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CERTAINTY, EFFICIENCY, AND REALISM: RIGHTS IN COLLATERAL UNDER ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

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Article 9 of the Uniform Commercial Code requires that the debtor have "rights in the collateral" for the attachment of a security interest. The drafters of the Code, however, left the determination of this phrase's meaning to the courts. The Article 9 Study Committee recently declined to recommend any changes in the existing requirement.

In this Article, Professor Margit Livingston argues that the requirement of "rights in the collateral" is unnecessary as it relates to tangible goods and should be deleted from Article 9. As an alternative to the uncertainty engendered by the phrase, Professor Livingston would substitute a set of notice and priority rules that more clearly define the rights and obligations of the parties undertaking an Article 9 transaction involving tangible goods. Professor Livingston concludes by observing that Karl Llewellyn's philosophy of Legal Realism would best be served by such an amendment.

The Uniform Commercial Code was promulgated originally to simplify and clarify commercial law and to facilitate the planning and execution of commercial transactions.¹ The Code's drafters and later commentators considered Article 9, covering secured transactions, the best integrated and most carefully conceived of the Code's provisions.² They believed that its clarity and precision

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1. The Code states that its underlying purposes are, among others, "to simplify, clarify and modernize the law governing commercial transactions." U.C.C. § 1-102(2)(a) (1991).

2. As one commentator describes the accomplishment, Article 9 . . . is considered by many to be the signal achievement of the Code. Taking the confused state of prior law relating to chattel mortgages and conditional sales, the Reporters reduced to black letter principles a Code which permitted easy and effective financing secured by accounts receivable and chattels, including inventories.

promoted certainty and stability in the rules governing secured lending.³

However, even the most thoughtfully drafted statute cannot anticipate every possible scenario, and in some cases deliberate ambiguity is desirable. One of the requirements for an attached security interest—that the debtor have “rights in the collateral”—was purposely left somewhat vague⁴ on the assumption either that no further elaboration was necessary or that the courts were in a better position to flesh out its meaning in the context of specific situations.⁵ This choice in favor of generality has produced extensive confusion in the case law and has resulted in a serious warping of some of the theoretic-

Charles A. Bane, *From Holt and Mansfield to Story to Llewellyn and Mentschikoff: The Progressive Development of Commercial Law*, 37 U. MIAMI L. REV. 351, 374 (1983).

Grant Gilmore, one of the principal drafters of Article 9, recounted the drafting committee's high expectations regarding the unifying and simplifying effect of Article 9 on secured transactions law:

Pre-Code personal property security law may be described as closely resembling that obscure wood in which Dante discovered the gates of hell. We thought that, with a little pruning and clearing, we could turn the obscure wood into a peoples park where widows and orphans and country bankers could enjoy their innocent pleasures, safe from the attack of ravening wild beasts and trustees in bankruptcy. The sad truth is that personal property security law is well on the way to becoming quite as fragmented and quite as complex as it ever was in the bad old days before the Code.

Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 620 (1981) [hereinafter Gilmore, *Confessions*].

3. Professor Karl Llewellyn, in an early article on the codification of security law, noted the considerable disadvantages created by the helter-skelter collection of pre-Code statutes and case law governing security devices: “What is not minor is the price in complexity, inconvenience, and often in unfairness which must be paid when legal patterns of happenstance origin are taken in all their history-ridden detail as the basis for the doing of remodeling jobs which are themselves piece-work.” Karl N. Llewellyn, *Problems of Codifying Security Law*, 13 LAW & CONTEMP. PROBS. 687, 688 (1948).

4. U.C.C. § 1-201(36) (1991) states only that “‘rights’ includes remedies.”

5. The 1962 version of § 9-204(2) defined “rights in the collateral” for some specific types of property:

(2) For the purposes of this section the debtor has no rights

(a) in crops until they are planted or otherwise become growing crops, in the young of livestock until they are conceived;

(b) in fish until caught, in oil, gas or minerals until they are extracted, in timber until it is cut;

(c) in a contract right until the contract has been made;

(d) in an account until it comes into existence.

U.C.C. § 9-204(2) (1962). With the 1972 Amendments to Article 9, the drafters deleted this list: “Former subsection (2) has been eliminated as unnecessary and in some cases confusing. Its operation appeared to be arbitrary, and it is believed that the questions considered are best left to the courts.” Official Reasons for the 1972 Change, UNIFORM COMMERCIAL CODE, 3 U.L.A. 280 (1981).

cal underpinnings of Article 9. Parties to secured transactions and others dealing with the debtor are left uncertain about what the law requires, and some of the litigated cases have yielded arguably unfair results.

The Article 9 Study Committee recently completed its review of Article 9 and concluded that amendments to the existing uniform statute are warranted in several areas.⁶ The Committee, however, recommended no change in the existing requirement that the debtor have rights in the collateral for the purpose of attachment of a security interest.⁷ The Committee acknowledged that "from time to time both courts and commentators have misunderstood the meaning and implications of this requirement,"⁸ but felt that "these problems do not warrant revision of Article 9."⁹ The Committee believed that because many of the general conveyancing principles defining the rights of third parties (such as purchasers) are derived from non-Code property law, they require no further elaboration within Article 9 itself.¹⁰

This Article criticizes the Study Committee's conclusion that amendment of the phrase "rights in the collateral" is not necessary and argues that the concept should be eliminated from Article 9, at least as it pertains to tangible goods. The notion of rights in the collateral has obscured the real issues in these cases: first, whether a particular claimant has an enforceable interest in particular property of the debtor, and second, if two or more parties have such interests, what relative priority exists among them. Unlike the Study Committee, I conclude that Article 9 should address these questions directly, rather than rely on non-Code property law.

Part I of this Article outlines the basic requirements for creation of an enforceable security interest and then focuses on the confusion generated by the requirement that the debtor have rights in the collateral, particularly when the collateral consists of tangible goods.¹¹ Part II examines the issue more specifically in cases in which the debtor has possession of goods that it does not own outright.¹² Part III dis-

6. Permanent Editorial Board for the Uniform Commercial Code, PEB Study Group: *UNIFORM COMMERCIAL CODE*, Article 9, at 18-42 (1992).

7. *Id.* at 94.

8. *Id.*

9. *Id.* at 95.

10. *Id.* The Committee did recommend, however, that the Permanent Editorial Board "seriously consider revising the official comments or issuing a PEB Commentary to deal with problems associated with the relationship of these conveyancing principles to Article 9." *Id.* at 96.

11. See *infra* notes 17-45 and accompanying text.

12. See *infra* notes 46-212 and accompanying text.

cusses the converse situation in which the debtor lacks possession of the goods but arguably has some rights in them.¹³ Part IV suggests that much of the confusion and inconsistency in the case law could be reduced by eliminating the concept of rights in the collateral as it relates to tangible goods¹⁴ and substituting a set of notice and priority rules that define the rights and obligations of the most common parties to these transactions.¹⁵ Finally, Part V explores the impact of Karl Llewellyn's realist jurisprudence on the Code and argues that Llewellyn's own jurisprudential goals would best be served by statutorily amending this section of Article 9.¹⁶

I. THE NATURE OF THE PROBLEM

To have a security interest enforceable against the debtor's assets, a lender must fulfill the requirements for attachment under section 9-203(1) of the Uniform Commercial Code.¹⁷ Until the security interest attaches, it is not enforceable against the debtor.¹⁸ The requirements for attachment consist essentially of a written security agreement signed by the debtor and describing the collateral,¹⁹ the giving of value by the secured party,²⁰ and the debtor's having rights in the col-

13. See *infra* notes 213-52 and accompanying text.

14. This Article does not attempt to address the issue of rights in the collateral as it relates to collateral other than tangible goods. The issue is framed differently for collateral other than tangible goods, such as accounts, general intangibles, chattel paper, and documents. For these intangible and semi-intangible forms of collateral, courts tend to focus less on whether possession and ownership are separated and whether the facts raise an equitable estoppel issue, and more on whether the property in question has come into existence (e.g., has an account receivable been created?) and whether the debtor has traditional ownership rights in the property (e.g., the right to alienate it). See, e.g., September-ber-tide Publishing, B.V. v. Stein & Day, Inc., 884 F.2d 675, 681-82 (2d Cir. 1989) (analyzing accounts and contract rights); *In re* GRF, Inc., 119 B.R. 68, 70 (Bankr. W.D. Pa. 1990) (addressing liquor license); *In re* Clark, 96 B.R. 605, 608 (Bankr. W.D. Pa. 1989) (addressing liquor license); Krohn v. Omni-Veterinary Supply Co. (*In re* Nash), 70 B.R. 40, 42 (Bankr. E.D.N.Y. 1987) (analyzing stock shares); Franke v. Third Nat'l Bank & Trust Co., 509 N.E.2d 955, 957 (Ohio Ct. App. 1986) (evaluating certificate of deposit); North Supply Co. v. Allco Fin. Servs., 728 P.2d 912, 915 (Or. Ct. App. 1986) (analyzing rights in account).

15. See *infra* notes 253-307 and accompanying text.

16. See *infra* notes 308-39 and accompanying text.

17. U.C.C. § 9-203(1) (1991) ("[A] security interest is not enforceable against the debtor or third parties with respect to the collateral and does not attach unless [the three following elements are satisfied]."); see also *infra* notes 19-21 and accompanying text.

18. U.C.C. § 9-203(1) (1991).

19. *Id.* at (a). In lieu of a written security agreement, the collateral may be "in the possession of the secured party pursuant to agreement"—a condition describing a pledge made under an oral or written contract. *Id.* The requirement of a writing or possession by the secured party satisfies Statute of Frauds and evidentiary concerns. *Id.* at cmts. 3, 5.

20. U.C.C. § 9-203(1)(b) (1991). Unless the secured party has given value to the debtor, presumably the debtor has no repayment obligation that could be secured by the collateral.

lateral.²¹ Both “security agreement”²² and “value”²³ are defined elsewhere in the Code, but the drafters left “rights in the collateral” undefined.²⁴

In its simplest sense the requirement that the debtor have rights in the collateral before the security interest can attach follows intuitively from the idea that “you can’t alienate what you don’t own.”²⁵ Just as the common law recognized that a thief could not pass good

21. U.C.C. § 9-203(1)(c) (1991).

22. A security agreement is defined as “an agreement which creates or provides for a security interest.” U.C.C. § 9-105(1)(l) (1991). Article 1 defines “agreement” as “the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance as provided in this Act.” *Id.* § 1-201(3). Thus defined, a security agreement need not be in writing, but the language of § 9-203(1)(a), by requiring that the agreement be signed by the debtor and contain a description of the collateral, implies that a security agreement for non-possessory security interests must be in writing. See *In re Bollinger Corp.*, 614 F.2d 924, 926 (3d Cir. 1980); *American Card Co. v. H.M.H. Co.*, 196 A.2d 150, 152 (R.I. 1963); BARKLEY CLARK, *THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* ¶ 2.02 (2d ed. 1988).

23. “Value” includes at its most basic level “any consideration sufficient to support a simple contract.” U.C.C. § 1-201(44)(d) (1991). Article 1 also defines “value” more specifically; for example, “value” can be “a binding commitment to extend credit or for the extension of immediately available credit.” *Id.* § 1-201(44)(a).

24. Grant Gilmore, one of the original reporters for Article 9, noted that “[t]he Article does not specify the quantum of ‘rights’ which a debtor must have in collateral to support a security interest.” 1 GRANT GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY*, § 11.5, at 353 (1965) [hereinafter GILMORE, *SECURITY INTERESTS*].

There is also scant law review literature on the subject of rights in the collateral. Existing commentary includes Ralph C. Anzivino, *When Does a Debtor Have Rights in the Collateral Under Article 9 of the Uniform Commercial Code?*, 61 MARQ. L. REV. 23 (1977) (arguing that the debtor has rights in the collateral when it has both possession and the ability to transfer good title to goods); Steven W. Sanford, *Debtor’s Rights in Collateral as a Requirement for Attachment of a Security Interest Under the Uniform Commercial Code*, 26 S.D. L. REV. 163 (1981) (concluding that non-Code and Code law outside of Article 9 basically define what constitutes rights in the collateral); Joseph W. Turner, Comment, *Rights in Collateral Under U.C.C. § 9-203*, 54 MO. L. REV. 677 (1989) (providing an overview of the topic).

Most treatise writers have also paid only cursory attention to the issue. See CLARK, *supra* note 22, ¶ 2.04; RICHARD F. DUNCAN ET AL., *THE LAW AND PRACTICE OF SECURED TRANSACTIONS* § 2.03[2] (1992); 1 GILMORE *supra*, § 11.5, at 352-53; RAY D. HENSON, *HANDBOOK ON SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* § 4-2, at 59-60 (2d ed. 1979); ELDON H. REILEY, *GUIDEBOOK TO SECURITY INTERESTS IN PERSONAL PROPERTY* § 3.02[5] (1993); JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* § 22-6, at 986-91 (3d ed. 1988).

A few scholarly treatises have probed the issue in greater depth. See 1 PETER F. COOGAN ET AL., *Debtor’s Rights in Collateral as a Requirement for Attachment of a Security Interest Under the Uniform Commercial Code*, in *SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* § 4B-1 (Supp. 1991); ROBERT A. HILLMAN ET AL., *COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE* ch. 18 (1985).

25. *United States v. Ables*, 739 F. Supp. 1439, 1443 (D. Kan. 1990) (quoting KAN. STAT. ANN. § 84-9-203, Kansas Comment 1983, at 417).

title to stolen property even to a bona fide purchaser for value,²⁶ a thief should not be able to give a valid security interest in stolen chattel.²⁷ The thief has no title, leasehold, license, or other contractual or property interest that will support the conveyance of a security interest to a lender.²⁸

A corollary to this first premise is that, in general, one cannot convey to another greater rights in property than one has.²⁹ For example, if A leases an airplane from B, A normally has the right to exclusive use of the airplane during the term of the leasehold, provided that the conditions of the lease, including the payment of rent, are satisfied.³⁰ If A in turn gives a security interest in the leased airplane to C, C's rights in the airplane can be no greater than A's.³¹ In other words, C's rights are derived from A's. If C forecloses on its security interest, C steps into A's shoes and assumes A's rights and obligations under the lease—e.g., the right to use the airplane during the term of the lease and the obligation to pay rent.

In some cases, however, the transferee of property can acquire rights greater than those of the transferor. The two principal means by which this enlargement of rights occurs in the secured lending con-

26. Professor Hawkland has noted that

[i]f a thief stole goods from the true owner, he, the thief, acquired nothing ("void" title), and the true owner remained with full ownership rights and not with a mere equity of rescission. The sale by the thief to a bona fide purchaser did not affect these rights in this situation.

2 WILLIAM D. HAWKLAND, UNIFORM COMMERCIAL CODE SERIES § 2-403:01 (1992).

27. First Nat'l Bank v. Avondale Mills Bevelle Employees Fed. Credit Union, 967 F.2d 556, 559 (11th Cir. 1992).

28. Schrier v. Home Indem. Co., 273 A.2d 248, 250 (D.C. App. 1971); McDonald's Chevrolet, Inc. v. Johnson, 376 N.E.2d 106, 109 (Ind. App. 1978); Inmi-Etti v. Alvisi, 492 A.2d 917, 923 (Md. App. 1985); Bay Springs Forest Prods., Inc. v. Wade, 435 So. 2d 690, 694 (Miss. 1983); O'Keeffe v. Snyder, 416 A.2d 862, 867 (N.J. 1980); Mattson v. Commercial Credit Business Loans, Inc., 723 P.2d 996, 999 (Or. 1986) (en banc).

29. This principle, sometimes referred to by the Latin phrase *nemo dat quod non habet* (one cannot give away what one does not have), is supposed to foster security of property, that is, to prevent disturbance of private property rights without the owner's permission. See John F. Dolan, *The U.C.C. Framework: Conveyancing Principles and Property Interests*, 59 B.U. L. REV. 811, 812-13 (1979); Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1057 (1954) [hereinafter Gilmore, *Good Faith Purchasers*]; Gilmore, *Confessions*, *supra* note 2, at 606; see also Bank of the West v. Commercial Credit Fin. Servs., Inc., 852 F.2d 1162, 1174-75 (9th Cir. 1988) ("[Secured party] can have no greater rights in the collateral than its debtor.").

30. This example is derived from a problem in DOUGLAS G. BAIRD & THOMAS H. JACKSON, *SECURITY INTERESTS IN PERSONAL PROPERTY* 169-170 (2d ed. 1987). See also Douglas G. Baird & Thomas H. Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175, 203-04 n.85 (1983) [hereinafter Baird & Jackson, *Possession and Ownership*] (offering another example).

31. "A security interest can attach only to the extent of the debtor's interest." South-west Georgia Prod. Credit Ass'n v. James, 350 S.E.2d 786, 787 (Ga. Ct. App. 1986).

text are consent and estoppel. In the first instance, the debtor itself may not own suitable collateral, but another individual may be willing to provide property acceptable to the secured party as collateral. The owner of this property could consent to the debtor's encumbering the property in favor of the lender and thereby grant the debtor some "rights" in the property short of full ownership.³² If the secured party forecloses, it takes the collateral free and clear of any interest of the debtor or the owner. Thus the debtor's limited right to encumber the property could ultimately result in the secured party's full ownership of the property.

Estoppel provides another legal theory by which the secured party's rights in the collateral become more extensive than those of the debtor. The concept of estoppel is recognized both under general equitable principles and in the Uniform Commercial Code itself. Under common law estoppel, the owner of property loses the ability to assert its ownership rights if it allows a debtor to use and control the property in such a way that third parties, such as creditors, are justifiably deceived into thinking that the debtor owns the property in question.³³ Thus once again the debtor's limited right to use or possess the owner's property expands in the secured party's hands to the right of foreclosure and, ultimately, full ownership.

Statutory estoppel stems from the Uniform Commercial Code's various bona fide purchaser doctrines. For example, under section 2-403 "[a] person with voidable title has power to transfer a good title to a good faith purchaser for value."³⁴ Thus if X buys equipment from Y and pays for it with a check that is later dishonored, X acquires voidable title to the equipment and can give a valid security interest to a secured party who acts in good faith.³⁵ That security interest, when enforced against X, will be superior to Y's right to void the sale to X.³⁶

32. See, e.g., *K.N.C. Wholesale, Inc. v. AWMCO, Inc.*, 128 Cal. Rptr. 345, 348 (Cal. Ct. App. 1976); *General Motors Acceptance Corp. v. Washington Trust Co.*, 386 A.2d 1096, 1098-99 (R.I. 1978); *First Nat'l Bank v. Feeney*, 393 N.W.2d 458, 460 (S.D. 1986).

33. See, e.g., *Preston v. Witherspoon*, 9 N.E. 585, 588 (Ind. 1886); *Drew v. Kimball*, 43 N.H. 282, 288 (1861); *American Exch. Nat'l Bank v. Winder*, 150 S.E. 489, 491 (N.C. 1929); *Medico Leasing Co. v. Smith*, 457 P.2d 548, 551 (Okla. 1969); *O'Connor's Adm'x v. Clark*, 32 A. 1029, 1030 (Pa. 1895).

34. U.C.C. § 2-403(1) (1991).

35. *Stowers v. Mahon (In re Samuels & Co.)*, 526 F.2d 1238, 1242 (5th Cir. 1976) (en banc), cert. denied, 429 U.S. 834 (1976); *National Pawnbrokers Unlimited v. Osterman, Inc. (In re Return of Property in State v. Pippin)*, 500 N.W.2d 407 (Wis. Ct. App. 1993).

36. *Ledbetter v. Darwin Dobbs Co.*, 473 So. 2d 197, 202 (Ala. Civ. App. 1985); *Jordan v. Butler*, 156 N.W.2d 778, 785 (Neb. 1968); *Cox v. Gerald Modell, Inc.*, 18 U.C.C. Rep. Serv. (Callaghan) 1200, 1202 (N.Y. App. Div. 1976).

At first glance these principles seem well defined enough to guide courts in determining whether the debtor has sufficient rights in the collateral for attachment of a security interest. However, the case law reveals that courts have been prone to ignore these principles in some instances and to misapply them in others. Some courts have refused to recognize that a debtor's limited rights in property can constitute rights in the collateral within the meaning of section 9-203(1)(c).³⁷ Others have used a debtor's limited rights in property as a springboard to give the secured party priority over a competing claimant, often the owner of the property, instead of limiting the secured party's rights to those of the debtor.³⁸

In both situations the ignorance or misapplication of the Code's basic principles can have pernicious effects on debtors, secured creditors, and others involved with the debtor's business. Courts rejecting limited ownership rights as rights in the collateral for Article 9 purposes eliminate a potential source of security for debtors holding those rights.³⁹ This restriction may result in the unavailability of credit to these debtors or the imposition of higher interest rates. Courts accepting limited rights as rights in the collateral have created a hidden rule of priority between secured creditors and titleholders that contradicts Article 9's stated goal of enhancing the certainty and predictability of commercial transactions.⁴⁰

37. See, e.g., *Rohweder v. Aberdeen Prod. Credit Ass'n*, 765 F.2d 109, 112-13 (8th Cir. 1985); *Chrysler Corp. v. Adamatic, Inc.*, 208 N.W.2d 97, 104 (Wis. 1973), *overruled on other grounds*, *Daniel v. Bank of Hayward*, 425 N.W.2d 416 (Wis. 1988).

38. See, e.g., *United States v. Ables*, 739 F. Supp. 1439, 1446 (D. Kan. 1990); *Federal Deposit Ins. Corp. v. Quality Inns*, 735 F. Supp. 1311, 1317-18 (D. Md. 1990); *Litwiller Mach. & Mfg. v. NBD Alpena Bank*, 457 N.W.2d 163, 166 (Mich. Ct. App. 1990) (per curiam); *Foster Wheeler Energy Corp. v. Fourth Nat'l Bank*, 40 U.C.C. Rep. Serv. (Callaghan) 1528, 1531 (Okla. Ct. App. 1985).

39. For example, equipment leasing has grown tremendously over the last twenty years, and often a debtor will hold much of its heavy equipment pursuant to long-term leases. Presumably the leasehold interests, if assignable, could be quite valuable as potential security. See generally Charles W. Mooney, Jr., *Personal Property Leasing: A Challenge*, 36 BUS. LAW. 1605 (1981) (arguing for uniform statutory treatment of personal property leasing).

40. Professors White and Summers have noted the *sub silentio* rule of priority created by some judicial decisions interpreting the phrase "rights in the collateral":

[E]quities between competing claimants may be fought out in the name of this phrase. And the time when a court determines that the debtor acquired rights in the collateral may not only depend on such equities, but also on the nature of the competing parties and the kind of law involved. In such cases, judges should be alert to the possibility that they may be deploying the phrase "rights in the collateral" as a priority determining device, and that the phrase was not, as such, intended to have that function.

WHITE & SUMMERS, *supra* note 24, § 22-6, at 990-91.

A review of the case law in this area reveals the confusion, inconsistency, and doctrinal distortion resulting from application and misapplication of the principles discussed above. While some inconsistency is inevitable when courts interpreting the Code are called upon to flesh out nebulous concepts such as "reasonableness"⁴¹ or "unconscionability,"⁴² this degree of uncertainty may be intolerable when the issue pertains to the very existence of a security interest—i.e., whether the secured party has an enforceable interest in the property in question.⁴³

Contested cases involving rights in collateral consisting of tangible goods generally involve those in which the debtor had possession of goods that it did not own outright and those in which the debtor lacked possession of goods in which it had some interest, up to full ownership. Cases in which the debtor has both possession and full ownership,⁴⁴ or in which the debtor has neither possession nor any

41. The terms "reasonable" and "reasonably" are used throughout the Uniform Commercial Code but are not defined therein. *See, e.g.*, U.C.C. §§ 1-105 (describing parties' rights to choice of law); 1-201(37) (defining security interest); 2-706 (concerning seller's resale of goods after buyer's breach); 2-712 (providing for buyer's cover); 7-308 (regarding enforcement of carrier's lien); 9-504(3) (describing methods for disposition of repossessed collateral) (1991). One may speculate that the Code's drafters employed the standard of reasonableness when they believed that factual circumstances would impinge heavily on what constitutes appropriate behavior by the parties. For example, U.C.C. § 2-602(1) (1991) gives buyers a "reasonable" time to reject goods after their delivery or tender. Professors White and Summers have suggested that what constitutes a reasonable time may vary according to four factual circumstances: "(1) the difficulty of discovering the defect, (2) the terms of the contract, (3) the relative perishability of the goods, and (4) the course of performance after the sale and before the formal rejection." WHITE & SUMMERS, *supra* note 24, § 8.3, at 362.

42. The courts may refuse to enforce any unconscionable contract or portion thereof. U.C.C. § 2-302(1) (1991). Again, specific factual circumstances will strongly influence whether a particular contract is unconscionable. The Official Comment to this section states that "[t]he basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract." *Id.* at cmt. 1.

43. The timing of attachment can also be important because it determines priorities between two secured parties where neither has filed or perfected its security interest, U.C.C. § 9-312(5)(b) (1991), and because it has an effect on the creation of a preferential transfer under the Bankruptcy Code. *See* 11 U.S.C. § 547(b), (e)(2) (1988).

44. CLARK, *supra* note 22, ¶ 2.04 ("If the debtor owns the collateral outright, it is obvious that the security interest may attach . . ."). Despite Professor Clark's unequivocal statement, one may assume that the issue is its most "obvious" when the debtor has both ownership *and* possession. *See, e.g.*, *Kansas State Bank v. Overseas Motorsport*, 563 P.2d 414, 417 (Kan. 1977) (holding that title and physical possession are sufficient to give a debtor rights in the collateral).

property or contractual interest, are rarely litigated.⁴⁵ Few courts would dispute that in the former situation the debtor has rights in the collateral or that in the latter situation it does not. It is the cases in the middle that have vexed courts and commentators alike.

II. OSTENSIBLE OWNERSHIP THROUGH POSSESSION

In many instances the debtor will acquire possession of goods to which it does not have title. Consignments, leases, sales on approval, sales or return, and bailments all involve possession of goods without full ownership. The purpose of the debtor's possession is normally defined by the agreement between the debtor and the owner of the property. In a consignment the debtor typically acts as a type of selling agent for the consignor, taking possession of the consignor's goods as part of the consignee's efforts to sell them to customers.⁴⁶ In a lease the debtor leases goods, usually equipment, for use in its own business.⁴⁷ In a sale on approval the debtor takes possession of goods that it intends to examine with an eye toward ultimate purchase.⁴⁸ A sale or return, like a consignment, involves transfer of the goods to the debtor for the purpose of finding an ultimate buyer for them.⁴⁹ Theoretically, the seller in a sale or return, unlike in a consignment, trans-

45. HILLMAN ET AL., *supra* note 24, ¶ 18.06[1], at 18-48 ("Since one cannot convey what one does not have, a debtor cannot create a security interest in property in which he has no rights.").

46. See *General Elec. Co. v. Pettingell Supply Co.*, 199 N.E.2d 326, 327-28 (Mass. 1964); *Columbia Int'l Corp. v. Kempler*, 175 N.W.2d 465, 468 (Wis. 1970). See generally William D. Hawkland, *Consignment Selling Under the Uniform Commercial Code*, 67 COM. L.J. 146, 146 (1962).

47. Article 2A defines "lease" as "a transfer of the right to possession and use of goods for a term in return for consideration." U.C.C. § 2A-103(1)(j) (1991); see also *In re Atlanta Times, Inc.*, 259 F. Supp. 820, 826 (N.D. Ga. 1966) (holding that a lessee only acquires the right to use of the property), *aff'd*, 383 F.2d 606 (5th Cir. 1967); *In re Telemax Corp.*, 12 U.C.C. Rep. Serv. (Callaghan) 742, 744 (S.D.N.Y. 1973) (holding that a lessee does not acquire an option to purchase the leased goods); Homer Kripke, *Some Dissonant Notes About Article 2A*, 39 ALA. L. REV. 791, 795 (1988) (stating that a lessor has a future interest in his leased goods, including the right to reclaim or repossess them on default); Charles W. Mooney, Jr., *The Mystery and Myth of "Ostensible Ownership" and Article 9 Filing: A Critique of Proposals to Extend Filing Requirements to Leases*, 39 ALA. L. REV. 683, 690 (1988) (explaining that a lessee pays consideration in exchange for the use of lessor's goods until expiration of the lease term).

48. U.C.C. § 2-326(1) (1991) provides that "[u]nless otherwise agreed, if delivered goods may be returned by the buyer even though they conform to the contract, the transaction is . . . a 'sale on approval' if the goods are delivered primarily for use." See *Valley Bank & Trust Co. v. Gerber*, 526 P.2d 1121, 1124 (Utah 1974).

49. A sales transaction in which the buyer has the right to return conforming goods is a "sale or return" if the goods are delivered primarily for resale." U.C.C. § 2-326(1)(b) (1991).

fers "title" to the goods to the debtor upon delivery, but it is title subject to defeasance if the debtor is unable to sell the goods.⁵⁰

In a bailment, the bailor gives the bailee possession of goods for a specified purpose.⁵¹ Upon fulfillment of the purpose, the bailee redelivers the goods to the bailor or handles them according to the bailor's instructions.⁵² The purpose of a bailment can vary as much as the kind of the goods involved. The bailor may instruct a bailee to store goods, repair them, refurbish them, care for them, or manufacture them into another product. In its broadest sense, the term "bailment" includes leases and consignments as well—a lessee takes possession of goods from the lessor for the purpose of using them in its business; a consignee takes possession of goods for the purpose of selling them on the consignor's behalf.

A. *Analysis under the Code*

1. Leases and Consignments

In lease or consignment cases, courts rarely discuss the rights-in-collateral issue. Usually, the party claiming to be the true "owner" of the collateral—i.e., the lessor or consignor—and the secured party of the lessee or consignee assert competing claims. The courts do not ask whether the debtor has "rights" in the leased or consigned property sufficient for attachment. Instead they examine whether the lease or consignment is a "true" one or one designed for security purposes (sometimes called a disguised security transaction).

If a lease or consignment is in reality a secured transaction, then the outcome of the case depends on the Article 9 priority rules. A lease or consignment designed for security purposes is subject to all the requirements of Article 9,⁵³ including attachment and perfection. The lessor/consignor's interest, once denominated an Article 9 security interest, must be perfected to have priority over a competing perfected secured party.⁵⁴ Very often the lessor or consignor will not have complied with Article 9 filing requirements and thereby will lose

50. *See American Nat'l Bank v. Tina Marie Homes, Inc.*, 476 P.2d 573, 576 (Colo. Ct. App. 1970).

51. *Zwagerman v. Comerica Bank-Detroit (In re Zwagerman)*, 115 B.R. 540, 547 (Bankr. W.D. Mich. 1990), *aff'd*, 125 B.R. 486 (W.D. Mich. 1991).

52. *Id.*; *Uni-Products, Inc. v. Bearse (In re Uni-Products, Inc.)*, 153 B.R. 764, 767 (Bankr. E.D. Mich. 1993).

53. Article 9 applies to "security interests created by contract including . . . [a] lease or consignment intended as security." U.C.C. § 9-102(2) (1991).

54. In general, between two secured parties, the first to file or perfect, whichever occurs earlier, has priority. U.C.C. § 9-312(5)(a) (1991).

to the secured party with a perfected security interest in the lessee/consignee's equipment or inventory.⁵⁵

Whether the consignee or lessee in a consignment or lease designed for security has sufficient rights in the collateral rarely arises because courts assume that a security consignment or lease is really a sale of the property involved. As the buyer of the property, the consignee or lessee has "title" to it as well as possession of it.⁵⁶ Title and possession have been assumed to be sufficient rights for attachment.⁵⁷ The consignor's or lessor's reservation of title amounts to the reservation of a security interest only, with the remainder of the bundle of rights being accorded to the consignee or lessee.⁵⁸

In "true" consignments or leases, the courts similarly skirt the issue of whether the consignee or lessee has sufficient rights in the consigned or leased property to trigger attachment of a security interest. In these transactions, the owner's retention of title is not a security device as such, but simply a reflection of the owner's property interest in the goods and the recipient's correspondingly limited interest.

The Code treats true leases differently from true consignments with respect to public notification requirements.⁵⁹ Because true leases are almost totally exempt from the filing requirements of Article 9,⁶⁰

55. See, e.g., *James Talcott, Inc. v. Franklin Nat'l Bank*, 194 N.W.2d 775, 780 (Minn. 1972) (applying rule to purported lease); *Nasco Equip. Co. v. Mason*, 229 S.E.2d 278, 283 (N.C. 1976) (applying rule to purported consignment); *Rainier Nat'l Bank v. Inland Mach. Co.*, 631 P.2d 389, 396 (Wash. Ct. App. 1981) (analyzing purported lease).

56. Generally, "title" to goods in a sales transaction passes from seller to buyer when "the seller completes his performance with reference to physical delivery of the goods, despite any reservation of a security interest." U.C.C. § 2-401(2) (1991).

57. See *supra* note 44.

58. Article 2 expressly states that "[a]ny retention or reservation by the seller of the title (property) in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest." U.C.C. § 2-401(1) (1991). The drafters have created, in effect, a tautology: by designating the former owner's interest as a security interest, they imply that attachment has taken place (assuming a sufficient writing) either upon delivery of the goods to the recipient or at some earlier point. Since attachment has occurred, the recipient/debtor must have "rights" in the property encumbered within the meaning of U.C.C. § 9-203(1)(c) (1991).

59. For cases stating that a lessee's interest in leased goods constitutes sufficient rights for attachment of a lender's security interest, see *Holiday Airlines Corp. v. World Airways, Inc.* (*In re Holiday Airlines Corp.*), 647 F.2d 977, 979 (9th Cir. 1981), *cert. denied*, 454 U.S. 1146 (1982) (by implication); *Uniroyal, Inc. v. Michigan Bank*, 12 U.C.C. Rep. Serv. (Callaghan) 745, 750 (Mich. 1972). *But see Holiday Airlines Corp.*, *supra*, at 983 (dissenting opinion); *Disch v. Raven Transfer & Storage Co.*, 561 P.2d 1097, 1099 (Wash. Ct. App. 1977).

60. Lessors of fixtures must make a fixture filing to have priority over the conflicting claim of an encumbrancer or owner of real estate to which the fixtures are annexed. U.C.C. § 2A-309(4) (1991); see also HENSON, *supra* note 24, § 3-12, at 44 (stating that the parties to a "lease" often intend a secured transaction, but if a legitimate lease is created, no Article 9 filing is necessary).

the dispute between a lessor and its lessee's secured party does not usually center on whether the lessee has rights in the leased goods sufficient to support attachment of a security interest. Regardless of whether the security interest attaches, the lessor will still have the superior position by virtue of its title retention.⁶¹

Unlike true leases, true or non-security consignments are brought into Article 9 by Article 2. Section 2-326 deems certain types of consignments to be sale or return transactions.⁶² Goods held under sale or return are subject to the claims of the "buyer's" creditors while in the buyer's possession.⁶³ The consignor can avoid having the consignment deemed a sale or return by complying with one of three options, each of which ensures that the consignee's creditors were or should have been made aware of the consignor's interest.⁶⁴ The consignor's safest option involves filing an Article 9 financing statement listing the consignor as the secured party, the consignee as the debtor, and the consigned goods as the collateral.⁶⁵

61. Article 2A provides that, in general, "a creditor of a lessee takes subject to the lease contract." U.C.C. § 2A-307(1) (1991).

62. Section 2-326(3) provides:

Where goods are delivered to a person for sale and such person maintains a place of business at which he deals in goods of the kind involved, under a name other than the name of the person making delivery, then with respect to claims of creditors of the person conducting the business the goods are deemed to be on sale or return.

U.C.C. § 2-326(3) (1991). In the normal consignment transaction the consignor does deliver goods to the consignee for the purpose of resale to end users, and the consignee will run the business under its own name rather than under the consignor's name. This type of transaction is typical of certain trades, such as the jewelry business. See Ingrid M. Hillinger, *The Treatment of Consignments in Bankruptcy: Two Codes and Their Fictions, at Play, in the Fields*, 6 BANKR. DEV. J. 73, 73-74 (1989). Sometimes the "consignment" involves more of a true agency because the consignee does not maintain a fixed place of business at which he deals in that type of goods. See *Manger v. Davis*, 619 P.2d 687, 692-93 (Utah 1980).

63. U.C.C. § 2-326(2) (1991).

64. The consignor can comply with an applicable sign law that allows its interest to be evidenced by a sign posted at the consignee's place of business; establish that the consignee is generally known by its creditors to be engaged in the business of selling consigned goods; or file an Article 9 financing statement. U.C.C. § 2-326(3) (1991). Article 9 itself provides for the filing of precautionary financing statements by consignors and lessors using appropriate terminology. *Id.* § 9-408.

65. William D. Hawkland, *The Proposed Amendments to Article 9 of the UCC—Part 5: Consignments and Equipment Leases*, 77 COM. L.J. 108, 109 (1972). In addition to the normal Article 9 filing, the consignor may have to take additional steps to protect itself against the interests of prior inventory secured parties. If the consignee's secured creditors have previously filed financing statements covering the consignee's own inventory of goods and the goods being consigned are of the same type, then the consignor must give the prior inventory secured parties direct written notification of its interest in order to have priority over the earlier secured parties. U.C.C. § 9-114 (1991). This provision parallels the provi-

True consignments, although indirectly brought into Article 9 in this fashion, are not necessarily equated with Article 9 secured transactions. The true consignor's interest is not denominated a security interest as such.⁶⁶ True consignments are often used when the consignor desires to fix the price at which the consignee sells the goods⁶⁷ or when the consignee does not want to bear the risk of the market by buying the goods from the consignor.⁶⁸ By requiring an Article 9 filing or similar act of public notification, the drafters simply recognized that consignments, whether true or security in nature, present problems of ostensible ownership. The consignee's possession of the goods may deceive third parties into believing that the consignee owns the goods free and clear of all other claims.⁶⁹

In a true consignment, the consignor remains the titleholder, and the consignee holds a more limited interest. That interest includes the right to retain the goods until they are sold or until the consignee decides to return them unsold to the consignor.⁷⁰ A true consignment seems therefore to be more like a traditional bailment, with the consignee possessing the goods for a restricted purpose and for a limited period of time. To the extent that a bailee has sufficient rights to support the attachment of a security interest, the consignee in a true consignment arguably has such rights as well.⁷¹

sion requiring purchase money inventory secured parties claiming a superpriority to have given written notification to earlier inventory secured parties. *Id.* § 9-312(3).

66. Only where the consignment is intended for security purposes is the consignor's reservation of title denominated a "security interest." U.C.C. § 1-201(37) (1991).

67. *See, e.g.*, *Columbia Int'l Corp. v. Kempler*, 175 N.W.2d 465, 471 (Wis. 1970) (noting that the presence of a price-fixing element in a consignment arrangement made it a "true" consignment). Professor Hawkland has been the chief promoter of the view that the only true consignments are those that involve price fixing. *See* William D. Hawkland, *Consignment Selling Under the Uniform Commercial Code*, 67 *COM. L.J.* 146, 148-49 (1962); Hawkland, *supra* note 65, at 109-10; William D. Hawkland, *Consignments Under the Uniform Commercial Code: Sales or Security?*, *UNIFORM COMMERCIAL CODE CO-ORDINATOR ANNOTATED* 395 (1963).

68. The consignee's right to return unsold goods spares it from bearing the risk of the market because presumably it is not obligated to pay for the goods returned. *See* 1 GILMORE, *SECURITY INTERESTS*, *supra* note 24, § 11.2, at 338.

69. *See* ROBERT M. LLOYD, *SECURED TRANSACTIONS* § 12.02 (1988); Peter Winship, *The "True" Consignment Under the Uniform Commercial Code, and Related Peccadilloes*, 29 *SW. L.J.* 825, 844-45 (1975).

70. Normally, the consignment agreement will specify that title to the consigned goods remains with the consignor until the goods are sold to a purchaser, at which time title passes directly from the consignor to the purchaser. *See, e.g.*, *Mann v. Clark Oil & Ref. Co.*, 302 F. Supp. 1376, 1378-79 (E.D. Mo. 1969), *aff'd*, 425 F.2d 736 (8th Cir. 1970) (*per curiam*).

71. *See, e.g.*, *Nasco Equip. Co. v. Mason*, 229 S.E.2d 278, 283 (N.C. 1976) (affirming summary judgment that debtor has sufficient rights in consigned goods for attachment of a security interest); *Sussen Rubber Co. v. Hertz*, 249 N.E.2d 65, 68 (Ohio Ct. App. 1969)

Section 2-326 itself hints at an answer to the question of whether security interests given by the consignee can attach to consigned goods. Goods held on sale or return are subject to the claims of the buyer's creditors while in the buyer's possession.⁷² Goods delivered to a consignee as part of certain true consignments⁷³ are deemed to be held on sale or return unless the consignor complies with one of the three notification options.⁷⁴ Thus, by negative implication, the consignor who complies with the notification provision can rest upon its title to remove the goods from the reach of all creditors, including secured creditors. The question of attachment is irrelevant in that instance. Even if the security interest attaches to the goods, the consignor's title preempts the security interest.⁷⁵

Conversely, if the consignor does not comply with one of the notification options, the goods are subject to the claims of the consignee's creditors.⁷⁶ Arguably, the consignee's "creditors" include its secured creditors, which would imply that the consignee has sufficient rights in the consigned goods for Article 9 security interests to attach.⁷⁷ Section 9-114 confirms this analysis by specifically subordinating a nonfiling consignor to a secured party with a security interest in the consignee/debtor's inventory.⁷⁸ Thus, the drafters of Article 9

(holding that debtor-consignee has sufficient rights in consigned goods for a security interest to attach).

72. U.C.C. § 2-326(2) (1991).

73. Section 2-326 refers to situations in which "goods are delivered to a person for sale and such person maintains a place of business at which he deals in goods of the kind involved, under a name other than the name of the person making the delivery." *Id.* at (3). True consignments in which the consignee takes possession of the consigned goods for the purpose of arranging their sale to a third party generally fit this description.

74. *Id.*; see also *supra* note 64 and accompanying text.

75. In this instance, the secured party would be accorded a ranking junior even to the consignor. The consignor's title or ownership interest in the goods will completely swallow up all other interests. The true consignment differs from the situation in which the debtor has given security interests to two secured parties. In the latter situation, even if the senior secured party satisfies its interest in full first, the remaining value of the collateral may be sufficient to satisfy at least a portion of the junior secured party's interest. In a true consignment, the consignee has no indebtedness to the consignor until the goods are sold. The consignor's interest is not in having a particular amount of debt satisfied, but in having the goods returned or their sale price remitted. It is therefore unlikely that there would be any surplus value to give to a secured party even if its security interest had attached to the consigned goods.

76. See *supra* note 64 and accompanying text.

77. *But see Cantor v. Anderson*, 639 F. Supp. 364, 368 (S.D.N.Y.) (holding that debtor-consignee did not have sufficient rights in consigned painting for attachment of security interest), *aff'd*, 833 F.2d 1002 (2d Cir. 1986).

78. Section 9-114 treats true consignments similarly to purchase money security interests in inventory by requiring the consignor desiring priority both to file a financing statement and to notify prior filed inventory secured parties in writing of the consignor's interest in particular goods. Compare U.C.C. § 9-114 (1991) (requiring consignors claiming

must have assumed that the consignee in a true consignment would have sufficient rights in the consigned goods for inventory security interests to attach.⁷⁹

2. Other Bailments

The drafters clearly thought more about consignments than they did about other types of bailments, and apparently desired to push almost all consignments into Article 9 for the purposes of filing and, to a lesser extent, determining priorities. Although the question of attachment does not appear to have been of paramount importance, the drafters seemingly assumed that security interests could attach to consigned goods, whether those goods were held on a true or a security consignment.⁸⁰ In a true consignment, however, the consignee's rights in the goods are minimal—the right of possession coupled with the ability to sell the goods on behalf of the consignor.⁸¹ If those rights satisfy the standard for rights in the collateral, then the bailee's interest in other types of bailments involving possession for some limited purpose arguably also satisfies it.

Bailments not constituting leases or consignments comprise several disparate types of transactions. They all involve the bailor's relinquishment of the goods to the bailee for a limited duration and for a specific purpose. These purposes include processing raw materials into a finished product,⁸² breeding and maintaining livestock,⁸³ repairing defective goods,⁸⁴ and storing or transporting goods.⁸⁵

priority to file a financing statement and notify prior inventory secured parties) *with* U.C.C. § 9-312(3) (requiring purchase money-secured parties claiming priority to notify prior inventory secured parties).

79. For an excellent discussion of this issue and others relating to consignments, see Hillinger, *supra* note 62.

80. See *supra* notes 62-79 and accompanying text.

81. See *supra* note 62.

82. *Medomak Canning Co. v. William Underwood Co.* (*In re Medomak Canning Co.*), 25 U.C.C. Rep. Serv. (Callaghan) 437, 440-41 (Bankr. D. Me. 1977); *Litwiller Mach. & Mfg., Inc. v. NBD Alpena Bank*, 457 N.W.2d 163, 164 (Mich. Ct. App. 1990) (*per curiam*); *State Bank of Young America v. Vidmar Iron Works, Inc.*, 292 N.W.2d 244, 247 (Minn. 1980); *Morton Booth Co. v. Tiara Furniture, Inc.*, 564 P.2d 210, 211 (Okla. 1977).

83. See *Germany v. Farmer's Home Admin.* (*In re Germany*), 73 B.R. 19, 21 (Bankr. S.D. Miss. 1986); *Union State Bank v. Cook* (*In re Cook*), 63 B.R. 789, 791-92 (Bankr. D.N.D. 1986).

84. See *Rameker v. Federal R.R. Admin.* (*In re Chicago, Madison & Northern Ry.*), 36 B.R. 292, 293-94 (Bankr. D. Wis. 1984).

85. See *In re Farmers Grain Exch., Inc.*, 20 U.C.C. Rep. Serv. (Callaghan) 1054, 1056 (W.D. Wis. 1976); *Petzoldt v. Lawrence Warehouse Co.*, 157 F. Supp. 184, 186-87 (D. Colo. 1957), *aff'd*, 262 F.2d 540 (10th Cir. 1958).

Courts have disagreed about whether a debtor who takes possession of goods from the owner for the purpose of processing them into some other form acquires sufficient rights for a security interest to attach. The resolution of the issue seems to turn on whether the court classifies the arrangement between the owner and the debtor as a bailment or a sale. Two cases involving the same debtor illustrate this point.

In *Eastman Kodak Company v. Harrison (In re Sitkin Smelting and Refining, Inc.) (Sitkin I)*,⁸⁶ Kodak, a manufacturer of photographic film, delivered film waste to Sitkin so that Sitkin could recover the silver content from the waste.⁸⁷ Under the contract Sitkin was required to purchase any silver so recovered.⁸⁸ At the time of Sitkin's bankruptcy, it had in its possession 382,000 pounds of Kodak film waste.⁸⁹ Despite several features of the arrangement that suggested a sale of future goods, the Fifth Circuit Court of Appeals held that the transaction between Kodak and Sitkin constituted a bailment.⁹⁰ The court emphasized that Kodak had special reasons for not wanting to sell the film waste to Sitkin outright.⁹¹

In addition, the contract between the two parties suggested that they did not intend a sale to Sitkin until the silver had been extracted from the waste.⁹² For example, Kodak had the right to demand return of the film waste at any time before the silver was extracted.⁹³ The film also retained its Kodak labels and was stored in separate warehouses apart from other material processed by Sitkin.⁹⁴ Only after the film had been processed and the silver extracted was Sitkin obligated to purchase the metal recovered on processing.⁹⁵

The Fifth Circuit panel held that Sitkin's rights in the film waste as a bailee were insufficient for the competing security interest to at-

86. 639 F.2d 1213 (5th Cir. 1981).

87. *Id.* at 1214.

88. *Id.*

89. *Id.*

90. *Id.* at 1216-17.

91. The film sent to Sitkin for processing was of inferior quality, and thus Kodak was concerned that, while intact, it should not fall into the hands of anyone who might attempt to sell it as Kodak film and thereby undermine Kodak's reputation for quality. *Id.* at 1214. In addition, Kodak was involved in litigation with Polaroid, for whom Sitkin also processed film, and it was imperative that the film not inadvertently fall into Polaroid's hands. *Id.*

92. *Id.*

93. Upon two days' notice, either party could cancel the contract and at that point the film waste in Sitkin's possession, at Kodak's option, would be either returned to Kodak or processed. *Id.*

94. *Id.*

95. *Id.*

tach.⁹⁶ In addition, the court found nothing in the Code that allowed the secured party to acquire any better rights than the ones enjoyed by the debtor.⁹⁷ Section 2-403(1), allowing certain purchasers with voidable title to pass good title to good faith purchasers for value, did not apply because the debtor was not a purchaser with a voidable title; it did not have any title at all.⁹⁸ Section 2-403(2), which applies explicitly to bailment situations, did not help the secured party either because it protects only buyers in the ordinary course of business.⁹⁹ The Code's definition of "buyer in the ordinary course of business" specifically excludes secured parties.¹⁰⁰ Thus, the secured party in *Sitkin I* could not boost its position beyond that of the debtor.

In a case decided a few months later involving the same bankrupt debtor, the Fifth Circuit panel found in favor of the inventory secured party and against the putative bailor. In *WESGO Division of GTE Products Corp. v. Harrison (In re Sitkin Smelting & Refining, Inc.) (Sitkin II)*,¹⁰¹ the plaintiff WESGO supplied scrap metal to Sitkin for processing. Under the contract, WESGO could elect that Sitkin purchase the precious metals recovered during processing or return metals of like kind and quality minus a processing fee.¹⁰² Upon Sitkin's insolvency WESGO sought to reclaim thirty-five drums of unprocessed scrap material in Sitkin's possession.¹⁰³ As in *Sitkin I*, the supplier argued that Sitkin held the goods as a mere bailee and thus WESGO, as the true owner, had the right to retake the goods based on its title.¹⁰⁴ The good faith purchaser doctrine of section 2-403(1), the supplier asserted, did not apply to give the inventory secured party good title.¹⁰⁵

96. *Id.*

97. *See id.* at 1215-16.

98. *Id.* at 1215; *cf. Stowers v. Mahon (In re Samuels & Co.)*, 526 F.2d 1238, 1242-43 (5th Cir.) (en banc) (holding that where the bankrupt was a purchaser from the claimant, the secured creditor can be a "good faith purchaser" and take good title under § 2-403(1)) *cert. denied*, 429 U.S. 834 (1976).

99. *Sitkin I*, 639 F.2d at 1215-16.

100. U.C.C. § 1-201(9) (1991) ("'Buying' may be for cash or by exchange of other property or on secured or unsecured credit . . . but does not include a transfer in bulk or as security for or in total or partial satisfaction of a money debt.").

101. 648 F.2d 252 (5th Cir. 1981).

102. *Id.* at 253.

103. *Id.*

104. *Id.* at 254.

105. The good faith purchaser doctrine of § 2-403(1) applies only when the transferor has at least voidable title. In that circumstance the transferor can transfer good title to a good faith purchaser for value. U.C.C. § 2-403(1) (1991). A simple bailee of goods arguably has no title in them whatsoever. *Sitkin II*, 648 F.2d at 254.

Contrary to *Sitkin I*, the court held that the transaction between WESGO and Sitkin was a sale of goods and not merely a bailment.¹⁰⁶ Sitkin in essence agreed to purchase the scrap material either for cash or by return of precious metals.¹⁰⁷ In contrast to Kodak's arrangement with Sitkin in *Sitkin I*, WESGO did not have the option to demand return of the scrap material once it was delivered to Sitkin for processing.¹⁰⁸ Nor did Sitkin have the option to cancel the contract and return the scrap, as it did in its arrangement with Kodak.¹⁰⁹ The court also noted that the unique features of the Kodak-Sitkin contract made it clear that "the parties intended that title remain in Kodak until the scrap material had been processed."¹¹⁰

Because the court found that the transaction between Sitkin and WESGO constituted a sale, it held that Sitkin's "voidable" title gave it the ability to pass good title to a good faith purchaser such as the inventory secured party.¹¹¹ The inventory secured party was thus entitled to prevail against the interest of WESGO as an unpaid seller.¹¹²

The opinions in these two cases illustrate some of the difficulties that courts have had in distinguishing between bailments and sales and between rights sufficient for attachment and rights that are not. For one thing, the distinction between the bailment in *Sitkin I* and the sale in *Sitkin II* turns mainly on facts not apparent to anyone but the parties to the transaction. Kodak's option to cancel the contract and its reasons for desiring to retain title would not be apparent to even a diligent inquiring creditor. If Sitkin's business is processing waste materials received from various suppliers, whom Sitkin is obligated to pay in some fashion, then perhaps it is asking too much to expect third parties to investigate the precise terms of every agreement that Sitkin has with its suppliers.

The Code's drafters recognized the unfair burden placed on third parties to discover the debtor's arrangement with individual suppliers in its treatment of consignments.¹¹³ A debtor holding inventory for sale may possess inventory purchased from suppliers as well as inventory held on consignment from suppliers. Regardless of the manner in

106. The court stated that "[t]he agreement was essentially a contract for the sale of future goods." *Sitkin II*, 648 F.2d at 254.

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.* In *Sitkin I*, Kodak had particular reasons for not wanting to sell the scrap film to Sitkin outright. See *supra* note 91.

111. *Sitkin II*, 648 F.2d at 255.

112. *Id.*

113. See *supra* text accompanying notes 66-69.

which the debtor holds the inventory, the supplier who desires to claim an interest in the property must cure the ostensible ownership problem in some fashion. The supplier who has sold goods to the debtor while reserving a security interest must file a financing statement under Article 9 to perfect its interest.¹¹⁴ The supplier who has consigned goods to the debtor in most cases will similarly be required to file an Article 9 financing statement.¹¹⁵

In either sale or consignment situations, the inquiring creditor can refer to the public record as the means of ascertaining prior interests. The creditor dealing with the debtor's inventory in these circumstances does not have to inquire into the details of arrangements between the debtor and its suppliers. The *Sitkin* cases illustrate that third-party creditors must investigate the debtor's arrangements to determine whether goods in debtor's possession are held on a bailment or owned outright. Such investigation may not be burdensome if the debtor's principal business is processing or repairing goods that are then returned to the bailor—e.g., a shoe repair shop normally does not purchase the shoes that it repairs; a film development store does not ordinarily purchase the exposed film that it processes into prints or slides. However in the *Sitkin* cases, the debtor's arrangements with its suppliers were not so clear-cut. The debtor, after extracting the precious metals from the waste products delivered to it, sometimes paid the supplier for the metals and sometimes returned the metals minus a processing fee.¹¹⁶ In the former situation the debtor ultimately bought the goods from the supplier; in the latter the debtor provided the supplier with a service. In some instances, the supplier apparently had the option to choose between the sale or service option.¹¹⁷

The courts deciding the *Sitkin* cases and others involving bailments and quasi-bailments sometimes bypass Article 9 analysis and instead focus unnecessarily on the good faith purchaser doctrine in section 2-403. By emphasizing the good faith purchaser doctrine, courts have portrayed the basic conflict in these cases as between an "owner" of the collateral and a "purchaser" of the collateral. In many of these cases the true nature of the conflict is between two secured parties. The true owner's reservation of title is in reality the reservation of a security interest only. If one looks behind the form of the

114. U.C.C. § 9-302(1) (1991).

115. See *supra* note 64.

116. See *Sitkin I*, 639 F.2d at 1214; *Sitkin II*, 648 F.2d at 253.

117. *Sitkin II*, 648 F.2d at 253.

transaction to its real purpose and substance, the security aspects become evident.

A “bailment” that functions as a financing device frequently occurs in industries where the bailor supplies raw materials to the bailee for manufacture into some finished product.¹¹⁸ In the typical secured transaction, the lender provides a loan to the debtor that enables it to acquire inventory for processing or immediate sale. The lender obtains a security interest in the inventory to secure the debtor’s repayment of the loan. In some industries a business sells particular goods that another business has manufactured according to the seller’s specifications. Instead of furnishing working capital to the manufacturer, the seller supplies the necessary raw materials to the manufacturer. Upon completion of the goods, the manufacturer then sells them on the seller/supplier’s behalf or returns them to the supplier minus a fee.¹¹⁹

When the supplier retains title to the raw materials supplied in these situations, it does so as a security device. If the manufacturer fails to deliver the finished product or fails to remit proceeds of finished goods sold to buyers on the supplier’s behalf, then the supplier may attempt to repossess the raw materials and any finished or unfinished goods to satisfy the manufacturer’s obligation.

In sales transactions, the Uniform Commercial Code treats the seller’s reservation of title as merely the reservation of a security interest.¹²⁰ Case law holds that in consignments intended for security, the consignor’s reservation of title is in effect the reservation of a security interest. The question remains whether title retention in a bailment should be treated as equivalent to the creation of a security interest.

Article 9 applies generally to transactions in which the parties intend to create a security interest in personal property or fixtures;¹²¹ “security interest” is defined generally as “an interest in personal

118. See generally Brent Gordon Summers, Note, “Bailment for Processing”: Article Nine Security Interest or Title Retention Contract?, 61 OR. L. REV. 441 (1982) (arguing that the supply of raw materials to a manufacturer is in essence a financing device).

119. See *Kinetics Technology Int’l Corp. v. Fourth Nat’l Bank*, 705 F.2d 396, 397 (10th Cir. 1983) (noting that supplier furnished tubes, castings, and other materials to debtor for manufacture into furnace economizers); *Medomak Canning Co. v. William Underwood Co.* (*In re Medomak Canning Co.*), 25 U.C.C. Rep. Serv. (Callaghan) 437, 439 (Bankr. D. Me. 1977) (noting that supplier furnished ingredients and packing and shipping materials for processing into canned pork and beans).

120. U.C.C. § 1-201(37) (1991) states that “[t]he retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer . . . is limited in effect to a reservation of a ‘security interest.’ ”

121. U.C.C. § 9-102(1)(a) (1991).

property or fixtures which secures payment or performance of an obligation."¹²² In the broadest sense of this definition, whenever the owner of goods releases them to the custody of another for some limited purpose, the owner's retention of title serves a security purpose. The owner expects that if the goods are not returned at the appropriate time or if some other obligation with respect to the goods is not satisfied, then the owner will be able to rely on its title to reclaim the goods. The owner also expects that its reclamation will be free from the claims of third parties—that, generally speaking, the bailee does not have the ability to encumber the property or sell it without the true owner's consent.

If all transactions in which ownership and possession are in different hands are denominated secured transactions covered by Article 9, then analysis under section 2-403—the good faith purchaser provision—is no longer necessary nor desirable. In such circumstances, the owner must file a financing statement to protect itself from the claims of third parties. In the absence of a filing or other act of perfection, a second secured party with a perfected security interest in the debtor's equipment or inventory will have priority over the unperfected security interest of the original owner of the goods. Under this analysis the courts need not bother with trying to determine whether the second claimant is a good faith purchaser or buyer in the ordinary course of business under section 2-403.

The end result of implicating Article 9 whenever ownership and possession are severed is that true bailments and leases would become subject to filing requirements, whereas currently they are considered outside the scope of Article 9's public notification system. In fact, some scholars have suggested that the inclusion of such transactions within Article 9 is highly desirable because it lessens the possibility that third parties will be deceived by the debtor's apparent ownership of property in its possession.¹²³ Of course, the inclusion of all such transactions within Article 9 carries with it costs that may or may not be offset by the benefits of increased notification to third parties.¹²⁴

For example, an individual who takes her watch to a jewelry store for repairs expects that the store may possess the watch for a week or two. To require a filing in that situation would unnecessarily burden

122. U.C.C. § 1-201(37) (1991).

123. See Baird & Jackson, *Possession and Ownership*, *supra* note 30, at 189 (arguing that, as a general rule, holders of nonpossessory property interests should have to cure the ostensible ownership problem); Kripke, *supra* note 47, at 800-01 (arguing that true leases should be subject to Article 9 filing requirements).

124. See Mooney, *supra* note 47, at 686-87 (arguing that inclusion of true leases within Article 9 filing requirements is not necessarily cost effective).

both the watch's owner and the filing system. The owner would be forced to undertake the expense and effort of filing to protect herself for a brief period during which ostensible ownership is problematic. In addition, it is doubtful that third-party creditors of the store would rely on the store's apparent ownership of a particular used watch. In many instances the watch's value will be insignificant compared to the value of the store's total inventory. The fact that the store has a repair department, moreover, will give third parties some reason to inquire as to whether the watch is in fact owned by someone else.

The temporary entrustment of a watch to a repair shop contrasts with the furnishing of raw materials to a manufacturer or processor in the cases described above. In the latter situation, the value of the property at stake and the likelihood of third party deception are much greater. Raw materials being processed into finished goods may constitute a large segment of the manufacturer's inventory at any given time. In addition, if the manufacturer routinely processes its own goods as well as those of others, third parties may be misled into thinking that the raw materials supplied by the supplier are part of the manufacturer's own inventory.

The relative costs and benefits must also be considered in other transactions in which possession and ownership are, at least for some period of time, separated: leases, transactions in which goods are stored either temporarily or relatively permanently, and situations in which the debtor is acting as a selling agent for the owner. In each case, the probability of deception of later creditors must be weighed against the expense of undertaking a filing.

Leased collateral tends to be equipment rather than inventory. Article 9 already imposes on inquiring parties interested in the debtor's equipment for security or other purposes the burden of determining the origin of the debtor's title in the equipment.¹²⁵ For example, a filed financing statement remains effective with respect to collateral transferred to a third party.¹²⁶ Hence if C-1 files an appropriate financing statement covering a drill press held by its debtor, D, the financing statement continues to perfect the security interest in the press once D sells the press to X.¹²⁷ If C-2 wants to take a security

125. Article 9 states that "any person searching the condition of the ownership of a debtor must make inquiry as to the debtor's source of title, and must search in the name of a former owner if circumstances seem to require it." U.C.C. § 9-402 cmt. 8 (1991).

126. *Id.* § 9-402(7).

127. U.C.C. § 9-306(2) (1991) provides that the security interest continues in collateral upon its sale or disposition unless the "disposition was authorized by the secured party in the security agreement or otherwise." Thus, if the secured party authorizes the sale of the drill press to X free of the security interest, then the security interest will be cut off at that

interest in the press in the hands of X, it must search for financing statements not only in X's name but also in D's name. Consequently, in any secured transaction involving used equipment, the later creditor must determine how the debtor acquired the equipment and whether there might be valid security interests given by a previous owner.

Other sections of Article 9 impose similar burdens of inquiry on later creditors.¹²⁸ Thus, it may not be unreasonable to ask these creditors to determine whether certain items of equipment are leased as opposed to owned by the debtor. Assuming that the inquiring creditor's standard investigation normally discloses the lessor's interest, then arguably leases need not be brought under the Article 9 filing requirements.

The inventory situation is different, however. The Code already allocates greater monitoring burdens to the inventory financier than to any other type of secured party. In addition to keeping track of interstate movement of the collateral, the creditor with a security interest in the debtor's inventory must remain abreast of name changes by the debtor¹²⁹ and the location and nature of any proceeds generated from the sale of the collateral.¹³⁰ Correspondingly, the burden of investigation on later creditors is lighter than in situations involving equipment. For example, a creditor interested in the debtor's inventory need not be concerned that the debtor purchased the goods from someone who had given a security interest to an earlier secured party. The second debtor would be a buyer in the ordinary course of business in most instances and would take free of any earlier security interests.¹³¹

point and the effectiveness of the financing statement is irrelevant. See PERMANENT EDITORIAL BOARD COMMENTARY NO. 3, 12 (Mar. 10, 1990) (harmonizing § 9-402(7) and § 9-306(2)).

128. See, e.g., U.C.C. § 9-103(1)(d) (concerning interstate movements of collateral); 9-402(7) (1991) (regarding effect of name changes).

129. If the debtor changes its name in such a way that the existing financing statement is rendered seriously misleading, then the secured party must refile in the debtor's new name to continue perfection in collateral acquired more than four months after the name change. U.C.C. § 9-402(7) (1991).

130. The security interest continues in any identifiable proceeds of the collateral. U.C.C. § 9-306(2) (1991). If the security interest in the original collateral was perfected, it continues to be perfected automatically in any proceeds for ten days after the debtor's receipt of them. U.C.C. § 9-306(3). Perfection in the proceeds beyond the ten-day period without any further action by the secured party continues only in certain limited circumstances. *Id.*

131. U.C.C. § 9-307(1) (1991) allows the buyer in the ordinary course of business to take free of a security interest created by his seller. "Buyer in the ordinary course of business" is defined as "a person who in good faith and without knowledge that the sale . . . is in violation of the ownership rights or security interest of a third party in the goods buys in the ordinary course from a person in the business of selling goods of that kind." U.C.C.

This analysis suggests that at least some leases and bailments may be properly excluded from Article 9 filing requirements. If the burdens of filing exceed the expected benefits to inquiring third parties, then inclusion of these transactions within the Article 9 scheme will not be cost effective. As will be explored more fully below, titleholders in short-term lease and bailment transactions may find filing particularly burdensome given the quick turnover of the leased or bailed property. At the same time, in these short-term transactions certain facts may suggest to third parties that they should not assume that the debtor owns the property in question—e.g., repair or refurbishment situations.

B. *Consent and Estoppel*

Consent and estoppel issues frequently arise in bailment cases. The bailee, though not the true or sole owner of the collateral, may be found to have sufficient rights in the collateral for attachment of a security interest by virtue of the true owner's or co-owner's consent or misleading behavior.¹³² These issues could also arise in non-bailment cases when the true owner or a third party possesses the collateral. The obligor-debtor need not possess the property sought to be encumbered for the true owner to give its consent to the encumbrance or even to be estopped to deny the obligor's apparent ownership of the property.¹³³

Estoppel, however, will be argued most frequently in cases in which the obligor-debtor physically possesses the collateral, e.g., by virtue of a bailment, lease, consignment, sale on approval, or other arrangement. Estoppel is predicated on the true owner's having misled the secured party by its actions as to the actual state of the obligor-debtor's rights in the collateral. The lender is more likely to be deceived, of course, when the debtor possesses the property.

When courts employ estoppel analysis in these cases, they step outside the strict confines of the Uniform Commercial Code and rely on general equitable principles. The Code itself permits reference to general notions of common law and equity unless they are displaced

§ 1-201(9). A debtor purchasing inventory will normally meet this definition because it will be buying from a manufacturer or wholesaler who deals in goods of the kind involved.

132. See *infra* notes 135-210 and accompanying text.

133. In *In re Pubs, Inc.*, 618 F.2d 432, 438-39 (7th Cir. 1980), the court found that the true owner, a corporation, was estopped to deny a security interest given by the obligor-debtors to the bank in equipment that the corporation, rather than the obligors, possessed. *Id.* at 438.

by specific provisions of the Code.¹³⁴ Because rights in the collateral is nowhere defined in the Code, it lends itself readily to elaboration by reference to non-Code concepts such as estoppel.

1. Consent

Article 9 expressly contemplates situations in which the owner of the collateral and the obligor of the secured debt are not the same person.¹³⁵ One assumes that the drafters envisioned transactions in which the owner of the property gives its consent to the encumbrance to secure repayment of a loan to the obligor. In this situation both the owner and the obligor can be considered "debtors" within the meaning of Article 9.¹³⁶

The owner might assent to another's encumbering its property for a variety of reasons—compensation, common business purposes, and familial relationships, among others. In most cases the owner will see some advantage in the loan to the obligor secured by the owner's property—for example, when an individual owning two separate but related incorporated businesses allows the assets of one to be pledged to secure a loan to the other.¹³⁷

Sometimes consent cases are relatively straightforward, as when a parent agrees in writing that a lender may take a security interest in his car to secure a loan to his child. When the consent issue is not straightforward, it tends to take one of three forms: (1) Is consent necessary to give the obligor rights in the collateral? (2) If so, did the

134. U.C.C. § 1-103 (1991) provides that "[u]nless displaced by the particular provisions of this Act, the principles of law and equity, including . . . the law relative to . . . estoppel . . . shall supplement its provisions."

135. See *infra* note 136.

136. The term "debtor" under the U.C.C. is defined generally as the obligor of the secured obligation, "whether or not he owns or has rights in the collateral." U.C.C. § 9-105 (1)(d) (1991). But when the obligor debtor and the owner of the collateral are not the same person, "the term 'debtor' means the owner of the collateral in any provision of the Article dealing with the collateral, the obligor in any provision dealing with the obligation, and may include both where the context so requires." *Id.* Courts have held that when the owner and the obligor are not the same person, the owner is a "debtor" for purposes of the provisions on the security agreements and financing statements. In other words, the owner, along with the obligor-debtor, must sign the security agreement and the financing statement. See *Baystate Drywall, Inc. v. Chicopee Sav. Bank*, 429 N.E.2d 1138, 1140-41 (Mass. 1982); *Little v. County of Orange*, 229 S.E.2d 823, 825 (N.C. Ct. App. 1976); *First Nat'l Bank v. Feeney*, 393 N.W.2d 458, 460 (S.D. 1986).

137. See, e.g., *Advanced Turbo Prods., Inc. v. Congress Fin. Corp. (Fla.) (In re Advanced Turbo Prods., Inc.)*, 126 B.R. 630, 631 (Bankr. S.D. Fla. 1991) (noting that president of owner of equipment was also debtor corporation's president); *Peterson v. First Tenn. Bank*, slip op. (Tenn. Ct. App. July 30, 1985) (LEXIS, States library, Tenn file) (same).

party permitting the encumbrance have authority to do so? and (3) Was the consent sufficiently manifested orally or in writing?

The necessity of obtaining consent depends on whether the debtor has rights in the collateral without the consent of the third party.¹³⁸ In other words, in the familiar bailment cases, if the debtor's possession of goods and the authority to transform them into a finished product are sufficient to give her rights in the collateral, then the bailor's consent to the security interest will not be necessary to ensure attachment.

In many cases, however, the debtor will not have even the minimal rights afforded a bailee or his rights will be restricted in some way.¹³⁹ For example, a corporation normally does not have any interest in the individual property of its officers and directors, but sometimes an officer will agree to pledge her individual assets to secure a loan to the corporation.¹⁴⁰ Similarly, a partner, although having a property interest in the partnership assets, may be prevented by the

138. When U.C.C. § 9-203(1)(c) (1991) refers to the "debtor" having rights in the collateral, the word "debtor" could mean either the obligor or the owner of the collateral when they are not the same person. Section 9-105(1)(d), which defines "debtor," indicates that the word "means the owner of the collateral in any provision of the Article dealing with the collateral, the obligor in any provision dealing with the obligation and may include both where the context so requires." Arguably, § 9-203(1)(c) concerns the collateral, and thus the debtor who has rights in the collateral must be the owner-debtor rather than the obligor-debtor. But it is somewhat redundant to say that the "owner" debtor must have rights in the collateral—the term "owner" implies that one has title to the property in question. Perhaps by "owner" the drafters meant the party who has rights in the collateral. In other words, in a secured transaction there could be two debtors—one who owes the obligation to the secured party and the other who furnishes the collateral and has some rights in it sufficient to support attachment, whether or not those rights amount to full title. If this interpretation is correct, then the obligor does not need to gain rights in the collateral through the owner's consent. It is merely implicit that the obligor needs the owner's permission to pledge the latter's property as security for a loan.

Some courts have treated the owner's consent, however, as giving the obligor-debtor the necessary rights in the collateral. *See, e.g.,* K.N.C. Wholesale, Inc. v. AWMCO, Inc., 128 Cal. Rptr. 345, 348 (Cal. Ct. App. 1976); General Motors Acceptance Corp. v. Washington Trust Co., 386 A.2d 1096, 1098 (R.I. 1978); First Nat'l Bank v. Feeney, 393 N.W.2d 458, 460 (S.D. 1986).

139. The Official Comment to § 9-112 states that that section does not purport to determine when an obligor debtor may encumber another's property or whether an owner-debtor may mortgage his own property to secure another's debt. These questions are presumably left to non-Code law. U.C.C. § 9-112 cmt. (1991).

140. *See* United States Small Business Admin. v. Guaranty Bank & Trust Co. (*In re* Whatley), 874 F.2d 997, 999 (5th Cir. 1989); Northeast Nat'l Bank v. Tillotson, 12 B.R. 124, 125 (Bankr. N.D. Tex. 1981); Recchio v. Manufacturers & Traders Trust Co., 286 N.Y.S.2d 390, 392 (N.Y. Sup. Ct. 1968), *rev'd on other grounds*, 316 N.Y.S.2d 915 (N.Y. App. Div. 1970).

partnership agreement from using partnership property as security for an individual debt without the consent of all partners.¹⁴¹

Sometimes a debtor who clearly has rights in the collateral will be restrained by his agreement with a third party from encumbering the property without the third party's consent. Courts often find these anti-assignment clauses valid; for example, in a franchise agreement the franchisor may prohibit a franchisee who owns various pieces of equipment and fixtures from assigning an interest in them to a creditor.¹⁴² On the other hand, Article 9 explicitly prohibits an account debtor from requiring that the debtor obtain its consent before assigning an account or encumbering a general intangible on which the account debtor is obligated.¹⁴³

If consent is necessary to attachment of the security interest, consent must be properly given. Hence the person giving consent must have authority to do so, and the consent must be sufficiently manifested. Ideally, the person giving consent should be either the true owner or an agent with actual authority to encumber the property. For example, a corporate officer acting pursuant to the corporate charter or a corporate resolution would have authority to give a security interest in corporate assets.¹⁴⁴ Similarly, a partner, depending on the partnership agreement, could be authorized to encumber partnership assets on behalf of the partnership.¹⁴⁵

Apparent authority and ratification cases are more difficult, however. In both instances the agent does not have actual authority to bind the true owner, but it has apparent authority to do so¹⁴⁶ or the true owner ratifies the agent's actions after the fact.¹⁴⁷ For example, a

141. See *Grant v. Podes (In re O'Connell)*, 119 B.R. 311, 312 (Bankr. M.D. Fla. 1990). On the other hand, a partner may validly assign his share of benefits to be received from the sale of a partnership asset without the consent of the other partners. See *Wellsville Bank v. Nicolay*, 638 P.2d 975, 977 (Kan. Ct. App. 1982).

142. *Capital Nat'l Bank v. McDonald's Corp.*, 625 F. Supp. 874, 877 (S.D.N.Y. 1986).

143. U.C.C. § 9-318(4) (1991); see *Knecht Bros. v. Ames Constr.*, 404 N.W.2d 859, 861 (Minn. Ct. App. 1987).

144. *New Commonwealth Publishing Co. v. Baybank Middlesex (In re New Commonwealth Publishing Co.)*, 118 B.R. 155, 159 (Bankr. D. Mass. 1990); *Mid City Bank, Inc. v. Omaha Butcher Supply, Inc.*, 385 N.W.2d 917, 920 (Neb. 1986).

145. Actual authority to bind the partnership may be derived from a statute, "from express provisions of the partnership agreement, from the directions of the other partners, or as an incident to other actual authority." *Bates County Nat'l Bank v. Wilson*, 767 S.W.2d 101, 104 (Mo. Ct. App. 1989).

146. See *Hill v. Van Sandt*, 40 P. 676, 678 (Kan. Ct. App. 1895); *First Nat'l Bank v. Kissare*, 98 P.2d 433, 434 (Okla. 1908); *Fuller & Co. v. Longmire*, 166 P.2d 623, 624 (Wash. 1917).

147. See *K.N.C. Wholesale, Inc. v. AWMCO, Inc.*, 128 Cal. Rptr. 345, 348 (Cal. Ct. App. 1976); *Bates County Nat'l Bank v. Wilson*, 767 S.W.2d 101, 104 (Mo. Ct. App. 1989);

partner might show the secured party a superseded resolution of the partnership authorizing her to grant a security interest in partnership property. If the secured party was not negligent in not further verifying the partner's status, then arguably the partner would have apparent authority to encumber partnership property. Similarly, if the partnership accepted the benefits of a loan from the secured party with the awareness that a partner had purported to give a security interest in partnership property, then a court may find that the partnership ratified the partner's actions even though he acted without actual or apparent authority.¹⁴⁸

Apparent authority and ratification may be viewed as embraced within the broader concept of estoppel, which will be discussed more fully below. In all three cases the true owner of the collateral misleads the secured party by its words or actions or both. The secured party justifiably relies on apparent consent, after-the-fact acceptance of benefits, or seeming ownership by the debtor in making the initial loan or continuing to advance funds under a line of credit. The existence of apparent authority, ratification, and estoppel depends on the nature of the true owner's conduct, any negligence on its part, the reasonableness of the secured party's reliance, and the detriment to the secured party.

If the true owner's consent to the encumbrance is the basis for the obligor-debtor's asserting its rights in the collateral, there remains the question of whether the consent must be manifested in writing. This issue raises the same policy concerns as the Statute of Frauds. In some cases the true owner of the collateral may argue that she never consented to the encumbrance. Requiring a writing provides concrete evidence of the parties' intent and reduces the issues for litigation. Even in cases in which the true owner admits his consent to the encumbrance, insistence on a writing guards against possible after-the-fact collusion among the owner, the debtor, and the secured party. For example, if the true owner has also personally guaranteed the debtor's obligation, she might prefer to admit to a security interest in certain of her business assets rather than be liable on the personal guarantee.

Both written security agreements and financing statements must be signed by the "debtor."¹⁴⁹ When the obligor-debtor and the owner

Mauch v. First Nat'l Bank, 4 U.C.C. Rep. Serv. (Callaghan) 831, 832 (Okla. 1967) (per curiam).

148. See *New Commonwealth Publishing Co.*, 118 B.R. at 160.

149. U.C.C. §§ 9-203(1)(a) (pertaining to security agreement), 9-402(1) (describing requirements of valid financing statement) (1991).

debtor are not the same person, courts have required that these documents be signed by both debtors¹⁵⁰ and that the financing statement be filed in both names. Requiring both signatures on these documents ensures that both the owner and the obligor consent to the granting of the security interest. Theoretically, if the obligor signed the promissory note and the owner signed the security agreement, one could perhaps dispense with the obligor's signature on the security agreement.¹⁵¹ But the security agreement usually contains matters pertaining to the obligation and the maintenance of the collateral that will directly affect the obligor, particularly if he has possession of the collateral.¹⁵²

The owner's signature on the financing statement guarantees that the owner agrees to the description of collateral contained in that document.¹⁵³ The description on the financing statement does not define the scope of the security interest unless the security agreement also serves as the financing statement.¹⁵⁴ Nonetheless, the owner might not want an overly broad description in the public records clouding its ability to obtain credit.¹⁵⁵

Finally, courts have generally required that the financing statement show the names of both the obligor and the owner and be in-

150. See *Midlantic Nat'l Bank North v. Borg-Warner Acceptance Corp. (In re Mayo)*, 112 B.R. 607, 648 (Bankr. D. Vt. 1990) (applying rule to financing statement); *K.N.C. Wholesale, Inc. v. AWMCO, Inc.*, 128 Cal. Rptr. 345, 348 (Cal. Ct. App. 1976); *Motz v. Central Nat'l Bank*, 456 N.E.2d 958, 963 (Ill. Ct. App. 1983) (applying rule to security agreements); *Baystate Drywall, Inc. v. Chicopee Sav. Bank*, 429 N.E.2d 1138, 1140-41 (Mass. 1982) (applying rule to security agreements); *First Nat'l Bank v. Feeney*, 393 N.W.2d 458, 460 (S.D. 1986) (applying rule to financing statements by implication).

151. See *Little v. County of Orange*, 229 S.E.2d 823, 825 (N.C. Ct. App. 1976) (implying that only owner debtor's signature is required on the security agreement).

152. A typical security agreement has clauses requiring the debtor to maintain insurance on the collateral, to keep it in good repair, and not to move it from the debtor's premises without the secured party's permission. It will also contain a definition of default and other matters relating to the obligation. All of these terms will be relevant to the obligor. See *DUNCAN ET AL.*, *supra* note 24, at A-1 to A-5.

153. See *WHITE & SUMMERS*, *supra* note 24, at 1032.

154. A security agreement may also serve as a financing statement if it contains the requisite information: the names and addresses of the debtor and the secured party, the debtor's signature, and a listing of the types of, or a description of the items of, collateral. U.C.C. § 9-402(1) (1991).

155. If the senior secured party files a security interest covering a broad category of property (e.g., "equipment"), then that party is ensured top priority in all items of property within that category even if security agreements regarding those items are not executed until a later date. Thus subsequent would-be lenders to the debtor will be reluctant to lend against any items in that category without a subordination agreement from the senior secured party. See U.C.C. § 9-312(5)(a) (1991); *REILEY*, *supra* note 24, § 3.09[2].

dexed in both names.¹⁵⁶ In this way, creditors of both debtors will be put on notice that the property described may be encumbered. Notifying the owner's creditors is particularly important if the owner retains possession of the collateral; otherwise, her creditors would have no other ready way of discovering the security interest given to secure an obligation undertaken by a wholly different debtor.

Recent cases have not addressed whether an owner could orally assent to the use of his property as collateral for a loan to the obligor. Some pre-U.C.C. cases suggest that oral consent, if sufficiently proved, would be adequate.¹⁵⁷ Because Article 9, however, requires that the security agreement be signed by the debtor, and debtor in this context means both the owner of the collateral and the obligor, it follows that oral consent will probably not be sufficient.

Although oral consent will not substitute for the owner's signature on the security agreement, some courts have applied the doctrine of estoppel to find that the true owner was estopped from denying the security interest's existence. In these cases the courts recognize that the true owner's actions, although not complying with the formal requisites for creating a security interest under Article 9, can mislead the secured party, and thus they force the owner of the collateral to take subject to the security interest.

2. Estoppel

The concept of equitable estoppel has been used to create rights in the collateral for purposes of attachment of security interests under section 9-203(1)(c). This concept most often operates to enlarge upon some slender rights that the debtor actually enjoyed in the property. Through this enlargement the debtor acquires sufficient rights for attachment of a security interest.

In most cases the true owner will have granted some rights to the debtor. Rarely will the debtor start with literally nothing and subsequently obtain rights through the application of estoppel. It is difficult to apply estoppel to the true owner when the true owner has not vested the debtor with possession or control over the collateral. Most often the true owner will have given the debtor possession of the collateral, frequently with some right to use or control the property.

156. *K.N.C. Wholesale, Inc. v. AWMCO, Inc.*, 128 Cal. Rptr. 345, 349 (Cal. Ct. App. 1976); *First Nat'l Bank v. Feeney*, 393 N.W.2d 458, 460 (S.D. 1986).

157. *See Parsons v. Kimmel*, 173 N.W. 539, 540 (Mich. 1919); *Mauch v. First Nat'l Bank*, 4 U.C.C. Rep. Serv. (Callaghan) 831 (Okla. 1967) (citing U.C.C. § 9-112, but relying on pre-Code analysis).

The application of estoppel in these cases is derived from two sources: the Code itself and common law. Section 2-403 of the Code recognizes that sometimes an individual can transfer more rights than she actually has to certain transferees. For example, under section 2-403(1) a "person with voidable title has power to transfer a good title to a good faith purchaser for value."¹⁵⁸ In other words, if X sells a drill press to A and A pays for it by check, title to the press will pass to A upon delivery.¹⁵⁹ Presumably, this title is subject to defeasance if A's check is returned for insufficient funds.¹⁶⁰ Nonetheless, A can pass good title to the press to a bona fide purchaser for value.¹⁶¹ X, the original owner of the press, is estopped from asserting its rights to reclaim the property in the hands of the bona fide purchaser.¹⁶²

The notion of estoppel extends further in subsection 2 of section 2-403, which creates the entrustment doctrine. If the true owner of goods entrusts possession of them to a merchant who deals in goods of that kind, the merchant may then transfer all of the owner's rights in the goods to a buyer in the ordinary course of business.¹⁶³ Thus if the true owner had full title to the goods, the merchant's buyer also acquires full title, even without the true owner's consent.¹⁶⁴

Both the voidable title doctrine and the entrustment doctrine involve concepts of estoppel in the sense that the transferee's rights are enlarged when it relies to its detriment on the original owner's conduct. In the cases involving voidable title, the transferor will normally have both title and possession of the goods ultimately sold to the good faith purchaser. The good faith purchaser, by definition, will have relied on this title and possession to form the belief that the transferor

158. U.C.C. § 2-403(1) (1991).

159. WHITE & SUMMERS, *supra* note 24, at 173.

160. The U.C.C. nowhere defines "voidable title"; at least one court has noted that "once there is delivery of possession of goods from a seller to a buyer, with the intent that the buyer become the owner of the goods, the buyer obtains voidable title." *Ledbetter v. Darwin Dobbs Co.*, 473 So. 2d 197, 200 (Ala. Ct. Civ. App. 1985). One may speculate that the concept refers also to the seller's right to stop delivery of goods in transit or to reclaim goods already delivered when it discovers that the buyer is insolvent. *See* U.C.C. §§ 2-702, 2-705(1) (1991).

161. *See* *Brumley Estate v. Iowa Beef Processors, Inc.*, 704 F.2d 1351, 1361 (5th Cir.), *modified*, 715 F.2d 996 (5th Cir. 1983); *Georgia Casualty & Sur. Co. v. Tenneville Banking Co. (In re Smith)*, 51 B.R. 904, 909 (Bankr. M.D. Ga. 1985); *Dick Hatfield Chevrolet, Inc. v. Bob Watson Motors, Inc.*, 708 P.2d 494, 496-97 (Kan. 1985).

162. *See* *Ledbetter*, 473 So. 2d at 202; *Jordan v. Butler*, 156 N.W.2d 778, 785 (Neb. 1968); *Cox v. Gerald Modell, Inc.*, 18 U.C.C. Rep. Serv. (Callaghan) 1200, 1202 (N.Y. Sup. Ct. 1976).

163. U.C.C. § 2-403(2) (1991); *see* WHITE & SUMMERS, *supra* note 24, at 175-78.

164. *See* *Simson v. Moon*, 222 S.E.2d 873, 874-75 (Ga. Ct. App. 1975); *General Elec. Credit Corp. v. Western Crane & Rigging Co.*, 166 N.W.2d 409, 411 (Neb. 1969); *American Clipper Corp. v. Howerton*, 316 S.E.2d 186, 194 (N.C. 1984).

owns the goods free and clear. For example, if the transferor presents a bill of sale reflecting a completed transaction with the original owner, then presumably the good faith purchaser will have no reason to question the state of the transferor's title, barring any irregularities in their dealings.

In cases involving the entrustment doctrine, the merchant seller will have possession of goods but no title.¹⁶⁵ The true owner of the goods has entrusted them to the merchant for the purpose of storing them, repairing them, or perhaps selling them to a third party. Even though completely lacking title, the merchant can pass good title to a buyer in the ordinary course of business because the statute essentially estops the true owner from asserting his title. The true owner's according the merchant the appearance of ownership creates the estoppel.

These two statutorily verified uses of estoppel do not apply, however, to all cases in which third parties may be deceived by another's possession and use of property. A creditor with an Article 9 security interest does not qualify as a buyer in the ordinary course of business.¹⁶⁶ Therefore, the entrustment doctrine will not affect the status of the secured party of the merchant bailee vis-à-vis the true owner of the goods. Similarly, the voidable title doctrine will not advance the position of a secured party whose debtor did not acquire any title, voidable or otherwise, from the original owner.

In several cases secured parties have argued that the doctrine of equitable estoppel, or *estoppel in pais*, operated to prevent the true owner of collateral from asserting her title to reclaim the goods as against the secured party. Traditionally, the party asserting equitable estoppel must show that six elements are satisfied: that the party to be estopped (1) engaged in conduct amounting to a false representation or concealment of material facts, (2) had the intention or expectation that such conduct would be acted upon by the other party, and (3) had knowledge of the actual facts; and that the party claiming the estoppel (4) lacked knowledge and the means of knowledge of the truth as to the facts in question, (5) relied in good faith upon the con-

165. U.C.C. § 2-403(3) (1991) ("'Entrusting' includes any delivery and any acquiescence in retention of possession regardless of any condition expressed between the parties to the delivery or acquiescence . . ."); see WHITE & SUMMERS, *supra* note 24, at 175-76 (describing various entrustment situations).

166. U.C.C. § 1-201(9) (1991); First Nat'l Bank & Trust Co. v. Jim Payne Pontiac GMC, Inc., 20 U.C.C. Rep. Serv. (Callaghan) 768, 773 (Okla. Ct. App. 1976).

duct or statements of the party to be estopped, and (6) acted or refrained from acting so as to prejudicially change his position.¹⁶⁷

A review of the cases discussing equitable estoppel reveals that some of the six elements are emphasized more than the others. The misrepresentation of a material fact does not have to be fraudulent in nature.¹⁶⁸ Though some courts refer to the true owner's actions as demonstrating an intent to deceive the public,¹⁶⁹ most hold that even a negligently made misrepresentation may estop the true owner.¹⁷⁰ If, for example, the true owner of cattle allowed the debtor to brand the cattle with the debtor's brand, the secured party need not show that the true owner intended to perpetrate a fraud on the public. Mere carelessness by the true owner in allowing the debtor to brand the cattle may suffice for some courts. Thus the "intention" or "expectation" element often translates into the idea that the true owner should have been aware that her actions might deceive others.

The most common misrepresentation in these cases involves clothing the debtor with apparent ownership of the goods. Courts are sharply divided as to whether simply giving possession to the debtor sufficiently misrepresents the true state of affairs so as to create an estoppel. Cases holding that the debtor's possession, without more, does not create an estoppel place the burden on the secured party to

167. See *In re Pubs, Inc.*, 618 F.2d 432, 438 (7th Cir. 1980); *In re Jordan Mfg. Co.*, 138 B.R. 30, 39 (Bankr. C.D. Ill. 1992); *In re Atlantic Marble, Inc.*, 126 B.R. 463, 467 (Bankr. E.D. Pa. 1991); *United Jersey Bank v. CS Assocs. (In re CS Assocs.)*, 121 B.R. 942, 958 (Bankr. E.D. Pa. 1990); *Webb v. First Mutual Corp. Goldome (In re Webb)*, 99 B.R. 283, 290 (Bankr. E.D. Pa. 1989); *Union State Bank v. Cook (In re Cook)*, 63 B.R. 789, 798-99 (Bankr. D.N.D. 1986); *First S. Ins. Co. v. Ocean State Bank*, 562 So. 2d 798, 800 (Fla. Dist. Ct. App. 1990); *Hill v. Van Sandt*, 40 P. 676, 678 (Kan. Ct. App. 1895); *Giovane, Ltd. v. Carlson*, No. C5-90-1971, 1991 Minn. App. LEXIS 285, at *4-5 (Minn. Ct. App. Mar. 20, 1991); *Hawkins v. M & J Fin. Corp.*, 77 S.E.2d 669, 672 (N.C. 1953); *Huntington Nat'l Bank v. Hartman*, No. CA89-06-013, 1990 Ohio App. LEXIS 365, at *2-3 (Ohio Ct. App. Feb. 5, 1990).

168. *The Exchange Nat'l Bank v. A.J. Rackers, Inc. (In re A.J. Rackers, Inc.)*, 167 B.R. 168, 174 (Bankr. W.D. Mo. 1994).

169. *Hill v. Van Sandt*, 40 P. 676, 678 (Kan. Ct. App. 1895); *O'Connor's Adm'x v. Clark*, 32 A. 1029, 1030 (Pa. 1895).

170. Several courts refer to the principle that "as between two innocent parties who must suffer from the fraud of a third, he who furnished the means to commit the fraud, or whose negligence enables the third party to commit it, must bear the loss." *McDonald v. Peoples Auto. Loan & Fin. Corp.*, 154 S.E.2d 886, 890 (Ga. Ct. App. 1967); see also *Drew v. Kimball*, 43 N.H. 282, 286 (1861) (stating that an owner who negligently induces another to act upon the belief that certain cattle do not actually belong to the owner must bear the loss of his negligence); *First Nat'l Bank v. Kissare*, 98 P. 433, 434 (Okla. 1908) (holding that where one of two parties must suffer from a third party's fraud, the loss should fall upon the one whose act, negligent or not, created the circumstances that permitted the fraud to be perpetrated).

inquire as to the source of the debtor's title to the goods.¹⁷¹ For example, in *In re Cook*¹⁷² the debtors, cattle ranchers, gave a security interest in their cattle, including after-acquired cattle, to the creditor.¹⁷³ Unbeknownst to the secured party, the debtors cared for their own cattle and about three dozen head owned by the nonresident brother of one of the debtors.¹⁷⁴ Even though all of the cattle carried the debtors' brand, the bankruptcy court held that the registration certificates for the disputed cattle sufficiently established the brother's ownership.¹⁷⁵ The brother, moreover, was not estopped from asserting his ownership.¹⁷⁶

Arguably, the debtors' custody and care of the cattle, without more, should not have misled the secured party. The court found that neither the debtors nor the brother intended to deceive the secured party about the true state of affairs.¹⁷⁷ In addition, the debtors and the brother for years had maintained separate records and accounts for the brother's cattle.¹⁷⁸ There was no evidence that the brother made an after-the-fact claim of ownership to defeat the security interest.¹⁷⁹

Finally, the secured party failed to show sufficient reliance on the debtors' ostensible ownership of the disputed cattle.¹⁸⁰ In ascertaining the quantity of cattle subject to the security interest, the secured party had relied on financial statements submitted by the debtors that did not list any of the brother's cattle.¹⁸¹ The secured party admitted that

171. *In re Atlantic Marble, Inc.*, 126 B.R. 463, 468 (Bankr. E.D. Pa. 1991) (finding the secured party negligent in failing to ascertain how debtor acquired title to collateral).

172. *Union State Bank v. Cook (In re Cook)*, 63 B.R. 789 (Bankr. D.N.D. 1986).

173. *Id.* at 792. The security agreement granted the bank a security interest in all of the debtors' "livestock now owned or hereafter acquired including the increase thereof but not limited to the attached list together with the young and produce thereof." *Id.*

174. *Id.* at 791.

175. *Id.* at 795-96. In addition, the brother in all cases purchased the cattle or the ancestors of the cattle with his own funds before commingling the cattle with the debtors' herd. *Id.*

176. *Id.* at 798-99.

177. The court noted:

None of the evidence before the court establishes that [the brother] knew of the Bank's security agreement covering the debtors' cattle Nor does the evidence establish that [the brother] intended or expected that his inaction in notifying the Bank of his ownership in the cattle would be acted upon by the Bank or influence its decisions.

Id. at 799.

178. *Id.* at 791-93.

179. The evidence established that the brother's "assertion of ownership is more than an eleventh hour scheme to dispossess a bank of its collateral." *Id.* at 800.

180. *Id.* at 799.

181. *Id.*

it had not actually counted the head of cattle at the ranch at any time.¹⁸²

The court in *In re Cook* clearly believed that the secured party had the burden of inquiring about the debtors' ownership of the cattle in which it sought to take a security interest. If the creditor had been reasonably diligent in ascertaining the true state of affairs, it would have discovered through an examination of the registration certificates that the debtor's brother owned certain cattle. The creditor could not rely only on the debtors' possession, control, and branding of the cattle.¹⁸³ The court's conclusion is perhaps surprising in light of the presumption under North Dakota law that a "legally registered brand on livestock shall be prima facie evidence that the animal bearing the same is property of the owner of such brand."¹⁸⁴

Other courts have similarly held that the debtor's possession, by itself, is not sufficient to estop the true owner from asserting its title to the goods.¹⁸⁵ Often these cases mention facts that should have alerted the secured party to the debtor's lack of full title to the property. For example, in *Huntington National Bank v. Hartman*,¹⁸⁶ the debtor gave a security interest in his farm equipment. The debtor's father in fact owned some of the equipment on the debtor's farm, and the father had not given his consent to his son's use of the property as collateral for a loan.¹⁸⁷ When the creditor attempted to enforce the security interest, the father asserted his ownership of the equipment.¹⁸⁸ The court found that the father's actions in allowing his son to use the equipment did not estop him from reclaiming the goods.¹⁸⁹ The father apparently was unaware that the son had sought to encumber the equipment and thus was not culpable in deceiving the creditor.¹⁹⁰ The creditor, moreover, knew that the son's farming business had some connection with his father's, and the court stated that it was unreason-

182. *Id.*

183. *But see* First Nat'l Bank v. Kissare, 98 P. 433 (Okla. 1908) (finding the true owner of cattle estopped to assert title against bailee's secured party where owner had given bailee possession and had branded cattle with bailee's brand).

184. N.D. CENT. CODE § 36-09-19 (1980).

185. *State Bank of Young Am. v. Wagener*, 479 N.W.2d 92, 95 (Minn. Ct. App. 1992) (holding that possession of hogs by debtors did not give them rights in the hogs where bailor had clearly reserved all right, title, and interest in the hogs to himself).

186. No. CA89-06-013, 1990 Ohio App. LEXIS 365 (Ohio Ct. App. Feb. 5, 1990).

187. *Id.* at *2-3.

188. *Id.* at *2.

189. *Id.* at *5-6.

190. *Id.* at *5; *see also In re Atlantic Marble, Inc.*, 126 B.R. 463, 468 (Bankr. E.D. Pa. 1991) (holding that the true owner of some equipment was not estopped to assert its ownership interest against the bailee's secured party when the true owner was unaware that the bailee had offered the owner's equipment as security for a loan).

able for the creditor to rely solely on the son's representations as to ownership.¹⁹¹

In many of the cases in which courts have found that estoppel created rights in the collateral, the true owner of the collateral seems to have been well aware that the secured party was laboring under a misapprehension concerning the ownership. In fact, the owner sometimes contributed directly to the deception. Often the same parties either owned or controlled the debtor and the owner of the collateral. The owner's acquiescence to the debtor's use of the property as collateral could thus be inferred.

For example, in *In re Pubs, Inc.*,¹⁹² one of the most often cited estoppel cases, a bank agreed to make a loan to Hein and Richardson individually, taking a security interest in their restaurant equipment.¹⁹³ Before both debtors had signed the security agreement, they conveyed the equipment to Pubs, Inc., a corporation of which they were the sole shareholders.¹⁹⁴ The bill of sale stated explicitly that the equipment was being transferred subject to the bank's security interest.¹⁹⁵ Subsequently, the debtors defaulted on their obligation to the bank, and the corporation filed a petition in bankruptcy.¹⁹⁶

The trustee in bankruptcy argued that the bank's security interest did not attach to the restaurant equipment because the individual debtors, having conveyed the property to the corporation, did not have any rights in the collateral at the time the security agreement was executed.¹⁹⁷ The Seventh Circuit Court of Appeals held that the bankrupt corporation was estopped to deny the validity of the bank's security interest.¹⁹⁸ Although the corporation, through its owners and

191. *Huntington Nat'l Bank*, 1990 Ohio App. LEXIS 365, at *5 ("The bank never demanded bills of sale or other proof of ownership . . . [and] the bank never interviewed [the father] with regard to ownership of the farm and equipment. We believe that the bank had a greater obligation to investigate the situation before loaning [the son] the money.").

192. 618 F.2d 432 (7th Cir. 1980).

193. *Id.* at 435.

194. *Id.*

195. *Id.*

196. *Id.* Shortly after the security agreement was signed, the bank filed financing statements covering the equipment with the county recorder of deeds and the secretary of state. Although the bank listed the debtors as Hein and Richardson individually, rather than as Pubs, Inc., the court found essentially that the bank was entitled to rely upon the debtors' status at the time that one of the debtors first signed a promissory note. The bank was unaware that shortly thereafter the debtors transferred the collateral to Pubs, Inc. *Id.* at 440 (citing ILL. REV. STAT. ch. 26, ¶ 9-402(7)).

197. *Id.* at 435-36.

198. The court stated:

Pubs' title to the property was clearly evidenced by the . . . bill of sale which recited that Pubs took the collateral subject the Bank's security interest. Having

officers, Hein and Richardson, had not affirmatively misled the bank by declaring the individual debtors to be the owners of the equipment after its sale to the corporation, it did not correct the bank's misimpression that the individual debtors still owned the equipment at the time the security agreement was signed.¹⁹⁹

Obviously, it is somewhat artificial to speak about the individual debtors and the corporation as if they were operating independently of each other. The individual debtors and the corporation were essentially alter egos. In that situation the court undoubtedly felt that it would be grossly unfair to the creditor to allow the individual debtors to avoid the security interest by making an undisclosed conveyance to the corporation on the eve of the signing of the security agreement.

The *Pubs* case stands in sharp contrast to the cases in which estoppel was not found. In the latter cases the true owner of the collateral was unaware that the debtor had encumbered its assets and that the debtor's possession of the owner's property had misled a secured party. In these cases, it seems, the true owners did not actively or passively participate in perpetrating a fraud on the secured party.

The level of reliance by the secured party arguably distinguishes the cases further. In *Pubs* the bank relied expressly upon the debtors' representations that they owned the collateral and that they would not be conveying it to the corporation until a later date. In the cases in which estoppel was not found, the courts generally held that a secured creditor is not entitled to rely only upon the debtor's possession of the collateral as the basis for assuming ownership—the creditor always has some obligation to investigate the source of the debtor's title to the property.

Like *Pubs*, several other cases in which the court found an estoppel involve common ownership or control of the debtor and the true owner of the collateral.²⁰⁰ In *Avco Delta Corporation Canada Limited v. United States*,²⁰¹ for example, a parent corporation owned two subsidiaries, one of which procured a loan from the secured party. The

been put on notice by the recital of the bill of sale, *Pubs* is estopped to deny the recited security interest by claiming an interest superior to it.

Id. at 438.

199. *Id.* at 438-39.

200. See, e.g., *Advanced Turbo Prods., Inc. v. Congress Fin. Corp.* (Fla.) (*In re Advanced Turbo Prods., Inc.*), 126 B.R. 630, 631 (Bankr. S.D. Fla. 1991) (noting that common president of debtor and owner of collateral stated that debtor owned collateral); *Peterson v. First Tenn. Bank*, slip op. (Tenn. Ct. App. July 30, 1985) (LEXIS, States library, Tenn file) (finding that common president of debtor and owner of collateral signed security agreement creating security interest in collateral).

201. 459 F.2d 436 (7th Cir. 1972).

secured party sought to obtain a security interest in twenty-nine pieces of heavy construction equipment that it believed the debtor-subsi-dary owned.²⁰² In fact, the other subsidiary owned the equipment. None-theless, the court found that the true owner was estopped from assert-ing its title against the secured creditor because it, along with the parent corporation, implicitly represented to the creditor that the debtor subsidiary owned the equipment.²⁰³ Although the parent and the owner subsidiary did not expressly state that the debtor owned the equipment, both provided guarantees of the debtor's obligation to the secured creditor and were clearly aware that the creditor was relying on the debtor's asserted ownership of the equipment.²⁰⁴

In innumerable cases not involving secured transactions, estoppel has been used to prevent the true owner from reclaiming property in the hands of a third party.²⁰⁵ Although these cases do not speak di-rectly to the question of whether the debtor acquires rights in the col-lateral for Article 9 purposes, they do suggest that, in general, estoppel will be applied when the true owner actively participates in creating the deception of the public. In other words, although the mere transfer of possession of property to the debtor is not enough to estop the owner from asserting its title, additional acts by the owner in furtherance of the debtor's ostensible ownership will create an estop-pel. In *Drew v. Kimball*,²⁰⁶ for instance, the plaintiff entrusted his cat-tle to the debtor so that the latter could sell them on his behalf. The debtor told plaintiff that the sale could be effected more readily if the debtor represented to potential buyers that the cattle were his; the plaintiff agreed to this arrangement.²⁰⁷ The debtor then told his credi-tor, the defendant, that he owned the cattle, and based on this infor-mation the creditor requested that the sheriff attach the cattle.²⁰⁸ Notwithstanding the fact that the plaintiff clearly did not intend for a creditor of his selling agent to assume that the agent owned the cattle, the court held that the plaintiff was estopped from asserting his own-ership interest against the creditor.²⁰⁹ By allowing the debtor to pos-

202. *Id.* at 438.

203. *Id.* at 441.

204. The debtor had furnished the secured creditor with corporate resolutions authoriz-ing the sale of the equipment from the other subsidiary to the debtor and a copy of a bill of sale reflecting the debtor's title to the equipment. *Id.* at 440.

205. *See, e.g.*, *Preston v. Witherspoon*, 9 N.E. 585, 588 (Ind. 1886); *American Exch. Nat'l Bank v. Winder*, 150 S.E. 489, 491-92 (N.C. 1929); *O'Connor's Adm'x v. Clark*, 32 A. 1029, 1030 (Pa. 1895).

206. 43 N.H. 282 (1861).

207. *Id.* at 284.

208. *Id.*

209. *Id.* at 288.

sess the cattle and also to represent to the public generally that he owned them, the plaintiff assumed the risk that some unintended party might rely on the debtor's representations to the plaintiff's detriment.²¹⁰

3. Equitable Estoppel and Its Relationship to the Code

The consent and estoppel cases lead inevitably to the conclusion that debtors, in certain circumstances, may grant security interests in property that they do not "own" or in which they do not have even a limited property interest, such as a leasehold or license. The express consent cases are not particularly troublesome because in those cases the true owner of the collateral, either with or without compensation, agreed to have the debtor encumber its property. However, in the estoppel and implied consent situations clearly some owners did not anticipate or desire that their bailee would grant a security interest in the property to a third party.²¹¹

Because of the infinite number of permutations of fact patterns in these cases, it is difficult to predict the outcome in any given case. Courts vary widely in the degree to which they emphasize one or more of the six elements traditionally cited as necessary for equitable estoppel. In fact, the cases assume or ignore some of the six elements—for instance, they often assume that the party claiming estoppel prejudicially changed its position when it took a security interest (element six) and that the party to be estopped had knowledge of the "actual" facts (element three), and they frequently ignore the "scienter" element (element two) by holding that a negligent misrepresentation can serve as the basis for estoppel. The case law's basic division is between those courts that stress the misrepresentation (element one)—i.e., the misleading appearance created by the debtor's possession of certain property and other actions by the true owner—and those that focus on the secured party's duty to investigate the source of the debtor's title before taking a security interest—i.e., the secured party's ability to ascertain the truth (element four) or its justifiable reliance on the true owner's misrepresentations (element five).

210. *Id.* According to the court, "the plaintiff put the cattle into [the debtor's] possession, with the distinct understanding that he should assume to be the owner, and so hold out to the world." *Id.*

211. See, e.g., *Litwiller Mach. & Mfg., Inc. v. NBD Alpena Bank*, 457 N.W.2d 163, 164-65 (Mich. Ct. App. 1990); *State Bank of Young Am. v. Vidmar Iron Works, Inc.*, 292 N.W.2d 244, 249-50 (Minn. 1980); *Morton Booth Co. v. Tiara Furniture, Inc.*, 564 P.2d 210, 212-14 (Okla. 1977).

It is doubtful that the original drafters envisioned the muddy pool that has collected around this issue over time. It is unclear under what circumstances the debtor has a sufficient quantum of rights in property for attachment to take place. The cases recite in unison that “naked” possession alone is not enough, but it is rare that a debtor has only possession and nothing more. Arguably, only a thief has possession and nothing more. Even a body shop doing a one-day repair on a car has something more than possession—namely, the right to make certain changes to the vehicle.

By importing the concept of equitable estoppel into these cases, the courts have attempted to achieve a fair result in situations in which the true owner has relinquished possession of property to the debtor for a limited purpose and the secured party conceivably could have relied on that possession in extending funds to the debtor. But after-the-fact, ad hoc determinations of this issue do not facilitate transaction planning by any of the parties involved. The courts’ continued recognition of estoppel, moreover, encourages secured parties to litigate this issue, even in marginal cases. Finally, the courts’ manipulation of the rights element of attachment has produced a hidden rule of priority. By holding that the secured party’s security interest has attached, courts often then conclude that the secured party has priority over another claimant.²¹² In fact, the other claimant is often relegated to the status of a general creditor.

212. See *WESGO Div. of GTE Prods. Corp. v. Harrison (In re Sitkin Smelting & Ref., Inc.)*, 648 F.2d 252, 254-55 (5th Cir. 1981); *Federal Deposit Ins. Corp. v. Quality Inns, Inc.*, 735 F. Supp. 1311, 1317-18 (D. Md. 1990); *Bischoff v. Thomasson*, 400 So. 2d 359, 369 (Ala. 1981); *Litwiller Mach. & Mfg., Inc.*, 457 N.W.2d at 167; *Morton Booth Co.*, 564 P.2d at 214; cf. *State Bank of Young Am.*, 292 N.W.2d at 250 (holding that secured party had priority over bailor but only to the extent of bailee’s rights in the collateral).

Article 9’s default priority rule gives secured parties priority over most other parties even if the former’s interests are unperfected: “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 (1991). Thus, unless some other Code provision stated a different priority, the drafters clearly wanted to elevate the secured party over most other claimants to the collateral—in particular, the debtor’s unsecured general creditors. *Valley Nat’l Bank v. Cotton Growers Hail Ins., Inc.*, 747 P.2d 1225, 1230 (Ariz. Ct. App. 1987); *WHITE & SUMMERS, supra* note 24, § 24-2, at 1126-27. But it is not clear that “purchasers” and “creditors” were intended to represent the entire set of third parties who might lay claim to the collateral. For example, a lessor is in some sense a “creditor” of the lessee, but lessors are allowed to reclaim the leased goods as against the lessee’s secured party despite the absence of a specific Article 9 priority rule to that effect. The courts assume that the lessor’s retention of title is sufficient to give it the superior claim. See also Donald P. Board, *The Scope of Article 9 is Only One Quarter as Great as is Commonly Supposed*, 47 U. MIAMI L. REV. 951, 1009-12 (1993) (arguing that § 9-201 does not provide secured parties with priority over “antecedent transferors,” including lessors).

III. OWNERSHIP WITHOUT POSSESSION

A. *Leases, Consignments, and Other Bailments*

In contrast to the situation in which the debtor has possession of property that it does not own, sometimes the debtor will have certain legal rights to property that it does not currently possess. In many cases the party with ownership but no possession will be involved in a transaction with a party with possession but no ownership—e.g., the lessor and lessee, the bailor and bailee, the consignor and consignee. In all instances the owner will have at least nominal title to the property in the hands of the other party. If the owner desires to give a security interest in the property to a creditor, the issue again arises as to whether the owner has sufficient rights in the collateral for the security interest to attach.

Although few cases have spoken to this question, it would seem that the owner's title to the property constitutes sufficient rights for attachment of a security interest. Despite Article 2's attempt to deemphasize the location of title in defining the rights and obligations of parties to a sales transaction,²¹³ title remains an important concept in determining ownership in general property law.²¹⁴

However, the sufficiency of the owner's title as rights in the collateral does not necessarily mean that the owner or the owner's secured party will prevail in a priorities dispute with the debtor's secured party. In a true lease, the lessor should be able to rely on its title to retrieve the property from the debtor or the debtor's secured

213. U.C.C. § 2-401 (1991) provides that "[e]ach provision of this Article with regard to the rights, obligations and remedies of the seller, the buyer, purchasers or other third parties applies irrespective of title to the goods except where the provision refers to such title." Karl Llewellyn, the chief architect of Article 2, believed that the concept of title, with its metaphysical overtones, was completely unhelpful in determining the various rights and obligations of sellers and buyers in the hurly-burly, practical world of commerce: "[Title] remains, in the Sales field, an alien lump, undigested. It even interferes with the digestive process." Karl Llewellyn, *Through Title to Contract and a Bit Beyond*, 15 N.Y.U. L. Q. Rev. 159, 169 (1938).

214. Professor Tabac argues convincingly that despite the Code's avowed deemphasis on title, the Code itself and subsequent case law in fact often look to title as a basic determinant of ownership rights: "The original Code did not embody the revolution in sales law that its drafters envisioned. A massive dose of contract was not able to ransom it from common-law title. . . . Title principles are still firmly in place, if not in sight, as the framework for today's commerce in goods." William L. Tabac, *The Unbearable Lightness of Title Under the Uniform Commercial Code*, 50 MD. L. REV. 408, 445 (1991).

Professor Dolan has noted similarly the ingrained psychological attachment to the concept of title: "[C]ourts and commercial lawyers have resisted—unconsciously, if not with deliberate stubbornness—the drafters' attempts to deprive them of a concept so central to their common law traditions and so responsive to the human longing to be able to say without condition, 'This is mine and that is yours.'" Dolan, *supra* note 29, at 821.

party. Because true leases are not subject to Article 9, the lessor has the right to return of the goods upon the lessee's default or at the end of the lease term.²¹⁵ As a result, the lessor's secured party, through the derivation principle, should have similar rights as against the debtor's secured party.²¹⁶

In true consignments and true bailments that are not functioning as disguised secured financing devices, the owner's title to the consigned or bailed goods should present adequate rights for attachment of a security interest. But true consignors have the additional burden of providing public notification of their interest in the goods possessed by the consignee.²¹⁷ Without that notification, the consignee's creditors will prevail in a priorities contest with the consignor.²¹⁸ Again, through the derivation principle the consignor's secured creditor can stand in no better position than the consignor itself.²¹⁹

Bailments have perplexed courts more than the other two types of transactions. In those cases in which the bailee has been endowed with something more than naked possession of the bailed goods, courts have been inclined to find that the bailee had rights in the goods sufficient for attachment of the security interest of the bailee's secured party. In a sales context, many courts have proceeded to find that the bailee's secured party had complete priority over the bailor, treating the bailor's reservation of title as an unperfected security interest.²²⁰ In those cases in which the bailment is viewed as a disguised secured financing device, it is unclear whether the bailor would have enough rights in the bailed property for attachment of a security interest granted to the bailor's own secured party. Under this theory, the bailor would have neither possession nor title²²¹ to the goods, but

215. The UCC provides that failure to make a payment when due constitutes default. U.C.C. § 2A-523(1) (1991). After such a default by the lessee, the lessor "has the right to take possession of the goods." U.C.C. § 2A-525 (1991).

216. Article 2A provides in general that the lessor's secured creditors take their interests subject to the lease contract unless the security interest in the leased goods was perfected before the lease contract became enforceable, U.C.C. § 2A-307(2)(c) (1991), or the secured party "holds a security interest in the goods and the lessee did not give value and receive delivery of the goods without knowledge of the security interest," *id.* § 2A-307(2)(b). Moreover, a lessee in the ordinary course of business, like the buyer in the ordinary course of business, takes its interest "free of a security interest in the goods created by the lessor even though the security interest is perfected . . . and the lessee knows of its existence." *Id.* § 2A-307(3) (citations omitted).

217. U.C.C. § 2-326(3) (1991); *see supra* text accompanying notes 64-65.

218. U.C.C. § 2-326(2) (1991); *see supra* text accompanying notes 72-79.

219. *See supra* notes 29-31 and accompanying text.

220. *See supra* notes 80-122 and accompanying text.

221. Those courts that treat certain bailments as disguised financing transactions are holding, in essence, that the bailor has sold the raw materials to the bailee and has reserved

merely the right to retake the goods upon termination of the bailment—a right that would be subordinated to a perfected secured party's interest if the bailor did not perfect its own interest.²²²

Theoretically, a future right to possession should constitute a sufficient right for attachment of a security interest. If the secured party's ultimate interest is in having collateral that can be seized upon the debtor's default, then the bailor's ability to retake the goods upon termination of the bailment, if transmitted to the secured party via the security interest, directly serves that interest. There is no apparent policy reason why the bailor's limited interest in the goods should not be sufficient to constitute rights in the collateral.²²³

B. Sales Transactions

Another common and troublesome situation in which the debtor will not have possession of goods but will arguably have some rights in them arises in sales transactions. Suppose a debtor gives a security interest in all its present and after-acquired inventory and equipment to a secured party. Subsequently, the debtor orders a new piece of equipment from a seller and signs a contract requiring delivery of the equipment to the buyer by a certain date. At some point before or after delivery of the new equipment the debtor defaults on its obligations to the secured party, who forecloses on the collateral. The secured party would like to be able to claim the new equipment as part of the encumbered collateral. Given the earlier existence of a written security agreement and the secured party's extension of value, attachment of the creditor's security interest will occur upon the debtor's acquisition of rights in the new equipment.²²⁴

"title" in itself as a security device. *See supra* notes 121-22 and accompanying text. Under this interpretation, "title" would not represent ownership by the bailor of the goods but merely a security interest in them.

222. *See supra* notes 118-23 and accompanying text.

223. Chattel paper transactions involve the debtor in the secondary transaction giving the secured party in essence a security interest in a security interest. In the primary transaction, D-1 gives SP-1 a security interest in goods in exchange for an extension of credit. In the secondary transaction, SP-1, now D-2, gives SP-2 a security interest in the installment contract signed by D-1, which constitutes chattel paper. U.C.C. § 9-105(1)(b) (1991). If D-2 defaults on its obligations to SP-2, then SP-2 may foreclose on the collateral and thereby assume whatever rights D-2 had against D-1 under the chattel paper. These rights will include the ability to retake the hard goods upon D-1's default. *See id.* § 9-306(5)(a). Thus, in effect, Article 9 already recognizes the propriety of what amounts to a security interest in a security interest.

224. *See* U.C.C. § 9-203(1) (1991) (regarding requirements for attachment of security interests).

The question of when the debtor acquires rights in property being purchased in an Article 2 sales transaction dovetails with the question of when the buyer/debtor becomes a buyer in the ordinary course of business (BIOCOB).²²⁵ A BIOCOB generally takes the goods free of all security interests created by its seller.²²⁶ Equating BIOCOB status not only with termination of the security interest of the seller's creditor but also with the buyer's acquisition of rights in the collateral for purposes of its own secured transaction would produce a certain cleanness and symmetry²²⁷ in the law.²²⁸ At the moment the seller's secured party's security interest was cut off, the buyer's secured party's security interest would attach. In this scheme, then, the two secured parties would not come into direct conflict with each other, and the security interest of the buyer's secured party would attach at the earliest possible moment that avoids this conflict. This approach seems to maximize the interests of both secured lenders.

In determining when a party becomes a BIOCOB, the courts have considered various points along a temporal continuum that follows the steps in the typical sales transaction: (1) contract formation;²²⁹ (2) identification of goods to the contract;²³⁰ (3) the passage of

225. Article 1 defines "buyer in ordinary course of business" as a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind but does not include a pawnbroker.

U.C.C. § 1-201(9) (1991).

226. A BIOCOB "other than a person buying farm products from a person engaged in farming operations 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." U.C.C. § 9-307(1) (1991).

227. Professor Llewellyn himself valued aesthetics in law but only if they served policy goals: "But the prime test of . . . legal beauty remains the functional test. Structural harmony, structural grandeur, are good to have, they add, they enrich; but they are subsidiary. So is ornament. Legal esthetics are in first essence functional esthetics." Karl N. Llewellyn, *On the Good, the True, the Beautiful, in Law*, 9 U. CHI. L. REV. 224, 229 (1942).

228. Of course, in some cases the debtor will not qualify for BIOCOB status because it lacks good faith or is not buying from a merchant seller. The debtor's secured party must still establish at what point the debtor acquired rights in the property purchased, even in a non-ordinary course transaction. Regardless of whether the debtor qualifies for BIOCOB status, rights in the collateral could come into existence at the same point in time in both ordinary and non-ordinary course transactions. See U.C.C. § 9-305(2) (1991). In the non-ordinary course purchase, however, the security interest of the buyer's security interest may be subordinated to the security interest of the seller's secured party. See U.C.C. § 9-301(1)(c).

229. *Rex Fin. Corp. v. Mobil Am. Corp.*, 580 P.2d 8, 10 (Ariz. 1978); *Troy Lumber Co. v. Williams*, 185 S.E.2d 580, 582 (Ga. Ct. App. 1971); *Wilson v. M & W Gear*, 442 N.E.2d 670, 674-75 (Ill. Ct. App. 1982).

230. *General Elec. Credit Corp. v. Gayl (In re Darling's Homes, Inc.)*, 46 B.R. 370, 375-80 (Bankr. D. Del. 1985); *Big Knob Volunteer Fire Co. v. Lowe & Moyer Garage, Inc.*, 487

title from seller to buyer;²³¹ (4) delivery of the goods to the buyer;²³² and (5) acceptance of the goods by the buyer.²³³ The courts have not arrived at any consensus on this issue, though they show particular solicitude for a buyer who has paid all or part of the purchase price when the seller, now insolvent, breaches the contract.²³⁴

Professor Frisch has argued persuasively that a buyer's rights should be defined in terms of the buyer's remedies.²³⁵ More specifically, he has asserted that a buyer should achieve BIOCOP status and be able to cut off the claims of third parties to the goods when the U.C.C. gives the buyer certain possessory remedies over the goods, such as those under sections 2-502 and 2-716(1) and (3).²³⁶ Under those sections, the buyer may seek to compel delivery of goods that are unique²³⁷ or that have been identified to the contract in certain circumstances that would work a hardship to the buyer if the goods were not delivered.²³⁸

A.2d 953, 956 (Pa. Super. Ct. 1985); *Serra v. Ford Motor Credit Co.*, 463 A.2d 142, 147-48 (R.I. 1983).

231. *Integrity Ins. Co. v. Marine Midland Bank*, 396 N.Y.S.2d 319, 320-21 (N.Y. Sup. Ct. 1977).

232. *Chrysler Corp. v. Adamatic, Inc.*, 208 N.W.2d 97, 106-07 (Wis. 1973), *overruled on other grounds by Daniel v. Bank of Hayward*, 425 N.W.2d 416, 417 (Wis. 1988).

233. See generally John R. Hughes, Note, *When Does a Buyer Become a Buyer in Ordinary Course? U.C.C. §§ 1-201(9), 9-307(1): A Test and A Proposal*, 60 NEB. L. REV. 848, 852 (1981) (discussing decisions that establish a buyer in ordinary course status at different stages of the sales transaction).

234. See, e.g., *Daniel*, 425 N.W.2d at 423.

235. David Frisch, *Buyer Status Under the U.C.C.: A Suggested Temporal Definition*, 72 IOWA L. REV. 531, 568-75 (1987).

236. *Id.* at 571-72.

237. U.C.C. § 2-716(1) (1991) provides that "[s]pecific performance may be decreed where the goods are unique or in other proper circumstances." Official Comment 2 to this section makes it clear that to be unique, goods need not have been "already specific or ascertained at the time of contracting." It also suggests that "other proper circumstances" comprise situations of scarcity—i.e., when the buyer cannot cover in the market. In these situations, contract-market damages would be inadequate to compensate the buyer for the loss caused by the seller's breach because no adequate substitute in the market exists. See *id.* §§ 2-712(2) (providing that the buyer may recover the difference between cover price and contract price); 2-713(1) (stating that the buyer may recover the difference between market price and contract price).

238. Under U.C.C. § 2-502(1) (1991), a buyer who has paid all or part of the purchase price of goods that have been identified to the contract "may on making and keeping good a tender of any unpaid portion of their price recover them from the seller if the seller becomes insolvent within ten days after receipt of the first installment on their price." Under U.C.C. § 2-716(3) (1991) a

buyer has a right of replevin for goods identified to the contract if after reasonable effort he is unable to effect cover for such goods or the circumstances reasonably indicate that such effort will be unavailing or if the goods have been shipped under reservation and satisfaction of the security interest in them has been made or tendered.

Without the ability to compel delivery of specific goods, it is hard to find that the debtor/buyer has rights in those goods as such. If the seller breaches the contract and refuses to perform, normally the buyer is left only with a remedy for damages and has to seek substitute goods in the market.²³⁹ Once those substitute goods have been procured, the security interest of the buyer's secured creditor would attach to them. Before that time, theoretically, the secured party would have no interest in the debtor's damages claim against the seller unless the secured party had taken a separate security interest in the claim as such,²⁴⁰ perhaps through an interest in the debtor's general intangibles.

One assumption behind inventory and equipment financing is that the secured party relies upon the debtor's possession of specific pieces of equipment and inventory in ascertaining the amount of credit to extend and the extent of collateralization once the loan has been extended.²⁴¹ Thus it is logical to restrict the attachment of the creditor's security interest to those goods that the debtor presently possesses or has the right to possess through compelling delivery by the seller. Particularly when the debtor uses proceeds from the sale of

Id.; see also *id.* § 2-711(2) (reiterating buyer's possessory remedies under §§ 2-502 and 2-716).

239. See U.C.C. § 2-712(1), (2) (1991) (allowing buyer to purchase substitute goods and recover from seller as damages the difference between the cost of cover and the contract price); see also *id.* § 2-713 (allowing buyer to recover from seller as damages the difference between the market price and the contract price).

240. The secured party might try to argue that contract damages are proceeds of the collateral and thus that its security interest automatically extends to them under U.C.C. § 9-306(2) (1991). But it is doubtful whether contract damages fit the definition of proceeds as "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." *Id.* at § 9-306(1). But see Joseph W. Turner, Note, *Rights in Collateral Under U.C.C. § 9-203*, 54 Mo. L. REV. 677, 685 (1989) (arguing that contract damages should be viewed as identifiable proceeds to which the inventory secured party's security interest attaches).

If the goods had been identified to the contract before the seller's breach, however, then the debtor would have had an insurable interest in them, whether or not the debtor could compel delivery. U.C.C. § 2-501(1) (1991). In that situation, if the goods were destroyed before delivery and the seller refused to deliver substitute goods, then any insurance monies paid to the debtor by virtue of the loss would fit the definition of proceeds: "Insurance payable by reason of loss or damage to the collateral is proceeds . . ." *Id.* § 9-306(1). Hence, insurance proceeds paid to the debtor or the secured party for identified goods destroyed in the seller's possession could be claimed by the secured party under its security agreement.

241. For example, a typical loan agreement might provide that the debtor agrees to maintain inventory at a particular level in relation to the debt owed and that if the inventory levels fall below a given amount, the secured party may foreclose on the collateral. See, e.g., REILEY, *supra* note 24, Form 4-20 (Inventory and Accounts Security Agreement), at F4-48.

encumbered inventory or equipment to purchase new items, the secured creditor has a strong expectation that its security interest will flow through to the new property.²⁴²

Identification of goods—namely, the seller's earmarking of particular goods for a specific contract—without the right to obtain possession of the goods should not be sufficient to confer rights in the collateral upon the buyer. In *Crocker National Bank v. Ideco Division of Dresser Industries*,²⁴³ the Fifth Circuit Court of Appeals held that the buyer's "special property" in goods identified to a sales contract did not give the buyer rights in the collateral sufficient to support attachment of the buyer's secured party's security interest.²⁴⁴ In *Ideco*, the buyer had agreed to purchase forty drilling rigs from the seller but later sought to cancel the order.²⁴⁵ The seller insisted that the buyer purchase six substantially manufactured rigs.²⁴⁶ The seller sent invoices to the buyer indicating that the goods were to be "held for shipping instructions" and containing an F.O.B. point of shipment term.²⁴⁷ Later, having found another buyer for the rigs, the seller issued a credit memorandum canceling the buyer's indebtedness.²⁴⁸ During the buyer's subsequent Chapter 11 reorganization, the buyer's secured party sought to claim the drilling rigs.²⁴⁹

The appellate court found that it would be unjust to the seller to find that the buyer's secured party had an attached and perfected security interest in the rigs superior to the seller's interest.²⁵⁰ The seller had not been paid for the goods nor had it delivered them to the

242. A security interest "continues in any identifiable proceeds . . . received by the debtor." U.C.C. § 9-306(2) (1991). Proceeds are defined to include "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." *Id.* § 9-306(1). Therefore, if D sells encumbered inventory to a customer who pays cash, the cash constitutes proceeds of the original collateral. If D then uses the cash to purchase additional inventory, the inventory will also constitute proceeds of the cash and thus also proceeds of the original collateral. Provided that the original inventory can be "traced" into the new inventory (i.e., the proceeds are identifiable), the security interest should continue to attach to the new inventory.

243. 839 F.2d 1104 (5th Cir. 1988) (mem.).

244. *Id.* at 1109.

245. *Id.* at 1105.

246. *Id.*

247. Retaining possession of the rigs during this time, the seller accounted for the transaction in its records as a sale. *Id.* at 1105-06.

248. The seller and buyer also executed a mutual release "whereby each party released the other from all contractual obligations arising from the sale of the six rigs." *Id.* at 1106.

249. The secured party argued that its perfected security interest in the buyer's inventory prevailed over any interest of the seller. *Id.*

250. *Id.* at 1109.

buyer.²⁵¹ The secured party, on the other hand, could not have relied on those specific rigs in extending credit to the buyer because the buyer neither possessed the rigs nor had the right to possess them.²⁵²

IV. A PROPOSAL FOR REFORM

Without attachment, a security interest does not exist. If a security interest has not attached, then it is not enforceable against the debtor, much less against a third party, such as another creditor.²⁵³ Of the three requirements for attachment, the first, a written security agreement, has the most extensive policy justification. The other two requirements, the secured party's giving of value and the debtor's having rights in the collateral, seem more practical than policy-driven. The written security agreement serves as a guard against fraudulently created security interests²⁵⁴ and as evidence of the specific agreement between debtor and creditor.²⁵⁵ The requirement that the secured party give value before the security interest is enforceable follows logically from the basic contract principle that an obligation is not enforceable unless supported by adequate consideration. Without some

251. The district court in *Ideco* observed, "[i]t would astonish the sellers of the world to discover that a seller who has not parted with goods nor received payment for them has an interest in the goods inferior to the creditor of a holder of an executory contract to buy them." *Id.*

252. The court of appeals clearly regarded the buyer's possession or the right to possession of the rigs as the linchpin of rights in the collateral. *Id.* at 1108-09; see also *First Tenn. Bank v. Graphic Arts Centre, Inc.*, 859 S.W.2d 858, 865 (Mo. Ct. App. 1993) (holding that identification alone does not confer rights in collateral on buyer of goods).

253. U.C.C. § 9-203(1) (1991). The timing of attachment may also be important for certain priority issues under Article 9 and preference issues under the Bankruptcy Code. One therefore needs to know not only *whether* the security interest has attached but *when* it attached. See, e.g., *Weaver v. Ford Motor Credit Co. (In re McFarland)*, 112 B.R. 906, 912 (Bankr. E.D. Tenn.) (mem.) (stating that time of attachment determined whether secured party had received a preferential transfer), *rev'd on other grounds*, 131 B.R. 627 (E.D. Tenn. 1990), *aff'd*, 943 F.2d 52 (6th Cir. 1991); *Union Fed. Sav. Bank v. INB Banking Co. Southwest*, 582 N.E.2d 426, 430 (Ind. Ct. App. 1991) (holding that time of attachment determined whether the secured party was "purchaser after removal" within U.C.C. § 9-103(1)(d)(i)).

254. Comment 5 to § 9-203 states that

the formal requisite of a writing stated in this section is not only a condition to the enforceability of a security interest against third parties, it is in the nature of a Statute of Frauds. . . . More harm than good would result from allowing creditors to establish a secured status by parol evidence after they have neglected the simple formality of obtaining a signed writing.

U.C.C. § 9-203 cmt. 5 (1991).

255. According to the Official Comments to Article 9, "[t]he requirement of written record minimizes the possibility of future dispute as to the terms of a security agreement and as to what property stands as collateral for the obligation secured." *Id.* § 9-203 cmt. 3.

value being given to the debtor, there is no obligation against which the secured party can enforce the security interest.²⁵⁶

The requirement that the debtor have rights in the collateral as a prerequisite to attachment of a security interest seems commonplace and obvious—the debtor cannot give a property interest in property in which it has no interest.²⁵⁷ But, as discussed in the earlier sections of this Article, the courts have used the concept not merely to decide whether a creditor has an enforceable security interest in particular collateral, but also whether the creditor has priority over a competing claimant. This use of rights in collateral to establish priorities is not necessarily undesirable if the results of these cases suggest that certain transactions currently excluded from Article 9 should more properly be subject to public notification requirements.

The bailment cases, taken at their extreme, stand for the proposition that the debtor's possession of goods coupled with almost any other rights—e.g., the right to use the goods or to make changes to them—will constitute rights in the collateral.²⁵⁸ As such, they will support attachment of the security interest of the possessor's secured party. The resulting attachment gives the secured party priority over the bailor/owner who has not filed a financing statement under Article 9.

By relying principally on rights in the collateral to elevate the secured party over the bailor, courts adopt a back-door method of deciding that the bailor's interest is in reality a security interest subject to the Article 9 filing requirements.²⁵⁹ Because the bailor has not filed a financing statement, it loses to the previously filed security interest of the possessor's secured party.

A more explicit definition of rights in the collateral would produce a more efficient and equitable system than the current regime.²⁶⁰

256. Implicit in every secured transaction is that the secured party will resort to the collateral only after the debtor's default—e.g., after the debtor fails to pay an installment on the obligation. The secured party therefore seeks to enforce the security interest only after an obligation has been created—i.e., after the creditor has lent money or otherwise extended credit to the debtor.

257. This is not to say that the debtor cannot give a security interest in property that it does not yet own. Security agreements predicated on after-acquired property are clearly permitted. See U.C.C. § 9-204 (1991). Section 9-203(1)(c) simply delays attachment of the security interest until the debtor has acquired rights in the collateral.

258. See *supra* notes 80-131 and accompanying text.

259. See *supra* notes 118-22 and accompanying text.

260. One scholar has noted the high degree of legal certainty demanded by those engaged in secured financing:

Article 9, which governs secured transactions, provides a sharp contrast to the bipolar world of sales. The most crucial disputes arising out of Article 9 are multipolar, involving priority disputes among numerous claimants against the insuffi-

As discussed earlier, the cases at either end of the rights spectrum should not present much difficulty.²⁶¹ If the debtor has both title to and possession of goods, then it has rights in the property sufficient for attachment of a security interest. In that instance the debtor has virtually the entire quantum of rights that property law recognizes.²⁶² In the converse situation, when the debtor lacks title (or any other property interest)²⁶³ and possession of goods, the debtor should not have rights in the property adequate for attachment. In such circumstances, the debtor is a complete stranger to the goods, having less connection to them than a thief, who would at least have possession.

In the middle cases, when the debtor has possession but incomplete ownership or when the debtor has ownership (or some other more limited property interest) but not possession, the Code's policies of efficiency and fairness dictate that the burdens of inquiry and public notification be equitably distributed between the titleholder and would-be secured parties dealing with the debtor. These policies also suggest that the use of equitable estoppel—with all of its nebulous considerations and ad hoc results—should be eliminated from the inquiry of what constitutes rights in the collateral. To these ends, I propose that the concept of rights in the collateral be eliminated as one of the requirements for attachment of a security interest, at least with

cient remaining assets of an insolvent debtor. In such a context, the open-ended standards of Article 2 would be unworkable because outcomes would never be sufficiently predictable, security interests would be insecure, and bankers (not to mention their attorneys) would regularly suffer nervous breakdowns. Thus, Article 9—with its detailed and carefully crafted provisions intended to resolve issues with as high a degree of certainty as practicable—was drafted in an entirely different style from Article 2. And when it was discovered that Article 9 had a number of omissions, interpretative uncertainties, and contradictions, it became the first article of the Code to undergo a complete revision, the aim of which was not to rectify serious errors, but rather to improve clarity and answer some open questions.

John A. Sebert, Jr., *Rejection, Revocation, and Cure Under Article 2 of the Uniform Commercial Code: Some Modest Proposals*, 84 Nw. U. L. Rev. 375, 382 n.45 (1990).

261. See *supra* notes 44-45 and accompanying text.

262. Of course, even in this situation the debtor's title could be encumbered if, for example, the debtor had earlier given a security interest to another lender. But the Code specifically contemplates multiple security interests in the same property, and thus even an encumbered title, when coupled with possession, should constitute rights in the collateral.

263. There are a number of situations in which the debtor will not have possession of goods or title to them, but will have some limited property interest in them—e.g., a security interest or lien. Article 9 acknowledges that a person with such a limited interest in goods can give a security interest in its limited interest to a secured party. For example, if D sells goods to B on time and reserves a security interest in them, D can then use the paper created in the first transaction with B as collateral for a loan from SP. The second transaction between D and SP involves the giving of a security interest in or the sale of chattel paper.

respect to security interests in tangible goods. In its place I argue that the Code should substitute a system of filing requirements and should rely on Article 2's existing principles regarding the ability to compel delivery of goods in a sales transaction.

A. *Ostensible Ownership Through Possession*

Whenever the debtor has possession of goods, there is the danger that third parties will be deceived into thinking that the debtor has all right, title, and interest in those goods.²⁶⁴ Would-be secured creditors, in particular, will extend credit to the debtor and take security interests in the goods, totally unaware that they are claimed by another with an unrecorded interest.

Currently, the Code solves this ostensible ownership problem by requiring all consignors to file financing statements under Article 9 or otherwise give public notice of their interests.²⁶⁵ Conversely, it allows lessors to rely exclusively on their reservation of title to reclaim goods from their lessees; they are not required to file in the recording system or cure the ostensible ownership problem by other means.²⁶⁶ Finally, the courts have treated bailments in divergent ways—in some instances finding bailments to be disguised financing devices requiring filing under Article 9,²⁶⁷ and, in others, holding that the bailee's interest in the goods was insufficient to constitute rights in the collateral and thus that the bailee was precluded from giving a security interest to a third party.²⁶⁸

This focus on rights in the collateral begs the real question: Under what circumstances is a third party entitled to rely on the debtor's possession of goods as an indication of ownership? In this respect, the cases relying on equitable estoppel examine the relevant issues. One approach places the burden of ostensible ownership problems entirely on later third parties dealing with the debtor. Those later third parties, most often secured creditors, would bear the responsibility of determining the state of the debtor's title to the goods before relying on them as collateral.

In this scheme, the would-be secured party would necessarily demand a bill of sale for all tangible collateral offered by the debtor, including inventory, equipment, farm products, and consumer goods. If the debtor could not produce a bill of sale, the secured party would

264. See *supra* note 69 and accompanying text.

265. See *supra* notes 73-74 and accompanying text.

266. See *supra* notes 59-61 and accompanying text.

267. See *supra* notes 101-12 and accompanying text.

268. See *supra* notes 86-100 and accompanying text.

be justified in assuming that the debtor did not own the property but held it on a consignment, lease, bailment, or sale on approval. Consignors, lessors, bailors, and sellers on approval would have no obligation to file financing statements to preserve their interests, and consequently, later secured parties could not rely on the public records to reveal these kinds of interests.

The converse approach would require all titleholders who transfer possession of their property to another to file financing statements in the public records. Thus, all consignors, lessors, bailors, and sellers on approval who relinquished possession of goods to the debtor would be forced to give public notification of their interests. Later third parties would be relieved of the burden of making an exhaustive inquiry into the state of the debtor's title and could simply rely on the interests disclosed by the public recording system. If the titleholder failed to file a proper financing statement, then the later secured party with a perfected security interest in those goods would prevail over the titleholder's interest.

Under either of these schemes the issue of whether the debtor had rights in the collateral would be irrelevant.²⁶⁹ In essence, it would be assumed that the debtor's lawful possession of the goods endowed it with sufficient rights for attachment of a security interest. The real question would be that of priority to the goods, as between the titleholder and the secured party.

Each scheme advances the Code's policies of certainty and predictability. If no titleholder must file, then secured parties know that they must independently determine the extent of the debtor's interest in proffered collateral. If all titleholders must file, then secured parties know that they can rely exclusively on the public record to disclose all adverse interests in property possessed by the debtor. Correspondingly, under either scheme titleholders know the precise nature of their rights and responsibilities when they relinquish possession of their property to the debtor.

Both schemes, however, have associated costs with them, and choosing between them depends on which scheme better promotes efficiency and fairness. Putting the entire burden of inquiry on the secured party in every instance is, of course, extremely costly for

269. The only exception to this general principle would be when the debtor was a thief. As a thief, the debtor presumably would have possession but no underlying legal right to possession. In that case, the common law maxim that a thief cannot pass good title to goods even to a bona fide purchaser for value would prevail. Secured parties dealing with thieves or their successors in interest would therefore still have to ascertain that the debtor had *lawful* possession of the goods.

would-be secured lenders. When the collateral is the debtor's inventory, the inquiry could involve examining hundreds of bills of sale and crosschecking them against the items in the debtor's possession. Even with equipment, the task of ascertaining the debtor's rights in dozens of individual items could be daunting.

On the other hand, requiring all titleholders to file financing statements could be excessively burdensome, especially to lessors and bailors who relinquish possession of their property for a short-term, limited purpose. For example, suppose the debtor leases computers for two months while it reviews its options for purchasing computers. The cost of filing such transitory possessions might not be counterbalanced by a commensurate benefit to third parties who might rely on the debtor's possession of the computers.

Overall, Article 9 has wisely favored distributing the burdens of filing and inquiry evenly between earlier and later parties. Secured parties desiring a perfected security interest must file a proper financing statement in the correct public office.²⁷⁰ Later parties dealing with the debtor can then rely upon that filing system to disclose all current security interests.

Post-filing changes, however, can render the public record inaccurate. For example, the debtor might change its name or move the collateral to another state. Because the filing system is indexed by debtors' names²⁷¹ and because often the location of the collateral controls the place of filing,²⁷² such post-filing changes could make it difficult for later parties to locate the original financing statement.

In general, Article 9 divides the burdens created by post-filing changes between the original filing creditor and the later inquiring party. For example, if the debtor moves ordinary goods from State A to State B, the secured party who filed in State A has four months to discover the move and refile in State B to maintain continuous perfection.²⁷³ As a consequence, a third party dealing with the debtor in State B must determine that the goods in question recently arrived

270. U.C.C. § 9-302(1) (1991). Perfection by possession is permitted for several types of collateral, including goods, but it is seldom used in ordinary business financing, except for stocks, bonds, and other instruments. U.C.C. § 9-305.

271. U.C.C. § 9-403(4).

272. For "ordinary goods," perfection issues "are governed by the law of the jurisdiction where the collateral is when the last event occurs on which is based the assertion that the security interest is perfected or unperfected." U.C.C. § 9-103(1)(b).

273. U.C.C. § 9-103(1)(d)(i) (1991) states:

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,

from State A and search for financing statements there. If the later party is uncertain of the accuracy of the information supplied by the debtor (e.g., perhaps the goods came from State C rather than State A), then it may either refuse to deal with the debtor or wait four months and then search for financing statements in State B. Similarly, when a debtor changes its name, the original filing secured party has four months to discover that the debtor has changed its name in a misleading way and to refile in the new name.²⁷⁴

Even with respect to the accuracy of the original financing statement, the Code puts some burdens on each party. The original filing secured party has the primary burden of ensuring that the financing statement is filled out correctly²⁷⁵ and filed in the proper public office.²⁷⁶ But the drafters recognized that some errors in filing would inevitably occur. Thus a financing statement "substantially complying with the requirements of [§ 9-402] is effective even though it contains minor errors which are not seriously misleading."²⁷⁷ Therefore, a later party searching the records must discern that a financing statement with the debtor's name slightly misspelled or misstated in fact relates to the same debtor with whom the later party is dealing.²⁷⁸ Similarly, a filing secured party can survive a mistake in the place of filing: A financing statement misfiled in good faith is "effective with regard to collateral covered by the financing statement against any person who has knowledge of the contents of such financing statement."²⁷⁹

(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 have been unperfected as against a person who became a purchaser after removal . . .

Id.

274. The four-month grace period provided for name changes is somewhat different from that provided for interstate movements of collateral. If the debtor changes its name in a misleading way, the original filing party must discover the name change and refile in the debtor's new name within four months after the change to remain perfected in collateral acquired more than four months after the change. U.C.C. § 9-402(7) (1991). Thus if the original filer's security interest is only in two pieces of equipment, the filer need not be concerned about a name change. This rule affects primarily inventory and accounts financiers, who rely heavily on after-acquired property.

275. U.C.C. § 9-402(1).

276. U.C.C. § 9-401(1).

277. U.C.C. § 9-402(8).

278. *Kay Automotive Warehouse, Inc. v. McGovern Auto Specialty, Inc.* (*In re McGovern Auto Specialty, Inc.*), 51 B.R. 511, 513-14 (Bankr. E.D. Pa. 1985); *In re Vaughan*, 4 U.C.C. Rep. Serv. (Callaghan) 61, 65 (Bankr. W.D. Mich. 1967).

279. U.C.C. § 9-401(2) (1991).

In one instance the Code puts the entire onus of discovering the change in circumstances on the later party. If D transfers the collateral to X, a third party, in an arms' length transaction, SP's financing statement "remains effective with respect to collateral transferred by the debtor even though the secured party knows of or consents to the transfer."²⁸⁰ A later creditor, Y, dealing with the collateral in X's hands cannot determine the encumbrances merely by searching for financing statements in X's name. Instead Y must inquire as to X's source of title to the goods and search for financing statements in the name of X's transferor.²⁸¹

The logic behind these provisions seems to be that the burdens of ensuring the availability of accurate information about the debtor's property are most efficiently borne by both filing and searching parties. Neither party alone, without instituting costly monitoring or investigating mechanisms, can guarantee the complete reliability of the public records. It is virtually impossible for the filing party to learn instantly of debtor name changes or movements of collateral without expensive daily monitoring of the debtor's activities. On the other hand, searching parties need assurance that they can rely on the public notification system at some point in time. The grace periods allowing filing parties to correct the records accommodate both interests.

A similar system that divides the responsibilities of acquiring and verifying information about property in the debtor's possession would best serve the policies of efficiency and fairness. Titleholders (with the exception of consignors) who relinquish possession of property to the debtor for a limited purpose, i.e., a lease or bailment, should be required to file financing statements to notify the world of their interests if the property remains in the debtor's possession for more than four months. Under my proposed scheme, short-term leases and bailments would not be subject to filing requirements. At the same time, titleholders in these short-term transactions could rely on their title to reclaim the collateral in the event of the debtor's default.

In this situation, the issue of rights in the collateral would no longer operate as a hidden priority mechanism. Short-term lessees and bailees could give security interests in the leased or bailed property to creditors, but only to the extent of their limited interest in it. Secured creditors would not be able to trump the titleholder's interest by asserting that they had attached, perfected security interests in the property with priority over the titleholder's unfiled interest.

280. U.C.C. § 9-402(7).

281. See U.C.C. § 9-402 cmt. 8.

On the other hand, lessors and bailors who relinquish possession of property to lessees and bailees for four months or longer would be required to file financing statements evidencing their interests in the leased or bailed property. In this way, later parties dealing with the debtor could search the public records and ascertain the existence of the titleholder's interest. These parties, if uncertain about the information supplied by the debtor, could wait four months and then determine whether financing statements appeared on the public records.

Again, under this regime, the issue of rights in the collateral becomes moot. If bailors and lessors failed to file for these longer-term transactions, they would lose their right to claim the property as against secured creditors who had perfected security interests in the bailed or leased property. Debtors in this situation would be assumed to have sufficient rights in the property for attachment of a security interest. Bailors and lessors who did make a proper filing would be protected against claims by secured creditors. The focus of the priorities contest would be public notification, not whether the debtor had rights in the collateral.

This scheme has several advantages for secured creditors, titleholders, and debtors. Secured creditors gain a reliable system from which to ascertain information about property in the debtor's possession. Many of Article 9's filing and priorities rules are predicated on the assumption that debtors may not willingly provide accurate information to third parties about the extent of their ownership interests in property in their possession.²⁸² By requiring titleholders in longer-term transactions to file in the public notification system, one ensures later third parties that they can discover the status of the possessor's interest in certain personal property without having to rely on possibly inaccurate or self-serving information supplied by the possessor.²⁸³

282. If the secured party

leaves the property in the debtor's possession and under his apparent control, the debtor will be given a false credit and will be enabled to sell the property to innocent purchasers or to induce other innocent persons to lend money to him on the strength of his apparently unencumbered assets.

1 GILMORE, SECURITY INTERESTS, *supra* note 24, §14.1, at 438.

283. One argument against including lessors and bailors in the filing system is that later third parties can easily ascertain whether the debtor has title to the leased or bailed goods by demanding a bill of sale before proceeding with the transaction. However, this argument overlooks the possibility that the debtor will provide a phony bill of sale, as well as the burdens attendant to examining bills of sale for all pieces of equipment in the debtor's possession. Theoretically, third parties dealing with debtors who may have consigned goods in their possession have the same option of demanding bills of sale, yet the Code requires all consignors to give public notification to protect their interests. See U.C.C. § 2-326(3) (1991).

At the same time, titleholders gain much greater certainty as to their responsibilities under the U.C.C. Under the present system, bailors in particular are unsure about when their bailments will be treated as disguised secured transactions and brought within the ambit of the Code's filing requirements. As a prophylactic matter, many bailors may already file financing statements, even in short-term transactions. This proposal removes from short-term bailors the burden of expense and filing.

The choice of four months as the determining point for filing meshes with the existing four-month grace periods in Article 9. Secured parties interested in a debtor's inventory or equipment cannot be certain that there are no conflicting security interests in those goods even after consulting the public records because those records may not reflect the most recent information regarding the debtor's name or the location of the collateral.²⁸⁴ As a result, to guarantee the accuracy of information found in the filing system, secured creditors must again search the records regarding the same collateral four months after the initial search. In this way, searching creditors ensure that an earlier creditor with a perfected security interest in the collateral has not refiled in the debtor's new name or in the collateral's new location.

Requiring that bailors and lessors file financing statements when bailed or leased goods have been in the debtor's possession for four months or more allows searching creditors to wait four months and then check for filings made by bailors or lessors. Searching creditors gain this additional information not currently provided by the Article 9 scheme without undertaking significant new burdens.

The four-month time limit also protects bailors and lessors in short-term transactions from compliance with filing requirements. The transitory nature of the debtor's possession probably does not justify imposing the costs of filing on these titleholders.²⁸⁵ For example, a titleholder who routinely sends its equipment to bailees for one-month stints for repair or refurbishment would find it extremely burdensome to file a financing statement for each of these temporary situations. Similarly, lessors in short-term leases already have high transaction costs because of the rapid turnover of the equipment,²⁸⁶

284. See *supra* notes 271-74 and accompanying text.

285. See Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 *YALE L.J.* 1143, 1158-61 (1979) (noting that costs of engaging in secured financing may outweigh the benefits to creditors where loan is small or duration of loan is short).

286. Every time a short-term lease ends, the lessor has to retake the property, clean and refurbish it, and find another lessee. In a short-term lease, moreover, the lessor is more

and adding filing costs would further reduce the profitability of these transactions.²⁸⁷

On the other hand, longer-term bailments and leases are more likely to be akin to secured financing transactions. In a long-term bailment, the bailor often provides raw materials to a bailee to manufacture into a finished product.²⁸⁸ The bailor supplies raw materials in lieu of lending the bailee funds to buy its own raw materials.²⁸⁹ Long-term leases are similarly used as a substitute for installment sales contracts for the purchase of equipment and, thus, are the functional equivalent of a secured financing device.²⁹⁰ Just as the classic secured transaction creates ostensible ownership problems, long-term bailments and leases can result in similar third-party deception. This potential deception justifies placing the burdens of filing on long-term bailors and lessors.

This proposed scheme could also be applied to consignment transactions. As mentioned previously, all consignors, whether engaged in true or security consignments, must give some sort of public notice of their interests to protect the consigned goods from the claims of the consignee's creditors.²⁹¹ The question arises as to whether, under my proposal, short-term consignors should be relieved of public notification burdens as are short-term bailors and lessors.

Inventory financiers often must monitor their debtors closely to ensure that the debtors maintain the proper levels of inventory and remit proceeds.²⁹² They must also keep abreast of name changes by the debtor and movements of the collateral across jurisdictional lines. These events trigger refiling obligations by the original secured party.²⁹³ In fact, the original secured party must monitor these factors at least every four months to avoid losing its perfected status.

likely to be responsible for ongoing maintenance and insurance costs than in a long-term transaction.

287. For example, using a similar cost-benefit analysis, the Truth-in-Lending Act exempts leases of personal property for four months or less from the extensive disclosure requirements mandated for longer-term leases. 15 U.S.C. §§ 1667(1), 1667a (1988).

288. See, e.g., *Litwiller Mach. & Mfg., Inc. v. NBD Alpena Bank*, 457 N.W.2d 163, 164-65 (Mich. Ct. App. 1990); *Morton Booth Co. v. Tiara Furniture, Inc.*, 564 P.2d 210, 211-12 (Okla. 1977).

289. See *Summers*, *supra* note 118, at 451-54.

290. Long-term leases not terminable by the lessee which are for the duration of the useful life of the goods are presumptively secured transactions and covered by Article 9. See U.C.C. §§ 1-201(37) (defining security interest), 9-102(2) (describing the scope of Article 9) (1991).

291. See *supra* notes 63-79 and accompanying text.

292. For example, the secured party can lose its security interest in proceeds that become nonidentifiable. See U.C.C. § 9-306(2) (1991); *CLARK*, *supra* note 22, ¶ 10.3.

293. See *supra* notes 271-74 and accompanying text.

Arguably then, inventory secured creditors face a minimal additional burden in determining whether the debtor is holding on consignment particular goods that appear to be part of its inventory. In actuality, however, the burden on secured creditors in this instance is considerable. Monitoring the remitting of proceeds, the general levels of inventory, the debtor's name, and the collateral's location, while tedious no doubt, can be accomplished in a relatively straightforward fashion. Determining the exact arrangement between the debtor and its supplier regarding hundreds of items of inventory, on the other hand, potentially involves close daily observation of the minute details of the debtor's business.

At present, the Code recognizes the considerable difficulties faced by inventory financiers in determining the existence of competing claims to their debtor's inventory. The rules regarding consignments and the purchase money inventory superpriority implicitly acknowledge the original inventory secured party's substantial monitoring problems. The consignor and the purchase money inventory secured party both gain priority over an earlier perfected inventory secured party if they file financing statements in a timely fashion and give individual written notification to the earlier secured party of their interests.²⁹⁴ The individual written notification relieves the original secured creditor of the task of frequently consulting the public records for new claimants or investigating the debtor's arrangements with its suppliers. In this scheme, the Code recognizes the significant burden that would be imposed on original inventory secured parties if they were not directly apprised of the later party's superseding interest.²⁹⁵

Notwithstanding the inventory financier's special vulnerabilities, my four-month notification proposal could be used for certain types of consignments. For example, art galleries, antique shops, craft outlets, and jewelry stores often sell unique goods received on consignment from individual artisans or collectors. Because third parties dealing with these types of sellers will likely know that much of their inventory is held on consignment, the statutory scheme could relieve the

294. U.C.C. §§ 9-114(1), 9-312(3) (1991).

295. Official Comment 3 to § 9-312 justifies the notification requirement:

The reason for the additional requirement of notification is that typically the arrangement between an inventory secured party and his debtor will require the secured party to make periodic advances against incoming inventory or periodic releases of old inventory as new inventory is received. A fraudulent debtor may apply to the secured party for advances even though he has already given a security interest in the inventory to another secured party. The notification requirement protects the inventory financier in such a situation: if he has received notification, he will presumably not make an advance

U.C.C. § 9-312 cmt. 3 (1991).

consignors of the public notification requirements unless the consigned goods were in the dealer's possession for more than four months. The consignors in this setting—i.e., artists and craftspeople—are less likely to have the resources and expertise to use the filing system. Arguably, these consignors should be relieved of all public notification requirements because the benefit to third parties does not outweigh the considerable burdens on the consignors.

B. *Ownership Without Possession*

1. Leases, Consignments, and Other Bailments

Titleholders in lease, consignment, and bailment transactions are concerned not only about being able to reclaim their goods from the possessor but also about being able to grant security interests in these goods to their own lenders. The earlier discussion suggests that under Article 9's current provisions titleholders do have sufficient rights in the goods to give an enforceable security interest in them to a secured party.²⁹⁶

If rights in the collateral is eliminated as a requirement for attachment of a security interest in tangible goods, one must then determine the enforceability of a security interest given by a titleholder to goods it does not presently possess. Again there is no particular reason why a lender should not be able to take a security interest in, for example, a lessor's interest in leased goods.²⁹⁷ Often the lender will want a security interest primarily in the rental payments and only secondarily in the leased goods themselves. The lender's security interest in the goods, however, would be limited by the lessor's interest in them; that is, the lessor generally has no right to retake the goods until the lease term ends or the lessee defaults.

Arguably, this situation presents no ostensible ownership problems for third parties dealing with the lessor.²⁹⁸ Third parties cannot be deceived by appearances into believing that the lessor owns certain goods because it possesses them, for here the leased goods are assumed to be in the lessee's hands. On the other hand, the lessor may convince a would-be lender that it in fact owns the leased

296. See *supra* notes 213-23 and accompanying text.

297. See U.C.C. § 2A-303 (1991) (providing that the transfer or creation of security interests either in the lessee's interest under the lease or of the lessor's residual interest is enforceable, notwithstanding a provision in the lease agreement prohibiting the transfer or making it a default).

298. This analysis could apply equally as well to consignments and other bailments.

goods²⁹⁹ and eventually will retake them.³⁰⁰ The lender at that point must be able to ascertain whether there are pre-existing security interests in the goods. Thus, it seems appropriate that secured parties desiring to have perfected security interests in both the lease payments and the leased goods should be required to file financing statements covering both.³⁰¹

2. Sales Transactions

The issue of rights in the collateral in sales transactions can be used to determine priority between the seller of the goods (or the seller's secured party) and the buyer's secured party. If the buyer has the right to obtain physical possession of the goods, one could say that it has rights in the collateral such that the security interest of the buyer's secured party attaches. At the moment that the buyer acquires its rights, one could say that the seller loses its rights (assuming the buyer is a buyer in the ordinary course of business) and the security interest of the seller's secured party thereby detaches or is cut off.

Again, the use of rights in the collateral or the BIOCOC rule is simply a way to determine priority between two "innocent" parties—namely, the unpaid (or partially paid) seller and the (presumably) unpaid secured party of the buyer. As Professor Frisch persuasively argued, Article 2, by giving the buyer certain possessory remedies in the event of the seller's default, seeks to validate legitimate buyer expectations regarding the goods.³⁰² If the goods in question are fungible, then the buyer has no need of the specific goods promised by the seller and will gladly accept market damages as a substitute.³⁰³ With those damages, the buyer can re-enter the market and purchase identical substitute goods. Only when substitute goods cannot be ob-

299. The lessor may show the lender its lease with the lessee to establish its ownership and may demonstrate that its primary business is leasing of equipment.

300. In a long-term lease, the useful life of the leased goods may be rather short at the end of the lease term. In those cases, the lessor's secured party may be more interested in the rental payments and less interested in the leased goods themselves, except as back-up collateral in case the lessee defaults during the term.

301. See *Feldman v. First Nat'l City Bank (In re Leasing Consultants, Inc.)*, 486 F.2d 367, 370-72 (2d Cir. 1973) (holding that party desiring perfected security interest in lessor's reversionary interest in leased goods had to file financing statement against the goods *qua* goods and could not rely only on filing as to chattel paper).

302. Frisch, *supra* note 235, at 570-71.

303. Frisch noted that

[a] central assumption of Article 2 is the homogeneity of goods. If the seller does not deliver the goods, the buyer will, most often, be able to obtain similar goods elsewhere. As a result, the buyer's expectation interest is fully vindicated by a damages award based on an imagined or actual substitute purchase.

Id. at 571 (footnotes omitted).

tained, or when a damages remedy would be relatively valueless because of the seller's insolvency, does the buyer prefer to have the specific goods promised by the seller.³⁰⁴

In some sense, the buyer's secured party's expectations track those of the buyer. The secured creditor with a security interest in the buyer-debtor's present and after-acquired equipment and inventory legitimately expects that it can foreclose on all items currently in the debtor's possession. It would also assume that it could foreclose on any items that are not currently in the debtor's possession but that the debtor has the right to possess under certain circumstances—e.g., leased goods that can be reclaimed from the lessee. Thus, if Article 2 affords the buyer certain possessory remedies in sales transactions, the buyer's secured party would expect to be able to take advantage of those remedies as it stands in the buyer's shoes.³⁰⁵

Assuming that the current Article 2 remedies strike an appropriate balance between the seller's and buyer's interests, it therefore seems logical to equate the buyer's right to possession of goods in a sales transaction with the attainment of rights in the collateral sufficient for attachment.³⁰⁶ But again one observes that rights in the collateral operate as a priority-giving mechanism; that is, to say that the buyer has rights in the goods being purchased is to say that the security interest attaches and that the seller's interest in the goods is essentially stripped away. This result could be accomplished directly by doing away with rights in the collateral and substituting a priority rule

304. *Id.* at 571-72.

305. In some cases, the foreclosing secured party may choose not to avail itself of the buyer's possessory remedies under Article 2. For example, to compel the seller to deliver goods under U.C.C. § 2-716(1) (1991) (describing buyer's right to specific performance), the buyer may be required to tender the balance of the purchase price. See U.C.C. § 2-716(2) ("The decree for specific performance may include such terms and conditions as to payment of the price, damages, or other relief as the court may deem just."). The buyer's secured party may prefer to keep the cash and forego obtaining the goods if it plans on selling the goods anyway.

306. Several of the early drafts of Article 9 defined rights in the collateral for certain types of property. In particular, the debtor had "no interest . . . in goods to be purchased by the debtor until they [were] tendered (defined in Sales Article) Section 2-503." U.C.C. § 9-203(2)(c) (1950), *reprinted in* 11 UNIFORM COMMERCIAL CODE *Drafts* 229 (Elizabeth Slusser Kelly ed. 1984). Under the 1950 version of § 2-503, "[t]ender of delivery requires that the seller put and hold conforming goods at the buyer's disposition and give the buyer any notification reasonably necessary to enable him to take delivery. The manner, time and place for tender are determined by the agreement and this Article . . ." U.C.C. § 2-503(1) (1950), *reprinted in* 10 UNIFORM COMMERCIAL CODE: *Drafts, supra*, at 195. When §§ 2-401, concerning passage of title, and 2-503 are read together with § 9-203(2)(c), it becomes apparent that the drafters intended that title to goods should pass from buyer to seller upon the seller's tender of them to the buyer and that thus the buyer/debtor did not have an "interest" in goods being purchased for Article 9 purposes until title passed.

that states that a secured party whose debtor-buyer has a possessory right in goods purchased in a sales transaction prevails over a seller seeking to retain or reclaim those goods.³⁰⁷

V. CERTAINTY, EFFICIENCY, AND REALISM

Legal scholars have frequently observed the impact of Karl Llewellyn's jurisprudential philosophy on the formulation of the Uniform Commercial Code.³⁰⁸ As the Chief Reporter for the U.C.C. project,³⁰⁹ Llewellyn was in a unique position to shape commercial law according to his view of the proper role of law in society. By his own admission, he sought to create a "case law" code in contrast to the more prescriptive civil codes of the European Continent.³¹⁰ He foresaw the courts as having a significant function in filling in the doctrinal gaps left by the Code's drafters and in updating the Code to fit changing and perhaps unanticipated business conditions.

As one of the foremost advocates of Legal Realism,³¹¹ Llewellyn also endeavored to engineer the Code to reflect the actual practices of reasonable business people. The body of commercial law, he believed, should not represent an artificial construct born of some legal academic's utopian vision of the ideal commercial world.³¹² It should

307. The seller has a limited right of reclamation of goods that have already been delivered to a buyer where the buyer has misrepresented its solvency to the seller. U.C.C. § 2-702(2) (1991). The seller must demand return of the goods within 10 days of the buyer's receipt of them unless the "misrepresentation of solvency has been made to the particular seller in writing within three months before delivery." *Id.* The seller's right of reclamation is subject to the rights of good faith purchasers, which have been interpreted to include Article 9 secured parties. *Id.* § 702(3); see *Collingwood Grain, Inc. v. Coast Trading Co. (In re Coast Trading Co.)*, 744 F.2d 686, 690-92 (9th Cir. 1984); *Stowers v. Mahon (In re Samuels & Co.)*, 526 F.2d 1238, 1244 (5th Cir.) (en banc), cert. denied, 429 U.S. 834 (1976); *In re Shattuc Cable Corp.*, 138 B.R. 557, 562-63 (Bankr. N.D. Ill. 1992); *House of Stainless, Inc. v. Marshall & Ilsley Bank*, 249 N.W.2d 561, 567 (Wis. 1977).

308. See GRANT GILMORE, *THE AGES OF AMERICAN LAW* 81-86 (1977) [hereinafter GILMORE, AGES]; WILLIAM TWINING, *KARL LLEWELLYN AND THE REALIST MOVEMENT* 302-40 (1973); Richard Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code*, 27 STAN. L. REV. 621, 621-22 (1975); John L. Gedid, *U.C.C. Methodology: Taking a Realist Look at the Code*, 29 WM. & MARY L. REV. 341, 342-43 (1988); Zipporah Batshaw Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 HARV. L. REV. 465, 466-72 (1987).

309. See William A. Schnader, *A Short History of the Preparation and Enactment of the Uniform Commercial Code*, 22 U. MIAMI L. REV. 1, 4 (1967) (referring to Llewellyn as the "outstanding man in the United States" to serve as Chief Reporter).

310. See TWINING, *supra* note 308, at 305.

311. See Karl Llewellyn, *A Realistic Jurisprudence—The Next Step*, 30 COLUM. L. REV. 431 (1930); Karl Llewellyn, *Some Realism About Realism—Responding to Dean Pound*, 44 HARV. L. REV. 1222 (1931).

312. See Karl Llewellyn, *The Effect of Legal Institutions Upon Economics*, 15 AM. ECON. REV. 665, 665-72 (1925).

be grounded instead in real-life business mores and customs, which have developed in response to the felt necessities of commercial interaction in a capitalist economy. Commercial actors in the real world are in a much better position to create trade customs that reduce risks and promote efficiency than remote lawgivers.

Llewellyn's vision of a case-law Code grew out of his realist jurisprudence.³¹³ He foresaw that the Code, like any statute, could become woefully outmoded in a relatively short period of time as new business practices arose and old ones vanished.³¹⁴ Rather than relying on the cumbersome process of legislative amendment, he envisioned the courts adapting the Code to changing circumstances. Because courts decide cases in the context of specific facts, Llewellyn believed that they were well situated to modernize the statutory dictates³¹⁵ and to prevent the Code from becoming fossilized in a bygone mercantile era.³¹⁶

Llewellyn's influence on the Code can be seen most starkly in Article 2's open-ended style. Article 2 is replete with phrases such as "reasonable,"³¹⁷ "good faith,"³¹⁸ "unconscionable,"³¹⁹ "conspicu-

313. GILMORE, AGES, *supra* note 308, at 85-86.

314. Llewellyn believed that commercial or mercantile law, in particular, ran the risk of being outstripped by societal and economic changes: "Nowhere does the eternal legal problem lie closer, of making antiquated and clumsy words and concepts do more delicate and modern work . . ." Karl Llewellyn, *Across Sales on Horseback*, 52 HARV. L. REV. 725, 727 (1939).

315. Llewellyn favored what he called the "Grand Style" of decisionmaking, which he believed characterized the American courts of the early nineteenth century. Under the Grand Style,

every current decision is to be tested against life-wisdom, and . . . the phrasing of authorities which build our guiding structure of rules is to be tested and is at need to be vigorously recast in the new light of what each new case may suggest either about life-wisdom, or about a cleaner and more usable structure of doctrine. In any event, and as overt marks of the Grand Style: "precedent" is carefully regarded, but if it does not make sense it is ordinarily re-explored; "policy" is explicitly inquired into; alleged "principle" must make for wisdom as well as for order if it is to qualify as such . . .

KARL LLEWELLYN, *JURISPRUDENCE: REALISM IN THEORY AND PRACTICE* 217 (1962).

316. Llewellyn noted both the narrowness and adaptability of judicial lawmaking: Rulings of wider import are made by the courts always under the impact of the concrete controversy . . . This serves at once to test and refresh rules of law by recurrent earthy contact with new experience . . . while, on the other hand, it serves to hold vision and thought down to small areas and to condition thought by the partially accidental impact of what happens to be litigated.

Karl Llewellyn, *American Common Law Tradition, and American Democracy*, 1 J. LEGAL & POL. SOC. 14, 30 (1942).

317. See, e.g., U.C.C. § 2-103(1)(b) (1991) (defining good faith); § 2-305(4) (construing an open price term); § 2-309 (construing the absence of specific time provisions relating to performance); § 2-606(1)(a), (b) (defining acceptance of goods); § 2-610(a) (providing for anticipatory repudiation); § 2-706 (permitting seller's resale).

ous,"³²⁰ "course of dealing,"³²¹ and "usage of trade"³²²—phrases that by themselves carry little meaning³²³ but can be fleshed out only when a court decides their meaning in the context of specific cases. Article 2 also allows the parties to sales transactions great latitude in varying the Code provisions by contract.³²⁴ Through the open-ended drafting style and the deference to freedom of contract, Article 2 could be adapted to the vast assortment of different sales transactions and could allow the parties maximum flexibility in tailoring the basic statutory provisions to their particular circumstances.

Article 9, in contrast, felt Llewellyn's influence less keenly. Drafted primarily by Grant Gilmore and Allison Dunham,³²⁵ it is much more tightly written and more prescriptive than Article 2.³²⁶ Article 9's great achievement was its development of a unitary security device controlled by a few basic requirements—a single model for secured transactions that replaced the plethora of pre-Code security devices such as the trust receipt and the chattel mortgage.³²⁷ Rather

318. *See, e.g.*, U.C.C. § 2-306(1) (construing provisions related to output, requirements and exclusive dealings); § 2-311(1) (concerning options and cooperation respecting performance); § 2-403(1) (regarding title acquired by good faith purchaser).

319. *See, e.g.*, U.C.C. § 2-302 (describing judicial options for remedying unconscionable contracts); § 2-719(3) (providing for limitations on exclusion of consequential damages).

320. *See, e.g.*, U.C.C. § 2-316(2) (discussing modification or exclusion of implied warranties).

321. *See, e.g.*, U.C.C. § 2-208 (describing interpretation of contract terms); § 2-314 (providing for implied warranties).

322. *See, e.g.*, U.C.C. § 2-208(2) (describing interpretation of contract terms); § 2-314(3) (providing for implied warranties).

323. "Good faith," "course of dealing," and "trade usage" are loosely defined in Article 1. *See* U.C.C. § 1-201(19) (defining good faith); § 1-205 (defining course of dealing and trade usage). "Good faith" is further defined as to merchants in Article 2. U.C.C. § 2-103(1)(b).

324. *See, e.g.*, U.C.C. § 1-105 (granting the parties choice of law right); § 2-316 (permitting the exclusion or modification of warranties); § 2-319 (providing default definition of F.O.B. and F.A.S. terms); § 2-401(2) (specifying default rule for passage of title); § 2-719 (providing for limitation or modification of remedies).

325. 1 GILMORE, *SECURITY INTERESTS*, *supra* note 24, at xi. Two lawyers, Homer Kripke and Peter Coogan, also made substantial contributions during the drafting process. *Id.*

326. GILMORE, *AGES*, *supra* note 308, at 140-41 n.38; Sebert, *supra* note 260, at 382 n.45.

327. Grant Gilmore, *The Secured Transactions Article of the Commercial Code*, 16 *LAW & CONTEMP. PROBS.* 27, 27 (1951) ("Article 9 . . . proposes to integrate, under a single system of legal propositions and a single system of terminology, the entire range of transactions in which money debts are secured by personal property."); *see also* Homer Kripke & Carl Felsenfeld, *Secured Transactions: A Practical Approach to Article 9 of the Uniform Commercial Code*, 17 *RUTGERS L. REV.* 168, 168 (1962) (noting that Article 9 "creates a uniform system for handling most forms of security devices heretofore covered by a bewildering variety of statutes and common law principles").

than emphasizing variety and flexibility, the drafters of Article 9 attempted to focus on similarities among secured transactions and to create certainty with respect to the rights and interests of the various affected parties.³²⁸ As a result, there is much less room for courts or private parties to maneuver under Article 9—much less opportunity for courts to fill in statutory gaps or to interpret vague statutory language and fewer chances for the parties to opt out of the Code scheme by contract.³²⁹

With respect to the issue of rights in collateral, Article 9 reads more like Article 2. Article 9 specifically fails to define that phrase and leaves the courts to find its meaning.³³⁰ But the courts have been inconsistent and often misguided in their interpretation of what constitutes sufficient rights in the collateral for attachment of an Article 9 security interest.³³¹ Parties in bailment and sales transactions are left to speculate what their obligations, if any, under Article 9 might be. The courts' use of equitable estoppel to decide some of these cases leads them to heavily fact-laden inquiries and subjective judgments about what would be a "fair" result.³³²

Given that the phrase "rights in the collateral" was left deliberately vague, one could argue that the Code drafters intentionally and wisely left the issue to the courts, that they realized that in borderline cases equitable concerns would properly weigh in the balance. But everything about Article 9's history suggests the contrary—that the drafters wanted to favor the policy of certainty wherever it conflicted with the policy of flexibility.³³³ Unlike Article 2, which focuses on two-party relationships, Article 9 is concerned with multiple-party situations involving, at a minimum, the debtor, the secured party, and a

328. Thomas H. Jackson & Ellen A. Peters, *Quest for Uncertainty: A Proposal for Flexible Resolution of Inherent Conflicts Between Article 2 and Article 9 of the Uniform Commercial Code*, 87 YALE L.J. 907, 909 (1978).

329. Professor Gilmore pointed out that contemporary statutes tended to be more tightly written than those of the past. As such, they left less room for the courts to mold them to fit new situations: "Modern statutes are much less susceptible to judicial manipulation. An unexpected change in the business cycle might leave the courts powerless until the complicated mechanisms of the state and federal legislatures could be set in remedial motion." Grant Gilmore, *Legal Realism: Its Cause and Cure*, 70 YALE L.J. 1037, 1046 (1961).

330. See *supra* note 24 and accompanying text.

331. See *supra* notes 46-252 and accompanying text.

332. See *supra* notes 158-212 and accompanying text.

333. No doubt the drafters wanted to create flexibility in certain areas under Article 9. See, e.g., U.C.C. § 9-504(3) (1991) (concerning the creditor's ability to dispose of the collateral after default). It is clear, however, that Article 9's main goal was to clarify the confusing pre-Code law governing personal property security devices so as "to make the taking of security easy, cheap, and certain." Gilmore, *Secured Transactions*, *supra* note 327, at 36.

competing claimant of some stripe. The competing claimant and the secured party need to know not only where they stand vis-à-vis the debtor but also where they stand relative to each other. By creating some level of certainty about relative priorities among conflicting claimants, Article 9 reduces risks associated with secured lending and promotes the availability of credit to a wide array of debtors.³³⁴

The treatment of rights in the collateral in open-ended, Article 2 fashion has produced certain anomalies in Article 9's supposedly straightforward priority scheme. My proposal to eliminate this concept as it pertains to tangible goods and to substitute a system of filing requirements would remove the anomalies and increase certainty and efficiency in certain transactions in which possession and ownership are separated. At the same time, my proposal is consistent with Karl Llewellyn's view of the proper role of the courts and with his realist jurisprudence.

Llewellyn conceded that the courts and the legislature must work together in leap-frog style to advance the law. In creating a commercial code, the legislature basically codifies the existing common law regarding commercial transactions, smoothing out inconsistencies where possible and selecting the most workable of divergent common law rules.³³⁵ The courts are left with the task, in applying the code to real-life fact situations, of interpreting the amorphous provisions and pouring content into the statutory lacunae.³³⁶ Over the years, a body of case law construing the code will develop—some of it contradictory, some of it bad policy.³³⁷ At that point, Llewellyn believed, the legislature should again intervene to refine the statute in light of the intervening case law developments, winnowing out the bad rules and clarifying the ambiguities where appropriate.³³⁸

334. See Douglas G. Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53, 60 (1983) (observing level of informational certainty provided to secured creditors by notice-filing system and resultant priority rules); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473, 502-08 (1984) (arguing that secured financing in general and Article 9 in particular are efficient).

335. KARL LLEWELLYN, *THE CASE LAW SYSTEM IN AMERICA* 66-67 (1989).

336. *Id.* at 67 ("Once a statute is adopted, . . . there is room *again* for the case law method, for only through it can legislative insight be elaborated, corrected, and perfected in light of the subsequent, unforeseen cases.").

337. Llewellyn railed against case-law rules that did not foster some degree of predictability and certainty: "there is still an unnecessary quantum of irregularity, unreckonability, gamble about the results of cases on appeal. . . . [T]he quantum of gamble that remains is in one sense shocking. I speak not of healthy uncertainty I speak of unnecessary uncertainty, of variances avoidable by human care and human skill." KARL LLEWELLYN, *THE COMMON LAW TRADITION: DECIDING APPEALS* 336 (1960).

338. LLEWELLYN, *supra* note 335, at 103.

The issue of rights in the collateral is ripe for legislative intervention. The original provision, through its vagueness, has led courts to interpret it in divergent and unsound ways. The Article 9 revision process, already underway, presents the ideal opportunity to examine this issue afresh in light of the intervening case law and to create a rule that better promotes efficiency and certainty in secured transactions.

Llewellyn's realist bent towards examining the actual practices of real-world commercial actors as the basis for creating legal rules also dictates that section 9-203(1)(c) be revised in the manner that I have indicated. Because of the uncertain differences between true leases and secured transactions and because of the vague nature of the "rights in the collateral" element of attachment, parties in borderline transactions already file financing statements to protect their interests in the event that they are construed to hold an Article 9 security interest in the debtor's property.³³⁹ Similarly, inventory secured parties may attempt to claim goods still held by the debtor's seller on the theory that they have been identified to the contract. Because of the needless nebulosity of one of the elements of attachment, parties must undertake the expense of litigation to determine their rights. Given that the courts have shown no inclination to construe rights in the collateral in a consistent way, the issue may have to be litigated repeatedly.

Arguably then, the current rule of law causes commercial actors to behave inefficiently, through unnecessary filings and repeated litigation. Because of the great need for certainty in secured transactions, even Llewellyn, with his fondness for open-ended code provisions, might concede that the current system should be revised in light of the real world response.

My proposal for eliminating the requirement of rights in the collateral as an element of attachment when the collateral is tangible goods will certainly not banish litigation in this area. If lessors, consignors, and bailors must file financing statements only when their property has been in the debtors' possession for more than four months, parties will no doubt argue over when the debtor acquired possession of the property. But parties to these transactions will find planning easier—no longer will they have to guess whether their lease or bailment is subject to Article 9 filing requirements. Third parties dealing with the debtor will have the assurance that once property has

339. Kripke, *supra* note 47, at 801; *see also* U.C.C. § 9-408 (1991) (allowing the filing of a precautionary financing statement by lessors and consignors).

been in the debtor's possession more than four months, they are safe in assuming that there are no other interests in it unless the filing system discloses them. Similarly, inventory secured financiers will know that it is useless to try to claim goods held by the debtor's seller unless the goods have been identified to the contract and the debtor has the right to replevy them under Article 2.

VI. CONCLUSION

The very earliest drafts of Article 9 did not include a provision regarding rights in the collateral.³⁴⁰ It was only later that the drafters felt the need to insert the self-evident proposition that a security interest cannot be enforceable against the collateral unless the debtor has some interest in that property. A debtor without any rights whatsoever in particular property cannot give away an interest in that property to another. But, however benign that proposition seems on its face, over the years the courts have used it in ways probably not imagined by the original drafters. In particular, the concept of rights in the collateral, as it relates to tangible goods, has become a mechanism for according priority between two or more claimants to specific goods.

This Article has suggested that the confusion and uncertainty generated by case-law interpretation of this concept can best be relieved by removing rights in the collateral from the required elements of attachment of security interests in tangible goods. As a substitute for this concept, a set of specific priority and filing rules for various transactions involving tangible goods should be adopted. In this way, it is hoped that Article 9 will gain in clarity, certainty, efficiency, and fairness—principles that have informed the Uniform Commercial Code since its inception.

340. See, e.g., Commercial Code Art. VII, § 306 (1948), reprinted in 5 UNIFORM COMMERCIAL CODE: *Drafts* 136 (Elizabeth Slusser Kelly ed. 1984) (specifying formal requisites for an inventory lien).