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Kentucky Law Survey: Commercial Law

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Commercial Law

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The Kentucky Uniform Commercial Code,[1] although enacted in 1958 and effective July 1, 1960,[2] contains numerous sections which have not yet been interpreted by the Kentucky appellate courts.[3] However, this is changing due to the evergrowing number of commercial transactions which provide the courts with opportunities to construe the Kentucky Uniform Commercial Code (Code).

From the cases interpreting the Code[4] since the last commercial law survey[5] was completed, I have chosen three on which to comment. In *Central Bank & Trust Co. v. Metcalfe*,[6] the Kentucky Court of Appeals defined the Kentucky Revised Statutes (KRS) section 355.9-504(3) requirement that notice of a sale of repossessed collateral be sent to the debtor. In *J.I. Case Co. v. Borg-Warner Acceptance Corp.*,[7] the Kentucky Court of

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[1] KY. REV. STAT. ANN. §§ 355.1-101 to 10-102 (Bobbs-Merrill 1970 & Cum. Supp. 1984) [hereinafter cited as KRS].

[2] 1958 Ky. Acts, ch. 77, §§ 1-101 to 10-108.

[3] Of the 385 substantive sections of the Kentucky Uniform Commercial Code, only 54 sections had been the subject of a reported decision by a Kentucky appellate court as of Sept. 1, 1983.

[4] *See* Hutchison v. C.I.T. Corp., 726 F.2d 300 (6th Cir. 1984) (discussing perfection of a security interest by possession under KRS § 355.9-305); Tresslar Co. v. Fritts, 665 S.W.2d 314 (Ky. Ct. App. 1984) (KRS § 355.3-416(1) not applicable to letter of guarantee not executed with commercial instrument); Richardson v. First Nat'l Bank of Louisville, 660 S.W.2d 678 (Ky. Ct. App. 1983) (clerical error not sufficient to discharge a negotiable instrument under KRS § 355.3-605(1)(a) and signers personally responsible for debt where no evidence of representative capacity under KRS § 355.3-403(2)); Brooks v. United Kentucky Bank, 659 S.W.2d 213 (Ky. Ct. App. 1983) ("continuing guarantee" not within purview of KRS § 355.3-115(1)); Commissioner, Dep't of Educ. v. Gravitt, 31 KY. L. SUMM. 4, at 3 (Ky. Ct. App. March 9, 1984) [hereinafter cited as KLS] (discussing measure of damages for breach of Article Two warranty under KRS §§ 355.2-714(2), 2-715 (1970)); Kane v. Citizens Fidelity Bank & Trust Co., 31 KLS 3, at 7 (Ky. Ct. App. Feb. 24, 1984) (continuing guarantee not Article Three negotiable instrument under KRS § 355.3-606).

[5] *See* Nowka, *Kentucky Law Survey - Commercial Law*, 72 KY. L.J. 336 (1983-84) (surveying commercial law cases decided during the period from approximately June of 1982 to June of 1983).

[6] 663 S.W.2d 957 (Ky. Ct. App. 1984).

[7] 669 S.W.2d 543 (Ky. Ct. App. 1984).

Appeals determined the priority between competing security interests in goods repossessed by a secured creditor and returned to the debtor's inventory. In *North Ridge Farms, Inc. v. Trimble*,[8] the court of appeals examined the rights of a secured creditor with a security interest in a fractional share of Affirmed, thoroughbred racing's last Triple Crown winner, vis a vis a buyer of an annual breeding season to Affirmed.

I. NOTICE OF SALE OF COLLATERAL AFTER DEFAULT—KRS 355.9-504(3)

In *Central Bank & Trust Co. v. Metcalfe*,[9] the Kentucky Court of Appeals considered both the statutory requirement that a secured party send notice to the debtor of the intended disposition of the collateral and the effect of a failure to provide such notice.[10] Herbert H. Metcalfe, Sr., and Evelyn Metcalfe cosigned a contract for the purchase of a vehicle by Herbert H. Metcalfe, Jr. The purchase contract, which created a security interest in the vehicle, was assigned to Central Bank & Trust Company (Central Bank). When default in the payment of the secured obligation occurred, the bank repossessed the vehicle for the purpose of resale.

KRS section 355.9-504(3) provides that "reasonable notification of the time and place of any public sale or reasonable notification of the time after which any private sale or other intended disposition is to be made shall be sent by the secured party to the debtor." In an attempt to fulfill this requirement with respect to Evelyn and Herbert, Sr., Central Bank mailed a notice in one envelope addressed to "Mr. & Mrs. Herbert H. Metcalfe, Sr." at the address on the contract. The collateral was subsequently sold. Application of the proceeds of sale to the indebtedness produced a deficiency of $6,610.68, and Central Bank filed suit for the deficiency.[11] When the circuit court granted summary judgment in Evelyn's favor, both in her individual capacity and in her capacity as administrator of the estate of

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[8] 30 KLS 15, at 2 (Ky. Ct. App. Dec. 2, 1983).

[9] 663 S.W.2d 957 (Ky. Ct. App. 1984).

[10] *See* 663 S.W.2d at 960.

[11] *Id.* at 958. Evelyn was sued in her individual and fiduciary capacities since she was administrator of the estate of Herbert H. Metcalfe, Sr., deceased. *Id.*

Herbert, Sr., Central Bank appealed. The court of appeals framed the issue as whether Central Bank gave reasonable notification of the sale of the vehicle to both Herbert, Sr., and Evelyn.[12]

Although the court stated that the only question was whether there had been proper notification, an underlying issue was the effect of lack of proper notification on the ability of the secured party to obtain a deficiency judgment.[13] This Article will explore both issues.

The court stated that in order to recover a deficiency judgment resulting from the sale of collateral, all of the provisions of KRS section 355.9-504 must be fulfilled.[14] Section 9-504(3) provides two separate requirements for disposition of collateral: (1) every aspect of the disposition must be commercially reasonable[15] and (2) the secured party must send notice of the sale.[16]

Consistent with the majority of courts[17] and citing *Bank Josephine v. Conn*,[18] a previous Kentucky Court of Appeals decision, the court placed the burden on the secured party to prove it had acted with commercial reasonableness in selling the collateral.[19] Stating that commercial reasonableness includes sending notice of the sale to the debtor,[20] the court also placed the burden of proving notice on Central Bank.[21]

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[12] *Id.*

[13] "In order to recover a deficiency judgment resulting from a sale of collateral *all of the provisions of KRS 355.9-504 must be met.*" *Id.* (emphasis added).

[14] *Id.*

[15] KRS § 355.9-504(3) states in part: "Sale or other disposition may be as a unit or in parcels and at any time and place and on any terms but every aspect of the disposition including the method, manner, time, place and terms must be commercially reasonable." *See generally* Annot., 7 A.L.R. 4th 308 (1981) (discussing what is "commercially reasonable" disposition of collateral as required by UCC § 9-504(3)).

[16] *See* KRS § 355.9-504(3).

[17] *See, e.g.*, First Nat'l Bank of Bellevue v. Rose, 196 N.W.2d 507, 510 (Neb. 1972); Don Jenkins & Son Ford-Mercury Inc. v. Catlette, 297 S.E.2d 409, 410 (N.C. Ct. App. 1982); First Nat'l Bank [of] New Bremen v. Turner, 439 N.E.2d 1259, 1263 (Ohio Ct. App. 1981). *See also* D. LEIBSON & R. NOWKA, THE UNIFORM COMMERCIAL CODE OF KENTUCKY § 8.6(G) (1983).

[18] 599 S.W.2d 773 (Ky. Ct. App. 1980).

[19] *See* 663 S.W.2d at 959.

[20] *See id.* The court stated, "The burden is on the secured party to prove it acted with commercial reasonableness in accomplishing the sale. . . . This includes notification to the debtor of the sale." *Id.* (citation omitted).

[21] *See id.*

The court erred by including the sending of reasonable notice as part of the duty of commercial reasonableness. KRS section 355.9-504(3) imposes two requirements on a secured party disposing of collateral—commercially reasonable disposition and sending reasonable notification of the disposition.[22] Under the language of section 9-504(3), these requirements are separate and independent:

> Sale or other disposition may be as a unit or in parcels and at any time and place and on any terms but every aspect of the disposition including the method, manner, time, place and terms must be *commercially reasonable.* Unless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, *reasonable notification* of the time and place of any public sale or reasonable notification of the time after which any private sale or other intended disposition is to be made shall be sent by the secured party to the debtor. . . .[23]

Nevertheless, the court reached the correct result when it found the bank's notification inadequate. The notice of sale was addressed to "Mr. & Mrs. Herbert H. Metcalfe, Sr." However, the contract was signed as "Herbert H. Metcalfe, Sr." and "Evelyn Metcalfe."[24] Finding no indication in the written documentation that Evelyn and Herbert, Sr., were married to each other, the court stated:

> We do not think it reasonable for the bank to assume that appellant and her husband were husband and wife, or that they would remain married or residents at the same address. The reasonable conduct for the bank to take would have been to mail 2 separate notices to Evelyn and Herbert, Sr.[25]

Evelyn did not reside at the address to which the notice was mailed, and she did not receive the notice.[26] However, the bank

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[22] *See* KRS § 355.9-504(3). *See also* D. LIEBSON & R. NOWKA, *supra* note 17, § 3.3(c), at 840-47; J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE, §§ 26-29 (2d ed. 1980).

[23] KRS § 355.9-504(3) (emphasis added).

[24] 663 S.W.2d at 959.

[25] *Id.*

[26] *Id.*

had mailed the notice to the address indicated on the contract.[27] The secured party is required only to *send* reasonable notification:

> "Send" in connection with any writing or notice means to deposit in the mail or deliver for transmission by any other usual means of communication with postage or cost of transmission provided for and properly addressed and in the case of an instrument to an address specified thereon or otherwise agreed, or if there be none to any address reasonable under the circumstances.[28]

Unless the bank had received notice of Evelyn's correct address, it acted reasonably in sending notice of sale to the address indicated on the contract. There is no requirement that the debtor receive the notice;[29] KRS section 9-504(3) requires only that "reasonable notification"[30] be sent. The secured party fulfills its duty when reasonable notification is sent, whether or not the debtor ever receives the notice. Thus, the court of appeals was correct in agreeing with the bank's contention that it was immaterial that Evelyn neither lived at the indicated address nor received notice.[31]

Sending the notice to the address listed on the contract was not unreasonable. However, considering that Evelyn did not reside at that address and that the notice was not addressed to Evelyn, the court concluded that two separate notices should have been sent: "By so doing, the appellant could then have reasonably assumed that, if one of these two persons was no longer living at the address appearing on the notice, the postal service would, by forwarding, transmit the correspondence to

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[27] *Id.*

[28] KRS § 355.1-201(38) (1970).

[29] KRS § 355.1-201(26) provides in pertinent part whether or not the person actually comes to know of it, "[a] person 'receives' a notice or notification when (a) it comes to his attention; or (b) it is duly delivered at the place of business through which the contract was made. . . ."

[30] "Reasonable notification" is not defined in Article Nine of the Uniform Commercial Code. However, the Commentary to KRS § 355.9-504 states: "[A]t a minimum, [reasonable notification] contemplates notice sent in such time that persons entitled to receive it will have sufficient time to protect their interests by taking part in the sale or other disposition if they so desire."

[31] *See* 663 S.W.2d at 959.

that person at his or her new address."[32] Thus, the court held that Central Bank "did not meet its burden as to the commercial reasonableness of notice to Evelyn individually."[33]

The court of appeals found no similar unreasonableness with respect to the notice to Herbert, Sr. Although Evelyn had moved to a different address, "there was no evidentiary indication that Herbert Sr. had moved."[34] Thus, Central Bank could have "reasonably anticipate[d] that delivery would be made to the addressee who remained at the address on the envelope."[35]

According to the Kentucky Court of Appeals, the critical factor in determining whether reasonable notification was sent "is the reasonable expectation . . . it would be transmitted to the addressee."[36] The court's designation of the expectation of transmission of the notice to the addressee as the critical factor in the "send" issue comports with the ostensible purpose behind the definition of "send." "Send" requires that postage be provided and a proper address be employed.[37] These requirements seem designed to foster a reasonable expectation that the notice will be transmitted to the addressee. Central Bank's expectation was unreasonable as to Evelyn because the Bank failed to send her an individual notice which could have been forwarded in the mails.[38] The Bank's expectation was reasonable as to Herbert, Sr., because his name appeared in the address and there was no evidence he had moved.

As noted previously, the court reached the correct result even though it incorrectly included the duty of sending reasonable notification within the duty of making a commercially reasonable disposition. Had the court separated the two duties, the same result would have been reached under a different rationale.

KRS section 355.9-504(3) mandates that "reasonable notification . . . shall be sent by the secured party to the debtor." The duty of "reasonable notification" should be limited to situations where the issue is the content or timeliness of the

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[32] *Id.*
[33] *Id.*
[34] *Id.* at 960.
[35] *Id.* at 959-60.
[36] *Id.* at 959.
[37] *See* text accompanying note 28 *supra.*
[38] 663 S.W.2d at 959.

notice.[39] The independent duty that notice be "sent" would concern whether notice is sent at all and whether it is correctly addressed. Since the issue in *Central Bank & Trust Co. v. Metcalfe* was whether the notice was properly sent, its resolution turned on the definition of "send."

"Send" means "to deposit in the mail . . . properly addressed."[40] The contract indicated the debtors were Herbert, Jr., Evelyn, and Herbert, Sr. A notice which was not addressed to "Evelyn Metcalfe" was not "properly addressed" and thus was not *sent*. If notice was not sent, then the duty of section 9-504(3) was not fulfilled.

As noted before, an underlying issue was the effect of failure to comply with section 9-504(3) on the secured party's ability to recover a deficiency. Central Bank brought suit to recover the deficiency existing after proceeds of the sale of the vehicle were applied to the debt. Evelyn Metcalfe, individually and as administrator of the estate of Herbert, Sr., defended the deficiency suit on the ground that the requirements of section 9-504(3) had not been met. The court of appeals agreed with the theory of the defense: "In order to recover a deficiency judgment resulting from sale of collateral, all of the provisions of KRS section 355.9-504 must be complied with."[41]

Although the court did not cite *Bank Josephine v. Conn*[42] in support of this statement, the court hearing that case had reached the same conclusion.[43] In *Bank Josephine*, a suit for a deficiency was denied on the ground the secured party had "failed to act with commercial reasonableness and, therefore, was estopped from securing a deficiency judgment against the appellees."[44]

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[39] *See* UCC § 9-504 comment 5 (1972); J. WHITE & R. SUMMERS, *supra* note 22, at 1112.

[40] KRS § 355.1-201(38).

[41] 663 S.W.2d at 959.

[42] 599 S.W.2d 773.

[43] *See id.* at 775.

[44] *Id.* Note that another Kentucky case arguably implies that a commercially reasonable sale is a condition precedent to a deficiency judgment. *See* Cox Motor Car Co. v. Castle, 402 S.W.2d 429 (Ky. 1966). In *Cox* the secured party, after repossession of the collateral, sought recovery of the unpaid balance of the purchase price. The court denied the recovery holding that the secured party, having repossessed the collateral, "was required to liquidate it at reasonable public sale, as a condition to seeking further recovery" from the debtor. *Id.* at 432. It seems that the court was merely stating the procedure for recovery of a deficiency, i.e., disposition of collateral and application of proceeds thereof to the unpaid indebtedness before any deficiency is warranted.

The issue of whether to allow a secured party who has not complied with section 9-504(3) to recover a deficiency has been faced by many courts. Article Nine gives little guidance on the subject. Subsection (2) of KRS section 355.9-504 provides that the debtor is liable for any deficiency unless otherwise agreed.[45] Subsection (1) of KRS section 355.9-507 provides that the secured party is liable for any loss caused by a failure to comply with Part Five of Article Nine.[46] Courts have responded to the issue in three ways.

Some courts have denied any recovery of a deficiency when the secured party failed to comply with the requirements of section 9-504(3). The reasoning of this approach is illustrated by *Camden National Bank v. St. Clair*,[47] where the secured party claimed that section 9-507(1) provided the exclusive remedy for its failure to comply with section 9-504(3). In *St. Clair*, the secured party had failed to give notice of the disposition. First, the court found that section 9-507(1) is not an exclusive remedy.[48] Second, since section 9-507(1) is not expressly exclusive,[49] the court found section 1-103[50] instructive in providing that, unless

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[45] KRS § 355.9-504(2) provides:

> If the security interest secures an indebtedness, the secured party must account to the debtor for any surplus, and, unless otherwise agreed, the debtor is liable for any deficiency. But if the underlying transaction was a sale of accounts, contract rights, or chattel paper, the debtor is entitled to any surplus or is liable for any deficiency only if the security agreement so provides.

[46] KRS § 355.9-507(1) states:

> If it is established that the secured party is not proceeding in accordance with the provision of this part disposition may be ordered or restrained on appropriate terms and conditions. If the disposition has occurred the debtor or any person entitled to notification or whose security interest has been made known to the secured party prior to the disposition has a right to recover from the secured party any loss caused by a failure to comply with the provisions of this part. If the collateral is consumer goods, the debtor has a right to recover in any event an amount not less than the credit service charge plus ten percent (10%) of the principal amount of the debt or the time price differential plus ten percent (10%) of the cash price.

[47] 309 A.2d 329 (Me. 1973).

[48] *Id.* at 332 ("[T]he § 9-507(1) cause of action is only one of a plurality of remedies available to the debtor.").

[49] *See* note 46 *supra*.

[50] UCC § 1-103 provides: "Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions."

displaced by particular provisions of the Uniform Commercial Code (UCC), remedies previously or otherwise afforded are supplemental to the UCC.[51] Pre-UCC case law generally denied an action for a deficiency when the disposition was not properly conducted.[52] In *St. Clair*, the court refused to award a deficiency and held that compliance with the notice provisions of section 9-504(3) is a condition precedent to the right of the secured party to recover a deficiency.[53]

A second approach, rapidly gaining popularity, is typified by *Norton v. National Bank of Commerce*.[54] In *Norton*, as in *St. Clair*, a failure to give notice of the disposition was the statutory defect. In rejecting the debtor's contention that failure to give notice completely discharged liability for any deficiency, the court stated:

> Upon the issue of Norton's damages simple considerations of fair play cast the burden of proof upon the bank. It was the bank which wrongfully disposed of the car without notice to the debtors. Thus it was the bank's action that made it at least difficult, if not impossible, for Norton to prove the extent of his loss with reasonable certainty. A chattel such as a car may well be a thousand miles away before the debtor learns of its sale without notice. It would be manifestly unfair for the creditor to derive an advantage from its own misconduct. We think the just solution is to indulge the presumption in the first instance that the collateral was worth at least the amount of the debt, thereby shifting to the creditor the burden of

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[51] 309 A.2d at 332.

[52] *See, e.g.*, Bulldog Concrete Forms Sales Corp. v. Taylor, 195 F.2d 417 (7th Cir. 1952) (deficiency judgment rendered where all requirements of notice and resale were met); Frantz Equip. Co. v. Anderson, 181 A.2d 499 (N.J. 1962) (defective notice of resale deprives seller of his right to seek a deficiency judgment); United Sec. Corp. v. Tomlin, 198 A.2d 179 (Del. Super. Ct. 1964) (failure to give notice of sale and to conduct sale at public auction deprives seller of right to judgment for balance due).

[53] *See* 309 A.2d at 333. *Accord* Skeels v. Universal C.I.T. Credit Corp., 222 F. Supp. 696, 702 (W.D. Pa. 1963), *vacated on other grounds*, 335 F.2d 846 (3rd Cir. 1964); Atlas Thrift Co. v. Horan, 104 Cal. Rptr. 315, 321 (Cal. Ct. App. 1972); Herman Ford-Mercury, Inc. v. Betts, 251 N.W.2d 492, 496 (Iowa 1977).

[54] 398 S.W.2d 538 (Ark. 1966). *See also* Weaver v. O'Meara Motor Co., 452 P.2d 87, 91 (Alaska 1969); Levers v. Rio King Land & Inv. Co., 560 P.2d 917, 920 (Nev. 1977); Conti Causeway Ford v. Jarossy, 276 A.2d 402, 404-05 (N.J. Dist. Ct. 1971), *aff'd*, 288 A.2d 872 (N.J. Super. Ct. App. Div. 1972).

proving the amount that should reasonably have been obtained through a sale conducted according to law.[55]

This approach results in the presumption that the collateral was worth at least the amount of the debt. The secured party can recover a deficiency only by first overcoming this presumption. An appraisal of the value of the collateral, followed by a good faith effort to obtain the highest price, has been held to overcome the presumption.[56] It is questionable, however, whether this second approach does any more than throw a tidbit to the hungry creditor. Quite probably the courts will require a greater showing than the secured party's estimate of the collateral's fair market value, and thus the ability to overcome the presumption may be more illusory than real.

A third approach is illustrated in *Wilson Leasing Co. v. Seaway Pharmacal Corp.*,[57] where it was found that disposition of the collateral in violation of the UCC does not absolve the debtor of liability for a deficiency.[58] However, the debtor is permitted to recover for any loss under secton 9-507(1).[59] The amount of damages to the debtor resulting from the secured party's failure to follow UCC requirements can be set off against the deficiency.[60]

It appears that the only difference between the second and third approaches is the allocation of the burden of proof of the fair market value of the collateral and thus of the amount of loss suffered by the debtor. Under the second approach, the secured party must overcome the presumption that the fair market value of the collateral was equal to the amount of the debt. In effect, this compels the secured party to show that his noncompliance with the UCC did not result in loss to the debtor. Under the third approach, the debtor bears the burden of proving loss. If the debtor does so, then—where the collateral was not a consumer good—the amount of loss is offset against the

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[55] 398 S.W.2d at 542.

[56] *See* Levers v. Rio King Land & Inv. Co., 560 P.2d at 920.

[57] 220 N.W.2d 83 (Mich. Ct. App. 1974). *See also* Zions First Nat'l Bank v. Hurst, 570 P.2d 1031, 1033-34 (Utah 1977); Associates Fin. Serv. Co., Inc. v. DiMarco, 383 A.2d 296, 302 (Del. Super. Ct. 1978).

[58] 220 N.W.2d at 89.

[59] *See* KRS § 355.9-507(1).

[60] Jones v. Morgan, 228 N.W.2d 419, 423 (Mich. Ct. App. 1975).

amount of deficiency.[61] If the collateral was a consumer good, the loss is offset only if it is greater than the statutory damages provided in section 9-507(1).[62]

The third approcah seems to be more consistent with the language of Article Nine. KRS section 355.9-507(1) gives the debtor a remedy for the secured party's breach of duty. If the secured party breaches its duty under section 9-504(3), it is liable under section 9-507(1) for any loss caused.[63] To further deny the secured party's right to a deficiency may unfairly penalize the secured party. However, after *Central Bank & Trust Co. v. Metcalfe* and *Bank Josephine v. Conn*, Kentucky seems to be aligned with the jurisdictions which completely deny deficiency judgments for failure to comply with section 9-504(3).

II. CHATTEL PAPER AND REPOSSESSED GOODS—KRS 355.9-306(5) & 9-308

In *J.I. Case Co. v. Borg-Warner Acceptance Corp.*,[64] the Kentucky Court of Appeals considered the complex provisions of the Uniform Commercial Code relating to the priority of security interests in repossessed goods. J.I. Case Company (Case), a manufacturer of farm equipment, sold farm equipment to Island Equipment Company (Island), an equipment dealer, for the purpose of resale. At issue in the controversy were two pieces of equipment sold by Case to Island pursuant to a "Wholesale Financing & Security Agreement" whereby Case retained and perfected a security interest in the equipment and also in Island's inventory, repossessions, and proceeds. Island sold the pieces of equipment pursuant to two separate retail installment contracts. Island assigned these contracts to Borg-Warner Acceptance Corporation (Borg-Warner). When both purchasers of the equipment defaulted on the retail installment contracts, Borg-Warner

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[61] *See id.* at 423.

[62] *See* KRS § 355.9-507(1).

[63] *See id.*

[64] 669 S.W.2d 543 (Ky. Ct. App. 1984). After rendering an opinion in favor of J.I. Case Company on Sept. 30, 1983, the court of appeals granted Borg-Warner's petition for rehearing. Subsequently the court withdrew its Sept. 30, 1983 opinion and issued a new opinion on Feb. 10, 1984. This later opinion overturned the previous holding and its rationale and held Borg-Warner had the superior interest in the repossessed goods. *Id.* at 543, 546.

repossessed the equipment and placed it with the inventory of Island. After Island defaulted on its obligation to Case, Case obtained a writ of possession authorizing it to take all of Case's equipment in Island's possession. Case subsequently obtained possession of this equipment, including the two pieces repossessed by Borg-Warner. Borg-Warner demanded that Case surrender the equipment. When Case refused, the priority of the conflicting security interests in the goods was placed in issue.[65]

The court, on rehearing, first noted the security interest of Case in the two pieces of equipment was extinguished pursuant to KRS section 355.9-306(2) when Island sold the equipment.[66] KRS section 355.9-306(2) provides that "a security interest continues in collateral notwithstanding sale . . . by the debtor unless his action was authorized by the secured party." Since Case authorized Island to sell the equipment, Case's security interest in the equipment was extinguished.[67]

However, the security agreement between Case and Island extended Case's security interest to the proceeds of the collateral, and thus Case maintained a security interest in the proceeds under KRS section 355.9-306(2).[68] The proceeds received by Island consisted of retail installment contracts.[69] These contracts must have evidenced a monetary obligation owed by the purchasers and a security interest in the equipment purchased because the court characterized the proceeds as chattel paper.[70] KRS section 355.9-105(1)(b) defines a chattel paper as "a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods." Thus, Case had a security interest in the chattel paper which was created by the sale of equipment.

The assignment of the chattel paper to Borg-Warner created a security interest in Borg-Warner's favor with the chattel paper as collateral. A security interest was created whether the transaction was a security assignment or in fact a sale of the chattel

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[65] *Id.* at 545.

[66] *Id.*

[67] *Id.*

[68] *Id.* at 546. KRS § 355.9-306(2) provides that notwithstanding sale "a security interest . . . continues in any proceeds including collections received by the debtor."

[69] 669 S.W.2d at 545.

[70] *See id.* at 545-47.

paper to Borg-Warner. Under KRS section 355.9-102, the provisions of Article Nine apply both to security interests created by assignment[71] and to sales of chattel paper.[72] Thus, both Case and Borg-Warner had security interests in the chattel paper.

Had there been a default by Island in its obligation to Case prior to default by the purchasers of the equipment and repossession of the equipment by Borg-Warner, the priority contest would have been resolved by determining whether Borg-Warner or Case had priority in the chattel paper under KRS section 355.9-308.[73] Repossession of the equipment does not change the resolution of the dispute even though the issue shifted to the priority of the parties' security interests in the equipment.[74]

The court of appeals first discussed the section 355.9-308 priority determination as to chattel paper. The second sentence of section 355.9-308 provides:

> A *purchaser* of chattel paper who gives *new value* and takes possession of it *in the ordinary course of his business* has priority over a security interest in chattel paper which is claimed merely as proceeds of inventory subject to a security interest, even though he knows that the specific paper is subject to the security interest.[75]

Having already noted the security interest of Case in the goods was extinguished upon sale, the court further found Case had a security interest in the chattel paper as proceeds of the equipment.[76] Without discussing the remaining conditions of priority under section 355.9-308, the court held that Borg-Warner had obtained priority in the chattel paper.[77]

In order to find Borg-Warner had a superior interest in the chattel paper, the court must have found Borg-Warner fulfilled the requirements of section 355.9-308. First, Borg-Warner must

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[71] *See* KRS § 355.9-102(2).

[72] *See* KRS § 355.9-102(1)(b).

[73] *See* text accompanying note 75 *infra*.

[74] *See* text accompanying notes 80-89 *infra*.

[75] KRS § 355.9-308 (emphasis added).

[76] *See* 669 S.W.2d at 546. The court must have decided Case claimed a security interest in the chattel paper "merely" as proceeds of inventory. This conclusion is reached because the court determined priority under the second sentence of KRS § 355.9-308, and that section operates only when the security interest in chattel paper "is claimed merely as proceeds of inventory subject to a security interest." KRS § 359.9-308.

[77] *See* 669 S.W.2d at 546.

have been a purchaser of chattel paper. "Purchase" is defined to include "taking by sale, discount, negotiation, mortgage, pledge, lien, issue or reissue, gift or any other voluntary transaction creating an interest in property."[78] Since the chattel paper was "assigned" to it, Borg-Warner undoubtedly took the chattel paper either by "sale" or as security which could be considered taking by "lien." Hence Borg-Warner was a purchaser. Second, Borg-Warner must have given "new value." Since the chattel paper was "assigned" to Borg-Warner, the assignment was probably made for value given in the form of money.[79] An assignment of chattel paper as security for, or in satisfaction of, a preexisting debt would not have involved "new" value. Third, Borg-Warner must have taken possession of the chattel paper. The facts of the case do not indicate whether Borg-Warner took possession of the chattel paper, but a normal course of dealing in an assignment situation would be for the assignee (Borg-Warner) to take possession. Finally, Borg-Warner must have been acting in its ordinary course of business in "purchasing" and "taking possession" of the chattel paper. No factual finding as to this requirement was made, but Borg-Warner was obviously a credit institution (i.e., Borg-Warner Acceptance Corporation) and thus could have purchased and possessed chattel paper in its ordinary course of business.

Repossession of the equipment by Borg-Warner brought KRS section 355.9-306(5) into operation: "If a sale of goods results in an account or chattel paper which is transferred by the seller to a secured party, and if the goods are returned to or are repossessed by the seller or the secured party, the following rules determine priority."[80] The court found the conditions to the operation of the priority rules of section 9-306(5) were fulfilled:[81] The sale of equipment resulted in chattel paper; the chattel paper was transferred to Borg-Warner, a secured party; and the goods were repossessed by the secured party.[82]

Pursuant to section 355.9-306(5)(a), if a creditor's security interest had attached to goods prior to their sale, the security

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[78] KRS § 355.1-201(32).

[79] See KRS § 355.1-201(44) for the definition of value.

[80] KRS § 355.9-306(5).

[81] *See* 669 S.W.2d at 546.

[82] *See* text accompanying notes 70-72 *supra*.

interest reattaches to the goods upon their repossession if the debt of the secured creditor remains unpaid:[83] "If the goods were collateral at the time of sale for an indebtedness of the seller which is still unpaid, the original security interest attaches again to the goods and continues as a perfected security interest if it was perfected at the time when the goods were sold."[84] Prior to its sale, the equipment represented part of the collateral for the perfected security interest of Case.[85] The debt to Case remained unpaid throughout the sale of equipment, assignment of chattel paper, and repossession of the equipment.[86] Accordingly, although Case's security interest had been extinguished as to the equipment, section 355.9-306(5)(a) reattached the security interest to the equipment upon its repossession.

The logic of reattaching the security interest to the repossessed goods is valid.[87] When the equipment was sold, Case's security interest in the equipment was extinguished, but its security interest continued in the chattel paper proceeds of the equipment. When the goods were repossessed due to the purchaser's default in payment, the chattel paper no longer had value since the purchaser obviously was not going to continue making payments pursuant to the chattel paper. The only security for Island's obligation to Case was the repossessed equipment.

The same logic applies to a secured party in the situation of Borg-Warner, and Article Nine provides the same result. KRS section 355.9-306(5)(b) provides the "unpaid transferee of the chattel paper [Borg-Warner] has a security interest in the goods [the repossessed equipment] against the transferor." Borg-Warner expected payment through the chattel paper which became valueless due to default. Article Nine gave Borg-Warner a security interest in the goods and thus the goods represented a fund for the payment of the debt.

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[83] D. LEIBSON & R. NOWKA, *supra* note 17, at 789. The § (5)(a) secured party is generally an inventory secured party since sale and return, or sale and repossession, typically happen in the sale of inventory situation.

[84] KRS § 355.9-306(5)(a).

[85] 669 S.W.2d at 544-45.

[86] *Id.* at 546.

[87] *See* D. LEIBSON & R. NOWKA, *supra* note 17, at 789.

This scenario created a priority conflict in the equipment between Case and Borg-Warner. Arguably, either of two paragraphs of section 355.9-306(5) could have resolved the conflict, with a different result under each paragraph. Section 355.9-306(5)(b) provides: "Such security interest [the security interest given the unpaid transferee, i.e., Borg-Warner] is prior to a security interest asserted under paragraph (a) [9-306(5)(a), i.e., Case] to the extent that the transferee of the chattel paper was entitled to priority under KRS 355.9-308."[88] The priority in the goods under (5)(b) is given to the secured party who had priority in the chattel paper, in this instance, Borg-Warner.[89] Section 9-306(5)(d) provides: "A security interest of an unpaid transferee asserted under paragraph (b) or (c) [Borg-Warner] must be perfected for protection against creditors [Case[90]] of the transferor [Island] and purchasers of the returned or repossessed goods." Under (5)(d), the unpaid transferee is given priority over other creditors if it has perfected its security interest. Borg-Warner had not perfected its security interest and thus was not given priority over the perfected security interest of Case.

In its original opinion, the court of appeals decided the priority issue by applying the provisions of section 355.9-306(5)(d).[91] The court noted the priority scheme of (5)(b) and stated Borg-Warner would have had priority in the equipment to the extent it had priority in the chattel paper.[92] The court then made the following finding:

> KRS 355.9-306(5)(d), however, requires that the security interest assertable under KRS 355.9-306(5)(b) or (c) by a transferee of chattel paper must be perfected for protection against creditors of the transferor. Although Borg-Warner's lien in the equipment existed pursuant to KRS 355.9-306(5)(b), it was inferior to the reattached lien of Case because of Borg-Warner's failure to perfect.[93]

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[88] KRS § 355.9-306(5)(b).

[89] *See* text accompanying notes 76-77 *supra*.

[90] Case is considered a "creditor" of Island under the UCC's definition of creditor. KRS § 355.1-201(12) provides creditor "includes . . . a secured creditor."

[91] *See* 30 KLS 12, at 4 (Ky. Ct. App. Sept. 30, 1983).

[92] *Id.*

[93] *Id.* Although the court did not note the perfected status of Case, the secured creditor in Case's position is considered to have a perfected security interest in the repossessed goods if "the security interest was originally perfected by a filing which is still effective." KRS § 355.9-306(5)(a). Thus, Case, a perfected secured party, would defeat Borg-Warner, an unperfected secured party pursuant to KRS § 355.9-301(1)(a).

Thus, the court held Borg-Warner's security interest inferior to the security interest of Case.[94]

The court of appeals seems to have chosen (5)(d) over (5)(b) on the basis of language in a comment to the Official Text of the Uniform Commercial Code:

> For protection against dealer's creditors or purchasers from him (other than buyers in the ordinary course of business, see Section 9-307), Bank X [here, Borg-Warner] as the transferee, under paragraph (5)(d), must perfect its interest by taking possession of the [equipment] or by filing as to it. Perfection of his original interest in the chattel paper or the account does not automatically carry over to the [equipment], as it does under paragraph (5)(a) where the secured party originally financed the dealer's inventory.[95]

The court focused on the above part of the comment notwithstanding language in the same comment as follows:

> In the situation covered by (5)(b) and (5)(c) a secured party who financed the inventory and a secured party to whom the chattel paper or the account was transferred may both claim the returned goods - the inventory financier under paragraph (5)(a), the transferee under paragraphs (5)(b) and (5)(c). With respect to chattel paper, section 9-308 regulates the priorities.[96]

This paragraph of the comment indicates that (5)(d) has no application to the conflict between a (5)(a) secured party and a (5)(b) secured party. Thus, Borg-Warner's failure to perfect its security interest in the goods was of no relevance, because (5)(b) does not consider perfection a requirement for priority.

On rehearing the court reconsidered the issue of which paragraph of KRS section 355.9-306(5) governs priority and ultimately determined priority on the basis of section 9-306(5)(b). This switch in rationale seems to be based on the operation of UCC section 9-306(5) as interpreted by Grant Gilmore, one of the principal drafters of Article Nine. The court's opinion quotes two passages from Gilmore's treatise on security interests which support the conclusion that (5)(b) rather than (5)(d) governs the

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[94] *See* 30 KLS 12, at 4.

[95] *See id.* (quoting UCC § 9-306 comment 4 (1962)).

[96] UCC § 9-306 comment 4 (1962).

priority question in issue. Professor Gilmore's analysis—including the passages quoted by the court—follows:[97]

> The second sentence of paragraph (b) regulates the priorities in the goods between an unpaid inventory lender and an unpaid transferee of the chattel paper: reasonably enough, the chattel paper transferee wins if he took the chattel paper under circumstances which entitled him to priority over the inventory lender's claim to the chattel paper either as proceeds or as the result of some 'new transaction' relating to the paper itself. The priorities established by § 9-308 at the time of the chattel paper transaction thus survive the destruction of the chattel paper and continue in the returned or repossessed goods. The one point of difficulty is whether the chattel paper transferee's interest must be kept at all times perfected in order to prevail over the inventory lender's interest which "attaches again" when the goods are returned or repossessed and, let us assume, "continues perfected" under a still effective filing . . . *Although section 9-306(5) does not make the point expressly, it is believed that the transferee, [Borg-Warner] even though his interest has become unperfected, retains his priority over the inventory lender, [Case] even though the latter's interest continues perfected. . . . The chattel paper transferee [Borg-Warner] took priority over the inventory lender [Case] at the time of the chattel paper transaction; paragraph (b) continues those priorities with respect to the goods; lapse of the transferee's interest should not disturb the priorities. That this was the intended result is quite clear from paragraph (d) of subsection (5), which provides that a transferee's claim under paragraph (b) "must be perfected for protection against creditors of the transferor and purchasers of the returned or repossessed goods." The apparent inference is that the transferee's claim need not be perfected for protection against the paragraph (a) claim of the inventory lender (who is not aptly described as either a "creditor" or a "purchaser of the . . . goods").*[98]

Professor Gilmore's interpretation of section 9-306(5) is substantial authority,[99] but not the only authority, in favor of the

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[97] The emphasized portions represent the quotations contained in the court of appeals' opinion. *See* 669 S.W.2d at 546-47.

[98] G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 27.5, at 738-39 (1965) (emphasis added).

[99] *See* D. LEIBSON & R. NOWKA, *supra* note 17, at 789-90.

interpretation adopted by the court of appeals. The language of section 9-306(5)(b) itself specifically applies to the conflict between (5)(a) and (5)(b) secured parties.[100] Section 9-306(5)(d) applies only because the Uniform Commercial Code's definition of creditors includes a secured creditor.[101] As noted above, the comment to the Official Text also speaks specifically to the situation and gives priority in accordance with the priorities established as to the chattel paper.[102] The logic of employing (5)(b) rather than (5)(d) is valid. Without repossession, both parties have conflicting security interests in the chattel paper. Since the chattel paper is now without value, the UCC gives both parties a security interest in the repossessed goods and continues the priority established between the parties as to the chattel paper. Thus, the language of section 9-306(5), the comment to section 9-306(5), the commentators, and logic all support application of section 9-306(5)(b) to decide the priority issue.

Once it was established that (5)(b) should determine the priority issue, the issue became determining who had priority in the chattel paper. The court considered this question and correctly found that Borg-Warner had priority in the chattel paper.[103] Accordingly, Borg-Warner was given priority in the repossessed goods.[104] Borg-Warner's failure to perfect its security interest in the goods was of no consequence since (5)(b) does not require perfection for priority.[105]

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[100] *See* text accompanying note 88 *supra*.

[101] *See* note 90 *supra*.

[102] *See* UCC § 9-306(5) comment 4 (1962).

[103] *See* text accompanying notes 76-77 *supra*.

[104] *See* 669 S.W.2d at 546.

[105] Although § 9-306(5) gives no reason for not requiring perfection of the security interest, a possible rationale is as follows. As noted, § 9-306(5)(b) simply maintains the priority determined under § 9-308. While the language of § 9-308 does not literally require perfection by the purchaser of chattel paper in order to achieve priority, compliance with the conditions for priority mandated by § 9-308 results in a perfected security interest. (Note that pursuant to KRS § 355.9-102(1)(b) Article Nine applies even when the transaction is a sale of chattel paper.) A security interest is perfected when it has attached and the applicable steps required for perfection have been taken. KRS § 355.9-303(1). The security interest of the chattel paper purchaser has attached because the debtor has rights in the collateral (debtor was owner of the chattel paper), the secured party has given value (under § 355.9-308 the chattel paper purchaser must have given new value), and the collateral is in the possession of the secured party (under § 355.9-308 the purchaser must take possession of the chattel paper). KRS §§ 355.9-203(1), .9-204(1). The applicable step required for perfection is taken when the purchaser takes

One question remains: to whom does the priority rule of section 9-306(5)(d) apply? It applies to creditors other than the (5)(a) secured party and to purchasers of the repossessed or returned collateral.[106] The following example illustrates the operation of (5)(d). Suppose Gannon is an unpaid transferee of chattel paper who repossesses the collateral and places it with the transferor's inventory. Article Nine gives Gannon a security interest, but Gannon takes no steps to perfect it. If Kean purchases the collateral, or alternatively if Kean recovers a judgment against the "transferor" and levies on the collateral, Gannon's interest will be inferior to Kean's.[107] Once the goods are returned to the transferor's/debtor's inventory, it is possible that other creditors could acquire an interest in the collateral or that someone might buy the collateral. If those parties had no notice of Gannon's unperfected security interest, they should take free of it. Thus, section 9-306(5)(d) requires perfection of the transferee's interest for protection against subsequent creditors and purchasers.

III. A LITTLE HORSING AROUND BY THE KENTUCKY COURT OF APPEALS

In *North Ridge Farms, Inc. v. Trimble*,[108] a buyer of breeding season rights in a fractional share of a thoroughbred horse asserted its priority against a secured creditor with a security interest in the fractional share. This case is notable from two aspects. It appears to be the first time a Kentucky appellate court considered a security interest in a thoroughbred horse.

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possession of the chattel paper. KRS §§ 355.9-302, .9-305. Thus, the chattel paper purchaser, e.g., Borg-Warner, has in fact perfected its security interest in the chattel paper by fulfilling the requirements of § 355.9-308 and has a superior interest over the claimant, e.g., Case, of the chattel paper merely as proceeds of inventory. Since § 355.9-306(5)(b) simply carries over the § 355.9-308 priority, no perfection as to the goods themselves is necessary.

[106] *See* D. LEIBSON & R. NOWKA, *supra* note 17, at 790.

[107] Of course this result assumes Kean complied with either KRS § 355.9-301(1)(c) as a purchaser or with KRS § 355.9-301(1)(b) as a lien creditor. Note also that the § 9-306(5)(d) creditor could be a secured creditor who takes a security interest in the goods subsequent to their return to inventory.

[108] 30 KLS 15, at 2 (Ky. Ct. App. Dec. 2, 1983), *discretionary rev. granted*, 31 KLS 15, at 19 (Ky. Nov. 9, 1984). The Kentucky Supreme Court heard the case on April 25, 1985.

Moreover, the horse involved in the controversy was Affirmed, thoroughbred racing's last Triple Crown winner.

Louis E. Wolfson, owner of Affirmed, had entered into a syndication agreement regarding the thoroughbred, with Combs Stallion Inc. as syndication manager. The agreement provided that ownership of Affirmed would be divided into thirty-six equal shares. Each share included voting rights regarding replacement of the syndicate manager and removal of Affirmed to another farm. Each share also entitled its owner to nominate one mare per breeding season to be bred to Affirmed.[109] In January of 1979, Anita Arbour purchased one fractional share of Affirmed. As part of the consideration for the purchase, Arbour gave Wolfson a promissory note secured by a security interest in the fractional share.

In July of 1979, Arbour purchased a filly from North Ridge Farms, Inc. In downpayment, Arbour assigned to North Ridge her 1982 breeding season right to nominate a mare to be bred to Affirmed. Arbour subsequently defaulted on payment of a promissory note representing the balance due for the purchase of the filly. As a result, the purchase agreement was rescinded and two new agreements were executed in May of 1980. These agreements cancelled the promissory note and provided that Arbour would sell her 1982 breeding rights in Affirmed to North Ridge for $50,000.[110]

The syndication agreement allowed the owner of a fractional share to sell, transfer or assign annual breeding seasons, provided notice of such transfer was given to the syndicate manager within ten days of the transfer. Combs Stallion indicated it would not approve the transfer of the breeding season because Arbour was in default under the terms of the syndication agreement.[111]

In 1981, Wolfson, upon Arbour's default of her obligation under the syndication agreement, repossessed Arbour's fractional

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[109] *Id.* The court noted that the primary benefit of share ownership is the right to an annual nomination of a mare. *See id.*

[110] *Id.* In the agreement Arbour warranted her title to the 1982 breeding season nomination to be free of liens and encumbrances except for Wolfson's security interest. *Id.*

[111] *Id.* at 3. Note, however, the syndication agreement did not require the syndicate manager's approval, but only that notice be given. *See id.* at 2.

share of Affirmed and gave notice he would sell the share unless it was redeemed pursuant to KRS section 355.9-506.[112] In a private sale held on October 5, 1981, Stathatos and Malisos, two other creditors of Arbour with security interests in the share, "redeemed Wolfson's rights in the collateral; and Wolfson acknowledged that all his right, title and interest in the collateral was thereupon transferred to Stathatos and Malisos [the two secured creditors]."[113]

As a result of the various transfers, North Ridge claimed, as a purchaser, Arbour's 1982 breeding season right in Affirmed, and Stathatos and Malisos claimed the breeding season pursuant to their "redemption" of Wolfson's security interest rights. Thus, the court found the issue to be whether North Ridge purchased Arbour's 1982 breeding rights free of the security interest of Wolfson (now Stathatos and Malisos) in Arbour's fractional share.[114]

The court ultimately held North Ridge did purchase Arbour's 1982 breeding rights in Affirmed free of the security interest.[115] In deciding this issue, the court applied and analyzed sections of UCC Article Nine which were unnecessary to its decision. Since the issue was whether the security interest survived the sale to North Ridge, the court could have begun and ended with a consideration of KRS section 355.9-306(2).

KRS section 355.9-306(2) provides:

> Except where this article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof by the debtor unless his action was authorized by the secured party in the security agreement or otherwise. . . ."

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[112] *Id.* KRS § 355.9-506 provides that after default the debtor or other secured party with a security interest in the collateral may redeem the collateral before the disposition upon "tendering fulfillment of all obligations secured by the collateral." Note that the notice of sale required by KRS § 355.9-504 does not require the secured party to give notice of the redemption rights.

[113] 30 KLS 15, at 3. Although the opinion states Stathatos and Malisos "redeemed Wolfson's rights" in the collateral, it would seem that in reality Wolfson must have assigned them his rights in the collateral, i.e., his rights under the security interest. This conclusion is reached because under KRS § 355.9-506 it is the collateral that is redeemed, not the secured party's right, title and interest.

[114] *Id.*

[115] *Id.* at 5.

The court noted its disagreement with the circuit court's finding that this section was "inapplicable" to the sale of the breeding season.[116] Section 355.9-306(2) determines whether a security interest in collateral which has been sold is terminated or continues notwithstanding the sale.[117] If the security interest in the collateral is terminated, the buyer of the collateral takes it free of the security interest; if not, the buyer takes the collateral subject to the security interest.[118]

In order for the security interest in the collateral to be terminated, the court must find that the secured party authorized the sale of the collateral. According to section 9-306(2), this authorization can be contained in the security agreement itself or the sale can be "otherwise" authorized. This "otherwise" authorization includes authorizations which are implied by a secured party's conduct.[119] It should also include written permission to sell found in documents other than the security agreement.[120] Since authorization to sell can be implied by conduct alone, an even stronger case for authorization arises when permission to sell is expressed in a written agreement.[121]

The court noted the language of the syndication agreement which "entitled Arbour as owner of Fractional Interest No. 17 to sell, transfer or assign her annual breeding seasons provided she gave written notice of such a transfer to the syndicate manager within 10 days after the transfer."[122] Relying on this provision, the court found the syndication agreement clearly authorized the sale of breeding seasons.[123]

The syndicate manager would not approve the sale to North Ridge because Arbour was in default under the syndication agreement.[124] However, the court found this default to be of no consequence to the operation of KRS section 355.9-306.[125] The court stated that, since the syndication agreement set forth no

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[116] *See id.* at 4.
[117] *See* D. LIEBSON & R. NOWKA, *supra* note 17, § 8.4(D), at 782-84.
[118] *Id.*
[119] *See id.* at 783-84. *See also id.* at 886 nn.621-22.
[120] *See id.* at 784.
[121] *See id.* at 784-85.
[122] 30 KLS 15, at 2.
[123] *See id.* at 5.
[124] *See id.* at 3.
[125] *See id.* at 5.

conditions or exceptions to the free transferability of breeding seasons, the fact Arbour had defaulted was irrelevant to her ability to transfer a breeding season.[126] The court also stated that the syndicate manager's approval was not necessary since the syndication agreement "required . . . merely notice of the sale."[127] Clearly the sale of the breeding season was authorized; the only issue remaining was whether the sale of the breeding season constituted a sale of "collateral."

As defined by KRS section 355.9-105(1)(c) "collateral" means the property subject to a security interst.[128] The collateral for Wolfson's security interest was Arbour's ownership of a share of Affirmed. One right of ownership was the annual right to nominate a mare to be bred to Affirmed. Thus, the right to the breeding season was part of the "collateral." The sale of a part of the collateral is no less a sale of collateral contemplated by KRS section 355.9-306(2) than a sale of the whole of the collateral.[129] An analogy to a more typical sale of part of the collateral may be helpful. If the collateral for a security interest consists of "all the debtor's inventory" a sale of one unit of the inventory is still deemed a sale of collateral even though the whole of the collateral is not sold.[130]

The court of appeals had no difficulty in finding the sale of the breeding season constituted a sale of collateral:

> There is no question that the 1982 breeding season was 'collateral,' being as it was a part of what was conveyed by

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[126] *Id.*

[127] *Id.*

[128] KRS § 355.9-105(1)(c) states that, "collateral means the property subject to a security interest, and includes accounts, contract rights and chattel paper which have been sold." *Id.*

[129] See KRS § 355.2-105(3) which allows a "sale of a part interest in existing identified goods." The court in *North Ridge Farms* stated:

> [T]here may be a part interest of a sale in goods: we have held that Fractional Interest No. 17 in the hands of Arbour was itself goods, specifically a farm product. However, sale of the 1982 breeding season conveyed nothing more than the right to breed the horse during that limited time period; it conveyed no actual ownership interest or fractional interest. We hold that the 1982 breeding season in the hand of North Ridge is classifiable as a "general intangible."

30 KLS 15, at 4.

[130] However, the Court stated that "a precise definition of the breeding season is unnecessary for purposes of KRS § 355.9-306." *Id.* at 5. *See also* note 131 *infra.*

> Fractional Interest No. 17; that it was personal property; that it was included in the definition of collateral. . . .[131]
>
> Therefore the security interest in the 1982 breeding season terminated when Arbour sold same to North Ridge. . . .
>
> We hold that the trial court erred in failing to hold that by virtue of KRS 355.9-306 appellant, North Ridge Farms, Inc., purchased the 1982 Affirmed breeding season from Arbour free and clear of the security interest of Wolfson. . . .[132]

As the quotation clearly indicates, the analysis of KRS section 355.9-306(2) determined whether North Ridge purchased the breeding rights free of the security interest. However, for unexplained reasons,[133] the court chose to consider the applicability of other sections of the UCC to security interests in fractional shares of a thoroughbred horse.

The court considered whether North Ridge bought the breeding season free of the security interest pursuant to KRS section 355.9-307(1).[134] This section provides that a buyer in the ordinary course of business takes free of a perfected security interest created by his seller.[135] A buyer in the ordinary course of business is defined by KRS section 355.1-201(9):

> "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.

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[131] 30 KLS 15, at 5. There is no reason to determine the classification of the "collateral"—e.g., inventory, chattel paper, general intangibles, farm product—because KRS § 355.9-306(2) does not depend on the classification but on whether the "collateral" was sold. Thus the only inquiry is whether the breeding season represents "collateral."

[132] *Id.*

[133] The court stated that the "application of the Uniform Commercial Code to the thoroughbred horse industry in Kentucky presents its own unusual problems in analysis and interpretation of the character of various transactions that are common in the business." *See id.* at 3. Perhaps the court simply wanted to give guidance to practitioners dealing with security interests in this type of collateral since no Kentucky case appears to have interpreted Kentucky's Uniform Commercial Code as applied to this situation.

[134] *See* 30 KLS 15, at 4 (Ky. Ct. App. Dec. 2, 1983).

[135] *See* KRS § 355.9-307(1).

Although the requirements for section 355.9-307(1) protection are numerous,[136] its benefit is great—a buyer meeting the requirements takes the collateral free of the security interest.

The circuit court had held KRS section 355.9-307(1) inapplicable because North Ridge had not bought the breeding season in accordance with the statutory definition of buying.[137]

As the court of appeals noted: KRS section 355.1-201(9) defines "buying" (part of the definition of a buyer in the ordinary course of business) to exclude a transfer "in total or partial satisfaction of a money debt."[138]

> Because Arbour attempted to assign the 1982 breeding season to North Ridge as a down payment for the purchase of the filly . . . but later sold the breeding season to North Ridge for $50,000 in conjunction with her return of the filly for inability to pay for it, the trial court found that the sale to North Ridge was at least in partial satisfaction of a debt from Arbour to North Ridge. . . .[139]

Thus, if Arbour's sale of breeding rights to North Ridge was, as the circuit court found, in partial satisfaction of a money debt, North Ridge did not *buy* the breeding season and could not be a "buyer in the ordinary course of business."

The sale price of the filly purchased by Arbour from North Ridge was $170,000. The consideration for the sale consisted of the breeding season and a promissory note in the amount of $95,000. Thus, it appears the breeding season was valued at $75,000. When Arbour defaulted on the promissory note, the sales agreement was rescinded, and two new agreements were executed wherein the $95,000 promissory note was cancelled and North Ridge purchased the breeding season of Affirmed for $50,000. Given this difference in valuation of the breeding season,[140] the circuit court could have reasoned that part of the

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[136] The requirements are: (1) good faith; (2) without knowledge that the sale violates the ownership rights or security interest of a third person; (3) buys; (4) in ordinary course; (5) from a person engaged in the business of selling goods of the kind involved; and (6) security interest is created by buyer's "seller." *See* KRS §§ 355.1-201(9) & 355.9-307(1). *See also* D. LEIBSON & R. NOWKA, *supra* note 17, § 8.4(C) at 756.

[137] 30 KLS 15, at 4.

[138] *See* KRS § 355.1-201(9).

[139] 30 KLS 15, at 4.

[140] The contract to purchase the filly was executed in July of 1979, while the agreements after the default were entered into in May of 1980. There is nothing to indicate that the value of a breeding season to Affirmed declined in value over that 10 month period.

consideration North Ridge paid for the breeding season was forbearance or cancellation of its rights against Arbour—those rights consisting of a money debt Arbour owed North Ridge as a consequence of Arbour's breach. Following this logic to its conclusion, the consideration North Ridge gave for the purchase of that breeding season was satisfaction of a preexisting money debt, and North Ridge would not be a buyer in the ordinary course of business.[141] The court of appeals, however, did not base its rejection of North Ridge's buyer in the ordinary course of business status on the definition of "buying."

The court noted that it was inclined to decide the section 355.9-307(1) issue on the fact that Arbour was not "in the business of selling goods of [the] kind" involved in the transaction.[142] Basing a decision on that requirement would have mandated a finding that Arbour was not a person in the business of selling breeding seasons.

The Official Comment to section 9-307 defines the requirement as relating "primarily to inventory."[143] Many cases are in agreement.[144] Thus, in order to buy from a person "in the business of selling goods of that kind," it can be argued the buyer must be buying a seller's inventory.[145] When a buyer buys goods held for resale, i.e., inventory, she is buying them from a person in the business of selling that kind of goods. Even assuming that breeding seasons can be characterized as inventory,[146] the facts noted in the opinion do not indicate whether

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[141] *See, e.g.,* Ray v. City Bank & Trust Co., 358 F. Supp. 630, 639 (S.D. Ohio 1973) (plaintiff's purchase was partial satisfaction of preexisting debt; therefore, plaintiff was not "buyer in the ordinary course."); Osborn v. First Nat'l Bank, 472 P.2d 440, 442 (Okla. 1970) (where sale is made to creditor upon satisfaction of antecedent indebtedness, creditor is not "buyer in ordinary course of business."); Chrysler Credit Corp. v. Malone, 502 S.W.2d 910, 913 (Tex. Civ. App. 1973) (since transfer of automobile was in partial satisfaction of money debt transferor owed to transferee of automobile, transferee was not "buyer in the ordinary course of business.").

[142] *See* 30 KLS 15, at 4. Being "in the business of selling goods of that kind" is a requirement of buyer in ordinary course of business status. KRS § 355.1-201(9) (1970).

[143] *See* UCC § 9-307 comment 2 (1962).

[144] *See, e.g.,* Al Maroone Ford, Inc. v. Manheim Auto Auction, Inc., 208 A.2d 290, 292 (Pa. Super. Ct. 1965) ("Under our cases a sale in the ordinary course normally means a sale from inventory."); Farmers & Merchants Nat'l Bank v. Ksenych, 252 N.W.2d 220, 223 (S.D. 1977) ("[T]he terminology of the article is primarily restricted to inventory.").

[145] *See* KRS § 355.9-109(4).

[146] *See* KRS § 355.9-109(4) which provides that "inventory" is a subcategory of "goods." Thus a breeding season must also be characterized as a "good" for KRS § 355.9-307(1) protection.

Arbour was in the business of selling breeding seasons. However, neither the language of section 355.9-307(1) nor the language of section 355.1-201(9) requires the sale to be of inventory. As one court has held, the requirement is that the purchase be made from a seller in the business of selling goods of that kind, not that the goods be inventory.[147] Thus, if the facts indicate Arbour was a seller of breeding seasons, North Ridge could argue it had fulfilled that criterion.

Even if Arbour were a person who sells breeding seasons, North Ridge would still have a difficult time meeting the buyer in the ordinary course of business standard for the reason on which the court of appeals ultimately focused. Although "inclined" to preclude North Ridge from section 355.9-307(1) protection because Arbour was not in the business of selling breeding seasons, the court instead denied North Ridge this protection on the ground that the breeding season was not a good.[148] Although the language of section 9-307(1) does not limit its protection to buyers of goods the Official Comment to that section clearly shows that this was the intent of the drafters: "This section states when *buyers of goods* take free of a security interest even though perfected."[149] Moreover, section 355.1-201(9) provides:

> "Buyer in the 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.[150]

Accordingly, it seems certain that the buyer must be buying goods. "Goods" are defined in section 355.9-105(1)(f):

> "Goods" includes all things which are movable at the time the security interest attaches or which are fixtures, but does not include money, documents, instruments, accounts, chattel pa-

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[147] *See In re* Morristown Lincoln-Mercury, Inc., 25 Bankr. 377, 388 (Bankr. E.D. Tenn. 1982) ("The statutory definition of buyer in the ordinary course of business does not require a conclusion that the goods purchased were inventory.").

[148] *See* 30 KLS 15, at 4. *See also* note 129 *supra*.

[149] *See* UCC § 9-307 comment 1 (1962) (emphasis added).

[150] KRS § 355.1-201(9) (emphasis added).

per, general intangibles, contract rights and other things in action. "Goods" also includes the unborn young of animals and growing crops.

A breeding season is part of the bundle of rights which comprise a fractional ownership interest in a horse. To be a good, the breeding season must be movable, and it seems impossible that a breeding season can fulfill this requirement. The Official Comment to section 9-105 states that the Article Nine definition of goods is similar to the Article Two definition.[151] The Article Two definition also speaks in terms of goods being "movable."[152] However, both the Article Nine and the Article Two definitions specifically include the unborn young of animals, a type of personal property which also seems to be hard pressed to be "movable," as goods.[153] Thus, possibly in anticipation of the argument that such property should not be considered "movable," the UCC made a specific inclusion for that type of property.

Whether a breeding season constitutes a good is certainly debatable. The court of appeals chose to characterize a breeding season as a general intangible.[154] " 'General intangibles' means any personal property (including things in action) other than goods, accounts, contract rights, chattel paper, documents and instruments."[155] Given the problems of characterizing a breeding season, this issue will not be extensively discussed since North Ridge did not need to rely on KRS section 355.9-307(1) to protect itself from the security interest.[156] As previously discussed, North Ridge clearly had a superior interest in the breeding season since its authorized sale extinguished the security interest in the season. Nevertheless, the court of appeals held that North Ridge, because it did not buy "goods," did not come within the protection KRS section 355.9-307(1) affords a buyer in the ordinary course of business.[157]

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[151] *See* UCC § 9-105 comment 3 (1962).
[152] *See* KRS § 355.2-105(1).
[153] *See* KRS §§ 355.2-105(1), .9-105(1)(f).
[154] *See* 30 KLS 15, at 4.
[155] KRS § 355.9-106.
[156] *See* notes 115-132 *supra* and accompanying text.
[157] *See* 30 KLS 15, at 4.

The court of appeals also deemed it important to decide how the fractional share in Affirmed should be characterized.[158] The choices for characterization of the breeding season seemed to be either as a good or as a general intangible.[159] Of course Affirmed is a "good" and since Article Two allows a sale of a part interest in goods[160] it can be argued, as the court of appeals noted, that "division of [Affirmed's] ownership between or among several individuals should have no effect on the existing status as 'goods.'"[161] However, as also noted by the court, the primary value of a fractional share lies in the breeding rights.[162] It could be argued that the breeding rights are the collateral and that the collateral, thus, seems to be a general intangible.[163]

Resolving this issue requires considering what was sold to Arbour. "The syndicate agreement . . . purported to convey undivided interests in the stallion and specifically categorized the owners of the fractional shares as tenants in common."[164] Among the ownership rights were entitlement to nominate one mare per breeding season to be bred to Affirmed and voting rights relating to control of Affirmed which enable a majority of shareowners to move the stallion to another farm or to replace the syndicate manager.[165] Thus, notwithstanding the fact that the primary economic benefit of owning a share was breeding rights, ownership also entailed additional rights.

While a breeding right seemed to be properly characterized as a general intangible, ownership of an undivided interest in a good seems to rise above a general intangible and attain the status of goods. As the court stated: " We believe that [Arbour] purchased, as a tenant in common, an actual part ownership in

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[158] *See id.* at 4. Note that the characterization of the collateral was not necessary to enable North Ridge to have a superior right in the breeding season pursuant to KRS § 355.9-306(2). *See* text accompanying notes 128-133 *supra.*

[159] *See* 30 KLS 15, at 3-5. Neither "contract right" nor "account" in KRS § 355.9-106 seems applicable because both speak in terms of a "right to payment," and a fractional share of a thoroughbred is not connected with a right to payment.

[160] *See* KRS § 355.2-105(3).

[161] 30 KLS 15, at 3.

[162] *See id.*

[163] *See id.* at 4-5.

[164] *Id.* at 3.

[165] *Id.* at 2.

the horse and that the nature of that part ownership . . . is that it is goods."[166]

The court found support for its position in the United States Tax Court decision of *Harry F. Guggenheim*.[167] In *Guggenheim*, the Internal Revenue Service argued that the sale of fractional shares of a horse was actually a sale of breeding rights and thus not within the definition of property that qualified as a capital asset.[168] The taxpayer argued that the fractional shares represented undivided ownership interests in the horse and that he had, thus, sold ownership of a horse—a capital asset.[169] The Tax Court noted the syndication agreement purported to pass undivided ownership interests and found the rights of a purchaser of a fractional share are significantly different from the rights of a purchaser of a breeding season.[170] Although the court believed that the rights of a shareholder may have no substantial economic value above the rights of a breeding season holder, the court noted that the rights of a shareholder "are substantive indicia of ownership, and, when combined with the form of the transaction, lead us to believe that the property interests transferred by the syndication agreement should be considered undivided ownership interests."[171]

In finding that the fractional share was "goods," the Kentucky Court of Appeals did not discuss whether the collateral was "movable," the primary requirement for goods.[172] Since the syndication agreement provided that the fractional shareholders owned undivided interests in the horse, each shareholder was given ownership in the horse, and the horse was movable. Thus, each fractional share was also "movable."

Even with the above logic, the characterization of a fractional share in a thoroughbred is a difficult issue, and solid arguments can be made for designating the fractional share as

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[166] *Id.* at 3.

[167] 46 T.C. 559 (1966). For a further discussion of the problem of characterization and support for the characterization of thoroughbred shares as "goods," see Lester, *Security Interests in Thoroughbred and Standardbred Horses: A Transactional Approach*, 70 KY. L.J. 1065, 1076-82 (1981-82).

[168] *See* 46 T.C. at 565.

[169] *See id.*

[170] *See id.* at 566-67.

[171] *Id.* at 567-68.

[172] *See* 30 KLS 15, at 3; KRS § 355.9-105(1)(f).

either a good or a general intangible.[173] The court indicated its characterization of the collateral as goods was largely dependent on the syndication agreement and then cautioned that such agreements must be "considered individually" in characterization problems.[174] In any event, the court should have resisted the temptation to decide a difficult issue unnecessary to resolving the case.[175]

It seems the court's purpose in determining the proper characterization of the collateral was to determine whether the security interest was perfected by the proper filing of a financing statement.[176] Characterization of collateral is necessary to determine whether a financing statement has been properly filed, since the place of filing depends in part on the nature of the collateral.[177] However, KRS section 355.9-306(2) operates to extinguish the security interest, whether perfected or unperfected, in the collateral sold if the sale was authorized.[178] Thus, whether the security interest was perfected was irrelevant.

In summary, the Kentucky Court of Appeals properly held North Ridge had a superior interest in the 1982 breeding season of Affirmed. The only rationale needed for that holding was that, under KRS section 355.9-306(2), where the sale of a breeding season is authorized by the secured party, the security interest in the collateral sold is extinguished.

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[173] *See* 30 KLS 15, at 3-4; Lester, *supra* note 167, at 1079.
[174] *See* 30 KLS 15, at 3.
[175] *See* text accompanying notes 128-133 *supra*.
[176] *See* 30 KLS 15, at 3-4.
[177] *See* KRS § 355.9-401(1) (Bobbs-Merrill Cum. Supp. 1984).
[178] KRS § 355.9-306(2).