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A New Proposal: Buyer Notification Under U.C.C. Section 9-307(1) Based on the Food Security Act of 1985

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Comment

A New Proposal: Buyer Notification Under U.C.C. Section 9-307(1) Based on the Food Security Act of 1985

I. INTRODUCTION

A. The Problem Case

In 1976, Dan Holland bought a tractor in Florida.[1] To insure repayment of the $13,000 loan, the lending bank retained a security interest[2] in the tractor.[3] Before Holland satisfied the debt, he sold the tractor to a dealership in Iowa in violation of the bank's security agreement.[4] Unaware of the encumbrance, a Montana resident purchased the tractor from the dealership.[5] When Holland defaulted on his obligation, the bank located the tractor in Montana and repossessed it.[6] Noting the hardship on the Montana buyer, the Montana Supreme Court stated:

> This Court recognizes that this is a harsh result, since the purchaser, on the date of purchase in Iowa, had no means to learn in Iowa that the property he purchased was subject to a security interest. It may be that legislative action is necessary to prevent such results in the future. Since we are bound by the enacted laws, . . . no other course is open to us here.[7]

B. The General Rule

A creditor obtains initial rights in collateral through a security agreement.[8] The security agreement creates a property interest in

1. Exchange Bank of Osceola v. Jarret, 180 Mont. 33, 34, 588 P.2d 1006, 1007, 25 U.C.C. Rep. Serv. (Callaghan) 877, 878 (1979).
2. Section 1-201(37) of the Uniform Commercial Code (the "U.C.C.") provides: "'Security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation." U.C.C. § 1-201(37) (1978).
3. *Exchange Bank*, 180 Mont. at 34, 588 P.2d at 1007, 25 U.C.C. Rep. Serv. (Callaghan) at 878.
4. *Id.*
5. *Id.* at 37, 588 P.2d at 1009, 25 U.C.C. Rep. Serv. (Callaghan) at 880.
6. *Id.* at 34, 588 P.2d at 1007, 25 U.C.C. Rep. Serv. (Callaghan) at 878.
7. *Id.* at 39, 588 P.2d at 1009, 25 U.C.C. Rep. Serv. (Callaghan) at 882.
8. U.C.C. section 9-203(1) provides, in pertinent part, that a security interest is not

the collateral,[9] and enables the holder of the interest to repossess the property specifically earmarked in the agreement.[10] As a general rule, the right to repossess may be enforced not only against a debtor, but also against subsequent purchasers of the collateral.[11] Accordingly, the risk of losing purchased goods shifts to the buyer in the event of debtor default.[12] Faced with the prospect of debtor default, a buyer should seek to protect his ownership of used merchandise.

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enforceable until the debtor has signed a security agreement which contains a description of the collateral. U.C.C. § 9-203(1)(a) (1978).

9. U.C.C. § 1-201(37) (1978). For the relevant text of section 1-201(37), *see supra* note 2.

10. Section 9-503 provides: "Unless otherwise agreed a secured party has on default the right to take possession of the collateral. In taking possession a secured party may proceed without judicial process if this can be done without breach of the peace . . . ." U.C.C. § 9-503 (1978). *See also*, D. EPSTEIN & J. LANDERS, DEBTORS AND CREDITORS 197 (2d ed. 1982) [hereinafter EPSTEIN] (quoting Davenport, *Default, Enforcement and Remedies Under Revised Article 9 of the Uniform Commercial Code*, 7 VAL. U.L. REV. 265, 267 (1973)).

11. U.C.C. section 9-201 states: "Except as otherwise provided by this Act a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors." U.C.C. § 9-201 (1978).

12. If a debtor does not default, no repossession occurs and the buyer suffers no actual loss. There is, however, always the potential of debtor default. Upon purchase, the "risk" of losing collateral shifts to a buyer and remains with the buyer as long as the security interest is unsatisfied. This "risk shift" originates in the security agreement itself, because section 9-201 states that a security agreement is effective between the debtor and creditor, *and against subsequent purchasers* of the collateral. U.C.C. § 9-201 (1978). Professor Dugan comments about the security agreement:

> It is a strange world indeed where a lender [through the security agreement] can shift the risk of the borrower's insolvency or perfidy to a third party whose only involvement is the purchase of goods in the ordinary course of business. . . . the risk shift originates in the contract but violates the fundamental axiom that a contract can bind only the parties thereto. Viewed as a restraint upon alienation, it violates the equally fundamental principal that such restraints shall not operate in complete secrecy.

Dugan, *Buyer-Secured Party Conflicts Under Section 9-307(1) of the Uniform Commercial Code*, 46 U. COLO. L. REV. 333, 344-45 (1975) [hereinafter Dugan].

Opposition to the secrecy of the security agreement has been met by the requirement that the debtor-creditor arrangement be given a degree of public notoriety. 1 P. COOGAN, W. HOGAN, D. VAGTS & J. MCDONNELL, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 1.02[2], at 1-8 (Supp. 1987) [hereinafter COOGAN]. Public notice protects third parties from dealing with the debtor on the assumption that the debtor fully owns the goods in which the secured party claims an interest. COOGAN, *supra* note 12. The requirement for some sort of public notice can be traced back to Twyne's Case, 76 Eng. Rep. 809, 811 (1601) ("[S]ome of . . . [the sheep] he sold; and he shore the sheep, and marked them with his own mark. . . ."). COOGAN, *supra* note 12, at 1-8 n.18.

Sections 9-401 through 9-408 comprise the notice-filing system of Article 9. U.C.C. §§ 9-401 to 9-408 (1978). Notice-filing involves "perfection" of the security interest. *In re* Certified Packaging, Inc., 8 U.C.C. Rep. Serv. (Callaghan) 95 (Bankr. D. Utah 1970), provided the following description of "perfection":

A buyer's ability to protect his interest requires at least an awareness of a creditor's lien.[13] To notify buyers of immediate creditor interests, Congress provided a system of buyer notification under a recent federal statute, the Food Security Act of 1985.[14] The federal statute is limited to situations in which farm products serve as collateral. [15] This Comment proposes extending notification requirements to other buyer transactions. Specifically, the writer would impose a notification requirement when nonmerchant buyers[16] purchase used goods[17] subject to certain creditor security

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One must distinguish the concept of security "attachment" from the concept of security "perfection" under the Uniform Commercial Code.

The first concept deals with those steps legally required under the act to give the secured party an interest in the subject property effective *as against the debtor.*

The second concept deals with those steps legally required under the Act to give the secured party an interest in the subject property effective *as against the world.*

Id. at 99 (emphasis added). Perfection ordinarily requires the creditor to perform some step in addition to attachment, either taking possession of the collateral or filing a record in a public office. EPSTEIN, *supra* note 10, at 218. "Perfection" is designed to "oil the wheels of commerce by placing information in a public place" or some other action which would alert a member of the public about the outstanding right in the property held by the creditor. *In re Certified Packaging*, 8 U.C.C. Rep. Serv. (Callaghan) at 100.

The problem addressed in this Comment is limited to sales involving perfected security interests. When a security interest is unperfected, it will be cut off in any sale to a buyer *not* in the ordinary course of business. U.C.C. § 9-301(1)(c) (1978). *Compare infra* notes 23-40 and accompanying text (defining a "buyer in ordinary course of business").

13. A "lien creditor" is "a creditor who has acquired a lien on the property involved by attachment, levy or the like and includes an assignee for benefit of creditors . . . ." U.C.C. § 9-301(3) (1978). Although Article 9 distinguishes between a lien creditor and a creditor with a security interest, this Comment will use the term "lien" to include a security interest.

14. 7 U.S.C. § 1631 (Supp. III 1985) (effective Dec. 23, 1986).

15. 7 U.S.C. § 1631(a)(1) (Supp. III 1985). U.C.C. section 9-109(3) defines "farm products" to include:

> [C]rops or livestock or supplies used or produced in farming operations or if they are products of crops or livestock in their unmanufactured states (such as ginned cotton, wool-clip, maple syrup, milk and eggs), and if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming operations. If goods are farm products they are neither equipment nor inventory.

U.C.C. § 9-109(3) (1978).

16. A person buying under section 9-307(1) need not be a consumer of goods and may actually be a dealer who will in turn place goods in his own inventory for resale. 9 W. HAWKLAND, R. LORD & C. LEWIS, UNIFORM COMMERCIAL CODE SERIES § 9-307:02, at 72 (Supp. 1987) [hereinafter HAWKLAND]. Presumably, merchants and dealers are sophisticated and understand the notice-filing system of Article 9. In this Comment, therefore, a "nonmerchant buyer" refers only to consumers and those business persons whose purchase of merchandise is infrequent and not intended for resale.

Whether a business person qualifies as a nonmerchant buyer would be dependent on the characteristics and circumstances of each case. Generally, this author proposes a two

interests.

II. ANALYSIS OF CURRENT BUYER PROTECTION UNDER SECTION 9-307(1)

The general rule that a security agreement is effective against purchasers is limited by section 9-307(1) of the Uniform Commercial Code (the "U.C.C." or the "Code"). Section 9-307(1) provides:

> A buyer in ordinary course of business (subsection (9) of Section 1-201) other than a person buying farm products from a person engaged in farming operations *takes free* of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.[18]

Subsection (1) of section 9-307 offers the buying public some protection from a security interest held by a seller's creditor.[19]

The policy behind the section 9-307(1) exception is to allow buyers to feel confident that their ownership of purchased goods will remain undisturbed.[20] A buyer would be reluctant to buy mer-

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prong analysis. It should first be determined whether a business-buyer possessed an "intent to resell." This would be a subjective analysis which looks to the thoughts of the buyer at the time of purchase. Second, it should be established whether a business-buyer purchased a particular item often. This would be an objective analysis which looks to specific merchandise and the frequency of its purchase measured over a given interval of time.

17. "Used goods" may be misperceived to refer only to goods that have substantially decreased in value or have been in the current buyer's hands for some time before eventual resale. The term "used goods" in this Comment, however, simply refers to any collateral that has gone through a transaction involving a prior buyer. A secured party is never a buyer because security transferred in satisfaction of a debt is not "buying." *See* U.C.C. § 1-201(9) (1978).

The following transactions took place in Swift v. J.I. Case Co., 266 So. 2d 379, 380 (Fla. Dist. Ct. App. 1972), within just a *few months*: (1) Case Co. ("CC") sold a tractor to Florida Tractor Mart ("FTM"), and took a security interest in the tractor; (2) FTM delivered the tractor to Gator Tractor ("GT") pursuant to an oral lease; (3) GT sold the tractor to Swift Ford Tractor ("Swift") for $5,600. To summarize, CC sold to FTM; FTM leased to GT; GT sold to Swift. A buyer from Swift would be a buyer of "used goods" for the purposes of this Comment.

18. U.C.C. § 9-307(1) (1978) (emphasis added).

19. McFadden v. Mercantile-Safe Deposit & Trust Co., 260 Md. 601, 624, 273 A.2d 198, 209, 8 U.C.C. Rep. Serv. (Callaghan) 766, 782 (1971).

20. *In re* Kline, 1 U.C.C. Rep. Serv. (Callaghan) 628, 634 (E.D. Pa. 1956). The purpose of section 9-307(1) "was to facilitate the movement or transfer of goods at the retail level from merchant to consumer." *Id.* "Any routine off-the-shelf purchase of inventory severs existing security interests granted by the seller. Were it otherwise, you would need a lawyer at your elbow in making *any* routine purchase. A plainly intolerable situation, which is ruled out by 9-307(1)." T. QUINN, UNIFORM COMMERCIAL CODE COMMENTARY AND LAW DIGEST ¶ 9-307[A][5], at S9-296 (Supp. I 1987) [hereinafter QUINN].

chandise if a secured lender could take goods from him in order to satisfy a seller's debt.[21] In essence, section 9-307(1) recognizes that a buyer will equate a merchant's possession or other evidence of ownership with an ability to sell goods free and clear of creditors' interests.[22]

The protection afforded a purchaser under section 9-307(1), however, is limited. The buyer must qualify as a "buyer in the ordinary course of business."[23] Under section 1-201(9), a "buyer in ordinary course of business" means a person who (1) in good faith and (2) without knowledge that the sale to him is in violation of a security interest, (3) buys from a person in the business of selling goods of that kind.[24]

A. The Meaning of "Buyer in Ordinary Course"

First, a "buyer in ordinary course" must purchase in "good faith."[25] The U.C.C. defines good faith for a nonmerchant buyer as "honesty in fact in the conduct or transaction concerned."[26]

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21. "The purpose of sec. 307(1) of Article 9 . . . is to protect consumers." Antigo Co-op Credit Union v. Miller, 86 Wis. 2d 90, 98, 271 N.W.2d 642, 646, 25 U.C.C. Rep. Serv. (Callaghan) 326, 332 (1978). *See also* Note, *Sections 9-307(1) and 1-201(9) of the Uniform Commercial Code: The Requirement of Buying From a Person in the Business of Selling Goods of That Kind*, 58 IND. L.J. 335, 339 (1982).

22. The basic principle embodied in section 9-307(1) is equitable estoppel. Note, *supra* note 21, at 340 (citing 3 J. POMPEROY, A TREATISE ON EQUITY JURISPRUDENCE §§ 801-821 (S. Symons 5th ed. 1941)). One reason for protecting the innocent purchaser is that the creditor set in motion the chain of events leading to the title dispute by entrusting the collateral to a dealer. Cherry Creek Dodge, Inc. v. Carter, 733 P.2d 1024, 1028 (Wyo. 1987). It is well settled that a creditor, by his conduct, may be estopped from denying the seller's authority to sell. Sherer-Gillett Co. v. Long, 318 Ill. 432, 434, 149 N.E. 225, 225-26 (1925)(applying the UNIFORM CONDITIONAL SALES ACT, *superseded by* U.C.C. Article 9). *See* 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 26.3, at 686-88 (1965) [hereinafter GILMORE]. "Owners of chattels must frequently intrust others with their possession, and the affairs of men could not be conducted unless they could do so with safety, so long as the possession of the chattel is not accompanied by some indicium of ownership or the right to sell." *Sherer-Gillett Co.*, 318 Ill. at 435, 149 N.E. at 226.

23. U.C.C. § 9-307(1) (1978). U.C.C. section 1-201(9) defines a "buyer in ordinary course" as:

> [A] person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind but does not include a pawnbroker.

U.C.C. § 1-201(9) (1978).

24. U.C.C. § 1-201(9) (1978).

25. *Id.*

26. U.C.C. § 1-201(19) (1978). *See, e.g.*, Sherrock v. Commercial Credit Corp., 290 A.2d 648, 10 U.C.C. Rep. Serv. (Callaghan) 523 (Del. 1972). The definition of good faith in section 1-201(19) determines whether a buyer of goods subject to a security interest acted in good faith within the meaning of section 9-307(1). *Id.* at 650, 10 U.C.C. Rep.

This good faith inquiry is a subjective test that focuses on the mind and thoughts of a purchaser.[27] A buyer will be deemed to have purchased in good faith if he had a reasonable and honest conviction that he purchased the goods in a legitimate transaction free of all liens.[28] Whether there is anything to make the buyer suspicious of the transaction is a question of fact to be determined in light of all circumstances surrounding the sale.[29] Presumably, suspicion must amount to "actual knowledge" to constitute bad faith,[30] because the Code uses the term "knowledge" to mean knowledge in fact, not mere constructive notice.[31]

A "buyer in ordinary course" also must buy without knowledge that the sale to him is in violation of a security interest in the goods.[32] The Official Code Comment to section 9-307 explains that a buyer takes free of an encumbrance if he knows only that there is a security interest which covers the goods he is about to purchase.[33] If the buyer also knows that the seller is exceeding his authority in violation of some term in the security agreement, the buyer will take subject to the security interest.[34] Ordinarily, a nonmerchant purchaser will have little difficulty in satisfying the limited knowledge provision of section 9-307(1), because he will not know anything about security interests, let alone any specific term of a security agreement.[35]

Serv. (Callaghan) at 526. *See also* Frank Davis Buick AMC-Jeep, Inc. v. First Alabama Bank of Huntsville, N.A., 423 So. 2d 855, 35 U.C.C. Rep. Serv. (Callaghan) 249 (Ala. Civ. App. 1982). Because Article 1 is applicable to the entire Code unless otherwise provided, Article 9, which does not have its own definition of good faith, will employ the good faith definition contained in Article 1, section 1-201(19), rather than the good faith definition of Article 2, relating to sales. *Id.* at 858, 35 U.C.C. Rep. Serv. (Callaghan) at 255.

27. *Frank Davis*, 423 So. 2d at 858, 35 U.C.C. Rep. Serv. (Callaghan) at 255.

28. Dion v. Silver City Dodge, Inc., 398 Mass. 58, 61, 495 N.E.2d 274, 276 (1986).

29. *In re* Del Tex Corp., 32 Bankr. 403, 407, 37 U.C.C. Rep. Serv. (Callaghan) 317, 322-23 (Bankr. W.D. Tex. 1983). *See also* Sebrite Corp. v. Tramsouth Financial Corp., 272 S.C. 483, 487, 252 S.E.2d 873, 875, 26 U.C.C. Rep. Serv. (Callaghan) 544, 547 (1979).

30. Martin Marietta Corp. v. New Jersey National Bank, 612 F.2d 745, 752, 27 U.C.C. Rep. Serv. (Callaghan) 1153, 1163 (3rd Cir. 1979).

31. U.C.C. § 1-201(25) (1978).

32. U.C.C. § 1-201(9) (1978).

33. U.C.C. § 9-307 comment 2, para. 1 (1978).

34. *Id.* For a buyer not to be a buyer in ordinary course, he must know that a secured party has rights in the goods *and* that the sale is in violation of those rights. *In re* Woods, 25 Bankr. 924, 931, 35 U.C.C. Rep. Serv. (Callaghan) 256, 267 (Bankr. E.D. Tenn. 1982). A purchaser who knows that someone is owed money, but does not know that the sale was in violation of a bank's rights is still a buyer in ordinary course. *Id.*

35. A nonmerchant buyer usually purchases without knowing that the sale is in violation of a security agreement. In Quinn v. Scheu, 66 Or. App. 644, 648, 675 P.2d 1078,

The third factor in the definition of a "buyer in ordinary course" is that one must buy from a person in the business of selling goods of that kind,[36] for example, a dealer or merchant.[37] A merchant within the meaning of section 9-307(1) may be defined as one who engages in a systematic economic enterprise.[38] This definition excludes isolated sales incidental to the seller's primary business.[39]

1081, 38 U.C.C. Rep. Serv. (Callaghan) 367, 370 (1984), however, the Oregon Appellate Court found a buyer had such knowledge. In *Quinn*, the secured party sent an invoice and letter informing the buyer of its security interest. *Id.* at 646-47, 675 P.2d at 1080, 38 U.C.C. Rep. Serv. (Callaghan) at 368. The buyer contacted his publisher (seller) and was told to ignore the matter. *Id.* Because the secured party had an interest in the publisher's accounts and inventory, the secured party was able to seize the buyer's books because of the publisher's default. *Id.* The Oregon Court concluded that when the buyer received the invoice and letter, he should have investigated the nature of the secured party's rights. *Id.* at 648, 675 P.2d at 1081, 38 U.C.C. Rep. Serv. (Callaghan) at 370.

36. Whether one is "in the business of selling goods of that kind" is a factual determination; factors may include advertisement and demonstration of the product, intent to resell, sales documentation, and prior sales of the product. *In re* Fiesta Corp., 25 Bankr. 236, 239, 34 U.C.C. Rep. Serv. (Callaghan) 1738, 1743 (Bankr. W.D. Wis. 1982). From a matrix of facts, the question becomes whether the public could have reasonably expected the sale to be part of an ongoing business. *Id.* at 240, 34 U.C.C. Rep. Serv. (Callaghan) at 1743. For example, in Kaw Valley State Bank v. Stanley, 514 S.W.2d 42, 44-45, 15 U.C.C. Rep. Serv. (Callaghan) 514, 515-17 (Mo. Ct. App. 1974), the Missouri Appellate Court found that the public would have expected a seller, who used his home as an office for his "part time occupation," to be in the business of selling boats when the seller used business cards and advertised his business name at a local shopping center.

37. U.C.C. § 1-201(9) (1978). When the seller is not a merchant, U.C.C. section 9-307(2) affords a used goods buyer protection from a perfected security interest. (A security interest in consumer goods is perfected without filing; perfection is automatic. U.C.C. § 9-302(1)(d) (1978).) Under section 9-307(2), however, *both* the buyer and seller must be consumers. HAWKLAND, *supra* note 16, § 9-307:04, at 78.

> *In the case of consumer goods*, a buyer takes free of a security interest even though perfected if he buys without knowledge of the security interest, for value and for his own personal, family or household purposes unless prior to the purchase the secured party has filed a financing statement covering such goods.

U.C.C. § 9-307(2) (1978) (emphasis added). Although the section 9-307(2) exception seems fairly broad, it works to protect a very limited group of purchasers because it applies solely to inter-consumer sales. HAWKLAND, *supra* note 16, § 9-307:04, at 78. The inter-consumer restriction comes from the prepositional phrase "[i]n the case of consumer goods." New England Merchants National Bank of Boston v. Auto Owners Finance Co., 355 Mass. 487, 488-89, 245 N.E.2d 437, 438, 6 U.C.C. Rep. Serv. (Callaghan) 58, 59 (1969). As a result of this inter-consumer limitation in 9-307(2), the sale is not one by a dealer, but by John Smith to a neighbor. "That, in itself, cuts down 9-307(2) to pygmy size." QUINN, *supra* note 20, ¶ 9-307[A][4], at 9-188 (1978).

38. Newton-Waltham Bank & Trust Co. v. Bergen Motors, Inc., 68 Misc. 2d 228, 230, 327 N.Y.S.2d 77, 80 (N.Y. Sup. Ct. 1971).

39. *See, e.g.*, Sindone v. Farber, 105 Misc. 2d 634, 432 N.Y.S.2d 778 (N.Y. Sup. Ct. 1980). When car towing firm A sold towing equipment to B, B was not a buyer in the ordinary course of business under section 1-201(9) because A was not a "person in the business of selling goods of that kind." *Id.* at 639, 432 N.Y.S.2d at 781. A's regular business was towing vehicles, not selling towing equipment. *Id.*

The term, "one who deals in selling goods of that kind" also makes a distinction be-

Ultimately, "selling goods of that kind" turns on whether the goods purchased are a regular part of the merchant's *selling inventory*.[40]

B. Buyer Takes Free Only of a Security Interest "Created by His Seller"

If the buyer satisfies the "buyer in ordinary course" definition, he must overcome one more hurdle before he can qualify for protection under section 9-307(1) and take free of a security interest. A buyer can take free of a security interest only if the interest is "created by his seller."[41] The phrase "created by his seller" refers only to a security interest given by the debtor-seller.[42] The Official Code Comment to section 9-307 specifically provides: "The limitations which this section imposes on the persons who may take free of a security interest apply of course only to unauthorized sales *by the debtor*."[43]

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tween merchants who sell and those who lease. In United Carolina Bank v. Capital Automobile Co., 163 Ga. App. 796, 294 S.E.2d 661, 34 U.C.C. Rep. Serv. (Callaghan) 1705 (1982), a leasing company was found not to be in the business of "selling" cars. Sales were merely incidental to the business of leasing. Therefore, the purchaser did not buy from a person who deals in *selling* goods of that kind and was not a buyer in ordinary course. *Id.* at 798, 294 S.E.2d at 663, 34 U.C.C. Rep. Serv. (Callaghan) at 1707.

40. *Sindone*, 105 Misc. 2d at 638, 432 N.Y.S.2d at 781. Section 9-307(1) applies to sales out of inventory by a person selling goods of that kind. First Dallas County Bank v. G.M.A.C., 425 So. 2d 464, 466, 35 U.C.C. Rep. Serv. (Callaghan) 701, 703 (Ala. 1983). Section 9-307(1) applies primarily to the sale of inventory, because section 1-201(9) requires the seller to be in the business of "selling goods"; goods held for sale are "inventory" under section 9-109(4). *Id.* at 466, 35 U.C.C. Rep. Serv. (Callaghan) at 703. *See also* U.C.C. §§ 1-201(9), 9-109(4) (1978).

41. U.C.C. § 9-307(1) (1978).

42. Ocean City National Bank v. Palmer, 188 N.J. Super. 509, 515, 457 A.2d 1225, 1228, 36 U.C.C. Rep. Serv. (Callaghan) 310, 315 (1983).

43. U.C.C. § 9-307 comment 2, para. 2 (1978) (emphasis added). Section 9-307(1) applies solely to unauthorized sales by the debtor. When a sale has been authorized by a creditor, however, section 9-306(2) will apply, and a buyer will be able to purchase collateral unencumbered. J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 25-12, at 1066 (2d ed. 1980) [hereinafter WHITE & SUMMERS]. Section 9-306(2) states:

> Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof *unless the disposition was authorized* by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

U.C.C. § 9-306(2) (1978) (emphasis added). A merchant's ability to sell collateral free of a security interest may occur in one of two ways. First, authorization may be effected through the security agreement itself. A creditor may specifically allow a merchant to sell inventory to its customers, and according to the terms of the agreement, will expect the loan to be repaid from the proceeds of the sales. GILMORE, *supra* note 22, § 26.1, at 677. Second, authorization may occur through judicial application of waiver. Waiver

As a general rule, the "created by his seller" language requires that the person who created the security interest, the debtor, be the same person who sells the goods.[44] A careful reading of section 9-307(1) demonstrates its limited protection for a purchaser of used goods. For instance, in the problem case set out above, a Florida debtor sold a tractor to a dealership; this dealership later sold the tractor to a Montana buyer.[45] The Montana buyer took subject to the encumbrance because the security interest had not been created by his immediate seller, the dealer.[46]

III. Judicial Commentary on Buyer Protection

Because of the limited application of section 9-307(1), anyone who buys goods subject to a security interest not created by his immediate seller will take subject to a remote encumbrance.[47] A nonmerchant buyer of used merchandise, therefore, will rarely qualify under section 9-307(1), although fair treatment of buyers would warrant consistent protection for purchasers of both new

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arises when a merchant's past sales violated the terms of a security agreement and the secured creditor failed to object. The creditor is seen to have relinquished its right to demand further compliance. First Tennessee Production Credit Ass'n v. Gold Kist, Inc., 653 S.W.2d 418, 421, 35 U.C.C. Rep. Serv. (Callaghan) 1377, 1380 (Tenn. Ct. App. 1983). The relationship between section 9-307(1) and section 9-306(2) has been explained as follows:

> [O]nce a security interest latches on to a piece of collateral, it stays with that piece of collateral, come what may. All very good for the secured party, but what about all the unfortunates who had the bad luck of having bought the asset from the debtor?
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> . . . .
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> [Section 9-306(2)] provides that where the sale is "authorized," as it routinely is with the inventory loan, the creditor's security interest is severed on the sale—a rule that is as sane as it is necessary.
>
> Suppose the sale is not authorized . . . [s]o then the buyer takes subject to the security interest? He does not; 9-307(1) now snaps into place and severs the security interest.

QUINN, *supra* note 20, ¶ 9-307[A], at 9-187 (1978).

44. Adams v. City National Bank & Trust Co. of Norman Oklahoma, 565 P.2d 26, 30, 21 U.C.C. Rep. Serv. (Callaghan) 1026, 1031 (Okla. 1977).

45. *See supra* notes 1, 3-7 and accompanying text.

46. *Exchange Bank*, 180 Mont. at 38, 588 P.2d at 1009, 25 U.C.C. Rep. Serv. (Callaghan) at 881.

47. *See, e.g.*, Garbarino v. American Bank & Trust Co., 21 Pa. D. & C.3d 448, 34 U.C.C. Rep. Serv. (Callaghan) 329 (1982), involving a plaintiff who purchased a used car in good faith from a recognized automobile dealer. *Id.* at 449, 34 U.C.C. Rep. Serv. (Callaghan) at 330. The plaintiff did not take free of the security interest created by the former owner of the car because the interest had not been created by the immediate seller, the dealer, as required by section 9-307(1). *Id.* at 450, 34 U.C.C. Rep. Serv. (Callaghan) at 330.

and used goods. Application of the rules seems illogical;[48] a mere matter of fortuity—buying from one seller and not another—bars protection.[49] Common sense and practicality dictate that nonmerchant purchasers receive some special consideration, since such buyers' understanding of security interests is usually poor.[50] Recognizing the buyer's dilemma, the Alabama Supreme Court commented:

> [I]t would be impractical to expect buyers to search through the records of financing statements every time they purchased an item, . . . it would likewise be unacceptable to put the risk of loss on the purchaser when the seller defaults on a loan supported by a security interest in the goods. The secured party is in a better position to look out for himself in this situation than is the buyer.[51]

The lender is more sophisticated than the buyer, and is in a better position to both absorb and prevent loss. [52] It remains unclear, therefore, why section 9-307 protects lender investment to the point where some good faith buyers are forced to become unwilling loan guarantors and, in essence, to assume the credit supervision

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48. The Illinois Appellate Court in Martin Bros. Implement Co. v. Diepholz, 109 Ill. App. 3d 283, 440 N.E.2d 320, 34 U.C.C. Rep. Serv. (Callaghan) 1749 (4th Dist. 1982), stated:

> We recognize that the result which flows from this construction of the statute may seem unjust. The buyer who purchases goods from a seller who has created the security interest takes free of that interest even though the buyer could conceivably discover the existence of a security interest by a title search. When a security interest exists in favor of a remote seller, however, that same buyer will not take the goods free and clear of the security interest, *even though the burden of locating the remote party's interest is much greater.*

Id. at 290, 440 N.E.2d at 325, 34 U.C.C. Rep. Serv. (Callaghan) at 1752-53 (emphasis added).

49. Professor Charles Knapp suggested that the "created by his seller" limitation should be deleted from section 9-307(1). "[T]he risks inherent in the business of money-lending should be borne by money-lenders, not by innocent buyers in the marketplace." Knapp, *Protecting the Buyer of Previously Encumbered Goods: Another Plea for Revision of U.C.C. Section 9-307(1)*, 15 ARIZ. L. REV. 861, 892 (1973). Because the security interest would be cut off upon *any* sale of the collateral, deletion of the "created by his seller" limitation would severely limit inventory financing. This author believes that such a proposal would never be accepted by the secured lending industry.

50. Nonmerchant purchasers do not understand the mechanics of filing; it is fatuous to assume they will check Article 9 filings. Dugan, *supra* note 12, at 362-63 n.103.

51. *First Dallas County Bank*, 425 So. 2d at 466-67, 35 U.C.C. Rep. Serv. (Callaghan) at 704 (citing R. BRAUCHER & R. RIEGERT, INTRODUCTION TO COMMERCIAL TRANSACTIONS § 5-4 (1977)).

52. "[T]he risks involved . . . should be placed on the inventory financer, . . . because it is better able to guard against those risks than the unwary buyer . . . ." Farmers State Bank v. Webel, 113 Ill. App. 3d 87, 95, 446 N.E.2d 525, 530, 36 U.C.C. Rep. Serv. (Callaghan) 319, 327 (4th Dist. 1983) (citing Herman v. First Farmers State Bank, 73 Ill. App. 3d 475, 480-81, 392 N.E.2d 344, 347 (3d Dist. 1979)).

that belongs to the lender, who is presumably making a profit from the loan.[53] Perceiving the lender's superior position, the Indiana Supreme Court expressed the need to protect certain purchasers against loss.[54] The Indiana Court stated:

> It would lead to serious and evil consequences if courts should be powerless to do or say anything . . . [with] unjust and oppressive laws, calculated to prejudice legitimate enterprise and create absurd situations. . . . [It] would be manifestly unjust, inequitable, and oppressive since no one could safely buy anything whatever from a retail establishment without first making a search of the county recorder's office to make certain that it was not encumbered with a chattel mortgage, or by seeing that the purchase price was paid to the mortgagee.[55]

More recently, the Oklahoma Supreme Court discussed the plight of the nonmerchant buyer:

> Ordinarily, when a person goes into a merchant's place of business to make a purchase, whether it be of an automobile, a television set, a washing machine, or a pound of nails, the purchaser ought to have the right to assume that the merchant has a right to sell the commodity in question and should not be required to make a record search . . . .[56]

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53. Food Security Act, H.R. REP. NO. 99-271, 99th Cong., 1st Sess. 109, *reprinted in* 1985 U.S. CODE CONG. & ADMIN. NEWS 1103, 1213.

54. Helms v. American Security Co., 216 Ind. 1, 22 N.E.2d 822 (1939).

55. *Id.* at 5, 8-9, 22 N.E.2d at 824-25.

56. Adams v. City National Bank & Trust Co. of Oklahoma, 565 P.2d 26, 31, 21 U.C.C. Rep. Serv. (Callaghan) 1026, 1032 (Okla. 1977) (quoting Texas National Bank of Houston v. Aufderheide, 235 F. Supp. 599, 604 (E.D. Ark. 1964)).

Although a buyer may unknowingly purchase encumbered property, the concept of entrustment under Article 2 may offer a nonmerchant buyer protection from a creditor's security interest. Entrustment has been successfully invoked in several cases. *See, e.g.*, Milnes v. General Electric Credit Corp., 377 So. 2d 725 (Fla. Dist. Ct. App. 1979); Litchfield v. Dueitt, 245 So. 2d 190 (Miss. 1971); Cherry Creek Dodge, Inc. v. Carter, 733 P.2d 1024 (Wyo. 1987). The entrustment provisions are set forth below, as well as the reasons why some courts find entrustment should not apply to Article 9.

U.C.C. section 2-403 provides:

> (2) Any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in ordinary course of business.
>
> (3) 'Entrusting' includes any delivery and any acquiescence in retention of possession regardless of any condition expressed between the parties to the delivery or acquiescence and regardless of whether the procurement of the entrusting or the possessor's disposition of the goods have been such as to be larcenous under the criminal law.

U.C.C. § 2-403(2), (3) (1978). The entrustment statute contemplates that a secured party will be estopped from claiming rights in the collateral when it has left the collateral in the hands of a merchant. *In re* Woods, 25 Bankr. at 932, 35 U.C.C. Rep. Serv. (Callaghan) at 267-68. A buyer will naturally assume the merchant can sell his goods free of any

Legislatures, however, have ignored these courts' words.

In light of past and present cases, it would be naive to assume that the Drafters of Article 9 did not anticipate the sale of used goods to nonmerchant buyers. Present inequities perhaps reflect an uneven compromise between some buyer interests and lender investment.[57] Peter Coogan, consultant to the Review Committee on the 1978 Amendments to the Code, suggested to the Committee that some problems were passed over in ignorance, "but there were many that we passed over fully aware of the fact that we could have done something if our instructions had allowed us to do it."[58] Although "sleeping dogs were allowed to lie," Mr. Coogan indicated, "they will wake up some day, and then in the next revision of Article 9, we probably will have to address ourselves to some of the problems our Committee passed over."[59]

IV. PROPOSAL

In view of the problems nonmerchant buyers face under current

security interest and should be able to rely on that assumption unless the circumstances become too suspicious. *Id.*

There are questions, however, about the relationship between Articles 9 and 2. It has been held that if a buyer cannot prevail under section 9-307(1), he cannot escape a security interest under the entrustment section 2-403. *See, e.g., In re* Woods, 25 Bankr. 924, 35 U.C.C. Rep. Serv. (Callaghan) 256 (Bankr. E.D. Tenn. 1982); Commercial Credit Equipment Corp. v. Bates, 154 Ga. App. 71, 267 S.E.2d 469, 28 U.C.C. Rep. Serv. (Callaghan) 675 (1980); National Shawmut Bank v. Jones, 108 N.H. 386, 236 A.2d 484, 4 U.C.C. Rep. Serv. (Callaghan) 1021 (1967). In *National Shawmut Bank*, 108 N.H. at 389, 236 A.2d at 486, 4 U.C.C. Rep. Serv. (Callaghan) at 1024, the New Hampshire Supreme Court provided three reasons why section 2-403 should not apply to Article 9. First, Article 9, section 9-306(2) states that a security interest will continue "except where this Article otherwise provides," thereby limiting any exceptions to those contained in Article 9 itself. Second, Article 2, section 2-403(4) provides that the rights of lien creditors are governed solely by Article 9. Finally, Article 2, section 2-402(3)(a) contains the strongest prohibition, "nothing in this Article shall be deemed to impair the rights of creditors of the seller under the provisions of the Article on Secured Transactions (Article 9)." U.C.C. § 2-402(3)(a) (1978). It is difficult to conceive of a situation more devastating to a security interest than allowing a buyer to take free under the doctrine of entrustment.

Professor Summers asks about section 2-403: "may a subsequent purchaser disappointed under 9-307 fall back on 2-403 and argue that it renders him superior to a prior security interest? We believe the answer is no and we think the cases holding to the contrary are in error." WHITE & SUMMERS, *supra* note 43, § 25-15, at 1073. This author agrees and has, therefore, deliberately left section 2-403 out of the Article 9 buyer protection analysis. Absent clearer legislative authority, Article 2 should not determine Article 9 buyer-secured party conflicts.

57. GILMORE, *supra* note 22, § 26.1, at 678. "Much ingenuity has gone into the drafting of clauses in the inventory security agreement which, it is hoped, will improve the lender's position if, as a last resort in a hopeless situation, he is forced to go against such a buyer." *Id.*

58. COOGAN supra note 12, § 3AA.04, at 3AA-7.

59. *Id.*

section 9-307(1), some changes are necessary. A recent federal statute, the Food Security Act of 1985 (the "Food Security Act" or the "Act"),[60] alters section 9-307(1).[61] Unfortunately, the Act only requires notification of security interests in farm products.[62] This Comment proposes a requirement of buyer notification which includes nonmerchant purchasers of used goods.

A. The Food Security Act of 1985

Under section 9-307(1), a buyer of goods who buys in the ordinary course of business takes free of a security interest created by his immediate seller.[63] An exception in section 9-307(1) denies protection to buyers of farm products.[64] Buyers of farm products are *not* protected because security interests created by farmers continue to encumber the collateral after sale.[65] The rationale underlying the farm products exception is that buyers of these products are sophisticated enough to know that their seller may have granted a security interest in the property.[66] Another justification is that the exception encourages financing using crops as collateral.[67] Whatever the explanation, the farm products exception has been criticized.[68] Many states responded with the creation of nonuniform variations of section 9-307(1), ranging from enacting sec-

60. 7 U.S.C. § 1631 (Supp. III 1985).

61. H.R. REP. NO. 99-271, 99th Cong., 1st Sess. 109, *reprinted in* 1985 U.S. CODE CONG. & ADMIN. NEWS at 1212. *See infra* notes 64-83 and accompanying text.

62. H.R. REP. NO. 99-271, 99th Cong., 1st Sess. 109, *reprinted in* 1985 U.S. CODE CONG. & ADMIN. NEWS at 1212-13.

63. U.C.C. § 9-307(1) (1978). *See supra* notes 41-46 and accompanying text.

64. The farm products exception of section 9-307(1) states: "A buyer in the ordinary course of business . . . *other* than a person buying farm products from a person engaged in farming operations takes free of a security interest . . . ." U.C.C. § 9-307(1) (1978) (emphasis added). As a matter of statutory congruity, "farm products" should be excluded from section 9-307(1). Section 9-307(1) applies primarily to the sale of inventory. *See supra* note 40. Because section 9-109(3) states that "farm products" are not inventory, section 9-307(1) cannot govern farm products. U.C.C. § 9-109(3) (1978). For the relevant provision of section 9-109(3), *see supra* note 15.

65. U.C.C. § 9-307(1) (1978). *See, e.g., Baker Production Credit Ass'n*, 266 Or. 643, 513 P.2d 1129, 13 U.C.C. Rep. Serv. (Callaghan) 531 (1973). *See also*, E. REILEY, GUIDEBOOK TO SECURITY INTERESTS IN PERSONAL PROPERTY § 13.09, at 13-34 (2d ed. 1987) [hereinafter REILEY].

66. HAWKLAND, *supra* note 16, § 9-307:03, at 76.

67. Richards, *Federal Preemption of the U.C.C. Farm Products Exception: Buyers Must Still Beware*, 15 STETSON L. REV. 371, 376 (1986).

68. REILEY, *supra* note 65, § 13.09, at 13-34 (the farm products exception has spawned a huge volume of litigation); 69 AM. JUR. 2D *Secured Transactions* § 470, at 331 n.70 (1973) (the farm products exception leads to the absurd result that a person who buys a dozen eggs from a farmer takes them subject to a perfected security interest, while a person who buys the same eggs from a retail store takes them free of such a security interest); GILMORE, *supra* note 22, § 26.10, at 707 (rightly or wrongly, and for reasons

tion 9-307(1) without the farm products exception, to imposing criminal penalties on farm sellers who fail to disclose the existence of a security interest to a buyer.[69] These variations defeat the purpose of a Uniform Commercial Code.

In an attempt to restore uniformity and expand farm purchaser protection, the federal government responded with the Food Security Act.[70] The operative language of the Act provides:

> [N]otwithstanding any other provision of Federal, State, or local law, a buyer who in the ordinary course of business buys a farm product from a seller engaged in farming operations *shall take free* of a security interest created by the seller, even though the security interest is perfected and the buyer knows of the existence of such security interest.[71]

Under the federal law, in a complete reversal of prior practices, a buyer of farm products will now take free of a security interest created by his immediate seller.[72] A buyer of farm products will purchase encumbered property only if one of two conditions has been satisfied. First, a buyer will take property subject to a lien if the secured party or seller has sent written notice of the security interest to the buyer within one year from the date purchase.[73] Second, a buyer will purchase property subject to a security interest if the buyer failed to register with the Secretary of State in those States which have established a central filing system.[74]

Under the first condition, the lender must provide notice of its security interest to potential buyers of the collateral.[75] The lender learns of these buyers through a buyer list supplied by the debtor.[76] The statute imposes a $5,000 fine (or 15% of the value of the products sold, whichever is greater) against a debtor who engages in

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which are never precisely articulated, the farm financer comes off much better than the inventory financer).

69. *See, e.g.*, CAL. COMMERCIAL CODE § 9307(1) (West Supp. 1987); MINN. STAT. ANN. § 336.9-307(1) (West Supp. 1987) (deletion of "other than a person buying farm products from a person engaged in farming operations"). *See also*, ILL. REV. STAT. ch. 26, para. 9-307.2 (1985) (selling agent must post written warning to inform buyers that they are to make payments to the secured party; failure to post warning subjects the selling agent to criminal penalties).

70. H.R. REP. NO. 99-271, 99th Cong., 1st Sess. 109, *reprinted in* 1985 U.S. CODE CONG. & ADMIN. NEWS at 1213.

71. 7 U.S.C. § 1631(d) (Supp. III 1985) (emphasis added).

72. *See generally* Fry, *Buying Farm Products: The 1985 Farm Bill Changes the Rules of the Game*, 91 COM. L.J. 433 (1986).

73. 7 U.S.C. § 1631(e)(1)(A) (Supp. III 1985).

74. 7 U.S.C. § 1631(e)(2)(A) (Supp. III 1985).

75. 7 U.S.C. § 1631(e)(1)(A) (Supp. III 1985).

76. 7 U.S.C. § 1631(h)(1) (Supp. III 1985).

"off-list" selling.[77] Somewhat at a disadvantage, the lender must depend on the honesty of its debtor, and the fine, without more, may not be enough to compel compliance.[78]

Under the second condition, the State sets up a central filing system, whereby filings are forwarded periodically to buyers of farm products who have registered with the Secretary of State.[79] The statute contemplates an additional filing system that is separate from the U.C.C.[80] Lenders must file in one system to protect their interest against bona fide purchasers, and file again under the U.C.C. to preserve their interest against other creditors.[81] Of greater concern, however, is that the Secretary of State is only required to distribute a copy of the master list as prescribed by the State itself.[82] If a purchaser buys between the regular distributions of the list and fails to receive notice, the lien will be cut off.[83] The secured lender is therefore at the mercy of the Secretary of State.

B. Section 9-307(1) Proposal

This Comment's amendment to section 9-307(1) is based on the Food Security Act and the existing state farm statutes. The proposal contemplates that notice of some creditor interests be sent to nonmerchant buyers before purchase of encumbered collateral.

> *9-307(1)*: A buyer in ordinary course of business (subsection (9) of Section 1-201) [*deletion of farm provision*] takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence. *A buyer in ordinary course of business, other than a person who buys goods intended for resale, also takes free of any other security interest, even though the security interest is perfected, unless prior to purchase, the secured party or the seller has given written notice of the security interest to the buyer.*[84]

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77. *Id.*

78. *Comptroller of the Currency Rules on Secured Agricultural Loans*, 3 Secured Lending Alert (Warren, Gorham & Lamont) No. 1, at 2-3 (Mar. 1987).

79. 7 U.S.C. § 1631(c)(2)(E) (Supp. III 1985).

80. Letter from Goodman, Schneider & Cohen (Philadelphia, Pennsylvania) to Corporate General Counsel, Associates Commercial Corporation (Chicago, Illinois) (Nov. 12, 1986) (discussing lending procedures under the Food Security Act).

81. *Id.*

82. REILEY, *supra* note 65, § 13.10[1], at 13-38.

83. *Id.* at 13-39.

84. *See* 7 U.S.C. § 1631(d)-(e)(1)(A) (Supp. III 1985); DEL. CODE ANN. tit. 6, § 9-307(2)(a) (Michie Supp. 1986); ILL. REV. STAT. ch. 26, para. 9-307(4) (1985); IND. CODE ANN. § 26-1-9-307(1)(a) (Burns/Michie Supp. 1986); KY. REV. STAT. ANN. § 355.9-307(4) (Michie Supp. 1986); MICH. COMP. LAWS ANN. § 440.9307(5), (10) (West Supp. 1986); TENN. CODE ANN. § 47-9-307(2)(a)-(d) (Michie Supp. 1986).

(a) Written notice must contain the name and address of the person indebted to the secured party, the name, address, and telephone number of the secured party from which information concerning the security interest may be obtained, and may contain other information so as to reasonably inform the buyer of the security interest.[85]

(b) If written notice is sent by mail, it shall be sent by registered or certified mail.[86]

(c) Any person selling to a buyer in ordinary course of business is obligated to provide the secured lender with the name and address of any buyer or potential buyer when requested by the secured party.[87]

(d) If the sale is to a buyer other than one for which the secured party has received notice, the seller must notify the secured party within 7 days after sale, and if required, account for the proceeds of such sale.[88]

(e) Any person who sells to a buyer in ordinary course of business and fails to comply with this section shall be liable to the secured party for any loss resulting from the sale.[89] *A seller's failure to comply with this section may result in imprisonment of not more than 60 days, or a fine of not more than $10,000, or both per violation.*[90] *If a secured party can prove by competent evidence that it has sustained a monetary loss and is unable to collect under the security agreement, the secured party is entitled to as much of the fine as is necessary to cover the loss.*[91]

The proposed amendment to section 9-307(1) does not seek to prevent creditors from pursuing collateral; the amendment merely requires notification so that a buyer of used goods may make an informed choice as to whether he will assume the risk of debtor default and repossession before buying encumbered merchandise. Furthermore, notification is not necessary in every sale. Dealer or merchant purchasers, those who buy collateral intended for resale, need not be notified. Nonmerchant purchasers need be notified only when a creditor believes the collateral will maintain sufficient value as used goods so that repossession would be commercially

85. *See* 7 U.S.C. § 1631(e)(1)(A)(ii)(I)-(II) (Supp. III 1985); IND. CODE ANN. § 26-1-9-307(1)(a)(i)-(ii) (Burns/Michie Supp. 1986).

86. *See* DEL. CODE ANN. tit. 6, § 9-307(2)(a) (Michie Supp. 1986); ILL. REV. STAT. ch. 26, para. 9-307(4) (1985); KY. REV. STAT. ANN. § 355.9-307(4) (Michie Supp. 1986).

87. *See* 7 U.S.C. § 1631(h)(1) (Supp. III 1985).

88. *See* 7 U.S.C. § 1631(h)(2) (Supp. III 1985).

89. *See* OKLA. STAT. tit. 12A, § 9-307(3)(e) (West Supp. 1987).

90. *See* 7 U.S.C. § 1324(h)(3) (Supp. III 1985); MICH. COMP. LAWS ANN. § 440.9307(4) (West Supp. 1986).

91. *See* IOWA CODE ANN. § 554.9307(5)(a) (West Supp. 1986).

practical. Recognizing that the buyer stands to lose, it is not exacting to require a disclosure from a creditor who wishes to maintain the option of repossession in the future.

In essence, the proposal shifts the burden of policing the collateral and the risk of loss from a buyer to a secured lender. As a trade-off, the proposal provides some benefits for the lender. First, in keeping with current law, the secured party is still entitled to proceeds when the debtor sells the collateral.[92] Second, if there is a deficiency, anyone who sells in violation of the lender's interest will be liable to the secured lender for any loss resulting from the sale. Accordingly, the secured creditor may base a cause of action directly on the new Code and avoid any problem a court may have in applying common law conversion.[93] Third, and most advantageous to lenders, the proposal provides state enforced sanctions, imprisonment and a fine, to discourage sales in violation of a secured creditor's rights in the collateral. If a secured party can prove by competent evidence that it has sustained a monetary loss and is unable to collect under the security agreement, the secured party is entitled to as much of the fine as is necessary to cover the loss.[94] The secured lender thereby benefits from the State's action and expense in bringing the lawsuit against the seller.

V. ANALYSIS

The proposal enables a nonmerchant buyer to take free of any security interests, including those created by one other than the buyer's immediate seller. If a lender is to protect its interests, it (or the buyer's immediate seller) must provide the buyer with written notice of the security interest. This written notice requirement has two elements.

A. Notice to Secured Lender

The first element of the proposal requires that notice be sent to the secured lender by the debtor of the collateral. The debtor must furnish the lender with the name of a buyer or potential buyer if requested. This information may be in the form of a "buyer list." A "buyer list" is a schedule of all names and addresses of buyers with whom the debtor deals. The lender should obtain a list of buyers from the debtor as a condition of extending credit and

92. U.C.C. § 9-306(2) (1978). *See supra* note 43.

93. Dugan, *supra* note 12, at 356-61 (explanation of when an auctioneer may be liable for conversion).

94. *See* IOWA CODE ANN. § 554.9307(5)(a) (West Supp. 1986).

should require a constant update of the buyer list.[95]

The goods become "used goods" when the collateral is sold by the debtor. If the debtor sells to a dealer, this dealer or the lender itself must provide notice of the lender's security interest to any nonmerchant purchaser in a subsequent sale. The lender could assure that a purchaser receives notice by sending a strongly worded warning to the dealer. For example,

> "YOUR FAILURE TO ENABLE THE LENDER TO GIVE NOTICE, OR YOUR FAILURE TO GIVE NOTICE TO A BUYER OF OUR SECURITY INTEREST IS A VIOLATION OF SECTION 9-307(1) OF THE COMMERCIAL CODE OF THIS STATE, AND MAY RESULT IN SEVERE SANCTIONS AGAINST YOU. UNDER SECTION 9-307(1), YOU MAY ALSO BE LIABLE TO US FOR ANY LOSS RESULTING FROM A SALE UNLESS NOTIFICATION HAS BEEN GIVEN."

A warning of the specific Code sanctions should compel compliance.[96]

B. Notice to Buyer

The second element of the proposal is a notice requirement to the nonmerchant buyer. Either the lender or the seller must provide adequate notice to the buyer apprising him of the security interest in the collateral that he is about to purchase. Not unfairly, the dealer, who is presumably making a profit from the sale, is asked to assist the lender in providing buyer notification.

To simplify paperwork, the lender may supply the dealer with a form using standardized language or a sticker to be affixed on the collateral so that the buyer is informed of the creditor's lien. For example:

> * * * NOTICE TO BUYER * * *
>
> THIS MERCHANDISE IN THE POSSESSION OF DEALER IS SUBJECT TO A SECURITY INTEREST HELD BY FINANCE CORP. IN THE EVENT OF A DEFAULT BY

95. The purpose of buyer lists is to enable the lender to trace collateral and provide notice of the security interest when a nonmerchant buyer potentially arises in the chain of title.

96. The imprisonment sanction may at first appear overly harsh. The threat of a discretionary imprisonment sanction may be necessary because of the insufficiency of a fine in some cases. For example, a buyer may be willing to pay more for a large piece of equipment if he could take free of the encumbering security interest. A dealer would then weigh the $10,000 fine against his enhanced profit, and if he comes out ahead, he would find it in his economic best interest to violate section 9-307. The added sanction of imprisonment should force most dealers to comply with the Code.

DEBTOR, 816 DEARBORN ST. CHICAGO, IL. 60610, FINANCE CORP. MAY HAVE THE RIGHT TO IMMEDIATE POSSESSION AND MAY FORECLOSE ON ITS INTEREST WITHOUT JUDICIAL PROCESS. YOU ARE ADVISED TO CONTACT FINANCE CORP., 555 MICHIGAN AVENUE, CHICAGO, IL. 60601 1-800-123-4567.[97]

In a dispute challenging the sufficiency of notice, a court would look to whether the notice satisfied certain requirements. These requirements might be that the notice was written and conspicuous, that the notice would induce a reasonable buyer to inquire, and that the notice gave the name, address and telephone number of the lender, so that information could be verified *before* a purchase. Incidentally, buyer contact would also aid the lender because it would be alerted of a sale and the existence of proceeds, where applicable.

C. Buyer's Options to Protect His Interest

After receiving notice of a security interest, the buyer's greatest leverage may arise through his refusal to purchase the encumbered collateral unless he can be assured that the goods being sold can be bought free and clear of the creditor's interest. In order to effectuate a sale, the creditor, dealer, and buyer could agree that the security interest will be satisfied using the proceeds from the imminent sale of the collateral. The buyer would name the secured lender and dealer as joint payees when the product is bought to assure that the lender receives payment and that the lien on the property is discharged.[98]

If the debtor is not in default (which is discovered when contact is made with the lender named in the notice), the buyer might obtain a partial release or waiver from the secured lender or seek a subordination agreement, which would declare the buyer's rights in the collateral superior to those of the creditor. A creditor would be willing to subordinate its interest because a sale results in proceeds, which puts the creditor in a position to receive repayment of

97. Some state Retail Installment Sales Acts require contract terms and disclosures in certain size typeface to advise buyers of warranties, interest rates, and rights to redeem property if repossessed. *See, e.g.*, Motor Vehicle Retail Installment Sales Act, N.Y. PERSONAL PROPERTY LAW §§ 301-315 (McKinney 1977); Retail Installment Sales Act, N.Y. PERSONAL PROPERTY LAW §§ 401-422 (McKinney 1977). This Comment's proposal amends section 9-307(1) directly. Alternatively, section 9-307(1) might be amended indirectly by altering Installment Sales Acts which govern U.C.C. Article 9.

98. *See, e.g.*, IND. CODE ANN. § 26-1-9-307(1)(d) (Burns/Michie Supp. 1986); IOWA CODE ANN. § 554.9307(4) (West 1987); N.D. CENT. CODE § 41-09-28(11) (Supp. 1985).

its loan.[99] If the security interest is no longer in effect, a prudent buyer should require the creditor to file a termination statement.[100]

If for some reason the above options prove unworkable, the buyer is always free to go elsewhere and buy unencumbered products. Should he choose to buy the encumbered collateral, he does so with the knowledge of the security interest.[101]

D. Application of the Proposal to a Particular Case

The following situation demonstrates how the proposal would operate to protect the nonmerchant buyer. In *Commercial Credit Equipment Corp. v. Bates*,[102] the debtor bought a tractor for use in his business from a dealer, Faircloth International.[103] The debtor granted a security interest to the Commercial Credit Equipment Corp. ("C.C.E.C.").[104] The debtor had no immediate use for the tractor, and so leased it to Anderson for use in his business (Ander-

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99. QUINN, *supra* note 20, ¶ 9-307[A][1], at S9-295 (Supp. I 1987).

100. U.C.C. § 9-404(1) provides:

> [w]henever there is no outstanding secured obligation and no commitment to make advances, incur obligations or otherwise give value, the secured party must on written demand by the debtor send the debtor, for each filing officer with whom the financing statement was filed, a termination statement to the effect that he no longer claims a security interest under the financing statement, which shall be identified by file number.

U.C.C. § 9-404(1) (1978).

101. Automobiles are treated differently than some other types of collateral because of Certificate of Title laws. The concept of these title laws is that any ownership right or security interest is noted on the title certificate. *In re* Friedman, 4 U.C.C. Rep. Serv. (Callaghan) 890, 892 (D. Conn. 1967). When the automobile is transferred or sold, the certificate accompanies it and puts a buyer on notice. *Id.*

> The thought underlying the Certificate of Title Act and the portions of the Uniform Commercial Code that have been incorporated in it is that there be a distinctive document, filed in a particular public office and available to the public, which establishes the title to each motor vehicle and reveals the security interests in it. This document and its contents should be that upon which all can rely with finality as to the title to and encumbrances on a motor vehicle.

Id. One problem with certificates is that an ignorant buyer has the opportunity to see the certificate only after sale. *See, e.g.*, Lightfoot v. Harris Trust & Savings Bank, 357 So. 2d 651, 21 U.C.C. Rep. Serv. (Callaghan) 864 (Ala. Civ. App. 1977), *aff'd*, 357 So. 2d 654, 23 U.C.C. Rep. Serv. (Callaghan) 750 (Ala. 1978). Another problem occurs when the buyer is misled because of a forged satisfaction of a creditor's lien on the certificate. *See, e.g.*, Muir v. Jefferson Credit Corp., 108 N.J. Super. 586, 262 A.2d 33, 7 U.C.C. Rep. Serv. (Callaghan) 273 (1970) (citing G.M.A.C. v. Hill, 95 Ariz. 347, 390 P.2d 843 (1964); Central Fiance Co. v. Garber, 121 Ind. App. 27, 97 N.E.2d 503 (1951)). It is uncertain what changes might be made within the Certificate of Title laws to remedy these problems.

102. 154 Ga. App. 71, 267 S.E.2d 469, 28 U.C.C. Rep. Serv. (Callaghan) 675 (1980).

103. *Id.* at 72, 267 S.E.2d at 470, 28 U.C.C. Rep. Serv. (Callaghan) at 675.

104. *Id.*

son coincidentally was an employee of the dealership).[105] Anderson then lent the tractor to Kenneth Faircloth, doing business as Faircloth International, the dealer.[106] Mr. Faircloth performed some dirt-moving work at his dealership and parked the tractor on his lot.[107] When a buyer in need of the tractor approached Faircloth, he agreed to sell the tractor and falsely informed the buyer that the tractor was new. [108] The buyer had no knowledge that the tractor was previously sold.[109] Further, assuming the buyer searched under the name of his seller, Faircloth International, no financing statement would have been found because no security interest existed against Faircloth. Simple application of section 9-307(1) required the Georgia Court to find that the buyer took subject to C.C.E.C.'s security interest.[110] Because Faircloth had not created the security interest, the "created by his seller" limitation barred protection for the buyer.[111]

Under this Comment's proposal, the court would have been able to reach a far more equitable result. Because it is unlikely under the facts of this case that the buyer would have received notice, he would have taken free of C.C.E.C.'s security interest. Faircloth, as seller, would have been liable to C.C.E.C. Faircloth might also face a fine and imprisonment. C.C.E.C. would offset its damages against any fine collected by the State. The proposal mandates that both C.C.E.C. and the buyer are compensated, and that Faircloth bear responsibility. Under current law, as the *Bates* case demonstrates, Faircloth avoids any liability and the buyer suffers the loss.

VI. CONCLUSION

Article 9 of the U.C.C. assumes that nonmerchant buyers recog-

105. *Id.* at 72, 267 S.E.2d at 470, 28 U.C.C. Rep. Serv. (Callaghan) at 675-76.
106. *Id.* at 72, 267 S.E.2d at 470, 28 U.C.C. Rep. Serv. (Callaghan) at 676.
107. *Id.*
108. *Id.* at 72, 267 S.E.2d at 470-71, 28 U.C.C. Rep. Serv. (Callaghan) at 676.
109. *Id.* at 72, 267 S.E.2d at 471, 28 U.C.C. Rep. Serv. (Callaghan) at 676.
110. *Id.* at 74, 267 S.E.2d at 472, 28 U.C.C. Rep. Serv. (callaghan) at 678.
111. *Id.* Under current law, the buyer's recourse in the *Bates* case may have been to bring a breach of warranty of title action against Faircloth. U.C.C. section 2-312(1) provides:

> (1) . . . there is in a contract for sale a warranty by the seller that
> (a) the title conveyed shall be good, and its transfer rightful; and
> (b) the goods shall be delivered free from any security interest or other lien or encumbrance of which the buyer at the time of contracting has no knowledge.

U.C.C. § 2-312(1)(a), (b) (1978). A breach of title suit against the dealer, however, may be burdensome and costly. The rationale behind the proposal is to avoid forcing a buyer to litigate in order to obtain clear title on purchased goods.

nize the existence of filing records and that such buyers understand the mechanics of filing.[112] These assumptions unquestioningly require purchasers of used goods to bear the loss when a creditor elects to repossess collateral. In view of the existing problems of nonmerchant purchasers and the logic of buyer notification under the Food Security Act as a possible solution, section 9-307(1) should be reexamined. If present-day secured financing transactions are to go forward with greater certainty,[113] unwary buyers must receive notice of creditors' interests before buying encumbered property. The new Code proposal is a means for inexpensive buyer notification.

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112. 7 U.S.C. § 1631(a)(1) (Supp. III 1985) explains: "[C]ertain State laws permit a secured lender to enforce liens against a purchaser . . . even if the purchaser does not know that the sale of the products violates the lender's security interest in the products, [and] lacks any practical method for discovering the existence of the security interest . . . ." *Id.*

113. U.C.C. § 9-101 comment, para. 7 (1978).