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UNIFORM COMMERCIAL CODE'S ARTICLE 9—WHEN FILING IS NOT REQUIRED TO PERFECT A SECURITY INTEREST

Perfection of a security interest under Article 9 of the Uniform Commercial Code is generally accomplished by filing a financing statement.¹ However, there are some transactions which are exempt from the filing requirements and some to which the filing requirements of Article 9 do not apply. Section 9-302 briefly outlines these transactions. This note is an attempt to analyze section 9-302 and to classify these non-filing situations into four basic categories.

POSSESSORY SECURITY INTERESTS

Section 9-302(1)(a) provides that a security interest in collateral which is in the possession of the secured party is perfected without filing. This exception to filing is a continuation of the common law of pledge. The general rule at common law is that a pledge need not be recorded.² This is based on the theory that possession of the collateral is the best evidence of a security interest and that to record this interest would be superfluous and useless. In Kentucky, however, the court of appeals had construed Kentucky Revised Statute 382.270 to mean that recording was necessary for a pledge transaction to be valid against a subsequent lien creditor.³ In a recent case decided after the adoption of the Code, the court stated that this statute was no longer applicable to transactions falling under Article 9.⁴

Under the Code perfection by possession can only be accomplished when the collateral is goods, chattel paper, negotiable documents or instruments.⁵ Goods include "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 paper, general intangibles, contract rights and things in action."⁶ Chattel paper is defined as "a writing or writings which evidence both a monetary obligation and a security interest in a lease of specific goods."⁷ Ordinary examples of chattel paper are conditional sales contracts and chattel mortgages. This means that if the creditor in a conditional sales transaction wishes to use the conditional sales contract as

¹ Uniform Commercial Code § 9-302 [hereinafter cited as UCC]. The Code has been enacted into law as ch. 355 of the Ky. Rev. Stat. Hereinafter this note cites only the section number of the Code, omitting Ky. Rev. Stat.

² 72 C.J.S. *Pledges* § 18 (1951).

³ *Meade v. Wells*, 309 Ky. 748, 218 S.W.2d 972 (1949).

⁴ *Lincoln Bank & Trust Co. v. Queenan*, 344 S.W.2d 383 (Ky. 1961).

⁵ UCC § 9-305, official comment 1.

⁶ UCC § 9-105 (1)(f).

⁷ UCC § 9-105 (1)(b).

security in another transaction in which he is the debtor, then the secured party in the second agreement may perfect by taking possession of the conditional sales contract. This does not mean that the original conditional sale can be perfected without filing. This applies only when the chattel paper itself is used for security. The term negotiable document refers to bills of lading, dock warrants, warehouse receipts and other similar documents.⁸ Instrument is defined simply as a negotiable instrument which evidences a right to payment of money, but is not itself a security agreement.⁹ The best example of this is a promissory note.

The possessory security interest is the most effective type of security because the secured party has control of the collateral. There are numerous situations, however, when it is not convenient for the debtor to give up possession of the mortgaged article. The underlying purpose of Article 9 is not only to offer protection to the secured party, but also to permit the greatest economic benefit to society by allowing use of the collateral.¹⁰ Therefore, use of the possessory type of security interest should be confined to transactions where the collateral has limited economic utility. It is evident that perfection by possession should be rarely used when the collateral is goods.

Chattel paper, documents and instruments have little or no economic utility. In most situations involving this type of collateral it is not only permissible, but also advisable, for the secured party to perfect by taking possession. Be that as it may, chattel paper or documents may be left in the hands of the debtor and the security perfected by filing. If, for example, the security interest were in a conditional sales contract held by a merchant, the secured party might feel that it is necessary to leave the chattel paper in the possession of the merchant and allow him to collect. In this situation the security interest may be perfected by filing, but certain purchasers of the chattel paper take free of the security interest. Section 9-308 provides that a purchaser gains priority over a security interest perfected by filing, if in the ordinary course of business he gives new value and takes possession of the chattel paper without knowledge of the security interest. Since the Code definition of a purchaser includes not only a buyer, but also a mortgagee of collateral,¹¹ perfection by filing alone is hazardous. If the debtor is allowed to retain possession of the chattel paper, the secured party should not only file to perfect, but also

⁸ UCC § 9-105 (1)(e); § 1-201 (15).

⁹ UCC § 9-105(1)(g).

¹⁰ Spivack, Secured Transactions 78 (1960).

¹¹ UCC § 1-201(31)&(32).

protect himself against purchasers by noting his security interest on the paper itself.¹²

Security interests in instruments may be perfected only by possession.¹³ This is based on the universal practice of instruments being turned over to the secured party when they are used as security. It is obvious that to allow a security interest in a promissory note to be perfected by filing would serve no useful purpose.

Perfection of security interests in negotiable instruments and documents does not affect the rights of holders in due course under Article 3 of the Code.¹⁴ When a debtor, who is in possession of negotiable paper, transfers it to a holder in due course, the transferee will prevail over the secured party even though his interest is perfected under Article 9.¹⁵ Therefore, a secured party should exercise caution before delivering negotiable collateral to his debtor. Even though he may be temporarily protected against creditors,¹⁶ his interest is still susceptible to being extinguished by a buyer who is a holder in due course.

A security interest in accounts,¹⁷ contract rights¹⁸ or general intangibles¹⁹ can never be perfected by the secured party taking possession of the collateral. This is not altered by the fact that the security agreement describes the assignment of the collateral as a "pledge." Generally this type of security interest may be perfected only by filing.²⁰ However, section 9-302(1)(e) exempts from the filing requirement "an assignment of accounts or contracts rights which does not alone or in conjunction with other assignments to the same assignee transfer a significant part of the outstanding accounts or contract rights of the assignor. . . ." This exemption from filing is not based on possession of the collateral by the secured party, but rather upon the public policy of saving casual or isolated assignments from automatic invalidation by broadly drafted accounts receivable statutes.²¹

¹² UCC § 9-308, comment 2.

¹³ UCC § 9-304(1).

¹⁴ "A holder in due course is a holder who takes the instrument (a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person." UCC § 3-302(1).

¹⁵ UCC § 9-309.

¹⁶ See UCC § 9-304(4) and (5).

¹⁷ "Account" means any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper. UCC § 9-106.

¹⁸ "Contract right" means any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper. UCC § 9-106.

¹⁹ "General intangibles" means any personal property (including things in action) other than goods, accounts, contract rights, chattel paper, documents and instruments, UCC § 9-106.

²⁰ UCC § 9-305, comment 1.

²¹ UCC § 9-302, comment 5.

Kentucky had no accounts receivable statute before the enactment of the Code, and the court of appeals had gone so far as to hold that an assignment of a close in action was unrecordable, since it was not set out in Kentucky Revised Statute 382.270.²² Today, under the Code, the general rule is that anyone who regularly takes assignments of accounts receivable should file.

There are two other exemptions to filing that seem to be based primarily on possession of the collateral by the secured party. No filing is required so long as a collecting bank retains possession of an item²³ for which it has not received final settlement in order for its security interest in the item to be perfected under Article 9.²⁴ Once possession is given up for any reason other than collection the security interest in the item is lost.²⁵ In a sales transaction arising under Article 2 (Sales), no filing is required to perfect a security interest that the seller retains so long as the buyer does not lawfully obtain possession of the goods.²⁶

PURCHASE MONEY SECURITY INTERESTS IN CERTAIN GOODS

A purchase money security interest is defined by section 9-107 as:

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

Prior to the Code a "purchase money interest" was limited to the concept given it in subsection (a), *i.e.*, a seller retaining a security interest in goods that he sells.²⁷ Subsection (b) extends the term to include a transaction where the secured party lends money to the debtor to purchase certain goods and the money is actually used to purchase the specific goods. There is no limit placed upon the amount of time which may lapse between the borrowing of the money and the purchasing of the goods.²⁸

Sections 9-302(1)(c) and (1)(d) exempt from filing purchase money security interests in all consumer goods and farm equipment

²² National Sur. Corp. v. Massachusetts Bonding & Ins. Co., 280 Ky. 785, 134 S.W.2d 611 (1939).

²³ "Item" means any instrument for the payment of money even though it is not negotiable but does not include money. UCC § 4-104(1)(g).

²⁴ UCC § 4-208(3)(b).

²⁵ *Ibid.*

²⁶ UCC § 9-113(b).

²⁷ Birnbaum, Secured Transactions under the Uniform Commercial Code § 11.9 (1954).

²⁸ *Ibid.*

having a purchase price not in excess of 2,500 dollars. Filing is required, however, to perfect a security interest in fixtures and motor vehicles required to be licensed which fall within the classification of either consumer goods or farm equipment. It is obvious that to apply this section there must be some simple method of distinguishing fixtures from consumer goods or farm equipment. The drafters of the Code have not provided this distinction. Consumer goods are defined as those "used or bought for use primarily for personal, family or household purposes."²⁹ Goods used primarily in the business of farming which are not inventory or farm products are considered farm equipment.³⁰ But the definition of a fixture is left to be decided by the real property law of the jurisdiction.³¹ This seems to assume that the real property law of most jurisdictions is fairly specific in determining when goods cease to be chattels and become fixtures. Nothing could be further from the truth.

The law on this point is uncertain and conflicting throughout the country.³² The Kentucky court has held that for a chattel to become so affixed to the realty as to constitute a fixture there must be: (1) actual or constructive annexation to the realty; (2) an adaptation to the use or purpose that the part of the realty to which it is connected is appropriated; and (3) an intention of the parties that the article be made a permanent accession to the freehold with title to the article in the one owning the freehold.³³ This is a test for determination by a jury. The burden of predicting how a jury would subsequently decide the question is placed on the merchant each time he makes a conditional sale of an article such as a washing machine or an air conditioner. The only safe thing for the secured party to do is to file the security interest with the real estate records as a fixture.³⁴ This seems to defeat the purpose of sections 9-302(1)(c) and (1)(d). One of the principle reasons these exemptions to filing are allowed is because it would place a heavy burden on the merchant to have to file each time he made a conditional sale of consumer goods or small farm equipment. The burden is the same if out of uncertainty he must file a large part of his conditional sales with the fixture records.

Section 9-307(2) provides that, if a buyer of consumer goods or farm equipment worth less than 2,500 dollars takes without knowledge

²⁹ UCC § 9-109(1).

³⁰ UCC § 9-109(2).

³¹ UCC § 9-313(1).

³² See Coogan, *Security Interests In Fixtures Under The Uniform Commercial Code*, 75 Harv. L. Rev. 1319 (1962).

³³ *Tarter v. Turpin*, 291 S.W.2d 547 (Ky. 1956).

³⁴ Under Article 9 fixtures are filed with the real estate records and not the chattel records. UCC § 9-313, comment 5.

of the security interest, gives value, and buys the article for his personal, family, household or farming purposes, he takes free of any security interest unless it was filed prior to the purchase. This favored treatment of other consumers and farmers who buy the collateral second hand for their own use can be defended on the grounds that they should not be held to as high a standard of care when buying as the businessman because they are unaccustomed to the intricacies of secured transactions. This will probably not result in a mass filing of this type of security interest because most secured parties would rather risk having the collateral sold to a consumer or farmer, than go to the expense of filing financing statements on every small consumer sale.³⁵ In any event, if the secured party wants absolute protection against his security interest being extinguished, he must file a financing statement.

Before the adoption of the Code in Kentucky all conditional sales had to be recorded in order to be valid against either a creditor or a bona fide purchaser.³⁶ Actually, under section 9-302, the rule is still basically the same, with only purchase money security interests in consumer goods and small farm equipment that could never become fixtures being perfected as to lien creditors without filing a financing statement.

CONTINUING PERFECTION

Article 9 outlines two situations in which perfected security interests continue to be perfected even though either the collateral or the security interest changes hands. Where a secured party assigns a perfected security interest, the assignee is not required to file in order to continue the perfected status of the security interest against the debtor's transferees and creditors.³⁷ In other words, the assignee is in the same position as the assignor was before the assignment. If, however, the assignment was itself intended for security, then the assignee must perfect this security interest in order to be protected against the assignor's transferees and creditors.³⁸

A security interest in proceeds continues perfected for a ten day period if the security interest in the original collateral was perfected.³⁹ Proceeds are defined as whatever is received when collateral is sold or otherwise disposed of by the debtor.⁴⁰ Under this provision the

³⁵ Spivack, *Secured Transactions* 95 (1960).

³⁶ *Munz v. National Bond & Ins. Co.*, 243 Ky. 293, 47 S.W.2d 1055 (1932);
In re *Selman's Inc.* 58 F.2d 681 (1932).

³⁷ UCC § 9-302(20).

³⁸ UCC § 9-302, comment 7.

³⁹ UCC § 9-306(3).

⁴⁰ UCC § 9-306(1).

secured party has ten days after the sale of the collateral in which either to take possession of the proceeds or to file a financing statement covering them. If he fails to act within this period he loses his perfected security interest in the proceeds unless the original financing statement covering the collateral also expressly covered proceeds.⁴¹

WHEN ARTICLE 9 DOES NOT APPLY

The filing provisions of Article 9 do not apply to transactions which are governed by an adequate system of state or federal filing outside the Article. Section 9-302(3) excludes from filing under Article 9 security interests in:

property subject to a statute (a) of the United States which provides for a national registration or filing of all security interests in such property; or (b) of this state which provides for central filing of, or which requires indication on a certificate of title of, such security interests in such property.

Security interests in collateral such as aircraft or railroad equipment would fall under subsection (a) of this provision and must be perfected as prescribed by the federal statute governing this type of property.⁴²

As to subsection (b), Kentucky has neither a central filing statute nor a certificate of title law as such, but Kentucky Revised Statute 186.195 requires liens affecting a registered motor vehicle to be noted on its registration receipt. The court of appeals, in *Lincoln Bank & Trust Co. v. Queenan*,⁴³ has held that perfection of a security interest in a registered motor vehicle is accomplished by filing under Article 9. However, the court went on to say that a county clerk may refuse to file a financing statement covering a registered motor vehicle if the lien is not noted on the registration receipt as provided by Kentucky Revised Statute 186.195. The result of this decision is that double filing is necessary for perfection of security interests in registered motor vehicles.⁴⁴ Since Kentucky Revised Statute 186.195 is the only Kentucky statute outside of the Code which resembles a central filing or certificate of title law, subsection (b) of 9-302(3) seems to be inoperative as far as Kentucky law is concerned.

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⁴¹ UCC § 9-306, comment 2(b).

⁴² See 49 U.S.C. § 1403 (1958); 49 U.S.C. § 20(c) (1958).

⁴³ 344 S.W.2d 383 (Ky. 1961).

⁴⁴ For a critical analysis of this decision see Whiteside and Lewis, *Kentucky's Commercial Code—Some Initial Problems in Security*, 50 Ky. L.J. 61 (1961).