neve as applicable to the rights of a subsequent purchaser or mortgagee, having actual notice of a prior unrecorded mortgage, notwithstanding the unqualified language of a registry act, has been generally accepted by courts of equity and textwriters upon the subject from 1747 to the present. It has been followed by this court as a proper interpretation of a registry statute and as stating an exception to be understood as modifying the absolute language of such statutes when the language, upon a literal reading, appears to be in conflict with the purpose of such acts . . . .

Id. 91 A. at 17. For a discussion of Le Neve v. Le Neve, see note 609 supra.

638. 2 J. POMEROY, supra note 398, § 665 at 886.
beautifully systematic as it may be, the notice-filing scheme of Article 9 serves the same function as the early chattel mortgage recording acts. It is only a means to an end, not an end in itself. What is important is that the subsequent creditor received notice of the earlier interest and not simply the way in which he did. This principle was recognized under all the various types of chattel mortgage statutes, including those which were silent about the effect of actual notice and which did not expressly condition the subsequent purchaser's priority on his good faith.\textsuperscript{639} Therefore, the fact that section 9-312(5)(a) is also silent cannot necessarily mean that actual knowledge is immaterial under it.

To this point the analysis establishes that ample pre-Code authority exists for construing section 9-312(5)(a) as a race-notice statute and that nothing in Article 9 clearly expressly displaces the common law rule which makes a subsequent purchaser's knowledge of an earlier interest material in deciding priorities. The question which now must be asked is whether the perpetuation of the rule tends more certainly to further the orderly conduct of commercial transactions than would its displacement. The answer requires a consideration of the commercial realities.

The principal purpose of any form of notice to subsequent creditors is to protect them. If they know about existing or potential interests, then they deal with the debtor at their own risk. Prudent lenders will not make loans on previously encumbered collateral unless the value of the property warrants it. Prudence in this regard, however, also benefits the debtor. It helps to protect him against the possibility of a deficiency judgment by insuring that loans will be made only if lenders are fully collateralized.\textsuperscript{640} The debtor is usually unconcerned about the relative priority of his creditors. He is concerned, however, that the property he uses as collateral is sufficient to satisfy all their claims should he default. Allowing a subsequent secured party who knows of an earlier interest to gain priority by being the first to perfect under section 9-312(5)(a) denies the debtor this protection. A subsequent creditor with actual notice of a prior unperfected security interest may be induced to lend the debtor money on collateral he knows is insufficient to satisfy his indebtedness and that of an earlier secured party because of the priority he can gain by being the first to file a financing statement.

The only reason given to support a literal interpretation of the first-to-file-or-perfect rule of section 9-312(5)(a) is the certainty it affords in determining priorities among creditors.

Under 9-312(5) no disappointed secured creditor can trump up facts

\textsuperscript{639} See notes 635-37 supra and text accompanying them.

\textsuperscript{640} If the proceeds resulting from the disposition of the collateral fail to satisfy the expenses and obligations detailed in U.C.C. § 9-504(1), "the debtor is liable for any deficiency." U.C.C. § 9-504(2).
from which a compassionate court might find knowledge on the part of the competitor. If the competitor filed first or perfected first, as the case may be, that’s the end of it; he wins even if he knew of the other party’s prior but unperfected claim.641

Undoubtedly, certainty in determining priorities promotes the orderly conduct of commercial transactions. It tends “to simplify . . . the law” which is an underlying purpose or policy of the Code.642 But this reasoning based on the importance of certainty in the law relates only to the situation between and among creditors. It fails to account for the possible effect on debtors of a priority rule based only on a pure race of diligence run by secured parties. The competitor who knows of an earlier but unperfected security interest also knows that he can gain priority by filing first. He may “Trump up” facts suggesting to the debtor that the collateral is worth more than it actually is. Subordinating the interest of the earlier secured party may be just punishment for his failure of diligence. But this result also has the effect of encouraging lending practices which are detrimental to the financial and economic interests of the debtor and of his creditors generally, including the one who is rewarded for his diligence.

Chances are that a debtor’s financial condition is unstable, at best, if he must attempt to use the same property to secure two loans which together exceed the value of the collateral. The second loan may be the straw which breaks his financial back. It probably would not have been made except for the priority which the second lender could attain by perfecting before the earlier secured party does. If the further indebtedness does result in the debtor’s financial downfall, the first perfected secured party must engage in sometimes lengthy, perhaps expensive and always risky foreclosure proceedings to reap the fruits of his priority. The possibility always exists that the embarrassed debtor will elect or be forced into bankruptcy where even a perfected security interest may be defeated by the trustee.643 The end result can easily be that the priority gained by the subsequent secured party nets him nothing. The moral is that the loan should not have been made in light of the earlier encumbrance actually known by the later creditor to exist.

These commercial realities suggest circumstances under which the interests of debtors and secured creditors may be better served by a race-notice interpretation of section 9-312(5)(a). Protecting them from undercollateralization is at least as important an objective as insuring cer-

642. See U.C.C. § 1-102(2)(a).
643. A perfected security interest, for example, may often be characterized as a preference which under the old Bankruptcy Act and the new Bankruptcy Code can sometimes be avoided by the trustee. See 11 U.S.C. § 60 (1970) (act superseded 1978); 11 U.S.C. § 547 (1978). And under both bankruptcy sections, the important time to consider when determining whether a transfer can be avoided is the time when the transfer is perfect. See note 557 supra.
tainty in determining priorities among competing claimants. Supplementing section 9-312(5)(a) with the common law rule regarding the effect of actual knowledge on priorities does then promote the orderly conduct of commercial transactions. Since nothing in Article 9, including its silence on the issue, mandates that the rule be displaced, it should be perpetuated.

D. "Or Otherwise" Authorizations To Dispose Of Collateral Resulting In the Waiver Of Security Interests

The courts have been willing to supplement section 9-312(5)(a) and other priority provisions with more familiar common law rules and equitable principles. The use of estoppel in the following situation is a good example. X has a perfected security interest in D's property. D seeks additional non-purchase money financing from Y and offers as collateral some of the same property in which X has its interest. Y does not examine X's properly filed financing statement but, instead, asks X what property belonging to D is subject to X's security interest. X tells Y about its interest in some of the property but fails to disclose its interest in the very property which D has offered as collateral for Y's loan. Y makes the loan and perfects a security interest in the property it believes is unencumbered.

A priority dispute arises between X and Y. X contends that, as the first to perfect, it has priority under section 9-312(5)(a). Y argues that X's failure to reveal its interest in the collateral amounts to a misrepresentation which estops X from relying on its security interest or the priority which section 9-312(5)(a) literally affords. In such a case Mansion State Bank v. Diamond, the court determined that X's "nonstatements" pre-

644. Estoppel "means simply that someone is 'stopped' from claiming or saying something; usually he is stopped from saying the true facts or claiming a lawful claim, and usually this is because of some prior inconsistent statement or activity." D. Dobbs, supra note 386, § 2.3 at 41-42. Estoppel is used here in the equitable, not the promissory, sense. Equitable estoppel is the effect of the voluntary conduct of a party whereby he is absolutely precluded, both at law and in equity, from asserting rights which might perhaps have otherwise existed, either of property, of contract, or of remedy, as against another person, who has in good faith relied upon such conduct, and has been led thereby to change his position for the worse, and who on his part acquiring some corresponding right, either of property, of contract, or of remedy.

3 J. Pomeroy, supra note 389, § 804 at 189. An equitable estoppel case has three important elements:

The actor, who usually has knowledge of the true facts, communicates something in a misleading way, either by words, conduct or silence. The other relies upon that communication. And the other would be harmed materially if the actor is later permitted to assert any claim inconsistent with his earlier conduct.

D. Dobbs, supra note 386, § 2.3 at 42. U.C.C. § 1-103 specifically provides that estoppel is among the principles of law and equity which shall supplement the provisions of the Code unless displaced by them.

645. 227 N.W.2d 195 (Iowa 1975).
vented it from asserting the priority of its security interest.\textsuperscript{646}

Estoppel has also been argued by a buyer of collateral against a secured party suing it for conversion.\textsuperscript{647} In United States v. gleaners & Farmers

\textsuperscript{646} The court determined that the essential elements of equitable estoppel were present because (1) X falsely represented or concealed material facts, \textit{see id.} at 201-202; (2) Y did not know the true facts (despite the financing statement properly filed by X), \textit{see id.} at 202-204; (3) X intended for Y to act upon X’s misrepresentation or concealment, \textit{id.} at 204; and (4) Y relied to its prejudice. \textit{See id.} at 204.

Other courts have considered arguments to vary the priority rules of U.C.C. § 9-312 on the basis of estoppel. \textit{See, e.g.,} Borg-Warner Acceptance Corp. v. First Nat’l Bank, 307 Minn. 20, 238 N.W.2d 612 (1976); Peoples Bank & Trust v. Reiff, 256 N.W.2d 336 (N.D. 1977); Manufacturers Acceptance Corp. v. Penning’s Sales, Inc., 487 P.2d 1053 (Wash. App. 1971). And \textit{see American Nat’l Bank of Denver v. Tina Marie Homes, Inc.,} 476 P.2d 573 (Colo. Ct. App. 1970). In Mammoth Cave Production Credit Ass’n v. York, 429 S.W.2d 26 (Ky. 1968), a subsequent secured party, who failed to perfect its purchase money security interest within the ten days permitted by U.C.C. § 9-312(4), argued generally that § 9-312(5) leads to unjust results and should not be followed. The facts were that the PCA had an unperfected security interest in all the debtor’s equipment, present and after-acquired. Several months after the debtor and PCA executed their security agreement, debtor purchased a item of new equipment from a seller who retained a security interest, failed to perfect it and assigned the interest to Commercial Credit. Subsequently, PCA perfected its existing security interest in all the debtor’s equipment. Commercial Credit argued “that principles of estoppel should be indulged in to prevent the unjust result of having a subsequently filed security agreement take priority over their reserved security interest.” \textit{id.} 429 S.W.2d at 28.

The court rejected the argument. Observing that U.C.C. § 9-312(5) controls the issue involved, the court said

This rule explicitly applies to that situation in question, a purchase money security interest not filed within the ten-day grace period given. It must be remembered that the purpose of the code is to set the rules of the road by which business decisions and practices are to be regulated. To go outside the overall scheme of the code in a situation where the code is unambiguous would lead to much confusion in the business world. . . . Once a vendor fails to take advantage of the special provisions set out in the code for his protection, he is placed on the same footing as any other secured party.

\textit{Id.} 429 S.W.2d at 28.

The Florida Supreme Court has been more sympathetic toward a purchase money secured party who fails to file within the ten-day period prescribed in § 9-312(4). In International Harvester Cr. Corp. v. American Nat’l Bank, 296 So. 2d 32 (Fla. 1974), the court held that under § 9-312(5)(a) the priority of an earlier secured party in the debtor’s newly acquired equipment is limited to the debtor’s equity in the after-acquired property. The court justified its decision “[u]pon principles of equity and in the avoidance of unjust enrichment. . . .” \textit{Id.} 296 So. 2d at 34. \textit{But see generally, e.g.,} Nat’l Bank & Trust Co. v. Moody Ford, Inc., 149 Ind. App. 479, 273 N.E.2d 757 (1971); Uniroyal, Inc. v. Michigan Bank, 12 UCC Rep. Serv. 745 (Mich. Cir. Ct. 1972); Evans Products Co. v. Jorgensen, 245 Ore. 362, 421 P.2d 978 (1966).

\textsuperscript{647} Under pre-Code law, “[a] purchaser of property upon which there is a valid mortgage who consumates or sells the property or any part of it is liable to the mortgagee for the damages so occasioned him . . . .” 2 L. JONES, supra note 509, § 490 at 264. And \textit{see S. EAGER, THE LAW OF CHATTEL MORTGAGES AND CONDITIONAL SALES AND TRUST RECEIPTS} § 190 (1941). Some courts held that the purchaser converted the mortgaged property simply by buying it without the mortgagee’s permission. \textit{See, e.g.,} Sternberg v. Strong, 158 Ark. 419, 250 S.W. 344 (1923).

Ingram, without paying the mortgage indebtedness, sold a part of the mortgaged property to Sternberg without the knowledge or consent of Strong, the mortgagee.
Cooperative Elevator Co. \(^{648}\) the Farmers Home Administration (FmHA) \(^{649}\)

This constituted a conversion of the property, and both Ingram [the debtor] and Sternberg [the purchaser] were liable to Strong for a conversion of it. 

Id., 250 S.W.2d at 347. The Torts Restatement supports the Sternberg holding.

One who receives possession of a chattel from another with the intent to acquire for himself or a third person a proprietary interest in the chattel which the other has not the power to transfer is subject to liability for conversion to a third person then entitled to the immediate possession of the chattel. 

Restatement (Second) of Torts § 229 (1965). According to the commentary accompanying this section,

Where there is a sufficiently serious interference, and the transaction is ineffective to give the actor the proprietary interest he intends to acquire, he is subject to liability to a person who is at the time entitled to immediate possession of the chattel, for its conversion. Thus a purported sale, lease, pledge, gift, or bailment which is ineffectual as against the true owner of the chattel makes the purported purchaser, lessee, pledgee, donee, or bailee subject to liability to the owner for conversion.

Id., Comment b.

Under the rule stated in this Section, one receiving a chattel from a third person with intent to acquire a proprietary interest in it is liable without a demand for its return by the person entitled to possession, although he takes possession of the chattel without knowledge or reason to know that the third person has no power to transfer the proprietary interest. The mere receipt of the possession of the goods under such circumstances is a conversion.

Id., Comment c (emphasis added). But see 2 L. Jones, supra note 509, §§ 490a & 491.

Obviously, however, no purchaser is liable for conversion if for some reason he takes free of the prior encumbrance or if the purchaser's interest is determined to be superior to the earlier one.

The drafters of Article 9 believed that nothing therein displaced the pre-Code rule making a purchaser who took collateral subject to a prior interest liable in conversion in an appropriate case to the earlier encumbrancer.

In most cases when a debtor makes an unauthorized disposition of collateral, the security interest, under prior law and under this Article, continues in the original collateral in the hands of the purchaser. That is to say, since the transferee takes subject to the security interest, the secured party may repossess the collateral from him or in an appropriate case maintain an action for conversion.


Subordinate secured parties have also been held liable in conversion to superior ones. See, e.g., Leasing Service Corp. v. American Nat'l Bank & Trust Co., 19 UCC Rep. Serv. 252 (D.N.J. 1976); United States v. PS Hotel Corp., 404 F. Supp. 1188 (E.D. Mo. 1975), aff'd per
had a perfected security interest in the debtor's crops. The collateral, or part of it, was sold to the Cooperative which was sued by the government. Presumably, the Cooperative could not benefit from any Article 9 priority section protecting buyers of collateral, but it argued estoppel as a de-


It was also true under pre-Code law in some jurisdictions that mortgaged property was not subject to levy and execution by judgment creditors. See U.C.C. § 9-311, Comment 2. Article 9 changes this rule. See U.C.C. § 9-311 & Comment 2 thereto, and see, e.g., Citizens Bank of Lavaca v. Perrin & Sons, Inc., 253 Ark. 639, 488 S.W.2d 14 (1972). But apparently this does not mean that a lien creditor is necessarily immune from conversion liability. See, e.g., Cooper v. Citizens Bank of Gainesville, 129 Ga. App. 261, 199 S.E.2d 369 (1973); Royal Store Fixture Co. v. New Jersey Butter Co., 114 N.J. Super. 263, 276 A.2d 153 (1971); Teddy's Drive In, Inc. v. Cohen, 54 A.D.2d 898, 388 N.Y.S.2d 20 (1976); Murdock & Butkovich, d/b/a/ P & B Oil Co. v. Blake, 484 P.2d 164 (Utah 1971). Where there was a pre-Code rule holding a purchaser liable simply for his act of buying encumbered property, see supra herein, § 9-311 may also change that rule. Cf. Citizens Bank of Lavaca v. Perrin & Sons, Inc., supra herein.

649. The Farmers Homes Administration (FmHA) is an agency of the United States Government which makes direct crop and realty loans to farmers. The FmHA and its various credit programs represent only one example of the federal government's significant role in farm finance. See generally Brake, A Perspective on Federal Involvement in Agricultural Credit Programs, 19 S.D. L. REV. 567 (1974). See also AMERICAN INSTITUTE OF BANKING, AGRICULTURAL FINANCE (R. Cacailler ed. 1969); COMMISSION ON AGRICULTURAL CREDIT, THE FARM CREDIT SYSTEM IN THE 70'S—THE REPORT OF THE COMMISSION ON AGRICULTURAL CREDIT (Including Appendix) (1970). For statistics regarding the extent of the federal government's role in farm related financing, see USDA ECONOMICS, STATISTICS, AND COOPERATIVE SERVICES, BALANCE SHEET OF THE FARMING SECTOR, 1979 (Agric. Info. Bull. No. 430, Augst, 1979); FARM CREDIT ADMINISTRATION, 44TH ANNUAL REPORT OF THE FARM CREDIT ADMINISTRATION AND THE COOPERATIVE FARM CREDIT SYSTEM, 1976-1977 (1978); USDA FARMERS HOME ADMINISTRATION, FARMER PROGRAM STATIS-

50. Even if the Cooperative was a buyer in the ordinary course of business, it could not take free of the security interest because it bought "farm products from a person engaged in farming operations." U.C.C. § 9-307(1). U.C.C. § 9-301(1)(c) was unavailable because the
fense. The FmHA county supervisor had told the Cooperative’s manager before the purchase was made that the government’s security interest covered only the debtor’s livestock and farm equipment and not his crops. The court held that the Cooperative’s allegations of estoppel based on these facts presented a valid defense to the government’s claim.651

Buyers and other parties who are not protected under the priority sections of Article 9 more often rely on the common law waiver principle.652 A typical case involves farm products.653 In Libson Bank & Trust

FmHA’s security interest was perfected. No other priority section is applicable on these facts.

651. The allegations were sufficient to prevent a summary judgment for the government; but the defendant buyer must have been unable to prove the allegations. Ultimately the court sitting without a jury heard the case and entered judgment for the government, and this decision was affirmed. See United States v. Gleaners & Farmers Co-op Elevator Co., 481 F.2d 104, 105 (7th Cir. 1973).

652. Not all courts agree with the lower court’s opinion that the government can be estopped by representations of its officials. See 314 F. Supp. at 1149-1152. Compare, e.g., United States v. E.W. Savage & Sons, Inc., 343 F. Supp. 123 (D.S.D. 1972), aff’d, 475 F.2d 305 (8th Cir. 1973). Also, cf. Champaign County, Ill. v. United States, 611 F.2d 1200, 1205 n.8 (7th Cir. 1979); Abbott v. Harris, 610 F.2d 563 (8th Cir. 1979); Gressley v. Callifano, 609 F.2d 1265 (7th Cir. 1979). Federal regulations explicitly state the circumstances and conditions under which an FmHA lien may be released. See 7 C.F.R. § 1872.4 (1979). For a general discussion of when the United States may be estopped by the acts of its agents and officers, see 1 J. McBride & T. Touhey, Government Contracts § 4.100 (1979). See also Comment, Equitable Estoppel of the Government, 79 Colum. L. Rev. 551 (1979).


654. A commonly accepted definition of waiver is an intentional and voluntary relinquishment of a known right. Undoubtedly, however, “[i] there is no one ‘correct’ definition; it can not be defined without reference to the kind of circumstance to which it is being related.” 3A A. Corbin, supra note 454, § 752 at 478. It is also true that facts which suggest waiver to one court or commentator may suggest estoppel or something else to another. See generally J. Ewart, Waiver Distributed (1917). And see note 692 infra.

655. Goods are “farm products if they are crops or livestock or supplies used or produced in farming operations or if they are products of crops or livestock in their unmanufactured states (such as ginned cotton, wool-clip, maple syrup, milk and eggs), and if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming operations.” U.C.C. § 9-109(3).

Co. *v.* Murray, the Bank loaned debtor money on January 15, 1969, to purchase 48 head of cattle. The loan was secured by a perfected security interest in the herd. Twelve of the cows were sold without the Bank’s knowledge, and it did not receive the proceeds. The debtor ultimately defaulted on his note, and the Bank sued the buyer who, it argued, bought the cattle subject to its security interest. Even if the defendant was a buyer in the ordinary course of business, he could not take free of the Bank’s security interest under section 9-307(1) because (the court assumed) he bought “farm products from a person engaged in farming operations.” Instead, the buyer argued that the Bank waived its security interest in the cattle because the secured party authorized the collateral’s disposition.

Section 9-306(2) provides that “a security interest continues in collateral notwithstanding sale, exchange or other disposition unless the disposition was authorized by the secured party in the security agreement or otherwise . . .” In this case the security agreement was silent about disposition of the collateral by the debtor, but the buyer contended that it was “otherwise” authorized. The contention was based on the conduct of the Bank and the debtor under earlier security agreements between them.

There was evidence . . . [t]he bank started loaning [the debtor] money on his livestock operation in January 1968. Several loans covered by the security agreements were made prior to January 15, 1969. At trial the bank acknowledged a general course of dealing, notwithstanding the security agreements, permitting him to sell collateral and apply the proceeds either to substitutions or on the notes. The bank admitted [the debtor] accordingly sold hogs and horses on several occasions but denied that he was authorized to sell cattle. There had been only one earlier cattle loan and those cattle had evidently not been sold at the time of the loan involved in this case. There was no evidence of any communication from the bank to [the debtor] making any distinction as to cattle.

The court in *Lisbon Bank* found that this evidence established a “course of dealing” between the parties which resulted in a “waiver” of the Bank’s security interest.

---


654. 206 N.W.2d 96 (Iowa 1973).

655. 206 N.W.2d at 97. Under U.C.C. § 9-307(1), a buyer in the ordinary course of business takes free of a security interest created by his seller unless the goods are farm products purchased from a person engaged in farming operations.

656. U.C.C. § 9-306(2) (*emphasis added*).

657. 206 N.W.2d at 98.


A security interest in farm products shall not be considered waived nor shall authority [to sell, exchange, or otherwise dispose of farm products] be implied or otherwise result from any course of dealing between the parties or by any trade usage.
The *Libson Bank* decision follows the rule under pre-Code law that a mortgagee waives his lien against a purchaser of the collateral by a course of conduct allowing the mortgagor to retain the property and sell it at will.\(^{659}\) But other courts have held that the Code displaces this common

2 G. Gilmore, supra note 425, § 26.11 at 714-15 (emphasis added). Frequently cited by the courts is commentary to § 9-306 providing that whether a secured party "or otherwise" disposes of collateral may depend upon the parties' course of dealing. U.C.C. § 9-306, Comment 3 (1962 Official Text with Comments). This language was eliminated from the commentary to the 1972 version of Article 9. See U.C.C. § 9-306, Comment 3.

While many courts agree generally that U.C.C. § 9-306(2) and the "or otherwise" language pervertuates the common law rules of waiver and estoppel, they sometimes disagree about the extent to which the pre-Code applications of these rules have been displaced by Article 9. See, e.g., text accompanying notes 660-669 infra. And in many cases similar to *Libson Bank* and *Bowers* where the purchaser argues waiver of the security interest, the courts find it unnecessary to reach the issue or conclude that the facts simply do not support a finding of waiver by the secured party. See, e.g., Weisbart & Co. v. First Nat'l Bank of Dalhart, 566 F.2d 391 (5th Cir. 1978); United States v. Greenwich Mill & Elevator Co., 291 F. Supp. 689 (N.D. Ohio 1968); Imperial NH3; Division of Western Farm Service, Inc. v. Central Valley Feed Yards, Inc., 70 Cal. App. 3d 513, 139 Cal. Rptr. 8 (1977); Vermilion County Production Credit Ass'n v. Izzard, 111 Ill. App. 2d 190, 249 N.E.2d 352 (1969); Overland Nat'l Bank v. Aurora Cooperative Elevator Co., 184 Neb. 843, 172 N.W.2d 786 (1969).


Most courts applying this pre-Code rule held that its application was unaffected by a provision in the mortgage either prohibiting disposition of the collateral or requiring the mortgagor to obtain the mortgagee's consent prior to sale of the collateral. See, e.g., Quaker Oats Co. v. McKibben, 230 F.2d 652 (9th Cir. 1956); First Nat'l Bank & Trust Co. v. Stock Yards Loan Co., 65 F.2d 226 (8th Cir. 1933), cert. denied, 290 U.S. 648 (1933); Producers Livestock Marketing Ass'n v. John Morrell & Co., 220 Iowa 948, 263 N.W. 242 (1935). The pre-Code rule regarding waiver of a mortgage lien on the basis of the parties' course of conduct was simply a specific application of a more general principle, i.e., that a mortgagee's consent to the sale of the collateral either results in the waiver of a mortgage lien or estops
law rule in farm products cases, at least in cases involving a fact not present in Libson Bank. In many of these cases the security agreement between the lender and the farmer expressly prohibits the sale of the collateral without the secured party’s written consent. The court in Libson Bank was careful to note that “[w]e are not here confronted with a security agreement with a provision requiring written consent prior to sale.”

It

the mortgagee from asserting it against a purchaser. The mortgagee’s consent can be expressed or implied and can be inferred from the circumstances of the transaction, including the parties’ course of dealing and other conduct. And in the majority of pre-Code cases, the courts routinely held that where a secured creditor consents to a sale of the collateral, regardless of how the consent is proved, he cannot assert his lien against a purchaser even though the security instrument requires the mortgagee’s prior express consent to any disposition of the collateral. See note 700 infra.

Courts applying the common law rules of waiver or estoppel to extinguish a pre-Code security interest also deemed immaterial the facts that the proceeds resulting from the collateral’s disposition were not remitted to the secured creditor or that the purchaser was unaware of the facts establishing the mortgagee’s consent to sell. The prevailing view was stated well by the Missouri Supreme Court:

If a mortgagee gives his consent for the mortgagor . . . to sell such property he thereby waives his lien on the property, even though the consent was given upon the express or implied condition that the mortgagor should apply, or deliver to the mortgagee to be applied, the proceeds of the sale on the mortgage debt. A consenting by the mortgagee to a sale of the property by the mortgagor and the passing of the title and the retention by him of the mortgage lien are wholly inconsistent positions. The mortgagee cannot in effect make the mortgagor his agent to sell the property and then when a sale is effected through such agency retain his lien notwithstanding. By consenting to a sale and the collection of the proceeds by the mortgagor, the mortgagee surrenders his lien and looks to the mortgagor personally for the payment of the mortgage debt. It is so held quite universally. It is not necessary that such consent in order to constitute a waiver be expressed; it may be implied. Nor is it necessary that the vendee of the mortgagor have knowledge of such consent, or even of the existence of the mortgage.

Moffett Bros. & Andrews Commission Co. v. Kent, 5 S.W.2d 395, 400 (Mo. 1928) (emphasis in original). And see note 700 infra. But see generally, e.g., Conway Compress Co. v. Adkisson, 189 Ark. 20, 69 S.W.2d 1079 (1934) (buyers from mortgagor cannot rely on a course of dealing between the mortgagor and mortgagee of which buyers had no knowledge). For a case decided under Article 9, but see Southwestern Washington Production Credit Ass’n v. Seattle-First Nat’l Bank, 92 Wash. 2d 30, 593 P.2d 167 (1979) (regarding condition of remitting proceeds). With respect to the mortgagee’s consent being conditioned on the proceeds of the sale being paid to him, this condition is effective if the buyer was a party to it. See generally, e.g., Arnold v. First Nat’l Bank, 96 Colo. 104, 39 P.2d 791 (1934).

660. The standard security agreement form used by the Farmers Home Administration provides that “Debtor will . . . (6) not abandon the collateral or encumber, conceal, remove, sell or otherwise dispose of it or of any interest therein, or permit others to do so, without the prior written consent of Secured Party . . . .” USDA-FmHA, Form FmHA 440-4 at ¶ III(B) (Rev. 6-10-76) (emphasis in original). This form also contains a clause reciting that the “SECURED PARTY HAS INFORMED DEBTOR THAT DISPOSAL OF PROPERTY COVERED BY THIS SECURITY AGREEMENT WITHOUT THE CONSENT OF THE SECURED PARTY . . . MAY CONSTITUTE A VIOLATION OF FEDERAL CRIMINAL LAW.” Id. at ¶ IV (K).

The standard form “Farm Security Agreement” used by production credit associations, at least those in District 6 of the federal Farm Credit System, contains this provision: “Debtor shall . . . (5) not sell, lease or otherwise dispose of Collateral except as specifically authorized in writing by the Secured Party . . . .” Form PCA6-401 at ¶ 4(b) (12-78).

661. 206 N.W.2d at 99.
pointed out "that a finding of authority to sell may be implied from a prior course of dealing at least in the absence of a security agreement prohibiting against sale without written consent."  

These caveats were necessary to distinguish cases such as *Garden City Production Credit Association v. Lannan*.663 There the PCA financed the debtor's farming and ranching operations. Several security agreements had been executed giving the PCA security interests in the debtor's equipment, crops and livestock. One of them covered 161 head of cattle involved in the case and "prohibited [the debtor] from encumbering, removing, selling, or otherwise disposing of the cattle without the written consent of PCA." Nevertheless,

Subsequent to these security agreements, the [debtors] at various times did sell and removed secured property in the course of their farming and ranching operation and each time they did so without first obtaining the written consent required by the financing agreement. The record shows that after various sales, [the debtor] endorsed all checks received for the sale of the cattle involved to PCA for application on his indebtedness. [The debtor] has never requested written consent to sell the various collateral nor has [the debtor] ever been rebuked by PCA for failing to secure the written consent required by its financing statement.665

The debtor had sold the cattle to a livestock brokerage firm which sold them to the defendant. The PCA knew about the intended disposition but did not give its written consent. The defendant's draft for the purchase price was endorsed to the PCA by the debtor, but it was later dishonored. The PCA then sued the buyer to replevy the cattle.

The defendant argued and the trial court held that the secured party had waived its security interest in the cattle by impliedly authorizing the sale. The argument and holding were based on the previous course of dealing between the lender and the debtor whereby collateral was sold without the secured party's consent. The Nebraska Supreme Court reversed and based its decision partly on section 1-205(4) which provides that

The express terms of an agreement and an applicable course of dealing or usage of trade shall be construed wherever reasonable as consistent with each other, but when such construction is unreasonable express terms control both course of dealing and usage of trade and course of dealing controls usage of trade.666

A number of courts have agreed with the *Garden City* decision667 and

662. *Id.* (emphasis added).
663. 186 Neb. 668, 186 N.W.2d 99 (1971).
664. 186 N.W.2d at 101 (emphasis in original).
665. *Id.*
666. U.C.C. § 1-205(4) (emphasis added). See 186 N.W.2d at 103-04. But see note 669 infra.
many have relied on the language in section 1-205(4) that "express terms control . . . course of dealing." They reason that it creates an exception "to the broad rule of [section 9-306(2)] that any authority to sell destroys a security interest in the property sold . . . [and that] when the security agreement requires prior written authorization, it cannot be proved by a course of dealing." Practical considerations and commer-


The Clovis case, supra herein, is the leading case among these decisions which are contra to Garden City Production Credit Ass’n v. Lannan, 186 Neb. 668, 186 N.W.2d 99 (1971). The New Mexico legislature reacted to the decision in Clovis by adding this language to that state’s U.C.C. § 9-306(2):

A security interest in farm products and the proceeds thereof shall not be considered waived by the secured party by any course of dealing between the parties or by any trade usage.


Perhaps, however, even these courts will reach a different decision if, despite the prior written consent requirement in the security agreement, the secured party expressly, though not in writing, agrees to a sale of the collateral. See North Central Kansas Production Credit Ass’n Washington Sales Co., Inc., 223 Kan. 689, 577 F.2d 35 (1978); North Central Kansas Production Credit Ass’n v. Boese, 2 Kan. App. 2d 231, 577 P.2d 824 (1978). And occasionally there is the case where the secured party agrees in the security agreement to the debtor’s sale of the collateral. See, e.g., Swift & Co. v. Jamestown Nat’l Bank, 426 F.2d 1099 (8th Cir. 1970).


The courts’ reasoning is suspect, however, when they rely heavily on U.C.C. § 1-205(4) for the conclusion that a waiver of a security interest by a course of dealing or other conduct is not possible if the security agreement requires prior consent to sale. The suspicion arises at least in those cases where the course of dealing or, more precisely, a course of performance develops after the security agreement is executed. See Southwest Washington Production Credit Ass’n v. Seattle-First Nat’l Bank, 19 Wash. App. 397, 577 P.2d 589 (1978). There the court first agreed with cases holding that a prior course of conduct without more is insufficient to waive a written security agreement to the contrary. Then the court said this:

Nevertheless, we are of the opinion that any course of performance . . . or other conduct subsequent to the agreement can amount to a waiver.

[U.C.C. § 1-205(4)] has two purposes: first, it complements the parol evidence rule regarding the interpretation of written agreements; citations omitted] second, it gives parties to a series of contracts the freedom to change their relationship by agreement [citations omitted]. It is apparent that neither of these purposes is frustrated by permitting waiver to be implied from conduct subsequent to the written agreement. The parol evidence rule has no applicability in such instances, [cita-
cial realities support a decision for the lender in this type of case whether or not the security agreement expressly prohibits sale without written consent. These realities surface when the situations of farm product and inventory lenders are compared.

The farm lender and the inventory financer are alike in that each prefers to have the obligations owed him repaid from the proceeds of collateral sold in the ordinary course of a debtor's business. Neither one relishes the thought of having to trace and repossess the collateral from the "debtor" and dispose of it under Part 5 of Article 9. The debtors, too, are alike. The modern farmer knows as much, if not more, about secured financing as, for example, the owner of a hardware store whose inventory secures a commercial loan from a local bank.

Despite these similarities, the farm products exception in section 9-307(1) gives greater protection to the farm lender. The section provides that a buyer in the ordinary course of business takes free of a perfected security interest created by his seller except when he buys "farm products from a person engaged in farming operations." The reasons for giving this protection to the farm products lender also suggest that the courts should be cautious, at least, in applying the common law rule of waiver of an interest by a course of dealing to transactions involving farm products collateral under Article 9. These reasons concern the type of person who usually buys from the farmer and the quantity he normally purchases.

---

671. Not among the reasons is the notion "that a farmer who borrows on his inventory cannot be trusted to turn over the proceeds from the sale in the way a lender has learned to trust other businessmen to do." Coogan & Mays, Crop Financing and Article 9: A Dialogue with Particular Emphasis on the Problems of Florida Citrus Crop Financing, 22 U. Miami L. Rev. 13, 19 (1967). According to Peter Coogan, a distinguished commercial law scholar, this is the philosophy reflected in the farm products exception to U.C.C. § 9-307(1). Id. But he believes "that the treating of the farmer as a second-class businessman who cannot be trusted to turn over the proceeds of collateral raised for sale is the result of conditions long since changed." Id. at 23. In some cases a farmer "is likely to be not only like other businessmen, but like other large businessmen." Id. at 2 (emphasis in original). To some extent, the tension between the old and new images of the American farmer is demonstrated by the courts' lack of agreement about whether a farmer should be treated as a merchant for certain purposes under Article 2. See generally cases collected in Annot., 95 A.L.R.3d 484 (1979). Compare, e.g., Cook Grains, Inc. v. Fallis, 239 Ark. 962, 393 S.W.2d 555 (1965) with Nelson v. Union Equity Co-Operative Exchange, 536 S.W.2d 635 (Tex. Civ. App. 1977). The better conclusions on this issue are that being a farmer does not by itself inhibit one from acquiring the specialized
A typical farmer in eastern Arkansas, for example, cultivates 600 acres of land\textsuperscript{672} and produces annually 22,200 bushels of rice\textsuperscript{673} and 11,200 bushels of soybeans.\textsuperscript{674} The estimated production costs, excluding those for land, management and general farm overhead, average $102.59 per acre of soybeans and $259.26 per acre of rice.\textsuperscript{675} Total production costs, therefore, may exceed $100,000.\textsuperscript{676} The farmer may borrow in January of each year from $50,000 to $100,000 to be dispersed through April and repaid by December. When the crops are harvested, Riceland Foods, Inc. or some other processor or mill will buy all of them.\textsuperscript{677} 

\textsuperscript{672} Arkansas county is very typical among the counties in the eastern part of the state of Arkansas with respect to crop production. The precise average size of farms in Arkansas county is 584 acres. USDA Economics, Statistics, and Cooperative Service, 1977 Agricultural Statistics for Arkansas 11 (1978).

\textsuperscript{673} See May & Walden, Arkansas Rice Budgets, 1979: Production Costs Estimates at 14 (University of Arkansas, Fayetteville, Cooperative Extension Service, 1979). These researchers report that the average amount of rice produced per acre in the Grand Prairie rice production area of Arkansas, which includes Arkansas county, is 5000 pounds. The standard conversion for rice is 45 pounds per bushel. Therefore, 111 bushels per acre is the average rice yield for farms in Arkansas county which is the county being used for purposes of this illustration. See note 672 supra. Most farmers, however, only plant one-third of their land in rice and the remaining portion is often planted in soybeans. This explains the 22,200 bushels figure used in the text, i.e., (600 total acres of land / 1/3 planted in rice) x (111 bushels of rice per acre) = 22,200 bushels of rice per year.

\textsuperscript{674} See May & Walden, Arkansas Soybean Budgets, 1979: Production Cost Estimates at 10 (University of Arkansas, Fayetteville, Cooperative Extension Service, 1979). The average amount of soybeans produced per acre in the South Delta (sandy loam soil with fungicide applied) soybean production area in Arkansas, which includes Arkansas county, is 28 bushels. The figure used in the text results from this formula: (600 total acres of farm land / 2/3's of it planted in soybeans) x 28 bushels of soybeans produced per acre = 11,200 bushels of soybeans. See note 674 supra.

\textsuperscript{675} For soybean production costs, see May & Walden, supra note 674, at 10; for rice production costs, see May & Walden, supra note 673, at 14.

\textsuperscript{676} The standard crop rotation is one-third rice and two-thirds soybeans. Therefore, assuming 600 total acres, the total production costs would be 200 acres of rice x $295.26 production costs per acre of rice + 400 acres of soybeans x $102.50 production costs per acre of soybeans which equals $100,088. The production costs estimates used here do not include estimates for land, management and general farm overhead. See May & Walden, supra note 673, at i; May & Walden, supra note 674, at i.

\textsuperscript{677} Riceland Foods is a farmer-owned cooperative headquartered at Stuttgart, Arkansas, that markets rice and soybeans across the United States and around the world. The organization has more than 20,000 members and handles one-half of the rice and one-third of the soybeans grown in the state. Letter from Bill Reed, Director of Communications for Riceland Foods to Steve H. Nickles (October 11, 1979). Riceland markets rice and soybeans in bulk and, in addition, processes some of it for eventual sale to the public at the retail level nationally. It is among the largest rice and soybean marketing and processing enterprises in the South. In addition, it "is the largest rice milling organization in the United States . . . [and] one of the leading soybean crushers in the South." Report of R.E. Short, Jr., Chairman of the Board of Riceland Foods, Before the Annual Membership Meeting (September 6, 1979). Stuttgart, Arkansas, where Riceland is headquartered, is known by some as one of the world's rice capitals. Ref-
Riceland is more likely to be aware of a security interest in the goods it buys from a farmer than is a consumer, for example, buying a hammer from the inventory of a hardware store. While a financing statement theoretically serves to notify the world, one can safely presume that Riceland is more likely to know about the existence of a filing system and the importance of searching it. A buyer like Riceland, therefore, is in a better position to account for a lender’s security interest when dealing with the debtor.\textsuperscript{678} The exceptional transaction between the secured party and the farmer about which the buyer may be unaware at the time of the sale does not obscure the typical buyer’s understanding of traditional farm products financing patterns and practices and should not relieve him of a commercially established, if not legally required, duty to honor them.

An equally important difference between the consumer buyer from inventory and a typical buyer of farm products concerns the quantity of goods they purchase. The practical value of having a security interest continue in collateral after its disposition is usually less significant to the inventory financer. Even if he can trace the property subject to his security interest into the hands of a buyer, he will normally have to follow a large number of hammers into an equally large number of hands in order to satisfy the obligation owed him. The farm lender’s situation is vastly

\textsuperscript{678} Not all buyers of farm products from a farmer will be as sophisticated as Riceland, but certainly the vast majority will be more knowledgeable than the typical consumer buying inventory who is protected under U.C.C. § 9-307(1). Nevertheless, some commentators suggest that as a practical matter, requiring even the most sophisticated buyers to check financing records is too burdensome and costly. See, e.g., Coogan & Mays, \textit{Crop Financing and Article 8: A Dialogue with Particular Emphasis on the Problems of Florida Citrus Crop Financing}, 22 \textit{U. Miami L. Rev.} 13, 22 (1967); Doolan, Section 9-307(1): \textit{The U.C.C.’s Obstacle to Agricultural Commerce in the Open Market}, 72 \textit{Nw. U. L. Rev.} 706, 717-18 (1977) (whose illustration is unlike the one used in the text of this article because it involves the problems of remote purchasers from the farmer).
different. His collateral will be sold by the debtor bulk to only one or maybe a few buyers. If the debtor defaults, the expense and trouble of tracing and repossessing collateral is justified. In addition, if the inventory debtor defaults, some collateral will ordinarily still be sitting on the shelves of the hardware store. But if the farmers defaults and flees with the proceeds resulting from the sale of his crops, his fields are barren. The lender holding a security interest in the livestock of a debtor's cattle-feeding operation is in a similar position. Both crop and cattle lenders often rely on collateral which will commonly be sold in bulk and will have little to depend on other than the proceeds resulting from such sales.

Considering the sophistication of the typical farm products buyer and the risk to the farm lender who may literally have all his eggs in one basket, special protection of a security interest in farm products under sections 9-307(1) and 9-306(2) is ordinarily justified. A consideration

679. Mr. Joe Barrett of Arkansas was a member of the Review Committee created by the Permanent Editorial Board of the U.C.C. whose work resulted in the 1972 version of Article 9. The Committee seriously considered deleting the farm products exception from § 9-307(1); but Mr. Barrett, who was closer to farming than any other member of the Committee, argued against such a change. Mr. Barrett generally disagrees with decisions like Clovis National Bank v. Thomas, 77 N.M. 554, 425 P.2d 726 (1967) (discussed at note 667 supra) and believes farm product lenders deserve more protection under Article 9 than inventory financiers. His argument, like that in the text of this article, emphasizes the differences between inventory and farm products collateral with respect to how and when the collateral is sold.

[T]he customer who walks into a retail establishment and pays cash for an item of inventory should take free of the security interest. . . . The theory of inventory financing is that the debtor takes the proceeds from the sale of a portion of his inventory and reinvests it in other inventory and the common practice of inventory financiers is to require that the debtor maintain a total inventory value in excess of the secured debt. Frequently the inventory is the most liquid collateral that a debtor has and inventory financiers permit the merchant to finance his inventory at the level that enables him to offer to the buying public a wide variety of merchandise and yet protects the public who buys some of that inventory even though it be part of a larger stock subject to a security interest.

It is common knowledge among those familiar with farming operations in mid-continent U.S. that with minor exceptions farm crops are harvested and marketed but once a year. The sale of farm products by one engaged in farming operations is wholly different from retail sales of merchandise which takes place during store hours each working day. Further, it is wholly different from the sale of goods manufactured by the debtor whose inventory of raw materials and finished products are subject to a security interest.

Sale of his crop by a farmer is somewhat like a merchant making a bulk sale of his entire stock. Special rules in the UCC govern Bulk Transfers (Article 6), hence it is logical to have a special rule for sale of farm products.

Brief Amicus Curiae in Support of Planters PCA (Submitted by Joe C. Barrett) at 30-31, Planters Production Credit Ass'n v. Bowles, 256 Ark. 1063, 511 S.W.2d 645 (1974). Article 6 only applies to transfers “of a major part of the materials, supplies, merchandise or other inventory (Section 9-109) of an enterprise subject to this Article.” U.C.C. § 6-102(1). The enterprises subject to the Article “are all those whose principal business is the sale of merchandise from stock . . . .” U.C.C. § 6-102(3).

680. Not all farm products transactions involve buyers as sophisticated as Riceland or farmers who sell their products in bulk a few times a year. The dairy industry suggests an
of similar factors, however, suggests that inventory financers may sometimes be better protected under the same sections than reason permits or commercial realities justify. Suppose, for example, that a dealer in certain goods is financed by a bank which has a perfected security interest in the dealer’s inventory. Dealer sells part of his inventory to a retailer who then sells one of the items to a buyer in the ordinary course of business. If the dealer defaults, the bank is unlikely to try to reach the property in the buyer’s hands unless it is a relatively valuable item. But if the bank does assert its security interest, the ultimate buyer will not take free of it under a literal interpretation of section 9-307(1) because the security interest was not “created by his [the buyer’s] seller [the retailer].”

The drafters failed to explain why they included the “created by his seller” exception. If they intended it to apply only to a specific class of cases, they should have said so because the courts have generally refused to limit its applicability. Many commentators, however, dislike the

---


682. Professor Knapp reports that

The “created by his seller” language was first added to the official text of the UCC in the 1957 version, pursuant to the 1956 Recommendations for Change, in which it was described as being “for clarification.” . . . The change may have been a response to criticism presented to the New York State Law Revision Commission, in which it had been suggested that the Code in its earlier form did not clearly decide cases where the buyer’s transferor was someone other than the debtor.

“[W]here the debtor is not himself engaged in selling goods of that kind, it might be thought that the secured party should not bear the risk of a fraudulent transfer to a person who is engaged in such business.” 1 N.Y. LAW REV. COMM’N 1955 REPORT—STUDY OF THE UNIFORM COMMERCIAL CODE 243, N.Y. LEG. DOC. NO. 65 (1955).

Knapp, supra note 681, at 877 n.89. The language could also have been added in response to the Commission’s recommendation a year later that Section 9-307(1) be revised to state more specifically the relation of the secured party whose interest is cut off by sale to a buyer in ordinary course and the possession, apparent ownership or apparent authority to sell of the person who sells to the buyer in ordinary course. It was suggested that, for consistency with Section 2-403(2), such provision should make it clear that “entrusting” of the goods to the seller by the person whose security interest is cut off, is the controlling factor, and should perhaps indicate specifically whether an entrusting by debtor to a third party, with the consent of the secured party, is sufficient to allow the third party’s sale to a buyer in ordinary course to cut off the security interest.


exception and have suggested various ways to get around it. A frequently mentioned method involves arguments based on section 2-403. But most courts have been unwilling to rely on an Article 2 provision regarding who gets title as between the original owner and a purchaser as a means of circumventing an Article 9 rule regarding who has priority as between a secured party and a buyer of collateral. Sections 2-403 and 9-307(1) are "intertwined in judicial construction . . . [and] their apparent conflicts are never satisfactorily resolved," but the cases appear to


685. For arguments which are based on this section and thus avoid the "created by his seller" language in § 9-307(1), see generally, e.g., Dugan, supra note 684, at 345-51; Knapp, supra note 681, at 883-85. And see note 687 infra.


687. Adams v. City Bank & Trust Co. of Norman, 565 P.2d 26, 29 (Okla. 1977). There a used car dealer assigned title to an automobile displayed on the sales lot to one of his salesman. The salesman borrowed money from a bank and used the car as collateral. The car remained for sale on the dealer's lot. Buyer purchased the car from the dealer, and, after this sale, the salesman reassigned title to the dealer. The buyer argued that the bank entrusted the car to the dealer who was a merchant and who was empowered to transfer title. The buyer, relying on U.C.C. § 2-403(2)(3), argued that "because car was entrusted to dealer, a 'merchant who deals in goods of that kind,' dealer had the power to transfer all of the rights of the entrustee to him as a buyer in the ordinary course of business free of the security interest of bank." Id. at 28. The court found that the buyer's "claim does not fall within the protection of § 2-403" because "Bank was not the owner of the Ford and could not be the entrustee. For the purpose of [the buyer's] argument, [the salesman], the title owner, rather than Bank, entrusted the Ford to dealer." Id. at 29. Still, however, the buyer prevailed in this case but under § 9-307(1). The "created by his seller" problem was overcome because the court found or fancied that "the same entity created the security interest and sold the Ford." Id. at 31.
support the following conclusion reached by the authors of a frequently cited treatise:

"We conclude that the draftsmen intended that priority disputes between secured creditors and subsequent purchasers be governed exclusively by Article Nine and that they did not intend that such purchasers invoke the more generous provisions of 2-403."

"Courts should use care to limit their consideration to Article Nine in those circumstances in which a buyer is competing with a secured creditor."

When considering Article 9, however, the buyer who confronts the "created by his seller" exception to section 9-307(1) should not forget section 9-306(2). The creditor may have authorized his debtor's disposition of collateral in the security agreement or otherwise. Exploring this possibility is especially important when the collateral originally served as inventory. Consider again the example given above involving the bank-dealer-retailer-buyer. The bank knew from the beginning that the dealer planned to offer the goods for sale. It expected and wanted him to sell the collateral. It needs and relies more on sales in the ordinary course by the debtor than does the farm products lender. One can reasonably expect, therefore, that the debtor's disposition of the collateral will be authorized by the inventory financer. Despite the lack of authority in the security agreement for the debtor to dispose of the collateral, pre-Code law supports a finding that a secured party with an interest in inventory impliedly consents to sales by the debtor to good faith purchasers in the ordinary course of trade and thereby waives its interest in collateral sold to them.

689. The total proceeds resulting from inventory disposed of in bulk by a repossessing secured party is likely to be significantly less than that which would have been received by the debtor selling it at retail to the public. But a significant discrepancy is less likely when the collateral is farm products. The secured party who is forced to foreclose will probably arrange to sell the collateral to the same types of buyers as those with whom the farmer would ordinarily deal.
690. No court has fully considered the pre-Code rule and thoroughly discussed the issue of its perpetuation under U.C.C. § 9-306(2). But the language in a few opinions suggests some courts might embrace the rule. In Universal C.I.T. Credit Corp. v. Middleboro Motor Sales, Inc., 424 S.W.2d 409 (Ky. App. 1968), C.I.T. floor planned the inventory of a car dealership, Middleboro Motor Sales, Inc. The owner of the dealership, Edward Mason, and his wife bought cars from the dealership. Their purchases of the cars had been financed by local banks which had security interests in the cars. Priority disputes arose between the banks and C.I.T. The court first looked at §§ 2-403 and 9-307 and concluded that the banks could prevail under those sections only if the Masons were buyers in the ordinary course of business which they were not. "There is a definite question about their 'good faith' in this situation." Id. at 412. But the court finally held for the banks on the basis of § 9-306(2). C.I.T.'s security interest did not follow the cars after they were bought by the Masons because the security agreement between the dealership and C.I.T. authorized sales "in the ordinary course of trade." Id. Although the Masons were not buyers in the ordinary course...
Courts deciding priority disputes between chattel mortgagees and buyers were practically unanimous in holding that where the mortgagee consents to a sale of the mortgaged property, he thereby waives his lien, and the purchaser takes title free of the mortgage, whether the latter knew of the existence of the mortgage or not, and notwithstanding the lack of knowl-

of business under the Code, the court believed the sales to them were "in the ordinary course of trade" under the terms of the security agreement.

The court added that even if the security agreement between C.I.T. and the dealership had not allowed such sales, "It could be that the section above referred to [§ 9-306(2)] is broad enough to protect a bank, who with no knowledge of violation of the agreement, loans money in this type situation in reliance on the apparent authority of the retailer to make the sales." Id. at 413. And in support of this statement the court cites Clovis Nat'l Bank v. Thomas, 77 N.M. 554, 425 P.2d 726 (1967). The court in Clovis concluded "[i]there being no particular provision of the code which displaces the law of waiver, and particularly waiver by implied acquiescence or consent, the code provisions are supplemented thereby." Id. 425 P.2d at 732. Presumably the court in C.I.T. Credit Corp. v. Middleboro Motor Sales, supra herein, was suggesting that C.I.T.'s consent to sale could be inferred from the fact that the dealership was in the business of selling cars, a fact known by C.I.T. and a practice it impliedly countenanced. Cf. Obsorn v. First Nat'l Bank of Holdenville, 472 P.2d 440, 7 UCC Rep. Serv. 908 (Okla. 1970) (mentioned note 651 infra).

McFadden v. Mercantile-Safe Deposit & Trust Co., 260 Md. 601, 273 A.2d 196 (1971), involved a priority dispute between a secured party with an interest in the debtor's inventory and a buyer of goods from the debtor's inventory. The court emphasized the normal understanding between creditor and debtor when the collateral is inventory, i.e., "the lender knows or should know that the borrower usually contemplates selling the encumbered goods in order to raise money to repay the loan." Id. 273 A.2d at 205. The court concluded that the goods purchased by the buyer from the debtor were inventory and held, that the sale of the trucks was implicitly authorized for purposes of . . . § 9-306(2) [T]he characterization of the trucks as inventory for sale without any restrictive clause prohibiting or at least requiring prior consent for such sales, implies the permissibility of such sales.

Id. 273 A.2d at 207 (emphasis added). An additional factor the court considered in McFadden was the secured party's claim of proceeds in the financing statement. Other courts have emphasized this factor as an important one in finding an implied authorization of sale under § 9-306(2). See, e.g., Long Island Trust Co. v. Porta Aluminum Corp., 44 A.D.2d 118, 354 N.Y.S.2d 134 (1974); Hemphstead Bank v. Andy's Car Rental System, Inc., 35 A.D.2d 35, 312 N.Y.S.2d 317 (1970). But this factor is not as relevant under the 1972 version of Article 9 which provides that an interest in proceeds will be automatic. See U.C.C. § 9-306(2). And compare U.C.C. § 9-306, Comment 3 (1962 version) with the present § 9-306, Comment 3.

The court in McFadden also emphasized the lack of a restrictive clause prohibiting sales of the collateral or requiring prior consent to sales. Such clauses did not prevent the application of the pre-Code rule with respect waiver based on implied consent to sell. See note 700 infra and text accompanying it. But, as the court in McFadden suggests, a restrictive clause may affect the extent of the rule's perpetuation under the Code. Cf. Central California Equipment Co. v. Dolk Tractor Co., 78 Cal. App. 3d 855, 144 Cal. Rptr. 367 (1978); Community Bank v. Jones, 278 Or. 647, 566 P.2d 470 (1977), where the courts emphasize U.C.C. § 1-205(4) as a limitation on the operation of the pre-Code waiver by implied consent rule. And cf. text accompanying notes 663-669 supra. But cf. note 669 supra. And see generally Cessna Finance Corp. v. Skyways Enterprises, Inc., 580 S.W.2d 491 (Ky. 1979).

Another Article 9 provision which some courts apparently believe limits, although does not preclude, the application of waiver principles under U.C.C. § 9-306(2) is § 9-205. See generally Weidinger Chevrolet, Inc. v. Universal C.I.T. Credit Corp., 501 F.2d 459 (8th Cir. 1974); United States v. Greenwich Mill & Elevator Co., 291 F. Supp. 609 (N.D. Ohio 1968). But see note 718 infra.
edge on the part of the purchaser that such consent has been given. And...the great weight of authority sustains the view that the authority of a chattel mortgagor to sell the mortgaged property may be inferred from the terms and provisions of the mortgage instrument or from the facts and circumstances attending the particular transaction.691

These courts frequently found that a mortgagee impliedly consented to sales in the ordinary course of trade when the debtor was known to be a dealer in the goods and offered them for sale to the public.692 The buyer

691. Comment, Waiver of Chattel Mortgage Lien by Estoppel or by Implied Consent of Mortgagee, with Special Reference to Automobile Cases, 1 IDAHO L.J. 85, 88 (1931). And see generally 2 L. JONES, supra note 509, §§ 457, 458, 465.

692. The Supreme Court of Vermont, for example, gave this statement of the rule and the reasoning behind it:

An unconditional license to sell mortgaged property operates, when acted upon, as a waiver of the security. It is wholly immaterial whether such license is oral or written, express or implied. The record before us discloses a typical case of implied license to sell. When the company took those liens, owing that the vendee bought the horses for resale in his business, its silence unequivocally amounted to an implied license to sell them in the ordinary course of trade.

Rogers v. Whitney, 91 Vt. 79, 99 A. 419, 420 (1916). “This holding,” the court said, “is supported by many authorities.” Id. 99 A. at 420. Many authorities before and after the case do support the holding in Rogers, but not all of them employ the same legal reasoning.

The theories vary and include apparent authority, implied agency and estoppel. The leading case using the estoppel theory is Boice v. Finance & Guaranty Corp., 127 Va. 563, 102 S.E. 591 (1920). There the court reasoned,

It is true that, as a rule, the seller of personal chattels cannot confer upon a purchaser any better title than he himself has; but if the owner stands by and permits a seller, who is a licensed dealer in such goods, to hold himself out to the world as owner, to treat the goods as his own, place them with other similar goods of his own in a public showroom, and offer the same indiscriminately with his own to the public, he will be estopped by his conduct from asserting his ownership against a purchaser for value without notice of his title. . . . The act of knowingly permitting the goods to be so handled and used by the seller in the ordinary and usual course of his business is just as destructive of the rights of the creditor as if such permission had been expressly granted in the mortgage or deed of trust.

Id. 102 S.E. at 593. Some courts questioned the soundness of the estoppel theory but very often agreed with the conclusion of the South Carolina Supreme Court.

Waiver and estoppel are close akin; but their likes and dislikes are not now material. The instant conduct more favors waiver than estoppel; but the conduct is effective without nomenclature.

No argument is needed to prove that if a mortgagee permits his mortgagor to engage in trade and to sell the incumbered property to whoever comes to buy, then the buyer takes his goods free from the line of the mortgage.

Cudd v. Rogers, 111 S.C. 507, 98 S.E. 796, 797 (1919) (emphasis added). Eventually other courts began to apply the rule without specifying the legal theory behind it, except to say that the buyer in the ordinary course of trade takes free of the creditor’s interest in his debtor’s inventory. For example, in Emerson-Brantingham Co. v. Faulkner, 119 Kan. 807, 241 P. 431 (1925), the court stated the rule this way: “[W]here a mortgagee knows the mortgagor is a dealer, buying to sell in the ordinary course of business, a purchaser takes free from the mortgagee’s lien.” Id. 241 P. at 432. As authority for this proposition, the court cited Rogers v. Whitney, supra, which based the application of the rule on a waiver theory, and the court in Emerson-Brantingham also cited Boice v. Finance Corp., supra, the leading estoppel theory case.

Regardless of the legal theories used by the courts, a great majority of pre-Code cases generally support the pre-Code rule stated in the text. See, e.g., cases collected in Annot., 97 A.L.R. 646 (1935). Also, see generally, e.g., Foyle v. General Credit, Inc., 71 App. D.C. 338,
of inventory took the property unencumbered by the mortgage, and the fact that it was recorded made no difference.\(^{693}\)


Professor Gilmore reports that in those states where the chattel mortgage was used as a vehicle for inventory finance it was soon discovered that the mortgagor could waive, and usually had waived, his lien against buyers by authorizing the mortgagor to sell in the ordinary course of business. It had always been possible for a mortgagor to authorize the mortgagor to sell the property free of the lien; the buyer took free. . . . By analogy from the actual authority cases, it was easy to find that a mortgagor who had consented to the mortgagor's placing the mortgaged goods in his regular inventory had thereby given him implied or apparent authority to sell free of the mortgage, no matter what happened to the proceeds. It is fair to say that the "implied authority" conclusion was automatic in all cases where (1) the mortgagor knew that the mortgagor was a dealer or merchant and that the goods mortgaged were his inventory or stock in trade and (2) the mortgagor made no attempt to restrict the mortgagor's power to sell the goods.

2 G. GILMORE, supra note 425, § 26.2 at 681. But even when the mortgagor did attempt to restrict the mortgagor's power to sell (as by requiring in the chattel mortgage that the mortgagor obtain the mortgagor's express consent prior to sale), the majority of courts held for the ordinary course buyer despite non-compliance with such a restriction. See note 700 infra and text accompanying it.

As the statement of it in the text suggests, the rule did have its limits. The cases generally confine the protection to purchasers in the ordinary course (some courts said purchasers at retail) of collateral which was the debtor's stock in trade. So if a court found that the transferee was not a purchaser in the ordinary course [see, e.g., Nat'l Guarantee & Finance Co. v. Pfaff Motor Car Co., 124 Ohio St. 34, 176 N.E. 678 (1931); Andre v. Murray, 179 Ind. 576, 101 N.E. 81 (1913); but see Bass, Heard & Howle Co. v. Internat'l Harvester Co., 169 Ala. 154, 53 So. 1014 (1910)] of collateral which formed part of the debtor's stock in trade [see, e.g., Saginaw Financing Corp. v. Detroit Lubricator Co., 256 Mich. 441, 240 N.W. 44 (1932); Rogers v. Booker, 184 N.C. 183, 113 S.E. 571 (1921)], the transferee was subject to the creditor's security interest. It was also essential to the application of the rule that the creditor know or have reason to know that the particular collateral would form part of the mortgagor's inventory. See, e.g., McQuay v. Mount Vernon Bank & Trust Co., 200 Va. 776, 108 S.E.2d 251 (1959). Occasionally a court held that a transferee who was another dealer or merchant in the type of goods involved failed to qualify as a buyer in the ordinary course of trade, see, e.g., Colonial Finance Co. v. McRae, 60 Ohio App. 68, 19 N.E.2d 527 (1938), but most courts reached a different conclusion. See authorities cited note 704 infra.

Howell v. Board\textsuperscript{694} is an illustrative pre-Code case. Burrus was a used car dealer. He borrowed $550 from the Central National Bank of Okmulgee and secured the loan with a chattel mortgage covering two automobiles. "The Central National Bank knew at the time it took its mortgage that the two automobiles were owned by Burrus, as a part of his stock in trade, for sale and were being offered to the public."\textsuperscript{695} Burrus later sold one of the cars to Crenshaw who executed a note and a mortgage on the car to Burrus to secure a portion of the purchase price. Burrus then sold this paper to the Liberty Investment Company. The Bank later repossessed the car from Crenshaw, and Howell bought it at a foreclosure sale. Liberty Investment then sued Howell to recover the car. Howell's rights depended "on the validity of the chattel mortgage executed to the bank by a dealer in cars covering his 'stock in trade' as against a mortgagee who obtained a mortgage from one who purchased the mortgaged property from the dealer in the usual course of business."\textsuperscript{696} In other words, if the Bank waived its lien against the buyer, Crenshaw, then neither it nor Howell had an interest in the car to assert against Liberty Investment.

After considering a number of decisions from other jurisdictions, the court deduced the prevailing rule and applied it to the facts of the case.

It is clear, that unless the contrary is apparent from the conduct or


But see, for the minority view, Palmasano v. Louisiana Motors Co., 166 La. 416, 117 So. 446 (1928); Finance & Guaranty Co. v. Defiance Motor Truck Co., 145 Md. 94, 125 A. 585 (1924); Utica Trust & Deposit Co. v. Decker, 244 N.Y. 340, 155 N.E. 665 (1927); Whitehurst v. Garrett, 196 N.C. 154, 144 (S.E. 385 (1928); Hardin v. State Bank of Seattle, 119 Wash. 169, 205 P. 382 (1922).

For commentaries and citations of additional authorities on the question of the rights of buyers in the ordinary course of trade under pre-Code law, see generally, e.g., Comment, Waiver of Chattel Mortgage Lien by Estoppel or by Implied Consent of Mortgagor, With Special Reference to Automobile Cases, 1 Idaho L.J. 85 (1931); Comment, Sales—Automobile Dealer Financing and the Bona Fide Purchaser, 43 Mich. L. Rev. 605 (1944); Notes, 35 Colum. L. Rev. 931 (1935); 3 U. Detroit L.J. 152 (1939); 8 Duke B.A.J. 65 (1940); 46 Mich. L. Rev. 255 (1947); 41 Minn. L. Rev. 687 (1957); 23 Minn. L. Rev. 846 (1939); 7 N.C. L. Rev. 306 (1929); 29 N.D. Bar Brie 140 (1949); 15 Ore. L. Rev. 265 (1936); 2 Rocky Mt. L. Rev. 261 (1930); 5 Temp. L.Q. 461 (1931); 46 Yale L.J. 1090 (1937).
agreement of the parties, one who takes a mortgage upon articles being offered for sale as a part of the dealer's stock, knowing that such articles will continue in the future to be a part of the stock by necessary implication, consents to a sale thereof by the dealer. Such consent is tantamount to a waiver of the lien.

Applying the principle, where the mortgagee has by necessary implication consented to the sale of the mortgaged property in the usual course of business, it is apparent that as to one purchasing as a customer of the dealer, the mortgage lien is waived.

It, of course, follows, that one acquiring a mortgage from such purchaser is likewise protected. And the court in Howell rejected the defendant's argument that its decision was inconsistent with the recording act.

The recording of a chattel mortgage does not add to its actual force and effect. It merely imparts a constructive knowledge of the mortgage to subsequent purchasers and makes their subsequently acquired rights subject to the rights of the mortgagee. When as in this case, by reason of agreement express or implied, the mortgagee has no rights against subsequent purchasers of the class here involved, the fact that the mortgage was filed of record does not confer such rights.

Most courts agreed with the rule applied in Howell. Buyers of inventory in the ordinary course were protected from the claims of chattel mortgagees and other types of secured creditors even though, in some cases, the security agreement expressly prohibited the debtor, i.e., the buyer's seller, from disposing of the collateral without the creditor's prior written consent. Not all courts used the implied consent or waiver the-

---

697. Id. 94 P.2d at 831-32.
698. Id. 94 P.2d at 832.
699. See generally authorities cited notes 692 & 693 supra.
700. This was true with respect to inventory and other types of financing regardless of the facts establishing the secured party's consent to sale by the debtor. See generally, e.g., Quaker Oats Co. v. McKibben, 230 F.2d 652 (9th Cir. 1956); Abbeville Live Stock Co. v. Walden, 209 Ala. 315, 96 So. 237 (1923); Coffman v. Citizens Loan & Inv. Co., 172 Ark. 889, 290 S.W. 961 (1927); Western States Acceptance Corp. v. Bank of Italy, 104 Cal. App. 19, 285 P. 340 (1930); Glass v. Continental Guaranty Co., 81 Fla. 687, 88 So. 876 (1921); Indiana Investment Securities Co. v. Whisman, 85 Ind. App. 109, 136 N.E. 512 (1923); Moore v. Ellison, 82 Colo. 447, 261 P. 461 (1927); Producers Livestock Marketing Ass'n v. John Merrill & Co., 220 Iowa 948, 263 N.W. 242 (1935); Denno v. Standard Acceptance Corp., 277 Mass. 251, 178 N.E. 513 (1931); Simmons v. State, 160 Miss. 582, 135 So. 196 (1931); Finance Co. of N.J. v. Jones 98 N.J.L. 165, 119 A. 171 (1921); First Nat'l Bank of Stephenville v. Thompson, 265 S.W. 884 (Tex. Comm. App. 1924); Jones v. Commercial Investment Trust, 64 Utah 151, 228 P. 896 (1924); Boice v. Finance & Guaranty Corp., 127 Va. 563, 102 S.E. 591 (1920); Bernhagen v. Marathon Fin. Corp., 212 Wis. 495, 250 N.W. 410 (1933).

But see, e.g., United States Motor Truck Co. v. Southern Securities Co., 131 Miss. 664, 95 So. 639 (1923); Utica Trust & Deposit Co. v. Decker, 244 N.Y. 340, 155 N.E. 665 (1927). Utica was followed in General Credit Corp. v. Rohde, 122 Conn. 100, 187 A. 676 (1936), applying New York law. Gilmore's conclusion about Utica is that the "case may be put down as an example of the occasional failure of even a great court to come up to its own standards of judicial excellence." 2 G. GILMORE, supra note 425, § 26.2 at 683.

Even if the debtor sells collateral without authority, express or implied, a secured party...
ory to reach the result, but an important factor in every case was the creditor’s knowledge that the goods would be held for resale. Statutes eventually incorporated the rule developed and followed in these cases, and three earlier uniform acts adopted the implied consent theory expressed in Howell.

Applying to Article 9 the pre-Code rule expressed in cases like Howell would protect some buyers who now may be denied protection under 9-307(1) because of the “created by his seller” language. A secured party with an interest in the debtor’s inventory would be deemed to have "or

may nevertheless be found to have waived his lien by accepting proceeds of the sale and thereby ratifying it. See, e.g., Texas Nat’l Bank of Houston v. Auferheide, 235 F. Supp. 599 (E.D. Ark. 1964). And see generally 2 L. Jones, supra note 509, § 455a; First Nat’l Bank v. American State Bank of Brighton, 73 Colo. 254, 215 P. 473 (1923); Sloan State Bank v. B.M. Stoddard & Son, 178 Iowa 104, 159 N.W. 636 (1916); Warrick v. Rasmussen, 112 Neb. 299, 199 N.W. 544 (1924); Parker v. Harrell, 188 N.C. 337, 124 S.E. 575 (1924); Wilkins-Ricks Co. v. Welch, 179 N.C. 266, 102 S.E. 316 (1920); Wade v. Cornish, 23 Okla. 40, 99 P. 643 (1909); Hanks v. First State Bank of Klondike, 265 S.W. 245 (Tex. Civ. App. 1924); Bank of Ashippun v. Els, 274 Wis. 530, 80 N.W.2d 357 (1957). And see Pieper v. First Nat’l Bank of Linn Creek, 453 S.W.2d 926 (Mo. 1970), decided under Article 9, where the court found that the secured party had waived its interest by implied acquiescence or consent and based its finding partly on the fact that the secured party had knowingly accepted proceeds from the debtor’s sale of the collateral.

The debtor’s non-compliance with other express or implied conditions on the right to sell the collateral, such as remitting the proceeds of sale to the secured party, also failed to affect the purchaser’s priority. See generally, e.g., United States v. Hansen, 311 F.2d 477 (8th Cir. 1963); Farm Bureau Co-op. Mill & Supply, Inc. v. Blue Star Foods, Inc., 238 F.2d 326 (8th Cir. 1956); First Nat’l Bank & Trust Co. v. Stock Yards Loan Co., 65 F.2d 226 (8th Cir. 1933); United States v. Christensen, 50 F. Supp. 30 (E.D. Ill. 1943); Abbeville Live Stock Co. v. Walden, 209 Ala. 315, 96 So. 237 (1923); Farm Bureau Co-op Mill & Supply v. Swift & Co., 227 Ark. 182, 297 S.W.2d 107 (1957); Kearby v. Western States Securities Co., 31 Ariz. 104, 250 P. 766 (1926); Brown v. Driverless Car Co., 66 Colo. 216, 280 P. 488 (1929); Peoples Loan & Finance Corp. of Rome v. McBurrette, 100 Ga. App. 4, 110 S.E.2d 32 (1959); Gernazian v. Harrison, 66 Ga. App. 689, 19 S.E.2d 165 (1942); Helms v. American Security Co., 216 Ind. 1, 22 N.E.2d 822 (1939); Hoyt v. Clemans, 167 Iowa 330, 149 N.W. 442 (1914); Penick v. White & Beauchamp, 264 Ky. 172, 94 S.W.2d 338 (1936); Tonnar v. Washington & Issaquena Bank, 140 Miss. 875, 105 So. 750 (1925); Moffet Bros. & Andrews Comm. Co. v. Kent, 5 S.W.2d 395 (Mo. 1928); Oklahoma Cattle Loan Co. v. Wright, 219 Mo. App. 157, 268 S.W. 712 (1925); Martin v. Ducan Automobile Co., 50 Nev. 91, 252 P. 322 (1927); First Nat’l Bank & Trust Co. of Oklahoma City v. First Nat’l Bank at Ardmore, 335 P.2d 900 (Okla. 1958); New England Mortgage Sec. Co. v. Great Western Elevator Co., 6 N.D. 407, 71 N.W. 130 (1897); Brown Bros. & Co. v. William Clark Co., 22 R.I. 36, 46 A. 239 (1900); Cunningham v. G.F.C. Corp., 35 Tenn. App. 237, 244 S.W.2d 181 (1951); Daggett v. Corn, 54 S.W.2d 1098 (Tex. Civ. App. 1932); Rusk County Lumber Co. v. Meyer, 126 S.W. 371 (Tex. Civ. App. 1910); Jones v. Commercial Investment Trust, 64 Utah 151, 228 P. 896 (1924). See also cases collected in Annot., 97 A.L.R. 646, 660 et seq. (1935). The result might be different, however, if the purchaser was aware of any such condition or was a party to it. See, e.g., Smith v. Swift & Co., 320 F.2d 268 (10th Cir. 1963); Arnold v. First Nat’l Bank, 96 Colo. 104, 39 P.2d 791 (1934); Rolette State Bank v. Minnewoka Elevator Co., 50 N.D. 141, 195 N.W. 6 (1923). And see 1 G. Gilmore, supra note 425, § 26.2 at 681; 2 L. Jones, supra note 509, § 456a.

701. See note 692 supra.
702. See generally authorities cited notes 692 & 693 supra.
703. See text accompanying notes 710-713 infra.
otherwise authorized sales to buyers in the ordinary course by impliedly consenting to sales of the collateral to them. Subsequent purchasers from such buyers would not then be subject to the secured party's interest because no interest would exist. Section 9-306(2) provides that a security interest follows the collateral only if the disposition was not authorized by the secured party. But in this type of case involving a first buyer who buys in the ordinary course from his seller's inventory, the disposition is authorized by implication. Therefore, if the retailer, in the bank-dealer-retailer-buyer example stated earlier, is a buyer in the ordinary course of business, then his purchase extinguishes the bank's security interest under section 9-306(2). The ultimate buyer will not have to rely on section 9-307(1) or any other priority section to defeat the bank's interest because the bank has no interest, and no priority dispute arises.


705. The commentary to § 9-307 stresses this point:

The limitations which this section imposes on the persons who may take free of a security interest apply of course only to unauthorized sales by the debtor. If the secured party has authorized the sale in the security agreement or otherwise, the buyer takes free without regard to the limitations of this section.

U.C.C. § 9-307, Comment 2 (emphasis added).

A secured party may, of course, expressly consent to the sale of collateral by the debtor and thereby waive his security interest. See generally In re Kittyhawk Television Corp., 383 F. Supp. 691 (S.D. Ohio 1974); In re Vieths, Inc., 9 UCC Rep. Serv. 943 (E.D. Wis. 1971); First Finance Co. v. Akahtis, 110 Ill. App. 2d 377, 249 N.E.2d 663 (1969); S & W Trucks, Inc. v. Nelson Auction Service, Inc., 80 N.M. 423, 457 P.2d 220 (1969); Surety Savings & Loan Co. v. Kanzig, 53 Ohio St. 2d 108, 372 N.E.2d 662 (1978). And typically a security agreement covering inventory will permit some types of sales by the debtor. It may provide, for example: "So long as the Debtor is not in default hereunder, Debtor shall have the right to process and sell Debtor's inventory in the regular course of business." Inventory Security Agreement Form used by Deposit Guaranty National Bank of Jackson, Mississippi. Different but substantially similar language may be used: "Until default, Debtor may use the Collateral in any lawful manner not inconsistent with this agreement . . . and except for accounts and contract rights may sell the Collateral in the ordinary course of business." D. Epstein & J. Landers, DEBTORS AND CREDITORS: CASE AND MATERIALS 176 (1978). "Borrower, unless in default, may use, consume and sell inventory . . . in carrying on its business in ordinary course substantially in the same manner as now conducted . . ." R. Speidel, R. Summers & J. White, TEACHING MATERIALS ON COMMERCIAL AND CONSUMER LAW 229 (2d ed. 1974). If such a sale is made by the debtor, the security interest does not continue in the collateral because the disposition was authorized in the security interest.
bank does not have a continuing interest in the goods to assert against anyone. By supplementing section 9-306(2) with the common law rule regarding implied consent to sales in the ordinary course of a debtor's stock in trade, the inventory lender will always lose when the ultimate purchaser traces his title from a buyer in the ordinary course who bought the goods from the original debtor.\textsuperscript{706}

Another way to achieve this result is to interpret section 9-307(1) in a manner which is consistent with the interpretations of its predecessors. Consider again the bank-dealer-retailer-buyer problem. If the retailer is a buyer in the ordinary course of business, he "takes free" of the bank's security interest because it was created by the retailer's seller, i.e., the dealer.\textsuperscript{707} A literal reading of the section, however, requires that the buyer, whether in the ordinary course of business or not, take subject to the bank's interest. The buyer's seller was the retailer, and he did not create the interest. But this reading ignores the fact that the retailer took free. It assumes that the interest is merely dormant while the goods are in the retailer's hands and then springs to life when the buyer purchases from the retailer. Is this a valid assumption? Why not argue that when a buyer takes free under section 9-307(1), the security interest created by his seller is extinguished as to him and, consequently, as to later purchasers from him?\textsuperscript{708}

\vspace*{0.5em}

\textsuperscript{706} Agreement. See U.C.C. § 9-306(2). Therefore, a priority dispute cannot arise between the inventory secured party and an ultimate transferee of such a buyer from the debtor because the secured party will have no interest to assert. The same reasoning argued in the text with respect to an "or otherwise" disposition obviously applies to an express authorization of sale.

\textsuperscript{707} This is true even though the ultimate buyer may not be a buyer in the ordinary course of business. Remember that the ultimate purchaser in the case will not be relying on § 9-307(1) for his protection, and, therefore its limitations on the persons who may take free under it are inapplicable. See note 705 \textit{supra} and text accompanying it. Therefore, the ultimate transferee in a case such as the following one would be protected: Bank takes a security interest in retailer's inventory and perfects by filing; retailer sells to a buyer in the ordinary course of business who intends to use the goods for personal, family or household purposes; buyer later sells the consumer goods to his neighbor who buys it for his own personal use. Retailer defaults, and bank seeks to repossess the goods from the neighbor. Neighbor cannot rely on § 9-307(1) because he was not a buyer in the ordinary course of business and, also, because the security interest was not created by his seller. Neither can he rely on § 9-307(2) because prior to the purchase the bank filed a financing statement covering the goods. But since the debtor was in the business of selling goods to the public, the bank impliedly consented to sales in the ordinary course. Therefore, the bank "or otherwise" authorized the disposition of the collateral, and under § 306(2) the security interest does not follow the collateral. The neighbor wins because the bank has no interest in the goods to assert against anyone.

\textsuperscript{708} Professor Knapp reaches the same result but without emphasizing the "take free" language of U.C.C. § 9-307(1). He argues that any subsequent transferee from a buyer in the ordinary course also takes free of the security interest under the shelter principle of U.C.C. § 2-403(1), i.e., "[a] purchaser of goods acquires all title which his transferor had or had power to transfer." See Knapp, \textit{Protecting the Buyer of Previously Encumbered Goods: Another Plea for Revision of UCC Section 9-307(1)}, 15 \textit{Ariz. L. Rev.} 861, 884 (1973). The problem with this analysis is the distinction the Code makes between title interests and security inter-
The prior uniform statutory provisions on which section 9-307(1) is based were themselves predicated upon the common law rule expressed in cases like Howell. The court there held that the rights of the ultimate purchaser were to be determined according to those of the immediate buyer from the debtor. The early uniform acts adopted the implied consent theory as expressed in Howell and converted it into a buyer's priority section. The Conditional Sales Act provided that

When goods are delivered under a conditional sale contract and the seller expressly or impliedly consents that the buyer may resell them prior to performance of the condition, the reservation of property shall be void against purchasers from the buyer for value in the ordinary course of business, and as to them the buyer shall be deemed the owner of the goods, even though the contract or a copy thereof shall be filed according to the provisions of this Act.

The Chattel Mortgage Act had a similar provision.

If the mortgagee allows the goods to be placed in the mortgagor's stock in trade or sales or exhibition room, this shall have like effect as written consent to sell, in favor of any purchaser in the ordinary course of business.

And if the mortgagor consented in writing to disposition of the collateral, "the purchaser under such disposition shall, without regard to notice of the mortgage or due filing, hold free of the mortgage." The Trust Receipts Act simply provided that

Where the trustee, under the trust receipt transaction has liberty of sale and sells to a buyer in the ordinary course of trade, such buyer takes free of the entruster's security interest in the goods so sold, and no filing shall constitute notice of the entruster's interest to such a buyer.

Authorities interpreting these provisions do not support the view that an interest void against one buyer is resurrected and valid against later purchasers from such buyer. Their reasoning is essentially that a trans-

---

709. See text accompanying note 694-698 supra. And see authorities cited note 714 infra.
712. Id. § 25(1).
714. Before the widespread adoption of uniform statutes, the rule undoubtedly was that when a mortgagor expressly or impliedly consents to a sale of the mortgaged property, he waives his lien and the buyer takes the title free from the lien of the mortgagee. If such buyer resells and is sued for breach of warranty of title, proof of the fact that the mortgage was released and that a title free from the lien therefore was acquired and transferred by him would constitute a valid and complete defense.
feree takes whatever rights his transferor had, and that if the transferor


The rule that if one purchaser takes free so does his transferee was continued under the uniform acts. For example, the Uniform Chattel Mortgage Act provided in this context that "If the mortgagee allows the goods to be placed in the mortgagor's stock in trade or sales or exhibition room, this shall have like effect as written consent to sell, in favor of any purchaser in the ordinary course of the mortgagor's business . . . ." UNIFORM CHATTEL MORTGAGE ACT § 25(2)(a) (act withdrawn 1943) (emphasis added). And "purchaser" meant "any person taking by purchase and any legal successor in interest of such person." Id. § 1 (emphasis added).

The provision in the Uniform Trust Receipts Act which is analogous to U.C.C. § 9-307(1) has language which could be the source of the phrase "created by his seller." Where the trustee, under the trust receipt transaction, has liberty of sale and sells to a buyer in the ordinary course of trade, . . . such buyer takes free of the entrustee's security interest in the goods so sold . . . .

UNIFORM TRUST RECEIPTS ACT § 9(2)(a)(i) (act withdrawn 1943) (emphasis added). This section supposedly makes it "clear that the buyer in the ordinary course must buy from the trustee or the dealer." 1 Report of the Law Revision Commission—Study of the Uniform Commercial Code 242, N.Y. LEG. DOC. NO. 65 (1955) (emphasis in original). But consider how the court in Commercial Credit Corp. v. General Contract Corp., 223 Miss. 774, 79 So. 2d 257 (1955), determined the rights of a purchaser from one who bought a car from the inventory of a debtor whose operation was floor planned pursuant to a trust receipts transaction.

General Contract Corp. had a security interest in the inventory of Stewart-Lacy Motor Company. Lacy sold one of its cars to another dealership, Williams Motor Company. Williams then sold the car to Commercial Credit Corporation which purchased it for use by one of its representatives. Lacy, however, never paid General which retained title to the car under a trust receipt agreement. General sought to replevy the car from Commercial. Judgment was for General at the trial level, but the case was reversed.

The case was submitted to the jury on the issues, first, whether Williams Motor Company was a purchaser of the Plymouth in good faith for value and, second, whether the sale to Williams by Lacy was in the regular course of Lacy's retail business. It is noted that the stated tests were made to apply to Williams—not to Commercial. Williams was not a party to the lawsuit and the tests, had it been proper to submit them in this case, should have been directed to Commercial. Id. 79 So. 2d at 260. This language suggests the court took a literal approach in construing UNIFORM TRUSTS RECEIPTS ACT § 9(2)(a)(i), supra, i.e., that the buyer that section refers to is the one who claims priority, the ultimate transferee, and that that buyer must meet the various tests of the section regardless of whether the first buyer did. It so happens in this case that the ultimate transferee did meet those tests, but that was not the reason given by the court for reversing the judgment below. According to the court, "the rights of the parties turn mainly upon the right and power of Lacy, as between himself and General, to sell the automobile . . . ." Id. 79 So. 2d at 258. The court reasoned that

The entrustee places the goods in the hands of the trustee for the very purpose of sale. The goods are in the possession of the trustee; are displayed and held out to the public for the specific purpose of sale. The entrustee has extensive powers over the trustee and the manner of conducting his business, with the right to repossess
held the property unencumbered by the secured creditor's interest, then so does the transferee. Since these earlier security devices frequently involved creditors holding title to the collateral as a means of securing their obligations, it is easy to see and understand the application of reasoning now expressed in section 2-403(1) of the Code.\footnote{715} Although the courts have held that the rules of section 2-403 are inapplicable literally to priority disputes under Article 9,\footnote{716} nothing precludes the analogous applica-

property and build up a reserve, and do many other acts to protect himself from default in payment of the trustee.

Id. 79 So. 2d at 262. What the court seems to say is that because the secured party knew the collateral was inventory and would be sold by the debtor, the secured party either waived its lien (on an implied consent theory) or was estopped to assert its interest against a bona fide purchaser. \textit{See} text accompanying notes 690 \textit{et seq. supra}. The citation of Garrett \textit{v}. Hunter, 48 So. 2d 871 (Miss. 1950), supports this interpretation. Necessarily, then, if the interest could not have been asserted against the immediate buyer from the debtor, it could not be asserted against that buyer's transferee.

The court in \textit{Commercial Credit} did not rest its opinion on this reasoning alone, however. It decided that the sale to Williams by Lacy was in the ordinary course of trade for purposes of \textit{Uniform Trusts Receipts Act} § 9(2)(a)(i). \textit{See} 79 So. 2d at 261. Why else would the court reach this issue under the Trust Receipts Act unless it believed that the sale to the first buyer as one in the ordinary course of trade extinguished the lien as to all subsequent transferees of that buyer? \textit{Also, see generally} General Credit Corp. \textit{v}. First Nat'l Bank, 283 P.2d 1009 (Wyo. 1955).

The court in \textit{Commercial Credit Corp. v. General Contract Corp. supra}, obviously believed, also, that commercial realities, as that concept is used in this article, supported a decision for the ultimate purchaser \textit{in this case}.

This case illustrates the hardship which would result from a rule preventing acquisition of title to this car by the purchaser by applying the doctrine of constructive notice. \textit{Commercial} bought the car from Williams. It would then have been necessary for it to have traced title back to Lacy and then ascertain the title of General by inquiry. Only the original trust receipt was placed on record. That simply announced the intention of the parties to make a financial arrangement. All the many details of such an arrangement appeared in the unrecorded papers in the private possession of Lacy and General. While in this case the inquiry would have led to Williams, then to Lacy, then to General, conceivably such an inquiry might cover a half dozen persons located in various parts of the country, depending upon the whereabouts of the people who had transmitted the car.

79 So. 2d at 261. A basic problem for the remote purchaser under both the Uniform Trust Receipts Act and Article 9 of the U.C.C. is that the document which is to notify the world of the secured party's interest is filed under the name of the original debtor which, on the facts of the \textit{Commercial Credit} case, is Lacy. \textit{See Uniform Trusts Receipts Act} § 13(3) (act withdrawn 1943); U.C.C. § 9-403(4). How can someone in \textit{Commercial}'s position be expected to search the records under that name? Should he even be required to suspect that someone owned the car before his seller did? The point is this: what the court in \textit{Commercial Credit} said about the inapplicability of the doctrine of constructive notice to the facts of that case is relevant today under the Code. Article 9 does not ease the burden on a remote purchaser who wishes to investigate the possibility of outstanding security interests in the collateral he wishes to purchase.

715. U.C.C. § 2-403(1) provides \textit{inter alia} that "[a] purchaser of goods acquires all title which his transferor had or had power to transfer except that a purchaser of a limited interest acquires rights only to the extent of the interest purchased." \textit{But see note 708 supra regarding a problem with the literal application of this section to the type of Article 9 case being discussed.}

716. \textit{See} notes 686-88 \textit{supra} and text accompanying them.
tion of its principles when good reasons support it.\textsuperscript{717}

Therefore, a purchaser from a buyer in the ordinary course of business who bought from the inventory of a debtor has three arguments based on the common law to avoid or overcome the “created by his seller” language in section 9-307(1). First, he can argue that the “or otherwise” authorizations sanctioned by section 9-306(2) encompass the rule announced in pre-Code cases like \textit{Howell}. Second, the “takes free of” language in section 9-307(1) may be interpreted in a manner consistent with interpretations of its statutory predecessors which perpetuated the \textit{Howell} rule. And third, the common law principles now embodied in section 2-403 and underlying the interpretations of the predecessors to section 9-307(1), i.e., that a transferee acquires the rights of his transferor, should be applied analogously, if not literally, to the construction of 9-307(1).

The force of these arguments is strengthened by the fact that commercial realities support the result which is sought by their advancement and the conclusion that Article 9 does not displace the common law rules which permit it. The inventory financer knows the collateral will be sold, and, as between it and the ultimate buyer, is in a better position to protect itself. The secured party can require a regular accounting of proceeds, and he relies primarily on them as security. And the extent of the secured party’s protection in this regard depends upon its diligence in monitoring the debtor’s business practices and transactions. To a large degree, therefore, the matter of the secured party’s protection is in his own control.\textsuperscript{718} The ultimate purchaser, however, will typically be a consumer buyer who lacks knowledge of and sophistication about com-

\textsuperscript{717} See generally U.C.C. § 1-102, Comment 1. The “created by his seller” language may have been added to U.C.C. § 9-307(1) for the very reason of making that section consistent with § 2-403, particularly the entrustment provision of § 2-403(2). See note 692 supra. The New York Law Revision Commission understood § 9-307(1) to perpetuate the “implied consent to sale theory, based on the fact that the goods are inventory or that the secured party claimed proceeds . . . .” 1 Report of the Law Revision Commission—Study of the Uniform Commercial Code 242, N. Y. Leg. Doc. No. 65 (1955). But the Commission recognized that this theory did not support cutting off a security interest when a sale was made to a buyer in ordinary course by just anyone. The commissioners suggested a series of transactions involving four parties, i.e., the secured creditor, the debtor, the debtor’s transferee and a buyer in the ordinary course buying from the debtor’s transferee. The Commission believed that under § 9-307 as it then existed without the “created by his seller” language, the buyer in the ordinary course would prevail. But they did not believe “the position of transferees from that person [the debtor’s transferee] should be determined by the question whether they are buyers in ordinary course.” \textit{Id}. at 243. They did believe, however, that the result could be justified if the debtor’s practice was to dispose of goods of the kind involved. To support such a result “an argument might perhaps be made that the secured party had in effect entrusted the goods in the person who sold to the buyer in ordinary course.” \textit{Id}.

\textsuperscript{718} Some might argue this reasoning results in punishing a secured party who fails to police his collateral and, therefore, the entire argument based on implied consent and waiver is an attempt to exhum\textit{e} Benedict \textit{v.} Ratner, 268 U.S. 353 (1925), which was buried by U.C.C. § 9-205. But a revival of \textit{Benedict} is not intended or even suggested, and § 9-205 is
not relevant or applicable to limit the waiver doctrine as used here to supplement U.C.C. § 9-306(2).

The Court held in Benedict that an assignment of accounts or other property as security was void as against creditors under New York law if the debtor reserves the right to dispose of the collateral and apply the proceeds thereof without accounting to the secured party. The debtor’s unrestricted dominion over the proceeds was the key to the decision. But the common law rule which finds consent to sell collateral and a waiver of the security interest implied from the fact that the debtor is in the business of selling goods of that kind is a completely separate doctrine. The Benedict rule and the waiver doctrine were never viewed by the courts under pre-Code law as necessary extensions one of the other. Professor Gilmore, for example, discusses the history of both in great detail and makes no direct connection between the two. See 1 G. Gilmore, supra note 425, at §§ 8.1-8.8; 2 G. Gilmore, supra note 425, §§ 26.1-26.5. In fact, despite Benedict and the New York law upon which it was based, the New York Court of Appeals was among the minority of courts which rejected the common law rule upon which Howell v. Board, 185 Okla. 513, 94 P.2d 830 (1939) (see text accompanying notes 690-703 supra) and U.C.C. § 9-307(1) are based. See, e.g., Utica Trust & Deposit Co. v. Decker, 244 N.Y. 340, 155 N.E. 665 (1927).

U.C.C. § 9-205 provides that

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. This section does not relax the requirements of possession where perfection of a security interest depends upon possession of the collateral by the secured party or by a bailee.

The common law doctrine of waiver based on implied consent to sale is not contrary to the rule of § 9-205. The waiver doctrine does not void the security interest as against the world; it merely provides that as against ordinary course buyers from the debtor and only as against them, the secured party has impliedly released his lien. The waiver results not from the debtor’s liberty to sell the collateral and his dominion over the resulting proceeds. The waiver results from the secured party’s implied acquiescence in the sale of the collateral to the type of persons the secured party knows will deal with the debtor in the ordinary course of trade.

It is true that a great many early cases held chattel mortgages, including those covering inventory, void as against creditors if the mortgagor retained possession of the collateral with the right to sell it. See cases collected in Annot., 73 A.L.R. 236 (1931). But the vast majority of them were based on the doctrine of Twyne’s Case, 76 Eng. Rep. 809 (1604) which anticipated the chattel mortgage recording acts and “had, in its origin, nothing to do with a mortgagor’s power of sale.” 1 G. Gilmore, supra note, 425 § 2.5 at 40. For a discussion of the effect of the rule of Twyne’s Case on inventory finance using the chattel mortgage, see Cohen & Gerber, Mortgages on Merchandise, 39 COLUM. L. REV. 1338 (1939). The doctrine with respect to waiver of a lien based on implied consent to sell in the ordinary course of trade is no more a perpetuation of the doctrine of Twyne’s Case than it is an extension of the Benedict rule. As one court said in a pre-Code case,

This issue is not whether the mortgage is fraudulent and void per se as to creditors of the mortgagor, but whether, as to a purchaser from him, the mortgagee, by the terms of the mortgage, express or implied, waived the lien of the mortgage. The two are quite different things.

Cunningham v. G. F. C. Corp., 35 Tenn. App. 237, 244 S.W.2d 181, 185 (1951) (emphasis in original).

The purpose of § 9-205 is to facilitate the floating charge or lien on a shifting stock of inventory. Supplementing § 9-306(2) with the common law doctrine of waiver based on implied consent to sell does not frustrate that intent. The application of the doctrine as
interests. Even if he suspects that one exists, a search of the financing records will be fruitless. The financing statement filed by the inventory secured party will be indexed under the original debtor’s name. 719 How is the buyer to know who that person is?

Another reality to consider is the predicament in which the first buyer may possibly find himself. As a buyer in the ordinary course of business, he will take free of a security interest created by his seller. Section 9-307(1) clearly protects him from his seller’s secured party. But a subsequent buyer from him, whether or not in the ordinary courses, will not take free because the interest was not created by his seller. Absent the applicability of some other rule, the ultimate buyer will take the property subject to the inventory lender’s interest. Does this not restrict the free alienability of the property? Will the first buyer who takes free be liable for breach of warranty of title to the second buyer who does not? 720 Protecting the secured party to this extent seems commercially unreasonable, unjustified and unnecessary in light of its continuing security interest in proceeds which is probably its primary security and over which it can exercise a significant degree of control.

Not all ultimate buyers, however, will be protected by supplementing Article 9 with the common law rules suggested earlier. They would not, for example, change the result in cases such as National Shawmut Bank of Boston v. Jones. 721 Debtor buys a car from seller who retains a security

719. See U.C.C. § 9-403(4).
720. See U.C.C. § 2-312 which provides inter alia that a seller warrants “that (a) the title conveyed shall be good, and its transfer rightful; and (b) the goods shall be delivered free from any security interest . . . of which the buyer at the time of contracting has no knowledge.”
interest and perfects it. Debtor sells the car to an automobile dealer, and a good faith buyer without knowledge of any security interest buys it from him. The buyer cannot take free of the seller’s security interest under section 9-307(1) because it was not created by the one who sold him the car. Interpreting section 9-307(1) consistently with its predecessors does not help the buyer because no one in his chain of title took free of the seller’s security interest. And the seller’s security interest continued in the car because its disposition by the original debtor was not authorized by the secured party in the security agreement or otherwise. Pre-Code cases like Howell are distinguishable because the collateral was not used by the original debtor as inventory. According to Howell the consent to sell is implied and the interest is thereby waived only when the secured party knows that the property will be held by the debtor for resale to the public.722 This knowledge is generally inferred, according to the pre-Code cases, when the collateral is inventory, but not when it is held by the debtor as consumer goods.

The court in National Shawmut Bank observed that sections 9-307(1) and 9-307(2) “are the only provisions of Article 9 under which a buyer of goods can claim to take free of a [perfected] security interest where a sale, exchange or other disposition of the collateral was without consent of the secured party.”723 And it concluded that section 9-306(2) “gives the court no leeway to create any other exceptions to its dictates and no custom, usage or agreement has been brought to our attention which would permit us to do so.”724 Even if the arguments based on the common law rules supplementing section 9-307(1) and 9-306(2) had been made to the court, the result would not have been different. The conclusion that the ultimate buyer should lose in cases like this is a sound one because of the fact that the original debtor is using the collateral as something other than inventory. In such a case the secured party does not expect disposition of the collateral by the debtor and, more importantly, is not relying for security on its proceeds to the extent that an inventory lender does.729


722. See text accompanying note 697 supra, and see authorities cited notes 692-93 & 700 supra.
723. 236 A.2d at 486.
724. Id.
725. The perspective of a secured party in a case such as National Shawmut Bank of Boston v. Jones, 108 N.H. 386, 236 A.2d 484 (1967) with respect to collateral security is very different from that of the inventory lender. Inventory lenders expect sales of the collateral and anticipate that the debtor will use the proceeds to rebuild his inventory stock. The modern loan theory of banking with respect to inventory financing is based on the assump-
1980] 

UNIFORM COMMERCIAL CODE 135

In the case of inventory, however, sales of the collateral are not only expected but encouraged. And a secured party thereby impliedly consents to sales of the collateral in the ordinary course. Under the common

tion "that borrowers will utilize proceeds of sales to acquire new inventory and will reduce the working capital loan not as a result of discrete sales but as a consequence of capital needs and cash flow." Dolan, supra note 653, at 709. But the secured party such as the one in National Shawmut Bank operates on a completely different premise: If the loan is not repaid, he will repossess the collateral. He does not look for his ultimate security either directly or indirectly at the proceeds (including proceeds from proceeds) resulting from a resale of the collateral. If the collateral is resold, he will ordinarily have a difficult time tracing the proceeds because the investment patterns of a consumer debtor are less predictable than those of persons operating going business concerns. Business debtors can reasonably be expected to reinvest in inventory, but who can predict what a consumer will do with the money he receives from the sale of a car or whatever? The inventory lender can easily take security interests in all the debtor's inventory and reasonably expect the proceeds of resale to find its way back there. But, as a practical matter, the secured party in cases like National Shawmut Bank has only the original collateral as his security. He cannot easily take security interests in all the debtor's other presently owned consumer goods, and U.C.C. § 9-204(2) effectively prevents after-acquired interests in consumer goods. Therefore, he deserves more protection against the claims of subsequent transferees from his immediate debtor.

The reasoning urged in the text and this note which supports the result in National Shawmut Bank emphasizes the position and expectations of the secured party. Other writers who criticize the case focus on the status of the ultimate buyer as one in the ordinary course and suggest that all such purchasers should be protected in any case. Where would the drafters have us place the emphasis in deciding these kinds of cases? Some evidence suggests that they intended to emphasize the position of the secured party and that for this reason the "created by his seller" language was added to U.C.C. § 9-307(1).

The "created by his seller" language was probably inserted in response to comments and recommendations by the New York Law Revision Commission. See notes 682 & 717 supra. In their discussions of U.C.C. § 9-307(1), the commissioners considered this question:

If the debtor having possession or control of collateral fraudulently sells it or subjects it to a claim of a person who is not a buyer in ordinary course, but is a person engaged in the business of selling goods of that kind, is the security interest cut off by a sale by that person to a buyer in the ordinary course?

1 REPORT OF THE LAW REVISION COMMISSION FOR 1955—STUDY OF THE UNIFORM COMMERCIAL CODE 243 (1955). They were posing the identical issue considered a dozen years later by the New Hampshire Supreme Court in National Shawmut Bank. The commissioners took the position that the answer should not depend upon the status of the ultimate buyer as one in the ordinary course. "It would seem that the position of transferees from the person should not be determined by the question whether they are buyers in ordinary course." Id. It is almost as though the commissioners had in mind the facts of National Shawmut Bank. They said, "Where the debtor is not himself engaged in the business of selling goods of that kind, it might be thought that the secured party should not bear the risk of a fraudulent transfer to a person who is engaged in such business." Id. Conversely the commissioners were not reluctant to allow the secured creditor to lose to an ultimate transferee if the original debtor himself was in the business of selling goods of the kind.

If the debtor himself was a person engaged in the business of selling such goods, evidence of collaboration with his transferee, as well as any principal and agent relation, might result in treating the sale as having been made by the debtor himself. Or, where the secured party failed to supervise the debtor's dealings with the goods, in the face of indications that the debtor made a practice of disposing of the goods in violation of restrictions, an argument might perhaps be made that the secured party had in effect entrusted the goods to the person who sold to the buyer in ordinary course.

Id.
law, therefore, he waives his interest against buyers in the ordinary course, and once waived it cannot later be asserted against the buyer's transferees. Pre-Code authority developed and applied these rules, and they can be perpetuated under Article 9 by supplementing the section 9-306(2) "or otherwise" language or interpreting the section 9-307(1) "takes free of" language in light of them. Regardless of the approach taken, however, commercial realities support their perpetuation.

E. Conversion As A Debtor's Remedy Under Part 5 of Article 9

Waiver has been used to supplement Article 9 in other contexts, including Part 5 which governs the rights and duties of the parties when the debtor defaults. In _Fontaine v. Industrial National Bank of Rhode Island_, the debtor was late in making his August and September car payments under an installment contract which the seller had assigned to the bank. The October payment was made on time. The bank repossessed the car in December even though no payment was then delinquent. The debtor sued the bank for "unwarranted repossession." The defendant argued that its action was justified because the August and September payments were late, denying that acceptance of them waived the earlier defaults under the contract. The court disagreed. It relied on pre-Code authority holding that a creditor who accepts part payment after a vendee's default thereby assents to delay, waives any forfeiture and cannot repossess on the basis of the untimely payments. The decision for the debtor in _Fontaine_ was made in defiance of a contract clause expressly providing that acceptance of late payments does not waive a default and the creditor's right to accelerate the balance. Enforcing such a clause would be "so unconscionable as to be against public policy" because it would "give judicial sanction to an arrangement whereby a conditional vendee, once in default, is in constant peril of having the chattel summarily repossessed even though said vendee has been in faithful compliance with periodic payments for months or even years after the original default."

727. 298 A.2d at 521. Later in its opinion the court said the plaintiff "predicated his cause of action on wrongful repossession." Id. 298 A.2d at 522 (emphasis added). See text accompanying notes 733-752 infra.
728. _But compare_, e.g., Philay v. Fulton Nat'l Bank, 139 Ga. App. 28, 227 S.E.2d 811 (1976) (late payments accepted after indebtedness accelerated by secured party).
730. 298 A.2d at 523-24.
A similar case involves a secured party who has regularly accepted late payments but eventually decides to repossess when the debtor fails to make the next payment on time. A clause in the security agreement usually gives the creditor the right to declare the contract in default if any payment is delinquent. When sued by the debtor, the secured party argues that this contract language entitled him to repossess despite the established pattern of accepting late payments and foregoing repossession. The courts typically hold that "an established course of dealing under which the debtor . . . makes continual late payments and the secured party . . . accepts them does not result in a waiver of the secured party’s right to rely upon such a clause in the agreement authorizing him to declare a default and repossess the chattel."\textsuperscript{731} But "a secured party who has not insisted upon strict compliance in the past . . . must, before he may validly rely upon such a clause to declare a default and effect repossession, give notice to the debtor . . . that strict compliance with the terms of the contract shall be demanded henceforth if repossession is to be avoided."\textsuperscript{732} By his course of dealing the secured party has, in effect, waived the right to repossession based on defaults in making timely payments. The secured party must then reinstate the right by giving the debtor notice that strict compliance with the contract is now expected before a late payment can justify repossession. In many of these cases such notice has not been given, and the secured party is found liable for wrongful repossession.\textsuperscript{733}

A secured party may take possession of the collateral under section 9-503 only when the debtor is in "default," and he may do so without judi-


\textsuperscript{732} Id.


The pre-Code cases generally support the principle that acceptance of late payments waives strict compliance with contract terms specifying time of payments. See, e.g., Commercial Credit Co. v. Ragland, 189 Ark. 349, 72 S.W.2d 226 (1934); General Motors Acceptance Corp. v. Hicks, 189 Ark. 62, 70 S.W.2d 509 (1934); Commercial Credit Co. v. Willis, 126 Fla. 444, 171 So. 304 (1936); Mathers v. Wentworth & Irwin, Inc., 145 Or. 668, 26 P.2d 1088 (1933); Seeley v. Peabody, 139 Wash. 382, 247 P. 471 (1926). But see Lundberg v. Switzer, 146 Wash. 416, 263 P. 178 (1928) where conditional sales contract expressly provided that acceptance of delayed payments should not be considered as a waiver of strict performance as to other payments or conditions under the contract. Compare Universal C.I.T. Credit Corp. v. Stewart, 262 F.2d 745 (5th Cir. 1964).
cial process only when it "can be done without breach of the peace." If the collateral is repossessed when the debtor is not in default, or if the secured party causes a breach of the peace while helping himself, he violates section 9-503. The courts sometimes refer to this violation as "unwarranted" or "improper" or "unjustified," but the most frequently used term is wrongful repossession. All these terms describe the same misconduct, i.e., action by the secured party in taking possession of collateral at a time or in a manner not sanctioned by Article 9. When, as in Fontaine for example, a secured party repossesses collateral on the basis of an event of default which he has waived, he is liable for wrongful repossession because he seized the property even though he was not entitled to possession. The debtor was not in default, and the secured party cannot repossess until he is.

734. U.C.C. § 9-503.
737. Wrongful repossession is a term which may also describe other, less common evils. For example, U.C.C. § 9-503 provides that a secured party may help himself "unless otherwise agreed." If the parties in their security agreement or otherwise have conditioned the right to repossession, the secured party's failure to abide by any such conditions can expose him to liability. See, e.g., Klingbeil v. Commercial Credit Corp., Inc., 439 F.2d 1303 (10th Cir. 1971); Ford Motor Credit Co. v. Hunt, 141 Ga. App. 612, 234 S.E.2d 112 (1977); Ford Motor Credit Co. v. Milline, 137 Ga. App. 565, 224 S.E.2d 437 (1976); Ford Motor Credit Co. v. Hitchcock, 116 Ga. App. 563, 158 S.E.2d 468 (1967).
And in Red Hat v. Downtown Chevrolet, Inc., 12 UCC Rep. Serv. 939 (Okla. Ct. App. 1973), the court held that repossession is improper where the security agreement imposes charges which are patently unlawful under the Uniform Consumer Credit Code.
What is the debtor's remedy for wrongful repossession by the secured party? Section 9-503 does not give an answer. Section 9-507(1) provides, however, that "the debtor . . . has a right to recover from the secured party any loss caused by a failure to comply with the provisions of this Part [5 on Default]." A literal reading of this provision and the accompanying commentary suggests that the statutory "any loss" remedy is appropriate only when a secured party fails to dispose of collateral pursuant to the procedures of Part 5 once he has repossessed it. The basis of a debtor's cause of action for failing to repossess at the time and in the manner prescribed by section 9-503 is, therefore, arguably not the remedy established under section 9-507(1). Most courts and debtor's lawyers must agree with this literal reading of section 9-507(1) because they look to pre-Code law for a remedy, and there they find one. The secured party's liability for wrongful repossession is usually based on the common law rule of conversion.

---

738. U.C.C. § 9-507(1). In the case of consumer goods, the same section provides for a minimum recovery, i.e., "the debtor has a right to recover in any event an amount not less than the credit service charge plus ten per cent of the principal amount of the debt or time price differential plus 10 per cent of the cash price." Id.

739. The commentary to the section often refers to the remedies given there as ones to compensate the debtor for the unreasonable disposition of the collateral, not the unlawful repossession of it. See U.C.C. § 9-507, Comments 1 & 2. But see note 746 infra.


But see Sheppard Federal Credit Union v. Palmer, 408 F.2d 1369 (5th Cir. 1969). There the court said, "Any tort action which previously existed for unlawful repossession must be considered displaced to the extent that it conflicts with applicable Code provisions." Id. at 1373. The court did not consider, however, to what extent, if any, a conversion theory has been displaced under Part V of Article 9.
“Conversion is an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel.”

One may commit conversion by dispossessing another of a chattel such as by “taking [it] from the possession of another without the other’s consent” or by “obtaining possession of [it] from another by fraud or duress.”

Chattel mortgagees and conditional vendors were routinely found liable for conversion under pre-Code law when they wrongfully repossessed collateral from the debtor, and these cases are

---

741. Restatement (Second) of Torts § 222A (1) (1965).
742. Id. § 223(a).
743. Id. § 221(a).
744. Id. § 221(b).
followed today under Article 9. The courts never fully explain the reason for perpetuating a remedy applied in analogous situations under pre-Code law. They necessarily decide that Article 9 has not displaced it but fail to explain why they so rule. Apparently the courts believe that since section 9-507(1) literally applies only to cases of improper disposition, Article 9 is silent on the question of a remedy for wrongful repossesion. They must conclude, therefore, that this silence openly invites, and even
requires, the use of supplemental common law rules. And after basing the secured party’s liability on a rule outside the Code, the courts must also conclude that they thereby avoid the proscription of penal damages contained in section 1-106(1).\textsuperscript{747} Debtors suing Article 9 secured parties in conversion for wrongful repossession are frequently awarded punitive damages in addition to actual ones.\textsuperscript{748}

Conversion is hardly mentioned in Article 9. The commentary to section 9-306 provides that a transferee of collateral who takes subject to a security interest may be liable to the secured party for conversion.\textsuperscript{749} Another reference is in section 9-505(1). A secured party who is prohibited from strictly foreclosing under that section must dispose of the collateral by sale or otherwise within 90 days after repossessing it.\textsuperscript{750} If he fails to do so, “the debtor at his option may recover in conversion or under Section 9-507(1) on secured party’s liability.”\textsuperscript{751}

Courts have also allowed conversion actions in other types of cases although the Code and its comments do not expressly or literally sanction them. The wrongful repossession action already discussed is an exam-

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{747} See text accompanying notes 752-857 supra.
\item \textsuperscript{748} U.C.C. § 1-106(1). When the courts decide that a debtor’s remedy for wrongful repossession is conversion, penal or punitive damages can be awarded if this “other rule of law” provides for them. Conversion is typical of the torts for which punitive damages may be awarded. See W. Prosser, Handbook of the Law of Torts § 2 at 10-11 (4th ed. 1971). Courts deciding pre-Code cases of wrongful repossession often held that under proper circumstances the secured party is liable for punitive damages in addition to actual ones. See cases collected in Annot., 35 A.L.R.3d 1016 (1971); Annot., 153 A.L.R. 769 (1945).
\item \textsuperscript{750} See U.C.C. § 9-306; Comment 3. And see authorities cited note 674 supra.
\item \textsuperscript{751} See U.C.C. § 9-505(1). A secured party does not have the option of proposing to retain the collateral in satisfaction of the obligation if the debtor has paid sixty per cent of the cash price in the case of a purchase money security interest in consumer goods or sixty per cent of the loan in the case of another security interest in consumer goods, and has not signed after default a statement renouncing or modifying his rights under this Part . . . .
\end{itemize}
\end{footnotesize}
The Article’s supposed silence on the remedy in such a case is the reason for allowing it. But several courts have permitted conversion suits in one type of case where Article 9 appears expressly to supply a remedy. Secured party rightfully repossesses the collateral, sells it at a public or private sale and then sues for a deficiency. In counterclaim the debtor shows that he failed to receive the notice required or that the sale was not conducted in a commercially reasonable manner under section 9-504(3). Section 9-507(1) plainly provides that in this type of case the debtor’s remedy is to recover “any loss caused by a failure to comply with provisions of this Part.” Some courts have correctly held, however, that this provision is not the exclusive remedy and does not displace an action for conversion or that the provision is a codification of the conversion remedy.

Prior to the adoption of the Code, a majority of courts held that a chattel mortgagee or a conditional vendor with the power of resale was liable for conversion for failing to follow the procedures prescribed by law or the parties’ contract with respect to disposing of the collateral. The

---

752. See text accompanying notes 726-748 supra.
753. U.C.C. § 9-507(1). And “[i]f the collateral is consumer goods, the debtor has a right to recover in any event an amount not less than the credit service charge plus ten per cent of the principal amount of the debt or the time price differential plus 10 per cent of the cash price.” Id.
755. In Mass v. Allred, 577 P.2d 127 (Utah 1978), the debtor sued the secured party for conversion based on the creditor’s wrongful repossession and wrongful foreclosure. The jury found that the disposition of the collateral was commercially unreasonable, and the court said “[t]his finding alone is sufficient basis to sustain the judgment against the defendant.” Id. 577 P.2d at 128.
usual measure of the debtor's damage was the value of the property at the

time of the conversion less the balance of the obligation owed the creditor.\textsuperscript{256} Section 9-507(1) does not displace the common law conversion

94 (1903); Smith v. Wood, 63 Vt. 534, 22 A. 575 (1891); Roberts v. Hunt, 61 Vt. 612, 17 A. 1006 (1889); Lemaire v. Yakima Valley Production Credit Ass'n, 194 Wash. 689, 79 P.2d 693 (1938); Richter v. Buchanan, 48 Wash. 32, 92 P. 762 (1907); Jacobson v. Aberdeen Packing Co., 26 Wash. 175, 66 P. 419 (1901); Pickle v. Smally, 21 Wash. 473, 58 P. 581 (1899); Charleston Milling & Produce Co. v. Craighead, 116 W. Va. 194, 179 S.E. 69 (1935); Rumary v. Livestock Morg. Credit Corp.; 234 Wis. 145, 290 N.W. 611 (1940); Kellogg v. Malick, 125 Wis. 239, 103 N.W. 1116 (1905); Gauhe v. Milbrath, 94 Wis. 674, 69 N.W. 999 (1897); Harder v. Hosp, 69 Wis. 286, 34 N.W. 145 (1887).

Also, see generally additional authorities cited note 756 infra, some of which do not use the word "conversion" to characterize the debtor's remedy but measure his damages as if that were his remedy.

Also, see generally, e.g., 2 J. COBBY, supra note 508, §§ 1033-1036; 2 T. COOLEY, A Treatise on the Law of Torts or the Wrongs Which Arise Independently of Contract § 333 (4th ed. 1932); 1 F. HARPER & F. JAMES, Jr., The Law of Torts § 2.30 (1956); 2 L. JONES, supra note 509, § 822.

Professors Harper and James wrote that whatever the theory supporting a debtor's action against a secured party for wrongful foreclosure or disposition, the debtor "reovers only the value of the converted article less the debt for which it was pledged as security," 1 F. HARPER & F. JAMES, Jr., supra note 755, § 2.30 at 180. See also 2 J. COBBY, supra note 509, §§ 1033-36; 2 A. SEDGWICK, A Treatise on the Measure of Damages §§ 497c & 497e (9th ed. 1913); 3 J. SUTHERLAND, A Treatise on the Law of Damages §§ 1136-1137 (2d ed. 1893). The rationale is that the creditor has converted the debtor's interest in the collateral, the full value of which is the difference between the value of the property and the amount of the balance owed to the creditor. See generally 1 F. HARPER & F. JAMES, Jr., supra note 755, §§ 2.18 & 2.30. Therefore, in cases of wrongful foreclosure

the proper procedure . . . is to ascertain and charge [the creditor] with the fair market value of the property at the time of its conversion by him and apply it on the debt and after that is done if there be any balance due [the creditor], he should have judgment for such amount. On the other hand, if the fair market value of the property was more than sufficient to extinguish the debt, then in this event [the debtor] should be awarded this amount. Interest should be charged against [the creditor] on the fair market value on the property from and after the date of its conversion.

Wells v. Derrick, 225 Ark. 993, 287 S.W.2d 4, 6 (1956).

A great many pre-Code cases follow the rule that a debtor's damages resulting from an unlawful disposition of collateral after its repossession are to be measured by crediting the balance of the debt owed with the value of the collateral. The courts followed this rule in the majority of cases whether or not in a specific case they characterized the creditor's wrongful act as a conversion. See generally, e.g., Wolf v. Aero Factors Corp. 126 F. Supp. 872 (S.D.N.Y. 1954), aff'd, 221 F.2d 291 (2d Cir. 1955); Maestro Music, Inc. v. Rudolph Wurlitzer Co., 88 Ariz. 222, 354 P.2d 266 (1960); Perryman v. Abston, Wynne & Co., 164 Ark. 290, 261 S.W. 622 (1924); Anderson v. Joseph, 95 Ark. 573, 130 S.W. 165 (1910); Jones v. Horn, 51 Ark. 19, 9 S.W. 309 (1888); McClure v. Hill, 36 Ark. 268 (1880); Murphy v. Wilson, 153 Cal. App. 2d 132, 314 P.2d 507 (1957); Grattan v. Wilson 82 Colo. 239, 239 P. 6 (1927); Aultman & Taylor Mach. Co. v. Forest, 23 Colo. App. 558, 130 P. 1086 (1913); Jones v. Brown, 108 Ga. App. 776, 134 S.E.2d 440 (1963); Motor Contract Co. v. Johnson, 61 Ga. App. 735, 7 S.E.2d 320 (1940); Marchand v. Rongahan, 9 Idaho 95, 72 P. 731 (1903); Whitemore v. Fisher, 132 Ill. 243, 24 N.E. 636 (1890); Waite v. Dennison, 51 Ill. 319 (1869); Haines v. P. Chambers, 31 Ill. 527 (1889); Lee v. Fox, 113 Ind. 90, 14 N.E. 889 (1888); Wetmore v. Wooster, 21 Iowa 1365, 237 N.W. 430 (1931); Howery v. Hoover, 97 Iowa 581, 66 N.W. 772 (1896); Montgomery County Nat'l Bank v. Wherry, 102 Kan. 224, 169 P. 1146 (1918); Kelly v. McCarty, 75 Kan. 818, 88 P. 882 (1907); Miller v. McElwain, 52 Kan. 91, 34
remedy for wrongful foreclosure (or at least its measure of damages) but,


The same rule with respect to the debtor's damages was applied in pre-Code wrongful
instead, expressly perpetuates it. The section should be interpreted so as


Exactly how the courts applied the value-less-debt rule in wrongful foreclosure cases is not immediately obvious. A great many of the cases simply discuss the measure of the debtor's damages in general terms without detailed explanations of its application in particular instances. If the creditor has failed to sell the collateral, applying the damages formula is not a complicated exercise. Problems arise, however, where an improper sale was conducted and proceeds resulted. Is the value of the collateral to be offset against the amount of the debt owing at the time of the sale or by that amount reduced by the tainted proceeds? In a few cases, the full value of the property was offset against the deficiency claimed by the creditor who had already credited the debtor's account with the proceeds of the improper sale. See Home Finance Co. v. Ratliff, 374 S.W.2d 494 (Ky. 1964); Advance Thresher Co. v. Doak, 56 Okla. 532, 129 P. 736 (1913). But these cases are clearly erroneous and in the minority. They give the debtor double credit for the proceeds resulting from the improper sale. The debtor is entitled to full credit for the value of the property but not that credit plus additional credit in the form of the improper resale proceeds.

Based on how they actually computed damages in particular cases and, more often, on inferences drawn from what they said about how to apply the value-less-debt damages rule, it appears that most courts took this approach: The debtor in a wrongful foreclosure case is entitled to credit for the actual value of the collateral or the amount received from an im-
to put the debtor "in as good a position as if the other party [the secured
proceeds, those proceeds should be ignored as a factor in computing the debtor's damages;
the debtor is entitled to have the value of the property as of the time of the conversion
(usually said to be at the time of the improper sale) credited against the amount of the debt
due at that time. In other words, since the sale was ineffectue, what the debtor is entitled to
have credited against this resale on that date is not the resulting proceeds but the actual
value of the collateral at the time of the conversion.

For example, the court in Conway v. Skidmore, 48 Wyo. 73, 41 P.2d 1049 (1935), said
that "[the deficiency due [the conditional vendor's assignee] will be ascertained by deduct-
ing $150, the lowest estimate of the value of the property at the time of resale, from the
amount due plaintiff under the contract at that time."
Id. 41 P.2d at 1053 (emphasis added).
The Vermont Supreme Court said

that, when a conditional vendor of property takes it and does not proceed in ac-
cordance with the statute, the measure of damages in a suit against him by the
conditional vendee is the value of the property at the time of the taking diminished
by the sum then remaining due upon the contract of sale.

Stetson v. Davidson, 119 Vt. 409, 126 A.2d 921, 924 (1956) (emphasis added). And in Com-
mercial Credit Corp. v. Flores, 345 S.W.2d 432 (Tex. Civ. App. 1961), the court affirmed a
judgment against a chattel mortgagee in the sum of $680 for conversion based on the dif-
ference between the value of the automobile when converted and the amount of money then
owed by the debtor. In Avery Co. v. Kemp, 196 S.W. 1069 (Mo. App. 1917), the creditor
wrongfully foreclosed collateral and sued for $265.50. The improper sale produced
$11.4.70. The creditor credited the debtor with that amount and sued for the difference.
The trial court found that the property's value on the date of the sale was $600 and gave the
derector judgment for the difference between $600 (the property's value on the date of the
conversion) and $265.50 (the amount of the debt on that date). The judgment was affirmed.

And in many cases this statement of the rule for measuring the debtor's damages is given:
The general rule for the measure of damages by a mortgagor against a mortgagee for a
conversion of the mortgaged property is the difference between the market value of the
property at the time of the conversion and the amount of the mortgage debt. See, e.g., Harrill v.
Weer, 26 Okla. 313, 109 P. 539, 541 (1910); Laam v. Green, 106 Or. 311, 211 P. 791, 794
(1923). The clear, if not demonstrable, inference drawn from a large number of cases is that
the market value on that date will be offset against the balance of the debt on that same
date, not the debt as reduced by any proceeds resulting from an improper sale. If the credi-
tor does sue for a deficiency based on the debt less the proceeds of a wrongful sale, the same
result can be reached, however, simply by giving the debtor credit for the difference between
the value of the property and the amount of such proceeds. See generally, e.g., Perryman v.
Abston, Wynne & Co., 164 Ark. 290, 261 S.W. 622 (1924); Peterson Tractor Co. v. Cal-West
Equipment Co., 386 P.2d 609 (Nev. 1963). As the New Jersey Supreme Court recognized
almost 100 years ago, in an action brought by a mortgagor against a mortgagee for wrongful
foreclosure "the measure of damages would be the difference between the price realized and
actual value of the property or the excess of the value of the property above the mortgage

Some pre-Code authority supported the proposition that where a secured creditor con-
verted the debtor's interest in the collateral, the value of the interest was to be measured by
the amount of payments the debtor had made to the creditor. As early as the late 1800's this
rule was established by statute in New York with respect to conditional sales contracts.

Under the provisions of the statute in effect prior to the adoption of the Uni-
form Conditional Sales Act in [New York], it was the rule that the seller should
hold the property for thirty days following the retaking and then resell the prop-
erty at public sale within the next thirty days. A resale was absolutely required
irrespective of what the buyer had paid on the contract, and upon the failure of the
seller to hold a proper resale, the buyer was entitled to recover from him the entire
amount of all payments made under the contract. The matter was covered by
former sections 116 and 117 of the Lien Law enacted in 1897 and amended in 1900
party] has fully performed." Therefore, the "loss caused by a failure to

and, upon the repeal of those sections, by Personal Property Law, Section 65,
which was in force until 1922.

S. EAGER, THE LAW OF CHATTEL MORTGAGES AND CONDITIONAL SALES AND TRUST RE-
CEPTS § 425 at 556 n.1 (1941). And see, e.g., Lanston Monotype Mach. Co. v. Curtis, 224
F. 403 (2d Cir. 1915); Rivara v. James Stewart & Co., 241 N.Y. 259, 149 N.E. 851 (1925),
aff'd, 274 U.S. 614 (1927); Hillelson v. Old Reliable Motor Truck Corp., 208 A.D. 327, 203
N.Y.S. 410 (1924), aff'd per curiam, 239 N.Y. 553, 147 N.E. 192 (1924); J. B. Van Derveer &
Son, Inc. v. Canzana, 206 A.D. 130, 200 N.Y.S. 563 (1923); Hoffman v. White Sewing
391 (1916).

Tennessee had a similar statute. See, e.g., White Co. v. Bragg, 168 Ark. 670, 273 S.W. 7
(1925) (applying Tennessee law); Mitchell v. Automobile Sales Co., 161 Tenn. 1, 28 S.W.2d
51 (1930); Massillon Engine & Thresher Co. v. Wilkes, 82 S.W. 316 (Tenn. 1904); Cowan v.
Singer Mfg. Co., 92 Tenn. 376, 21 S.W. 663 (1893). A conditional vendee could elect, how-
ever, not to proceed under the statute but, instead, to sue the vendor in conversion. See
Barger v. Webb, 216 Tenn. 275, 391 S.W.2d 664 (1965); Barnes v. Walker, 191 Tenn. 364,
234 S.W.2d 648 (1950).

The Uniform Conditional Sales Act provided that if the conditional vendor wrongfully
foreclosed, "the buyer may recover from the seller his actual damages, if any, and in no
event less than one-fourth of the sum of all payments which have been made under
the contract, with interest." UNIFORM CONDITIONAL SALES ACT § 25 (H. Green ed. 1922) (act
withdrawn 1943). The title of the section was "Recovery of Part Payments," and, according
to the Commissioners' Note, the debtor's "actual damages" were "the difference between
the amount of his part payments and the value of the use of the property which he has had,
and also the value of his bargain." 2 UNIFORM LAWS ANNOTATED—UNIFORM CONDITIONAL
SALES ACT 39 (H. Green ed. 1922). But the courts applying this section seldom measured
the debtor's actual damages according to a payments-less-use-value formula. See, e.g., au-
thorities cited note 845 infra.

Absent a statute specifically prescribing recovery of payments made, most courts re-
jected that approach as the proper way to measure a debtor's damages for wrongful foreclo-
sure or repossession by the creditor. See generally authorities cited supra herein applying
the value-less-debt rule for measuring a debtor's damages for wrongful repossession or fore-
closure. And particularly see, e.g., Cable Co. v. Greenfield, 196 Ky. 314, 244 S.W. 692 (1922);
(1960); Murray v. Federal Motor Truck Sales Corp., 160 Tenn. 140, 22 S.W.2d 227 (1929),
decree modified, 160 Tenn. 140, 23 S.W.2d 913 (1930); Olson v. Schaefer, 200 Wash. 646, 94
P.2d 480 (1939).

The South Carolina Supreme Court took a unique approach to measuring the debtor's
damages when a creditor converted the collateral. It agreed that the measure of damages
was the value of the collateral. Therefore, if the value was more than the debt, the debtor
was entitled to a recovery. But if the value was less than the debt, the secured party was
denied any deficiency. See, e.g., Fowler v. Goldsmith, 131 S.C. 119, 126 S.E. 431 (1925);
Renitz v. Crosby, 108 S.C. 431, 94 S.E. 1053 (1918); Green v. Scruggs, 73 S.C. 403, 53 S.E.
612 (1906). In effect, then, a debtor's minimum recovery in any case was the balance owed
on the debt. But it is clear that that was not his maximum recovery: In any case where the value
exceeded the debt, he would recover the excess in addition to having the balance of the debt
extinguished. In this type of case, the debtor recovered the value of the property less the
debt owed.

In several early cases the courts' position was that a wrongful foreclosure by a creditor
amounted to a conversion but that the consequence was simply extinguishment of the lien.
The rule applied in these cases was frequently stated to be either that a proper sale was a
condition to recovering a deficiency or that an improper sale barred a deficiency. See gener-
ally, e.g., Metheny v. Davis, 107 Cal. App. 137, 290 P. 91 (1930); First Nat'l Bank v. Poling,
42 Idaho 636, 248 P. 19 (1926); Boomer v. Isley, 42 Idaho 547, 246 P. 966 (1926); Cranston
v. Western Idaho Lumber & Bldg. Co., 41 Idaho 141, 238 P. 528 (1925); Rein v. Callaway, 7
comply” with Part 5 of Article 9 must be the difference between the

Idaho 634, 65 P. 63 (1901); Wellens v. Beck, 84 N.W. 2d 345 (N.D. 1957); Peterson v. Wolff, 68 N.D. 354, 280 N.W. 187 (1938); Walkin v. Horstwill, 24 S.D. 191, 123 N.W. 668 (1909); J. I. Case Threshing Mach. Co. v. Watson, 122 Tenn. 148, 122 S.W. 86 (1909), rehearing denied, 122 Tenn. 148, 122 S.W. 974 (1909); Commerce Union Bank v. Jackson, 21 Tenn. App. 412, 111 S.W. 2d 870 (1937); Bekkedal v. Johnson, 127 Wis. 624, 107 N.W. 5 (1906). Many of these cases, however, involved the application of statutes specifically providing for the extinguishment of a security interest if the creditor wrongfully foreclosed or converted the collateral.

For example, a statutory provision still on the books in California provides that the wrongful conversion of personal property by a lienholder “extinguishes the lien thereon.” CAL. CIV. CODE § 2910 (West 1974). Oklahoma and South Dakota have identical provisions. See OKLA. STAT. ANN. tit. 42 § 22 (West 1979); S.D. COMPILED LAWS ANN. § 44-3-3. North Dakota also has a statutory provision similar to the California one, but the North Dakota statute adds this sentence: “In an action for the conversion of personal property, the defendant may show in mitigation of damages the amount due on any lien to which the plaintiff's rights were subject and which was held or paid by the defendant or any person under whom he claims.” N.D. CENT. CODE § 35-01-20 (Repl. 1972). A Wisconsin statute provided that in case of an instrument for sale by a chattel mortgage, “the debt secured by such mortgage shall be deemed fully satisfied and the mortgage canceled.” WIS. STAT. § 2316c (1921), quoted in American Hardware Co. v. Moore, 177 Wis. 190, 187 N.W. 996, 997 (1922). The application of some of these provisions is discussed infra herein.

In the absence of such a statute, most courts specifically rejected the argument that a wrongful foreclosure extinguished the creditor’s interest, except where the property’s value equalled or exceeded the debt owed at the time of the conversion. See generally authorities cited supra herein applying the value-less-debt rule for measuring a debtor’s damages for wrongful foreclosure. And particularly see, e.g., Wells v. Derrick, 225 Ark. 993, 287 S.W. 2d 4 (1956); Lee v. Fox, 113 Ind. 98, 14 N.E. 889 (1888); Jankowitz v. Kaplan, 138 Minn. 452, 165 N.W. 275 (1917); Powell v. Gagnon, 32 Minn. 232, 53 N.W. 1148 (1893); General Motors Acceptance Corp. v. Holland, 30 S.W. 2d 1087 (Mo. Ct. App. 1930); Priddy v. Miners' & Merchants' Bank, 132 Mo. App. 279, 111 S.W. 865 (1908); Harrison v. Hall, 239 N.Y. 51, 145 N.E. 737 (1924); National Exch. Bank v. Holman, 31 S.C. 161, 9 S.E. 824 (1889).

In most of the cases where the courts cited the rule that a wrongful foreclosure extinguished the creditor's lien or barred him from recovering a deficiency, the creditor was suing to foreclose a mortgage or to recover a deficiency. Also, the debtor usually asserted no counterclaim for damages. What about those instances, however, where the debtor either asserted a counterclaim in an action against him by the creditor or brought an independent action against the creditor for wrongful foreclosure? Was the debtor's recovery limited to the balance owed the creditor? Or, was the debtor entitled to be released from liability for any debt still owed the creditor and, in addition, to recover damages? In Wisconsin, the answer apparently was release from liability plus damages. The applicable statute, however, was very specific about the consequences of wrongfully foreclosing a chattel mortgage:

'Any person violating the provisions of this section shall be liable to the person personally liable for the indebtedness, in which case such person shall be entitled to recover in addition to his actual damages the sum of twenty-five dollars liquidated damages. In case of the failure of the owner of any such mortgage, or his agent conducting such sale, to comply with the provisions of this section within the time herein limited, the debt secured by such mortgage shall be deemed fully satisfied and the mortgage canceled.'

American Hardware Co. v. Moore, 177 Wis. 190, 187 N.W. 996, 997 (1922) (quoting WIS. STAT. § 2316c (1921)). And see Banking Commission of Wisconsin v. Ray, 214 Wis. 433, 253 N.W. 556 (1934). But see Gauche v. Milibrath, 94 Wis. 674, 69 N.W. 999 (1897). In Gauche, a chattel mortgagor sued the assignee of a chattel mortgage for the conversion of the collateral. The creditor had repossessed the property but failed to comply with statutory procedures regarding its disposition. Apparently, under the same statute quoted above, the trial court held the defendant liable for the conversion of the property and assessed damages as
amount which would have been obtained from the resale of the collateral.

It provides that the offender shall be liable for actual damages and $25 in addition, in an action therefore. [The measure of plaintiff's recovery would be the value of the property at the time of the sale, less the mortgage debt and expenses of taking and caring for the property up to the time of sale, and in addition thereto any special damages suffered by the respondent and $25. To be sure, the statute says the sale shall operate as a cancellation of the debt, but that does not mean that the mortgagor shall lose his debt as a penalty for violation of the statutory provision, but that the consideration received by him, without respect to whether it is sufficient to satisfy the mortgage debt or not, shall be deemed sufficient for such purpose, so that the offender shall not be able to assert any further claim against the mortgagor. In such a case the mortgagor, if actually aggrieved by the premature sale, but reason of his property being sold for a less sum than its actual value, or is otherwise damaged, may sue the mortgagee, and recover as damages his actual loss and $25; if not actually injured, by reason of the fact that the mortgage debt exceeds the value of the mortgaged property, then the offender, as a penalty for violation of the statute, will lose the deficiency.

Id. 69 N.W. at 1000-01. What the court said was that despite the language of the statute, the usual measure of damages for wrongful foreclosure was to apply in cases such as this one, i.e., the debtor could recover as actual damages the difference between the value of the property and the debt owed, and that only where the unpaid debt exceeded the property's value would the debt be deemed extinguished by the improper sale. But see generally, e.g., Gracy v. Southern Auto Parts Co., 6 Tenn. App. 360 (1927), where the court said, "The purchaser may recover the money paid upon the vendor's failure to sell as required by statute, and the seller cannot set-off the balance of the debt against demands of purchaser where he did not comply by advertisement and sale." Id. at 362.

An approach similar to that in Gänse was taken in Force v. Peterson Mach., Co., 17 N.D. 220, 116 N.W. 84 (1908). There the debtor sued the creditor for wrongful foreclosure. The court found the creditor's acts amounted to conversion of the collateral for which it was liable to the debtor. The applicable statute provided that a lien on personal property was extinguished by the lienholder's conversion of the collateral, but it also provided that the lien is allowed as an offset against the debtor's recovery in mitigation of damages. The court indicated that this approach, i.e., value-less-debt, was employed by it in wrongful foreclosure cases before the statute allowing the liens to be offset was enacted, and this is true. See Lovejoy v. Merchants' State Bank, 5 N.D. 623, 67 N.W. 956 (1896). There the court conceded that according to statute the lien of a creditor who wrongfully forecloses the collateral is thereby extinguished. But the court, nevertheless, decided, even in the absence of a statute requiring it, that the creditor is entitled to offset his debt against the value of the property when he is sued in conversion for wrongful foreclosure. The court emphasized that the measure of damages "must be interpreted with reference to the underlying principle of compensation" and concluded that:

where a party, who has a lien on, or other special interest in property, wrongfully converts it, he is liable for the value of the property, but is nevertheless, . . . entitled to recoup the value of the special property, and he may likewise mitigate the plaintiff's recovery to an amount which will compensate him for the actual loss resulting from the conversion.

Id. 67 N.W. at 957.

South Dakota also had a statute similar to North Dakota's providing that conversion of the collateral by the lienholder extinguishes the lien. But that state's supreme court likewise suggested that when there is evidence that the mortgage debt is yet unpaid, it can be set off against the debtor's damages for conversion based on the creditor's wrongful foreclosure. See generally Northwestern Port Huron Co. v. Iverson, 22 S.D. 314, 117 N.W. 372 (1908). Both this opinion and the one in Lovejoy cite Everett v. Buchanan, 2 Dak. 249, 6 N.W. 439 (1880), 8 N.W. 31 (1881) (separate opinion). In that case the court made a statement which may help to explain how a court can find that a conversion by the secured creditor extinguishes
if the secured party had complied with the provisions of Part 5 and that
which was actually received.\textsuperscript{758} This differential is to be offset against the
deficiency sought by the creditor. If the debtor’s “loss” under section 9-
507(1) is measured in this way, it will be identical to the compensatory
damages for which the secured party would be liable under a common
law conversion theory, i.e., the value of the property at the time of conver-
son less the outstanding balance on the debt at that time.\textsuperscript{759}

the debt, yet still allow that debt to be offset against the value of the collateral in determin-
ing the debtor’s damages. In \textit{Evertt} the court said that the wrongful foreclosure by the credi-
tory was clearly a \textit{wrongful conversion} of the property subject to the lien, and worked a

forfeiture of the lien.

We are not to be understood, however, as deciding that such conversion ex-
tingished the mortgage debt. A lien may be extinguished or released without
afflicting the debt or claim for which it stands as security.

\textit{Id.} 6 N.W. at 439 \textit{(emphasis in original)}.

Finally, there is Advance-Rumely Thresher Co. v. Brady, 47 Idaho 726, 278 P. 224
(1929). In this case a mortgagor sued for a deficiency. The mortgagor counterclaimed for
conversion because the mortgagor wrongfully foreclosed. The court said

Failure to foreclosure in compliance with the statute deprives the mortgag-
e of the right to any deficiency. Conceding . . . [the mortgagor] was entitled to urge
conversion, the measure of damages in such case would be the value of the con-
verted chattel at the time of the conversion. But the damages must be mitigated
by offsetting against them the amount of any lien outstanding against the property
at the time of the conversion.

\textit{Id.} 278 P. at 226.

In sum, therefore, even in those instances where the courts decided that a wrongful
foreclosure extinguished a secured creditor’s lien or barred him from recovering a deficiency,
they often applied the standard conversion measure of damages when the debtor sought
actual damages, i.e., value-less-debt. It is clear that the balance still owed the creditor was
not the maximum recovery, but it is equally clear that when determining that recovery, the
amount of the debt owed to the creditor was an offsetting or mitigating factor.

The approach taken by the courts for determining the debtor’s damages for wrongful
foreclosure under the Uniform Conditional Sales Act is discussed at text accompanying
notes 792-816, 843-853 \textit{infra}.

\textsuperscript{757} U.C.C. § 1-106(1).

\textsuperscript{758} That this is the proper measure of damages was argued in a brief filed on behalf of
the Code’s Permanent Editorial Board. See Brief Amicus Curiae on Behalf of Permanent
Editorial Board, Uniform Commercial Code at 7-8, Norton v. Nat’l Bank of Commerce of
is discussed at text accompanying notes 761 et seq. \textit{infra}.

A debtor has suffered no damages if there is no difference in the amounts and can
recover nothing, unless the collateral is consumer goods. “If the collateral is consumer
goods, the debtor has a right to recover in any event an amount not less than the credit service
charge plus ten per cent of the principal amount of the debt or the time price differential
plus 10 per cent of the cash price.” U.C.C. § 9-507(1) \textit{(emphasis added)}. For a discussion
about awarding this measure of damages in the absence of any actual loss by the debtor, see
\textit{generally} note 839 \textit{infra}.

\textsuperscript{759} The balance of the debt against which the value of the property is offset is the
balance owed before it is reduced by the proceeds of the improper disposition. See note 756
\textit{supra}.

An assumption must be made in order to equate this measure of damages with that
specified at text accompanying note 758 \textit{supra}. The assumption is that a disposition complying
in all respects with the provisions of Part 5 of Article 9 will yield proceeds equivalent to
Conversion is usually not listed as a separate theory, however, when the courts and commentators discuss the approaches typically used to determine a secured party's liability for improperly disposing of collateral.

The jurisdictions that have considered this issue are divided in three distinct ways. Some have adopted the view that compliance with § 9-504(3) is a condition precedent to a secured party's right to recover a deficiency judgment.

Other jurisdictions have followed the view that a secured party may recover a deficiency judgment subject to the debtor's right to recover damages shown to have been a proximate result of the secured party's wrongdoing under § 9-507.

Other jurisdictions have adopted a third view, under which a secured party has the burden of rebutting the presumption that the value of the collateral at the time of the disposition was at least equivalent to the underlying debt. 760

Judges and scholars endlessly debate the merits of each approach but seldom attempt to reconcile them. Each jurisdiction selects its own rule without trying to find common ground upon which to build a uniform approach, and one of the principal purposes of the Code is thereby frustrated. 761 The courts fail to realize what the following discussion reveals: common law conversion may form the basis of an approach which in reality, if not in theory, subsumes all the others.

A few courts have adopted what appears to be a literal approach to interpreting section 9-507(1) and place the burden on the debtor to prove the actual damages he suffered by reason of the secured party's failure to comply with the provisions of Part 5. 762 In Farmers State Bank of Parkston v.

or, at least, approximating the actual value of the collateral. Part 5 of Article 9 needs revision if this assumption is invalid. Surely the objective of a commercially reasonable disposition is to insure that a fair price is obtained for the collateral; and a fair price is one which approximates the collateral's value. The courts seem willing to accept this assumption. They regularly state that "only where the sale is conducted according to the requirements of the code [is] the amount received or bid at sale of collateral . . . evidence of its true value in an action to recover a deficiency." Universal C. I. T. Credit Co. v. Rone, 248 Ark. 665, 453 S.W.2d 37, 39-40 (1970). See also, e.g., Community Management Association of Colorado Springs, Inc. v. Toulouse, 32 Colo. App. 33, 505 P.2d 1314, 1317 (1973); Hall v. Owen County State Bank, 370 N.E.2d 918, 928 (1977); Clark Leasing Corp. v. White Sands Forest Products, Inc., 87 N.M. 451, 535 P.2d 1077, 1082 (1975).


761. One of the purposes and policies underlying the U.C.C. is "to make uniform the law among the various jurisdictions." U.C.C. § 1-102(2)(c).

Otten, the secured party failed to conduct a sale of the collateral within a commercially reasonable time after repossession. The court allowed the debtor to recover damages under section 9-507(1) measured by "the value of the security less the debt." The court did not say that the secured party was liable for conversion but applied the common law measure of damages for conversion based on wrongful foreclosure. In any case where the "any loss" to the debtor under section 9-507(1) is measured in this fashion or by offsetting the deficiency claimed with the difference between value of the property and the amount received from an improper disposition of it, the court is actually perpetuating the common law conversion action for wrongful foreclosure.

A more widely accepted approach for determining the debtor's damages for wrongful foreclosure is illustrated by the leading case, Norton v. National Bank of Commerce. The Bank repossessed a car and sold it for


763. 87 S.D. 161, 204 N.W.2d 178 (1973).

764. 204 N.W.2d at 182. The "debt" against which the value of the collateral was offset was the amount of the obligation owing before the improper disposition, not the amount of the obligation reduced by proceeds from the improper sale. This is consistent with the pre-Code approach to computing the debtor's damages for wrongful foreclosure. See note 756 supra.

765. See note 756 supra.

766. For discussion and citations to authorities regarding pre-Code actions for conversion for wrongful foreclosure and measures of damages, see notes 755 & 756 supra.


In Pennsylvania, a special statute governing motor vehicle financing provides that when a creditor sues for a deficiency

the buyer may have the reasonable value of the motor vehicle at the time of resale, determined in any action or proceeding brought by the seller or holder to recover the deficiency, the resale price being prima facie, but not conclusive evidence, of said reasonable value and the said reasonable value, as determined, or the resale price, whichever is greater, shall be credited to the buyer in account of his indebtedness.


$75.00 at a private sale without notifying the "debtor"768 "of the time after which any private sale . . . is to be made."769 The Bank sued to recover a $277.88 deficiency. The defendant argued "that the bank's failure to give him notice discharged his entire liability."770 The Arkansas Supreme Court disagreed but decided that "simple considerations of fair play cast the burden of proof upon the bank"771 and not upon the debtor as does the first mentioned approach. The court indulged "the presump-

---

768. The debtor in this case, Norton, was the seller of an automobile who had endorsed the buyer's note and transferred it and the conditional sales contract to the Bank. The written assignment of the contract which Norton executed contained a repurchase provision. If the conditional vendee defaulted in his payments, Norton agreed to repurchase the contract from the Bank. The vendee did default, the Bank repossessed and sold the collateral without notice to either Norton or the vendee. The Bank sued only Norton for the deficiency which remained. An issue the court had to decide was whether Norton was a "debtor" to whom notice should have been given as U.C.C. § 9-504(3) requires. The court concluded that Norton was a "debtor" and that the Bank was liable to him for failing to give him notice of the disposition. In a brief filed on its behalf, the Code's Permanent Editorial Board argued that Norton was not a "debtor" and as such entitled to notice from the Bank. See Brief Amicus Curiae On Behalf Of Permanent Editorial Board, Uniform Commercial Code at 4-5, Norton v. Nat'l Bank of Commerce of Pine Bluff, 240 Ark. 143, 398 S.W.2d 538 (1969) (brief filed by Joe Barrett). But see id. at 5-7 arguing that the Bank breached a duty owed to Norton by failing to offer him the chattel paper or the car for repurchase.

In a number of more recent cases the courts have held that guarantors generally are "debtors" for purposes of notice under Part V of Article 9. See, e.g., Commercial Credit Corp. v. Lane, 466 F. Supp. 1326 (M.D. Fla. 1979). And see Commercial Discount Corp. v. Bayer, 57 Ill. App. 3d 295, 372 N.E.2d 926 (1978); Chase Manhattan Bank, N.A. v. Natarelli, 93 Misc. 2d 78, 401 N.Y.S.2d 404 (1977); FMA Financing Corp. v. Pro-Printers, 590 F.2d 803 (Utah 1979), and cases cited therein. But one leading scholar writes, "If such a person [a guarantor] were to be a debtor entitled to notice [prior to disposition of the collateral under Section 9-504(3)], then it would seem that the right to notice could not be waived or varied under Section 9-501(3). However, the ordinary form of guaranty would almost certainly waive the right to notice, just as the ordinary form of note would contain a waiver by the makers and indorsers of the requirements of presentment, notice of dishonor, and so on. It would be peculiar if a guarantor of a secured obligation (who is not the owner of the collateral) could not waive notice and be held to this, and be held to the ensuing liability. . . ."

R. HENSON, HANDBOOK ON SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 10-11 at 371 (2d ed. 1979). In Norton, however, the bank argued "that Norton waived his right to notice of the sale by signing a printed assignment of the conditional sales contract (prepared by the bank) which recited that Norton waived all notices to which he might otherwise have been entitled." 398 S.W.2d at 541. To this argument the court responded, "Under [U.C.C. § 9-501(3)] the attempted waiver was ineffective." Id. Also, see generally, e.g., Barnett v. Barnett Bank of Jacksonville, P.A., 336 So. 2d 1213 (Fla. Dist. Ct. App. 1977). But see generally First Nat'l Park Bank v. Johnson, 553 F.2d 599 (9th Cir. 1977) United States v. Pirnie, 339 F. Supp. 702 (D. Neb. 1972), aff'd, 472 F.2d 712 (8th Cir. 1973); and compare United States v. Cawley, 464 F. Supp. 189 (E.D. Wash. 1979).

769. U.C.C. § 9-504(3).

770. 398 S.W.2d at 539.

771. Id. at 542.
tion in the first instance that the collateral was worth at least the amount of the debt, thereby shifting to the creditor the burden of proving the amount that should have been obtained through a sale conducted according to law.\textsuperscript{772}

The only difference between the Norton approach and the conversion theory is the presumption that the value of the collateral is at least equivalent to the balance of the obligation owed the secured party. The reason for indulging it is based on "simple considerations of fair play."\textsuperscript{773}

It was the bank which wrongfully disposed of the car without notice to the debtors. Thus it was the bank’s action that made it at least difficult, if not impossible, for Norton to prove the extent of his loss with reasonable certainty. A chattel such as a car may well be a thousand miles away before the debtor learns of its sale without notice. It would be manifestly unfair for the creditor to derive an advantage from its own misconduct.\textsuperscript{774}

This reasoning comports with an elementary principle of evidence "that where the facts with regard to an issue lie particularly in the knowledge of a party, that party has the burden of proving the issue."\textsuperscript{775} But it does not alter the basic thrust of the court’s approach in Norton which is to allow a secured party who has improperly disposed of collateral under Article 9 to sue for a deficiency but to require him to account for the actual "worth" or value of the property. The Norton approach is nothing more than the common law conversion theory with a twist, i.e., the presumption regarding the property’s value.\textsuperscript{776}

\textsuperscript{772} Id.
\textsuperscript{773} Id.
\textsuperscript{774} Id.
One can argue that in terms of result the Norton approach is identical to the other widely accepted view which simply denies a secured party a deficiency for failing to comply with Part 5. It is difficult in many cases for the secured party to prove that a sale conducted pursuant to Part 5 would have produced the same amount of proceeds as did the improper one. Therefore, secured parties may seldom recover the full deficiency they seek.\(^{777}\) This may be true, but the Norton approach as developed by the Arkansas Supreme Court is not an all-or-nothing proposition; a secured party may recover a partial deficiency. Under the Norton approach the secured party has "the burden of showing the amount of the deficiency it is entitled to recover."\(^{778}\) He will try to show that the amount which would have been obtained at a sale conducted in compliance with the provisions of Part 5, i.e., the true value of the collateral, is the same as that actually received upon the improper disposition. The debtor will not sit idly by, of course, but will attempt to show the contrary. Suppose that (1) the debt prior to disposition was $2000; (2) the improper sale produced $1000; (3) a $1000 deficiency is claimed; and (4) the evidence sup-


The Norton approach has also been followed in North Carolina. See Hodges v. Norton, 29 N.C. App. 193, 223 S.E.2d 848 (1976). But that state has added to its Article 9 a non-uniform Part VI which prescribes particulars regarding disposition of collateral by public sale. If the secured party complies with these provisions, there is a conclusive presumption of commercial reasonableness. See N.C. GEN. STAT. §§ 25-9-601 et seq. See also North Carolina Nat'l Bank v. Burnette, 297 N.C. 524, 256 S.E.2d 389 (1979); Allis-Chalmers Corp. v. Davis, 37 N.C. App. 114, 245 S.E.2d 566 (1978); Itt Indus. Credit Co. v. Milo Concrete Co., 21 N.C. App. 450, 229 S.E.2d 814 (1976).


ports a finding that the value of the collateral at the time of sale was $1500, which presumably is the amount which would have resulted from a proper sale under Part 5. The secured party cannot recover the full deficiency he claims, but under the Norton approach he can recover a partial deficiency of $500. The full $1000 deficiency claimed is reduced by the difference between the value of the collateral, $1500, and the amount actually received from the improper disposition, $1000. The debtor’s damages amount to $500, and this figure is offset against the secured party’s claim.\footnote{779}

Partial deficiencies are not possible under the widely accepted approach which simply denies the secured party any deficiency if he failed to comply with Part 5. And a logical extension of the Norton line of cases encompasses another situation not possible under the simple denial of any deficiency approach. Suppose the debtor in the hypothetical fact situation posed above produces evidence which supports a finding that the value of the collateral at the time of the sale was $3000. The $1000 deficiency claimed by the secured party would then be offset by $1500. Therefore, the secured party’s deficiency would be completely extinguished and he would be liable for an additional $500. Nothing in the Norton line of cases suggests that the presumption the court indulges establishes a maximum recovery for the debtor.\footnote{780} The Norton approach, like the conversion theory, bases the debtor’s damages on the actual loss

\footnote{779. In Universal C.I.T. Credit Co. v. Rone, 248 Ark. 665, 453 S.W.2d 37 (1970), for example, the secured party sued for a deficiency judgment of $756.26. It failed to give the debtor notice of sale as required by U.C.C. § 9-504(3). The trial court entered judgment denying the secured party any deficiency. C.I.T. appealed. The Arkansas Supreme Court reversed and remanded because

Even if proper notice was not given, in this case under the evidence adduced [regarding the value of the collateral], appellant . . . may have been entitled to judgment for $180.26, the amount of its apparent deficiency ($755.26 less the difference between Rone’s lowest valuation of the pick-up truck ($700) and the sale price ($125).

453 S.W.2d at 41. And see generally e.g., United States v. Cawley, 464 F. Supp. 189 (E.D. Wash. 1979); Levers v. Rio King Land & Investment Co., 93 Nev. 95, 560 P.2d 917 (1977).

780. The courts following the Norton approach indulge in the presumption that the value of the collateral “was worth at least the amount of the debt,” Universal C.I.T. Credit Co. v. Rone, 248 Ark. 665, 453 S.W.2d 37, 39 (1970) (emphasis added), not that it is worth at most this amount. See also, e.g., United States v. Cawley, 464 F. Supp. 189, 192 (E.D. Wash. 1979); Kobuk Engineering & Contracting Services, Inc. v. Superior Tank & Construction Co-Alaska, Inc., 568 P.2d 1007, 1013 (Alaska 1977); Hall v. Owen County State Bank, 370 N.E.2d 918, 931 (Ind. App. 1977). In Associates Financial Services Co. v. DiMarco, 383 A.2d 296 (Del. Super. Ct. 1978), the court, which rejected the no-deficiency rule in favor of the Norton approach, concluded: “Ample compensatory protection for the debtor exists under §§ 9-507(1) . . . by which any loss suffered by the debtor . . . may be offset against the deficiency judgment or may result in judgment for the debtor, supported by a presumption favorable to the debtor.” Id. at 302. (emphasis added). Undoubtedly the secured party will not produce evidence tending to show that the value exceeded the debt; to recover anything, he must show the contrary. But the debtor is “free to submit to the jury under § 9-507 any evidence that [he was] prejudiced by the lack of notice”, United States v. Whitehouse Plas-
which he has suffered. The court presumes, in the absence of contrary evidence, that the collateral’s worth or value was equivalent to the amount of the debt, but the secured party may prove otherwise and has the burden of doing so. Likewise, the debtor is not thereby precluded from introducing his own evidence to show that the property was worth more than the debt. In every case, therefore, the court is actually applying a measure of damages based on that used in a common law conversion action for wrongful foreclosure, i.e., the value of the property less the debt, which, only in the absence of proof to the contrary offered by either party, is presumed under Norton not to exceed the worth of the property.\footnote{\textit{supra.}}

Many courts have adopted the simplest and easiest approach to determining the debtor’s damages for wrongful foreclosure by an Article 9 secured party. They engage in no presumptions. Neither the creditor nor the debtor is required or permitted to prove actual value of the collateral at the time of sale. The amount a proper sale would have produced is immaterial. A secured party who has not complied with the provisions of Part 5 of Article 9 is denied any deficiency.\footnote{\textit{supra.}} The debtor’s “recovery” is

\footnotesize{\textit{ticas}, 501 F.2d 692, 696 (5th Cir. 1974), \textit{cert. denied}, 421 U.S. 912 (1975), or by any other violation of Part 5 of Article 9.}

\footnote{\textit{supra.}}\footnote{\textit{supra.}}
the amount of the debt he still owes the secured party, which may be either more or less than the amount the debtor actually lost by reason of the secured party's failure to comply with Part 5.783

The leading cases adopting this approach are among the earliest ones deciding the issue of a debtor's damages for wrongful foreclosure by an Article 9 secured party. Three of the most important and frequently cited cases are Braswell v. American National Bank,784 Leaseo Data Processing Equipment Corp. v. Atlas Shirt Co.,785 and Atlas Thrift Co. v. Horan.786 All these cases rely on pre-Code authority to support the rule that failure to comply with the provisions of Part 5 simply precludes any deficiency. A close analysis reveals, however, that the pre-Code authority relied on in each case has been displaced under Article 9. The reason for this conclusion is simple: Significant differences exist between its default provisions and those of the statutes under which the pre-Code authority developed. The courts are relying on rules which were justifiable under prior law but not under the Code.

Despite the express language of section 9-507(1), the Georgia Court of Appeals concluded in Braswell that

the majority of courts in this country . . . reached the conclusion that
the act of the secured party, in selling the collateral without strict compliance
with the notice of sale provisions, precludes the purchaser or
owner from exercising his right of redemption . . . , and for that reason
the secured party cannot recover for the deficiency. See in this connection
Moody v. Nides Finance Co., Inc. . . . and Section 24 on Page 82 of the
Annotation in 49 ALR2d 15. We concur with this view.787

Moody v. Nides Finance Co.788 was not in point. It was a wrongful reposses-

783. But see text accompanying notes 840-854 infra.
786. 27 Cal. App. 3d 999, 104 Cal. Rptr. 315 (1972).
787. 161 S.E.2d at 422.
sion case, and the court in Braswell noted early in its opinion that Moody was inapplicable to the case before it.789

The court appears to have relied principally on an American Law Reports Annotation.790 The text on the page cited by the court in Braswell reads as follows:

Under the various statutes requiring a resale of repossessed property, it is generally held that such a sale, properly carried out, is a condition precedent to the recovery of the balance due under the conditional sales contract, and accordingly, where the seller defaults as to the sale he loses any claim to recovery of the deficiency.791

Supporting this statement are decisions from six states and Canada. Four of these states, including New York, had adopted the Uniform Conditional Sales Act (U.C.S.A.).792 Leasco Data Processing Equipment Corp. v. Atlas Shirt Co.,793 another important case deciding that an improper disposition under Article 9 bars a deficiency, also relies on pre-Code cases decided under the U.C.S.A. The New York court in Leasco agreed with

---

789. The court cited Moody to support its conclusion that since the repossession was lawful, the application of the doctrine of accord and satisfaction was precluded. See 161 S.E.2d at 422.
790. Id. at 82. The same annotation provides, however, that
In the absence of a statutory or contractual provision settling the rights of the parties, it would appear that the measure of recovery for a repossessing vendor's failure to carry out a resale of the property so as to protect the purchaser's interests (where such a duty is recognized) would be the value of the property interest lost by the purchaser, that is, ordinarily, the excess of the value of the property at the time of repossession over the amount due on the contract and allowable expenses. This is apparently the rule applied by the courts.
791. Id. at 77. This is the measure of damages under a conversion theory. See notes 755 & 756 supra and text accompanying them.
792. The other states listed by the annotator are New Jersey, West Virginia, Wisconsin, Idaho and Tennessee. See Annot., 49 A.L.R.2d 15, 82 (1956). The first three, like New York, adopted the Uniform Conditional Sales Act, the provisions of which are substantially different from those of Part 5 of Article 9. See discussion at notes 794-816 infra.
793. Tennessee's statute governing conditional sales specified in great detail the manner in which repossessed property should be disposed of at public sale. See CODE OF TENNESSEE § 7287 (1932). And it provided that a conditional vendor could recover a deficiency only "[i]f the property is sold by the vendor, at the sale provided by this article, fail to realize a sufficient sum to satisfy the claim of the seller . . . ." Id. § 7290 (emphasis added). The Tennessee statute, therefore, is, like the Uniform Conditional Sales Act, significantly different from Part 5 of Article 9 regarding when a deficiency may be sought. In addition, though the Tennessee Act specified the debtor's remedy for a vendor's failure to resell (see id. § 7291), an aggrieved buyer could elect not to sue under the statute and sue in conversion. See Barger v. Webb, 216 Tenn. 275, 391 S.W.2d 664 (1965); Barnes v. Walker, 191 Tenn. 364, 234 S.W.2d 648 (1950).
794. The A.L.R. annotator lists Idaho among the no-deficiency rule states on the basis of one case. See Annot., 49 A.L.R.2d 15, 82 (1956), citing Cranston v. Western Idaho Lumber & Bldg. Co., 41 Idaho 141, 238 P. 528 (1925). But there are numerous Idaho cases which either characterize as a conversion the conduct of a secured creditor who improperly disposes of collateral or which hold that the measure of a debtor's damages in such a case is the traditional "value less debt." See Idaho citations at notes 755 & 756 supra.
the annotator’s statement of the general rule under that act. “[T]he principle became firmly established in New York, as in virtually all states that adopted the Uniform Conditional Sales Act, that the right of a conditional vendor to secure a deficiency judgment was dependent upon precise compliance with the statutory requirements as to notice.”

The problem with perpetuating under the U.C.C. the no-deficiency rule of the U.C.S.A. is the significant differences between the default provisions of the two uniform statutes. Section 25 of the U.C.S.A. provided that “[i]f the seller fails to comply with the provisions of Sections [dealing with redemption, compulsory and optional resale, proceeds of resale and rights of parties where there is no resale], after retaking the goods, the buyer may recover from the seller his actual damages, if any . . . .”

This provision is similar to section 9-507(1) of Article 9, entitling the debtor to recover “any loss caused by a failure to comply with the provisions of this Part [5].” But the cases from New York and other states holding that a conditional vendor could not recover a deficiency if he wrongfully foreclosed were decided under section 23 of the Act rather than section 25. Section 23 provided that “[w]here there is no resale, the seller may retain the goods as his own property without obligation to account to the buyer . . . , and the buyer shall be discharged of all obligation.”

Many courts interpreted this section to mean that a resale not in compliance with the statutory procedures of the U.C.S.A. was not a resale at all. Hence, the buyer was discharged, and no deficiency existed. The courts interpreting the Uniform Conditional Sales Act were practically unanimous in holding that a resale in compliance with its provisions was a condition precedent to the recovery of a deficiency.

A good example

---

794. 323 N.Y.S.2d at 15. Not all the New York cases are in accord with Leasco that this principle should be perpetuated under Article 9. See New York citations at notes 762 & 776 supra.


796. U.C.C. § 9-507(1). This section also provides a minimum recovery in the case of consumer goods. It is quoted note 758 supra. The U.C.S.A. also contained a minimum recovery provision, but its application was not limited to cases involving consumer goods. It provided that the buyer should recover “in no event less than one-fourth of the sum of all payments which have been made under the contract, with interest.” U.C.S.A. § 25 (act withdrawn 1943).

797. Uniform Conditional Sales Act § 23 (act withdrawn 1943) (emphasis added).

is a New York case, Mott v. Moldenhauer. Buyer purchased a new automobile, and the seller financed part of the purchase price. The sale was conditional with the title remaining in the seller until the price of the car was fully paid. The buyer defaulted; the seller repossessed the collateral, sold it and sued the buyer for breach of contract. The resale, however, failed to comply with the formalities of the U.C.S.A. No written notice of the intended disposition had been given to the buyer. A trial court judgment for the seller was reversed by the appellate division.

In this case plaintiff makes no claim that he complied with such requirements by serving and posting notices of sale. His failure in that regard rendered the sale nugatory insofar as the statute is concerned, and he is in the same position as if he made no resale. It follows that the buyer was discharged from any obligation under the alleged agreement.

Except for section 9-505 dealing specifically with strict foreclosure proposed affirmatively by the secured party, Part 5 of Article 9 does

---


800. In this case the seller was required to give to the buyer not less than ten days' written notice of a sale, either personally or by registered mail, directed to the buyer at his last known place of business or residence. The seller shall also give notice of the sale by at least three notices posted in different public places within the filing district where the goods are to be sold, at least five days before the sale. U.C.S.A. § 19 (act withdrawn 1943).


802. See U.C.C. § 9-505(2). And retaining the collateral in satisfaction of the debtor's obligation is not an option for the secured party

[i]f the debtor has paid sixty per cent of the cash price in the case of a purchase money security interest in consumer goods or sixty per cent of the loan in the case of another security interest in consumer goods, and has not signed after default a statement renouncing or modifying his rights under this Part... U.C.C. § 9-505(1).

If the debtor has paid more than sixty per cent, "a secured party who has taken possession of the collateral must dispose of it under Section 9-504 and if he fails to do so within ninety days after he takes possession the debtor at his option may recover in conversion or
not contain a provision substantially similar to U.C.S.A. section 23.\textsuperscript{803} Therefore, pre-Code cases decided under that section cannot legitimately be used to supplement U.C.C. section 9-507(1). Even under the U.C.S.A., the elimination of section 23 changes the result reached in Mott. In Randall v. Pingree,\textsuperscript{804} a conditional vendor sued for a deficiency after reselling his collateral. The sale had been improperly conducted under the U.C.S.A. as enacted in New Hampshire. The trial court held “that the defendant owed nothing to the plaintiff”\textsuperscript{805} because the resale was not made in compliance with the Act’s procedures. The New Hampshire Supreme Court recognized that under the uniform version of the U.C.S.A. the buyer would be discharged and the seller denied a deficiency.

A “resale” as the term is used in § 23 . . . and elsewhere in the statute is uniformly construed to mean a resale as provided in §§ 19 and 20 . . . , which requires a sale at public auction after notice as therein provided. This interpretation has resulted from § 23 of the Uniform Act and in part from [other] provisions . . . . Thus under the uniform provisions, and the decisions construing them, a verdict for the defendant would be proper in the instant case.\textsuperscript{806}

under Section 9-507(1) on secured party’s liability.” \textit{Id.} \textit{See}, \textit{e.g.}, Charley v. Rico Motor Co., 82 N.M. 290, 480 P.2d 404 (1971). Because the debtor’s recovery under § 9-505(1) is phrased in the alternative, \textit{either conversion or damages} under § 9-507(1), some might argue that actual damages under § 9-507(1) must be based on a theory other than conversion. \textit{But see} 2 G. Gilmore, supra note 425, § 44.9.2. Since the debtor’s damages under § 9-505(1) based on conversion will be measured according to the standard formula of “value less debt,” see notes 755 & 756 supra and text accompanying them and Charley v. Rico Motor Co., supra herein, a debtor suing under this section may suffer little or no actual loss. \textit{Therefore}, the cross-reference to § 9-507(1) is intended to make the penalty there prescribed applicable to § 9-505(1) situations.

\textsuperscript{803} Professor Gilmore sees a substantial degree of symmetry between the provisions of Part 5 of Article 9 and the default provisions of the U.C.S.A. \textit{See} 2 G. Gilmore, supra note 425, § 44.9.4. In his view, “We may conclude that the secured party’s compliance with the default provisions of Part 5 . . . is a condition precedent to the recovery of a deficiency.” \textit{Id.} at 1264. But he relegates to a footnote any mention of U.C.S.A. § 23 (\textit{see id. at} 1262 n.4) which has no counterpart in Article 9 and which was critical to the court’s analysis in \textit{Mott}, for example. \textit{See} text accompanying notes 794-801 supra. In addition, Article 9 does not provide, as did the U.C.S.A., that a debtor is liable for a deficiency only after a “resale.” \textit{See} U.C.S.A. §§ 88-22 & 23. Article 9 provides that a debtor is liable for any deficiency after a sale, lease or “\textit{other disposition}” of the collateral by the secured party. \textit{See} U.C.C. § 9-504(1) & (2). Even if “sale” for purposes of Article 9 means only one which is conducted in compliance with the provisions of Part 5, a sale which violates its provisions could be classified as an “\textit{other disposition}.” The differences between the two statutes are more substantial than Gilmore suggests.

The precise wording of the two acts is different, as discussed above; but, also, the U.C.C. provisions governing disposition of the collateral allow the secured party more flexibility. Some courts have considered this difference important when deciding whether to perpetuate the no-deficiency rule of the U.C.S.A. \textit{See}, \textit{e.g.}, Associates Financial Services Co. v. DiMarco, 383 A.2d 296 (Del. Super. 1978).

\textsuperscript{804} 100 N.H. 322, 125 A.2d 638 (1956).

\textsuperscript{805} 123 A.2d at 660.

\textsuperscript{806} \textit{Id.}
But the New Hampshire legislature had eliminated the language in U.C.S.A. section 23 providing that "the buyer shall be discharged from all obligations" and substituted language providing that "the 'rights of the parties shall be determined by the provisions of section 25." And—as noted above—section 25 based the buyer's damages on those actually suffered because of the seller's failure to comply with the Act's provisions on resale. The court then concluded that "the interpretation which has been placed upon the Uniform Act elsewhere is not controlling . . ." because of the deletion of the discharge language in section 23 and other changes which indicate a plain purpose to depart from the scheme of the Uniform Act, and to preserve to the seller a right to recover his losses regardless of whether a statutory resale has been held. . . . Hence under the present statute . . ., the seller must be deemed entitled following repossession to recover any deficiency to the extent provided by § 25 . . . regardless of whether a resale is conducted as provided by [provisions of the act], . . .

To measure the buyer's actual damages under U.C.S.A. section 25, the court in *Randall* concluded that pre-U.C.S.A. law should be consulted, and it cited *Mercier v. Nashua Buick Company*. In *Mercier* the court gave this example:

> If A sells B goods on credit and A after B's receipt of them injures or deprives B of them, B's debt for the price remains unaffected. A is liable for the wrong he does, but the sale is not thereby vacated, and liability for the wrong gives B no release from liability for the price.

> . . .

> If the vendor carelessly destroys the property or wrongfully disposes of it, he is liable for damages on ordinary theories of compensating injuries, and the [conditional sales] statute carries no implication of release of the vendee for what he owes. Wrongful dealing with the security under no reasonable theory of the law can operate to discharge a just debt.

In accordance with this rule, the debtor's measure of damages for wrongful foreclosure is a credit on the unpaid price of the property equalling its value or the amount received upon its resale, whichever is greater. Other courts also held that the proper measure of a buyer's actual damages under section 25 was the difference between the value of the property

809. "[T]he buyer may recover from the seller his *actual damages* resulting from the seller's wrongful foreclosure of the collateral. *Uniform Conditional Sales Act* § 25 (act withdrawn 1943) (emphasis added).
810. 125 A.2d at 661.
811. *Id.* See also *Shanahan v. George B. Landers Const. Co.*, 266 F.2d 400 (1st Cir. 1959) (applying New Hampshire law); *Caraway v. Jean*, 97 N.H. 506, 92 A.2d 660 (1952).
812. 84 N.H. 59, 146 A. 165 (1929).
813. 146 A. at 168.
814. See *id.*, and see notes 755 & 756 *supra* and text accompanying them.
and the amount of the debt under the conditional sales contract. The measure of damages applied in these cases is identical to that under a common law conversion theory. It is the rule established in these cases which should be perpetuated under Article 9. They interpret section 25 of the U.C.S.A. which is similar to U.C.C. section 9-507(1). But Article 9 contains no provision substantially similar to section 23, and the no-deficiency rule developed in cases construing the section has no place under the Code.

The pre-Code authority relied upon by the California court in Atlas Thrift Company v. Horan is also based upon a statute significantly different from any provision of Part 5 of Article 9. The court reported in Atlas that "California law prior to the Uniform Commercial Code clearly provided that a creditor who disposed of property after default, without following the notice requirements of the mortgage agreement, has extinguished the mortgage lien and is thus barred from recovering a deficiency judgment." Citing section 1-103, the court then perpetuated this prior law under Article 9. The pre-Code case Metheny v. Davis was relied upon by the court in Atlas. Metheny holds, however, that a mortgagee who improperly disposes of collateral is liable for conversion. A number of other California cases recite the same rule, but they also hold that the creditor is denied a deficiency because his lien is extinguished. Why did they not apply the standard measure of damages for conversion? The reason was the existence of a California statute expressly providing that "the wrongful conversion by the person holding the lien [on personal property], extinguishes the lien thereon." Article 9 does not contain

---

815. See authorities cited note 845 infra.
816. See notes 755 & 756 infra and text accompanying them.
817. 27 Cal. App. 3d 999, 104 Cal. Rptr. 315 (1972).
818. 104 Cal. Rptr. at 318.
820. "Where a mortgagee takes possession of the mortgaged property and sells it to a third person without either the method of sale prescribed by the law or the mortgage, it amounts to a conversion of the property by the mortgagee, resulting in the extinguishment of the mortgage lien . . . ." Id. 290 P. at 91.
821. For example, in Kee v. Becker, 54 Cal. App. 2d 466, 129 P.2d 159 (1942), the court said:

A mortgagee who takes possession of the mortgaged goods and sells them to a third party, but who fails to conduct the sale either according to the statute or the terms of the chattel mortgage, converts the goods and forfeits not only his lien but his right to a deficiency judgment.

Id. 129 P.2d at 162.
822. Cal. Civ. Code § 2910 (West). This provision was cited by the court in Metheny v. Davis. See 290 P. at 92. North Dakota, Oklahoma and South Dakota have statutory provisions essentially identical to California's. See N.D. CENT. CODE § 35-01-20; OKLA. STAT. ANN. tit. 42 § 22 (West); S.D. COMPLIED LAWS ANN. § 44-5-3. Despite such a statutory provision, authority exists for using a conversion theory or value-less-debt approach to determine the debtor's damages for wrongful foreclosure. See pertinent discussion note 756 supra.

Other types of state statutes, particularly those governing consumer transactions, may expressly limit the deficiency judgment remedy. For example, California's Unruh Act has
such a provision.\textsuperscript{823} Therefore, while the California cases support the conclusion that wrongful foreclosure amounts to a conversion of the collateral, they are not useful authority on the consequences of the conversion in states without comparable legislation. Moreover, any generally applicable state statutes, including the California law and ones similar to it have been superceded by the enactment of the Code.

Pre-Code authority in many jurisdictions held that a creditor who wrongfully foreclosed was liable for conversion and measured the debtor’s damages by offsetting the debt owed by the value of the property.\textsuperscript{824} This authority is consistent with the express language of section 9-507(1) providing that the debtor can recover “any loss.” Reliance should not be placed on cases like \textit{Braswell} and \textit{Leasco} in construing the section because they follow a rule decided under a statutory scheme significantly different from Part 5 of Article 9. And California authority establishes a rule peculiar to states which by statute expressly extinguish a lien if its holder converts the collateral by improperly disposing of it or otherwise. The common law rule which should supplement section 9-507(1) is one which, \textit{first}, measures the debtor’s damages on the basis of his actual loss—which is in reality the difference between the value of the property and the amount received upon its improper disposition\textsuperscript{825}—and, \textit{second}, puts the

\textit{an anti-deficiency provision}. \textit{See} \textit{Cal. Civ. Code} § 1812.5 (West 1973). \textit{But this Act does not apply to the sale of ‘any vehicle required to be registered under the Vehicle Code, nor any goods sold with such a vehicle . . .’} \textit{Id.} § 1802.1. \textit{The Uniform Consumer Credit Code} provides that a “consumer is not liable for a deficiency unless the creditor has disposed of the goods in good faith and in a commercially reasonable manner.” \textit{U.C.C.C.} § 5.103(1) (1974). “[T]his section adopts the position that line of cases under the UCC that directly or indirectly deny the creditor a deficiency if the creditor has not disposed of the collateral in good faith and in a commercially reasonable manner.” \textit{Id.}, Comment 2. \textit{See, e.g., Atlas Thrift Co. v. Horan}, 27 Cal. App.2d 999, 104 Cal. Rptr. 315 (1952). In addition, under the \textit{U.C.C.C.}, “[i]n cases of sales of $1750 or less, this section gives the seller the option of either suing for the unpaid balance or repossessing, but he may not do both.” \textit{Id.}, Comment 3. \textit{See U.C.C.C.} § 5.103(2). \textit{See also id. subsections (3) & (4) regarding this option when the seller has a non-purchase money security interest or when a lender makes a loan and takes a purchase money security interest.}

\textit{In the District of Columbia, one of the Rules of Civil Procedure for the Superior Court is that}

\textit{No deficiency judgment after repossession of personal property shall be granted unless it shall appear to the satisfaction of the court by proper evidence that said plaintiff complied with applicable law and that said property was resold for a fair and reasonable price.}

\textit{D.C. Super. Ct. Civ. R. 55-II(b).}

\textsuperscript{823} U.C.C. § 9-504(4) is not an analogous provision. Its purpose is simply “to give the purchaser of any type of collateral the same protection that he would get if what he bought was instruments or documents technically negotiable.” 2 G. GILMORE, supra note 425, § 44.7 at 1249. While U.C.C. § 9-504(4) is designed to determine the rights of buyers of collateral improperly disposed of by secured parties, statutes like the California one focus on the consequences between the creditor and the debtor when the former has wrongfully foreclosed and, therefore, is guilty of converting the collateral.

\textsuperscript{824} \textit{See notes 755 & 756 supra and text accompanying them.}

\textsuperscript{825} “Value less debt” is another way to express and compute the measure of damages
debtor in as good—not better or worse—a position as if the secured party had fully complied with Part 5. The no-deficiency rule is not based upon the debtor's actual loss. Though it may approximate actual damages in some cases, it permits awards in any others which under- or over-compensate the debtor.\textsuperscript{826} A conversion theory accomplishes both the stated objectives in every instance by calculating damages according to the facts of each case and not by approximating them in the general run of cases.

Advocates of the no-deficiency rule sometimes argue, however, that the secured party's failure to comply with Part 5 often impairs the debtor's right to redeem. This was the reasoning in the often cited case \textit{Skeels v. Universal C.I.T. Credit Corporation}.\textsuperscript{827} "A security holder who disposes of collateral without notice denies to the debtor his right of redemption which is provided him in Section 9-506 . . . [and] may not look to the debtor for any loss."\textsuperscript{828} Other courts also have adopted or suggested this analysis as a justification for the no-deficiency rule.\textsuperscript{829} But in \textit{Skeels} the court overlooked the widely accepted common law remedy for a debtor who is denied his right of redemption, i.e., \textit{conversion}.\textsuperscript{830} Here, for wrongful foreclosure based on conversion. The "debt" in this formula is the balance owed on the obligation before it is reduced by the proceeds of an improper disposition. See discussion note 756 \textsuperscript{supra}.

\textsuperscript{826} But see discussion regarding the no-deficiency-PLUS approach at text accompanying notes 840-854 \textit{infra}.

\textsuperscript{827} 222 F. Supp. 696 (W.D. Pa. 1963), \textit{vacated on other grounds}, 335 F.2d 846 (3rd Cir. 1964).

\textsuperscript{828} 222 F. Supp. at 702. Regarding redemption, Article 9 provides,

\begin{quote}
At any time before the secured party has disposed of collateral or entered into a contract for its disposition under Section 9-504 or before the obligation has been discharged under Section 9-505(2) the debtor or any other secured party may unless otherwise agreed in writing, after default redeem the collateral by tendering fulfillment of all obligations secured by the collateral as well as the expenses reasonably incurred by the secured party in retaking, holding and preparing the collateral for disposition, in arranging for the sale, and to the extent provided in the agreement and not prohibited by law, his reasonable attorneys' fees and legal expenses.
\end{quote}

\textit{U.C.C.} § 9-506.


\textsuperscript{830} Frequently the pre-Code decisions justified holding a secured creditor liable for conversion when he wrongfully foreclosed because his conduct impaired the debtor's right to redeem. See generally, e.g., \textit{Anderson v. Joseph}, 95 Ark. 573, 130 S.W. 165 (1910); \textit{Wygall v. Bigelow}, 42 Kan. 477, 22 P. 612 (1899); \textit{Hawkins Furniture Co. v. Morris}, 143 Ky. 738, 137 S.W. 527 (1911); \textit{Harvey v. Anacone}, 134 Me. 245, 184 A. 889 (1936); \textit{Avery v. Midwest Commercial Credit Co.}, 254 Mich. 324, 236 N.W. 798 (1931); \textit{McLeod Nash Motors v. Commercial Credit Trust}, 187 Minn. 452, 246 N.W. 17 (1932); \textit{Latusek v. Davies}, 79 Minn. 279, 82 N.W. 587 (1900); \textit{Powell v. Gagnon}, 52 Minn. 232, 53 N.W. 1148 (1893); \textit{Loeb v. Milner}, 21 Neb. 392, 32 N.W. 205 (1887); \textit{Mahanna v. Westland Oil Co.}, 107 N.W.2d 353 (N.D. 1960); \textit{Valicenti v. Central Motors, Inc.}, 115 Pa. Super. 74, 174 A. 799 (1934); \textit{Fowler v. Goldsmith}, 131 S.C. 119, 126 S.E. 431 (1925); \textit{Lyon v. Wood}, 363 S.W.2d 179 (Tex. Civ.
again, the conversion theory compensates the debtor for his actual loss and places him in as good a position as if he had received notice of the intended disposition and redeemed his collateral. The no-deficiency approach does not. Presumably it establishes a maximum measure of compensatory damages the debtor can recover at the amount of the debt still owed.831 The debtor will be undercompensated if the difference between the value of the collateral and the amount received on resale exceeds the outstanding obligation. On the other hand, the creditor will be penalized if the value of the collateral equals the amount received from the resale which is less than the debt still owed. The possibility of penalizing the creditor may be the reason courts often contend that the no-deficiency rule insures compliance with Part 5. They sometimes cite the deterrent effect of that rule as a principal justification for the rule.832

It can be argued that the no-deficiency rule is necessary or desirable because the debtor is unlikely to suffer any damages if they are measured according to the conversion formula. That is particularly the case where a secured party fails to give the required notice. This argument assumes that a sale conducted in all respects pursuant to Part 5, except for a failure to notify the debtor, will always yield an amount equivalent to the value of the property. This assumption ignores what some courts see as a

831. But see text regarding the no-deficiency-PLUS approach accompanying notes 840-854 infra.

832. In Camden Nat'l Bank v. St. Clair, 309 A.2d 329 (Me. 1973), for example, the court said that the no-deficiency rule "tends to promote the UCC objective that the debtor be able, if he chooses, to reacquire the collateral in specie by redemption" because it provides "an additional deterrent to non-compliance with the statutorily prescribed procedures." 309 A.2d at 333 (emphasis added). A number of courts have also summarized the situation this way: "If [the secured party] wishes a deficiency judgment he must obey the law . . . . If he does not obey the law he may not secure a deficiency judgment." Leasco Data Processing Equipment Corp. v. Atlas Shirt Co., 66 Misc. 2d 1089, 323 N.Y.S.2d 13, 17 (1971). See also, e.g., Atlas Thrift Co. v. Horan, 27 Cal. App. 3d 999, 104 Cal. Rptr. 315, 321 (1972); Bank of Gering v. Glover, 192 Neb. 575, 223 N.W.2d 56, 59 (1974).

On the other hand, as is sometimes pointed out by courts which reject the no-deficiency rule and follow the Norton approach,

The "no notice, no deficiency" rule undoubtedly serves as an incentive to compliance with the notice provisions of § 9-504(3), but the alternative of creating a rebuttable presumption favoring the debtor would also tend to serve this function and appears more in keeping with the scheme of the Code.

principal purpose of notifying the debtor, i.e., to give him the opportunity to attend the sale and encourage others to do so, and thereby to bid up the sale price. If this is true, then a public disposition under Part 5 will insure a resale price approaching the true value of the collateral only when the debtor receives notice of the sale. Therefore, actual damages are possible under the conversion theory even though the secured party's only default under Part 5 is failing to give the notice it prescribes.

Assuming that an otherwise proper sale without notice will produce an amount equivalent to the value of the collateral, no ground exists for applying the no-deficiency rule as a means of punishing creditors. The effect is to penalize the secured party whenever the debt still owed exceeds the value of the property. But the Code prohibits penal damages except where expressly authorized. Such damages are authorized under section 9-507(1) only where the collateral is consumer goods; even then they must be calculated according to the statutory formula. The courts aiming to deter violations of Part 5 by denying a creditor a deficiency in all cases of noncompliance with Part 5 are proceeding without statutory authorization.

In truth—though these courts fail to consider it—the conversion theory for measuring actual damages if applied under section 9-507(1) permits the award of "penal" damages expressly authorized by the Code. First, if the conversion theory if applied and if the resale of consumer goods is conducted in a proper manner but without notice to the debtor and if such a sale is presumed to and does yield an amount equivalent to the property's true value, the debtor cannot recover actual damage. He has suffered none. Nevertheless, in a proper case he may recover the statutory


834. See U.C.C. § 1-106(1).

835. The formula is "an amount not less than the credit service charge plus ten per cent of the principal amount of the debt or the time price differential plus ten per cent of the cash price." U.C.C. § 9-507(1).

For a discussion about damages calculated according to this formula being "penal," see generally note 839 infra.
penalty described in section 9-507(1). Second, the authority for awarding punitive damages in a wrongful foreclosure case is more certain if section 9-507(1) is interpreted to perpetuate the conversion theory. Article 1 of the Code sanctions the award of penal damages when they are "specifically provided in this Act or by other rule of law." By the use of conversion theory to determine the debtor's "any loss" under section 9-507(1), a secured party's liability for compensatory damages may exceed the debt owed. If the debtor suffered no actual loss, he still may recover in the case of consumer goods the statutory penalty prescribed in section 9-507(1). And in any proper case, the secured party may also be liable for punitive damages. These elements of damages for which a secured party can be

836. "If the collateral is consumer goods, the debtor has a right to recover in any event an amount not less than the credit service charge plus ten per cent of the principal amount of the debt or the time price differential plus 10 per cent of the cash price." U.C.C. § 9-507(1) (emphasis added).

837. U.C.C. § 1-106(1) (emphasis added).


For a discussion of the other side of the coin, i.e., where the debtor does suffer actual loss, the secured party cannot recover a deficiency and, instead of seeking actual loss damages, debtor seeks damages according to the "in no event" formula of U.C.C. § 9-507(1), see note 854 infra. The question in this type of case is whether the penalty damages must be reduced by the amount of deficiency denied.

839. Authority exists for awarding punitive damages in cases of wrongful foreclosure under Article 9. See, e.g., Davidson v. First Bank & Trust Co., Yale, 559 P.2d 1228 (Okla. 1976). And see generally, e.g., Hall v. Owen County State Bank, 370 N.E.2d 918, 927 n.10 (Ind. Ct. App. 1977). And see 2 C. GILMORE, supra note 425, § 44.9.2. Although a number of courts have refused to award punitive damages in wrongful foreclosure cases under Article 9, they have usually done so because of the absence of circumstances to justify that type of an award, not because punitive damages are never recoverable in such cases. See, e.g., Western Decor & Furnishing Industries, Inc. v. Bank of America, 91 Cal. App. 3d 293, 154 Cal. Rptr. 287 (1979); Fairchild v. Williams Feed, Inc., 169 Mont. 18, 544 P.2d 1216 (1976).

Where the situation is that envisaged in the text and the debtor has suffered no actual loss, there are two arguments against awarding him both the statutory damages prescribed in U.C.C. § 9-507(1) and punitive damages. The first argument is that the statutory damages are themselves "penal" and that by providing for them the Code specifically displaces the possibility of punitive damages in this context. The second argument is that if the debtor suffered no actual damages because of the creditor's non-compliance with Part 5, punitive damages are not possible because the former kind of damages is a predicate to the latter.

One response to the first argument is this: Even though the courts and commentators frequently refer to the damages allowable under the § 9-507(1) formula as a "penalty," as has been the case in this article, the statutory formula may also be characterized as a liquidated damages provision. Yet this characterization does not resolve the issue; it creates others. Initially it raises another question: Do liquidated damages support punitive ones? In addition, this characterization suggests a more fundamental, if only conceptual, issue: If the debtor has suffered no actual loss because of the secured party's wrongful foreclosure, can the debtor recover the statutory damages in the first place? If, for example, parties to a contract include a liquidated damages clause in their agreement and a breach occurs, the plaintiff cannot recover the stipulated amount in the absence of proof that he suffered actual loss. See, e.g., 1 T. SEDGWICK, A TREATISE ON THE MEASURE OF DAMAGES § 391 (9th ed. 1913). This general rule of contract law obviously has no applicability, literally or analogi-
liable under section 9-507(1), interpreted to perpetuate the common law conversion action for wrongful foreclosure, should suffice to deter violations of Part 5 at least as much as the simple no-deficiency rule does.

Authority exists for yet another approach to determining a debtor's damages for wrongful foreclosure under Part 5. A few courts have held that in addition to being relieved from any liability for a deficiency, the debtor is entitled to damages under section 9-507(1). Courts using this

cially, where a statute provides to the contrary; but there is no need to cling to this line of reasoning.

The better response to the argument about the § 9-507(1) formula displacing the possibility of punitive damages in wrongful foreclosure cases is a response which accounts for the realities involved. The statutory damages amount to a penalty. “Under this provision the consumer-debtor has a right to recover the penalty without proof of actual loss and, indeed, even though no loss was in fact caused by the secured party’s violation.” 2 G. GILMORE, supra note 423, at § 44.9.3 (emphasis added). Who can doubt that these damages are penal ones when they can be awarded whether or not there has been any actual loss by the complaining party? Nevertheless, characterizing them as a penalty does not necessarily mean that the section eliminates the possibility of awarding punitive damages in addition to them.

The § 9-507(1) penalty is there to discourage violations of the provisions in Part 5 governing disposition of the collateral, violations which may be committed unintentionally and without any mal-intent. Punitive damages will not be proper in all wrongful foreclosure cases and certainly not in a case where the creditor acted with a complete absence of bad faith. They are awarded “usually as punishment or deterrent levied because of a particularly aggravated misconduct on the part of the defendant.” D. DOBBS, supra note 386, § 3.9. If a secured party violates the provisions of Part 5 of Article 9 and does so maliciously, should the extent of his punishment be the same as that of the innocent violator? The arguable answer is “no.” The statutory penalty should be assessed to encourage compliance with Part 5; punitive damages should be available to discourage malicious, fraudulent or oppressive non-compliance.

In a case where the debtor has suffered no actual damages, there remains the second argument against allowing him to recover the § 9-507(1) penalty and punitive damages. The argument is that actual damages are a predicate to punitive ones. The response to this argument is simple: It is not necessarily true that punitive damages cannot be recovered in the absence of actual ones. For example, an award of nominal damages may support a recovery of punitive damages; and there are other circumstances under which punitive damages are awarded by the courts in the absence of proof of actual loss. See generally, e.g., D. DOBBS, supra note 386, § 3.9; 1 T. SEDGWICK, supra herein, § 361.

840. See, e.g., Western Decor & Furnishings Industries, Inc. v. Bank of America, N.T.S.A., 91 Cal. App. 3d 293, 154 Cal. Rptr. 287 (1979); Northwest Bank & Trust Co. v. Gutshall, 274 N.W.2d 713 (Iowa 1979); Wilkerson Motor Co. v. Johnson, 580 P.2d 505 (Okla. 1978). See also Randolph v. Franklin Investment Co., 398 A.2d 340 (D.C. Ct. App. 1979); Gavan v. Washington Post Emp., 397 A.2d 968 (D.C. Ct. App. 1979). But a rule of court in the District of Columbia specifically provides, “No deficiency judgment after repossession shall be granted unless it shall appear to the satisfaction of the court by proper evidence that said plaintiff complied with applicable law and that said property was resold for a fair and reasonable price.” D.C. Super. Ct. Civ. R. 55-II(b). In addition, see also J.T. Jenkins Co. v. Kennedy, 45 Cal. App. 3d 474, 119 Cal. Rptr. 578 (1975), where the court holds that compliance with Part 5 provisions of Article 9 is a condition precedent to recovery of a deficiency judgment and suggests that at trial after remand debtor may recover damages under U.C.C. § 9-507(1). But see Union Trust Co. of Ellsworth v. Hardy, 400 A.2d 384 (Me. 1979), where the court’s opinion is unclear: It says either that the debtor cannot recover the U.C.C. § 9-507(1) statutory penalty if the secured party is denied a deficiency or simply that the debtor in the case is not asking for such damages in the event a deficiency is denied. See id. 400 A.2d at 385-86 n.1.
approach apply what may be called the no-deficiency-PLUS rule. A debtor’s minimum recovery is discharge of the balance owed on the obligation to the secured party plus “any loss” resulting from an improper disposition or, in a proper case, the statutory penalty.\textsuperscript{841} Calculated according to this rule, the debtor’s recovery will invariably compensate him fully for his loss. To this extent, at least, this rule is preferable to the simple no-deficiency approach.\textsuperscript{842} The no-deficiency-PLUS approach is not new; precedent for it can be found among cases decided under the Uniform Conditional Sales Act and other pre-Code statutes.\textsuperscript{843} Given the proper set of circumstances, courts which have already applied the simple no-deficiency rule under Article 9 are generally free to embrace the no-deficiency-PLUS approach. The vast majority of courts which have adopted the simple no-deficiency rule have not decided a case in which the debtor asked for damages in addition to discharge of any further liability on the obligation owed the secured party.

The inevitable question is how to measure the debtor’s actual damages under this approach. The cases decided under Article 9 are too few to give an answer.\textsuperscript{844} The answer given by the pre-Code authorities is a familiar one: the damages were usually measured according to the stan-

---

\textsuperscript{841} A proper case is one involving consumer goods. \textit{See} U.C.C. \textsuperscript{90} 9-507(1).

\textsuperscript{842} This solves one of the problems with the simple no-deficiency approach, but it does not solve the other problem. Under both approaches the debtor may be over-compensated and the creditor penalized beyond that which Article 9 specifically allows. \textit{See} text accompanying notes 834 et seq. \textit{supra}.

\textsuperscript{843} \textit{See generally} pertinent part of discussion and supporting authorities cited in note 756 \textit{supra}.

\textsuperscript{844} Under the Uniform Conditional Sales Act, the vendor was not required to resell the collateral after repossession unless the buyer had paid at least fifty per cent of the purchase price at the time of the retaking or, where he had not paid that much, if the buyer timely demanded a resale. \textit{See} U.C.S.A. §§ 19-20 (act withdrawn 1943). The courts which followed the no-deficiency-PLUS rule generally agreed that the debtor could recover damages under § 25 of the Act (actual damages or the penalty there prescribed) if the debtor was entitled to a sale but a proper one was not conducted. \textit{See}, \textit{e.g.}, Elizabethport Banking Co. v. Tuszeneau, 87 N.J. Super. 17, 207 A.2d 707 (1965); La Rocca Builders v. Sanders, 230 A.D. 594, 245 N.Y.S. 262 (1930); Universal C.I.T. Credit Corp. v. Owens, 8 Misc. 2d 1074, 171 N.Y.S.2d 686 (1958); Commercial Investment Trust v. Weling, 53 S.D. 337, 220 N.W. 855 (1928). The courts disagreed, however, whether as a result of an improper \textit{optional} resale the debtor, in addition to having the debt owed the vendor discharged, was entitled to damages. The New Jersey courts, for example, said the debtor could recover damages. \textit{See}, \textit{e.g.}, Frantz Equipment Co. v. Andesos, 37 N.J. 420, 181 A.2d 499 (1962); Bancredit, Inc. v. Meyers, 62 N.J. Super. 77, 162 A.2d 109 (1960). The New York courts held that in such a case, the debtor was not entitled to damages. \textit{See}, \textit{e.g.}, Associates Discount Corp. v. Reiley, 31 N.Y.S.2d 476 (Supp. App. L. 1941); Ryan v. General Motors Acceptance Corp., 246 A.D. 668, 288 N.Y.S. 912 (1936); Ellner v. Commercial Credit Corp., 137 Misc. 251, 242 N.Y.S. 720 (1930); Capital Dist. L.A. W. Corp. v. Blake, 136 Misc. 651, 241 N.Y.S. 476 (1930).

\textsuperscript{844} \textit{But see} discussions of cases at notes 851 & 853 \textit{infra}.
standard conversion formula which is the value of the collateral less the debt owed at the time of the conversion. In Berge v. Yellow Manufacturing Acceptance Corp., for example, the assignee of a conditional sales contract repossessed the collateral and sold it to satisfy a balance of $768. A deficiency of $230 remained after sale at a public auction. The conditional vendee sued the creditor for conversion, arguing that the sale had not been properly conducted. The creditor denied this and counterclaimed for $252.50, the amount of its deficiency plus foreclosure costs. The court found that the defendant's sale of the collateral failed to satisfy fully the requirements of the Uniform Conditional Sales Act, and it affirmed the trial court's judgment for the plaintiff-debtor in the amount of $937. The judgment was based upon the court's finding that the value of the truck at the time of its seizure by defendant was $1,700; that the balance due under the contract [immediately before the sale] was $768; that the difference between the value of the truck and the balance due was $932, which sum, with legal interest from the date of seizure to the date of judgment, amounted to $937.

The court calculated damages by crediting the balance of the debt existing before the improper sale with the market value of the collateral at that time. Another way to compute the damages and arrive at about the same result is to determine the difference between the value of the property and the amount received from the improper sale, and set this figure off against the deficiency claimed by the secured party. The amount remaining after deducting the deficiency sought is the debtor's actual damages.

This measure of damages is identical to that used by a majority of courts under pre-Code law in determining a secured party's liability for

845. For authorities which applied the standard conversion theory, see those cited in the first part of note 756 supra.

For examples of courts which prior to the Code's adoption used the no-deficiency-PLUS rule but measured the debtor's actual damages based on the standard conversion theory see generally, e.g., Commercial Credit Corp. v. Swiderski, 195 A.2d 546 (Del. Super. 1963), rehearing denied, 196 A.2d 214 (Del. Super. 1963); Fisher v. Stewart Motor Corp. 132 Misc. 225, 228 N.Y.S. 549 (1928); Berge v. Yellow Mfg. Acceptance Corp., 57 S.D. 306, 232 N.W. 45 (1930); Underwood v. Raleigh Co., 102 W.Va. 305, 135 S.E. 4 (1926). See additional authorities cited last part of note 756 supra. But see, e.g., Carl v. McDonald, 60 Ariz. 170, 133 P.2d 1013 (1943) (holding that in the event of wrongful foreclosure debtor can recover purchase price; but court refers to the situation as a breach of contract for which rescission may be granted); Cox v. General Motors Acceptance Corp., 59 S.D. 588 241 N.W. 609 (1932) (debtor sued creditor for conversion due to wrongful foreclosure and seeks return of his payments; measure of damages disputed by creditor but court does not reach the issue because if there was an error committed by the trial court it was in creditor's favor).


847. "Defendant complied with all the requirements of this section except that of posting the required notices in at least three different public places within the filing district." Id. 232 N.W. at 46. See Uniform Conditional Sales Act § 19 (act withdrawn 1945).

848. 232 N.W. at 46.
wrongful foreclosure. The only difference is that under the no-deficiency-PLUS rule, had the value of the collateral been less than the debt owed, the creditor would not have been entitled to a partial deficiency (as he would under the pre-Code simple conversion-based rule). Under the no-deficiency-PLUS approach, a debtor’s minimum “recovery” is always the deficiency claimed by the secured party, for a proper foreclosure is a condition precedent to a secured creditor’s action for any deficiency. Yet in determining whether the debtor is entitled to actual damages in addition to having the balance owed the creditor discharged, the rule of damages and the theory supporting it under the no-deficiency-PLUS approach were and should remain “value less debt” based on conversion.

The pre-Code authorities applying the no-deficiency-PLUS approach were also in accord about how to decide a case in which the debtor sought a statutory penalty in lieu of actual damages. The secured party was denied any deficiency, and the debtor was awarded the full amount of penal damages allowable under the statute without any set-off. Among the courts which follow the no-deficiency rule under Arti-

849. See authorities cited note 756 supra.

850. And, although the debtor would have suffered no actual damages, he still could recover the penalty provided under the Uniform Conditional Sales Act, i.e., “one-fourth of the sum of all payments which have made under the contract, with interest.” UNIFORM CONDITIONAL SALES ACT § 25 (act withdrawn 1943). See generally, e.g., Commercial Investment Trust v. Wesling, 53 S.D. 337, 220 N.W. 855 (1928). And see, e.g., other authorities cited note 852 infra.

851. In Western Decor & Furnishings Industries, Inc. v. Bank of America, N.T.S.A., 91 Cal. App. 3d 293, 154 Cal. Rptr. 287 (1979), the jury was instructed by the trial court that [the debtor’s] debt is extinguished if [the secured party] did not conduct the sale of the inventory in a commercially reasonable manner and did not give notice to [the debtor] of the sale. The jury was further instructed that under such circumstances, [the secured party] is liable for the difference between the sale price and the reasonable value of the inventory.

Id. 154 Cal. Rptr. at 295. The jury found for the debtor thereby denying the secured party any deficiency, but it awarded the debtor only one dollar in damages. The appellate court found no reason to disturb the verdict believing that it demonstrated the jury’s conclusion that “the amount of money [the secured party] received from the two sales was the reasonable value of the inventory.” Id. Since only nominal damages were awarded in this case, whether the court approved this measure of the debtor’s actual damages for the wrongful foreclosure is uncertain. To be consistent with the pre-Code authorities’ application of the no-deficiency-PLUS rule the difference between the sale price and the value of the collateral should be reduced by the amount of the deficiency denied. The excess above the deficiency represents the debtor’s actual damages.

There is a suggestion in Randolph v. Franklin Investment Co., 398 A.2d 340 (D.C. Ct. App. 1979), that the debtor’s actual damages are to be reduced by the amount of the deficiency denied the secured party. See id. at 352.

852. For example, see these cases decided under the Uniform Conditional Sales Act which provided that a secured party who fails to comply with its provisions regarding resale of the collateral was liable for the debtor’s “actual damages, if any, and in no event less than one-fourth of the sum of all payments which have been made under the contract, with interest.” U.C.S.A. § 25 (act withdrawn 1943) (emphasis added): Farmers Bank of the State of Delaware v. Odom, 246 A.2d 85 (Del. Super. 1968); Commercial Credit Corp. v. Swiderski, 195 A.2d 546 (Del. Super. 1963), rehearing denied, 196 A.2d 214 (Del. Super. 1963); Frantz Equipment Co.
cile 9, only a few have faced this issue, and they have disagreed about the result. How the issue should be resolved by courts following the Norton approach is debatable.


853 Compare Northwest Bank & Trust Co. v. Gutshall, 274 N.W.2d 713 (Iowa 1979) with Wilkerson Motor Co. v. Johnson, 580 P.2d 505 (Okla. 1978). In Gutshall, the secured party was denied a deficiency of more than $1000. The debtor claimed that in addition to being discharged from the debt, he was entitled to damages calculated according to the minimum recovery or penalty provision in section 9-507: "If the collateral is consumer goods, the debtor has a right to recover in any event an amount not less that the credit service charge plus ten per cent of the principal amount of the debt or the time price differential plus 10 per cent of the cash price." U.C.C. § 9-507(1). The court denied the claim because the "amount of the alleged deficiency, $1,078.32, which the Bank is barred from collecting, is greater than either figure [depending upon which of two agreements is used as the basis for establishing the penalty] computed by the defendant." 274 N.W.2d at 719.

In Wilkerson, however, the secured party sued for a deficiency judgment, and the debtor counterclaimed for $982.82, calculated according to the "in no event" formula prescribed in § 9-507(1). The jury found that the secured party failed to conduct the sale of the repossessed collateral in a commercially reasonable manner, denied the plaintiff's claim for a deficiency and awarded defendant-debtor the damages he sought by way of counterclaim. There was no set-off against the damages awarded defendant for the amount of the deficiency which had been denied the secured party. The Oklahoma Supreme Court affirmed the district court's judgment. Apparently the District of Columbia Court of Appeals is in accord with the result in Wilkerson and will not offset against any penalty award the deficiency denied the creditor. See generally Randolph v. Franklin Investment Co., 398 A.2d 340 (D.C. Ct. App. 1979); Gavin v. Washington Post Emp., 397 A.2d 968 (D.C. Ct. App. 1979).

854 Suppose, for example, that the secured party conducted a commercially unreasonable sale of collateral to satisfy an obligation of $400. The improper sale produced $200. The creditor sues for a $200 deficiency. He fails to prove compliance with Part V of Article 9 and offers no evidence to overcome the presumption that the value of the collateral was worth at least as much as the debt owed. Debtor does not seek actual damages but does counterclaim for the statutory penal damages prescribed in U.C.C. § 9-507(1). The secured party cannot recover a deficiency under the approach used in Norton v. National Bank of Commerce, 240 Ark. 143, 398 S.W.2d 538 (1966), and the debtor is entitled to the damages he seeks under § 9-507(1). See text accompanying notes 767 et seq. supra. But must these damages be reduced by the deficiency denied the creditor, or can the debtor recover the full amount of penal damages without accounting for the fact that a $200 deficiency has been denied the creditor?

If the cases decided under the Uniform Conditional Sales Act are followed, the debtor can recover the full amount of damages without a set-off or accounting. See note 852 supra and text accompanying it. But the courts taking the no-deficiency approach under that Act, and also those under Article 9, do not necessarily view the amount of deficiency denied as a "recovery" for the debtor. They simply view compliance with statutory provisions regarding foreclosure as a condition precedent to an action for any deficiency.

The theory behind the Norton approach, however, is essentially one based on conversion. See text accompanying notes 767 et seq. supra. Conducting a proper sale of the collateral is not technically a prerequisite to an action for a deficiency judgment. Instead, the secured party who has wrongfully foreclosed is simply forced to account for the actual worth or value of the collateral which, in the absence of proof, is presumed to be at least as much as the debt. Therefore, the amount of the deficiency denied the secured party is a recovery of damages for the debtor. If the debtor's penal damages computed on the basis of the formula prescribed in § 9-507(1) are reduced by the amount of the deficiency which has been denied,
The common law rule of liability for wrongful foreclosure based on conversion is consistent with the express language of section 9-507(1). It requires that the debtor's actual loss be calculated on the facts of each case and that the outcome neither under-compensate the debtor nor penalize the creditor except as specifically authorized by law. Four approaches have developed for determining the debtor's remedy for wrongful foreclosure under Article 9, and three of them are based essentially on conversion. The other is the simple no-deficiency rule, which derives from cases interpreting statutes significantly different from Part 5 of Article 9. These cases and their rule should not be perpetuated under the Code. The concerns voiced by the advocates of the no-deficiency rule are important ones, but the conversion theory accommodates these concerns as well as, or better than, the approach they support. More importantly, the conversion theory measures damages on the basis of the facts, i.e., the realities, of each case. And to the extent that the conversion theory subsumes the other approaches to determining a debtor's damages under 9-507(1), the orderly conduct of commercial transactions is best promoted by using it to build a uniform approach for determining an Article 9 secured party's liability.

SECTION VI. EXPERIENCE AS THE LIFE OF THE LAW AND THE KEY TO ITS INTERPRETATION

The debtor is not recovering "an amount less than" that prescribed because the amount of the deficiency is part of his recovery. To deny the secured party a deficiency and, without accounting for this measure of recovery, to award the debtor the penal damages calculated according to § 9-507(1), is, in effect, giving the debtor a double recovery. But In re Frye, 9 UCC Rep. Serv. 913 (S.D. Ohio 1970), may be a case in which the court did just that.

On the other hand, a rule which offsets the deficiency against the penal damages has a curious effect: the larger the deficiency the less likely it is that the debtor will recover any penal damages; and it can be argued that the more flagrant the violations of Part V of Article 9, the larger the deficiency. This is not to say that such a rule would encourage gross violations of Article 9's provisions governing the foreclosure of collateral. Secured parties rarely, if ever, set out with the intention of violating those provisions, and conducting proper sales is in their best interests. Nevertheless, a secured party's deficiency claim and a debtor's penal damages recovery are inversely related under a rule which reduces the debtor's penal damages by the amount of the deficiency denied the creditor.

855. The three approaches are the literal approach (see text accompanying notes 762-766 supra), the Norton approach (see text accompanying notes 767-781 supra) (Norton v. National Bank of Commerce, 240 Ark. 143, 348 S.W.2d 538 (1966)) and the no-deficiency-PLUS approach (see text accompanying notes 840-851 supra).

856. See text accompanying notes 782-839 supra.

857. A court which has followed the no-deficiency rule and persists in the view that a proper disposition is a condition precedent to recovering a deficiency should, when given the opportunity, embrace the no-deficiency-PLUS approach. See text accompanying notes 840-854 supra. Although this approach, like the simple no-deficiency one, can result in penalizing the secured party and over-compensating the debtor, it insures that the debtor will never be under-compensated. The simple no-deficiency rule does not provide this insurance.
supplementing it with a common law rule or equitable principle? The present series of articles addresses this sources of law problem which arises under the Uniform Commercial Code because of the existence of conflicting interpretative methodologies suggested by sections 1-102(1) and 1-103. The answer these articles give is that the proper source to consult is the one supplying a rule which tends most certainly in a particular case or class of cases to further the orderly conduct of commercial transactions. Deciding which rule accomplishes this objective requires an analysis of the pertinent commercial practices and circumstances or the “commercial realities” involved.

Doubtful cases are the product of a statute’s “open texture.” The statute may work smoothly over the great mass of cases, but at some points it will prove indeterminate. Statutory language

becomes unclear in the face of specific facts that have arisen. . . . You do not simply look at the language of a statute . . . and ask yourself what words and phrases are unclear. You ask yourself if an unclarity or ambiguity exists when an attempt is made to apply the language to the facts that have arisen.

More precisely, however, a statute becomes unclear when the result of its application to the facts seems incorrect or arguably so. The reason it appears incorrect is based on some sense or knowledge of the result the statute generally is intended to achieve in transactions of the class represented by the particular case. This knowledge is achieved by examining the interests, needs and relative positions of the kinds of parties involved in the particular type of transaction before the court. Legal rules result from weighing and balancing these factors. The U.C.C. as a body of commercial law rules and principles is no different. Its basic purpose is to promote the orderly conduct of commercial transactions. Its orderliness derives originally from a consideration of these factors and can be insured only through a perpetual process of balancing them.

In a doubtful case under the Code, the decision about whether to apply a Code section or a common law rule must be based to some extent on the purposes and policies the Code is designed to achieve, including those listed in section 1-102(1) and others. But how does one know whether the application of a particular rule in a certain way to a specified class of doubtful cases will promote one or another of the statute’s objectives? And what is a court to do when one rule promotes Purpose A and another rule promotes Policy B? Simply analyzing purposes and policies qua purposes and policies is not enough. They are much like canons of interpretation which “cannot eliminate, though they can diminish, these

860. U.C.C. § 1-102(1).
uncertainties; for these canons are themselves general rules for the use of language, and make use of general terms which themselves require interpretation. They cannot, any more than rules, provide for their own interpretation.\footnote{861}

The Code as a “code,” and moreover a uniform one, has objectives different from those of a mere statutory compilation. But beyond its form is its character as a body of law the rules of which evolved from a deliberate consideration of the interests, needs and relative positions of the parties whose transactions are within its scope. Therefore, when a doubtful case arises under the Code and the decision is whether to apply one of its sections or a common law rule, the answer should depend on a consideration of factors of the same kinds. This is the essence of the approach for deciding doubtful cases suggested by this series of articles. It calls for an examination of commercial practices and circumstances, i.e., the pertinent commercial realities, and an analysis of how the application of a rule or principle may effect them. The rule or principal to apply is the one which most certainly furthers the orderly conduct of commercial transactions. The object of the search is the rule that best accommodates the interests, needs and relative positions of the parties in light of the commercial realities involved in the particular type of transaction.

One of the most familiar utterances in the law is Holmes’ statement that “[t]he life of the law has not been logic; it has been experience.”\footnote{862} Experience includes “[t]he felt necessities of the time, the prevalent moral and political theories, intuitions of public policy, avowed and unconscious, even the prejudices which judges share with their fellow men.”\footnote{863} It is the “conscious perception or apprehension of reality.”\footnote{864} The Code was drafted by people who understood commercial realities and who tried both to make the law conform to a large extent to established commercial practices and circumstances and to accommodate the interests, needs and relative positions of parties to commercial transactions. The approach suggested here simply urges that doubtful cases be decided on the basis of commercial experience or reality.\footnote{865} The orderly conduct of commercial transactions will thereby be furthered because this approach provides a mechanism for continuing to appraise and balance the changing needs, interests and positions of parties whose rights and duties are governed by the Code and supplemental principles of law and equity. These principles

\footnote{861}{H. Hart, supra note 858, at 123.}
\footnote{862}{O. Holmes, The Common Law 1 (1881).}
\footnote{863}{Id.}
\footnote{864}{Webster's Seventh New Collegiate Dictionary 293 (1965).}
\footnote{865}{Deciding doubtful cases on the basis of commercial realities will require the courts to articulate the real reasons for their decisions; but clearly enunciating these reasons in judicial opinions is a practice which should be and has been encouraged. See, e.g., Leflar, Honest Judicial Opinions, 74 NW. U. L. REV. 721 (1979).}
“are—like the Code formulations—hard-won recognitions of commercial realities. That is the point, surely, of section 1-103.”866

866. Letter from William F. Young, Jr. to Steve H. Nickles (January 24, 1980). This is Professor Young’s conclusion after reading a draft of this article. I fully agree with him.
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-102</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>9 n.379</td>
</tr>
<tr>
<td></td>
<td>88 n.628</td>
</tr>
<tr>
<td></td>
<td>131 n.717</td>
</tr>
<tr>
<td>1-102(1)</td>
<td>3-9</td>
</tr>
<tr>
<td></td>
<td>7-8 n.375</td>
</tr>
<tr>
<td></td>
<td>178</td>
</tr>
<tr>
<td></td>
<td>178 n.860</td>
</tr>
<tr>
<td>1-102(2)(a)</td>
<td>102 n.642</td>
</tr>
<tr>
<td>1-103</td>
<td>3-9</td>
</tr>
<tr>
<td></td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>34 n.470</td>
</tr>
<tr>
<td></td>
<td>69 n.566</td>
</tr>
<tr>
<td></td>
<td>70 n.568</td>
</tr>
<tr>
<td></td>
<td>77</td>
</tr>
<tr>
<td></td>
<td>83 n.609</td>
</tr>
<tr>
<td></td>
<td>95-96 n.633</td>
</tr>
<tr>
<td></td>
<td>103 n.644</td>
</tr>
<tr>
<td></td>
<td>166</td>
</tr>
<tr>
<td></td>
<td>178</td>
</tr>
<tr>
<td>1-106(1)</td>
<td>142</td>
</tr>
<tr>
<td></td>
<td>142 n.747</td>
</tr>
<tr>
<td></td>
<td>152 n.757</td>
</tr>
<tr>
<td></td>
<td>170 n.834</td>
</tr>
<tr>
<td></td>
<td>171 n.837</td>
</tr>
<tr>
<td>1-201(3)</td>
<td>52 n.533</td>
</tr>
<tr>
<td>1-201(19)</td>
<td>95 n.633</td>
</tr>
<tr>
<td>1-201(25)</td>
<td>78 n.602</td>
</tr>
<tr>
<td>1-201(34)</td>
<td>13 n.396</td>
</tr>
<tr>
<td>1-291(36)</td>
<td>13 n.396</td>
</tr>
<tr>
<td></td>
<td>15 n.405</td>
</tr>
<tr>
<td></td>
<td>31 n.464</td>
</tr>
<tr>
<td>1-201(37)</td>
<td>52 n.533</td>
</tr>
<tr>
<td>1-201(44)(a)</td>
<td>34 n.472</td>
</tr>
<tr>
<td>1-201(44)(b)</td>
<td>34 n.472</td>
</tr>
<tr>
<td>1-203</td>
<td>75</td>
</tr>
<tr>
<td></td>
<td>75 n.587</td>
</tr>
<tr>
<td></td>
<td>95-96</td>
</tr>
<tr>
<td></td>
<td>95 n.631</td>
</tr>
<tr>
<td></td>
<td>95-96 n.633</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
</tr>
<tr>
<td>------------------</td>
<td>--------------</td>
</tr>
<tr>
<td>1-205(4)</td>
<td>111 n.666</td>
</tr>
<tr>
<td></td>
<td>112</td>
</tr>
<tr>
<td></td>
<td>112-113 n.669</td>
</tr>
<tr>
<td>1-206</td>
<td>61 n.533</td>
</tr>
<tr>
<td>1-208</td>
<td>96 n.633</td>
</tr>
<tr>
<td>2-103(1)</td>
<td>95 n.633</td>
</tr>
<tr>
<td>2-201</td>
<td>61 n.554</td>
</tr>
<tr>
<td></td>
<td>68</td>
</tr>
<tr>
<td></td>
<td>68 n.562-63</td>
</tr>
<tr>
<td></td>
<td>69 n.566</td>
</tr>
<tr>
<td></td>
<td>70 n.568</td>
</tr>
<tr>
<td>2-201(1)</td>
<td>61 n.553</td>
</tr>
<tr>
<td>2-201(3)(a)</td>
<td>68 n.563</td>
</tr>
<tr>
<td>2-201(3)(c)</td>
<td>68 n.563</td>
</tr>
<tr>
<td>2-208(3)</td>
<td>113 n.669</td>
</tr>
<tr>
<td>2-210</td>
<td>30 n.463</td>
</tr>
<tr>
<td></td>
<td>32 n.466</td>
</tr>
<tr>
<td>2-210(4)</td>
<td>95 n.632</td>
</tr>
<tr>
<td>2-236</td>
<td>32 n.466</td>
</tr>
<tr>
<td>2-301(3)(b)</td>
<td>68 n.561</td>
</tr>
<tr>
<td>2-312</td>
<td>133 n.720</td>
</tr>
<tr>
<td>2-401</td>
<td>128 n.708</td>
</tr>
<tr>
<td>2-403</td>
<td>118-119</td>
</tr>
<tr>
<td></td>
<td>119 n.690</td>
</tr>
<tr>
<td></td>
<td>128 n.708</td>
</tr>
<tr>
<td></td>
<td>130-131</td>
</tr>
<tr>
<td></td>
<td>131 n.717</td>
</tr>
<tr>
<td>2-403(1)</td>
<td>127 n.708</td>
</tr>
<tr>
<td></td>
<td>130</td>
</tr>
<tr>
<td></td>
<td>130 n.715</td>
</tr>
<tr>
<td>2-403(2)</td>
<td>118 n.687</td>
</tr>
<tr>
<td></td>
<td>130</td>
</tr>
<tr>
<td></td>
<td>131 n.717</td>
</tr>
<tr>
<td>3-302(1)</td>
<td>35 n.472</td>
</tr>
<tr>
<td>3-306</td>
<td>28 n.454</td>
</tr>
<tr>
<td></td>
<td>30 n.463</td>
</tr>
<tr>
<td>3-306(a)</td>
<td>28 n.454</td>
</tr>
<tr>
<td>3-306(c)</td>
<td>28 n.454</td>
</tr>
<tr>
<td>3-414(1)</td>
<td>10 n.383</td>
</tr>
<tr>
<td>3-415(1)</td>
<td>10 n.384</td>
</tr>
<tr>
<td>3-415(2)</td>
<td>10 n.383</td>
</tr>
<tr>
<td>3-415(5)</td>
<td>11 n.385</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
</tr>
<tr>
<td>---------</td>
<td>------</td>
</tr>
<tr>
<td>3-502(1)(a)</td>
<td>10 n.384</td>
</tr>
<tr>
<td>3-507(1)(a)</td>
<td>10 n.384</td>
</tr>
<tr>
<td>3-507(2)</td>
<td>10 n.384</td>
</tr>
<tr>
<td>3-603(2)</td>
<td>11 n.385</td>
</tr>
<tr>
<td>3-606(1)(a)</td>
<td>12 n.393</td>
</tr>
<tr>
<td>6-102(1)</td>
<td>116 n.679</td>
</tr>
<tr>
<td>6-102(3)</td>
<td>116 n.679</td>
</tr>
<tr>
<td>8-102</td>
<td>72 n.578</td>
</tr>
<tr>
<td>8-319</td>
<td>61 n.553</td>
</tr>
<tr>
<td></td>
<td>71 n.568</td>
</tr>
<tr>
<td>8-319(d)</td>
<td>68 n.561</td>
</tr>
<tr>
<td>9-102</td>
<td>19 n.421</td>
</tr>
<tr>
<td>9-102(1)</td>
<td>19 n.421</td>
</tr>
<tr>
<td>9-102(1)(b)</td>
<td>19 n.421</td>
</tr>
<tr>
<td>9-104</td>
<td>19 n.421</td>
</tr>
<tr>
<td></td>
<td>20 n.425</td>
</tr>
<tr>
<td>9-104(a)</td>
<td>39 n.487</td>
</tr>
<tr>
<td>9-104(f)</td>
<td>20 n.425</td>
</tr>
<tr>
<td>9-105(1)</td>
<td>22 n.432</td>
</tr>
<tr>
<td>9-105(1)(i)</td>
<td>51 n.532</td>
</tr>
<tr>
<td>9-105(1)(k)</td>
<td>72 n.578</td>
</tr>
<tr>
<td>9-105(1)(m)</td>
<td>34 n.472</td>
</tr>
<tr>
<td>9-106</td>
<td>138 n.737</td>
</tr>
<tr>
<td>9-109(3)</td>
<td>17 n.413</td>
</tr>
<tr>
<td>9-202</td>
<td>107 n.653</td>
</tr>
<tr>
<td>9-203</td>
<td>128 n.708</td>
</tr>
<tr>
<td></td>
<td>41</td>
</tr>
<tr>
<td></td>
<td>48</td>
</tr>
<tr>
<td></td>
<td>48 n.515</td>
</tr>
<tr>
<td></td>
<td>48 n.520</td>
</tr>
<tr>
<td></td>
<td>49 n.527</td>
</tr>
<tr>
<td></td>
<td>50 n.528</td>
</tr>
<tr>
<td></td>
<td>51 n.530</td>
</tr>
<tr>
<td></td>
<td>51 n.533</td>
</tr>
<tr>
<td></td>
<td>53</td>
</tr>
<tr>
<td></td>
<td>59</td>
</tr>
<tr>
<td></td>
<td>59 n.547</td>
</tr>
<tr>
<td></td>
<td>60 n.549</td>
</tr>
<tr>
<td></td>
<td>60 n.550</td>
</tr>
<tr>
<td></td>
<td>64 n.556</td>
</tr>
<tr>
<td></td>
<td>66 n.557</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
</tr>
<tr>
<td>----------------</td>
<td>------------</td>
</tr>
<tr>
<td>9-203(1)</td>
<td>48-50</td>
</tr>
<tr>
<td></td>
<td>50 n.529-30</td>
</tr>
<tr>
<td></td>
<td>51 n.533</td>
</tr>
<tr>
<td></td>
<td>52-53</td>
</tr>
<tr>
<td></td>
<td>56</td>
</tr>
<tr>
<td></td>
<td>59-61</td>
</tr>
<tr>
<td></td>
<td>64</td>
</tr>
<tr>
<td></td>
<td>69-72</td>
</tr>
<tr>
<td>9-203(1)(a)</td>
<td>48 n.514</td>
</tr>
<tr>
<td></td>
<td>52</td>
</tr>
<tr>
<td></td>
<td>54</td>
</tr>
<tr>
<td>9-203(2)</td>
<td>47 n.513</td>
</tr>
<tr>
<td>9-204(2)</td>
<td>135 n.725</td>
</tr>
<tr>
<td>9-205</td>
<td>120 n.690</td>
</tr>
<tr>
<td></td>
<td>131-133 n.718</td>
</tr>
<tr>
<td>9-208</td>
<td>60 n.549</td>
</tr>
<tr>
<td>9-301</td>
<td>88 n.622</td>
</tr>
<tr>
<td>9-301(1)(b)</td>
<td>63 n.556</td>
</tr>
<tr>
<td></td>
<td>88-89 n.622</td>
</tr>
<tr>
<td>9-301(1)(c)</td>
<td>88 n.622</td>
</tr>
<tr>
<td></td>
<td>106 n.650</td>
</tr>
<tr>
<td>9-301(4)</td>
<td>88 n.622</td>
</tr>
<tr>
<td>9-302</td>
<td>39 n.487</td>
</tr>
<tr>
<td>9-302(1)</td>
<td>39 n.487</td>
</tr>
<tr>
<td>9-302(1)(e)</td>
<td>22 n.432</td>
</tr>
<tr>
<td>9-302(2)</td>
<td>14 n.400</td>
</tr>
<tr>
<td></td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>15 n.408</td>
</tr>
<tr>
<td>9-302(3)</td>
<td>39 n.487</td>
</tr>
<tr>
<td>9-302(3)(a)</td>
<td>39 n.487</td>
</tr>
<tr>
<td>9-303(1)</td>
<td>66 n.557</td>
</tr>
<tr>
<td></td>
<td>81 n.605</td>
</tr>
<tr>
<td>9-304</td>
<td>80 n.605</td>
</tr>
<tr>
<td>9-304(1)</td>
<td>72 n.578</td>
</tr>
<tr>
<td>9-304(4)</td>
<td>80 n.605</td>
</tr>
<tr>
<td>9-304(5)</td>
<td>80 n.605</td>
</tr>
<tr>
<td></td>
<td>90 n.623</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
</tr>
<tr>
<td>--------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td>9-306</td>
<td>105 n.646</td>
</tr>
<tr>
<td></td>
<td>109 n.658</td>
</tr>
<tr>
<td></td>
<td>120 n.690</td>
</tr>
<tr>
<td></td>
<td>142</td>
</tr>
<tr>
<td></td>
<td>142 n.749</td>
</tr>
<tr>
<td>9-306(2)</td>
<td>108</td>
</tr>
<tr>
<td></td>
<td>109 n.658</td>
</tr>
<tr>
<td></td>
<td>112</td>
</tr>
<tr>
<td></td>
<td>112 n.667</td>
</tr>
<tr>
<td></td>
<td>116</td>
</tr>
<tr>
<td></td>
<td>119</td>
</tr>
<tr>
<td></td>
<td>119-120 n.690</td>
</tr>
<tr>
<td></td>
<td>126-127</td>
</tr>
<tr>
<td></td>
<td>127 n.706</td>
</tr>
<tr>
<td></td>
<td>131</td>
</tr>
<tr>
<td></td>
<td>132 n.718</td>
</tr>
<tr>
<td></td>
<td>134</td>
</tr>
<tr>
<td></td>
<td>136</td>
</tr>
<tr>
<td>9-307</td>
<td>119 n.690</td>
</tr>
<tr>
<td></td>
<td>126 n.704</td>
</tr>
<tr>
<td></td>
<td>88 n.622</td>
</tr>
<tr>
<td>9-307(1)</td>
<td>89</td>
</tr>
<tr>
<td></td>
<td>106 n.650</td>
</tr>
<tr>
<td></td>
<td>108</td>
</tr>
<tr>
<td></td>
<td>108 n.655</td>
</tr>
<tr>
<td></td>
<td>113</td>
</tr>
<tr>
<td></td>
<td>113 n.671</td>
</tr>
<tr>
<td></td>
<td>115 n.678</td>
</tr>
<tr>
<td></td>
<td>116-119</td>
</tr>
<tr>
<td></td>
<td>116 n.679</td>
</tr>
<tr>
<td></td>
<td>117 n.681</td>
</tr>
<tr>
<td></td>
<td>118 n.658</td>
</tr>
<tr>
<td></td>
<td>125-128</td>
</tr>
<tr>
<td></td>
<td>127-128 n.706-708</td>
</tr>
<tr>
<td></td>
<td>129 n.714</td>
</tr>
<tr>
<td></td>
<td>131</td>
</tr>
<tr>
<td></td>
<td>131 n.717</td>
</tr>
<tr>
<td></td>
<td>133-134</td>
</tr>
<tr>
<td></td>
<td>135 n.725</td>
</tr>
<tr>
<td></td>
<td>136</td>
</tr>
<tr>
<td>9-307(2)</td>
<td>88 n.622</td>
</tr>
<tr>
<td></td>
<td>127 n.706</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
</tr>
<tr>
<td>------------------</td>
<td>------------</td>
</tr>
<tr>
<td>9-307(3)</td>
<td>88</td>
</tr>
<tr>
<td>9-308(a)</td>
<td>88</td>
</tr>
<tr>
<td>9-308(b)</td>
<td>88</td>
</tr>
<tr>
<td>9-311</td>
<td>106</td>
</tr>
<tr>
<td>9-312</td>
<td>78-81</td>
</tr>
<tr>
<td></td>
<td>82</td>
</tr>
<tr>
<td></td>
<td>82</td>
</tr>
<tr>
<td></td>
<td>82</td>
</tr>
<tr>
<td></td>
<td>87</td>
</tr>
<tr>
<td></td>
<td>88</td>
</tr>
<tr>
<td>9-312(2)</td>
<td>90</td>
</tr>
<tr>
<td>9-312(4)</td>
<td>104</td>
</tr>
<tr>
<td>9-312(5)</td>
<td>38</td>
</tr>
<tr>
<td></td>
<td>74</td>
</tr>
<tr>
<td></td>
<td>76</td>
</tr>
<tr>
<td></td>
<td>80-81</td>
</tr>
<tr>
<td></td>
<td>86</td>
</tr>
<tr>
<td></td>
<td>88-89</td>
</tr>
<tr>
<td></td>
<td>95</td>
</tr>
<tr>
<td></td>
<td>96</td>
</tr>
<tr>
<td></td>
<td>101</td>
</tr>
<tr>
<td>9-312(5)(a)</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>26</td>
</tr>
<tr>
<td></td>
<td>39</td>
</tr>
<tr>
<td></td>
<td>72-74</td>
</tr>
<tr>
<td></td>
<td>77-79</td>
</tr>
<tr>
<td></td>
<td>77</td>
</tr>
<tr>
<td></td>
<td>79</td>
</tr>
<tr>
<td></td>
<td>79-81</td>
</tr>
<tr>
<td></td>
<td>86-87</td>
</tr>
<tr>
<td></td>
<td>88-89</td>
</tr>
<tr>
<td></td>
<td>90</td>
</tr>
<tr>
<td></td>
<td>90</td>
</tr>
<tr>
<td></td>
<td>94-96</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
</tr>
<tr>
<td>---------------------------------</td>
<td>--------</td>
</tr>
<tr>
<td>9-312(5)(b)</td>
<td>39 n.484</td>
</tr>
<tr>
<td>9-312(7)</td>
<td>24 n.436</td>
</tr>
<tr>
<td>9-317</td>
<td>30 n.463</td>
</tr>
<tr>
<td>9-318</td>
<td>29 n.456</td>
</tr>
<tr>
<td>9-318(1)</td>
<td>28-29</td>
</tr>
<tr>
<td>9-318(1)(a)</td>
<td>29 n.455</td>
</tr>
<tr>
<td>9-401</td>
<td>39 n.487</td>
</tr>
<tr>
<td>9-401(1)</td>
<td>30-31 n.463</td>
</tr>
<tr>
<td>9-401(2)</td>
<td>33 n.470</td>
</tr>
<tr>
<td>9-402</td>
<td>74</td>
</tr>
<tr>
<td>9-402(1)</td>
<td>87 n.620</td>
</tr>
<tr>
<td>9-403(4)</td>
<td>76</td>
</tr>
<tr>
<td>9-501(3)</td>
<td>76-77 n.597</td>
</tr>
<tr>
<td>9-503</td>
<td>86-87</td>
</tr>
<tr>
<td></td>
<td>87 n.620</td>
</tr>
<tr>
<td></td>
<td>74</td>
</tr>
<tr>
<td></td>
<td>133 n.719</td>
</tr>
<tr>
<td></td>
<td>135 n.768</td>
</tr>
<tr>
<td></td>
<td>137-139</td>
</tr>
<tr>
<td></td>
<td>138 n.734</td>
</tr>
<tr>
<td></td>
<td>138 n.737</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
</tr>
<tr>
<td>-------------</td>
<td>---------------</td>
</tr>
<tr>
<td>9-504</td>
<td>163 n.802</td>
</tr>
<tr>
<td>9-504(1)</td>
<td>101 n.640</td>
</tr>
<tr>
<td></td>
<td>164 n.803</td>
</tr>
<tr>
<td>9-504(2)</td>
<td>101 n.640</td>
</tr>
<tr>
<td></td>
<td>164 n.803</td>
</tr>
<tr>
<td>9-504(3)</td>
<td>143</td>
</tr>
<tr>
<td></td>
<td>155 n.769</td>
</tr>
<tr>
<td></td>
<td>158 n.779</td>
</tr>
<tr>
<td></td>
<td>169 n.832</td>
</tr>
<tr>
<td>9-504(4)</td>
<td>167 n.823</td>
</tr>
<tr>
<td>9-504(5)</td>
<td>12 n.392</td>
</tr>
<tr>
<td></td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>15 n.406</td>
</tr>
<tr>
<td></td>
<td>16</td>
</tr>
<tr>
<td>9-505</td>
<td>163</td>
</tr>
<tr>
<td>9-505(1)</td>
<td>142</td>
</tr>
<tr>
<td></td>
<td>142 n.750</td>
</tr>
<tr>
<td></td>
<td>163-164 n.802</td>
</tr>
<tr>
<td>9-505(2)</td>
<td>163 n.802</td>
</tr>
<tr>
<td>9-506</td>
<td>168</td>
</tr>
<tr>
<td></td>
<td>168 n.828</td>
</tr>
<tr>
<td>9-507</td>
<td>139 n.739</td>
</tr>
<tr>
<td></td>
<td>153</td>
</tr>
<tr>
<td></td>
<td>158 n.780</td>
</tr>
<tr>
<td></td>
<td>176 n.853</td>
</tr>
<tr>
<td>9-507(1)</td>
<td>139</td>
</tr>
<tr>
<td></td>
<td>139 n.738</td>
</tr>
<tr>
<td></td>
<td>141-143</td>
</tr>
<tr>
<td></td>
<td>141 n.746</td>
</tr>
<tr>
<td></td>
<td>143 n.753</td>
</tr>
<tr>
<td></td>
<td>145</td>
</tr>
<tr>
<td></td>
<td>152-154</td>
</tr>
<tr>
<td></td>
<td>152 n.758</td>
</tr>
<tr>
<td></td>
<td>160</td>
</tr>
<tr>
<td></td>
<td>162</td>
</tr>
<tr>
<td></td>
<td>162 n.796</td>
</tr>
<tr>
<td></td>
<td>164</td>
</tr>
<tr>
<td></td>
<td>164 n.802</td>
</tr>
<tr>
<td></td>
<td>166-167</td>
</tr>
<tr>
<td></td>
<td>170-172</td>
</tr>
<tr>
<td></td>
<td>170-171 n.835-836</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
</tr>
<tr>
<td>---------</td>
<td>--------------</td>
</tr>
<tr>
<td></td>
<td>171-173 n.838-841</td>
</tr>
<tr>
<td></td>
<td>176-177 n.853-854</td>
</tr>
<tr>
<td></td>
<td>177</td>
</tr>
</tbody>
</table>