Articles

Some Problems Involving Documents of Title

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Article 7 has not been totally ignored in the legal literature of our time, but it has not inspired violent feelings and great controversy. Considering how common warehouse receipts and bills of lading are, the litigation and the literature are sparse. This may be, at least in part, because some of the ramifications of documentary transactions are little understood and largely ignored. This Article deals with problems, some litigated and some not, which seem to be relevant to our time.

Section I[1] considers the extent to which bailors may limit their liability for loss of bailed items under Article 7. In particular, a New York decision, *I.C.C. Metals, Inc. v. Municipal Warehouse Co.*,[2] seems to raise serious questions about the bailor's ability to limit liability for negligent *loss* of items, as opposed to actual conversion. Sections II[3] and III[4] deal with complicated questions of which party has priority in collateral subject to security interests when goods are subject to document of title.

I. LIABILITY FOR LOST GOODS: DEFINING § 7–204 "CONVERSION"

Suppose that a bailor stores goods in a warehouse, receiving a warehouse receipt stating that the warehouseman's liability is limited to fifty dollars for damage to each identified item which has been bailed, although the bailor has the option of paying an increased rate based on increased valuation of the goods if a higher degree of protection is desired. No fee for increased protection is paid. When return of the goods is demanded and they cannot be produced by the bailee, is the bailee's liability per item limited to fifty dollars when no increased rate is paid?

It would seem to be reasonably clear under section 7–204(1) of the Uniform Commercial Code that a "warehouseman is liable for loss of or injury to goods caused by his failure to exercise such care in regard to them as a reasonably careful man would exercise under like circumstances . . . ," but nevertheless the "damages may be limited by a term in the warehouse receipt or storage agreement limiting the amount of liability in case of loss or

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1. *See* notes 1–30 and accompanying text *infra.*

2. 50 N.Y.2d 657, 409 N.E.2d 849, 431 N.Y.S.2d 372 (1980).

3. *See* notes 31–64 and accompanying text *infra.*

4. *See* notes 65–108 and accompanying text *infra.*

damage . . . ."[5] The section goes on to provide that the bailor may request in writing, at the time the storage agreement is signed or within a reasonable time after the warehouse receipt is received, that the liability be increased, in which event increased rates based on increased valuation may be charged, unless such an increase is contrary to a lawful limitation contained in the warehouseman's tariff.[6] But "[n]o such limitation is effective with respect to the warehouseman's liability for conversion to his own use."[7]

The clear implication to be derived from the statute is that a limitation of liability in the warehouse receipt[8] is effective unless the warehouseman converts the goods to his own use. What is a conversion? According to Prosser, "[a] conversion can result only from conduct intended to affect the chattel. For merely negligent interference with it, such as failure to protect it against loss, damage or theft, the remedy is an action for negligence . . . ."[9] Moreover,

> [n]ot every failure to deliver upon demand . . . will constitute a conversion. The defendant does not become a converter when the goods are no longer in his possession or control, so that he is unable to comply with the demand, even though they may have been lost or destroyed through his fault. The remedy in such a case is an action for "negligence."[10]

While shrouded in the mists of history,

> the [modern] tort of conversion has been confined to those major interferences with the chattel, or with the plaintiff's rights in it, which are so serious, and so important, as to justify the forced judicial sale to the defendant which is the distinguishing feature of the action . . . . [Among factors to be considered are] the extent and duration of defendant's exercise of control over the chattel; his intent to assert a right which is in fact inconsistent with the plaintiff's right of control; the defendant's good faith or bad intentions; the extent and duration of the resulting interference with the plaintiff's right of control; the harm done to the chattel; and the expense and inconvenience caused to the plaintiff.[11]

For whatever the reason, there are apparently occasions when goods disappear from warehouses and simply cannot be produced at the demand of the bailor. In such cases the Code provides for liability in damages for loss or injury caused by a failure to exercise the care of a "reasonably careful man" and allows this liability to be limited in amount, subject to the bailor's right to

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5. U.C.C. § 7–204(1) and (2). [References not otherwise identified hereinafter will be to the 1972 version of the Code.]

6. *Id. See* § 7–103, stating that the provisions of Article 7 are subject to any applicable "tariff, classification or regulations filed or issued pursuant thereto" to the extent that they are applicable.

7. § 7–204(2) (last sentence).

8. Section 7–204(2) provides that damages may be "limited by a term in the warehouse receipt or storage agreement . . .", but "storage agreement" is not defined in the Code or used in any other section. As used in the section, storage agreement may be synonymous with warehouse receipt or it may refer to a situation where a storage agreement covers the bailment but does not meet the requirements of a warehouse receipt. Section 7–202 "does not require that a warehouse receipt be issued but states formal requirements for those which are issued." § 7–202, comment.

9. W. PROSSER, HANDBOOK OF THE LAW OF TORTS 83 (4th ed. 1971).

10. *Id.* at 90 (footnotes omitted).

11. *Id.* at 80–81 (footnote omitted).

pay an additional fee to increase the liability.[12] This limitation is effective unless the warehouseman has converted the goods "to his own use."[13] There is no requirement that the limitation be stated in conspicuous type,[14] but the limitation must set forth "a specific liability per article or item, or value per unit of weight."[15] A general limitation of fifty dollars, for example, for all goods subject to a receipt would not necessarily seem to comply with the statute,[16] and a total exoneration of the bailee from any liability also would appear to be ineffective.[17]

The recent New York Court of Appeals decision in *I.C.C. Metals, Inc. v. Municipal Warehouse Co.*,[18] raises some interesting questions in this area. Here three separate lots of indium, having an aggregate value of $100,000, were stored in a warehouse. Each warehouse receipt contained a limitation of liability for listed items of fifty dollars and provided that the liability could be increased by the payment of increased rates. (The liability was for "damage" but an inability to return the items would seem to result in maximum liability, not to exceed actual value, so that loss of the property might be construed to be "damage" in the sense of total loss.) The bailor neither requested increased liability nor told the bailee of the value of the metal. After about two years, during which the bailor paid a storage charge monthly, the return of the goods was demanded. The goods could not be found or returned. The bailor sued in conversion, and the bailee defended on the ground of theft and relied on the contractual limitation of liability to $50 for each lot of indium.[19] Plaintiff was granted summary judgment for the full value of the indium and both the Appellate Division and the Court of Appeals affirmed.[20]

When goods cannot be returned by a warehouseman, then the liability would appear to be the value of the goods, whether negligence or conversion is claimed. The difference between charging negligence or conversion in most cases seems to lie in the ability of the warehouseman to rely on a limitation of liability in one case but not in the other. In a certain number of cases, the bailor presumably has its own insurance, obtained perhaps at rates lower than the warehouse would charge for comparable coverage, which is probably in turn covered by insurance. Indeed, in this instance the bailor had its own insurance and reported the loss as a "theft,"[21] which would seem to be

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12. § 7-204(1)

13. § 7-204(2)

14. *See* Sanfisket, Inc. v. Atlantic Cold Storage Corp., 347 So. 2d 647 (Fla. App. 1977).

15. § 7-204(2). *See* Keefe v. Bekins Van & Storage Co., 36 Colo. App. 382, 540 P.2d 1132 (1975); Durfee v. Blue Rock Van & Storage, Inc., 266 A.2d 187 (Del. Super. 1970). *See also* World Prods., Inc. v. Central Freight Serv., Inc., 222 F. Supp. 849 (D.N.J. 1963), *aff'd*, 342 F.2d 290 (3d Cir. 1965) (based on pre-Code law); Annot. 21 A.L.R.3d 1339.

16. *See* Modelia, Inc v. Rose Warehouse, Inc., 5 U.C.C. Rep. Serv. (Callaghan) 1004 (N.Y. Sup. Ct. 1968).

17. § 7-202(3).

18. 50 N.Y.2d 657, 409 N.E.2d 849, 431 N.Y.S.2d 372 (1980).

19. *Id.* at 661-62, 409 N.E.2d at 851-52, 431 N.Y.S.2d at 374-75.

20. *Id.* at 662, 409 N.E.2d at 852, 431 N.Y.S.2d at 375.

21. *Id.* at 664 n.3, 409 N.E.2d at 853 n.3, 431 N.Y.S.2d at 377 n.3: "ICC reported the loss to its insurers as a theft . . . ."

inconsistent with claiming the warehouseman had converted the goods "to his own use," as section 7–204(2) requires. If the bailor collected from its own insurance company, as seems likely, then it looks as if the bailor's insurance company is the real party in interest and, absent a showing of conversion by the bailee's act, this loss should have been left where it lay.[22]

The effect of the New York decision is to eliminate the action based on negligence so that all actions probably are now based on conversion in that state, with the result that the contractual limitation of liability is ineffective.[23] Clearly the New York Court of Appeals is not following the *Restatement of Torts*, in which conversion is defined as "an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel."[24] There is no suggestion in the opinion that bailor introduced any proof whatsoever that the bailee had exercised any dominion over the goods. The problem was that the indium could not be found and the bailee had no knowledge of what had happened to it,[25] although the bailor had reported the loss to its insurer as a theft and presumably should have been bound by this explanation. But the court felt that "the warehouse [was] required to show not merely what might conceivably have happened to the goods, but rather what actually happened to the goods."[26] This would in many cases, and certainly in the case of the indium, appear to be an impossibility, for the warehouse was not aware of the disappearance of the goods until their return was demanded and could scarcely have proved the "actual theft" of the goods as distinguished from the probability of the theft of the goods. It would appear to be incontrovertible that there was no proof that the warehouseman had converted the goods "to his own use," as section 7–204(2) requires.

The dissenting judge made the cogent point that a cause of action for conversion should not be maintainable absent proof of intentional wrongdoing by the bailee, and no such proof was presented.[27] The judge also noted that the bailor had not disclosed to the bailee the value of the goods, had not paid an increased storage rate commensurate with the value of the goods, and

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22. The point in time at which the loss is measured may be immaterial if the bailed goods do not fluctuate in value, as appears to have been true of indium, for the issue was not raised. The obvious point in time to measure the loss is at the date of the loss, but this date will not always be known, as in the principal case discussed in the text. *See also* Proctor & Gamble Distrib. Co. v. Lawrence Am. Field Warehousing Corp., 16 N.Y.2d 344, 213 N.E.2d 873, 266 N.Y.S.2d 785 (1965). In Federal Compress & Warehouse Co. v. Reed, 339 So. 2d 547 (Miss. 1976), the date when the loss occurred was known but the bailor was not notified of the extent of loss for some time. Goods comparable to the bailed goods had risen in value in the interim, with the result that the increased value was used to measure the bailee's liability. *Id.* at 549. Had the market value of the bailed goods gone down after the loss, it seems unlikely that the bailor would have asked for or been given a lesser amount.

23. The fall-out of *I.C.C. Metals* is evident in a number of recent New York conversion cases. *See* Phillipp Bros. Metal Corp. v. S.S. Riolguazu v. Empresa Lineas Maritimas Argentinas, 658 F.2d 30, 32 (2d Cir. 1981) (applicable to common-law bailment); Clairol, Inc. v. Moore-McCormack Lines, 79 A.D.2d 297, 436 N.Y.S.2d 279 (1981) (conversion theory of *I.C.C. Metals* not applicable to federal maritime carriage law).

24. RESTATEMENT (SECOND) OF TORTS § 222A (1965).

25. 50 N.Y.2d 657, 661, 408 N.E.2d 849, 852, 431 N.Y.S.2d 372, 375 (1980).

26. *Id.* at 664 n.3, 408 N.E.2d at 853 n.3, 431 N.Y.S.2d at 377 n.3.

27. *Id.* at 668, 409 N.E.2d at 856, 431 N.Y.S.2d at 379 (Jasen, J., dissenting).

therefore should be held to the terms of the bailment.[28] Despite the mandate of section 7–204, the New York Court of Appeals found "no sound reason to apply a different rule to the two types of action where, as here, the bailee comes forward with insufficient proof of its explanation for the loss of the bailed goods."[29] The majority result is an instance of judicial legislation overriding the clear language of a statute.[30]

II. Inventory Priority Problems with Documentary Drafts

A.

Suppose that a manufacturer of snarps contracts to sell 1000 of these items to a retailer for sale in the ordinary course of business. Suppose further that the inventory[31] of both parties is subject to security interests which have been properly filed and perfected. The security interest in the manufacturer's inventory will be cut off when the goods are sold to a buyer in the ordinary course of business,[32] and a retailer buying from a manufacturer presumably would be such a buyer. When is the manufacturer's financer's security interest cut off? When is the retailer's financer's security interest attached and perfected?

When the manufacturer identifies the goods covered by the contract for sale, the retailer acquires a "special property" in them.[33] Ordinarily title passes to the buyer at the time and place at which the seller completes his performance, even though the goods are being shipped under a document of title, if the seller is required to send, but not to deliver, the goods.[34] But the passage of title does not determine the rights of the parties.[35] From the time the goods are identified to the contract and the buyer has acquired a "special property" in them, presumably the buyer has sufficient rights in the goods for a security interest to attach,[36] and presumably the goods are "inventory" as

28. *Id.* at 671–72, 409 N.E.2d at 858, 431 N.Y.S.2d at 381–82.

29. *Id.* at 667, 409 N.E.2d at 855, 431 N.Y.S.2d at 379 (1980).

30. Interestingly, in Adrian Tabin Corp. v. Climax Boutique, 34 N.Y.2d 210, 313 N.E.2d 66, 356 N.Y.S.2d 606 (1974), the judges occupied opposite positions, with Judge Jasen, who dissented in *I.C.C. Metals*, writing the majority opinion and Judge Gabrielli, who wrote the majority opinion in *I.C.C. Metals*, dissenting. The majority opinion in the *Adrian Tabin* case gave full effect to the clear language of § 6–104(3) of the Code, while the dissenting opinion would have given no effect to the legislation. At least these two judges seem to be consistent in their views toward legislation, although perhaps some of their colleagues are not so consistent.

31. Under § 9–109(4), goods held for sale by the retailer would be "inventory," as would also be true of goods held by the manufacturer. But in the case of a manufacturer "inventory" would also include "raw materials, work in process or materials used or consumed in the business."

32. § 9–307(1). "Buyer in ordinary couse of business" is defined in § 1–201(9). A buyer in ordinary course will take free of a perfected security interest in the seller's inventory so long as the buyer does not know that the sale is in violation of the underlying security agreement, and while such knowlege may be rare, the problem is not unknown. *See* O. M. Scott Credit Corp. v. Apex, Inc., 97 R.I. 442, 198 A.2d 673 (1964).

33. §§ 2–401(1) and 2–501(1).

34. § 2–401(2).

35. § 2–401 (first sentence).

36. Section 9–203(1) requires that the debtor must have rights in the collateral for a security interest to attach, and attachment is a necessary prerequisite for perfection under § 9–303(1). What is meant by "rights in the collateral" is not explained in the Code.

to the buyer even though they are not then "held" by the buyer, as section 9–109(4) requires.[37] But for the buyer to be a buyer in ordinary course, such a person must "buy" the goods, and "'buying' . . . includes *receiving* goods or documents of title under a pre-existing contract for sale."[38] There is no express definition of "buy" or "buying" in the Code, but if "buying" is interpreted to require receiving the goods or documents covering them, it would be possible for a security interest to attach, because the buyer has rights in the collateral[39] before the buyer acquires "buyer in ordinary course" status and the rights given to such a buyer under section 9–307(1).[40]

This kind of problem could arise on the facts stated above if the retailer-buyer had previously granted a security interest to its financer. The buyer would acquire a special interest in the goods on their identification, which ought to be sufficient for a security interest to attach; but "buyer in ordinary course" status might arise only on receipt of the goods or documents covering them, and one must be a buyer in ordinary course of business to take free of a security interest created by a seller under section 9–307(1). When the buyer acquires rights in the collateral, its financer will have a perfected security interest if the financer has made proper filing and all of the events necessary for attachment have occurred. Between the time when the buyer acquires rights in the collateral (and its financer's security interest is perfected) and the time when the buyer receives the goods or documents covering them, when the seller's financer's security interest is cut off, there apparently are two perfected security interests in the goods. The Code does not resolve this kind of priority problem, in which the secured parties of *two different debtors* claim interests in the same goods.

B.

When a bank finances a retail store's inventory and wants to acquire a purchase money security interest,[41] then the store and its bank can arrange for the bank to pay a draft drawn by the seller of goods on the buyer or the buyer's bank when the draft is accompanied by a bill of lading in negotiable form[42] with the goods deliverable to the seller's order. The seller can indorse

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37. Because of the exclusive nature of the § 9–109 categories, the only alternative is that the identified goods are equipment, an inappropriate result in this transaction. *See* § 9–109, comment 3. *But see id.*, comment 5 ("it will be noted . . . that any goods which are not covered by one of the other definitions in this section are to be treated as equipment.").

38. § 1–201(9) (emphasis added).

39. § 9–203(1)(c).

40. § 9–307(1) provides, in part, "A buyer in ordinary course of business . . . takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence."

41. Section 9–107 provides:

> A security interest is a "purchase money security interest" to the extent that it is (a) taken or retained by the seller of the collateral to secure all or part of its price; or (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

42. *See* § 7–104(1).

the bill of lading and deliver it to its bank, accompanied by the draft.[43] When the bill of lading and the draft reach the buyer's bank and the draft is paid, that bank can then control delivery of the goods. If the buyer's bank has previously filed a financing statement covering the goods, its security interest should be perfected if the document is released to the buyer so that the buyer can arrange for delivery. While the goods are in transit subject to a negotiable document, a security interest in the goods is perfected by perfecting a security interest in the document;[44] a security interest in the document might be perfected by filing,[45] but clearly perfection by possession of the document[46] is the only safe means of avoiding the priority problems which could arise if the buyer were to receive the document, as to which the bank's filing was made, and then improperly but duly negotiate[47] it to a holder who would have priority.[48] If the buyer's bank has on request engaged to pay the seller for the goods in a documentary transaction, as will happen when the bank has paid the seller's draft accompanied by documents, then this is a letter of credit transaction under Article 5.[49]

If we assume that the buyer's bank has acquired a perfected security interest in a negotiable document (and the goods it represents)[50] by paying a draft accompanied by the document, the bank will ordinarily release the document to the buyer so that the buyer can obtain possession of the goods. If we assume that the goods are inventory and that the buyer gets possession of the goods through surrender of the document to the bailee in order to deal with them or process them for sale, the bank's security interest will remain perfected for twenty-one days without filing or taking any other action.[51] It is possible, of course, that a dishonest buyer might contact another financer to arrange double financing as soon as the buyer gets possession of the goods, and if the first financer has filed nothing, the second financer (not aware of having such secondary status) may file and make an advance against the goods. This will result in two perfected security interests in the same inventory. If the buyer's bank, the first secured party, files a financing statement within twenty-one days from the time the goods or documents are made "available" (whatever that may mean in section 9–304(5)(a)), then the bank's security interest will continue to be perfected after the end of the twenty-one day period.[52] Which financer is entitled to priority in the goods?

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43. *See* §§ 4–501 and 4–504 on collection of documentary drafts. A "documentary draft" is defined in § 4–104(1)(f) as a "negotiable or non-negotiable draft with accompanying documents . . . to be delivered against honor of the draft."

44. § 9–304(2).

45. § 9–304(1).

46. § 9–305.

47. Section 7–501(4) states when a document is "duly negotiated." A document could be duly negotiated even though the negotiation was in violation of an underlying agreement.

48. §§ 9–309 and 7–502(1).

49. §§ 5–102(1)(a) and 5–103(1)(a).

50. Subject to the provisions of §§ 7–205 and 7–503, a holder to whom a negotiable document of title has been duly negotiated acquires title to the document and title to the goods. § 7–502(1).

51. § 9–304(5)(a).

52. §§ 9–303(2) and 9–304(6).

Section 9–312(3) deals with priority between a purchase money security interest and a conflicting security interest in the same inventory, and it gives priority to the purchase money financer who meets the requirements of the section. The first requirement is that the purchase money security interest must be perfected when the debtor receives possession of the inventory;[53] this requirement is met on the facts stated. The second requirement is that

> the purchase money secured party [give] notification in writing to the holder of the conflicting security interest if the holder has filed a financing statement covering the same types of inventory (i) before the date of the filing made by the purchase money secured party, or (ii) before the beginning of the 21 day period where the purchase money security interest is temporarily perfected without filing or possession (subsection (5) of Section 9–304) . . . .[54]

This provision clearly contemplates a situation in which a financing statement claiming inventory is on file before the purchase money financing takes place. On our facts the holder of the conflicting security interest (the second financer) does not have a financing statement on file when the debtor receives possession of the goods subject to the purchase money security interest, and this presumably marks the beginning of the twenty-one day period.[55] (The starting of the twenty-one day period is not as clearly expressed in section 9–304(5)(a) as it might be, and the period may begin running when the document is released to the debtor rather than when the debtor gets the goods.) The purchase money secured party cannot send a notice of purchase money financing to a secured party who is not in existence at the time the notice is required to be sent. While this problem would seem to be intended to fall (if it falls anywhere) under clause (ii) of section 9–312(3)(b), it arguably falls under clause (i), quoted above,[56] because the holder of the conflicting interest has indeed filed a financing statement before the date of the filing made by the purchase money secured party. But where section 9–304(5)(a) is involved, as it is here, it seems only reasonable to resolve the problem under section 9–312(3)(b)(ii), relating to the twenty-one day period, if that can be done. But such a resolution does not seem to be possible here because the second financer would not have a filed financing statement. Unfortunately, in the context of our problem, the last clause, added to section 9–304(5)(a) in the 1972 version of Article 9, says that "priority between conflicting security interests in the goods is subject to subsection (3) of section 9–312 . . . ." The clause was added to make clear that Section 9–304 was intended to refer to perfection, not priority.[57] The provision was not designed

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53. § 9–312(3)(a).

54. § 9–312(3)(b).

55. The 21-day period comes from § 60(a)(7) of the Bankruptcy Act of 1898, 11 U.S.C. § 96(a)(7) (1976) (repealed 1978). Its effect was to immunize from a preference attack those new value security interests which it covered. The somewhat comparable provision in the Bankruptcy Reform Act of 1978, 11 U.S.C. § 547(e) (Supp. II 1978), reduces the period from 21 days to 10.

56. *See* text accompanying note 54 *supra*.

57. § 9–304, comment 4; REVIEW COMMITTEE FOR ARTICLE 9, FINAL REPORT 90 (1971).

to cover our problem in which no prior inventory financer has filed. It covers the case in which an inventory financer has filed and a subsequent purchase money financer enters the scene by documentary financing, but not the reverse. If the problem is not covered by section 9-312(3), then section 9-312(5) should resolve the problem. This residual provision would rank conflicting security interests "according to time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier . . . ."[58]

Under this provision priority would go to the purchase money security interest which was perfected before the second secured party filed. The first security interest in the goods was perfected by possession of the negotiable document covering the goods prior to the time the debtor received possession of the goods or the second secured party filed. For twenty-one days the security interest was perfected, first in the document and, after its surrender to the bailee, in the goods.[59] Perfection continued after the twenty-one day period because of a timely filing.[60] This problem will not come under section 7-504(1), because the document is duly negotiated, not transferred, and the title to the section refers to "Rights Acquired in the Absence of Due Negotiation."[61]

Would it have made any difference if the goods had been shipped under a non-negotiable document? So long as goods were in the possession of a bailee who had issued a non-negotiable document, the first financer's security interest could have been perfected by having the document issued in the bank's name as consignee, or by the carrier's receipt of notice of the financer's security interest, or by filing as to the goods,[62] although determining the proper place to file might have presented some problems.[63] If the interest was perfected, it would remain perfected on release of the goods to the debtor in the same circumstances as would a security interest arising under a negotiable document.[64]

III. WAREHOUSED INVENTORY PRIORITY PROBLEMS

Suppose that a retail store and a bank have entered into a security agreement covering inventory and that the bank has advanced funds and has promptly filed a financing statement in the proper office. This is not a purchase money arrangement, but both the agreement and the statement cover all inventory owned by the debtor during the five-year period of the financing. Suppose that a shipment of inventory arrives on the store's premises when it

58. § 9-312(5)(a).
59. § 9-304(4), (5).
60. § 9-303(2).
61. § 7-504 (caption).
62. § 9-304(3).
63. *See* § 9-401(1).
64. § 9-304(5). *See id.*, comment 4.

cannot conveniently be accommodated, and the store decides to store the inventory in a warehouse, gets a negotiable warehouse receipt, and then negotiates this receipt to a finance company as collateral for a loan. Which secured party will be entitled to priority in the goods, the bank with a filed and perfected security interest in the inventory or the finance company which has lent against a negotiable document of title representing the same goods and which has a perfected security interest in the goods by virtue of possession of the negotiable document?[65]

Section 9–309 provides that nothing in Article 9 limits the rights of a "holder to whom a negotiable document of title has been duly negotiated (Section 7–501)," and such a holder will "take priority over an earlier security interest even though perfected. Filing under . . . [Article 9] does not constitute notice of the security interest to such holders . . . ." Under the rules of section 7–501, a negotiable document of title running to the order of a named person is negotiated by indorsement and delivery, and a document running to bearer, either because it is issued in that form or because it has been properly indorsed in blank, can be negotiated simply by delivery.[66] As in the case of commercial paper,[67] if a negotiable document is indorsed to a named person, that person's indorsement is required plus delivery of the document for negotiation.[68] If the document has been negotiated in accordance with these rules, it will be "duly negotiated" if the holder "purchases it in good faith without notice of any defense against or claim to it on the part of any person and for value, unless it is established that the negotiation is not in the regular course of business or financing or involves receiving the document in settlement or payment of a money obligation."[69] The "regular course" requirement prevents non-professionals from "duly negotiating" documents of title.[70]

If a document of title has been duly negotiated, the holder acquires title to the document and title to the goods, unless those rights are cut down by section 7–205 on fungible goods or section 7–503 dealing with certain situations where the document does not cut off prior interests.[71] Section 7–205 will have no effect on our problem, for it protects a buyer in ordinary course who buys fungible goods sold and delivered by a warehouseman who is also in the business of buying and selling such goods.[72] On the other hand, section 7–503(1) states:

65. §§ 9–304(2) and 9–305.
66. § 7–501(1), (2).
67. §§ 3–204(1) and 3–202(1).
68. § 7–501(3).
69. § 7–501(4).
70. *See* § 7–501, comment 1.
71. § 7–502(1).
72. § 7–205 provides: "A buyer in the ordinary course of business of fungible goods sold and delivered by a warehouseman who is also in the business of buying and selling such goods takes free of any claim under a warehouse receipt even though it has been duly negotiated."

> A document of title confers no right in goods against a person who before issuance of the document had a legal interest or a perfected security interest in them and who neither
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> (a) delivered or entrusted them or any document of title covering them to the bailor or his nominee with actual or apparent authority to ship, store or sell or with power to obtain delivery under this Article (Section 7–403) or with power of disposition under this Act (Sections 2–403 and 9–307) or other statute or rule of law; nor
>
> (b) acquiesced in the procurement by the bailor or his nominee of any document of title.

The finance company will be asserting rights under a document of title, which we will assume it received by due negotiation, and therefore the finance company will acquire title to the goods by due negotiation of the document unless section 7–503(1) cuts down these rights.

If no "other statute or rule of law" applies to these facts, did the bank give the store a "power of disposition" under sections 2–403 or 9–307? The finance company did not acquire its interest in the goods through a sale,[73] and the finance company as a secured party could not be a buyer in ordinary course of business[74] without a sale, so there could be no reliance on a "power of disposition" under section 9–307.

The possibilities of using section 2–403 are not so easily eliminated, for it seems clear that the store must have a "power of disposition" in the case of sales from inventory, and a secured party should be treated as a "purchaser"[75] who can cut off security interests in the proper circumstances. In a proper fact situation it might be claimed that the bank "acquiesced" in the procurement of the document if the bank knew that the store had no space adequate to accommodate the inventory on its own premises, but it would be foolish for a financer knowingly to allow its debtor to put goods into a warehouse which could issue warehouse receipts which might be negotiated to innocent third parties, and it will be assumed that the bank had no knowledge of this transaction. Unless acquiescence in procuring the document can be found, the other possibilities of cutting off the bank's interest would seem to founder on the requirement that the bank "delivered or entrusted" the goods to the store "with actual or apparent authority to ship, store or sell" the goods,[76] for the bank in no sense delivered to the store the goods or a document covering them. Arguably the bank might be said to have "entrusted" the goods to the store, if the definition of "entrusting" is taken from section 2–403(3), but if the consequences of an entrustment are those stated in section

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73. "Sale" is defined in § 2–106(1): "A 'sale' consists in the passing of title from the seller to the buyer for a price (Section 2–401)."

74. "Buyer in ordinary course of business" is defined in § 1–202(9), and one must be such a buyer in order to cut off a security interest created by his seller under § 9–307(1). The possibilities contained in § 9–307(2) and (3) are inapplicable, for we are not dealing with consumer goods or future advances.

75. A "purchaser" is "a person who takes by purchase," under the definition of § 1–201(33), and "purchase" includes any "voluntary transaction creating an interest in property." § 1–201(32).

76. § 7–503(1)(a).

2–403(2),[77] the entruster's rights can be cut off only by a buyer in ordinary course of business, which the finance company could not be,[78] and it is to section 2–403 that section 7–503(1)(a) refers.

The priority problem arising between the security interests of the bank and the finance company apparently has to be resolved under section 9–312 because it is not covered by any of the other priority rules in Article 9. Because the other provisions of section 9–312 do not apply, we are left with the residual rules of section 9–312(5), giving priority in the order of filing or perfection. The bank's security interest was perfected first, and it was perfected by filing, so the bank should have priority. This seems to be required by the Code, and it may be thought to be a fair answer because the bank's security interest was a matter of public record before the finance company acquired its security interest and advanced funds.

If the store had warehoused the inventory subject to the bank's perfected security interest and received a non-negotiable receipt in the finance company's name, the finance company's security interest would have been perfected by the issuance of the receipt.[79] Again, the bank's security interest would be entitled to priority under section 9–312(5) because it was perfected first and it was perfected by filing.[80] This would seem to comport with the provision contained in section 7–504(1), by which the transferee of a document, which the finance company would be in the case of a non-negotiable document, acquires the title and rights of the transferor, the store.[81] The store's rights would be subject to whatever interest the bank had in the goods.[82]

To change the facts in the example, assume that the bank files a financing statement, proper in all respects, covering the store's inventory before the bank and the store enter into a security agreement or the bank advances any funds. The bank might choose to do this in an attempt to assure priority over a purchase money inventory financer, relying on sections 9–312(3) and (5). After this filing the store receives the inventory in question and promptly stores it in a warehouse, and the warehouse issues a non-negotiable receipt in the finance company's name, which is immediately pledged to the finance company as collateral for a loan. Then the bank and the store enter into a security agreement and the bank advances its loan, at which point the bank has a perfected security interest.[83] If a problem now arose, which secured

77. Section 2–403(2) provides a merchant entrusted with goods in which he deals the "power to transfer all rights of the entruster to a buyer in ordinary course of business." *See generally* Dolan, *Good Faith Purchase and Warehouse Receipts: Thoughts on the Interplay of Articles 2, 7, and 9 of the UCC*, 30 HASTINGS L.J. 1 (1978).

78. § 2–403, comment 2.

79. § 9–304(3).

80. *See* Philadelphia Nat'l Bank v. Irving R. Boody Co., 1 U.C.C. Rep. Serv. (Callaghan) 560 (1963) (Funk, Arb.). *See also* Douglas-Guardian Warehouse Corp. v. Esslair Endsley Co., 10 U.C.C. Rep. Serv. (Callaghan) 176 (W. D. Mich. 1971).

81. Section 7–504(1) provides, in part: "A transferee at a document, . . . to whom the document has been delivered but not duly negotiated acquires the title and rights which his transferor had or had actual authority to convey."

82. *See* § 9–311.

83. §§ 9–303(1) and 9–203(1).

party would have priority under Section 9–312(5)? The bank might be said to have filed first (but "first" only in the sense that the finance company did not file at all), but it did not perfect first. The finance company perfected its security interest by having a document issued in its name,[84] and this occurred before there was a security agreement or any funds were advanced by the bank. Under the 1962 version of section 9–312(5),[85] because both parties did not file, priority would be determined in the order of perfection, which would give priority to the finance company. If the 1972 version of section 9–312(5) is read to give priority to the bank because of its filing, then this result does not seem to be in accord with section 7–504(1) which would give the transferee of the document whatever title and rights the transferor had.

Assume that the facts are the same as those stated immediately above except that the non-negotiable receipt was issued in the store's name and then pledged with the finance company. In this case, the pledge will not perfect the finance company's security interest.[86] Where goods are held by a bailee who has issued a non-negotiable document, a security interest in the goods could be perfected by filing as to the goods, by the bailee's receipt of notification of the secured party's interest, or by having a new document issued in the finance company's name.[87] If we assume that the finance company notified the bailee of its interest or had a new document issued in its name before the bank's security interest was perfected, then the finance company's interest would be perfected first. If the finance company were entitled to priority under section 9–312(5), the result would be in accord with section 7–504(1) under which a transferee of a non-negotiable document would acquire the title and rights of the transferor at the time of the transfer. If the store had transferred its right in the goods to the finance company, presumably there might be no rights left in the goods to which the bank's security interest could thereafter attach, and attachment is required for perfection.[88] If section 9–312(5) requires priority for the bank because it filed first, then different results come out of the two sections.

If the finance company had a perfected security interest which did not extend to the full value of the collateral, the debtor's interest in the goods—the debtor's equity, perhaps—could be transferred to the bank.[89] Of course, on our facts the bank was the first to file a financing statement but the second to perfect its security interest. Would it raise a conflict between section 9–312(5) and section 7–504(1) if the finance company, having perfected its interest otherwise than by filing, subsequently filed?

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84. § 9–304(3).

85. Under § 9–312(5) of the 1962 Code, priority between conflicting security interests in the same collateral was determined "(a) in the order of filing if both are perfected by filing . . . ; (b) in the order of perfection unless both are perfected by filing."

86. See § 9–305.

87. § 9–304(3). If the finance company perfected its security interest by having a document issued in its name or by notifying the bailee of its interest and thereafter a financing statement was filed while the bailee still held the goods, the perfection would be continuous from the time of the orginal perfection. § 9–303(2).

88. § 9–303(1).

89. § 9–311.

According to section 9–312(5)(a) of the 1972 Code:

> Conflicting security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided there is no period thereafter when there is neither filing nor perfection.

Under the comparable provision of the 1962 Code, priority was determined, first, in the order of filing if both were perfected by filing, and, then, in the order of perfection if both were not perfected by filing; and in both cases priority was determined without regard to which interest attached first or whether it attached before or after filing, if perfection was by filing.

On our facts the bank filed first but its security interest was perfected after the finance company's security interest, which was initially perfected by a means other than filing, although a filing was made.

To show how the newer provision is intended to work, example 3 in the official comment to section 9–312 states:

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

It should be noted that on the facts in the example both security interests are in a negotiable document, and a security interest in goods subject to a negotiable document is perfected by perfecting a security interest in the document,[90] which may be done either by possession of the document[91] or by filing,[92] but there may be a temporarily perfected security interest in a negotiable document without either filing or possession for twenty-one days from the time of attachment to the extent the interest arises for new value under a written security agreement.[93] In example 3 both security interests are perfected from the time they arise. In the situation posited above in the text, the goods are subject to a non-negotiable document, there is no automatic perfection, the document does not represent the goods, and the first filing, by the bank, did not perfect a security interest at the time of the filing. Example 3 therefore has no application to our problem.

Section 9–312(5)(a) can be read to give priority to the finance company on the basis that it made the first filing "covering the collateral" and the bank's earlier filing was not effective at the time it was made because at the time of the filing the parties had not entered into a security agreement and the debtor had not granted a security interest in anything, so that there is no "collateral"[94] at this point in time. This kind of analysis is similar to reason-

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90. § 9–304(2). This assumes that the goods are in the issuer's possession.
91. § 9–305.
92. § 9–304(1).
93. § 9–304(4). Section 9–304(5) also provides for a 21-day temporary perfection in the situations covered.
94. Section 9–105(1)(c) defines "collateral" as "property subject to a security interest."

ing found in some cases arising under section 9–312(4),[95] but it appears not to be the result contemplated for section 9–312(5) by the drafters of the official text of the Code, in that priority is intended to be in the order of filing where both secured parties file,[96] although the result is perhaps less than crystal clear based on the statutory language: "Priority dates from the time a filing is first made *covering the collateral* or the time the security interest is first perfected, whichever is earlier . . ."[97] If this provision is read to give the bank priority because of its earlier filing, then there again appears to be a conflict with Article 7.[98] Section 7–504(1) states, "A transferee of a document, whether negotiable or non-negotiable, to whom the document has been delivered but not duly negotiated, acquires the title and rights which his transferor had or had actual authority to convey." Here there were rights for the store to transfer to the finance company, for there was no other security interest in the goods at the time this transaction was entered into, and the finance company notified the bailee of its interest or had a document issued in its name. The bank had a financing statement on file but there was no security agreement and no loan had been made.

This may be one of those situations where the security agreement between the store and the bank is effective according to its terms between the parties "except as otherwise provided *by this Act*,"[99] and the Act, meaning the entire Code, provides otherwise in section 7–504(1) by restricting the collateral which can be subjected to the bank's security interest, and that collateral will be what is left after the interest arising under the document is satisfied.

If the finance company had *purchased* the non-negotiable document from the store between the time when the bank filed a financing statement and the time when the bank and the store entered into a security agreement and funds were advanced, the finance company would appear to prevail over the bank under the rule of section 7–504(1), even though the transfer of ownership was accomplished by the transfer of a non-negotiable document of title, following which transfer the bailee should have been given the required notification under section 7–504(2). This situation does not involve a conflict between security interests, and it would *not* be resolved by section 9–312. It is possible that the finance company could qualify as a buyer in ordinary course of

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95. *See, e.g.*, Brodie Hotel Supply, Inc. v. United States, 431 F.2d 1316 (9th Cir. 1970).

96. *See* § 9–312, comment 5, example 1. In example 1 the debtor apparently owned the collateral prior to the times when the conflicting security interests were entered into.

97. § 9–312(5)(a) (second sentence) (emphasis added).

98. For other possible conflicts between Article 7 and Article 9, see Dolan, *Good Faith Purchase and Warehouse Receipts: Thoughts on the Interplay of Articles 2, 7, and 9 of the UCC*, 30 HASTINGS L.J. 1 (1978). In this important article, Professor Dolan's proposed resolution of conflicts between Article 7 and Article 9 is somewhat different from the suggested resolution in the text of the present article. Professor Dolan would resolve conflicts between secured parties under Article 9; the present article does not accept that view in all cases and is, at least to that extent, unorthodox.

99. § 9–201 (emphasis added).

business by receiving documents of title[100] in place of goods, and such a buyer would take the goods free of a perfected security interest,[101] so there should be no question of taking free of a non-existent one. If the finance company is not a buyer in ordinary course, then as a person buying documents or goods and giving value and receiving delivery of the "collateral" without knowledge of the unperfected security interest, the finance company would have priority over an unperfected security interest.[102] But again the bank has no security interest at the time of the transfer of the document. There appears to be no way that the bank could prevail over the finance company as transferee of the document under section 7–504(1) if the finance company gives the bailee prompt notice of the transfer and, depending on further facts, even in the absence of notice.

In a few situations there are, arguably, conflicts between Article 7 and Article 9. However, rights arising under documents of title are specified in Article 7, and it is these rights which may be subjected to security interests under Article 9. In some cases of presumed conflict, the debtor may have no interest left which could be transferred to a secured party or to a second secured party.[103] While Article 9 has a section delineating its coverage,[104] Article 7 has no scope section. Section 7–103 states that the provisions of Article 7 are subject to "any treaty or statute of the United States, regulatory statute of this State or tariff, classification or regulation filed or issued pursuant thereto" to the extent that they are applicable, from which it may be inferred that Article 7 covers whatever it covers and that nothing elsewhere in the Code is intended to override whatever Article 7 says on a point within its coverage.

The 1972 revisions in sections 9–304(5) and 9–312(5) were designed to protect an inventory secured party who had filed and who made advances against in coming inventory,[105] but the protection is given in the absence of

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100. *See* § 1–201(9) (third sentence): "'Buying' . . . includes receiving . . . documents of title under a pre-existing contract for sale . . . ."

101. § 9–307(1). Although apparently not involving a sale of goods subject to a document, a buyer of goods not in the possession of the seller but stored at the time of the sale on the premises of one subsequently asserting a security interest was held to be a buyer in ordinary course in Tanbro Fabrics Corp. v. Deering Milliken, Inc., 39 N.Y.2d 632, 350 N.E.2d 590, 385 N.Y.S.2d 260 (1976). *See* R. HENSON, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE 134–35 (2d ed. 1979).

102. § 9–301(1)(c).

103. Section 9–203(1)(c) requires that the debtor must have "rights in the collateral" for a security interest to attach and be enforceable against the debtor. There is no explanation in the Code as to what those rights must be.

104. § 9–102.

105. REVIEW COMMITTEE FOR ARTICLE 9, FINAL REPORT 222 (1971): "[T]he obvious purpose of Section 9–312(3) [is] to permit a first-filed inventory financer to rely on his priority in making advances unless he receives notice of a competing purchase money security interest before the debtor receives the inventory."

future advances.[106] Some priority questions were resolved more satisfactorily under the 1962 version of Article 9 which was facially consistent with the provisions of Article 7. The delay between the time when a filing is made[107] and the time when the filing becomes accessible to a searcher may result in a documentary financer coming into the picture in entire good faith with no possibility of knowing of an earlier filing, and the filing may not have been effective to perfect a security interest at the time it was made. This problem may deserve fresh thought.

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106. The first sentence of § 9-312(7) of the 1972 Code, which in general gives future advances the same priority under § 9-312(5) as the first advance, would in fact appear to be redundant when that result is in any case required by § 9-312(5).

107. A filing is effective on its acceptance or on its presentation to the filing officer with tender of the filing fee. § 9-403(1).