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# The Implicit "Takings" Jurisprudence of Article 9 of the Uniform Commercial Code

## Cover Page Footnote

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## ARTICLES

# THE IMPLICIT "TAKINGS" JURISPRUDENCE OF ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

DAVID FRISCH\*

*The question is of forced exchanges, not of forced transfers, for a transfer is not an exchange; and a forced transfer without equivalent, even for the benefit of the state, would be a mere injustice, an act of power devoid of that tenderness which the principle of utility ever demands.\*\**

### INTRODUCTION

ARTICLE 9 of the Uniform Commercial Code<sup>1</sup> is well-known for its labyrinth of priority rules. Those rules are intended to sharply define the extent to which the secured creditor's interest in specific property of its debtor is effective against competing claims to that property.<sup>2</sup> Since the Code was first drafted, scholars have struggled to articulate a single unifying theory that explains all aspects of Article 9

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I acknowledge with thanks the summer research grant so generously provided by Widener University School of Law. For invaluable editorial assistance, I thank Barbara S. Hundley, Class of 1995, Marshall-Wythe School of Law, College of William & Mary.

\*\* Jeremy Bentham, *The Theory of Legislation* 90 (Richard Hildreth trans., Oceana Publications, Inc., ed. 1975) (1864).

1. Unless otherwise indicated, all references and citations to "the Code" or "U.C.C." in this Article are to the text and comments of the Uniform Commercial Code (1994).

2. Section 9-201 provides in part: "Except as otherwise provided by this Act a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors." U.C.C. § 9-201. Thus, unless some exception exists, a secured creditor prevails against all other parties. Unfortunately for the secured creditor, the Code provides a host of exceptions scattered throughout Part 3 of Article 9. *See, e.g., id.* §§ 9-301 (giving certain persons priority over unperfected security interests), 9-307 (protecting buyers in the ordinary course of business), 9-308 (protecting buyers of chattel paper or instruments), 9-309 (protecting holders in due course and bona fide purchasers), 9-310 (giving priority to statutory and common law liens), 9-312 (ordering priority among conflicting security interests in the same collateral), 9-313 (relating to priority of interests in fixtures), 9-314 (relating to accessions), 9-315 (determining priority when goods are commingled or processed). Moreover, "despite 9-201's bold assertion that only other provisions of the Uniform Commercial Code override it, obviously other statutory law (such as the Internal Revenue Code and the Bankruptcy Code) must be considered." Douglas G. Baird & Thomas H. Jackson, *Security Interests in Personal Property* 367-68 (1984).

priorities. Their efforts, however, remain largely unsatisfactory.<sup>3</sup> Without exception, each effort inevitably falters because of the asymmetry of the statutory language. The structural asymmetry of the statute, and the persistent failure of theorists to rationalize Article 9, strongly suggest that it cannot be done.<sup>4</sup> In any event, it seems clear that commentators have done just about all that can be done from within the analytical models that have governed discourse to date.

The model advanced here is not intended to discredit all other theories, nor does it explain all Article 9 priorities. Instead, the model presents a fresh perspective that may help to explain, at least in part, particular Article 9 rules, and to assist in the debate over what those rules ought to be. The model rests on the simple notion that a security interest is a protectable property interest.<sup>5</sup> Shifting the inquiry to a property model does not entail a radical alteration in the explanation of priorities, but it does recast the conflicts in terms that clearly present the true interests at stake. Certainly, anyone who believes in the institution of private property is likely to resist the idea that property rights can be involuntarily transferred without compensation.<sup>6</sup> Yet, in the realm of Article 9, such a forced transfer of rights is currently

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3. See, e.g., Douglas Baird & Thomas Jackson, *Information, Uncertainty, and the Transfer of Property*, 13 J. Legal Stud. 299, 309 (1984) (stating that efficiency is the explanatory principle underlying Article 9 priorities); David M. Phillips, *The Commercial Culpability Scale*, 92 Yale L.J. 228, 251-54 (1982) (contending that the relative culpability of the claimants is the explanatory principle underlying Article 9 priorities). For an excellent critique of these explanations and the assertion that Article 9's priorities cannot be explained by a single pervasive principle, see David G. Carlson, *Rationality, Accident, and Priority Under Article 9 of the Uniform Commercial Code*, 71 Minn. L. Rev. 207 (1986).

4. Indeed, contemporary commentators cannot even agree on the societal benefits, if any, of secured credit. For a critical summary of the literature on this subject, see Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 Va. L. Rev. 2021 (1994). Even a casual follower of the secured transactions policy debates can see that the amount of published literature is voluminous; however, there are few, if any, empirical studies. Absent a comprehensive, fact-based perspective on why we are where we are, it is impossible to establish the broad framework of consensus on the need for the availability of secured credit. See *id.* at 2036 ("Whether the benefits of secured credit outweigh its costs in a few, many, or most of the circumstances in which security interests are granted is an empirical question that cannot be answered with any certainty using existing information.").

5. It may be important to note there is some disagreement on this point. Compare *id.* at 2051 ("It seems clear enough that security interests, under Article 9 and real estate law alike, are interests in property.") with *id.* at 2051 n.82 (acknowledging that certain scholars reject the notion that security interests are property interests). One purpose of this Article is to explicate, with some degree of detail, the proposition that security interests are property and the implications of that proposition.

6. See, e.g., U.S. Const. amend. V, cl. 4 ("[N]or shall private property be taken for public use, without just compensation."). The "just compensation" clause is applicable to the states through the fourteenth amendment. *Chicago, B. & Q. R.R. v. Chicago*, 166 U.S. 226, 241 (1897).

possible.<sup>7</sup> If the contingent nature of security interests is at odds with the traditional conception of noncontingent property interests, it is reasonable to ask whether the difference can be convincingly explained.<sup>8</sup>

In this Article the proposed model is applied to those situations in which a perfected security interest lapses because of the secured party's failure to take some action prescribed by the Code.<sup>9</sup> Although the doctrine of lapsed perfection is only a small part of the complex body of Article 9 rules, it is an important part, both practically and conceptually. Practically, this doctrine is important because once a security interest becomes unperfected, it generally will no longer have priority over the claims of purchasers and lien creditors,<sup>10</sup> including the trustee in bankruptcy.<sup>11</sup> Conceptually, the doctrine invites us to examine whether security interests are sufficiently distinct from other forms of property to justify an exception to the basic idea that property rights are sufficiently durable so as to withstand a change in the conditions that existed when the rights were first acquired.

Part I of this Article begins by reasserting that central to the idea of property rights is the legal entitlement to remedies that permits a person to exercise dominion over the specific asset or to exclude the exercise of dominion by others.<sup>12</sup> Next, part I examines the essence of a security interest and demonstrates that it is a protected property interest. Part II sets forth a model of priorities that suggests that although property interests should ordinarily be protected by a property rule, there is something special about a security interest, implying the need for greater contingency and justifying a liability rule for their protection.<sup>13</sup> Although security interests may be contingent, they should

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7. A transfer of rights, in this context, includes both the termination and the subordination of a security interest. See *infra* notes 68-83 and accompanying text.

8. If it cannot, this of course does not necessarily suggest that security interests should be made less contingent. It is quite conceivable that the more appropriate response is to make all property interests more contingent.

9. For an exhaustive analysis of the doctrine of lapse, see Michael P. Pearson, *Absolute Versus Conditional Protection for Secured Parties: Problems of Lapsed Perfection Under Article 9 of the Uniform Commercial Code*, 17 Hous. L. Rev. 1 (1979).

10. See U.C.C. § 9-301.

11. See 11 U.S.C. § 544 (1994).

12. Portions of this part are adapted with some substantive revisions, from the relevant parts of David Frisch, *Remedies as Property: A Different Perspective on Specific Performance Clauses*, 35 Wm. & Mary L. Rev. 1691 (1994).

13. A legal entitlement is protected by a property rule when it cannot be transferred without the owner's consent. Consequently, anyone who wishes to acquire it is compelled to purchase it at a price acceptable to the owner. With a liability rule the transfer of an entitlement may be compelled without the current owner's consent, provided the owner is compensated, *ex post*, for its loss. See generally Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089 (1972) (discussing the circumstances under which entitlements should be granted and protected by using a property, liability or inalienability rule).

rarely be subject to an uncompensated taking. Part III surveys the development and present status of the lapsed perfection doctrine under Article 9 and suggests an alternative formulation that is intended to reflect the valid insights of the model. This part concludes that principles of compensation provide an appropriate guide for determining issues of priority. Finally, part IV briefly discusses other contexts in which application of the model might be helpful. This Article concludes that although subordination of secured claims against a variety of other claimants is inevitable, conflicts must always be resolved by a continual elaboration of the nature of the competing interests. The statutory taking of a security interest without compensation is permitted, but only when the benefits are extremely high relative to the loss of property that results.

### I. SECURITY INTERESTS AS PROPERTY

A central intellectual theme of the analysis of property rights in the twentieth century has been a shift in focus from physical things to legal relations.<sup>14</sup> It is now widely accepted that society would be unmanageable if Blackstone's conception of property as the "sole and despotic dominion which one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe"<sup>15</sup> were an accurate description of the actual world.

First, Blackstone's conception conflicts with the present-day reality that property is always subject to limitations. For example, the law tells us that (1) owners cannot always do with their property as they

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14. See Felix S. Cohen, *Dialogue on Private Property*, 9 Rutgers L. Rev. 357, 361 (1954) ("[E]ssentially this institution of private property that we are trying to identify in outline is not a collection of physical objects, but rather a set of relationships . . ."). In the words of Stephen Munzer:

The other way of understanding property is the sophisticated conception. One might almost call it the legal conception, for it is very common among lawyers. It understands property as *relations*. More precisely, property consists in certain relations, usually legal relations, among persons or other entities with respect to things. A metaphorical way of stating the sophisticated conception is that property is a bundle of "sticks."

Stephen R. Munzer, *A Theory of Property* 16 (1990); see also Morris S. Cohen, *Property and Sovereignty*, 13 Cornell L.Q. 8, 12 (1928) ("Whatever technical definition of property we may prefer, we must recognize that a property right is a relation not between an owner and a thing, but between the owner and other individuals in reference to things."); Eirek G. Furuboth & Svetozar Pejovich, *Property Rights and Economic Theory: A Survey of Recent Literature*, 10 J. Econ. Literature 1137, 1139 (1972) ("[P]roperty rights do not refer to relations between men and things but rather, to the sanctioned behavioral relations among men that arise from the existence of things and pertain to their use.").

15. 2 William Blackstone, *Commentaries On the Laws of England* 2 (1992). This conception has two aspects or dimensions: property can exist only in tangible things and all property is absolute. Clearly, neither aspect is credible today.

please;<sup>16</sup> (2) the right of owners to exclude others from their property is not unlimited;<sup>17</sup> (3) the power that owners have to transfer their property is not without restriction;<sup>18</sup> and (4) owners can, under certain circumstances, lose their property without their consent.<sup>19</sup>

The second difficulty with this conception is that property may or may not involve tangible things. The idea that property is limited to a collection of physical objects lost whatever force it had when courts looked for ways to extend the protective umbrella of the Due Process Clause of the Fourteenth Amendment to protect new forms of wealth. The best strategy the courts found was to designate the interest involved as property.<sup>20</sup>

The most influential manifestation of the modern conception of property is the *Restatement of Property*.<sup>21</sup> The best insights into the thinking that underlies the *Restatement* come from the initial paragraph of the Introductory Note:

The word "property" is used sometimes to denote the thing with respect to which legal relations between persons exist and sometimes to denote the legal relations. The former of these two usages is illustrated in the expressions "the property abuts on the highway" and "the property was destroyed by fire." This usage does not occur in this Restatement. When it is desired to indicate the thing with regard to which legal relations exist, it will be referred to either specifically as "the land," "the automobile," "the share of stock," or, generically, as "the subject matter of property" or "the thing."<sup>22</sup>

This is a profoundly enlightening passage, and it explains why the term "property" is nowhere defined in the *Restatement*—a position that seemed necessary, because the term is used in the *Restatement* to

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16. See Joseph W. Singer, *The Reliance Interest in Property*, 40 Stan. L. Rev. 611, 641-42 n.108 (1988) (stating that the limitations on use include "building codes, nuisance law, law of easements, covenants, servitudes, licenses, profits, defeasible fees, law of waste, water rights, zoning, environmental protection statutes").

17. *Id.* (stating that the limitations on the power to exclude include "public accommodation laws, antidiscrimination laws and fair housing statutes, common carrier obligations to the public, free speech access to shopping centers or universities under state constitutional law, public policy exception to trespass law, the incomplete defense of necessity").

18. *Id.* (stating that the limitations on the power to transfer include "the rule against perpetuities, rule against restraints on alienation, rule against creation of new estates, procedures for drafting valid wills, statutory forced shares, the public trust doctrine").

19. *Id.* (noting that an involuntary taking of property can result from "recording statutes, title registration, adverse possession, prescriptive easements, implied easements, marital property statutes, constructive trusts, eminent domain law").

20. See Dean G. Acheson, Book Review, 33 Harv. L. Rev. 329, 330 (1920) ("Everything was thought of in terms of property—reputation, privacy, domestic relations, and as new interests called for protection their success depended upon their ability to take on the protective coloring of property." (footnote omitted)).

21. Restatement of Property (1936).

22. *Id.*, Introductory Note, ch. 1, at 3.

"denote legal relations between persons with respect to a thing."<sup>23</sup> For the drafters of the *Restatement*, the term "property," standing alone, was viewed as a weak vehicle for adequately expressing the widely differing types of relations that were possible. By instead using the defined terms "right,"<sup>24</sup> "privilege,"<sup>25</sup> "power,"<sup>26</sup> and "immunity,"<sup>27</sup> the drafters were better able to promote the "[c]larity of thought and exactness of expression"<sup>28</sup> they sought.

A conception of property that assumes a relational context does nothing in itself, however, to distinguish between property relations and other legal relations. This is a serious and difficult problem. If property is properly thought of as a collection of legal relations between persons, how do we distinguish between property relations and other legal relations? Indeed, because all legal relations can be described in terms of "rights, privileges, powers, and immunities," it has been suggested that, under the *Restatement*, the right to kill in self-defense could qualify as a property right.<sup>29</sup> Thus, although the obser-

23. *Id.*

24. *Id.* § 1 ("A right . . . is a legally enforceable claim of one person against another, that the other shall do a given act or shall not do a given act.")

25. *Id.* § 2 ("A privilege . . . is a legal freedom on the part of one person as against another to do a given act or a legal freedom not to do a given act.")

26. *Id.* § 3 ("A power . . . is an ability on the part of a person to produce a change in a given legal relation by doing or not doing a given act.")

27. *Id.* § 4 ("An immunity . . . is a freedom on the part of one person against having a given legal relation altered by a given act or omission to act on the part of another person.")

28. *Id.* ch. 1, at 4. It should be noted that the language used and the conception of property embodied in the *Restatement* was not new. It grew out of the analytical jurisprudence of Wesley N. Hohfeld. In a well-known series of articles, Hohfeld set out the contours of what he described as the eight "lowest common denominators of the law." Wesley N. Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 *Yale L.J.* 16, 58 (1913) [hereinafter *Judicial Reasoning I*]; Wesley N. Hohfeld, *Faulty Analysis in Easement and License Cases*, 27 *Yale L.J.* 66 (1917); Wesley N. Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 26 *Yale L.J.* 710 (1917) [hereinafter *Judicial Reasoning II*]. These denominators consist of four primary entitlements (rights, privileges, powers, and immunities) and their opposites and correlatives (no-rights, duties, disabilities, and liabilities). It was Hohfeld's purpose to demonstrate that only by using these fundamental conceptions was it possible to "think straight" about everyday legal problems. See *Judicial Reasoning I, supra*, at 18. In this connection, he exposed abstract legal ideas like "title," "due process," "privity," and "ownership" as meaningless expressions and, hence, unsuitable guides to the understanding and correct solutions of cases.

29. See Felix S. Cohen, *Dialogue on Private Property*, 9 *Rutgers L. Rev.* 357, 365 (1954). Cohen illustrates his point in the following exchange:

C. . . . Mr. Fielden, what do you think of the American Law Institute definition of property as including any "rights, privileges, powers and immunities?" Under that definition, would immunity from racial discrimination in the exercise of the franchise be a property right?

F. Yes, under that definition I suppose it would.

C. And would the right to kill in self-defense be a property right?

F. Yes, I believe so.

C. In fact, any legal relationship under the definition of the American Law Institute is property, is it not?



vation that property is a set of legal relations may prove highly useful, in a sense, we have taken only the first step. A relations-based theory cannot itself explain why certain kinds of relations are not and should not be considered property. As previously demonstrated,<sup>30</sup> the "liberal" concept of ownership can be used to explicate the standard incidents of ownership and, in particular, to grasp which lesser incidents comprise more limited property rights.

The argument proceeds first from the observation that the incidents of ownership that have value<sup>31</sup> may be rendered meaningless, unless the owner is given the power to exclude third parties generally from exercising dominion over the thing.<sup>32</sup> For example, one important incident of ownership is the right to decide how the thing shall be used and by whom. This right would be seriously impaired, and possibly destroyed, unless some mechanism existed for securing the owner's possession. Legal remedies provide that mechanism. The consequence of this view is that the relevant question here concerns the remedies that are available to the owner.

When the existence of X's property interest in a thing is called into question, the courts have three alternatives.<sup>33</sup> They can (1) withhold all remedies, thus allowing third parties generally to deprive X of possession and control; (2) require third parties generally to compensate X (pay damages) if they wish to deprive her of possession and control;

F. Yes, I think the definition is comprehensive enough to cover any legal relation.

C. Might such a definition of property be useful to the teachers of property law who agreed on this definition in case they want to stake out jurisdictional claims to cover any legal problem whatsoever in their property courses?

F. Yes, I suppose it might have some utility in that direction.

C. But this definition would not be useful to us in trying to determine whether property exists in a given [thing]?

F. No.

*Id.*

30. See Frisch, *supra* note 12, at 1706-10. The full or liberal concept of ownership is explored in great detail by A.M. Honore. See A.M. Honore, *Ownership*, in *Oxford Essays In Jurisprudence (First Series)* 107 (A. G. Guest ed., 1961). As Honore explains:

Ownership comprises the right to possess, the right to use, the right to manage, the right to the income of the thing, the right to the capital, the right to security, the rights or incidents of transmissibility and absence of term, the prohibition of harmful use, liability to execution, and the incident of residuary . . . .

*Id.* at 113. He is careful to point out, however, that the presence of all 11 incidents, while together sufficient to constitute ownership, may not be individually necessary.

*Id.* at 112-13.

31. All the incidents of ownership should not be seen as having positive value to the owner. For example, the prohibition of harmful use entails a disadvantage; the owner is under a duty not to use or manage the thing owned in ways that would be harmful to other members of the public.

32. See Frisch, *supra* note 12, at 1710-16.

33. *Id.* at 1716.

or (3) protect X's interest with a property rule, thus giving X the power to exclude third parties generally.<sup>34</sup> Only the third option is consistent with the recognition of a property interest.<sup>35</sup> Properly understood, a legal relation, defined as a right, privilege, power, or immunity, that a person has with regard to a thing is a property relation only if a possessory remedy is available for its protection.

It is possible to understand the precise nature of a security interest by understanding that a property interest is predicated on the remedial power to exclude.<sup>36</sup> The Code defines a security interest as "an interest in personal property or fixtures which secures payment or performance of an obligation."<sup>37</sup> Although this language is strongly suggestive of a property interest, it must be understood that definitions do not create property interests. Whatever terminology is employed, the key point is that a true property interest cannot be defined independently of the remedies that are available to the secured party.

A preliminary comment must be made before turning to a discussion of remedies. This Article does not claim that the existence of a property interest depends upon the availability of remedies that can be used to exclude all persons from the property; rather, it argues that the interest holder must be entitled to exclude persons generally.<sup>38</sup>

34. *Id.*

35. If the interest can only be protected by a liability rule, the interest (whatever else it may be) is not a property interest. See Jules L. Coleman & Jody Kraus, *Rethinking the Theory of Legal Rights*, 95 Yale L.J. 1335, 1338-39 (1986) ("It is surely odd to claim that an individual's right is protected when another individual is permitted to force a transfer at a price set by third parties. Isn't the very idea of a forced transfer contrary to the autonomy or liberty thought constitutive of rights?"). This view reveals that the conception of entitlements includes more than property interests. For example, where a sales tax must be paid to the state when an item is sold, the state has an entitlement; but, few would argue that it has a property interest in the items that are subject to the tax.

36. Courts often assert that a security interest is a property interest. See, e.g., *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935) (finding that mortgages given to secure a loan were a property interest). There the Court stated:

If the public interest requires, and permits, the taking of property of individual mortgagees in order to relieve the necessities of individual mortgagors, resort must be had to proceedings by eminent domain; so that, through taxation, the burden of the relief afforded in the public interest may be borne by the public.

*Id.* at 602. Unfortunately, such assertions are not explained.

37. U.C.C. § 1-201(37). "The term also includes any interest of a buyer of accounts or chattel paper which is subject to Article 9." *Id.* For purposes of this Article, the term "security interest" is used to denote the more limited and traditional interest described in the text.

38. In other words, what we are looking for is a right that is *in rem*, not necessarily one that is *in personam*. On this distinction, Hohfeld writes:

A paucital right, or claim, (right *in personam*) is either a unique right residing in a person (or group of persons) and availing against a single person (or single group of persons); or else it is one of a few fundamentally similar, yet separate, rights availing respectively against a few definite persons. A multital right, or claim, (right *in rem*) is always one of a large class of fundamentally similar yet separate rights, actual and potential, residing in a single

For example, suppose that X, the owner of a machine, leases the machine to Y. X would no longer have the power to wrest possession of the machine from Y; yet, no one would doubt that X continues to have a property interest in the machine. Moreover, X's property interest does not preclude the possibility that Y may also have a property interest in the machine.<sup>39</sup> Whether Y has a security interest will depend on the extent to which she is empowered under the relevant law to exclude others.

Therefore, before concluding that a security interest is a property interest, it is necessary to determine the character of the secured party's remedies. However, discussions about a secured party's remedies are inevitably bound up with discussions about the particular secured party's priority. For example, it is quite possible that a secured party with a subordinated interest may find that he is unable to gain possession of the collateral or control its disposition.<sup>40</sup> In effect, examining the remedial consequences of an interest holder's priority illuminates the underlying political, social, and economic judgments about the rights at stake. Ultimately, for the thesis proposed here, it does not matter whether a security interest is a property interest in all cases. The normative question at issue is how the Code ought to respond to security interests that are property interests.<sup>41</sup>

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person (or single group of persons) but availing *respectively* against persons constituting a very large and indefinite class of people.

*Judicial Reasoning II*, *supra* note 28, at 718 (footnotes omitted).

39. See *International Postal Supply Co. v. Bruce*, 194 U.S. 601 (1904). There, Justice Holmes explained:

In the case at bar the United States is *not the owner* of the machines, it is true, *but it is a lessee in possession*, for a term which has not expired. It *has a property, a right in rem*, in the machines, which, though less extensive than absolute ownership, has the same incident of a right to use them while it lasts.

*Id.* at 606 (emphasis added).

40. See also *infra* notes 160-66 and accompanying text. See generally J. Peter Byrne et al., *Junior Creditors' Realization on Debtors' Equity Under U.C.C. Section 9-311: An Appraisal and a Proposal*, 77 Geo. L.J. 1905 (1989) (discussing the deficiencies of § 9-311 in dealing with junior creditors' interests); Steve H. Nickles, *Rights and Remedies Between U.C.C. Article 9 Secured Parties With Conflicting Security Interests in Goods*, 68 Iowa L. Rev. 217, 230 (1983) (stating that when a subordinated interest does not satisfy a senior party's interest in a property the senior party may possess the collateral and control its disposition); Cynthia Starnes, *U.C.C. Section 9-504 Sales by Junior Secured Parties: Is a Senior Entitled to Notice and Proceeds?*, 52 U. Pitt. L. Rev. 563 (1991) (discussing sales by junior secured parties under § 9-504); Steven Wechsler, *Rights and Remedies of the Secured Party After an Unauthorized Transfer of Collateral: A Proposal for Balancing Competing Claims in Repossession, Resale, Proceeds, and Conversion Cases*, 32 Buff. L. Rev. 373 (1983) (discussing the senior creditor's rights as against junior creditors).

41. Although the implications of a security interest's priority cannot be dismissed as beyond the scope of this Article, at this juncture assume a security interest with priority over all existing and potential third party claimants.

The Code specifically gives the secured party the right to take possession of the collateral upon the debtor's default<sup>42</sup> and either propose to keep it in satisfaction of the debt<sup>43</sup> or resell it and apply the proceeds to the debt.<sup>44</sup> Possession may be obtained "without judicial process if this can be done without breach of the peace or [the secured party] may proceed by action."<sup>45</sup> If a default does exist, the secured party's right to possession under section 9-503 will also be enforceable against a buyer or other transferee of the collateral.<sup>46</sup> This means that the secured party can successfully replevy the collateral regardless of who the present possessor is. Moreover, if an unsecured creditor has levied on the collateral, the secured creditor may be able to vacate the levy and conduct the foreclosure.<sup>47</sup>

If the collection of remedies available to the secured party after default establishes anything, it ought to be that it is a coherent basis for calling the interest a property interest.<sup>48</sup> The question arises, however, as to whether there is any basis for finding the existence of a property interest prior to an event of default. That is, should an interest be disqualified from being a property interest because the right to possession is contingent upon future events? The appropriate response, in most cases, is that it should not. Understanding that the incidents of ownership may be spread in a variety of ways among two or more persons enables us to appreciate that a property interest may be present even though an immediate and unqualified right to possession is lacking.<sup>49</sup> Moreover, in an appropriate case, the fact that there

42. U.C.C. § 9-503 ("Unless otherwise agreed a secured party has on default the right to take possession of the collateral."). For the present purpose, assume that the collateral is tangible and can be possessed.

43. *Id.* § 9-505(2).

44. *Id.* § 9-504.

45. *Id.* § 9-503. See James J. White & Robert S. Summers, *Uniform Commercial Code 1206-07* (3d ed. 1988) ("A secured party, wishing to repossess by judicial action, has several means available. For instance, he can bring an action in replevin (originally a common-law action, now largely codified). In other jurisdictions he can proceed under the statutory successor to replevin, an action of claim and delivery.").

46. The source of the secured party's presumptive priority and better right to possession is § 9-201. For the relevant text of this section, see *supra* note 2. For a more complete explanation of the secured party's rights following a transfer of the collateral, see Steve H. Nickles, *Enforcing Article 9 Security Interests Against Subordinate Buyers of Collateral*, 50 *Geo. Wash. L. Rev.* 511 (1982).

47. Although § 9-311, providing that a debtor's rights may be voluntarily or involuntarily transferred, would seem to permit a levy and sale, many courts have held otherwise. Compare *William Iselin & Co. v. Burgess & Leigh, Ltd.*, 276 N.Y.S.2d 659, 663 (Sup. Ct. 1967) (permitting secured party to vacate the levy) and *Brescher v. Associates Fin. Servs. Co.*, 460 So. 2d 464, 467 (Fla. Dist. Ct. App. 1984) (same) with *First Nat'l Bank v. Sheriff of Milwaukee Co.*, 149 N.W.2d 548, 550-51 (Wis. 1967) (permitting lien creditor to sell the collateral).

48. Although much more can be said about the secured party's remedies following a default, the purpose here is simply to facilitate a better understanding of why the security interest is indisputably a property interest.

49. See *supra* notes 40-41 and accompanying text. Nor should it matter that the contingency might never occur. For example, if we assume a lease with an option to

has been no default would not preclude a court from enjoining the debtor from disposing of the collateral or restraining third parties from interfering with the secured party's prospective right of possession.<sup>50</sup>

Given the remedies that enable the secured party to obtain possession of the collateral and to exclude others, there is strong reason to conclude that a security interest can qualify as a property interest regardless of whether a default has occurred. The next logical step is to inquire whether there are reasons peculiar to security interests that would justify a departure from the more traditional model of noncontingent property interests and the jurisprudence of takings.

## II. CONTINGENT INTERESTS AND THE "TAKINGS" JURISPRUDENCE OF ARTICLE 9

As part I demonstrated, if the secured party can exercise its Article 9 remedies free from the interference of others, a security interest can be considered a property interest. Any concept of remedies, however, must assume a social context. To speak of the secured party's rights without considering where its interest stands in relation to others is illogical. Remedies should not be treated as an abstract concept, to be gauged without reference to other legal contingencies, such as the order in which competing interests are ranked. Were remedies decided separately, outcomes would inevitably undermine the purposes of the statute or common law decision in which the priority rule is formulated and expressed. This threat can be defused, however, once it is openly acknowledged that remedies are a particularly authoritative expression of a property claimant's relative priority. To understand and evaluate what all of this means for secured parties, attention must focus on Article 9. This part discusses the interests that are created after the security interest has attached. Specifically, this part assumes the ability of the subsequent claimant to take priority over the secured party.

### A. *The Effect of Priority: Termination Versus Subordination*

Article 9 establishes two different methods for achieving a relational order of interests between the secured party and the later in time priority claimant: (1) termination of the security interest; (2)

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purchase, it is certainly possible that the lessor will never again be entitled to possession. Yet, no one would doubt in such a case that, prior to the time the lessee exercises the option, the lessor continues to have a property interest in the subject matter of the lease.

50. See, e.g., *In re Haugabook Auto Co.*, 9 U.C.C. Rep. Serv. (Callaghan) 954 (M.D. Ga. 1971) (discussing remedies available to the holder of an unperfected security interest in motor vehicles in a proceeding to restrain and enjoin the bankrupt from disposing of the collateral).

subordination of the security interest.<sup>51</sup> This section examines those aspects that bear on the "takings" question and the points made later in this part. The strategy here is to draw out the implicit conception of priority that animates each method, and to illuminate the ways in which this conception colors the chosen statutory language. Once this framework is in place, one can argue that the secured party's loss of priority will always diminish the value of its property and result in a taking.

As for the first method, termination of the interest, in some situations the continued existence of the security interest would be inconsistent with the notion that the subsequent interest has priority. In such instances, the Code provides that the security interest is eliminated altogether. For example, consider the language of section 9-307(1): "A buyer in ordinary course of business . . . takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence."<sup>52</sup> Because the words "take free" were chosen to express the buyer's priority, the security interest will cease to exist once the sale has been completed.<sup>53</sup>

In this way, the drafters have guaranteed absolute protection to the buyer and all subsequent transferees.<sup>54</sup> Eliminating the security interest, rather than subordinating it to the interest acquired by the ordinary course buyer, appears to be a particular application of the black letter rule that a transferee of property ordinarily acquires whatever rights the transferor had.<sup>55</sup> This rule in turn grew out of the notion

51. Developing each of these methods in detail and identifying fully the policy judgments reflected in each is not a task to be undertaken here. See generally David G. Carlson, *Death and Subordination Under Article 9 of the Uniform Commercial Code: Senior Buyers and Senior Lien Creditors*, 5 *Cardozo L. Rev.* 547 (1984) (examining situations in which security interests should be subordinated to lien creditors and buyers and those in which the security interest should be eliminated).

52. U.C.C. § 9-307(1) (emphasis added).

53. I have argued elsewhere that completion of the sale is not always a prerequisite for the buyer's protection. See David Frisch, *Buyer Status Under the U.C.C.: A Suggested Temporal Definition*, 72 *Iowa L. Rev.* 531, 570-71 (1987) (arguing that buyer status occurs at the moment the buyer obtains the remedial right to the goods *vis-à-vis* the seller).

54. Because most ordinary course transfers are authorized (implicitly or explicitly) by the secured party, § 9-306(2) will also be terminal for the security interest. See § 9-306(2) ("Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise . . .").

55. The rule expressed in the text has two aspects. One is the "derivation" principle of *nemo dat quod non habet* (one cannot give what one does not have). *Nemo dat* dictates that the transferee takes its interest subject to all third party claims and interests that were enforceable against the transferor. See, e.g., U.C.C. §§ 2-403(1) (describing the title acquired by a purchaser of goods), 3-305(a) (providing defenses to claims to enforce payment of an instrument), 3-306 (stating that a person without rights of a holder in due course takes an instrument subject to claims), 7-504(1) (pro-

that the value of the priority interest should be unaffected by other competing interests.<sup>56</sup> If the original security interest was permitted to linger, it would lead to the assumption that the interest could be reinvigorated if the goods were later transferred by the buyer. Given this assumption, the goods obviously would be worth considerably less to the buyer than comparable unencumbered goods. If not, there is no reason to permit the security interest to continue. In either event, this discussion of section 9-307(1) demonstrates the logic and significance of choosing termination of the security interest as the method for protecting the buyer's priority.

A quite different approach is taken in those sections that express the idea of priority in terms of subordination.<sup>57</sup> For example, section 9-301(1)(b) provides: "[A]n unperfected security interest is subordinate to the rights of . . . a person who becomes a lien creditor before the security interest is perfected."<sup>58</sup> Putting aside the question of whether the security interest continues to have positive economic value, it is obvious that it continues to exist. Presumably, this viability is permitted because the interest of the senior lien is adequately safeguarded by the basic principle of lien foreclosure. As a general rule, a person who buys property at a foreclosure sale acquires the debtor's equity plus the equity created by the absence of the lien being foreclosed and all subordinate liens and interests.

Lien foreclosure inevitably preserves the value of the senior lien. If the secured party chooses to dispose of the collateral, she may do so

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viding that a transferee of a document acquires the title and rights the transferor had or had authority to convey), 8-301 (relating to the rights of a purchaser of securities), 9-318 (relating to the rights of the assignee). The second aspect of the rule is commonly referred to as the "shelter" principle. When the transferor has priority over third party claims, the transferee will enjoy that same priority. *See, e.g., id.* §§ 2-401 ("Passing of Title; Reservation for Security; Limited Application of This Section"), 3-203(a) (describing transferee's right to enforce an instrument), 7-504(1) (stating that a transferee acquires all rights "which his transferor had or had actual authority to convey"). Thus, even if § 9-307(1) did not provide for termination of the security interest, *all* transferees—whether voluntary or involuntary—would be sheltered by the buyer's priority. For insightful discussions of the conveyancing principles that underlie the Code, see Permanent Editorial Board For The Uniform Commercial Code, PEB Commentary On The Uniform Commercial Code: Commentary 6 (Final Draft Mar. 10, 1990), reprinted in [Index/PEB Commentaries] U.C.C. Rep. Serv. 2d (Callaghan) [hereinafter *PEB Commentary 6*]; John F. Dolan, *The U.C.C. Framework: Conveyancing Principles and Property Interests*, 59 B.U. L. Rev. 811 (1979); Steven L. Harris, *The Interaction of Article 6 and 9 of the Uniform Commercial Code: A Study in Conveyancing, Priorities, and Code Interpretation*, 39 Vand. L. Rev. 179 (1986).

56. *See* White & Summers, *supra* note 45, at 172 ("[A]ppropriate protection of a transferee's 'market' for retransfer requires some recognition of a shelter principle.").

57. It is important to note that a section can employ this method without using the word "subordination." Subordination occurs whenever the effect of the priority rule is to leave the junior interest intact. *See, e.g.,* U.C.C. §§ 9-308 ("has priority over"), 9-310 ("takes priority over"), 9-312(5)(a) ("security interests rank according to priority").

58. *Id.* § 9-301(1)(b).

under the Code<sup>59</sup> or she may resort to the independent foreclosure provisions under state lien law.<sup>60</sup> Both alternatives will normally result in the buyer at the foreclosure sale acquiring a title that is subject to the senior judicial lien.<sup>61</sup> Thus, in either case, the lien creditor receives the full protection that Article 9 gives her.

Difficulties surface, however, when the disposition of the property is controlled by the judicial lien creditor. A literal reading of the Code may lead one to the conclusion that the buyer will not take free of the subordinate security interest.<sup>62</sup> Such a conclusion, however, would have disastrous consequences for the judicial lien creditor. Consider the following illustration:

Suppose the sheriff levies equipment worth \$10,000. Just prior to the sale the debtor creates a \$4,000 security interest, which the secured party advertises at the sheriff's sale. Buyers will pay no more than the encumbered value of the equipment; thus, the lien creditor will realize only \$6,000 toward satisfaction of his judgment. If the junior secured party had been senior in the first place, the lien creditor would have realized the same \$6,000 from the sheriff's sale. Therefore, inability to foreclose the junior security interest reverses the priorities and puts the senior lien creditor in the same position as if he had been junior.<sup>63</sup>

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59. See *id.* § 9-504 (providing in part that "[a] secured party after default may sell, lease or otherwise dispose of any or all of the collateral.").

60. See *id.* § 9-501(1) (providing that a secured creditor "may reduce his claim to judgment, foreclose or otherwise enforce the security interest by any available judicial procedure."); see also *id.* § 9-501(5) (stating that a judicial lien acquired by the secured party will enjoy the same priority as the security interest and the secured party may purchase the collateral at a judicial sale).

61. See *id.* § 9-504(4) ("When collateral is disposed of by a secured party after default, the disposition . . . discharges the security interest under which it is made and any security interest or lien subordinate thereto."). If the property is sold at an execution sale, non-Code rules must also be taken into account. In several jurisdictions this will mean that the sale discharges *all* liens. See, e.g., *Maryland Nat'l Bank v. Porter-Way Harvester Mfg. Co.*, 300 A.2d 8, 11 (Del. 1972) (stating that when title is acquired by the purchaser at an execution sale it is "free and clear" of all liens); *Carlson, supra* note 51, at 574 (illustrating an example where the U.C.C. and state case law combine to discharge both junior interests and senior judicial liens). The senior lien creditor is not prejudiced since its claim is satisfied first from the proceeds. *Id.*

62. See *Carlson, supra* note 51, at 575-81. Sections 9-201, providing that a security agreement is effective between the parties, against purchasers and creditors, and 9-306(2), stating that a security interest continues in collateral despite sale or other disposition, would seem to keep a security interest alive absent a contrary provision in Article 9. More than one court has searched in vain for such a provision. See, e.g., *Tabers v. Jackson Purchase Prod. Credit Ass'n*, 649 S.W.2d 202, 204 (Ky. Ct. App. 1983) (basing its decision on a Kansas commercial law statute to find that a judicial sale "does not necessarily 'cleanse title.'"); *Bloom v. Hilty*, 234 A.2d 860, 863-64 (Pa. 1967) (relying on § 9-312). *But see In re Dean Monagin, Inc.*, 170 N.W.2d 924, 927 (Mich. Ct. App. 1969) (finding that the assignee for the benefit of creditors can sell free of an unperfected security interest).

63. *Carlson, supra* note 51, at 578.



If the courts recognize that unless the lien creditor's priority extends to the buyer, the effect will be to repeal that priority, then the Code's literal language is not necessarily an insuperable objection to an outcome in accord with non-Code foreclosure law.<sup>64</sup> One possibility might be to permit resort to non-Code law pursuant to section 1-103.<sup>65</sup> Another alternative is to read section 9-301(1)(b) as rebutting the presumptive immortality bestowed upon security interests by sections 9-201 and 9-306(2).<sup>66</sup>

In sum, a priority rule can adequately balance the legitimate interests of competing claimants only by focusing on the priority claimant's protectable interests and limiting the other claimant's interest to the extent necessary to ensure that the latter in no way devalues the former. Implicit in this strategy is a vital distinction between termination and subordination of the junior interest. What is crucial to understand is that the appropriateness of the method chosen will depend on the nature of the priority interest. In short, full protection of a priority ownership interest requires that all junior interests be eliminated whereas creditors with priority liens require only their subordination.<sup>67</sup>

### B. *The Loss of Priority as a Taking*

Regardless of which method is chosen to express the secured party's loss of priority, there has been a taking of rights for which the party has specifically bargained. This raises the question of whether there has been a taking which mandates the payment of just compensation under the Fifth Amendment. It is one thing to conclude that a secur-

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64. If §§ 9-201 and 9-306(2) were ignored, it is clear that under non-Code law the buyer at the execution sale would be sheltered by the lien creditor's priority. See 4 American Law of Property § 17.30, at 612 (A. James Casner ed., 1952) ("[I]f the judgment creditor himself was protected by the statute against unrecorded transactions, the purchaser at the sale obtains a good title irrespective of notice . . ." (footnotes omitted)).

65. U.C.C. § 1-103 provides in relevant part: "Unless displaced by the particular provisions of this Act, the principles of law and equity . . . shall supplement [the Code's] provisions." But see Carlson, *supra* note 51, at 578 ("[S]ection 1-103 could be used to assert nonuniform foreclosure rules over section 9-201, but this would seriously impair the general utility of section 9-201 to secured lenders.").

66. Carlson, *supra* note 51, at 579-80.

67. Strangely enough, § 9-301(1) "subordinates" an unperfected security interest to the interests of judicial lien creditors, secured parties and buyers. This is an appropriate way to treat priority lienors, but it has the effect of destroying the buyer's priority. See Carlson, *supra* note 51, at 552-53. Unfortunately, one court has held that an unperfected security interest survives a sale to a senior buyer. See *Aircraft Trading and Serv., Inc. v. Braniff, Inc.*, 819 F.2d 1227, 1233 (2d Cir. 1987). In response to this case, the Permanent Editorial Board for the Uniform Commercial Code issued a commentary which amends the Official Comment to § 9-301 to make clear that the shelter principle effectively terminates the junior security interest. See *PEB Commentary 6*, *supra* note 55.

ity interest is "private property" under the Constitution;<sup>68</sup> it is quite another thing to conclude that the loss of priority without compensation runs afoul of the takings clause. Surely it does not.<sup>69</sup> The main purpose of this section is to show that the jurisprudence of takings is able to offer illuminating analyses of Article 9 that may offer assistance in solving the problems posed by competing interests.

Aside from the obvious statement that a "taking" occurs when a government entity formally condemns a landowner's property and obtains the fee simple pursuant to its sovereign power of eminent domain,<sup>70</sup> there is no generally accepted test for determining whether a taking has occurred. The courts' struggle to balance the variety of factors involved has produced a series of "essentially ad hoc" inquiries.<sup>71</sup> Notwithstanding this confusion and inconsistency, courts do agree on the most fundamental point in any takings case: "the deprivation of the former owner rather than the accretion of a right or interest to the sovereign constitutes the taking."<sup>72</sup>

Clearly the elimination of a security interest is a taking. The secured party does not simply lose a single strand from its bundle of property rights, it loses every strand.<sup>73</sup> Subordination of the security interest, however, presents a more difficult issue.

68. See *United States v. General Motors Corp.*, 323 U.S. 373, 378 (1945) ("The constitutional provision is addressed to every sort of interest [in property] the citizen may possess.").

69. Perhaps the most obvious way to resolve the constitutional issue is to recognize that secured creditors willingly subject themselves to the vagaries of Article 9 with a presumptive understanding of the risks involved. Cf. Carol M. Rose, *Mahon Reconstructed: Why the Takings Issue is Still a Muddle*, 57 S. Cal. L. Rev. 561, 582 n.110 (1984) ("One reason why legislation can abate nuisances without taking property is that property owners know that they may be enjoined from noxious uses, and must have built this risk into their purchase price.").

A less obvious response to the constitutional issue relies on the concept of "average reciprocity of advantage." See *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 415 (1922). Loosely speaking, no taking occurs if the harm caused by one aspect of a regulation is more or less offset by a corresponding benefit to the same property owner. In other words, the owner's economic situation has not changed. Conceptually, this "wash" may be the economic consequence of the secured party's proceeds claim under § 9-306. See *infra* notes 90-92 and accompanying text.

70. *San Diego Gas & Elec. Co. v. City of San Diego*, 450 U.S. 621, 651 (1981).

71. *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979); *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978); see also John A. Humbach, *A Unifying Theory for the Just-Compensation Cases: Takings, Regulation and Public Use*, 34 Rutgers L. Rev. 243, 244 (1982) (describing the area as somewhat illogical); Corwin W. Johnson, *Compensation for Invalid Land-Use Regulations*, 15 Ga. L. Rev. 559, 594 (1981) (describing the area as chaotic); Patrick Wiseman, *When the End Justifies the Means: Understanding Takings Jurisprudence in a Legal System With Integrity*, 63 St. John's L. Rev. 433, 434 (1988) (describing the area as incoherent).

72. *United States v. General Motors Corp.*, 323 U.S. 373, 378 (1945).

73. See *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 435 (1982) ("[T]he government does not simply take a single 'strand' from the 'bundle' of property rights: it chops through the bundle, taking a slice of every strand."). Again, it bears repeating that this Article does not assert that a taking *requires* just compensation. Rather, this Article asserts that the jurisprudence of takings and of Article 9

In *Pennsylvania Coal Co. v. Mahon*,<sup>74</sup> the Supreme Court applied the "diminution in value" test to the question of whether a 1921 Pennsylvania statute, which restricted the mining of anthracite coal deposits, unconstitutionally took property without compensation.<sup>75</sup> In essence, the statute precluded property owners from releasing miners from their common law duty to support the surface under which they mined.<sup>76</sup> Its effect was to take from some miners the subsurface mineral rights and support rights for which they had bargained. After relating the familiar assumption that "to some extent values incident to property" could be diminished by the exercise of the state's police power without there being a compensable taking,<sup>77</sup> the Court recognized that at some point property will be deemed "taken" depending upon the magnitude and/or quantity of rights invaded. Thus the court found, "[O]ne fact for consideration in determining such limits is the extent of the diminution. When it reaches a certain magnitude, in most if not in all cases there must be an exercise of eminent domain and compensation to sustain the act."<sup>78</sup>

Thus, the Supreme Court has never attempted to construct a coherent framework for determining how much diminution in value is sufficient to constitute a taking. Without such a framework, the diminution in value test can easily be manipulated to make ad hoc discretionary judgments about the use of the state's police power.<sup>79</sup> The propriety of takings decisions must therefore depend upon the courts' willingness and ability to administer the constitutional guarantee in a manner consistent with the policies that we expect that guarantee to serve.

Notwithstanding the current indeterminacy of takings jurisprudence, analysis of the remedial and economic consequences of lien subordination indicates that a taking may have occurred. In many ju-

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often compliment each other. The clearest way to make this point is simply to ignore the fact that the secured party accepts its interest with full knowledge of the risks involved.

74. 260 U.S. 393 (1922).

75. *Id.* at 413.

76. *Id.* at 412-13.

77. *Id.* at 413.

78. *Id.*

79. See *Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470, 497 (1987) ("[O]ne of the critical questions is determining how to define the unit of property 'whose value is to furnish the denominator of the fraction.'" (quoting Frank I. Michelman, *Property Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 Harv. L. Rev. 1165, 1192 (1967))). As Carol Rose stated:

When a court expands the relevant property to which the "taken" portion is compared, the diminution in value test emerges as a deep pocket rule, as holders of extensive property must suffer a greater diminution in value in order to establish a takings claim. Conversely, contracting the relevant property interest . . . may turn every regulation into a taking.

Rose, *supra* note 69, at 568.

risdictions, junior secured parties have been effectively proscribed from taking possession of their collateral.<sup>80</sup> Although this prohibition is found nowhere in the Code, courts have grafted this principle onto the concept of priority and held that repossession is a conversion of the priority creditor's interest.<sup>81</sup> Nor is the secured creditor's loss of remedy its only loss.<sup>82</sup> Furthermore, correct implementation of the senior lien creditor's priority depends upon the diminishment of the value of the subordinated lien.<sup>83</sup> Generalizations are difficult because creditors vary in a myriad of ways, and thus no loss of priority will have exactly the same impact in two different cases. Differences in the total value of all available collateral and in the amount of the senior debt may mean, for example, that a senior lien that would have the effect of denying secured status to the junior creditor in one case would pose no significant threat to the junior creditor's position in the next case. Even though we may be left guessing whether the extent of the diminution in value meets the required threshold for a taking, the effects of subordination reveal its potential to cause significant harm to the junior creditor's interest unless safeguards are instituted.

### C. *The Contingent Nature of Security Interests and the Code's "Just Compensation" Principle*

A principle burden of the argument thus far has been to show that security interests are property. Implicit in this proposition is the premise that the interest should be protected by a property rule.<sup>84</sup> Within the conventional framework of the common law, this notion is inherent in the jurisprudence of property law. Yet, perhaps the most noteworthy comment that can be made about an Article 9 security interest is that it may be contingent and terminable under certain conditions.

A commonly offered rationale for the contingency of security interests is that it is necessary in order to satisfy society's goal of achieving

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80. See, e.g., *General Elec. Credit Corp. v. Town & Country Mobile Homes, Inc.*, 574 P.2d 50, 54 (Ariz. Ct. App. 1977) (holding that a perfected security interest had priority over an unperfected retained security interest); *International Harvester Creditor Corp. v. Commercial Credit Equip. Corp.*, 188 S.E.2d 110, 113 (Ga. Ct. App. 1972) (finding that a purchase money security interest in a money debt did not have priority over the purchase money security interest in the goods, thus, first party prevailed in the conversion suit); *Barnett v. Everett Trust & Sav. Bank*, 534 P.2d 836, 837-38 (Wash. Ct. App. 1975) (finding that repossession by a successor in interest to a purchaser after judicial foreclosure constituted conversion).

81. See cases cited *supra* note 80.

82. For example, if the junior secured party neglects to give written notice of its claim to the senior secured party, it is not entitled to "reasonable notification" of a proposed disposition of the collateral. U.C.C. § 9-504(3). Neither is the junior party entitled to a distribution of excess proceeds. See U.C.C. § 9-504(1).

83. See *supra* notes 74-79 and accompanying text.

84. See *supra* notes 38-39 and accompanying text.

efficient outcomes.<sup>85</sup> Perhaps most significantly, contingency promotes efficiency by facilitating the integrity of the marketplace. For example, consider the protection afforded to the buyer in ordinary course who purchases from inventory. The buyer will take free of all security interests "created by his seller."<sup>86</sup> The ordinary course of business rule is justified by its minimization of transaction costs to facilitate economic exchange. Buyers are no longer required to search for outstanding liens. To require otherwise necessarily would interfere with the efficiency of the market because of the large volume of purchases from inventory and the fact that in the vast majority of cases the sale has been authorized by the secured party.<sup>87</sup> As Professor Grant Gilmore has noted, the good faith purchaser "is protected not because of his praiseworthy character, but to the end that commercial transactions may be engaged in without elaborate investigation of property rights and in reliance on the possession of property by one who offers it for sale or to secure a loan."<sup>88</sup>

The contingency of security interests raises the question of principle concern here: whether the secured party is justly compensated for the taking?<sup>89</sup> The discussion of compensation might be generalized by supposing once again that the transaction at issue involves the purchase from inventory by a buyer in the ordinary course of business. Although the original security interest terminates, subsections (1) and (2) of section 9-306 provide for the automatic attachment of the security interest to proceeds.<sup>90</sup> In other words, the Code gives the secured

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85. See, e.g., Baird & Jackson, *supra* note 3 (arguing that legal rules should balance the risk of loss between prior owners and subsequent owners); Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 Yale L.J. 1143 (1979) (examining the priority rules of Article 9); Alan Schwartz, *A Theory of Loan Priorities*, 18 J. Legal Stud. 209 (1989) (advocating the abolition of the "first in time is first in right" principle in creditor law).

86. U.C.C. § 9-307(1). For a thoughtful discussion of the section's "created by his seller" requirement, see William H. Lawrence, *The "Created by His Seller" Limitation of Section 9-307(1) of the U.C.C.: A Provision in Need of an Articulated Policy*, 60 Ind. L.J. 73 (1984).

87. If the disposition of the collateral is authorized by the secured party, the security interest will terminate pursuant to § 9-306(2). See *supra* note 54. The section has been rationalized in terms of waiver. See *Swift & Co. v. Jamestown Nat'l Bank*, 426 F.2d 1099, 1103-04 (8th Cir. 1970).

88. Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 Yale L.J. 1057, 1057 (1954). See also Barkley Clark, *The Law of Secured Transactions Under the Uniform Commercial Code* § 3.04 (2d ed. 1988) (stating that section 9-307(1) "encourages the marketability of goods and supports the reliance interest of buyers who assume that they have clear title to the goods they purchase.").

89. This cursory explanation for the contingency of security interests is intended to suggest that there are principled reasons which justify treating security interests differently from other property interests. One qualification is necessary here. In this section, the concern is with only those takings of security interests which can be said to occur at the very moment that the competing interest comes into existence. Later this Article will address takings that occur sometime after the competing interest is acquired. See *infra* notes 97-102 and accompanying text.

90. Section 9-306 states that:

party a substituted property interest in any items received by the debtor upon the disposition of the contractually granted collateral.<sup>91</sup> Thus, one can conclude that the secured party has been justly compensated for its loss.<sup>92</sup>

The question of just compensation is somewhat more difficult when the secured party's interest is "taken" without a corresponding disposition of the collateral. What is important to appreciate about the current scope of the term "proceeds" under section 9-306 is that it has a transactional focus. The secured party obtains a security interest in anything received upon the "sale, exchange, collection or other disposition of" the collateral.<sup>93</sup> Accordingly, most courts have taken the position that the debtor must have transferred title to the collateral before an asset can be classified as proceeds of that collateral.<sup>94</sup> This has, for example, led to a series of decisions which have denied proceeds status to such items as lease payments,<sup>95</sup> and cash

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(1) "Proceeds" includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds. Insurance payable by reason of loss or damage to the collateral is proceeds, except to the extent that it is payable to a person other than a party to the security agreement. Money, checks, deposit accounts, and the like are "cash proceeds." All other proceeds are "non-cash proceeds."

(2) Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

U.C.C. § 9-306(1)-(2).

91. In fact, the claim to proceeds is automatic and is in no way dependent upon the presence of a proceeds clause in the security agreement. *See id.* § 9-203(3) ("Unless otherwise agreed a security agreement gives the secured party the rights to proceeds provided by Section 9-306."). Moreover, if the security interest in the original collateral does not terminate upon its disposition, the secured party will be able to pursue both that collateral *and* its proceeds. Of course, while the value of both items is available, the secured party can have only one satisfaction. *See id.* § 9-306 cmt. 3.

92. Just compensation under the takings clause is "market value fairly determined," *Olson v. United States*, 292 U.S. 246, 255 (1934), or "what a willing buyer would pay in cash to a willing seller" at the time of the taking. *United States v. Miller*, 317 U.S. 369, 374 (1943). It is probably safe to assume that the proceeds received by the debtor upon a sale of the collateral will closely approximate this standard.

93. U.C.C. § 9-306(1).

94. *See, e.g., In re Hastie*, 2 F.3d 1042, 1045 (10th Cir. 1993) ("[E]ach of the foregoing events describes an event whereby one asset is disposed of and another is acquired as its substitute.").

95. *See, e.g., In re Cleary Brothers Constr. Co.*, 9 B.R. 40, 41 (Bankr. S.D. Fla. 1980) ("Had the Sponsors intended . . . to include rent for temporary use of collateral . . . they would have included the term 'leased.'"); *In re Corpus Cristi Hotel Partners*, 133 B.R. 850, 855 (Bankr. S.D. Tex. 1991) (finding that hotel revenues are not proceeds). *But see In re Investment Hotel Properties*, 109 B.R. 990, 995 (Bankr. D. Colo. 1990) (finding that payment for the use of hotel rooms is proceeds post-petition); *In re Southern Equip. Sales Co.*, 24 B.R. 788, 794 (Bankr. D.N.J. 1982) (finding that lease payments on equipment are proceeds). The Permanent Editorial Board for the U.C.C. has taken the position that the right to receive rentals is proceeds:

dividends.<sup>96</sup>

Examples of such denials of proceeds status include subordination of the security interest to a later-in-time judicial lien creditor<sup>97</sup> and subordination to a later-in-time secured party.<sup>98</sup> In these cases the Code provides no compensation.<sup>99</sup> This uncompensated taking is, in significant part, an effort to promote the public notice features of Article 9.<sup>100</sup> If subordination serves as the motivation for public notice, perfection of the security interest ordinarily would provide the secured party with the necessary protection against loss.

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Where a debtor has granted to a secured party a security interest in goods that the debtor later leases as lessor, the lease rentals would constitute proceeds of the secured party's collateral for the reason that the debtor's conveyance of a leasehold interest in the goods constitutes a disposition of the goods for purposes of § 9-306(1).

PEB Commentary On The Uniform Commercial Code: Commentary No. 9, reprinted in [Findex/PEB Commentaries] U.C.C. Rep. Serv. 2d (Callaghan) [hereinafter *PEB Commentary 9*].

96. See, e.g., *In re Hastie*, 2 F.3d 1042, 1046-47 (10th Cir. 1993) (finding that the receipt of cash dividends is not within the definition of proceeds). Courts have drawn a distinction between ordinary cash dividends and a liquidating dividend. The latter would seem to be proceeds. See, e.g., *Aycock v. Texas Commerce Bank, N.A.*, 127 B.R. 17, 19 (Bankr. S.D. Tex. 1991) (finding that where the principal is proceeds, the secured party is entitled to interest earned on liquidating dividends).

97. See U.C.C. § 9-301(1)(b).

98. See, e.g., *id.* § 9-312(5) ("Conflicting security interests rank according to priority in time of filing or perfection."). Because the later-in-time secured party has pre-filed pursuant to § 9-401(1), its lien is perfected the moment it attaches. However, if the later-in-time secured party has not pre-filed, the case resembles that of lapsed perfection. Consider the following: D grants security interests in the same equipment to Secured Party-1 (SP-1) and Secured Party-2 (SP-2), respectively. If both security interests initially are unperfected, SP-1's security interest will have priority pursuant to the § 9-312(5)(b) first-to-attach rule. However, SP-1's priority is not necessarily permanent. If SP-2 proceeded to file first, it would achieve priority by operation of § 9-312(5)(a)'s first-to-file or perfect rule.

Although the scope of this Article is limited to cases where the first-in-time secured party was initially perfected, it should be pointed out that there is no obvious theoretical justification for SP-1's loss of priority in the foregoing hypothetical. Arguably such an outcome encourages prompt filing, while underscoring the perceived benefits of Article 9's public notice rules. That argument, however, is not persuasive. First, § 9-312 does not appear to have been designed to protect the basic expectations of SP-2. Though SP-2 might have fixed its expectations based on the absence of a filing by SP-1, that assumption does not support a priority rule based on time of filing. In the hypothetical given, if SP-1 files first, but subsequent to SP-2's security interest, SP-1 will have priority, notwithstanding SP-2's reliance. If this law is intended to protect SP-2, it is ineffective.

99. See *supra* note 89 and accompanying text.

100. Both §§ 9-301(1)(b) and 9-312(5) are race priority provisions. Once the secured party takes the steps necessary to perfect its interest, subsequent lien creditors and secured parties cannot prevail. This approach implicitly assumes that publicizing a security interest advances important values. It has been said, for example, that publication permits the efficient movement of goods by reducing the "innocent purchaser risk." See Harold R. Weinberg, *Sales Law, Economics, and Negotiability of Goods*, 9 J. Legal Stud. 569, 570 n.7 (1980).

In most cases, a perfected security interest will not be subordinated to later-in-time claimants. There are, however, exceptions. If the collateral is negotiable or "quasi" negotiable paper, even a perfected secured party may risk subordination.<sup>101</sup> In addition to requiring public notice of a security interest, this outcome represents a general effort to promote the free alienability of a particular type of property. In such a case the secured party usually can protect itself. The official comments to section 9-308 reflect this idea by suggesting that a secured party "who wishes to leave the paper in the debtor's possession can . . . protect himself against purchasers by stamping or noting on the paper the fact that it has been assigned to him."<sup>102</sup>

A general conclusion emerges from the discussion: The Code provides compensation to secured parties when the particular context suggests that the taking cannot reasonably be avoided. For example, when the security interest is in inventory held for sale, there is usually little that the secured party can do to preserve its lien.<sup>103</sup> A security interest does not survive a sale if the secured party somehow authorized the disposition.<sup>104</sup> This result is the natural outcome in the case of inventory. Also, even when a sale of inventory is unauthorized, section 9-307(1) will protect all buyers in the ordinary course of business. In either event, although the secured party loses its interest in the inventory and has no further claim to it, the party still has claim to proceeds.

The same concern for the secured party also arises when, for some other reason, the security interest is the subject of an unavoidable taking. This latter category includes all cases where there has been an unauthorized disposition of the collateral<sup>105</sup> and cases where the col-

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101. *See, e.g.*, U.C.C. §§ 9-308 ("Purchase of Chattel Paper and Instruments."), 9-309 ("Protection of Purchasers of Instruments, Documents, and Securities."). The Code provides for subordination of a perfected security interest in several other cases. These cases, however, are unlikely to occur. *See id.* § 9-313(4),(7) (providing, in part, that a non-purchase money security interest will be subordinate to a prior recorded interest of an encumbrancer of the real estate). A subordination may occur where the new priority claimant has caused the collateral to appreciate in value. *See id.* § 9-310 ("Priority of Certain Liens Arising by Operation of Law.").

102. *Id.* § 9-308 cmt. 3. Of course, an uncompensated taking would only occur if the purchaser is a secured party. *See id.* § 1-201(32) ("Purchase" includes taking by sale, discount, negotiation, mortgage, pledge, lien . . ."). If the paper were sold, its "disposition" would give rise to a proceeds claim.

103. In situations where the secured party wishes maximum protection against debtor misconduct, it can setup a "field warehouse" or use a more modern arrangement known as a "certified (or 'verified') inventory control." But either method will add to the cost of the loan and may, therefore, be impractical. *See generally* James T. McGuire, *The Impact of the UCC on Field Warehousing*, 6 UCC L.J. 267, 277-83 (1974) (discussing the impact of Article 9 on the existence and importance of field warehousing).

104. U.C.C. § 9-306(2).

105. While the nature of the disposition as authorized or not will have no effect on the secured party's right to proceeds, it may, however, dictate whether the security interest will continue in the original collateral. *See id.*



lateral has been processed or commingled.<sup>106</sup> Consequently, the Code provides a coherent and unitary framework for preserving the value of the creditor's security interest. The Code does not proscribe every taking of a secured party's property, only those without just compensation.

### III. THE LAPSED PERFECTION DOCTRINE

The implications of the implicit takings jurisprudence of Article 9 for the lapsed perfection doctrine are fairly straightforward. The lapsed perfection controversy, in fact, is one that permits an unusually easy application of takings jurisprudence.

The doctrine of lapsed perfection fails in most respects to conform to the fundamental values inherent in the Code's approach to takings. Moreover, accepting that the Code implicitly reflects a jurisprudence of takings undermines the vision of commercial rationality inherent in the treatment that lapsed perfection has received under the Code. The nature and reach of the lapsed perfection doctrine can best be understood by considering several contexts in which it is likely to become relevant.<sup>107</sup> This Article contends that the proper solutions to all lapsed perfection problems can be derived from the compensation principle of Article 9, and that these solutions are the only practical means of resolving the dilemma without disrupting the scheme of priorities and expectations established by the Code.

#### A. Section 9-103: Multiple-State Transactions

Section 9-103(1) provides that a security interest in ordinary goods,<sup>108</sup> if perfected in state X, continues to be perfected after the debtor moves the goods into state Y until either the state X perfection expires or four months elapse, whichever occurs first.<sup>109</sup> The follow-

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106. Where the collateral has been processed or commingled, the secured party will be compensated by being able to lay claim to the resulting product or mass. *See generally* David Frisch, *UCC Section 9-315: A Historical and Modern Perspective*, 70 Minn. L. Rev. 1, 24-28 (1985) (arguing that a pre-confusion purchase money security interest in goods should continue in a confused mass).

107. This part of the Article is not intended as an exhaustive list of these contexts but rather as a demonstration of their number and variety.

108. "Ordinary goods" in § 9-103 is a residual category which includes goods "other than those covered by a certificate of title described in subsection (2), mobile goods described in subsection (3), and minerals described in subsection (5)." U.C.C. § 9-103(1)(a).

109. U.C.C. § 9-103(1)(d) provides in relevant part:

When collateral is brought into and kept in this state while subject to a security interest perfected under the law of the jurisdiction from which the collateral was removed, the security interest remains perfected, but if action is required by Part 3 of this Article to perfect the security interest,

(i) if the action is not taken before the expiration of the period of perfection in the other jurisdiction or the end of four months after the collateral is brought into this state, whichever period first expires, the security interest becomes unperfected at the end of that period and is thereafter deemed to

ing sequence of events can be used to demonstrate how some lapsed perfection priority issues might arise:<sup>110</sup>

- March 1 — Secured Party-1 (SP-1) perfects (by filing) a security interest in state X.
- April 1 — The debtor moves the collateral to state Y.
- May 15 — L acquires a judicial lien on the collateral in state Y or Debtor sells the collateral to B in state Y or Secured Party-2 (SP-2) perfects security interest in the collateral in state Y.  
Assume that SP-1 never reperfects its security interest in state Y. What is the result?

In each case, it is clear that SP-1 had priority for the four months immediately following the removal of the collateral to state Y, and that its priority would have continued had it refiled before the end of that period.<sup>111</sup> The question is whether SP-1's priority is permanent, notwithstanding its failure to file in state Y, i.e., after its perfection lapsed.<sup>112</sup> This issue became particularly pronounced before the 1972 revision of Article 9 took effect. Prior to 1972, the Code provided no clear answer, and the law thus reflected a puzzling and relatively ad hoc set of outcomes about when a priority once gained could be lost.<sup>113</sup> All this has changed.

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have been unperfected as against a person who became a purchaser after removal; (ii) if the action is taken before the expiration of the period specified in subparagraph (i), the security interest continues perfected thereafter

U.C.C. § 9-103(1)(d).

110. The lapsed perfection issues under § 9-103(1) will all involve the transportation of collateral because the choice of law rule adopted thereunder is the law of the location of the collateral. With other types of collateral (accounts, general intangibles, mobile goods, and sometimes chattel paper) lapse problems might arise when the debtor relocates. These problems can occur because the location of the debtor dictates the choice of law rule for filing. *See id.* § 9-103(3)-(4). The universe of lapse issues that are possible under § 9-103 can also arise following the intrastate movement of collateral or relocation of the debtor in those states which have adopted alternative subsection (3) to § 9-401.

111. *See supra* note 109.

112. Another way of asking the same question is whether the four-month period is a grace period or is an absolute period of protection of the secured party's interest. If viewed as a grace period, the failure of the secured party to file within four months would mean that its security interest would be deemed unperfected from the moment the collateral entered the state. Indeed, grace periods can be found in Article 9. *See, e.g.,* U.C.C. §§ 9-301(2) (giving a secured party that files within ten days after the debtor takes possession of the collateral priority over the rights of certain transferees between the time of attachment and perfection), 9-312(4) (stating that a purchase money security interest in collateral has priority over a conflicting interest in the collateral if perfected at the time the debtor takes possession).

113. A New York court was one of the first courts to hold that the four-month period was not a grace period for filing. *See Churchill Motors, Inc. v. A.C. Lohman, Inc.*, 229 N.Y.S.2d 570, 577 (App. Div. 1962). In *Churchill Motors*, the court ruled that § 9-103 allowed the secured party four months of absolute perfection. *Id.* For identical holdings see also, *First Nat'l Bank v. Stamper*, 225 A.2d 162, 169 (N.J. Super. Ct. Law Div. 1966) (stating that the four-month period is intended to provide suffi-

The 1972 Code's approach to these cases can be summarized as follows: if the secured party's perfection lapses because it delays beyond the four-month period, its interest will be subject to defeat by anyone who purchased the collateral during that period.<sup>114</sup> Thus, returning to the foregoing hypothetical, under the 1972 approach, SP-1 would continue to have priority over L; it would have its interest terminated in favor of B; and it would have its interest subordinated to that of SP-2.<sup>115</sup> This result presents the appropriate question: What is the theoretical justification for the reversal of priorities with respect to B and SP-2?

It is fair to assume that the primary reason for SP-1's loss of priority is to protect third parties *other than B and SP-2*. This becomes apparent if we recognize that, notwithstanding their reliance on the absence of a filing by SP-1 in state Y, SP-1 would continue to have priority if it

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cient time for investigation and location of the collateral); *Newton-Waltham Bank and Trust Co. v. Bergen Motors, Inc.*, 327 N.Y.S.2d 77, 81 (Civ. Ct. 1971) (stating that during the four-month period there is absolute protection throughout the nation while the party searches for the missing property); *Al Maroone Ford, Inc. v. Manheim Auto Auction, Inc.*, 208 A.2d 290, 293 (Pa. Super. Ct. 1965) (stating that failure to file during the four-month period does not affect the secured party's status); *Morris v. Seattle-First Nat'l Bank*, 516 P.2d 1055, 1057 (Wash. Ct. App. 1973) (stating that a secured interest continues to be perfected for the first four months regardless of whether the secured party complied with state procedures). *But see United States v. Squires*, 378 F. Supp. 798, 804 (S.D. Iowa 1974) (holding that a party who does not perfect its security interest after a lapse of four months has a junior interest to the buyer for value); *Arrow Ford, Inc. v. Western Landscape Constr. Co.*, 532 P.2d 553, 558 (Ariz. Ct. App. 1975) (choosing to adopt a conditional protection interpretation of the 1962 provision).

114. *See supra* note 109 for the text of § 9-103(1)(d).

115. Whether or not a party is a purchaser will depend upon whether she acquired her interest in property in a voluntary transaction. *See U.C.C. § 1-201(32)-(33)*. Accordingly, only B and SP-2 will have their respective priorities reversed after lapse. *See Review Committee for Article 9 of the Uniform Commercial Code, Permanent Editorial Board for the Uniform Commercial Code, Final Report, Appendix: General Comment on the Approach of the Review Committee of Article 9, at 193, 245 (Apr. 25, 1971) [hereinafter Final Report]* ("The negative inference is that judgment lienors remain subordinate."). *But see Prairie State Bank v. IRS.*, 745 P.2d 966, 971 (Ariz. Ct. App. 1987) (holding that § 9-103(1)(d) protects intervening lien creditors, regardless of whether they are purchasers). It is unknown why the drafters decided to treat lienors differently from purchasers. Whenever SP-1 is provided with absolute protection against the claims of intervening lien creditors, however, it obviates problems that SP-1 might otherwise encounter under section 544(a) of the Bankruptcy Code. *See 48 A.L.I. Proceedings 256-60 (1972)*.

Because B now owns the collateral free of SP-1's interest, it should also follow that any claim SP-1 might have had for conversion, will vanish with its priority. *See text accompanying supra* note 81. It would be peculiar if SP-1 were still permitted to recover the value of the collateral from B. The Review Committee for Article 9, in an attempt to rationalize this puzzling outcome, characterizes the situation in terms of priority only. *See Final Report, supra*, at 237 ("While technically the conversion was complete at the time of purchase, it is to be hoped that the proposed clarification of the effect of lapse will cause similar cases to be analyzed in the future in terms of priority, not of conversion.").

files within the four-month period.<sup>116</sup> If the Code intended to protect the expectations of B and SP-2, the rule would be otherwise.<sup>117</sup> But concern for third parties misses the simple point that their respective priority is independent of how SP-1 fares against B and SP-2. For example, regardless of the relative priority of SP-1 and SP-2 inter se, one who buys the collateral after the perfection of SP-1's interest lapses will take free of that interest. Therefore, a reversal of priorities is not necessary to protect the buyer against SP-1 because its priority is assured by section 9-301(1)(c). Consequently, there is no apparent reason why the lapsed filing should cause SP-1 to lose its original priority over any third party, including purchasers.<sup>118</sup>

Perhaps most important, the drafters' approach to the problem of lapse in section 9-103(1)(d) runs afoul of the Code's takings jurisprudence. To the extent that SP-1's security interest is subordinated to the interest of SP-2, there has been a taking for which no compensation has been provided. This result occurs because the transaction between the debtor and SP-2 has failed to generate any proceeds to which SP-1's security interest could attach.<sup>119</sup>

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116. If SP-1 makes a timely filing in the removal jurisdiction (within the four-month period) its security interest continues to be perfected without interruption under U.C.C. § 9-103(1)(d). With no break in perfection, the security interest will have priority over the later-acquired interests of B and SP-2. *See* U.C.C. §§ 9-201, 9-301(1)(c), 9-306(2), 9-312(5).

117. A major consequence of the four-month rule is that fraudulent debtors can go a long way towards making a filing disappear simply by taking goods across state lines. Thus, an innocent third party who wishes to acquire an interest in the collateral must assure herself that the goods have been in-state for a least four months or she must check (assuming this information can be obtained) for a filing in every state where the debtor does or has done business. If the primary objectives of Article 9 were to reduce the risk to third parties and their information acquisition costs, one might consider treating the security interest as unperfected the moment the collateral leaves the state in which the secured party filed.

118. Some have suggested that the conditional priority approach of § 9-103 is necessary in order to eliminate circular priority problems in the case of purchasers. *See, e.g.,* D. Fenton Adams, *The 1972 Official Text of the Uniform Commercial Code: Analysis of Conflict of Laws Provisions*, 45 *Miss. L.J.* 281, 330-31 (1974) (stating that the four-month rule eliminates some of the circular priority problems); Paul J. Petit, *Choice of Law Under Article Nine of the UCC*, 7 *Loy. U. Chi. L.J.* 641, 661-62 (1976) (“[I]t is clear that the only reasonable conclusion is that the perfection bestowed by the four-month grace period of 9-103(3) is conditional upon filing in the state to which the goods have been removed within the four-month period.”). To be sure, a conditional approach to lapse is a viable method for untangling the circular priority dispute that would arise if the Code permitted SP-1 to retain its priority. (SP-1 is senior to SP-2; SP-2 is senior to the buyer; the buyer is senior to SP-1). But until we have some idea of the costs that such a situation would generate, we cannot say that SP-1's loss of priority is warranted. *See* Pearson, *supra* note 9, at 43 n.131 (“The avoidance of [the circular priority] problem should never become the sole rationale supporting the imposition of conditional protection upon a secured party.”); *see also infra* notes 128-30 and accompanying text (discussing the problems with circular priority).

119. This is because there has been no “sale, exchange, collection or other disposition of collateral . . .” U.C.C. § 9-306(1).

By contrast, the sale to B does give rise to proceeds which are available to SP-1, at least in theory, and which arguably legitimize the taking. This view, however, completely ignores the crucial fact that SP-1 is presumptively unaware of the debtor's activities and is in no position to protect its interest in those proceeds. After all, the underlying premise of section 9-103(1)(d) is that the secured party needs four months to discover that the collateral has been removed.<sup>120</sup> Upon comparison, therefore, a fundamental difference exists between a sale by the debtor within the initial four-month period and a sale after the expiration of that period. Only in the latter situation were the drafters willing to presume that the secured party would be able to assert an effective claim to proceeds. This explains why a rule which makes SP-1's original priority over B absolute logically discriminates between B and a buyer who purchases the collateral after the filing in state X has lapsed.<sup>121</sup>

To summarize, the drafters' decision to treat purchasers differently from lien creditors in section 9-103(1)(d) is seriously flawed because in neither case will the secured party be compensated for the resultant taking.<sup>122</sup> Implicit in the four-month rule is an assumption that during that period the secured party has lost track of its collateral. Thus, even if a transaction with the debtor prior to lapse gives rise to proceeds, it is unlikely that the secured party will be in a position to lay claim to them. The implication of this view is that in the context of section 9-103, *all* pre-lapse priorities should be preserved post-lapse.

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120. See U.C.C. § 9-103 cmt. 7 ("The four-month period is long enough for a secured party to discover in most cases that the collateral has been removed and refile in this state . . .").

121. Indeed, the idea of discriminating against pre- and post-lapse buyers is particularly troublesome to some courts. For example, the Indiana Court of Appeals emphasized:

[T]he absolute protection construction works a blatant inequity in the case of an innocent purchaser who by misfortune happens to purchase the collateral three months and thirty days after removal. Had the unknowing purchaser waited one more day to buy, he would take priority over the secured party. His unwitting purchase at the wrong time, however, permanently subordinates him to the security holder.

*International Harvester Credit Corp. v. Pefley*, 458 N.E.2d 257, 264 n.5 (Ind. Ct. App. 1983). This Article concedes that this is a compelling hypothetical. But rationality of rules cannot always be assessed through formal criteria of consistency. Appeals to formal consistency of outcomes must be jettisoned to develop more meaningful approaches to a problem. This Article has shown that there is a conceptual difference between the two buyers. See *supra* text accompanying notes 116-18. A bright-line test is justified in these circumstances because any other test would undermine the certainty of application which this context requires.

122. *But cf.* Pearson, *supra* note 9, at 45 ("Section 9-103(1)(d) produces thoroughly acceptable results in priority conflicts generated by the removal of collateral from one state to another.").

B. *Section 9-403: The Effectiveness of a Financing Statement*

Subsections (2) and (3) of section 9-403 provide that the effectiveness of a filed financing statement lapses after five years unless the secured party files a continuation statement within six months prior to the end of the five-year period.<sup>123</sup> As in the case of multiple state transactions, the failure of the secured party to take the action necessary to maintain its perfection may potentially impact existing priorities. To illustrate, assume:

- March 1, 1990 — Secured Party-1 (SP-1) perfects (by filing) a security interest in equipment.
- April 1, 1994 — L acquires a judicial lien on the collateral or Debtor sells the collateral to B or Secured Party-2 (SP-2) perfects a security interest in the collateral.
- March 15, 1995 — SP-1 has never filed a continuation statement.

What should be done post-lapse about SP-1's pre-lapse priority over all three parties?<sup>124</sup> Concern and debate over the drafters' intended solution to this problem ended with the 1972 version of section 9-403(2).<sup>125</sup> This section now provides that "[i]f the security interest becomes unperfected upon lapse, it is deemed to have been unperfected as against a person who became a purchaser or lien creditor before lapse."<sup>126</sup>

Some strongly support this rule of conditional protection, at least in the case of intervening, pre-lapse purchasers. Michael Pearson, for example, concludes that resolving the issue in this way protects those "reliance" third parties who do not anticipate that the purchased property is encumbered by an existing security interest.<sup>127</sup> Those who

123. U.C.C. § 9-403(2)-(3). The five-year period of filing effectiveness is inapplicable if the debtor is a transmitting utility or if a real estate mortgage serves as a fixture filing. In the former case, the filing is effective until a termination statement is filed. *Id.* § 9-403(6). In the latter case, the filing is effective until the mortgage is terminated. *Id.*

124. SP-1 has priority by virtue of U.C.C. §§ 9-201, 9-301(1)(a)-(c), 9-312(5).

125. The 1962 version of § 9-403(2) simply stated that "[u]pon such lapse the security interest becomes unperfected." *Id.* § 9-403(2) (1962). In comment 3, however, the drafters stated that after lapse, the security interest can be defeated by those persons who take priority over an unperfected security interest. *Id.* Because a second secured party is such a person, see *id.* §§ 9-301(1)(a), 9-312(5), several courts held that an intervening subordinated secured party steps-up in priority after lapse. See, e.g., *Eastern Ind. Prod. Credit Ass'n v. Farmers State Bank*, 287 N.E.2d 824, 826 (Ohio Ct. App. 1972) (holding that a party with a conflicting subordinated perfected security interest takes priority after lapse); *Morse Electro Prods. Corp. v. Beneficial Indus. Loan Co.*, 579 P.2d 1341, 1343-44 (Wash. 1978) (same). Not all commentators agreed. See, e.g., Comment, *Section 9-103 and the Interstate Movement of Goods*, 9 B.C. Indus. & Com. L. Rev. 72, 84-85 (1967) (disputing the proposition that a conflicting subordinated perfected security interest takes priority over an out-of-state secured creditor who does not perfect his interest within the four-month period).

126. U.C.C. § 9-403(2).

127. Pearson, *supra* note 9, at 23-24.

rely on the expectations of pre-lapse purchasers to advocate a reordering of priorities, however, forget that when these intervening interests were first acquired SP-1 had priority. When subordination is the outcome, absent lapse, no other outcome after lapse can be said to reflect the original expectations of the parties. In these cases, no coherent notion of advancing the priorities of particular parties can be constructed out of a preference to protect expectations.

The only hint given by the drafters for their policy choice in section 9-403(2) is the statement in comment 3 that the rule selected "avoids the circular priority which arose under some prior statutes."<sup>128</sup> Yet, this type of conflict occurs more infrequently than typically assumed in discussions of proposed solutions to the problem.<sup>129</sup> Moreover, when these conflicts do arise, courts and commentators have provided us with a variety of simple techniques for breaking the circle.<sup>130</sup>

Rules chosen for no other reason than to avoid circular disputes, therefore, cannot be represented as desirable. Because this objective should not dictate the proper solution to lapse issues, thinking in such terms makes it impossible to consider whether a particular decision to reverse priorities was rational—that is, whether it was based on normatively persuasive conceptions of the appropriateness of devaluing SP-1's interest.

Respect for property rights demands discrimination in the selection of outcomes after lapse. Lien creditor and purchaser cases are initially distinguishable. In the lien creditor case, no proceeds are taken in return. This is a provocative challenge to the legitimacy of the conditional protection rule of section 9-403(2). If the arguments regarding expectations and circular priority do not explain the section's approach, there is little reason to believe that there are any policies which would, in this context, outweigh the social interest in preserving the secured party's property interest.

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128. U.C.C. § 9-403(2) cmt. 3.

129. See Pearson, *supra* note 9, at 15 ("Circular priority systems created by lapsed filings have been extremely rare in the last half century . . .").

130. See, e.g., *In re Quaker City Uniform Co.*, 238 F.2d 155, 159 (3d Cir. 1956) (discussing approaches taken by various courts to lien subordination in bankruptcy context); *Hoag v. Sayre*, 33 N.J. Eq. 552, 562 (N.J. Ch. 1881) (Dixon, J., dissenting) (stating that where senior party fails to comply with registry laws the effect is not that junior parties supplant the senior, but that the senior's lien is void as to the junior); *In re 250 Bell Road*, 388 A.2d 297, 300 (Pa. 1978) (resolving circuitry problem by applying the Pennsylvania temporal priority rule); Carville D. Benson, Jr., *Circuitry of Lien—A Problem in Priorities*, 19 Minn. L. Rev. 139, 153 (1935) (proposing as a solution to the circuitry problem that all claimants be treated as junior lienholders); Albert Kocourek, Note, *Diversities De La Ley: A First-Rate Legal Puzzle—A Problem in Priorities*, 29 Ill. L. Rev. 952, 955 (1935) (solving circuitry problem by resort to the parties' legitimate expectations). See generally 2 Grant Gilmore, *Security Interests In Personal Property* 1020-46 (1965) (proposing solutions and describing several approaches to litigation of priorities).

When one shifts from lien creditors (whose transactions with the debtor never produce proceeds) to intervening purchasers, interjecting greater contingency into the realm of security interests may be acceptable. The case for a rule of conditional protection will properly turn, at least in part, upon whether proceeds are directly attributable to the disposition of the collateral. Keep in mind that "purchasers" can take many forms.<sup>131</sup> SP-2 is one form of purchaser. The earlier critique of intervening secured parties is applicable here.<sup>132</sup> The law should not elevate SP-2 to a position of priority because its transaction with the debtor produces no proceeds.

Consequently, the conditional approach in the case of B might well be defended on the ground that its transaction with the debtor did produce proceeds that were directly attributable to the original collateral. But we have seen that sometimes a secured party cannot plausibly be expected to learn of the disposition in time to protect its interest. In these circumstances, the economic value of the proceeds claim is insufficient compensation for the loss of priority.<sup>133</sup> The resolution of the compensation issue calls for an inquiry into something other than whether there is a transactional link between the original collateral and the debtor's acquisition of new property. In examining those other considerations, reference to considerations of both fact and policy must be made.

A secured party's ability to reach proceeds is never certain because it always depends on their being identified as such.<sup>134</sup> Sometimes identification fails because of the debtor's misbehavior. For example, in many instances where the collateral is sold without the secured party's authorization, the debtor most likely did so with the specific intention of absconding with or somehow dissipating the proceeds. Here the secured party would have to act promptly to protect its interest. Even if the sale was authorized, unanticipated consequences are common. For example, the nature of the collateral may exacerbate the secured party's risks. This is a particularly acute problem in the context of cash proceeds. If the proceeds have been commingled with other funds, a secured party who cannot use a tracing device to make them "identifiable" will not be able to claim them as his own.<sup>135</sup>

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131. See *supra* note 102.

132. See *supra* notes 118-19 and accompanying text.

133. See *supra* notes 120-21 and accompanying text.

134. See U.C.C. § 9-306(1).

135. Except for the statement in § 9-306 cmt. 2 that for insolvency proceedings "[p]aragraphs 4(a) through (c) substitute specific rules of identification for general principles of tracing," there is nothing in the Code to suggest that the drafters intended that the unidentifiable could be made identifiable by resort to fictional tracing. Despite this silence, most courts have allowed the secured party to identify commingled monies by using the lowest intermediate balance method of tracing. See, e.g., *Brown & Williamson Tobacco Corp. v. First Nat'l Bank*, 504 F.2d 998, 1002 (7th Cir. 1974) ("[E]xamining the language of the Code, in light of its purpose, we conclude that the more reasonable implication is that the proceeds may be identifiable, and the



Moreover, if cash proceeds are paid out by the debtor in the ordinary course of its business, anyone who receives the payment without knowledge or reason to know of the secured party's interest will take free of that interest.<sup>136</sup>

All this might suggest that a more accurate approach to the compensation question would be to decide in each case whether the secured party has a realistic chance of reaching the proceeds. Whatever the abstract merits of a particularized inquiry into the specifics of each case may confer, there are too many individual contexts and factual settings for this idea to lend itself well to implementation.<sup>137</sup> A more manageable approach would be to determine under what circumstances the risk will be so exceptionally high that the secured party's interest in proceeds will not be viable. When relatively high risk exists, the rules of Article 9 can be adjusted accordingly. For example, the drafters recognized that the interstate relocation of collateral is a factor that can thwart even the most diligent secured party. For this very reason, the secured party is given four months to track down its collateral and take whatever lawful action it deems appropriate.<sup>138</sup> The goal is to detect situations like the foregoing, which are reasonably reliable indicators of when a secondary claim to proceeds is unlikely to constitute effective compensation.

Where, as in the preceding example, proceeds from the disposition of collateral have not changed location, the situation involves precisely the type of circumstances the drafters contemplated when they decided to provide for the automatic attachment of the security interest to proceeds.<sup>139</sup> If the sale of the original collateral was authorized by the secured party, it would not be unreasonable to assume that a monitoring system had been established to inform the secured party of when the sale occurred. In such circumstances, the ability of the secured party to deal effectively with the proceeds ought to be presumed. Therefore, a rule terminating the security interest in favor of

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security interest therein survive, even though commingled."); *Universal C.I.T. Credit Corp. v. Farmers Bank*, 358 F. Supp. 317, 324 (E.D. Mo. 1973) (stating that the mere fact that the proceeds from the sale of the assets were commingled with other funds and withdrawals were made from those funds does not make the proceeds unidentifiable); *C.O Funk & Sons, Inc. v. Sullivan Equip., Inc.*, 431 N.E.2d 370, 372 (Ill. 1982) (stating that the lowest intermediate balance approach is a common sense method of identifying fungible proceeds).

136. U.C.C. § 9-306 cmt. 2(c); see PEB Commentary on the Uniform Commercial Code: Commentary No. 7, reprinted in [Findex/PEB Commentaries] U.C.C. Rep. Serv. 2d (Callaghan) [hereinafter *PEB Commentary* 7].

137. To the credit of the drafters of Article 9, they apparently recognized the infirmities of rules that give rise to difficult fact questions. This point can be illustrated by their decision to reject a rule which would have required the secured party to reperfect its security interest in the removal state within a certain period of time after the secured party learned of the removal. See *A Second Look at the Amendments to Article 9 of the Uniform Commercial Code*, 29 Bus. Law. 973, 978-79 (1974).

138. See *supra* notes 108-09 and accompanying text.

139. U.C.C. §§ 9-203(2), 9-306(2).

the buyer does not seem unduly harsh.<sup>140</sup> If, however, the sale was unauthorized, there is a high degree of probability that the secured party will not receive timely notice of its occurrence. Because this failure is likely to cost the secured party its proceeds, continuation of the security interest in the original collateral is necessary.<sup>141</sup> In short, "authorized" and "unauthorized" dispositions are shorthand expressions of radically different degrees of likelihood that the secured party's interest in proceeds will have sufficient economic value to substitute for the loss of original collateral.

Under the takings jurisprudence of Article 9, because the sale to B was unauthorized, the rule of section 9-403(2) is presumptively inappropriate even as to her.<sup>142</sup> Of course, even if we were to conclude otherwise, it would not suggest that B should be treated differently from L and SP-2.<sup>143</sup> This discussion regarding compensation provides only the most general answer to the question. Determining the wisdom of a conditional priority rule, even in cases where there is compensation for the taking, depends upon how well the rule promotes a fair and efficient system of secured credit.

### C. Section 9-306(3): Proceeds

Section 9-306(3) provides that a security interest in proceeds is a "continuously perfected security interest if the interest in the original collateral was perfected . . . ."<sup>144</sup> This period of automatic perfection is limited to ten days after receipt of the proceeds by the debtor unless one of the requirements of subsection (3) has been met.<sup>145</sup> The fol-

140. See *supra* note 120.

141. *Id.*

142. In the context of lapse problems arising under § 9-403(2), all sales will be unauthorized. If the situation were otherwise, the buyer would take free of the security interest under § 9-306(2) and issues of perfection would be irrelevant.

143. The stated intention of this Article is to explore when a taking of the secured party's interest in the original collateral is permissible. This analysis does not imply, however, that all permissible takings ought to occur. Any truly rational approach to priorities requires consideration of the balance of all relevant reasons, including reasons pertaining to fairness and economic efficiency.

144. U.C.C. § 9-306(3).

145. The secured party's interest will continue to be perfected beyond the ten-day period if:

- (a) a filed financing statement covers the original collateral and the proceeds are collateral in which a security interest may be perfected by filing in the office or offices where the financing statement has been filed and, if the proceeds are acquired with cash proceeds, the description of collateral in the financing statement indicates the types of property constituting the proceeds; or
- (b) a filed financing statement covers the original collateral and the proceeds are identifiable cash proceeds; or
- (c) the security interest in the proceeds is perfected before the expiration of the ten-day period.

lowing pattern of interests illustrates one way in which a lapse problem could occur:<sup>146</sup>

- March 1 — Secured Party-1 (SP-1) perfects (by notation on the certificate of title)<sup>147</sup> a security interest in a truck.
- April 1 — Debtor trades the first truck for a second truck.
- April 5 — L acquires a judicial lien on the second truck or Debtor sells the second truck to B or Secured Party-2 (SP-2) perfects (by notation on the certificate of title) a security interest in the second truck.
- April 12 — SP-1 has not had its interest noted on the certificate of title for the second truck.

Within this pattern of interests, SP-1 would have had priority over L, B, and SP-2 through April 11.<sup>148</sup> How these interests rank thereafter will depend on whether the ten-day period of automatic perfection is a grace period or a period of absolute protection.<sup>149</sup> As for the statutory text and its accompanying comments, neither offers a solution to the problem.

Thus, to understand and evaluate whether particular priority outcomes reflect a coherent approach to lapse, attention must focus on the extent to which SP-1 is likely to be compensated for any taking that might occur. As previously argued at length, L and SP-2 should never step-up in priority because there is no compelling reason why they should,<sup>150</sup> and their dealings with the debtor produce no identifiable proceeds to which SP-1's security interest could attach.<sup>151</sup>

In deciding whether to permit buyers of first generation proceeds to advance in priority, the fundamental problem is determining the capability of the secured party to safeguard its interest in the second generation proceeds. No one should be taxed with demonstrating with absolute certainty what would occur in an actual potential proceeds

146. The idea of creating a lapsed perfection problem by having the debtor trade in one truck for another comes from the not so hypothetical case of *Security Sav. Bank v. United States*, 440 F. Supp. 444 (S.D. Iowa 1977). There the United States acquired a tax lien during the ten-day period of automatic perfection. Relying on the approach taken by the drafters in § 9-403(2), the court held that the relative rights of the parties were reordered once the secured party's perfection lapsed. *Id.* at 447.

147. Inasmuch as the truck would be covered by a certificate of title statute, the filing requirements of Article 9 are not applicable. *See* U.C.C. § 9-302(3).

148. *See id.* §§ 2-201 ("Formal Requirements; Statute of Frauds"), 9-301(1)(a)-(c) ("Persons Who Take Priority Over Unperfected Security Interests; Rights of Lien Creditor"), 9-306(3) ("Proceeds; Secured Party's Rights on Disposition of Collateral"), 9-312(5) ("Priorities Among Conflicting Security Interests in the Same Collateral").

149. Because under § 9-306 a security interest in proceeds must be perfected through one of the methods permitted for original collateral, SP-1 had until ten days after receipt of the second truck by the debtor to perfect its interest through compliance with the certificate of title statute. *Id.* § 9-306(3).

150. *See supra* note 118 and accompanying text.

151. *See supra* note 121 and accompanying text.

situation.<sup>152</sup> The central question must be what capabilities secured parties are likely to have, rather than speculation about what might, or could, occur. A showing that the secured party has the capability of obtaining the proceeds requires nothing more than demonstrating the customary absence of barriers and the lead time necessary to take whatever action is needed or desired.

The key step in this analysis should be an inquiry into whether the debtor's disposition of the original collateral had been authorized by the secured party. This is another way of asking whether there is reason to believe, on the basis of commercial experience, that the secured party had set up a monitoring system to keep tabs on its collateral. If so, the secured party would be expected to be in a position to move easily and promptly in response to the first sale and, presumably, the second. The only situation in which this conclusion might not hold true would be when the first sale was authorized, but the second sale was not. On the other hand, if the first sale was unauthorized it would usually mean that the secured party would not receive timely notice of the second sale.

Recognizing that an inquiry into whether the disposition of the original collateral and its proceeds was authorized by the secured party is useful in screening cases of likely compensation. It does not, however, compel the conclusion that such a test should be adopted to determine the post-lapse priority of a pre-lapse intervening buyer. The principal problem with the use of this idea as a test, however, is that deciding the question of authorization in particular cases may be complex. Moreover, there is no valid reason why lapse should affect pre-lapse priorities.<sup>153</sup> By contrast, a bright-line rule protecting the secured party has the comparative virtue of simplicity. For these reasons, an ad hoc inquiry into authorization would be an exceptionally poor way to handle the question of how buyers should be treated in lapse situations under section 9-306(3). The relevant considerations can be captured more sensibly by a rule that preserves the secured party's priority in all cases.

#### D. Summary

This part of the Article has shown that the compensation principle contributes significantly to the choice of post-lapse priority rules. To the extent possible, the secured party should be compensated for any loss of priority. The best, and perhaps only, way to accomplish this is to determine whether the debtor's transaction with the intervening

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152. The infinite variety of possible situations would make this an impossible task. Moreover, the existing empirical evidence on the behavior of the secured credit system is inadequate for drawing trustworthy conclusions about the way the system actually performs. Anecdotes simply do not provide the information one needs to answer a wide range of questions, from theory to policy.

153. See *supra* note 118 and accompanying text.

pre-lapse claimant has produced identifiable proceeds, and to preserve the secured party's initial priority where it has not. The difficulty comes in identifying those situations where the proceeds will actually work to maintain the overall value of the secured party's interest. At a minimum, the significance of the proceeds claim will depend on the secured party knowing that the disposition has occurred. Unless we wish to make the actual knowledge of the secured party an issue in every case, a system of rules is needed to decide when the secured party should be treated as having knowledge.

In selecting post-lapse priority rules, there are three relevant claimants to consider: (1) another secured party; (2) a lien creditor; and (3) an intervening buyer. The easy cases involve either another secured party or a lien creditor. These claimants should receive equal treatment because neither is responsible for any proceeds which might enhance the first secured party's position. Accordingly, the relative priority of the parties pre-lapse should be viewed as absolute, rather than conditional.

The problem is somewhat more difficult in the third instance when the intervening claimant is a buyer. The compensation principle recommends one of two responses. First, there are cases where the secured party cannot be expected to know that a sale of the collateral has occurred. In this situation the secured party's rational ignorance prevents it from exercising dominion and control over the proceeds should it choose to do so. When the relevant sale was unauthorized by the secured party, its ignorance can be presumed. In these cases the Code should adopt a rule of absolute priority. This clearly would be a rule designed to foster the compensation principle. Second, when the sale was authorized by the secured party, we may say that a presumption of knowledge is reasonable. With this in mind, we can characterize a rule of conditional priority as consistent with the compensation principle.<sup>154</sup>

#### IV. MORE EXAMPLES

This Article began with the premise that one characteristic of all forms of private property is the specific remedial power to exclude others.<sup>155</sup> After articulating the remedies available to a secured party, the article demonstrated that a security interest fits this concept of property.<sup>156</sup> This reconceptualization of a security interest as property has potentially broad normative consequences. In general, rights of property ought to be respected. It follows that, while property is

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154. Once again, this Article, does not claim that, if compensated, a secured party should always lose its pre-lapse priority, post-lapse. It does assert, however, that without compensation, a secured party's pre-lapse priority should always be preserved.

155. See *supra* notes 14-40 and accompanying text.

156. See *supra* notes 41-50 and accompanying text.

hardly inviolate today, the government should not be permitted to destroy property without compensating the owner.

Some provisions in Article 9 are intended to respond to a "taking" of the secured party's property and thus to promote principles of compensation. One example is the idea that the secured party is entitled to the proceeds of a sale or disposition of collateral. Similarly, when collateral is commingled or processed, the secured party is automatically compensated for its loss by receiving a substitute security interest in the product or mass.<sup>157</sup>

This basic idea has several benefits. Primarily it is a plausible way to determine the wisdom of particular priority rules and to resolve statutory ambiguities. From the vantage point of the compensation principle, we have seen that many of the rules governing post-lapse priorities are ill-advised. In many other cases, the compensation principle will be a helpful guide. For example, there may be a question of whether particular property should be treated as proceeds. To demonstrate, courts have almost equally split on the issue of whether amounts received by the debtor from a tort-feasor who caused damage to the collateral constitute proceeds.<sup>158</sup> The courts that have been unwilling to include tort payments in the definition of proceeds have based their decisions on a literal reading of section 9-306(2) that effectively excludes any disposition that does not involve a voluntary transfer of collateral.<sup>159</sup> A proper analysis should look instead to the implications of the disposition, rather than its form.<sup>160</sup>

Courts seeking to determine whether property should be deemed proceeds should be concerned principally with the extent to which the disposition diminishes the value of the secured party's interest. Proceeds should be recognized whenever an economic substitute for collateral—that is, compensation—is needed, regardless of whether the new property arises out of a transaction that is technically voluntary. This broad conception of proceeds will minimize arbitrariness, build coherence in the law, and advance the policies embodied in section 9-306(2).

One common effort in recent years has been to find a consequence-oriented approach for resolving post-default conflicts between competing security interests.<sup>161</sup> Although Article 9 explicitly envisions the existence of junior security interests in collateral,<sup>162</sup> it is presently

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157. See *supra* note 106.

158. Compare *In re Boyd*, 658 P.2d 470, 474 (Okla. 1983) (holding that monies received from tortfeasor are not proceeds) with *In re Stone*, 52 B.R. 305, 307-08 (Bankr. W.D. Ky. 1985) (ruling that monies received from tortfeasor are proceeds).

159. See *Boyd*, 658 P.2d at 474.

160. Although a tort claim should qualify as proceeds under § 9-306(1), it could not be the subject of a valid security interest because tort claims are excluded from Article 9 by § 9-104(k).

161. See *supra* notes 114-53.

162. See U.C.C. § 9-504(3).

silent on many of the issues raised in connection with the junior's enforcement. One topic that has generated extensive discussion concerns the junior's right to retain proceeds arising from the disposition of collateral under section 9-504 or collections from account debtors and other obligors under section 9-502.<sup>163</sup> The Article 9 Drafting Committee of the National Conference of Commissioners on Uniform State Laws has proposed that the junior has no obligation to apply the proceeds of collection or other disposition to a debt secured by a senior lien on the collateral.<sup>164</sup>

On its face, the Committee's proposal inherently involves compensation concerns, which means that following such a rule may result in a taking of the senior's interest. The purpose of this Article is not to provide a general analysis of what the rules are, or ought to be, when there are multiple security interests in collateral. A few points may be made briefly. A junior's disposal of goods normally will have no effect on the validity of the senior's lien.<sup>165</sup> Although there may be potentially adverse consequences for the senior,<sup>166</sup> permitting the junior to retain the proceeds would not necessarily undermine the compensation principle. In the collections context, it is significant that the value of the collateral is destroyed by the very act that created the proceeds. Accordingly, if the senior can be denied the proceeds, opportunities could arise for the junior to destroy its lien without compensation. Recognizing this fact might help to explain the suggestion by the Reporters for the Article 9 Drafting Committee that it revisit the issue once more.<sup>167</sup>

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163. See generally Permanent Editorial Board For The Uniform Commercial Code, *PEB Study Group Uniform Commercial Code Article 9 Report* § 30, at 216-22 (1992) [hereinafter *PEB Article 9 Report*] (advocating a broad reading of the shelter principle as to junior interests).

164. See U.C.C. §§ 9-502, 9-504 (Tentative Draft Aug. 4, 1995).

165. See *id.* § 9-504(4) ("When collateral is disposed of by a secured party after default, the disposition transfers to a purchaser for value all of the debtor's rights therein, discharges the security interest under which it [was] made and any security interest or lien *subordinate* thereto." (emphasis added)).

166. At a minimum, the senior will have to locate the collateral and must deal with a stranger to the original transaction. See *PEB Article 9 Report*, *supra* note 163, at 220-22. For these reasons, among others, the Article 9 Study Committee thought it appropriate to provide in the statutory text or comments that the senior has the right to take the collateral away from the junior. *Id.* at 221-22.

167. See U.C.C. § 9-502 Reporters' Explanatory Note 8 (Tentative Draft Aug. 5, 1995). Those defending a rule that would protect the junior's right to retain the proceeds might claim that it is justified by the general principles of negotiability underlying official comment 2(c) to § 9-306 and *PEB Commentary No. 7*. See *supra* note 136. Whether they are correct to conclude that the Code's interest in protecting transferees of proceeds in the "ordinary course" of the borrower's business is in fact sufficiently compelling in this setting is a distinct question. If we have a sincere commitment to the U.C.C. filing system, and the concept of priority, it would seem that the junior should not be permitted to keep the proceeds with impunity.

## CONCLUSION

Although more attention to these compensation issues is surely warranted, fuller treatment requires a degree of detail inappropriate to the scope of this Article. The intent of this Article is to outline the general contours of a model of priorities that is based on the implicit takings jurisprudence of Article 9. The model would not replace existing models with another; rather, it would recognize the diversity of potentially conflicting claims, and would accord a level of protection commensurate with the interest at stake. If compensation for the taking of a security interest is a demand of fairness, even limited deviations from it should be justified only by strong, countervailing reasons.