University of Miami Law Review

Volume 27
Number 3 *Volume 27 Numbers 3-4 (Spring & Summer 1973)*

Article 14

7-1-1973

Merchant-Buyer's Good Faith Duty to Inquire Under 9-307: A Confusion of Concepts

Adam K. Llewellyn

This is questionable in that the ordinance clearly provides for control by a committee of not less than ten.[46] It also defines the type of housing to be controlled,[47] establishes the basis for the maximum rent to be charged,[48] defines the circumstances under which adjustments of maximum rents may be made by the city rent agency,[49] and finally the provisions state objective guidelines for the exercise of power by the city rent agency.

In sum, while *Fleetwood* precludes the establishment of rent controls by a municipality in the absence of enabling state legislation, it has far broader implications. The judicial limitation on the home rule powers of municipalities, imposed by the creation of a local-state function test for allocating power, effectively places basic policy choices on the judicial branch of the government. It is submitted that the courts are neither the proper forum for such decisions to be made, nor are they the best mechanism for determining the needs of the people at any particular time.

RICHARD A. HERMAN

MERCHANT-BUYER'S GOOD FAITH DUTY TO INQUIRE UNDER 9-307: A CONFUSION OF CONCEPTS

The plaintiff, J. I. Case Company, sold a tractor to Florida Tractor Mart, Inc., and took back a security agreement (a conditional sales contract), and a financing statement which it recorded.[1] Florida Tractor then delivered possession of the tractor to Gator Tractor Company pursuant to an oral lease.[2] Shortly thereafter Gator Tractor traded the tractor to the defendant, Swift, in exchange for three other items of equipment.[3]

46. Section 16.A.3.C. of Ordinance 1791, provides:

> There shall be an advisory committee composed of not less than 10 members who shall be appointed by the city council. The committee shall be provided by the administrator with all data necessary for it to advise and consult with the Mayor and City Council *for all its actions*. (Emphasis added.)

Mr. Justice Ervin, in his dissent, points out that the city rent agency is a branch of the Miami Beach government and as such is subject to the controls of, and accountable to the Mayor and city council. 261 So.2d at 811.

47. *See* note 1 *supra.*

48. *See* note 41 *supra.*

49. *See* note 39 *supra.*

1. *See* FLA. STAT. § 679.302(1) (1971). Florida has adopted the Uniform Commercial Code in chs. 671-79 FLA. STAT. (1971). The Code sections correspond to the last four numbers of the statute section.

2. Once Case Company's security interest was perfected, it continued, despite the leasing of the tractor by Florida Tractor to Gator Tractor. FLA. STAT. § 679.306(2) (1971).

3. The exchange of equipment between Swift and Gator Tractor constituted a "buying" and therefore Swift became a "buyer" of the tractor. FLA. STAT. § 671.201(9) (1971).

Plaintiff's replevin complaint charged that its perfected security interest in the controverted tractor was superior to any rights subsequently acquired by Swift Ford Tractor, Inc. The trial court entered partial summary judgment for the plaintiff, holding that it was entitled to recover immediate possession of the tractor and damages for its detention. Defendant took an interlocutory appeal. The District Court of Appeal, First District, *held*, affirmed: A commercially prudent tractor merchant may not purchase a tractor from another dealer and thereby acquire title free of a prior recorded security interest without first making a good-faith inquiry into the existence and *terms* of such previously perfected security interest. *Swift v. J. I. Case Company*, 266 So.2d 379 (Fla. 1st Dist. 1972).

The holding in *Swift* that a *merchant* has a duty to inquire into the existence of previously perfected security interests was precipitated by the court's misapplication of section 9-307(1) of the Uniform Commercial Code. This section states:

> A buyer in ordinary course of business . . . [subsection (9) of Section 1-201] 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*.[4]

The court stated the thrust of that section as follows: "In this state a buyer of goods in the ordinary course of business takes free of a perfected security interest."[5]

The court failed to note the important qualification that the security interest must be "created by his [the buyer's] seller." Thus section 9-307(1) would allow Swift to take free of a security interest created by his seller, Gator Tractor, but not free of a security interest created by one other than his seller, in this case, Florida Tractor.[6] Therefore, Case Company's perfected security interest was superior to the after-acquired rights of Swift, although the court did not adopt this rationale.

The court, however, reached this same conclusion—that Case Company should prevail—by reasoning that Swift was not a "buyer in ordinary

---

4. FLA. STAT. § 679.307(1) (1971) (emphasis added).

5. 266 So.2d at 381.

6. This issue has come to the attention of four courts. A recent decision by a California appellate court illustrates the correct application of this aspect of section 9-307(1) in Security Pac. Nat'l Bank v. Goodman, 24 Cal. App. 3d 131, 100 Cal. Rptr. 763 (2d Dist. 1972). *Accord*, National Shawmut Bank v. Jones, 108 N.H. 386, 236 A.2d 484 (1967). That it is easy to overlook this limitation "created by his seller" and misapply section 9-307(1) is illustrated by the dicta in the decision of the Supreme Court of Nebraska in General Elec. Credit Corp. v. Western Crane & Rigging Co., 184 Neb. 212, 166 N.W.2d 409 (1969). The Supreme Court of Iowa recognized this limitation but chose to disregard it because of the compelling and unique facts giving rise to the case in General Motors Accep. v. Keil, 176 N.W.2d 837 (Iowa 1970).

course of business"[7] and, therefore, was not entitled to take free of Case Company's security interest under section 9-307(1). This inquiry into whether Swift was a buyer in ordinary course was both necessary and proper only assuming Case Company's security interest had been created by Swift's seller, Gator Tractor, rather than by Florida Tractor. The conclusion of the court, however, that Swift was not a buyer in ordinary course because he failed to inquire into the existence of any prior security interest appears to have been a misapplication of section 1-201(9) as used in the context of section 9-307(1).

Section 1-201(9) of the Uniform Commercial Code defines a buyer in ordinary course of business as one who buys in good faith and without knowledge that the sale to him is in *violation* of the security interest of a third party.[8] Section 9-307(1) of the Code provides that such a buyer takes free of a security interest created by his own seller even though he knows it *exists*.[9] Reading these two provisions together,

> the buyer takes free if he merely knows that there is a security interest which covers the goods but takes subject [to the security interest] if he knows, in addition, that the sale is in violation of some term in the security agreement not waived by the words or conduct of the secured party.[10]

Thus the duty of inquiry imposed upon *merchant* buyers by the court in *Swift* is meaningless unless the duty extends to inquiry into the *terms* of the security agreement, for mere knowledge of the existence of the security interest does not defeat the priority of the buyer.

But must a merchant buyer inquire into the terms of a prior, perfected security interest in order to qualify for the protection provided for in section 9-307(1)? The answer to this question may be found in an analysis of the good faith element in the definition of buyer in ordinary course of business. The court in *Swift* reasoned that the requirements for establishing one's self as a good faith buyer vary with the commercial status of the buyer. Since Swift was a tractor dealer, the court looked to section 2-103(1)(b) of the Uniform Commercial Code for the requirements of good faith: " 'Good faith' in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."[11] Thus, concluded the court, commercial reasonableness demands that a merchant buyer make an inquiry, and failure to do so constitutes bad faith.

---

7. "Buyer in ordinary course of business" means 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. FLA. STAT. § 671.201(9) (1971) (emphasis added).

8. See note 7 *supra*.

9. FLA. STAT. § 679.307(1) (1971).

10. FLA. STAT. ANN. § 679.9-307, Comment 2 (1966) (Comments to the UCC are not contained in Florida Statutes).

11. FLA. STAT. § 672.103(1)(b) (1971).

The section 2-103(1)(b) definition of good faith utilized by the court to impose upon Swift the duty of inquiry as an observance of reasonable commercial standards is not applicable to the section 1-201(9) definition of buyer in ordinary course when used in the context of section 9-307(1). That this Article 2 definition of good faith is not applicable to Article 9 is suggested by section 9-105(4), which states that Article 1 contains the general definitions applicable in Article 9.[12] Article 1, section 1-201(19) of the Code defines good faith as "honesty in fact in the conduct or transaction concerned,"[13] and does *not* include the requirement of commercial reasonableness. That the Article 2 definition of good faith, including commercial standards, is inapplicable to Article 9 is further suggested by the official commentary:

> "Good faith," whenever it is used in the Code, means at least what is here stated [honesty in fact]. In certain Articles, by specific provision, *additional* requirements are made applicable. See, e.g., Secs. 2-103(1)(b) . . . [observance of reasonable commercial standards]. To illustrate, in the Article on Sales, Section 2-103, good faith is expressly defined as including in the case of a merchant observance of reasonable commercial standards of fair dealing in the trade, so that throughout *that* Article wherever a merchant appears in the case an inquiry into his observation of such standards is necessary to determine his good faith.[14]

The Supreme Court of Delaware recently passed on this precise issue in *Sherrock v. Commercial Credit Corp.*[15] Reversing both lower courts, the court said:

> The error we find here lies in the Trial Court's misapplication of the Sales Article definition of "good faith," set forth in § 2-103(1)(b), instead of the Secured Transaction Article definition of "good faith," set forth in § 1-201(19). In so doing, the Trial Court found that, although the appellants were honest in fact, they did not act "in a commercially reasonable manner." The Trial Court reasoned that, in substance, this secured transaction revolved around a sale of the automobiles; that since Article 2 of the Code deals with the sale of goods, the definition of "good faith" in that Article must be applied; with the result that a merchant-buyer's "good faith" is to be distinguished from the "good faith" of a consumer-buyer under Article 9 of the Code. In the view of the Trial Court, it was not reasonable to conclude that the drafters of the Code intended to apply more than one standard of "good faith" to the same individual in related transactions and that, therefore, the definition in

12. FLA. STAT. § 679.105(4) (1971).
13. FLA. STAT. § 671.201(19) (1971).
14. FLA. STAT. ANN. § 671.1-201, Comment 19 (1966) (emphasis added).
15. — Del. —, 290 A.2d 648 (1972).

> § 2-103(1)(b) must be applied to merchant-buyers throughout the entire Code. See 269 A.2d 407. We are unable to approve that rationale.
>
> Article 2 of the Code concerns itself with the rights and obligations of buyer and seller, one to the other. Here we are concerned with the rights and obligations of buyer and secured creditor, one to the other—a transaction expressly controlled by Article 9.[16]

In this situation,[17] when a buyer meets the qualifications of section 9-307, he takes free of the security interest in the goods. Nevertheless, the creditor's security interest still continues in the proceeds of the sale in the hands of the debtor-seller.[18] When a buyer is denied the protection of section 9-307, the creditor's security interest continues in both the proceeds *and* the collateral goods.[19] Thus to impose a duty of inquiry to any extent, on any buyer, which will act to defeat his status as a buyer in ordinary course of business, is in effect to require the buyer to assume the economic risk that a debtor-seller will fail to apply the proceeds from an unauthorized sale toward the satisfaction of his debt.

When a buyer has actual knowledge that the sale to him is in violation of the security interest of a third party and still elects to buy, the buyer is in effect consciously assuming the risk that the debtor-seller will satisfy his debt from the proceeds, and is thus denied the protection of section 9-307. But where the buyer does not have actual knowledge, why should he be burdened, under the guise of good faith, with an economic risk that should rightfully fall on the creditor?[20]

Thus, the court in *Swift* reached the correct result—that Case Company's prior perfected security interest should prevail over the rights of Swift—by making two independent mistakes in its application of section 9-307(1) of the Uniform Commercial Code to the facts. The second of these mistakes cancelled the first. The protection to buyers provided in section 9-307(1) was not available to Swift since the prior perfected security interest in the tractor was not created by Swift's seller. Therefore, it was unnecessary to deny Swift this protection by holding him not to be a buyer in the ordinary course of business, which, in the author's opinion, he was. The drafters of the Code achieved a delicate

16. *Id.* at 650.

17. It must be remembered that the scope of section 9-307 is limited primarily to inventory situations in which the creditor—holder of the security interest—has *forbidden* any sale by the debtor or has placed latent limitations upon the debtor's apparent authority to sell. FLA. STAT. ANN. § 679.9-307, Comment 2 (1966).

18. FLA. STAT. § 679.306(2) (1971).

19. FLA. STAT. § 679.306(2) (1971).

20. It is interesting to note that in two New York decisions, the courts assumed without analysis that the Article 2 definition of good faith applied to merchant-buyers in Article 9, yet expressly held that failure to make an inquiry into the existence of prior perfected security interests did not constitute bad faith. Bank of Utica v. Castle Ford, Inc., 36 App. Div. 2d 6, 317 N.Y.S.2d 542 (1971); Hempstead Bank v. Andy's Car Rental Sys., Inc., 35 App. Div. 2d 35, 312 N.Y.S.2d 317 (1970).

balance between the rights of a secured party and a subsequent buyer in sections 9-306 and 9-307, and to engraft into either section, by judicial interpretation, requirements that are not there, upsets this balance. The proper result in *Swift* should not be accepted blindly. An understanding of the concepts underlying sections 9-306 and 9-307 is essential to their proper application.

ADAM K. LLEWELLYN

THE RIGHT TO LIGHT: DUE PROCESS AND PUBLIC UTILITY TERMINATION

Colorado gas and electric customers sought declaratory and injunctive relief, as well as money damages, against a privately owned Colorado public utility company. Their complaint in the federal district court charged that the company had violated the customers' rights to procedural due process by unlawfully terminating their gas and electric service without a hearing or without providing for one. Plaintiffs contended that the public utility's termination of service involved state action within the purview of the Civil Rights Acts,[1] and thus gave federal jurisdiction over the basic dispute. The company maintained that its policy of terminating service for failure to pay bills did not involve state action, and, therefore, that the customers did not have a claim for the taking of property without due process. The United States District Court for the District of Colorado, refusing to grant the motion to dismiss,[2] *held:* The actions of a privately owned public utility operating under close supervision of the state public utilities commission and supplying service under an exclusive franchise from the state are "state action" under the purview of 42 U.S.C. § 1983 (1970). *Hattell v. Public Service Co.*, 350 F. Supp. 240 (D. Colo. 1972).

---

1. The Civil Rights Acts are 42 U.S.C. § 1983 (1970) and 28 U.S.C. § 1343 (1970). Section 1983 provides a cause of action in the event a state contravenes the Constitution. The act states:

> Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

28 U.S.C. § 1343(3) provides federal district courts with jurisdiction to redress deprivation under color of state law of any right secured by the Constitution. Section 1343(3) reads:

> The district courts shall have original jurisdiction of any civil action authorized by law to be commenced by any person: . . . (3) To redress the deprivation, under color of any State law, statute, ordinance, regulation, custom or usage, of any right, privilege or immunity secured by the Constitution of the United States or by any Act of Congress providing for equal rights of citizens or of all persons within the jurisdiction of the United States. . . .

2. The claim for money damages, however, was dismissed. It was asserted under state