Security Interests in Inventory Priorities and Problems

Daniel E. Murray

Follow this and additional works at: http://repository.law.miami.edu/umlr

Recommended Citation
Available at: http://repository.law.miami.edu/umlr/vol25/iss4/3

This Article is brought to you for free and open access by Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized administrator of Institutional Repository. For more information, please contact library@law.miami.edu.
SECURITY INTERESTS IN INVENTORY
PRIORITIES AND PROBLEMS

DANIEL E. MURRAY*

I. INTRODUCTION ............................................................ 635
II. PERFECTION PROBLEMS ...................................................... 638
   A. Classification of Collateral .............................................. 638
   B. Description of Inventory .............................................. 638
   C. Claiming Proceeds of Inventory ....................................... 640
   D. After-Acquired Inventory .............................................. 641
   E. Policing Inventory .................................................... 642
   F. There Must be a Security Agreement .................................... 642
   G. Assignment of Security Interest ........................................ 643
   H. Notification of First Inventory Lender by Second Inventory Lender .......... 643
   I. Subordination Agreements .............................................. 644
   J. Payee Banks Are Not Collecting Banks .................................. 645
   K. Perfection by Possession ............................................... 645
III. PRIORITY PROBLEMS .................................................... 646
   A. After-Acquired Inventory Vis-a-Vis Section 60 of the Bankruptcy Act (Sections 9-108, 9-204 and 9-303) .......... 646
   B. Buyer in Ordinary Course of Business (Sections 9-307 and 2-403) .......... 650
      1. GENERAL PRINCIPLES ................................................. 650
      2. ANTECEDENT DEBT AS CONSIDERATION ................................ 652
      3. REPOSESSION OF GOODS AND REVERSION TO INVENTORY STATUS ........... 652
      4. MERCHANT BUYER AS A BUYER IN ORDINARY COURSE OF BUSINESS ........... 653
      5. CAN A LESSEE BE A BUYER? .......................................... 655
      6. MUST THE SELLER CREATE THE SECURITY INTEREST? ......................... 656
      7. LENDER’S RETENTION OF CAR TITLES DOES NOT DEFEAT THE OPERATION OF 9-307 .......... 657
      8. A VENDOR OF FRANCHISES UNDER 9-307 .................................. 657
      9. INVENTORY FINANCIER VERSUS AUCTIONEER ................................ 658
     10. AUTO DEALER SURETY BONDS .......................................... 658
     11. EXTENSIONS OF THE CONCEPT ........................................ 659
     12. AIRCRAFT INVENTORY SECURITY INTERESTS ................................ 660
     13. BONA FIDE BUYERS OUT OF THE ORDINARY COURSE ............................ 661
     14. 9-307(1) COMPARED TO 9-307(2) ....................................... 662
     15. “NON PROFESSIONAL SUPPLIER OF INVENTORY” VERSUS BUYERS IN ORDINARY COURSE OF BUSINESS .................. 663
     C. Inventory Lender’s Interest in Proceeds (Sections 9-306 and 9-308) .......... 663
        1. GENERAL PRINCIPLES ................................................. 663
        2. THE NATURE OF PROCEEDS (9-306(1) AND (2)) .......................... 664
        3. CASH PROCEEDS PROBLEMS (9-306(4)(d)) ............................. 668
        4. REPOSESSED GOODS AS PROCEEDS (9-306(5)(d)) ......................... 668
        5. FINANCIER OF INVENTORY VERSUS FINANCIER OF CHATTEL PAPER (9-306 VS. 9-308) .................. 669
        6. ARE INSURANCE PROCEEDS INVENTORY PROCEEDS? ......................... 670
     D. Consignment Suppliers Versus Inventory Lenders (2-326, 9-312 and 9-306) ........ 671
     E. Defrauded Supplier of Inventory Versus Inventory Lender (2-702 and 9-312) ........ 679
     F. Landlord Versus Inventory Lender ....................................... 682
     G. Mechanic’s Lien Claimant Versus Inventory Lender (9-310) .................... 685
     H. Surety Versus Inventory Lender ......................................... 686
     I. Ad Valorem Taxing Authority Versus Inventory Lender ......................... 687
     J. Inventory Lender’s Tort Liability for Wrongful Interference with Buyers Rights ........................................ 608

* Professor of Law, University of Miami.

634
I. INTRODUCTION

Article 9 has been questioned for its seeming emphasis upon tangible collateral such as inventory and equipment at the seeming expense of attention devoted to accounts, contract rights, and general intangibles because of the view that account factoring (in particular) has become much more important than inventory lending.\(^1\) This criticism may be justified if one compares the dollar volume of account loans to the dollar volume of inventory loans. On the other hand, the lawyer may not perceive things through the spectacles of the economist: To the lawyer the litigation volume in any area may be more significant than the dollar volume of transactions which have not resulted in litigation. From this latter perspective, the inventory lending area is alive and well and living in the Uniform Commercial Code.

It is the purpose of this article to examine and discuss most of the important inventory financing cases in accordance with the above outline. Various non-inventory cases will be discussed in certain areas because of a lack of inventory cases. This article does not devote any attention to federal tax liens because of more than adequate coverage elsewhere.\(^2\)

Inventory consists of goods which:

are held by a person who holds them for sale or lease or to be furnished under contracts of service or if he has so furnished them, or if they are raw materials, work in process or materials used or consumed in a business.\(^3\)

Under this definition, a car or other hard goods which are leased are defined as inventory\(^4\) but it will be shown in a subsequent part of this article\(^5\) that a buyer of this “lease inventory” will not be treated as a buyer in the ordinary course of business. Inventory held for sale is treated in one way while inventory held for leasing is treated in another.

Section 9-312(3) provides that a purchase money security interest in inventory will have priority over an existing security interest in the same inventory if the purchase money security interest is perfected at the time the debtor obtains possession of the inventory and any secured party whose security interest is known to the holder of the purchase money security interest or who, prior to the date of the filing made by the holder of the purchase money security interest, had filed a financing statement covering the same items or type of inventory.

---

3. UNIFORM COMMERCIAL CODE § 9-109(4) [hereinafter cited as “U.C.C.” or “the Code.”]
5. See notes 81-89 infra and accompanying text.
has received notification before the debtor has received possession of the inventory covered by the purchase money security interest and the notification states that the purchase money lender has or expects to acquire a purchase money security interest in the described inventory. The only prudent procedure under this sub-section is for the purchase money security interest lender to file his financing statement and to give the requisite notice to prior secured parties before the debtor receives possession of the inventory.\(^7\) Unfortunately, this simple procedure, which is adequate for the majority of transactions, breaks down in the following illustrations:

1. Assume that the debtor is a retailer who sells a bewildering variety of items supplied by a multitude of manufacturers, wholesalers, or distributors. If each supplier who claims a purchase money security interest in the particular inventory that he is supplying is very careful in articulating a very narrow description of “the same items or type of inventory”\(^7\) there will not be any real chance of a conflict between the inventory security interests. However, if any one supplier perfects a security interest in “inventory,” then he may come in conflict with every other subsequent supplier, and each of these subsequent suppliers then will have to notify this “greedy” supplier in order to obtain priority over him. Complying with the quirks of Section 9-312(3) is not difficult even in the event of broad descriptions in the security agreement and in the financing statement when there are a handful of suppliers. However, when there are hundreds of greedy suppliers the economic cost of compliance becomes impossible.

2. Under the literal wording of the code, “any secured party whose security interest is known to the holder of the purchase money security interest,”\(^8\) even though a secured party never files a financing statement, he will be entitled to protection against a purchase money lender who has knowledge of a non-filed security interest. Assume the following hypothetical: \(A\) has a properly perfected purchase money security interest in a dealer’s inventory of appliances under a broad “inventory” description in the security agreement and financing statement. \(B\) supplies a new line of appliances to the dealer under an equally broad description and notifies \(A\) in accordance with Section 9-312(3) but fails to record. \(C\) supplies another line of appliances under another broad description and complies with Section 9-312(3) by notifying \(A\). \(C\) fails to notify \(B\) because he is unaware of \(B\)’s interest. \(A\) is protected against \(B\) and \(B\) is protected against \(A\), but \(C\) has priority over \(B\). This problem may be dismissed with the thought that since \(B\) did not file a financing statement, his loss was self-induced. But consider the following “wildeyed” hypothetical posed by

---

7. U.C.C. § 9-312(3)(b) and Comment 3.
8. U.C.C. § 9-312(3)(b) (emphasis added).
Professor Gilmore. A properly perfects a purchase money security interest in widgets of a dealer. A now receives a notice from B that he (B) has or expects to acquire a purchase money security interest in widgets of the same dealer. B's "security interest is known to the holder of the purchase money security interest," i.e., A. Must A abstain from financing additional widgets for the dealer or must he (A) notify B, who in turn will notify A and vice versa? Gilmore suggests that the UCC provides no answer to this notification problem and no solution as to who would have priority. As Professor Gilmore succinctly puts the case:

Section 9-312(3) sensibly makes no attempt to answer these wild-eyed hypotheticals. In such a situation, A and B, once they have become aware of each other's presence, will be well advised to sit down together and come to an agreement: the notification mechanism will not solve their problems for them. If, in defiance of common sense, they engage in a battle of notifications, they should both be hung. It is not worth anyone's time to try to figure out the priorities between them.10

It is all very well to talk about hanging the two lenders, but, in the meantime, the dealer will be unable to secure financing if A and B will not sit down together. In effect, this notification procedure may allow one lender to monopolize the extending of credit to a debtor.

3. This notification procedure displays a certain ambivalence that is difficult to reconcile with the rest of Section 9-312. Under Section 9-312(3), a purchase money security interest lender in inventory must notify other inventory lenders if he has knowledge of their existence even though they have not filed financing statements. If the same lender should contemplate lending money on equipment, consumer goods, chattel paper, or crops he is concerned solely with the possible existence of filed financing statements. If the lender should learn that the non-inventory collateral was obtained by the debtor under an unperfected purchase money security interest with another lender, the second lender has the perfect legal right to ignore this fact and perfect first. Knowledge of the existence of a non-perfected purchase money security interest in non-inventory collateral is irrelevant. The race is to the swift.11

9. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 790 (1965).
10. Id.
II. Perfection Problems

A. Classification

When a supplier of washers and dryers,\textsuperscript{12} or a supplier of stoves and television sets\textsuperscript{13} or a supplier of farm machinery\textsuperscript{14} sells these items to retail dealers for purposes of sale under purchase money security agreements, it is imperative that the supplier realize that he is dealing with inventory which requires the filing of a financing statement in order to perfect the security interest. The fact that these items will eventually be consumer goods or farm equipment when sold to retail customers may mislead the supplier into thinking that his interest will be perfected without filing under Sections 9-302(1)(c) and (d). The mistake will be discovered when the trustee in the bankruptcy of the retail dealer is able to invalidate the security interest.

B. Description of Inventory

A broad view of the legal effect of the word “inventory” was adopted by a lower Pennsylvania court in one of the earlier UCC inventory cases.

The final argument of defendant is that “inventory” is too vague a description and that petitioners’ security interest must be more specific. Section 9-110 expressly states: “For purposes of this Article any description is sufficient whether or not it is specific if it reasonably identifies the thing described.” The Code repeatedly refers to security interests in “inventory” and defines the term as above noted. All goods held for sale come within the scope of the term and, as applied here, are readily identifiable in the retail trade. To require enumeration of all types of articles handled would be unreasonably burdensome and neither within the letter or the spirit of the Code. Certainly one who sells to a retailer must be aware of the character of his goods and the disposition contemplated by the buyer and that the goods sold would become inventory as defined in the Code and subject to a security agreement declaring a security interest in future inventory.\textsuperscript{15}

This liberal construction was soon followed in two cases which held that the phrase “motor vehicles” used in a financing statement signed by a car dealer and a finance company is sufficient as a statement indicating the type of property covered,\textsuperscript{16} and the phrase “inventory of merchan-

\textsuperscript{13} In re Sam’s Furniture & Appliance Stores, Inc., 1 UCC Rep. Serv. 422 (W.D. Pa. 1962).
INVENTORY SECURITY

...in the Kiddy and Women's Wear Shop" is also sufficient description of inventory under Sections 9-110 and 9-203(1)(b).

This liberal approach to the interpretation of descriptions was extended, perhaps to its outer limits, in In re JCM Cooperative, Inc. where the court held that a description reading “equipment...including but not limited to...all tangible personal property...proceeds of collateral and products of collateral” (emphasis by court) would include not only equipment, but all inventory and accounts receivable resulting from the sale of inventory.

In Security Tire & Rubber Inc. v. Hlass the security agreement and financing statement provided for a security interest in “Company owned inventory of Stephens Tire Company, 2517 Alma Highway, Van Buren, Arkansas.” The court held that this description was not inadequate as a matter of law. It was a question of fact as to whether the goods could possibly be identified under the agreement. As the court stated it: “the description need not be such as would enable a stranger to select the property and that a description is sufficient which will enable third persons, aided by inquiries which the instrument itself suggests, to identify the property.”

Security Tire should be compared with In re Mann. In the latter case a financing statement included:

inventory of new pianos, organs, including hi-fidelity equipment and stereo tape recorders, as well as all other miscellaneous inventory including but not limited to the above items together with all documents of title representing such collateral as well as accounts receivable and contract rights now in existence or hereafter arising or acquired.

Unfortunately for the lender, his security agreements (trust receipts) listed as collateral particular organs and other items of musical equipment describing each item by make, model and serial number. The debtor (who became a bankrupt) entered into a security agreement covering the debtor’s general inventory with the Small Business Administration. The court held that the trust receipts constituted a valid “lien” in favor of the lender upon the particular items of inventory which they listed and that the SBA held a lien upon the debtor’s inventory other than those items listed in the bank’s trust receipts. Between the two lenders, the bank was first in priority as to the particular items of

18. 8 UCC REP. SERV. 247 (W.D. Mich. 1970). But see In re Laminated Veneers, Inc., 8 UCC REP. SERV. 602 (E.D.N.Y. 1970) which held that the term “equipment” does not necessarily include the generic term “automobiles.”
20. Id. at 1114, 441 S.W.2d at 92 [6 UCC REP. SERV. at 737].
21. Id. at 1117, 441 S.W.2d at 94 [6 UCC REP. SERV. at 739].
23. Id. at 33 [8 UCC REP. SERV. at 134].
inventory listed while the SBA was first in priority as to the other items of inventory. The court flatly held that a “financing statement cannot add collateral not described in the security agreement.”

A security agreement which describes the collateral as “RCA merchandise” followed by a financing statement which describes the collateral as “RCA Merchandise; Stereos, Radios, Televisions or the like or any combination thereof . . .” is apparently a sufficient description of inventory collateral. Although the issue was not raised, it would appear that the description in the financing statement in its itemization was narrower than the description in the security agreement and this could cause problems if there were RCA manufactured goods which would fall outside of the description of stereos, radios and televisions.

A bankruptcy referee has recently held that the following wordy description in a financing statement is sufficient: “all inventory including without limitation all commercial and replacement parts and other goods used or intended to be used in conjunction with any of the foregoing.”

Although Section 9-110 of the Code is liberal in the requirement of description of collateral, there are some limits; hence, a financing statement which covers “cotton waste and proceeds” (cotton waste is a waste product from cotton mills) could not be deemed to include “cotton linters” (cotton linters are a by-product in the manufacture of cotton oil from cotton seed).

When the security agreement uses the word “premises” in referring to leases of retail stores, this word cannot include inventory and accounts even though the filed financing statement attempts to embrace these two items. As a result, the security interest cannot include the inventory and accounts.

C. Claiming Proceeds of Inventory

In order to have a properly perfected security interest in proceeds of inventory, it is necessary that the “proceeds box” in the financing statement be checked prior to its filing. A filed financing statement which simply states that the secured party was to have a security interest in all of a tire dealer’s inventory and proceeds is sufficient to put all persons on notice that he is asserting a claim to all accounts receivable

arising out of the sale of the inventory and to preclude the state-appointed receiver from asserting a claim to the accounts.30

A security agreement describing collateral to include "customer accounts" of a business and a financing statement covering "processing supplies and inventory in trade" and "proceeds of collateral" sufficiently describes "accounts receivable" of the debtor's business collected by the debtor and turned over to the debtor's trustee in bankruptcy.91

D. After-Acquired Inventory

One court has held that it is not necessary to claim "future" or after-acquired inventory in the financing statement in order for the security interest to include after-acquired inventory. "No reasonable searcher of the records would conclude that the secured party had a lien on only the past accounts and inventory of the debtor, especially where the debtor is in an active retailing business."32

In a similar vein, it has been held that the words "[s]ales and service of new and used automobiles"32 in a financing statement were sufficient to describe the inventory of a car dealer and to put a prudent examiner upon further inquiry. Furthermore, inasmuch as the debtor was a car dealer, after-acquired cars were subject to the security interest, even though the financing statement did not mention after-acquired property because a car dealer is in the continuing business of buying and selling new and used cars, and the addition of the words "sales and service" .
indicates even more clearly a continuing financing arrangement, with a floating lien over the dealer's inventory.

Another court has held that after-acquired inventory was covered in a security agreement which stated that "inventory of merchandise to be maintained in an amount not less than $10,000, as per agreement of sale, at seller's wholesale cost, contained in the Kiddy and Women's Wear Shop."34 The decision would seem to be logical; because in order to maintain inventory at a fixed level, it is necessary to replace goods which were sold. The security interest should then embrace the replacement inventory. Although it is not necessary to claim after-acquired inventory in the financing statement, it is necessary that it be claimed in the underlying security agreement.35

E. Policing Inventory

It would seem rather certain that the failure of the inventory financier to police the inventory will not result in judicial invalidation; the courts are following the wording of the U.C.C. in this regard.36

F. There must be a Security Agreement.

Although a filed security agreement covering inventory may meet the requisites of a financing statement (if it is signed by both parties, gives the address of the debtor, etc.)37 a naked financing statement in its usual statutory form and disclosing no terms of a security agreement may not additionally serve as a security agreement.38 And, of course, without a written security agreement there cannot be any enforceable security interest in inventory goods which are left in the possession of the debtor.39

As is well known, the Code has established a notice system of recording and the notice may be such as to require a creditor or potential creditor to make further inquiry. Perhaps the most extreme example of this concept was presented in the case of Rooney v. Mason.40 A husband and wife sold their long established drug store in Cheyenne, Wyoming to another husband and wife. The sales agreement provided that if the buyers defaulted on their purchase payments, the sellers could terminate the buyers' rights under the sale agreement. The buyers did

37. U.C.C. § 9-402.
39. U.C.C. §§ 9-203(1) and (2).
40. 394 F.2d 250 [5 UCC REP. SERV. 308] (10th Cir. 1968).
default and they gave back to the sellers possession of the drug store with all of its inventory. Two days later, the buyers filed a voluntary petition in bankruptcy and the trustee brought suit against the sellers claiming that they had received a voidable preference. At the time of the sale, the following statement was filed in the proper office for the filing of financing statements:

Notice of Agreement.
Pursuant to the terms and conditions of an Agreement of Sale dated December 31, 1962, and executed by all the parties hereto, the undersigned, Thomas F. Mason, and Doris G. Mason, agree to sell and James R. Johnson and Dolores J. Johnson, husband and wife agree to purchase, Mason’s Airbase Pharmacy, consisting of the personal property and stock in trade used in connection therewith.
Dated this 31st day of December 1962.

/s/ Thomas F. Mason
/s/ Doris G. Mason, Sellers
/s/ James B. Johnson
/s/ Dolores J. Johnson, Buyers

The Tenth Circuit Court of Appeals in affirming the district court decision held that: (1) even though Section 9-402 requires the addresses of the parties on a financing statement the above “Notice of Agreement” was a sufficient compliance because creditors in Cheyenne, Wyoming knew of the business and the home addresses of all of the parties and had dealt with them; and, (2) in spite of the contentions of the trustee that this form was defective because it did not state that there was an underlying security agreement, “[t]he Wyoming courts might reasonably hold that a creditor examining the records is put on notice to make further inquiry upon seeing the notice of agreement.”

As a result, the sellers’ security interest was perfected against the trustee in bankruptcy.

G. Assignment of Security Interest

A security interest may be assigned to another holder without loss of priority even if no filing of the assignment is made.

H. Notification of First Inventory Lender by Second Inventory Lender

Under Section 9-312(3) a purchase money security interest lender who desires to obtain number one priority in inventory goods must notify any prior inventory lender who had “filed a financing statement covering

41. Id. at 252 [5 UCC REP. SERV. at 310-11].
42. Id. at 253 [5 UCC REP. SERV. at 312].
the same items or type of inventory" that he (the subsequent lender) has or expects to acquire a purchase money interest in this inventory before the debtor receives possession of the goods. Must this "notification" be made by means of some written communication? Sections 1-201(25) and (26) define the concept of notice but give no indication that the means of giving notice must be in writing, and at least one court has held that a telephone conversation between two lenders would meet section 9-312(3)'s requirement.\textsuperscript{44} The court further held that this telephone conversation which discussed the possibility of "furnishing merchandise or money for merchandise for Alberts [the debtor] to have additional TV sets and so forth to sell them,"\textsuperscript{45} was a sufficient description of the TV inventory under Sections 9-312(3)(c) and 9-110.

\section*{I. Subordination Agreements}

Financing Statements must be in writing to be valid. Security agreements must also be in writing to be valid unless the lender has possession of the collateral. Priorities under Sections 9-301 and 9-312 among security interest holders and between security interest holders and judgment lien creditors are determined by the filing of written financing statements. However, the question arises as to whether subordination agreements between holders of security agreements must be in writing to be valid? Surprisingly, Section 9-316 simply provides that "nothing in this Article prevents subordination by agreement by any person entitled to priority" without delimiting that the "agreement" must be in writing. The word "agreement" itself is not defined in the sense of whether it may be oral or written,\textsuperscript{46} and inasmuch as the Statute of Frauds Section of the Code\textsuperscript{47} applies to sales, and the parol evidence rule\textsuperscript{48} simply prevents the modification of a written contract by parol evidence, neither rule requires that subordination agreements (which alter priorities between security interest holders) must be in writing. As a result, the Supreme Court of Oklahoma and an Indiana appellate court have held in non-inventory cases that oral subordination agreements are valid between secured parties.\textsuperscript{49} It would appear that the same result should follow in inventory cases.

Although it is not extremely common, it is possible for a secured lender in inventory to agree (either in the initial security agreement or in a subsequent agreement) with the debtor that the lender's security interest shall be subordinate to a later lender's security interest. The agreement need not be with the later lender whose rights would be de-

\begin{itemize}
\item 44. GAC Credit Corp. v. Small Business Administration, 323 F. Supp. 795 [8 UCC REP. Serv. 952] (W.D. Mo. 1971).
\item 45. Id. at 798 [8 UCC REP. Serv. at 956].
\item 46. See U.C.C. §§ 1-201(3), 1-205, 2-208, and Comment § 1-205.
\item 47. U.C.C. § 2-201.
\item 48. U.C.C. § 2-202.
\end{itemize}
A subordination agreement, if it can be regarded as a release at all, operates only to release an interest to a third party and is not in any sense a release to the debtor.51

J. Payee Banks Are Not Collecting Banks

Section 9-302(1)(f) provides that a financing statement need not be filed to be perfected when it deals with "a security interest of a collecting bank (Section 4-208) . . ." Section 4-208 refers to an "item" which in turn is defined by Section 4-104(1)(g) as "any instrument for the payment of money even though it is not negotiable . . ." Section 4-208 is designed to cover the situation when a bank is handling an "item" in the collection process and it has made an advance against the item. As a result, when a bank is the secured party in two security agreements covering inventory and accounts as collateral of a debtor who is now bankrupt, the bank cannot claim that it need not file a financing statement in order to perfect its security interests under the above sections of the Code. "The interest [banker's temporary security interest] arises in favor of banks in the collection chain; it does not arise in favor of a bank which holds a security agreement and collects as payee against the secured note. Such a bank is not a 'collecting bank' within the purview of § 4-208."52

K. Perfection by Possession

Section 9-305 provides that a security interest may be perfected by the secured party taking possession of the goods, and Comment 2 to this section adds the thought that: "Possession may be by the secured partly himself or by an agent on his behalf: it is of course clear, however, that the debtor or a person controlled by him cannot qualify as such an agent for the secured party." This comment was followed by a recent case wherein the president of a corporation which manufactured mobile homes borrowed money from a "family trust" under a security agreement and, as managing agent of the trust, held the manufacturer's certificate of origin (as provided for under Nebraska law) as collateral for each advancement of money for each mobile home. The court held that the president of the debtor company could not act as agent for the lender-family trust. As a result, the trust did not have legal possession of the mobile homes and did not have a perfected security interest in them on the date of bankruptcy of the debtor.53

52. In re Granite City Cooperative Creamery Assoc., 8 UCC REP. SERV. 393, 394 (D. Vt. 1970).
III. PRIORITY PROBLEMS

A. After-Acquired Inventory vis-a-vis Section 60 of the Bankruptcy Act (Sections 9-108, 9-204, and 9-303).

Section 9-204 of the Code states that a security agreement may provide that collateral, whenever acquired, shall secure all obligations covered by the security agreement. Section 9-108 attempts to articulate that the security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires the collateral in the ordinary course of business and the secured party makes an advance which is to be secured in whole or in part by the after-acquired property. These two sections obviously authorize the "floating-lien" idea, i.e., that the lien floats on a constantly changing sea of inventory. Unfortunately, Section 9-204(1) states that a security interest cannot attach until, among other things, the debtor has rights in the collateral. Section 9-303(1) continues this theme by stating that "a security interest is perfected when it has attached . . . ." These latter two sections would seem to contradict the first two. When this is coupled with Section 60(a)(2) of the Bankruptcy Act, it can be argued that that portion of the floating lien which covers new inventory acquired by the bankrupt-debtor within four months of his bankruptcy would be a voidable preference, assuming the other requisites of a voidable preference are provable. Under Section 60(a)(2) the transfer of property "shall be deemed to have been made . . . at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee." Federal law refers back to the state law to determine the rights of the lien creditor on the newly acquired inventory which is acquired within four months of the date of bankruptcy in order to determine when the "transfer" was made.

The case of Rosenberg v. Rudnick would seem to be the post-Code starting point for reconciling this potential conflict between the Code and the Bankruptcy Act. Rosenberg used a number of approaches to reconcile this apparent conflict. First, insofar as the apparent obstacle presented by Sections 9-303(1) and 9-204(1) is concerned, the court said:

A first literal reading of these provisions would seem to support the trustee's contention. However, § 60(a)(2) does not make the test one of when the state law may denominate a security interest as perfected. The specific test of § 60(a)(2) is one of when under state law the security interest, however described, becomes one which cannot be defeated by a subsequent lien obtainable in proceedings on a simple contract action. Perfection

under state law need not be full perfection but only perfection so far as is necessary to meet the test of § 60(a)(2). While the Massachusetts law may not regard a security interest in after-acquired inventory as fully perfected until it attaches to items as they are acquired by the debtor, nevertheless § 9-204(3) recognizes that a lien in such inventory items can be validly created by a security agreement. Such a lien, after proper compliance with the filing provisions, is superior to a subsequently acquired contract creditor’s lien or other claims of third parties. . . .

Second, Section 9-108 would produce the same result in favor of the inventory-secured lender in his claim against after-acquired property even if (as the trustee argued) no transfer would take place until each specific item of inventory was acquired by the debtor; under this section it would be deemed to have been made for new value rather than for an antecedent debt and would not be a preferential transfer. Third, even if the definition of Section 9-108 is not accepted, it does show that the intent of the Code is that such a transfer should not be considered as a preferential one. Fourth, liens under a security agreement with an after-acquired clause should not be considered as attaching separately to each distinct item in the inventory. “In applying § 60, . . . inventory subjected to a security interest should be viewed as a single entity and not as a mere conglomeration of individual items each subject to a separate lien.” Fifth, Section 60 was designed to prevent secret liens and the filing under the Code is the antithesis of a secret lien.

As a factual matter, the court concluded by stating that the trustee had failed to prove any substantial increase in the amount of the inventory as a result of inventory acquired within the four-month period immediately preceding the date of bankruptcy. It should be noted that this latter approach was more in the nature of an “assuming for the sake of argument” approach than a square holding that the secured lender would not have any claim over after-acquired inventory which substantially exceeded the original valuation. Within a few months after the decision in Rosenberg, the famous case of In re Portland Newspaper Publishing Co., virtually adopted the entire reasoning in Rosenberg and applied it to after-acquired accounts receivable. However, Portland seemed to adopt the dicta in Rosenberg by stating that when the after-acquired clause embraces the after-acquired accounts, the bankrupt’s estate will not be diminished “because the creditor is only receiving a substitution of security. There is no preference when new accounts are substituted for released old ones.” The following year a federal district court in Indiana in the case of In re Grain Merchants of Indiana,
Inc.,60 followed Rosenberg and Portland by upholding the account lender's rights in after-acquired accounts as not being a voidable preference against the trustee. The court reached this result but expressly disclaimed any use of Section 9-108 to reach this conclusion. The court believed that Section 60 of the Bankruptcy Act is intended not only to invalidate secret liens but also to give effect to legitimate forms of secured financing and that the UCC carries out this intent. It is interesting to note that the court adopted the "single entity" inventory test of Rosenberg and applied it to accounts.

The Seventh Circuit Court of Appeals affirmed the Grain Merchants case primarily by paraphrasing the lower court's opinion.61 The appellate court also expressly adopted the "single entity"62 and "substitution of collateral"63 test of existing and after-acquired accounts receivable, and used these tests as a means of dispensing with any necessity for the use of Section 9-108 in the voidable preference area:

However, there is no need to resolve any asserted conflict [between Section 9-108 and Article 60 of the Bankruptcy Act], for Section 9-108 is unnecessary to the result reached here. That Section merely attempts to codify as state law the substitution of collateral doctrine, which is implicit in the provisions of the Bankruptcy Act, with the additional safeguard that such substitution arise in the ordinary course of business.64

Less than a month prior to the publication of the seventh circuit's decision in Grain Merchants, a federal district court in Alabama,65 in a case involving claims to after-acquired inventory expressly followed Rosenberg, Portland and Grain Merchants in upholding the claim of the inventory lender to after-acquired property as against the claim of the trustee in bankruptcy. The court then added the flat holding that the failure of the lender to police the inventory did not invalidate the security interest.

The same federal district court re-affirmed its holding in a subsequent case involving both after-acquired accounts as well as inventory.66 Unfortunately the court invalidated the lender's claim to after-acquired inventory acquired during the four months prior to bankruptcy because, although the financing statement claimed after-acquired inventory, the security agreement did not and the financing statement cannot encompass property unless it is covered in the security agreement. It is interesting to note that the separate security agreement covering accounts

---

62. Id. at 216 [6 UCC REP. SERV. at 10].
63. Id. at 217-18 [6 UCC REP. SERV. at 11-12].
64. Id. at 218 [6 UCC REP. SERV. at 13-14].
did claim after-acquired accounts while the inventory agreement did not.

The case of In re Portland Newspaper Publishing Co., Inc.\(^6\) reappeared in the Court of Appeals for the ninth circuit under the name of DuBay v. Williams.\(^6\) The court had to deal with the contention of the trustee in bankruptcy that even though a security agreement is entered into and a financing statement is filed more than four months preceding the filing of a petition in bankruptcy, any security interest claimed in accounts which came into existence within four months of bankruptcy would fall within the voidable preference rule of Section 60 of the Bankruptcy Act.

The court noted that Section 9-204(2)(d) provides that "the debtor has no rights in an account until it comes into existence," and that the trustee asserted that to obtain a right there must be a transfer to the lender and that this transfer cannot occur until the right arose. Therefore, it was argued that a transfer occurring within the four months preceding bankruptcy cannot relate back to the filing of the financing statement and cannot be perfected before the commencement of the four-month period.

The court held in favor of the lender, but, in the process, seemed to reject some (if not all) of the theories (res, entity, etc.) expressed in the cases previously discussed in this section.

Some ingenious theories have been spun to avoid the result to which the trustee's logic leads. It is unnecessary for us to resort to any of them to reject the trustee's argument. The inarticulated premise is that Congress left to state law the definition of "transfer" and of "perfection," thereby permitting state law to control the impact of preferences. The premises is flawed. Congress itself defined these concepts leaving only some details to be brushed in by state law.

Section 60a(2) of the Bankruptcy Act provides that "a transfer of property . . . shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee."

Congress did not state that a "transfer" occurs when a security interest attaches or when state law says a conveyance has been made. Congress provided that a transfer is "deemed" to have been made when it became "so far perfected" that no subsequent lien creditor could achieve priority. "Transfer" for the purpose of section 60a(2) is thus equated with the act by which priority over later creditors is achieved and not with the event which attaches the security interest to a specific account.

We look to state law, therefore, only to decide the point at which Rose City’s claim to the future accounts was sufficiently


\(^6\) 417 F.2d 1277 [6 UCC Rep. Serv. 885] (9th Cir. 1969).
asserted to prevent a subsequent lien creditor from achieving priority over it in those accounts. That time was the date upon which Rose City filed its financing statement. (Grain Merchants of Indiana, Inc. v. Union Bank & Savings Co. (7th Cir. 1969) 408 F.2d 209). Because Rose City filed its financing statement long before the four-month period antecedent bankruptcy, its security interest is immune from the trustee’s preference challenge.60

After this successful battle of the inventory lender versus the Trustee in Bankruptcy, it is almost anti-climactic to state that a lender whose properly perfected security agreement covers after-acquired inventory has priority over a judgment lien creditor who has levied on the inventory in the hands of the debtor and is entitled to its return in accordance with the terms of the agreement and Section 9-503.70

B. Buyer in Ordinary Course of Business (Sections 9-307 and 2-403)

1. GENERAL PRINCIPLES

Section 9-307 of the Code provides that a buyer in the ordinary course of business takes free of a security interest created by his seller even though the security interest has been perfected and even though the buyer knows of the existence of the security interest. The buyer in order to meet the definition of a buyer in the ordinary course of business must buy in good faith and be without knowledge that his purchase is forbidden by the terms of a security agreement or in violation of the ownership rights of another. The buying must be for cash or exchange or on secured or unsecured credit, but it cannot be for an antecedent debt.71 Section 9-307(1) has a narrow scope as it is limited primarily to “inventory” in situations in which the holder of the security interest has forbidden any sale by the dealer or has placed latent limitations upon the dealer’s apparent authority to sell the goods. If the holder of the security interest has authorized sales of this inventory without any strings then this section has no application and Section 9-306 (which is discussed in the next section) comes into play.72

Section 9-307 typically applies in cases in which the dealer has sold inventory “out of trust,” i.e., he has failed to pay the inventory financier

69. Id. at 1287-88 [6 UCC Rep. Serv. at 897-98]. See also In re King-Porter Co., 446 F.2d 722 [9 UCC Rep. Serv. 339] (5th Cir. 1971), handed down after this article initially went to press, which upheld the view that an after-acquired property clause in an inventory security agreement under Article 9 is not in conflict with the voidable preference rule of the Bankruptcy Act.
71. U.C.C. § 1-201(9).
72. U.C.C. § 9-307, Comment 2. For a classical factual illustration of the application of Section 9-307 in the automotive trade, see Hamilton County Bank v. Tuten, 250 So.2d 17 (Fla. 1st Dist. 1971).
with the proceeds of the sale to the buyer. Section 9-307 is designed to prevent the inventory lender from "hunting with the hounds and running with the fox" by claiming, on the one hand, that his security interest has priority over the good faith buyer, and, on the other hand, allowing the financier to clothe the dealer with apparent authority to sell without obvious restraint.

In order for a buyer from a merchant to be able to cut off the security interest of a secured lender in inventory, the buyer must be a buyer in the ordinary course of business which in turn requires that the buyer be in good faith and without knowledge that the sale is in violation of the interests of the secured lender. The 1953 version of Sections 9-307 and 1-201(9) did not require that the buyer be in good faith nor that he be without knowledge that the sale was in violation of the interests of the secured lender. The 1953 version stated that: "[A] buyer in ordinary course takes free of a security interest . . . even though the buyer knows of the terms of the security agreement." A lower Pennsylvania court held, under the 1953 version of the code, that when the same individual was the managing officer of a car dealer whose inventory was subject to a security interest and also a managing officer of a corporation which "purchased" the car from the dealer that this corporate purchaser was not a buyer in the ordinary course of business. Of course, the same result should be reached today under the 1962 version of the Code.

It has been held that a buyer may be a buyer in the ordinary course of business even though he fails to take possession of the goods (which are subject to a floor-plan security interest) and leaves the dealer in possession.

The very recent case of Sierra Financial Corp. v. Brooks-Farrer Co. illustrates a very clumsy attempt of an inventory lender to don the garb of a buyer in the ordinary course of business in order to cut off a prior perfected inventory security interest. The debtor gave a security interest in fire-lighters and butane fuel to an inventory lender. The security interest covered inventory and after-acquired inventory. Subsequently, the debtor, being in financial distress, "sold" 17,900 lighters for $1.00 apiece and 7,000 cans of butane gas for 30 cents apiece to another company which agreed that the debtor could repurchase the lighters for their regular sales price of $2.23 or $3.30 each and the fuel for 45 cents per can. The buyer knew of the existing security interest in the same inventory. The "buyer" claimed that it was a buyer in the ordinary course of business, but the court held that the "sale" was not in good faith and was not in the ordinary course of business of either the debtor

73. U.C.C. §§ 9-307 and 1-201(9) (1953 version).
or the "buyer." The purpose of the "sale" was to finance the foundering debtor and to enable the "buyer" to acquire control of the debtor and another company. "The price at which the goods purportedly were 'sold,' coupled with the contemporaneous agreement for 'resale' at a price close to the market price, amply evidences . . . that the transaction was a security transaction expressly excluded . . ." 77 by the wording of Section 1-201(9) which states that "buying" does "not include a transfer . . . as security for . . . a money debt."

2. ANTECEDENT DEBT AS CONSIDERATION

Section 1-201(9) in defining a buyer in ordinary course of business states (in part) that:

Buying may be for cash or by exchange of other property or on secured or unsecured credit and includes receiving goods or documents of title under a pre-existing contract for sale but does not include a transfer in bulk or as security for or in total or partial satisfaction of a money debt (emphasis added).

There would seem to be little doubt that if the total consideration for a sale of goods was the satisfaction of a money debt, the buyer would not be considered to be a buyer in the ordinary course of business. 78 Should the same rule apply if a portion of the consideration is a satisfaction of a money debt? A part of this section of the Code was obviously borrowed from the Uniform Trust Receipts Act 79 and at least two cases under that act held that a buyer could still be a buyer in the ordinary course of business even if part of the consideration was the cancellation of a prior debt. 80 A federal district court has expressly followed these pre-Code cases and refused to "fractionalize" the transaction by protecting the buyer as to part of the goods and subordinating him for another portion of the goods which would be "fractionalized" or apportioned for the antecedent debt consideration. 81

3. REPOSSESSION OF GOODS AND REVERSION TO INVENTORY STATUS

If the complete facts of Commercial Credit Corp. v. Associates Discount Corp. 82 were used as the basis for a law school examination, it would probably result in the justifiable homicide of the professor. Briefly, Finance Company A held a purchase money security interest on a car purchased by White from Dealer Cox; Cox had received the security

77. Id. at 703, 93 Cal. Rptr. at 425 [8 UCC Rep. Serv. at 1128].
79. UNIFORM TRUST RECEIPTS ACT § 1.
agreement and had indorsed with recourse to Company A. White subse-
quently traded in the car with Cox, and it was sold to a buyer who as-
sumed White’s obligations. Later, Finance Company A repossessed the
car from the buyer and stored it with Dealer Cox. Someone forged
White’s signature and the signature of Finance Company A’s employee
and secured a duplicate title to the car. Then someone forged the sig-
nature of Company A’s employee on a release of the security interest.
The duplicate title in its forged condition came into the hands of Finance
Company B which had a “floor plan” arrangement with Dealer Cox. The
car was then sold to Chaney who financed the purchase through Finance
Company B. Still later Finance Companies A and B discovered each
other’s security interests in the car. The court held that when Finance
Company A delivered the car to Dealer Cox with leave to sell it, it en-
trusted him with the car under Section 2-403 of the Code thereby giving
Cox the power to convey all rights of Finance Company A to Chaney and,
therefore, Finance Company B as well as Chaney cut off Finance Com-
pany A. Finance Company A asserted that subsection 4 of Section 2-403
which provides that the rights of lien creditors are governed by Article 9
removed subsections 2 and 3 from Section 2-403. The court stated:

Commercial [Finance Company A] contends that the terms
“entrustment” and “entruster” apply only to inventory financ-
ing, and that its rights here as a “lien creditor” were specifically
removed from subsections (2) and (3) of § 85-2-403 by sub-
section (4) which in turn places lien creditors under § 85-9-307.
Commercial then contends that the Chaneys cannot take free
of its lien under § 85-9-307(1) because its lien was not created
by the Chaneys’ seller.

We do not agree with Commercial’s theory that its rights as
a lien creditor with respect to repossessed property have been
removed from subsection (2) and (3) of § 85-2-403. It clearly
had possession with the right to transfer title without a certifi-
cate of title, and as pointed out by the committee comment, has
no right to complain, whether it be considered as a consignor or
a lender with a security interest, for the very purpose of placing
goods in inventory is to turn them into cash by sale. Therefore,
we think that the entrustment of possession is most applicable
to a repossessing lien holder with right of sale.83

4. MERCHANT BUYER AS A BUYER IN ORDINARY COURSE OF BUSINESS

Prior to the Code, it was held under the Uniform Trust Receipts
Act that a merchant buying from another merchant could be considered
as a “buyer in the ordinary course of business” so that he would take
free of a security interest—trust receipt—created by the merchant
seller.84

83. Id. at 126, 436 S.W.2d at 813 [6 UCC REP. SERV. at 87].
84. Colonial Fin. Co. v. De Benigno, 125 Conn. 626, 7 A.2d 841 (1939). See 2 G.
A lower court in Delaware⁸⁸ has recently held that a car dealer buying inventory cars from another car dealer may be a buyer in the ordinary course of business under Sections 9-307(1), 1-201(9) and 1-201(19). However, inasmuch as the buyer was a merchant, the court held that not only must he be in good faith (under the preceding quoted sections) but he must also comply with Section 2-103(1)(b) and “observe reasonable commercial standards of fair dealing in the trade.” The court noted that Article 2-103(1) provides that “[i]n this Article unless the context otherwise requires ... (b) ‘Good Faith’ in the case of a merchant ...” would by its wording be limited to use in Article 2; however, “[i]f the standard of good faith is to have meaning in Article 9 with regard to merchants, it should not vary with that applied to merchants under Article 2.”⁸⁶ Therefore, it is a question of fact as to whether the merchant buyer in the auto business acted in a commercially reasonable manner. If the question is answered in the affirmative, then the merchant buyer in the ordinary course of business can cut off the floor plan financier of the merchant vendor. This result can be devastating because although the floor plan lender may be willing and able to absorb the loss when a “retail” buyer in the ordinary course of business buys one car and cuts off the security interest, the loss ceases to be bearable when the buyer buys a number of cars on the “wholesale” level.

A recent New York case⁸⁷ presents another facet of this “wholesale” buyer in the ordinary course of business concept. A wholesale used car dealer purchased 13 used cars from a car leasing business. The car leasing business purchased its lease cars subject to a purchase money security interest, which provided that the debtor was not to sell the cars and that an attempt to sell would result in a default. A financing statement was filed with the proper county clerk under New York law, but it contained no statement dealing with the question of sale. The “proceeds box” was checked in the financing statement. The wholesale buyer did not check for any filing of financing statements and claimed it was a buyer in ordinary course of business. The court held that: First, since the buyer was a merchant it had to meet the double definition of good faith set forth in Sections 1-201(19) and 2-103(1)(b)—the court made no mention of the fact that Section 2-103 refers to “this article” which might be meant to confine it to Article 2 rather than allowing it to come into Article 9 as held by the Delaware court. Second, there was no obligation incumbent upon the wholesale buyer to check the records for a financing statement even though he was a dealer with supposed expertise in the

⁸⁶. Id. at 409 [8 UCC Rep. Serv. at 126-27]. In a subsequent opinion the court held that it was a departure from custom in the trade for the buyer to leave the purchased cars in the possession of the dealer-seller. The retention of possession misled the floor plan lender hence the buyer was not a buyer in ordinary course of business. Sherrock v. Commercial Credit Corp., 277 A.2d 708 [9 UCC Rep. Serv. 294] (Del. Super. Ct. 1971).
INVENTORY SECURITY

automotive trade; this buyer was not to be charged with bad faith for failing to check. And even if it had checked, the financing statement would not have disclosed the restriction on sale imposed in the security agreement. Third, even though the cars in question were classifiable as inventory under Section 9-109(4), that section is not the true test of applying the buyer in ordinary course of business rule under Sections 9-307 and 1-201(9). The true test is whether the car leasing business was "in the business of selling goods of that kind." Since the car leasing business was not in the business of selling cars, then a buyer from it could not be, as a matter of law, a buyer in the ordinary course of business. Fourth, aside from Section 9-307, Section 9-306(2) provides that a security interest in collateral may be lost if the debtor's sale "was authorized by the secured party in the security agreement or otherwise" and the claim to proceeds in the financing statement might be construed as impliedly authorizing the sale. A jury question is presented as to whether there was an implied authorization to sell. It is interesting to note that the court seemingly assumed without discussion that the whole-sale buyer in this case could be a buyer in the ordinary course of business. The Supreme Court of Texas has also held that the purchase by an auto dealer from another dealer of a new, unregistered motor vehicle which is subject to a security interest created by the seller comes within Section 9-307(1), and similar views have been expressed by lower courts in Georgia and Pennsylvania. The Supreme Court of Oklahoma has held that a car dealer who purchases a used car from another used car dealer may be a buyer in the ordinary course of business under Section 2-403 of the Code.

Although a car dealer may be a buyer in the ordinary course of business when he purchases from another car dealer, it has been held that when the sale takes place on the auction lot of a third party located in a state in which neither buyer nor seller was doing business this was not in the ordinary course of business.

5. CAN A LESSEE BE A BUYER?

A lease of chattels is not required to be filed under the UCC, and a floor plan lender for cars takes subject to the rights of a lessee of a car

88. Id. at 39, 312 N.Y.S.2d at 321 [7 UCC REP. SERV. at 936].
89. Id. at 39, 312 N.Y.S.2d at 321 [7 UCC REP. SERV. at 936] (emphasis in original).
who is in possession of it. Further, it may be a question of fact as to whether a lessee of a car may be treated as a buyer in the ordinary course of business with the power to cut off a security interest perfected prior to the lease of the car. 98

6. MUST THE SELLER CREATE THE SECURITY INTEREST?

It must be remembered that Section 9-307(1) provides that a buyer in the ordinary course of business “takes free of a security interest created by his seller,” and it is easy to overlook the italicized words and misapply the section. A recent case from the Supreme Court of Nebraska 97 seems to illustrate this point. The court stated as dicta that if the Code were applicable to a case involving a sale of machinery by a dealer on conditional sale to a company and then the dealer assigned the conditional sale contract to a bank and then later the buyer returned the machinery to the dealer for repair and the dealer sold it to another buyer, this second buyer would be a buyer in the ordinary course of business who cuts off the original security interest. The court seemingly overlooked the fact that the security interest was not created by the seller-dealer; it was created by the first buyer. Fortunately, the court decided the case on pre-Code law and the apparent mistake did not affect the outcome of this case; it might, however, adversely affect the outcome of others. 98

Some fancy footwork by a clever auto dealer confronted the Iowa Supreme Court in General Motors Acceptance Corp. v. Keil. 99 A retail franchised auto dealer had possession of a new Pontiac under a manufacturer's certificate of origin which showed that the manufacturer had transferred title to the dealer. Subsequently, the dealer assigned the certificate of origin to itself and applied for a certificate of title. The certificate of title was issued to the dealer. Later the president of the dealer and the dealer company entered into a conditional sales contract for the car and the contract was assigned to G.M.A.C. The lien of G.M.A.C. was shown on the title certificate, but the title certificate never showed the title of the “president-buyer” of the car. Subsequently, Taylor purchased the car which was in the showroom of the dealer and gave a check to the dealer. Taylor did not know of the prior dealings involving this car, and he never received a certificate of title for it. Of course, the payments were not made to G.M.A.C. on the conditional sales contract and G.M.A.C. brought replevin for the car against Taylor, the buyer. Taylor asserted that he was a buyer in the ordinary course of business out of inventory and should prevail over G.M.A.C. under 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 . . . ." The difficult point was, of course, that the seller in this case did not create the security interest—it was created by the president who purportedly purchased the car from the corporate dealer. The Iowa court summarily brushed this argument aside:

The title rested in Pemberton and Keil, Inc., [the dealer] and was regular on its face. The application for the notation of the lien to appellant was made by the president of the corporate titleholder. The automobile was purchased from the showroom of the corporate titleholder. We see no reason why the purchaser of an automobile should not be afforded the same protection as the purchaser of other property out of inventory, and we refuse to hold that the Legislature, which obviously intended broad protection to the consumer by enactment of section 554.9307(1) [9-307] would anticipate the giving of preference to a lien because its creator was not as shown on the records, but another party under a confidential transaction of which the ultimate purchaser had no knowledge.100

7. LENDER'S RETENTION OF CAR TITLES DOES NOT DEFEAT THE OPERATION OF 9-307

It seems to be a common practice for floor plan lenders of used car dealers to keep possession of the title certificates for the car dealer's inventory and to release them to the dealer only upon his payment of a loan or by complying with some other releasing procedure. It would appear that this procedure affords little protection to the lender even in a state which has a rather strict car title statute because Section 9-307(1) comes into play to protect the buyer in the ordinary course.101

8. A VENDOR OF FRANCHISES UNDER 9-307(1)

The buyer in the ordinary course notion received an interesting application in McFadden v. Mercantile Safe Deposit & Trust Co.102 which held that a man who purchases two "Mister Softee" ice cream trucks and a franchise from the franchisor may be a buyer in the ordinary course of business and thereby cut off the properly perfected security interest which was filed against these trucks sold by the franchisor.

9. INVENTORY FINANCIER VERSUS AUCTIONEER

An auctioneer who sells automobiles which are subject to a floor plan security interest and applies the proceeds in payment of a pre-

100. Id. at —, 176 N.W.2d at 841 [7 UCC REP. SERV. at 841].
existing debt owed to the auctioneer by a used car dealer-debtor is not a "buyer" under Section 9-307 of the Code. Since he has been paid for an antecedent debt he cannot be a "buyer in ordinary course of business" even if he were a "buyer." Further, the auctioneer would be liable to the floor plan financier in trover under a conversion theory for conducting the sale of the cars even if he had turned over the proceeds of the sale to the car dealer, and this liability would be even more certain when the auctioneer keeps the proceeds to pay an antecedent debt. In a similar vein, another court has held that an auctioneer in conducting an auction sale is an agent and cannot be considered a seller or buyer.

10. AUTO DEALER SURETY BONDS

North Dakota requires that an applicant for a motor vehicle dealer's license furnish a surety bond in the amount of $10,000 indemnifying any person dealing or transacting business with said dealer in connection with any motor vehicle from any loss or damage occasioned by the failure of such dealer to comply with any of the provisions of title 39, including, but not limited to, the furnishing of a proper and valid certificate of title to the motor vehicle involved in any such transaction.

North Dakota gives its statutes a liberal construction, and it has been held that this statute is broad enough to protect a floor plan lender who has been ordered by a court to deliver certificates of title to buyers in the ordinary course of business from a car dealer who sold the cars and did not turn over the proceeds to the inventory lender. The court held that Section 9-307(1) protects the buyers in the ordinary course against the lender and there would be little need for this statute if its remedy were limited to purchasers who are already protected.

Florida also requires that applicants for annual licenses as motor vehicle dealers post a surety bond (in the amount of $5,000) in "favor of any person who shall suffer any loss as a result of any violation of the conditions" dealing with the sale or exchange of motor vehicles under

Chapters 319 and 320 of the Florida Statutes. In a recent case a dealer "floor planned" three cars for $4,856. The dealer retained possession of the cars, and gave the lender the original certificates of title for the cars. The dealer obtained duplicate certificates of title, sold the three cars and failed to pay the floor plan lender. The lender sued the dealer and obtained a worthless judgment. The court held that the bonding statute is designed to protect the general buying public buying cars in this state, but that this protection is not the statute's sole purpose. The facts established that the dealer falsely represented that the original title certificates had been lost or destroyed in order to secure duplicate certificates which constitutes a violation of Section 319.29 of the Florida Statutes. This violation is a breach of the bond required by the Florida law which further provides that the bond is in "favor of any person who shall suffer any loss" and this would include the floor plan lender.

11. EXTENSIONS OF THE CONCEPT

The normal operation of Section 9-307(1) is to protect a buyer of goods in the ordinary course of business from a security interest created by the dealer before the sale to a buyer. However, this Code section has been extended in Florida and Pennsylvania to protect a buyer who purchases and takes possession of a motor vehicle as against a floor plan lender who has taken a security interest after the sale to the buyer when the dealer has retained the title certificate for the supposed purpose of obtaining a new title certificate in favor of the new buyer.

Section 2-403 can also come into play in questions involving the supplying of inventory. For example, in Humphrey Cadillac & Oldsmobile Co. v. Sinard, a car dealer had been selling cars for years to a second car dealer. The wholesale and truck sales manager of the first dealer was instructed not to sell any more cars to the second dealer because of difficulties in securing payment. For some reason, the sales manager sold two Cadillacs to the second dealer who in turn sold them to two customers. These customers did not receive their car titles, and after numerous telephone conversations with the sales manager of the first dealer they were reassured that they would receive the titles in due course. The second dealer failed to pay the first dealer and the first dealer brought replevin against the two buyers. The court held that the sales manager had acted within the apparent scope of his authority in selling the cars to the second dealer; that the buyers from this second dealer

were buyers in the ordinary course of business; and, that the buyers were entitled to the cars as against the first dealer.

12. AIRCRAFT INVENTORY SECURITY INTERESTS

Section 9-104(a) of the UCC provides that Article 9 does not apply to a security interest subject to any statute of the United States such as the Ship Mortgage Act, 1920, to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property." (emphasis added) Comment 1 to this section is particularly enlightening:

Where a federal statute regulates the incidents of security interests in particular types of property, those security interests are of course governed by the federal statute and excluded from this Article. The Ship Mortgage Act, 1920, is an example of such a federal act. Legislation covering aircraft financing has been proposed to the Congress, and, if enacted, would displace this Article in that field. The present provisions of the Civil Aeronautics Act (49 U.S.C.A. § 523) call for registration of title to and liens upon aircraft with the Civil Aeronautics Administrator and such registration is recognized as equivalent to filing under this Article (Section 9-302(3)); but to the extent that the Civil Aeronautics Act does not regulate the rights of parties to and third parties affected by such transactions, security interests in aircraft remain subject to this Article, pending passage of federal legislation.

Section 503 of the 1958 Federal Aviation Act112 provides for a central system of recording conveyances, mortgages, etc. for aircraft and states that no conveyance, mortgage, etc. shall be valid until it is recorded. Section 506 of the Act was added in 1964,113 and provides that

the validity of any instrument the recording of which is provided for by section 1403 of this title shall be governed by the laws of the State . . . in which such instrument is delivered, irrespective of the location or the place of delivery of the property which is the subject of such instrument.

It is submitted that although the federal government could take exclusive jurisdiction over the substantive law dealing with titles to and security interest priorities in aircraft, it has not done so. In brief, Section 503 says that no conveyance, mortgage, etc. shall be "valid" until it is filed, but the section does not expressly state what the effects of filing will be and then the law itself states that the "validity" is measured by state not federal law.114 Unfortunately, the case law is confused on the question

of whether a buyer of an aircraft in the ordinary course of business from an aircraft dealer takes free of a security interest created by the dealer. The California Supreme Court,\textsuperscript{115} in reversing a scholarly decision of the California District Court of Appeal,\textsuperscript{116} has held that the federal act has preempted the field and Section 9-307 of the UCC has no application. A buyer of an aircraft in California from a dealer must check with the Federal Aviation Authority before purchasing or take subject to a floor plan security interest. A federal district court in Michigan,\textsuperscript{117} a lower Ohio court,\textsuperscript{118} and a federal district court in Arkansas\textsuperscript{119} dealing with a pre-Code floor plan have held, contrary to the California Supreme Court, that a buyer in the ordinary course of business does take free of a filed floor plan security interest in aircraft. On the other hand two lower California courts\textsuperscript{120} and a lower court in New Jersey\textsuperscript{121} have held (in factually different cases) that federal law has preempted the field and the UCC has no application.

It should be noted that the Supreme Court of Oregon has recently held\textsuperscript{122} that where the Ship Mortgage Act does not govern the rights of the parties either because the vessel in question is not a federally documented vessel or because the formalities of the Act have not been complied with fully, Article 9 does govern the rights of the parties. It is submitted that a similar approach should be followed in dealing with security interests in aircraft.\textsuperscript{123}

13. \textbf{BONA FIDE BUYERS OUT OF THE ORDINARY COURSE}

It should be noted that if the inventory lender should fail to properly perfect his security interest by filing a financing statement, it is possible for a bona fide purchaser buying the inventory \textit{out} of the ordinary course of business for a valuable consideration and having neither actual nor

\begin{itemize}
\end{itemize}
constructive knowledge of the security interest to take free of the interest.\textsuperscript{124}

14. 9-307(1) COMPARED WITH 9-307(2)

Any prudent lender in a purchase money inventory arrangement will insist that he be given a security interest in the proceeds arising from the sale of the inventory, and the security agreement and financing statement should provide for this interest.\textsuperscript{125} The proceeds from the sale of this inventory, especially at the retail level, will often consist of chattel paper (a security agreement and promissory note) given by the consumer to the dealer who in turn will assign the paper to the inventory lender. For example, the retailer sells an electric stove to a retail buyer for the buyer's own use as "consumer goods." The stove is subject to a security interest as inventory goods, but, of course, the retail buyer (buyer in the ordinary course of business) takes free of this perfected security interest under Section 9-307(1).\textsuperscript{126} Often, the retail vendor will not file a financing statement covering this sale of the stove, but, under Section 9-302(1)(d), this purchase money security interest is perfected without filing. However, if the consumer-buyer should sell the stove to an individual for "personal, family or household use," the "perfected" security interest would be cut off under Section 9-307(2). In the event of bankruptcy of the retail store, this would result in a complete loss to the inventory financier because there would not be any security interest in the stove and no claim against the "second" consumer buyer.

If the first consumer buyer in our example should sell this stove to a merchant who in turn sells it to another individual for his personal use would the same result follow? Fortunately for the original inventory financier and unfortunately for the second buyer, the answer would be no. Subsection (2) of Section 9-307 provides that "in the case of consumer goods" a buyer takes free of an unfiled security interest if he buys "without knowledge of the security interest, for value and for his own personal, family or household purposes." It can be argued that the italicized words "in the case of consumer goods" imply that a buyer must buy the goods from a consumer because only as long as the goods remain in a consumer's hands will they meet the description of consumer goods—in short a consumer must buy from a consumer and not from a merchant because in the latter case the goods become "inventory" rather than "consumer goods." This latter approach has been taken by the courts in Massachusetts\textsuperscript{127} and apparently by the Supreme Court of New Hamp-


\textsuperscript{125} U.C.C. § 9-306(3)(a).


The original lender may sue the purchasing merchant for conversion.\textsuperscript{129}

Of course, the whole problem can be obviated by the proper filing of a financing statement which prevents any consumer from cutting off the security interest.\textsuperscript{130}

15. "NON-PROFESSIONAL SUPPLIERS OF INVENTORY" VERSUS BUYERS IN ORDINARY COURSE OF BUSINESS

It is a relatively common practice for car owners to deliver their used cars to used car dealers under an agreement whereby the dealers sell the cars as agents for the owners and then remit an agreed amount to the owners. The dealers have the advantage of not having their capital tied up in the cars and with the right to return the cars if they do not sell at the prices set by the owners—in short the individual owners are financing the used car dealers' inventories. Unfortunately, the individual car owners may not have equal advantages if the dealers should sell the cars and abscond with the proceeds. It has been held in Oklahoma\textsuperscript{131} and Nevada\textsuperscript{132} that when an owner entrusts his car to a used car dealer who sells the car to a buyer in the ordinary course of business, the buyer obtains valid title under Section 2-403 even though the buyer does not receive the certificate of title which was held by the entrusting owner. It is interesting to note that Oklahoma law provides that a car title is not a muniment of title while Nevada generally requires strict compliance with its certificate of title laws, but that both states give full effect to Section 2-403 in an effort to protect the buyer in the ordinary course of business at the expense of the owner. It is further worthy of note that the car owner in the Nevada case was a layman while the owner in the Oklahoma case was a car leasing agency and the buyer (from the used car dealer) was also a car dealer—different facts but similar results.

C. Inventory Lender's Interest in Proceeds

1. GENERAL PRINCIPLES

Section 9-307 of the Code is designed to help the buyer in the ordinary course of business at the expense of the financier of the inventory-goods. Section 9-305 is the other side of the coin designed to give some


protection to this financier. In most secured transactions, a security interest continues in the collateral in spite of any sale, exchange, or other disposition. However, if the sale, exchange or other disposition is authorized in the security agreement "or otherwise" the security interest in the specific collateral is cut off and the holder of the security interest will then have a claim in the proceeds received in the sale or exchange of the original collateral. The proceeds can consist of cash (money and checks) or be of a non-cash nature (accounts, chattel paper, negotiable documents and instruments, or tangible trade-in goods). Normally, in the case of inventory the debtor will be expressly authorized to sell the inventory and the security agreement and financing statement will both cover proceeds; this arrangement will give continuous perfection to the inventory lender. In the event that the financing statement fails to claim an interest in proceeds, the lender must perfect within ten days after the debtor receives the proceeds of the sale of the inventory. Somewhat surprisingly, most of the cases involving proceeds questions have revolved around the basic issue: "What are proceeds?" rather than exotic questions dealing with perfection vis-a-vis the trustee in bankruptcy, etc.

2. THE NATURE OF PROCEEDS (9-306(1) AND (2))

In a case decided under the 1953 version of Section 9-306, it was held that a floor plan financier of new cars under a security agreement covering proceeds would have rights in a car which was received by the dealer when he exchanged one of the financed cars for another car from another dealer. In addition, the proceeds clause under Section 9-306 would reach cars (in the hands of the dealer's receiver) which the dealer had purchased with funds received from the sale of cars which were covered by the floor plan security interest provided that it could be proved that the funds received were in fact used to purchase the cars in question. It would appear that this decision would not be impaired by the 1962 version of Section 9-306. It has been held in another case under the 1953 version of 9-306, that used cars taken as trade-in cars by a car dealer would be subject to the floor plan security interest as proceeds. The court noted that the particular security agreement provided that "the

133. U.C.C. § 9-306(2).
134. The facts in Pieper v. First Nat'l Bank, 453 S.W.2d 926 [7 UCC Rep. Serv. 858] (Mo. 1970) are a classical illustration of the words "or otherwise."
135. Id.
137. U.C.C. § 9-306(3).
138. Id.
following proceeds are also covered: ... (b) merchandise taken in trade.\textsuperscript{141}

It should be noted that Section 9-307(1) is not the only provision in the Code which enables a buyer under certain circumstances to take free of a security interest in inventory. In some cases the inventory financier may authorize the debtor to sell the inventory free of the security interest. For example, a buyer of an expensive piece of special order inventory machinery may enter into an agreement with his seller that all payments are to be made to the seller and the inventory financier of the seller as joint payees and the court may then find that although Section 9-307(1) does not protect the buyer from the claims of the inventory lender, Section 9-306(2) does.\textsuperscript{142}

It sometimes happens that courts deal with inventory problems without ever recognizing them. The case of Noble Co. v. Mack Financial Corp.\textsuperscript{143} is merely one illustration of this statement. Noble sold three Autocar trucks to A.B.C. Truck Rentals, Inc., and obtained a purchase money security interest in the trucks; however, a financing statement was never filed. Subsequently, A.B.C. Truck Rentals traded two of the Autocar Trucks to Mack Trucks as part of the purchase price of two Mack trucks. Noble agreed to this transaction on condition that A.B.C. Truck Rentals obtain a Small Business Administration loan and apply the incomes received from the operation to the two Mack trucks to pay off the debt to Noble. Mack Trucks retained a purchase money security interest in the Mack trucks which were sold to A.B.C., and Mack then assigned the security interest to Mack Financial Corporation which later repossessed the two trucks and sold them to satisfy its security interest. Noble then claimed that its unperfected security interest in the two Autocar Trucks carried over into the proceeds of their trade-in into the Mack Trucks and it was superior to the purchase money interest of Mack in the same trucks on the basis that Mack Trucks knew of Noble's interest at the inception of the transaction. The court first overlooked the fact that since these trucks were apparently being used for rental purposes by A.B.C. Truck Rentals, they should be classified as inventory because they were to be "held by a person who holds them for sale or lease or to be furnished under contracts of service. ..."\textsuperscript{144} The court then turned to a discussion of Section 9-301 which was irrelevant to the facts of the case. The court then correctly noted that under Section 9-306(2) Noble's security interest in the trucks would be deemed to follow into the proceeds of the sale of these two trucks, namely the two new Mack trucks. However, since Noble failed to perfect its security interest by filing, Section 9-312(4) would serve to cut off Noble's security interest.

\textsuperscript{141} Id. at 286 [1 UCC REP. SERV. at 523].
\textsuperscript{144} U.C.C. § 9-109(4).
in proceeds in favor of Mack Trucks' properly filed purchase money security interest. Unfortunately, the facts fail to indicate that Mack filed its financing statement within the ten-day grace period provided by Section 9-312(4). The court was quite correct in holding that the fact that Mack Trucks had actual knowledge of Noble's unperfected security interest would not deprive Mack of its rights under Section 9-312. But one nagging question remains: If the court had correctly labeled these two trucks as inventory, would the actions of Mack Trucks have been a sufficient compliance with Subsection 3 of Section 9-312? The author suggests not and that Noble should have won on the basis that when neither security interest holder has perfected as against the other, then priority should be determined in the order of "attachment" under Subsection 9-312(5)(c).

A properly perfected security interest in inventory and its proceeds will encompass an account receivable growing out of the sale of the inventory to a buyer, and this right of the inventory lender will not be cut off by the appointment of a receiver for the insolvent seller before the buyer of the inventory makes any payment to the now insolvent seller. The payments to be made on the account will be owing to the inventory lender and not to the receiver.

A buyer in the ordinary course of business of new cars who has not paid the entire purchase price to the car dealer must pay the balance to the floor plan lender, and the money is not subject to the claims of the creditors of the dealer.

Section 9-306(2) provides that "a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof by the debtor unless his action was authorized by the secured party . . . ." One court has construed this provision as continuing the perfection of a security interest in the inventory of a drugstore when the store is sold without the consent or knowledge of the secured party; there is no necessity of filing a new financing statement or of refileing the security agreement itself which agreement was held to meet the requirements of Section 9-402.

Section 9-306(2) can have some unusual applications which operate to the detriment of the inventory lender when officials of the business indulge in questionable dealings. In Universal C.I.T. Credit Corp. v. Middlesboro Motor Sales, Inc. an incorporated car dealer's inventory was subject to a floor plan security interest. The wife of the owner of the corporation was secretary-treasurer. The wife and a chief salesman each

---

145. U.C.C. §§ 9-306(1) and (4)(a) and 9-105(g).
"purchased" a car from the dealer. The salesman gave back a security interest for the purchase price to the dealer and the security interest was assigned to a bank while the wife dealt directly with the bank and gave the bank a purchase money security interest. Although the court labeled the conduct of the wife and the chief-salesman as being of a questionable character, no evidence was shown that the bank had knowledge of their activities. The court held, quite correctly, that neither the wife nor the chief-salesman were buyers in ordinary course of business under Sections 9-307 and 1-201(9) of the Code. However, the original floor plan security agreement provided that the dealer "shall have liberty to exhibit and to sell each chattel in the ordinary course of trade and for the respective Principal Obligations shown in the respective statements."

The court held that under Section 9-306(2) the security interest in proceeds as provided for in the original floor plan security agreement was cut off by this authorization clause in the same agreement. The court noted that the evidence at the trial indicated that purchasers of the type involved in this case were common among car dealers in the area and, therefore, the sales were "in the ordinary course of trade" as called for in the floor plan security agreement. It would seem that it would be wise, in light of this case, for draftsmen to remove clauses of the kind involved in this case and to spell out that only sales to buyers in the ordinary course of business under Sections 9-307 and 1-201(9) will be authorized.

Section 9-306(2) was again used in a recent case involving cattle. A cattle buyer had been engaged primarily as a buyer for Swift & Co., but he also bought and sold cattle on his own account. A bank had a continuing security agreement covering his livestock, feed, and inventory. The bank seized 85 head of cattle and sold them in spite of the fact that the debtor-dealer told the bank that the cattle belonged to Swift. Swift brought suit against the bank and the buyer of the cattle from the bank. The court first held that the cattle were farm products and that the bank's security interest was invalid because the bank filed its financing statement with the Secretary of State rather than in the county as required under North Dakota law. The bank, of course, contended that the cattle in the hands of the buyer were not "farm products" but "inventory" and that its filing was proper. The court seemingly rejected this argument, and then, in a moment of uncertainty, seemed to agree that the cattle were inventory goods. Then the court noted that the security agreement between the buyer and the bank provided that the buyer "will not sell, lease or otherwise dispose of the collateral other than in the ordinary course of its business . . . ." The court then tied in this clause with Section 9-306(2) and held that since the buyer had "blanket permission" to sell the cattle, Swift which was a purchaser in the ordinary course of business under Sections 9-307 and 1-201(9) will be authorized.

150. Id. at 412 [4 UCC Rep. Serv. at 1131] (emphasis in original).
152. Id. at 1103 [7 UCC Rep. Serv. at 793] (emphasis in original).
course of business took free of the bank’s security interest even though it might have been properly perfected.

3. **CASH PROCEEDS PROBLEMS (9-306(4)(d)(11))**

A lender who has a properly perfected security interest in “all inventory, merchandise, accounts receivable, fixtures and proceeds or products thereof” of a hobby and art store has an enforceable security interest in and priority over undeposited, uncommingled, identifiable cash proceeds received in the regular course of business from the sale of inventory. Once these cash proceeds are deposited in a general bank account the perfected interest in this cash is limited to the amount received by the debtor within the ten-day period preceding the filing of the petition in bankruptcy.

4. **REPOSESSED GOODS AS PROCEEDS (9-306(5)(d))**

The recent Oklahoma case of *Osborn v. First National Bank* illustrates some of the dangers faced by a lender whose debtor-dealer repossesses a car and then resells it. A bank had acted as floor plan lender for a car dealer and had also taken consumer paper from the dealer. The bank took chattel paper with recourse from the dealer for a car sale and a financing statement was filed. The purchaser defaulted on several occasions, and the bank notified the dealer who subsequently, without the knowledge or authority of the bank, repossessed the car and sold it to another dealer who in turn sold it to the defendant. The bank contended that the original perfection of its security interest carried over and was effective against the retail buyer. The court held that the bank was estopped to deny that the dealer had authority to repossess the car from the original buyer with the apparent authority to sell it again, and that the case was governed by Section 9-306(5)(d), which provides that the unpaid transferee of the chattel paper must perfect its security interest by either taking possession of the chattel or by filing a new security interest as to the dealer in order to prevail over a purchaser of the returned or repossessed goods. Section 9-306(5)(d), in effect, provides that the original perfection does not carry over into the repossessed goods. It should be noted that even if the buyer of the repossessed goods takes the car in satisfaction of an antecedent debt, he will still be a “purchaser” under 9-306(5)(d) and be able to cut off the original security interest. Under a “straight” Section 9-307(1) transaction, the sale could not be made for an antecedent debt.

153. *Id.* at 1103 [7 UCC REP. SERV. at 794].
The classic contest between the lender on the inventory and the financier of chattel paper which is the proceeds of the sale of this inventory arose in a lower New York court. 156 A lady purchased a used car from a dealer. Her purchase price consisted of a security agreement calling for monthly payments, a trade-in auto, a supposed down payment of $443.00 and a promise to pay another $100 within thirty days. Her supposed down payment was not paid; in actuality it consisted of her oral promise to pay it when she received an income tax refund. The buyer and the dealer orally agreed that the dealer would keep possession of the car until she made the cash down payment of $443.00. Before she could make the payment, the floor plan lender of the dealer seized all of the cars on the dealer's lot, including the one purchased by the lady. Litigation ensued between the financier of the retail purchase and the floor plan lender; the lady purchaser's whereabouts were unknown at the time of the trial. The court held that the chattel paper between the purchaser and “her” finance company was proceeds of the sale of inventory and initially subject to the floor plan security agreement, but that under Section 9-308 the purchase-money financier of the lady’s purchase would have priority over the floor plan lender. The court seemingly held that the applicability of Section 9-308 hinged upon the question of whether the lady was a buyer in the ordinary course of business. It is submitted that under the second sentence of Section 9-308, the buyer in the ordinary course status of the buyer of the car is quite irrelevant—what is important is that the financier of the chattel paper operate “in the ordinary course of his business.” Regardless of this latter point, the court was correct in holding that the financier of the chattel paper prevailed over the floor plan lender on the inventory.

A further, and most unusual, aspect of the contest between the financier of inventory and the financier of chattel paper was presented to the Supreme Court of Pennsylvania. 157 A bank floor planned the automobiles of a retail dealer; the floor plan security agreement covered proceeds. The dealer sold a car to a buyer and the buyer gave back a “bailment lease” (security agreement in Pennsylvania) which the dealer sold to a discounter. The discounter paid the dealer by check and the dealer delivered this same check to the bank which had floor planned the car. The dealer requested that the bank turn over the title certificate which it held for the car; the bank refused to do so and used the title certificate “as a lever” to induce the buyer to execute a new bailment


lease in favor of the bank and induced the buyer to make payments to it rather than the discounter who held the original "bailment lease." The bank then applied the discounter's check which it had received from the dealer in payment of other obligations owed by the dealer to the bank. The court held that the buyer was a buyer in ordinary course of business and he cut off the lien of the bank in the car, but the bank then had a security interest in the proceeds from the sale of the car—the chattel paper. But, this chattel paper security interest was in turn cut off by the sale to the discounter under Section 9-308 of the Code. However, the bank's security interest would extend and include the check with which the discounter paid the dealer. As a result, the bank could keep the check, but it was deemed to be a constructive trustee for the amount of payments which it had received from the buyer. As a result of this case, it can be said that the concept of proceeds in the sale of inventory will extend to the proceeds (the check) which in turn was the proceeds from the sale of the chattel paper which was in turn the proceeds from the sale of the car.

6. ARE INSURANCE PROCEEDS INVENTORY PROCEEDS?

Section 9-306(1) of the UCC provides that proceeds includes whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of. It would appear rather obvious that a casualty loss from fire, windstorm, or other causes could not be classified as a sale or exchange which are consensual transactions. The only possibility remaining is that the phrase "otherwise disposed of" might include the collection of insurance "proceeds" in the event that the goods are "disposed of" by virtue of some involuntary act. Courts in Rhode Island and Maine have held that the "otherwise disposed of" phrase cannot be found to include the involuntary conversion of insured goods, with the result that the holder of the security interest has no claim against the insurance proceeds as proceeds of the goods under 9-306(1).

It should also be noted that Section 9-104(g) provides that Article 9 does not apply "to a transfer of an interest or claim in or under any policy of insurance." The Official Comment notes that rights under insurance policies "do not fit easily under a general commercial statute and are adequately covered by existing law." The Rhode Island Supreme Court used this comment for the view that indicates "a legislative recognition that this right to the insurance moneys is a matter of contract and does not run with the goods."

In the absence of any parochial state statute giving a lender a claim

160. U.C.C. § 9-104(g), Comment 7.
to insurance proceeds, it would appear that lenders should insist that
debtors assign any rights under insurance policies to them and arrange for
a loss-payable indorsement to be issued by the insurance company’s agent.
If the suggested procedure is not followed, the “secured” lender may
discover when his debtor has suffered a covered loss that the debtor has
assigned the insurance proceeds to another creditor, or another creditor
garnished the proceeds in the hands of the insurance company. A
facet of this inventory-proceeds vis-a-vis insurance-proceeds was pre-
seated in a recent lower court opinion from Wisconsin162 which held that
a loss-payable clause in insurance on inventory which was payable to the
mortgagee was effective against the claims of creditors who had judgment
liens against the inventory even though the chattel mortgage was not
properly perfected. This case indirectly stands for the proposition that if
the secured party is “lucky” enough to have the encumbered inventory
goods destroyed by fire he will recover from the insurance company, but
if the goods are not destroyed he will lose at the hands of the judgment
lien creditors. This is a rather strange result.

D. Consignment Suppliers Versus Inventory Lenders
(2-326, 9-312 and 9-306)

It is and has been a common business practice for consignors to
deliver goods to consignees under contracts whereby the consignee is an
agent with power and right of sale to third parties and with a right to
return the goods (without any obligation to pay for them) in the event
that the goods cannot be sold. A “true” consignment is based upon an
agency concept that the title to the goods remains in the consignor and
any transfer of title is in a direct line from the consignor to the customer
of the consignee-agent. Prior to the Code, a true consignor could reclaim
his goods from a creditor of the consignee.163 At the other end of the
pre-Code spectrum was the “sale or return” contract wherein the “con-
signee” purchased and paid for the goods from a consignor but with the
right to return them if unsold. Under this latter arrangement, creditors of
the consignee could levy on the goods and the consignor would not care
because he had received payment.164 In between these two extremes there
is and was a variety of other arrangements for the distribution of goods.
Experts have skirmished over whether the consignment concept is limited
to either a security device or a price-fixing device or whether it can en-
compase a number of other purposes in addition to these two.165 For
purposes of this article, the approach narrows to the question as to

162. Distributor’s Warehouse, Inc. v. Madison Auto Parts & Service Corp., 8 UCC REP.
SERV. 569 (Wis. Cir. Ct., Dane County 1970).
163. See 2 W. HAWKLAND, A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE
736-54 (1965) [hereinafter cited as 2 W. HAWKLAND].
164. Id. at 738-39.
165. E.g., see Duesenberg, Consignments Under the UCC: A Comment on Emerging
whether the consignment device is to be controlled by Article 2 or by Article 9 and the consequences of either choice.

This whole issue has been nicely raised by a relatively recent Wisconsin case.\(^1\) Columbia International Corp. shipped machinery to itself in care of Kramer Industries; subsequently, Preci-Matic also shipped machinery to itself care of Kramer, and then later assigned all of its (Preci-Matic) rights to Columbia. Kramer was to demonstrate these machines and to sell them at a fixed price. The contracts between Columbia and Kramer and Preci-Matic and Kramer reserved title in the “consignors,” and risk was placed on Kramer. Prior to these transactions, Kramer had entered into a security agreement with Lakeshore Corporation under which all of Kramer’s inventory and after-acquired inventory (as well as equipment) was collateral for a loan. Later, Lakeshore petitioned for the appointment of a receiver for Kramer and one was appointed. After the appointment of the receiver, Lakeshore assigned its security interest to Kepco which had full knowledge of the Columbia claim to the machinery. A few weeks later, the receiver sold all of his interest to Kepco and Columbia claimed the machinery by bringing replevin against Kepco. Kepco asserted that Columbia’s claims to the machinery were subordinate to the receiver’s title and Lakeshore’s perfected security interest. In order to resolve whether this consignment was a “security interest consignment” or a price fixing consignment—a “true” consignment—the court noted that Section 9-102(2) provides that Article 9 applies to a “consignment intended as security,” and that Section 9-113 provides that a “security interest arising solely under the Article on Sales (Article 2) is subject to the provisions of this Article (Article 9).” Finally, Section 1-301(37) states that “Unless a lease or consignment is intended as security [an interest in personal property to secure payment of an obligation], reservation of title thereunder is not a ‘security interest’ but a consignment is in any event subject to the provisions on consignment sales (Section 2-326).” In short, if the consignment is intended as a “security interest” then it is subject to all of the provisions of Article 9, while a “true consignment” (i.e., one which is not intended as security) is governed by Article 2 except for the limited idea that filing will be necessary (in the majority of cases) under Article 9 in accordance with Section 2-326(3)(c). Therefore, inasmuch as Columbia did not file a financing statement, its true consignment interest was cut off by the receiver under Section 9-301, and since Kepco purchased the receiver’s interest it steps into his shoes with exactly the same rights. There seems little doubt that the court reached the correct result. However, the author must quarrel with at least three points raised by the court: First, the court, after saying this was a true consignment—one not intended as security—then held that Article 9 “is circuitously brought into play by

the filing provision in Sec. 402.326(3) [2-326(3)]167 and stated that under Sections 9-201 and 9-301 the unfiled "security interest" of Columbia was superior to non-lien creditors. The court was in error; as stated by Professor Hawkland, "General Creditors as well as lien creditors are entitled to this protection (Filing, etc.). This is made clear by the use of the unmodified word ‘creditors’ in Section 2-326 and by the broad definition of the term ‘creditor’ in subsection 1-201(12)."168 Second, as pointed out by Mr. Duesenberg169 the court was led into error by good masters in deciding that there are only two kinds of consignment transactions; and, third, the court ignored the fact that Kepco’s properly perfected inventory security interest which embraced after-acquired property would have had priority over the Columbia consignment transaction without any reference to the receiver—Kepco need not have traced any “title” through the receiver; Kepco already had priority.

The inter-play between Section 2-326 and Article 9 was nicely illustrated in In re De’Cor Wallcovering Studios, Inc.170 wherein a supplier delivered lighting fixtures to a retail dealer for display and sale, with the dealer to pay the supplier the wholesale price. The only thing in writing was a “Showroom Order Form” which simply listed the items and the wholesale price. A small amount of the goods were sold and the dealer went bankrupt. The court held that it was clear that the goods were delivered as a “security consignment” rather than as a “price-fixing device,” and since the security agreement was not in writing it was invalid under Section 9-203(1)(b). Additionally, under Section 2-326 and in accordance with the Columbia International171 case since there was no filed financing statement (regardless of whether the agreement was a price-fixing device or a security device), the trustee in bankruptcy cut off the supplier’s right to reclamation.

A relatively recent New Jersey case172 furnished an unusual application of Section 2-326. Crest was an installer of plumbing and heating apparatus, and was in financial trouble. Elite Sales had been selling inventory supplies to Crest. Elite then formed Vonins, Inc. which agreed to furnish inventory supplies (obtained from Elite) to Crest. In return, Crest assigned its existing installation contracts to Vonins and Vonins agreed to employ Crest as its sub-contractor for the assigned contracts and others which might be obtained. Vonins agreed to pay Crest 40 percent of Vonins’ billings on each completed job. Crest later executed an assignment for the benefit of creditors under New Jersey law, and the assignee for creditors entered into litigation with Vonins as to the title to the in-

167. Id. at —, 175 N.W.2d at 473 [7 UCC REP. SERV. at 660].
168. 2 W. HAWKLAND, supra note 163, at 747.
169. See note 165 supra.
171. See note 166 supra and accompanying text.
ventory supplies in the possession of Crest at the time of the assignment. The court held that it was not necessary under Section 2-326 for Crest to have been engaged in "over-the-counter retail selling of plumbing equipment." The fact that Crest maintained a place of business at which it dealt in goods of the kind involved was sufficient; even though an overall price would be charged for the installation, the price would include a price for the installed components. Vonins thus delivered the goods to Crest for sale to others, and that sale need not have been consummated at Crest's premises for Section 2-326 to apply. The court further found that the "exceptions" to Section 2-326 were not shown by Vonins, and that the assignee for creditors was under New Jersey Law and Section 1-201(12) to be treated as if he were an actual creditor with rights greater than those possessed by the assignor-creditors of Crest. As a result, the assignee cut off the interest of Vonins in the inventory supplies.

Although not mentioned by the Court, it should be noted that Section 1-201(12) in its definition of the word "creditor" includes the wording "a general creditor." It would appear, therefore, that a "general creditor" as distinguished from a "secured creditor" may invalidate a 2-326 transaction, while a "general creditor" as distinguished from a "lien creditor" or "secured creditor" would not be able to invalidate an unperfected Article 9 transaction. It is believed that this is an additional reason for not using a "sale or return" arrangement without perfecting under Article 9.

The inter-relationship between Sections 2-326, 9-204 and 9-108 was nicely drawn in Sussen Rubber Co. v. Hertz. Lee Motor Products was a supplier of inventory auto parts, and it agreed to extend credit to Hillcrest (a dealer in auto parts) in return for a security interest in all the assets of Hillcrest including any after-acquired property. Subsequently, Lee appointed Hertz, as trustee, to be the secured party. Lee extended credit in the initial sum of $15,000 and additional sums subsequently. Still later, Sussen Rubber consigned inventory goods to Hillcrest and a salesman for Lee was informed of this fact. Hillcrest defaulted under its contract with Lee, and Hertz took possession of Hillcrest's assets and sold them. Sussen Rubber notified Hertz before he sold the goods that some of the goods were claimed by Sussen under its consignment contract. The court held that the after-acquired property clause in the security agreement between Lee and Hillcrest would initially be controlled by Section 9-204. Section 9-204 requires that there be a security agreement creating a security interest, that value be given and that the debtor must have rights in the collateral. The court stated that there was no

173. Id. at 181, 243 A.2d at 841 [5 UCC Rep. Serv. 438].
doubt about the existence of the security agreement and that value had been given. The court noted that the effect of this later idea of value must also be tested by the terms of Section 9-108 which require that a security interest

in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given.

Hillcrest was extended credit for $15,000 initially and it did acquire "rights in such collateral" in the ordinary course of its business. Finally, the court held that Hillcrest need not be deemed an "owner" of the consigned goods in order for Lee's after-acquired security clause to fasten on these goods. The court was less than clear as to how Sections 9-204 and 9-108 relate to Section 2-326, and the relationship only becomes clear when it is remembered that the word "creditor" in Section 2-326 includes the concept of a "secured creditor" under Section 1-201(12).

The case of In re Mincow Bag Co.177 points out a risky way in which a vendor may have all of the advantages of being a consignor without the handicaps itemized in Section 2-326. Finale Inc., manufactured ladies gloves and entered into an agreement with Mincow Bag Co. whereby Finale delivered shipments of gloves on consignment to various stores wherein Mincow had contracts for the sale of these gloves by employees of these stores. Title to the gloves remained in Finale and Mincow would receive commissions for having arranged the sales by the store outlets. Mincow never had physical possession of the goods. Mincow subsequently made an assignment for the benefit of creditors, and the assignee claimed gloves in the possession of Finale which it had previously assigned to Mincow and any proceeds received by Finale from the sale of merchandise consigned by Finale to Mincow. The court held that inasmuch as Mincow never had possession at its place of business "at which he deals in goods of the kind involved," Section 2-326 could have no application and the assignee would have no claim to the goods.

Section 2-326 operates to cut off a consignor's ownership rights when the consignee is under the umbrella of an existing security interest in inventory with an after-acquired property clause, but does it also cut off the rights of a holder of a security interest in the consigned goods? This question was partly answered in a recent Colorado case.178 A valuable tractor was subject to a recorded pre-Code chattel mortgage in Colorado. The owner and the mortgagee together authorized a dealer to

make repairs on the tractor and then to sell it for a set figure with any excess going to the dealer. The dealer had been receiving floor plan financing from a bank under a security interest with an after-acquired property clause. The dealer later defaulted and the bank brought replevin for the tractor and other inventory. The court held that pre-Code Colorado law governed the validity and priority of the chattel mortgage and that under this law the chattel mortgage had priority over the bank, but that the bank's after-acquired property clause cut off the rights of the owner of the tractor. The court noted the argument that since the mortgagee authorized the dealer to sell the tractor this should serve to cut off the mortgagee's interests under pre-Code law; however, the court held this pre-Code law was applicable solely when the goods are sold to a third party rather than when the goods come within the reach of an after-acquired property clause of a security agreement.

Section 2-326 provides that where goods are delivered to a person for sale and such person maintains a place of business at which he deals in goods of the kind involved “under a name other than the name of the person making delivery” then with respect to claims of the creditors conducting the business the goods are deemed to be on sale or return. In *Mann v. Clark Oil & Refining Corp.*, 179 Kline leased a gas station from Clark which was to be operated under the Clark trade name, but with the name of Kline on a sign posted over the doorway. Gasoline was “consigned” to Kline by Clark under a retail dealer consignment agreement which provided that Kline agreed that the gasoline was to remain the property of Clark until sold and that all of the proceeds of the sale of the gasoline were to be remitted daily to Clark by Kline. Kline was responsible for all gasoline and all receipts for gasoline even though there might be losses of either or both from theft or other causes. The court held that even though the gas station was conducted under the Clark trade name, the presence of the name of the dealer over the entrance doorway coupled with the terms of the consignment contract came within the idea that Kline was operating under a name other than the name of the person making the delivery, and the trustee in bankruptcy could cut off the interest of Clark which had not been perfected under Article 9.

The “Uniform” Commercial Code becomes less than uniform in inventory questions dealing with motor vehicles, mobile homes and other vehicles which might come within the provisions of state statutes dealing with the title to motor vehicles. The problem of non-conformity becomes acute when courts misinterpret the Code. The Florida case of *Taylor*

---

179. 302 F. Supp. 1376 [6 UCC REP. Serv. 1253] (E.D. Mo. 1969). A federal district court has expressly followed the rationale of the *Mann* case and held that the insolvent debtor's return [within four months before it filed a voluntary petition in bankruptcy] to the consignor of unsold goods constituted a preferential transfer under Section 60(b) of the Bankruptcy Act and Section 2-326(3) of the U.C.C. because of a failure to file a financing statement at the time of the consignment. In *re Gross Mfg. & Importing Co.*, 328 F. Supp. 905 [9 UCC REP. Serv. 353] (D. N.J. 1971).
Mobile Homes v. Founders Investment Corp. is illustrative of this latter point. Founders floor planned the inventory of Glover, a retail dealer in mobile homes. The floor plan security agreement provided for after-acquired property and a financing statement was properly filed with the Secretary of State. Subsequently, Taylor, a manufacturer of mobile homes, delivered "four newly manufactured mobile homes for the purpose of display and retail sale" to Glover. Certificates of title to these four mobile homes were never issued, nor were statements of origin, documents of consignment, or any other contracts executed or exchanged between Taylor and Glover. Taylor never served any notice upon Founders that it (Taylor) was claiming a purchase money security interest in the mobile homes in accordance with Section 9-312(3) of the Code. Glover defaulted and Founders filed suit to foreclose its security interest and attach all of the inventory of Glover including the four mobile homes supplied by Taylor. Taylor then instituted a replevin action against Founders, and Founders asserted that it had priority because Taylor did not comply with Section 9-312(3) in that Taylor did not notify Founders that it (Taylor) claimed a purchase money security interest in the four mobile homes. It was stipulated that the four mobile homes "were not sold by Taylor to Glover but were merely placed on his sale lot for the purpose of display and retail sale to the public." The court further noted that "Glover possessed no indicia of ownership sufficient to enable him to pass title to the units to a purchaser." As a consequence of this approach, the court held that Glover was not a purchaser of the mobile homes and Taylor had no purchase money interest in them. Therefore, Taylor had no obligation to notify Founders of "its interest in the units in order to preserve the priority of its interest over the security interest held by Founders in Glover's after-acquired inventory."

It is submitted that the Florida court completely missed the mark; the stipulation that Taylor did not sell the mobile homes to Glover was irrelevant in light of Code Section 2-326(3). This section is designed to protect creditors of the person who "maintains a place of business at which he deals in goods of the kind involved," and under this Section any private contractual terms between the business man and his supplier cannot affect third parties. The court never cited Section 2-326, and it is doubtful if it was even considered by the court or counsel.

The Taylor case ought to be compared with an earlier Georgia case involving somewhat similar facts. Peoples Automobile Loan and

181. Id. at 117 [7 UCC REP. SERV. at 1364].
182. Id. at 119 [7 UCC REP. SERV. at 1367].
183. Id. at 119 [7 UCC REP. SERV. at 1367].
184. Id. at 119 [7 UCC REP. SERV. at 1367].
Finance Corporation had a properly perfected security interest covering all of the motor vehicle inventory and after acquired inventory of Thurmond, a franchised new car dealer and licensed used car dealer. McDonald, a used car dealer, sold two used cars to Thurmond but held the titles to the cars pending payment by Thurmond. McDonald gave Thurmond bills of sale with the description of the cars left blank and Thurmond was authorized to fill in the descriptions. Thurmond filled in the descriptions of the two cars and delivered the bills of sale to Peoples and received advances. Thurmond failed to pay Peoples for moneys advanced on other cars which Thurmond sold. Peoples then levied on all of the remaining cars in Thurmond's possession, including the two cars sold by McDonald. The court held that the transactions between Peoples and Thurmond and between Thurmond and McDonald were not covered by the motor vehicle statutes of Georgia, but solely by the Code. The court first held that since there was no written security agreement between McDonald and Thurmond, there could not be a valid security interest by McDonald in the cars because he had given up possession. But even if there were a valid security agreement between them, McDonald failed to comply with the requisites of Section 9-312(3) and Peoples would have priority. The majority opinion of the court flatly rejected any possibility of Section 2-326 being applicable because the sales between McDonald and Thurmond were not sales or return, while a special concurring opinion stated that Section 2-326 was applicable because McDonald did not sell the cars to Thurmond but simply treated Thurmond as his agent to sell the cars and remit a net amount as the proceeds for each sale when it was made. A year earlier, the same Georgia Court of Appeals held that when an owner delivered four cars to a used car dealer under an arrangement whereby the owners kept possession of the car titles and authorized the dealer to find buyers for the cars and the dealer would then pay the owners a fixed price for the cars and the owners would deliver the title certificates to the dealer or the buyer, that this arrangement was a sale or return transaction under Section 2-326. Since there is no "sign law" in Georgia, and there was insufficient proof that the dealer was generally known by his creditors to sell goods of others, and there was no filing under Article 9, a finance company which advanced money to the dealer and received trust receipts and bills of sales for the cars had the right to recover in trover against the original entrustors. It is to be noted that in both of these Georgia cases the original entrustor (whether he was claiming as a holder of a security interest or as an owner) was held to be subservient to an inventory financier. In these two Georgia cases, the entrustor was a merchant—a dealer. In a later case the same Georgia court held that when

an individual owner of a car delivered the car to a dealer for the purpose of having the dealer secure offers and to sell the car with the approval of the owner (the dealer was to receive a commission for his sales services regardless of the sales price), this transaction was not a "sale or return" under Section 2-326 so as to be subject to the levy of a lien creditor against the dealer; the court noted that "for this reason" the two prior cases "have no application."

Although filing as required by a combination of Sections 2-326, and 9-402 in order to perfect a consignment intended as a security interest would not seem too difficult, it does require the filing of a financing statement. Hence, the filing of a termination statement signed solely by the consignor and not by the consignee-debtor will not be sufficient to enable the consignor to successfully maintain reclamation proceedings against the trustee in bankruptcy.

The consignor of inventory to a dealer is not only subject to having his interests cut off by a creditor of the consignee-dealer, but if the goods are consigned for the purpose of sale and the goods are sold to a buyer in the ordinary course of trade, the buyer also cuts off the consignor's interest.

E. Defrauded Supplier of Inventory Versus Inventory Lender (2-702 and 9-312)

In the event that a seller discovers that his buyer has received goods on credit while the buyer is insolvent, the seller may make a reclamation demand within ten days after the buyer has received the goods. However, "if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten-day limitation does not apply." This section places no outside time limit for reclamation in the event of written misrepresentation of solvency. One court has seemingly held that the seller must prove a reliance upon the buyer's written misrepresentation and that even a check given by the buyer to the seller (which is subsequently dishonored) could, if relied upon by the seller, be considered a written misrepresentation of solvency which would raise a question of fact to be determined by the trier of fact.

Regardless of whether the ten-day or unlimited reclamation period controls any particular case, Subsection 3 provides that the reclamation rights of the seller are "subject to the rights of a buyer in ordinary

189. Id. at 105, 159 S.E.2d at 459 [5 UCC REP. SERV. at 93].
190. Id. at 105, 159 S.E.2d at 459 [5 UCC REP. SERV. at 93].
193. U.C.C. § 2-702(2).
194. Id.
course or other good faith purchaser or lien creditor” under Article 9. One court has seemingly overlooked this latter rule while another has, in dicta, stated that a holder of a prior perfected security interest in inventory who employs an after-acquired property clause would come within the definition of “purchaser” and thereby cut off the other defrauded seller’s rights of reclamation. The defrauded seller’s right of reclamation may also be cut off by a lien creditor in those states which preserved the phrase “lien creditor” in original Section 2-702.

Subsection 3 which provides that the seller’s right to reclaim is subject to a “lien creditor under this Article (Section 2-403)” really fails to delineate the rights that a lien creditor has vis-a-vis the defrauded seller because Section 2-403 does not discuss the rights of a lien creditor but simply refers the reader to Article 9. Section 9-301 articulates the rights of a lien creditor against a security interest, but the right to reclaim under 2-702 does not meet the description of a security interest. Hence, if the phrase “lien creditor” is to have any meaning in Section 2-702, it must impliedly incorporate by reference the pre-Code law of each state governing the rights of defrauded sellers vis-a-vis lien creditors. As a result of this approach of a “uniform” law impliedly adopting a “non-uniform” pattern of state law, one Federal court in applying Pennsylvania law has held that the lien creditor cuts off the defrauder seller’s rights of reclamation while other federal courts applying Kentucky and Tennessee law reach the opposite result. It would appear, therefore, that a defrauded seller could wind up with number three priority behind an inventory security interest holder under his after-acquired property clause and a judgment lien creditor. The defrauded seller will also, of course, be cut off by a trustee in bankruptcy if the seller fails to make a demand within the magic ten-day period. Of course, this possible “circuity of liens problem” can be obviated by elimination of the phrase “lien creditor” from the section in accordance with the 1967 recommendation, and it would appear that fifteen states have now eliminated this phrase.

A rather artful but unsuccessful pyramiding of the old cash sale concept and the UCC reclamation remedy and buyer in ordinary course

196. Id.
198. But see In re Behring & Behring, 5 UCC REP. SERV. 600 (N.D. Tex. 1968) for a contrary view.
199. In re Kravitz, 278 F.2d 820 [1 UCC REP. SERV. 159] (3d Cir. 1960).
204. 2 ULA 422-23 (1968) and 1971 Supplement at 87.
theory was attempted in Evans Products v. Jorgensen. An inventory financier had a properly perfected security interest in the inventory and proceeds of inventory of a plywood manufacturer. A supplier of veneer sold veneer to the manufacturer and when payment was not forthcoming, the supplier subsequently accepted the manufactured plywood in payment. The financier of the manufacturer then claimed that its security interest covered this plywood which was now in the hands of the veneer supplier. The veneer supplier then asserted that it was a buyer in the ordinary course of business, or a cash sale seller, or in the position of a reclaiming seller which had exchanged its goods for the plywood. The court quickly held that receiving plywood in payment for an antecedent debt would prevent the supplier from being a buyer in ordinary course of business. Second, the cash sale theory had been buried by one section of the Code and Section 2-507(2) (which provides that the buyer's rights to dispose or retain goods are conditional upon the buyer's making payment when it is due and demanded on delivery by the seller) is effective between the buyer and seller but not as against the inventory financier. Third, the veneer supplier failed to demand a return of the veneer within the ten-day period as required by Section 2-702. Fourth, the court mentioned in dicta, even if the supplier had made his demand within ten days, the inventory financier could be deemed a purchaser who would cut off the supplier's right of reclamation. Finally, the court rejected any idea that the equitable doctrine of unjust enrichment can be used to vary the priority rules of Article 9.

A fact pattern greatly resembling a law school examination was presented in a recent case from North Carolina. A number of colleges delivered books to a company under an arrangement whereby the company would microfilm the books and then exchange the microfilm for the books which were later sold by the microfilm company. The microfilm company and a bank entered into a security agreement which covered after-acquired property. The microfilm company became insolvent before it had completed its contracts with the various colleges, and they sought to reclaim the books under Section 2-702 of the Code. The court held that these books were inventory in the hands of the microfilm company, and that assuming that the microfilm company had made written misrepresentations of solvency within three months prior to the delivery of the books, the bank as a holder of a perfected security interest in after-acquired inventory qualified as a good faith purchaser and cut off the interests of the colleges.

206. U.C.C. §§ 9-307(1) and 1-201(9).
207. U.C.C. § 2-403.
F. Landlord Versus Inventory Lender

The last sentence of Section 9-102(2) provides that Article 9 shall “not apply to statutory liens except as provided in Section 9-310.” Section 9-310 refers to liens for “services or materials” with respect to goods, and it has been held that this section is not applicable to a landlord’s lien.\(^{210}\) Section 9-104(b) states that Article 9 does not apply to a landlord’s lien. It is difficult, if not impossible, to reconcile these two sections. If the phrase, “landlord’s lien,” in 9-104(b) refers to “statutory liens” as used in Section 9-102(2), then Section 9-104 is redundant. On the other hand, a form of landlord’s lien may be created by the terms of a lease, rather than by statute, and it might be argued that Section 9-104-(b) was designed to outlaw even this kind of “consensual landlord’s lien.” Official Comment 2 to Section 9-104(b) does nothing to clarify the problem and merely adds another conundrum. In any event, the Sixth Circuit has held in a non-inventory case arising in Kentucky that when a lease provides that the lessor shall have a lien on all the equipment used in a coal mining lease of land, that Section 9-104(b) refers solely to the landlord’s lien created by statute and not to a lien created by contract. The result was that the lease created “lien” had to comply with all of Article 9’s perfection rules or be held invalid under the bankruptcy act.\(^{211}\) A somewhat similar view has been held in a federal case arising in Arkansas.\(^{212}\) It should be noted that Arkansas apparently does not follow the common law right of a landlord to distrain for rent. An interesting fact pattern developed in the non-inventory case of *Dunham’s Music House, Inc. v. Asheville Theatres, Inc.*\(^{213}\) when a lease-created security interest collided with a purchase-money security interest in an organ and a piano. A lessor leased premises to a lessee under a lease which provided that the lessor had a lien against the lessee’s furnishings, fixtures and equipment for any unpaid rent. The lessee purchased an organ and a piano under a purchase-money security interest from a third party. Neither the lessor nor the third party filed a financing statement. Upon default in the payment of the rent the lessor took possession of the premises and the piano and organ; the third party then brought suit against the lessor. The court held that the lease created a security interest within the ambit of Article 9 and that a financing statement should have been filed. However, the court also held that the


third party should have filed a financing statement, and, since neither party filed, priority would be determined by the order of perfection. The lessor by taking possession under Section 9-503 perfected and had priority over the purchase-money vendor in accordance with Section 9-312(5)(b). The court pointed out that the vendor could easily have protected itself by filing within ten days after the lessee had received possession of the organ and piano in accordance with the terms of Section 9-312(4) which gives a limited priority to a purchase-money security interest when it is competing against a non-purchase-money security interest.

Sections 9-312(3) and (4) give priority (under prescribed conditions) to purchase-money security interests over non-purchase-money security interests. The question remains: Does a purchase-money security interest have priority over a "statutory" landlord's lien? One answer was presented in *Universal C.I.T. Credit Corp. v. Congressional Motors, Inc.*, wherein the court held that under the Maryland law then in effect a landlord's lien in the automotive inventory of car dealer had priority over a purchase-money security interest which was properly perfected under the UCC. The court pointed out that the cumulative effect of Sections 9-102, 9-104 and 9-310 was to leave unaffected the landlord's lien rules of the various states. It should be mentioned that Maryland amended its law relating to distraint, and now the holder of a properly perfected purchase-money security interest will have priority over the holder of a landlord's lien. In somewhat converse vein, an Illinois appellate court has held that a non-perfected (no financial statement was filed) purchase-money security interest in consumer goods would not have priority over a landlord's lien under the law of Illinois; the inference was that a properly perfected purchase-money security interest would have had priority. The impact of the case is weakened by the fact that the court overlooked that a purchase-money security interest in consumer goods may be perfected in Illinois without filing in accordance with Section 9-302(1)(d).

As indicated by the preceding cases, it is necessary to look at the landlord's lien law of each state in conjunction with the Code in order to determine relative priorities. The necessity for "localizing" the law under the UCC seems to follow the pre-Code necessity for "localizing."
In Florida a statute provides that the landlord has a lien upon all property usually kept on the premises by the lessee; "[t]his lien shall be superior to any lien acquired subsequent to the bringing of the property on the premises leased."217 In addition, the landlord's lien extends to all other property of the defendant and this lien dates from the levy of the distress warrant. In two recent cases218 the Third and Fourth District Courts of Appeal of Florida held that the landlord's lien attaches either at the time of the commencement of the tenancy or when a chattel is brought on the premises and that the landlord's lien would have priority over chattel mortgages which were subsequently perfected upon the tenant's goods located within the leased premises. A similar view has been followed in the District of Columbia in a pre-Code case involving a "deed of trust" (chattel mortgage) imposed upon the tenant's goods after the commencement of the tenancy.219 Unfortunately, neither Florida appellate court made any reference to the UCC even though at least one220 of the cases would seem to be within its provisions. In accordance with the terms of the Florida statute it would appear that a purchase money security interest which was properly perfected prior to the "bringing of the property on the premises leased" would have priority over the landlord's lien. However, a more difficult question persists: does the holder of a purchase money security interest in inventory (or any other goods sold to a tenant) have the grace period of ten days after possession of the goods is given to the tenant to perfect as against the landlord in accordance with Sections 9-301 and 9-312? Under the literal wording of the Florida statute and the foregoing UCC Sections it would be logical to argue that if, for example, a purchase money security interest were perfected by filing on May 8th for goods purchased on April 30th but delivered to the leased premises on May 1, the UCC interest would have priority over the landlord's lien. In other words, the "relation-back" principle of Sections 9-301 and 9-312 might be used in such a way that the filing may occur subsequent to the bringing of the goods on the premises to relate back to a date prior to the bringing of the goods on the leased premises. On the other hand as indicated at the beginning of this section, it can also be argued that Article 9 has not bearing on any aspect of the landlord's lien. Therefore, it is suggested that until a definitive decision has been rendered by the Supreme Court of Florida it might

over the chattel mortgage. East Gadsden Bank v. Bagwell, 278 Ala. 430, 178 So.2d 823 (1965). See also Electric Constr., Inc. v. Azar, 405 F.2d 475 (5th Cir. 1968) construing Alabama law. The pre-Code law of Delaware seemed to give the landlord's lien priority over a properly perfected chattel mortgage, but if the mortgagee was the United States, then since the lien is inchoate, the United States had priority. Stein v. Most, 297 F. Supp. 708 (D. Del. 1969).

217. FLA. STAT. § 83.08 (1969).
be wise for inventory suppliers and lenders to seek to obtain waivers of lien from landlords.221

G. Mechanic’s Lien Claimant Versus Inventory Lender (9-310)

Although it may not be extremely common, it is possible for a mechanic (or other artisan) to furnish service or materials to inventory goods and to put himself in a position of contention with the holder of a security interest in this inventory. Section 9-310 provides that when the artisan furnishes these services or materials in the ordinary course of his business “a lien upon goods in the possession of such person given by statute or rule of law for such materials or services takes priority over a perfected security interest unless the lien is statutory and the statute expressly provides otherwise.” This Code provision has the effect of localizing any dispute between inventory lender and mechanic’s lien claimant by requiring observance of state mechanics’ lien statutes.

Kentucky,222 Tennessee,223 Florida,224 Pennsylvania,225 Michigan,226 and formerly Illinois227 have held in non-inventory cases that the mechanic in possession of a car has priority over the holder of a prior perfected security interest in the car. On the other hand, Arkansas,228 Ohio,229 Alaska,230 Iowa,231 and now Illinois232 hold that the holder of the security interest has priority because their respective mechanics’ lien statutes expressly provide for subordinate status of these liens or otherwise condition the obtaining of priority. Colorado has substituted the phrase “does not take priority” instead of the words “takes priority” and it would appear that the artisan will step in line behind the prior security interest holder.233

In Virginia the mechanic is granted a lien for repairs and a garage-
man is granted a lien for storage; the mechanic has priority over a prior perfected security interest in a car in an amount not exceeding $75.00 and has subordinate status for anything in excess of this amount. The garageman's lien is subordinate in all respects to the prior perfected security interest.\(^{234}\)

A recent Tennessee case has presented an interesting interpretation of Section 9-310 of the Code.\(^{235}\) In Tennessee the mechanic has a common law possessory lien which is lost upon relinquishment of possession of the property and a statutory lien which is not dependent upon possession. The Tennessee court held that when a mechanic surrendered four repaired trucks to their owner and these trucks were subject to perfected security interests, the mechanic lost any priority which he would have had under a combination of the common law possessory lien and Section 9-310 because Section 9-310 states that the mechanic's lien is limited to those liens upon "goods in the possession of" the artisan or repairman. It is somewhat fascinating to note that a statute which was obviously designed to give the mechanic something he did not have under the common law, i.e., a non-possessory lien, has the result when combined with Section 9-310 of taking something from him.

H. Surety Versus Inventory Lender

It is a common legal requirement in most states that construction contracts entered into between the state and general contractors for construction work provide a surety bond guaranteeing performance of the contract. Similar patterns are today often found in non-governmental building contracts. Usually the surety contract will provide that the general contractor assigns all of his construction contract rights (with the owner, governmental or non-governmental) to the surety company and this assignment will be activated in the event that the contractor defaults and the surety is forced to defray the cost of completion. It is also common for contractors to give banks and other lenders security interests in the contractor's inventory, accounts and contract rights, and these lenders will file financing statements to perfect their interests. In the event of a default and completion of the work by the surety company, who will have priority as to any funds owing as a result of the completion of the work—the lender who has perfected by filing or the surety company which has not filed a financing statement? In spite of the views advocated in several law review articles and notes,\(^{236}\) the general view is that the

---

surety has priority over the holder of a security interest in the contractor's accounts or contract rights who has properly filed his financing statement.

The consensus seems to be that since Article 9 "applies to security interests created by contract" while the surety's rights grow out of law-created rights of subrogation (even though the contract of suretyship might specify a contractual assignment), Article 9 should not apply to the surety because its subrogation rights are not security interests. In brief, the surety has protection without any filing.\(^{237}\)

It should also be mentioned (as noted by one court)\(^{238}\) that it was proposed to add a Subsection 7 to Section 9-312 which would have provided that: "A security interest which secures an obligation to reimburse a surety . . . secondarily obligated to complete performance is subordinate to" a subsequent lender who perfects its security interest. The official comments note that this proposed addition would have completely reversed the pre-Code case law in a majority of the states if it had been adopted. This historical background would seem to be a clear rejection of any notion that the surety's rights were to be dependent upon any compliance with Article 9.

It should also be noted that some states prohibit any assignment of an account when its source happens to be a contract with a state or county government\(^{239}\) while federal law, on the other hand, requires that assignments of claims against the United States be filed in a particular manner.\(^{240}\)

I. \textit{Ad Valorem Taxing Authority Versus Inventory Lender}

Some states (Florida, for example)\(^{241}\) provide that all tangible personal property in the possession of the taxpayer as of January 1 of each year is subject to a tax lien assessment even though the amount of the assessment (including both the millage rate as well as the assessed value)
value) will not be known until the latter part of that year. The statutes may also provide that this lien on inventory will be superior to all other liens, including security interests. These tax lien statutes will not necessarily work an injustice to a lender holding a security interest in collateral such as equipment or fixtures which remain relatively constant in quantity and quality except for normal depreciation. However, difficulties are presented when inventory is considered. For example, assume that a lender has a purchase money security interest in all of the television sets constituting the inventory of a retail television dealer. On January 1, the dealer has 100 sets on his floor and in the storeroom and the tax lien assessment is based on the market value of these 100 sets. The dealer fails to pay his tax on this inventory and in the following year the tax collector attaches all the inventory then in the retail store and conducts a sale to satisfy the tax lien. Unfortunately for all concerned, the dealer has only ten sets in his possession at the time of the tax attachment and the amount of the tax on 100 sets is equal to or in excess of the value of the ten sets levied upon. As a result, the purchaser at the sale obtains a title free of the security interest while the holder of the purchase money security interest receives nothing. In effect, the taxing authorities are not obligated to apportion the tax with regard to the available property (i.e., in the assumed hypothetical ten percent of the tax could be assessed and collected from the ten percent remaining inventory). Apportionment would result in the taxing authorities and the secured lender each receiving ten cents on the dollar while under the present system the taxing authorities take everything and the lender receives nothing.

It may be asserted that this tax lien problem may be solved by the lender’s policing of the debtor; however, it would seem to require a certain degree of clairvoyance for the lender to be able to predict what the millage rate will be when it is not established until months after the accrual of the lien on the first of the year. Some protection might be afforded by the security agreement requiring that a certain percentage of loan proceeds be placed in escrow in order to defray the payment of taxes, but this would require policing the debtor and result in increased overhead costs to the lender which will be passed on to the debtor.

J. Inventory Lender’s Tort Liability for Wrongful Interference with Buyer’s Rights

Section 2-722 of the Code attempts to articulate the “real party in interest” concept by stating that when a third party causes injury to goods which have been identified to a contract for sale, either party to the sales contract has a right of action against the tort feasor provided that party has title to, a security interest in, a special property right in, or an insurable interest in the goods. An unusual application of this

concept arose in a relatively recent case.\textsuperscript{243} A farmer entered into a contract with a farm equipment dealer to purchase a tractor; the tractor was not in stock and the contract provided for certain "extras" to be added to the tractor when it arrived from the manufacturer. The tractor was delivered to the dealer subject to a trust receipt security interest held by the manufacturer; the security interest permitted the dealer to sell the tractor. The farmer visited the dealer and the dealer pointed out the tractor to the farmer and said it was his; unfortunately, the extras were not available. The farmer never paid any part of the purchase price, and the manufacturer repossessed this tractor (and others) when the dealer defaulted in making payments pursuant to the trust receipts security agreement. The farmer attempted to negotiate directly with the manufacturer, but the negotiations were not successful. The farmer had to farm with his old tractor (which was to have been the trade-in tractor) and suffered a monetary loss in his farming operations as a result of not having the new tractor. The farmer then sued the manufacturer and the court held that the tractor had been "identified" to the contract (under Section 2-501); that the intent of the trust receipt security agreement was for the dealer to sell the tractor free and clear of the security interest of the defendant-manufacturer and the security interest would not be a bar to this suit by the farmer against the manufacturer.

It would seem that if the rationale of this case should gain acceptance, it would behoove inventory financiers to carry out the contracts of their defaulting dealers; the loss of profits ($396.70 in this case) might not be much from a small farmer but they might be tremendous in the case involving a large passenger aircraft, a large dragline, etc.