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Section 9-307(1) of the U.C.C.: The Scope of Protection Given a Buyer in Ordinary Course of Business

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SECTION 9-307(1) OF THE U.C.C.: THE SCOPE OF THE PROTECTION GIVEN A BUYER IN ORDINARY COURSE OF BUSINESS

In Section 9-307(1) of the Uniform Commercial Code a rule of priority for secured parties and buyers in ordinary course of business is set forth. This rule is designed to determine the conflicting interests of these parties following an unauthorized sale of secured collateral by a debtor. The section 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. (Emphasis added.)

Since a "buyer in ordinary course of business" is one who buys "from a person in the business of selling goods of that kind,"[1] the section applies primarily to sales from inventory.[2] Usually three parties are involved; a secured party, a debtor-merchant, and a buyer in ordinary course of business. In such a situation the security interest is cut off by the operation of section 9-307(1) if the debtor-merchant sells the goods to a "buyer in ordinary course of business." The addition of a fourth party in one case, and a questionable degree of buyer knowledge of existing ownership rights in another, recently have presented two courts with significant issues concerning the application and interpretation of section 9-307(1).

In *National Shawmut Bank v. Jones*,[3] the New Hampshire Supreme Court was called upon to decide what effect the addition of a fourth party has on the applicability of section 9-307(1). In *Jones* a four-party (as opposed to the usual three-party) situation was presented wherein a consumer-debtor holding goods subject to a prior security interest sold them to a merchant, who in turn sold the goods to a "buyer in ordinary course of business." The court thus had to determine whether a "buyer in ordinary course of business" in such a four-party situation would take free of the outstanding security interest under section 9-307(1), in view of the section's specific requirement that for the buyer to take free, the security interest must have been "created by his seller."

A "buyer in ordinary course of business" must buy "without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods."[4] However, under section 9-307(1), such a buyer will take free of a security interest created by his seller "even though the buyer knows of its existence." In *Cash Loan Co. v. Boser*,[5] the Wisconsin Supreme Court was called upon to interpret the interplay of these "knowl-

[1] U.C.C. § 1-201(9). All citations to the Uniform Commercial Code are to the 1962 Official Text unless otherwise indicated.

[2] See U.C.C. § 9-307, Comment 2.

[3] 108 N.H. 386, 236 A.2d 484 (1967).

[4] U.C.C. § 1-201(9).

[5] 34 Wis. 2d 410, 149 N.W.2d 605 (1967).

edge" provisions in order to find what "knowledge" is sufficient to result in a denial to a buyer of the protection of section 9-307(1). It is the purpose of this comment to examine the restriction on the applicability of section 9-307(1) to security interests "created by his seller," and the "knowledge" requirements of a buyer who seeks protection under this section, in light of the Code's policy toward the "buyer in ordinary course of business."

I. The Application of the "Created by His Seller" Limitation to Four-Party Situations.

In the *Jones*[6] case the plaintiff, National Shawmut Bank, held a purchase-money security interest[7] in an automobile purchased by one Wever "for personal family or household purposes"[8] from the Wentworth Motor Company, Incorporated. This security interest was perfected by the plaintiff through timely filing[9] with the town clerk of Hampton, New Hampshire, wherein Wever made his residence. Sometime after the filing, Wever, without the plaintiff's consent, sold or traded the car to Hanson Rock, Incorporated of Hampton, an automobile dealer in the business of selling new and used cars to the public. Subsequently the defendant Jones purchased the car from Hanson Rock for good and sufficient consideration.[10] At the time of the purchase Jones acted in good faith and with no actual knowledge of any outstanding security interest in the car.[11] Though neither Jones nor the local bank from which he borrowed the money for the purchase price searched the files in the town clerk's office, it was agreed at argument of the case that the plaintiff's interest could be found only if the search was made under Wever's name or through an examination of all entries covering automobiles for the serial number of the vehicle in question.[12] Sometime after Jones purchased the

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[6] 108 N.H. 386, 236 A.2d 484 (1967).

[7] U.C.C. § 9-107 states:

> A security interest is a "purchase money security interest" to the extent that it is
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> (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.

[8] 108 N.H. at 387, 236 A.2d at 485.

[9] Id. U.C.C. § 9-302(1)(d) provides:

> (1) A financing statement must be filed to perfect all security interests except the following:
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> . . .
>
> (d) a purchase money security interest in consumer goods; but filing is required for a fixture under Section 9-313 or for a motor vehicle required to be licensed . . . .

U.C.C. § 9-301(2) allows the secured party a ten-day grace period in which to file his purchase-money security interest. In this case, National Shawmut filed nine days following the sales to Wever, and thus its security interest "relates back" and is perfected as of the date of the sale to Wever.

[10] 108 N.H. at 387, 236 A.2d at 485.

[11] Id.

[12] Id.

automobile, Wever defaulted on his obligation, and the plaintiff brought an action of replevin.

The court had to determine if Jones was a "buyer in ordinary course of business" and, if so, whether he took free of the security interest created by the consumer, Wever. In the Code a "buyer in ordinary course of business" is defined 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."[13] The court found that Jones qualified as a "buyer in ordinary course of business," yet held that he did not take free of the plaintiff's security interest under section 9-307(1) because that interest had been created by Wever, and not by his seller, Hanson Rock.[14] The court found, in addition, that Jones was not protected under section 9-307(2),[15] since the secured party had filed a financing

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[13] U.C.C. § 1-201(9).

[14] For a proposal to amend section 9-307(1) by deleting the language "created by his seller" in order to reverse the result that obtains from application of the Code to the *Jones*-type situation, see Vernon, Priorities, The Uniform Commercial Code and Consumer Financing, 4 B.C. Ind. & Com. L. Rev. 531, 536 (1963); see also W. Willier & F. Hart, Uniform Commercial Code Reporter-Digest 2-1046 to-1048 (1967).

[15] Section 9-307(2) provides in part:

> 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.

In U.C.C. § 9-109(1), consumer goods are defined as those which are "used or bought for use primarily for personal, family or household purposes." From this definition it is unclear whether section 9-307(2) is restricted in its application to sales wherein one consumer is selling directly to another. This question, in terms of the relationship between the two subsections of section 9-307, becomes one of whether a buyer in ordinary course of business is restricted to section 9-307(1) for his protection. Several writers who have considered this question have concluded that a "buyer in ordinary course of business" is so restricted; i.e., when section 9-307(1) applies, it does so to the exclusion of section 9-307(2). See, e.g., 2 P. Coogan, W. Hogan & D. Vagts, Secured Transactions Under the U.C.C. § 19.02[3][c] (1966); Coogan, Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien," 72 Harv. L. Rev. 838, 848 (1959); Vernon, supra note 14, at 535; Comment, Protection of a Buyer at an Execution Sale Under U.C.C. Section 9-307, 9 B.C. Ind. & Com. L. Rev. 97, 104 (1967). This conclusion seems to be supported by the construction of the section itself. The introductory phrase "[i]n the case of consumer goods" is followed later in the section by a specific statement of the requirement that the buyer buy "for his own personal, family or household purposes." Consequently, if the introductory phrase does not embody the idea that the goods must be "consumer goods" in the hands of the seller it would appear to be mere surplusage and add nothing to the definition of the scope of the section's application. This argument is even more clear when applied to a restatement of the rule of § 9-307(2) found in official comment 3 accompanying that section. "Under subsection (2) a buyer of *consumer goods* or farm equipment takes free of a security interest even though perfected a) if he buys without knowledge of the security interest, b) for value, c) for his own personal, family, or household purposes." (Emphasis added.) Goods purchased for "personal, family, or household purposes" *are* consumer goods under U.C.C. § 9-109 and consequently the only meaningful interpretation of "a buyer of consumer goods" in the comment is that the goods must be consumer goods before he buys them, i.e., in the hands of the seller. This interpretation

statement prior to Jones' purchase. Since he did not qualify under either of these provisions of Article 9, which permit a buyer of goods to take free of a perfected security interest, judgment was rendered against Jones for $1,490.17, the amount outstanding under the plaintiff's security agreement with Wever.[16]

In applying section 9-307(1) to the *Jones* case, the court could reach but one decision. As Wever was not a dealer, Hanson Rock, his vendee, was not a "buyer in ordinary course of business." Consequently, section 9-307(1) did not operate to cut off the bank's interest. When Hanson Rock subsequently sold to Jones it had only its encumbered title to convey. Furthermore, as the applicable security interest was *not* "created by his seller," section 9-307(1) could not operate to permit Jones to take free of the bank's interest.

In view of the history[17] and language of section 9-307(1) it is quite apparent that the section was intended to protect directly the "buyer in ordinary course of business" only in the three-party situation. If four or more parties are involved, the final party in the chain, even though a "buyer in ordinary course of business," will not be asserting priority over a security interest "created by his seller," and consequently he will be unable to take direct advantage of section 9-307(1). Thus, a secured party who takes and files an interest in goods held by a consumer is given priority over all subsequent

of § 9-307(2) is also compatible with its counterpart, § 9-307(1). The classes of goods in the Code are mutually exclusive, and thus the same goods cannot be both inventory and consumer goods to the same person at the same time. U.C.C. § 9-109, Comment 2. Section 9-307(1) was specifically designed to determine the rights and liabilities of the buyer where he buys from inventory. In the 1952 Official Draft the section began "[i]n the case of inventory." In the 1956 Recommendation of the Editorial Board for the Uniform Commercial Code the reason given for the deletion of this opening language was that "the definition of 'buyer in ordinary course of business' limits subsection (1) to inventory cases." American Law Institute and National Conference of Commissioners on Uniform State Laws, 1956 Recommendations of the Editorial Board for the Uniform Commercial Code 284 (1957). Thus, it would appear that § 9-307(1) should control, to the exclusion of § 9-307(2), in a transaction involving a buyer in ordinary course of business. See Everett Nat'l Bank v. Deschuiteneer, 244 A.2d 196 (N.H. 1968).

[16] Though the action was brought in replevin to recover possession of the automobile, Jones' motion for custody was granted upon his filing of a bond in the amount of $2000 to secure payment of any judgment which might be rendered against him. 108 N.H. at 387, 236 A.2d at 485. The general rule is that "a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof by the debtor." U.C.C. § 9-306(2).

[17] The phrase "created by his seller" was inserted in § 9-307(1) when the section was revised in 1957. In the 1952 Official Draft the section provided:

> In the case of inventory, and in the case of other goods as to which the secured party files a financing statement in which he claims a security interest in proceeds, a buyer in ordinary course of business takes free of a security interest even though perfected and even though the buyer knows of the terms of the security agreement.

Though this statement of § 9-307(1) does not expressly limit the protection of the buyer in ordinary course to those security interests "created by his seller," the comments which accompanied this draft of the section indicate that such a limitation was intended. U.C.C. § 9-307(1), Comment 2, of the 1952 Official Draft provides: "Under subsection (1) a buyer in ordinary course of business . . . takes free of a perfected security interest in goods . . . when the goods are inventory *of the debtor* . . . ." (Emphasis added.)

purchasers following an unauthorized sale by the consumer-debtor,[18] including a "buyer in ordinary course of business" such as Jones. In both the typical three-party situation and the four-party situation of the *Jones* case, the final purchasers are "buyers in the ordinary course of business." Yet in the former situation the buyer is protected, while in the latter he is not. In view of the underlying policy of the Code this apparent anomaly deserves closer examination, both from the standpoint of the "buyer in ordinary course of business" and that of the secured party.

It should be noted that the *Jones* result is predicated on the goods having been initially encumbered by a consumer-debtor. Should the goods be initially encumbered by a dealer who holds them as inventory, a contrary result obtains under the Code in a four-party situation such as that found in *Jones*. In a hypothetical situation, a secured party takes a security interest in the inventory of a dealer. The secured party files a financing statement, thus perfecting his interest.[19] The debtor-dealer then sells the goods to another dealer in goods of that kind, who in turn sells the goods to a "buyer in ordinary course of business," who holds the goods in the capacity of a consumer. Viewing the overall transaction as of the time of the first sale, the dealer who purchased the goods from the debtor-dealer will take free of the security interest by operation of section 9-307(1), as he is a "buyer in ordinary course of business" and the security interest was "created by his seller." However, viewing the overall transaction as of the time of the second sale, section 9-307(1) would not appear to allow the consumer-buyer to take free since the security interest was not "created by his seller."[20]

If, however, the secured party is able to enforce his security interest against the consumer-buyer, a conflict with other provisions in the Code would result. The Code provides in Article 2 that "[a] purchaser of goods acquires all title which his transferor had or had power to transfer . . . ."[21] As previously stated, following the first sale, the dealer-buyer would have title in the goods "free" of the secured party's interest by operation of section 9-307(1). When the dealer in turn sells to a consumer-buyer, the buyer takes "all title which his transferor had" and thus would also take title free of the secured party's interest.[22]

It is thus apparent that the result in the *Jones* case would have been otherwise had the party who created the security interest been a dealer rather than a consumer. In both cases the ultimate buyer purchased from a

[18] See U.C.C. § 9-307, Comment 3; 1 G. Gilmore, Security Interests in Personal Property 550-51 (1965).

[19] See U.C.C. § 9-302.

[20] Coogan, A Suggested Analytical Approach to Article 9 of the Uniform Commercial Code, 63 Colum. L. Rev. 1, 25 (1963).

[21] U.C.C. § 2-403(1).

[22] It should be noted that the application of Article 2 in this analysis is not violative of U.C.C. § 2-402(3). That section in part provides: "Nothing in this Article shall be deemed to impair the rights of creditors of the seller (a) under the provisions of the Article on Secured Transactions (Article 9). . . ." The section refers only to "creditors of the seller," whereas in this analysis Article 2 is applied only to the second sale, i.e., from the dealer to the consumer-buyer. As the secured party is not a creditor of the seller in this sale, application of Article 2 provisions does not "impair the rights of creditors of the seller."

dealer, yet whether or not he took free of the security interest was determined by the status of his seller's transferor, a party with whom he had not dealt. As a consequence of the possibility that the party from whom his seller purchased was a consumer who had encumbered the goods, the "buyer in ordinary course of business" must search the title to the goods and the files. Only through such a search can he reasonably be assured that he will take the goods free of a possible outstanding security interest.[23] The buyer's alternative, assuming that he does not wish to undertake a search of the title and files, is to evaluate his seller's financial position in order that he may reasonably be assured of recovering against his seller for breach of warranty of title[24] should a secured party subsequently enforce his interest through an action of replevin or for conversion.[25]

It should be noted that this necessity of a search of the files and title by a "buyer in ordinary course of business" is not limited to a four-party situation, even though a "buyer in ordinary course of business" in a three-party situation takes free automatically by virtue of section 9-307(1). This is demonstrated by the fact that any buyer must first search the title and files before he can reasonably be assured that there is no outstanding encumbrance created by one not his seller, and thus that he is in fact in a three-party situation. Therefore, even in those situations where section 9-307(1) would operate to allow the "buyer in ordinary course of business" to take free, the buyer cannot be certain that the section will apply without a search of the title and files.

This necessity to ascertain whether someone has encumbered the goods prior to their purchase by the buyer's immediate seller would appear to operate contrary to the Code's policy toward the "buyer in ordinary course of business." It is one of the basic objectives of the Code to promote and facilitate the free flow of commerce in goods.[26] This policy favoring the free

[23] Other provisions of the Code make possible a situation wherein even this procedure will not enable the buyer to learn of security interests in the goods which may be enforceable against him. Under the Code a purchase-money security interest in consumer goods need not be filed to be perfected. U.C.C. § 9-302(1)(d). In a hypothetical situation, *B* purchases a television set and borrows the purchase price from *A*, who takes a purchase-money security interest in the set. *A* does not file. *B* then, in violation of his agreement with *A*, sells the set to *C*, a dealer in television sets. *C* then sells the set to *D*, a "buyer in ordinary course of business." *D* would not take free under § 9-307(1) because the security interest was not created by his seller. Nor would *D* take free under § 9-307(2), for that section applies only to sales wherein one consumer sells to another consumer. See note 15 supra. The result is somewhat anomalous in view of the fact that had *D* purchased directly from *B* he would have taken free under § 9-307(2). *D*, furthermore, is virtually incapable of protecting himself in this situation. His only mode of discovering the security interest, since there has been no filing, is to inquire of *B* as to any encumbrances on the set. It would appear highly unlikely that *B*, who has violated his agreement with *A*, is going to be any more honest with *D*.

[24] U.C.C. § 2-312.

[25] See U.C.C. § 9-306, Comment 3; 1 G. Gilmore, supra note 18, at 551.

[26] See Kennedy, Secured Lending Under the Uniform Commercial Code, 83 Banking L.J. 283, 285 (1966). Warren, Cutting Off Claims of Ownership Under the Uniform Commercial Code, 30 U. Chi. L. Rev. 469, 493 (1963). The Special Committee on the Uniform Commercial Code of Commerce and Industry Association of New York, Inc., in reporting to the New York Law Revision Commission, specifically approved "[t]he policy of the free movement of goods expressed in Section 9-307(1). . . ." 2 New York Law Revision Commission Report, Study of the Uniform Commercial Code 1018 (1954).

movement of goods is reflected in the entrusting provisions of Article 2 and section 9-307(1), which are designed to operate concurrently as "a single principle protecting persons who buy in ordinary course out of inventory."[27] As regards Article 9 specifically, this policy is preserved by protecting a security interest created under that Article "as long as it does not interfere with the normal flow of commerce."[28] However, by providing that a "buyer in ordinary course of business" takes free of a perfected security interest created by his seller, section 9-307(1) is indicative of a determination by the draftsmen that priority must be granted such buyers in order to preserve the normal flow of commerce.

This policy benefits both the secured party and the debtor in that it facilitates the conversion of the collateral to cash and thus payment of the debt. However, the limitation of section 9-307(1) protection to security interests created by the seller leads to an apparent internal inconsistency in the section in that it would appear to restrict, rather than promote, the free flow of goods by forcing the "buyer in ordinary course" (even in a three-party situation) to undertake a search of the title and files for possible security interests created by one not his seller.

An examination of section 9-307(1) would appear to indicate that the draftsmen intended that the prospective purchaser could rely for his protection upon his status as a "buyer in ordinary course of business," and not upon his ability to search the title and files. Section 9-307(1) provides that "[a] buyer in ordinary course of business . . . takes free of a security interest created by his seller even though the security interest is perfected and *even though the buyer knows of its existence.*" (Emphasis added.) A "buyer in ordinary course," furthermore, must buy 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.[29] When these two provisions are read together, "it results that the buyer takes free if he merely knows that there is a security interest which covers the goods but takes subject if he knows, in addition, that the sale is in violation of some term in the security agreement not waived by the words or conduct of the secured party."[30]

From this it is apparent that a "buyer in ordinary course of business" who has no knowledge of a security interest created by his seller has no duty or reason to search the files to ascertain whether one does in fact exist. This results because section 9-307(1) "protects" such a buyer even if he knows of the existence of the security interest. However, due to the "created by his seller" limitation the "buyer in ordinary course" must follow a somewhat anomalous procedure in order to protect himself. He must search the title and files for all possible security interests created by one not his seller. Yet as to his seller, the buyer not only need not check the files to be protected, but in fact he is encouraged not to do so. If the secured party has filed the security

[27] U.C.C. § 2-403, Comment 2.

[28] Lee, Perfection and Priorities Under the Uniform Commercial Code, 17 Wyo. L.J. 1, 34 (1962); see also Project, California Chattel Security and Article Nine of the Uniform Commercial Code, 8 U.C.L.A.L. Rev. 806, 898 (1961).

[29] U.C.C. § 1-201(9).

[30] U.C.C. § 9-307, Comment 2.

agreement in place of or along with the financing statement,[31] the buyer, by checking the files under the name of his seller, could obtain knowledge that the sale is in violation of the security interest of the secured party and thus lose the protection of section 9-307(1).

The "buyer in ordinary course of business" would appear to be concerned primarily with the price, quality and condition of the goods. For all of these aspects of his purchase he can look to his seller. Furthermore, no matter from whom the seller purchased the goods, to the "buyer in ordinary course of business" they are simply inventory. Yet due to the "created by his seller" limitation it is very relevant who transferred the goods to his seller. If it had been a dealer, then the "buyer in ordinary course of business" will take free of any security interest created by his seller's transferor, on the assumption that his seller took free under section 9-307(1). However, if his seller's transferor had been a consumer, then the "buyer in ordinary course of business" will take subject to any security interest he created. This distinction based upon the nature of his seller's transferor would appear to be arbitrary from the viewpoint of the "buyer in ordinary course of business." If the phrase "created by his seller" were deleted from section 9-307(1) this distinction would no longer be made, and any restriction on the free flow of goods that results from the buyer being forced to search the files and title would be eliminated. Before such a change in the scope of the protection given a "buyer in ordinary course of business" can be proposed, however, the "created by his seller" limitation must also be appraised from the viewpoint of the secured party.

A security interest, by its very nature, secures the loan extended by the secured party and thus reduces the risk that the lender must assume. Should the debtor default on his obligation, the secured party may repossess the goods and satisfy his claim out of the proceeds of their sale.[32] Furthermore, should the debtor sell or otherwise dispose of the goods, to the extent that the security interest "continues"[33] in the goods, the lender's risk is reduced. These attributes of a security interest undoubtedly serve as a great incentive to the release of credit by money lenders. With an economy that is highly dependent on credit buying, such an incentive would appear desirable. However, the desire to realize these favorable effects of enforceable security interests must also be reconciled with the desire to protect innocent purchasers from the debtor.

Under the Code, the protection afforded a security interest against sale by the debtor is determined by the nature of the debtor. Whereas in a four-party situation it would appear unimportant to the "buyer in ordinary course of business" whether his seller's transferor was a consumer or a dealer, to the secured party the nature of the debtor is of primary importance. If the debtor is a dealer, then the secured party "expects" that the debtor will sell the collateral to buyers in ordinary course of business. Consequently, the principle embodied in section 9-307(1) that buyers from such debtors take free of the security interest is not considered by the Code draftsmen to be violative of

[31] See U.C.C. § 9-402, Comment 1.
[32] U.C.C. §§ 9-503, -504.
[33] U.C.C. § 9-306(2).

the interests of consignors or lenders who hold a security interest in the inventory, "since the very purpose of goods in inventory is to be turned into cash by sale."[34] On the other hand, if the debtor holds the goods as consumer goods, the secured party would not generally expect the debtor to sell them until the debt had been satisfied. Thus, the secured party may protect his interest against subsequent purchasers and creditors should the debtor fraudulently sell or further encumber the goods by prohibiting sale in the security agreement and filing. As seen by the *Jones* case, in which the debtor was a consumer, the "created by his seller" limitation in section 9-307(1) even protects such a security interest against a sale by the debtor's vendee to a "buyer in ordinary course of business." Yet because this limitation seems inconsistent with the overall policy of the Code toward the "buyer in ordinary course of business," by forcing him to search the title and files, the effect of its removal upon the secured party should be examined.

With the deletion of the language "created by his seller," a secured party would be required to enforce his possessory rights in the collateral prior to its sale to a "buyer in ordinary course of business" or else lose them. Therefore, in order to protect his security interest from loss through a sale to a "buyer in ordinary course of business," the secured party would be required to make periodic checks on his collateral to make sure his debtor had not sold the goods to a dealer.[35] Of course, the secured party could decline to check on who holds his collateral and rely upon a suit for conversion against each purchaser of the goods prior to a sale to a "buyer in ordinary course of business."[36]

Forcing the secured party to protect his security interest by maintaining knowledge of the whereabouts of his collateral, however, would be a significant departure from the present situation wherein the secured party need locate the collateral only upon default by the debtor in his payments. Yet there are provisions in the Code which support the proposition that certain situations do warrant the imposition of affirmative duties on the secured party to maintain knowledge of the whereabouts of his collateral. Where the secured party is required to file in the county wherein the debtor resides, the filing becomes ineffective four months after the debtor moves to a new county unless the second party files in the new county.[37] Similarly, if goods subject to a perfected security interest are moved to another state from that wherein the security interest attached, the security interest becomes unperfected after four months unless the secured party perfects by refiling in the new state.[38] In light of these provisions, deletion of the words "created by his seller" would not appear to be violative of any overall Code policy against forcing the secured party to maintain a check on his collateral.

By deleting "created by his seller" from section 9-307(1), the risk of

[34] U.C.C. § 2-403, Comment 2.

[35] An unauthorized sale of the collateral by the debtor to a dealer would constitute default on the part of the debtor, see U.C.C. § 9-306, Comment 3, and the secured party could repossess the collateral from the dealer. U.C.C. § 9-503.

[36] See U.C.C. § 9-306, Comment 3; 1 G. Gilmore, supra note 18, at 550-51. See also U.G.I. v. McFalls, 18 Pa. D. & C.2d 713 (Lancaster County Ct. 1959).

[37] U.C.C. § 9-401, Alternative Subsection (3).

[38] U.C.C. § 9-103(3).

loss of his security interest in consumer goods through a sale to a "buyer in ordinary course of business" would be placed upon the secured party. It is reasonable to assume that this risk will be passed on to debtors by money lenders in the form of an increase in the cost of consumer credit. However, this result would appear more equitable in that it spreads such economic losses among the entire class of consumer borrowers, rather than imposing the entire loss on a single party who may be totally unable to protect himself. Yet this does not mean that the consumer class as a whole will not benefit from such a change in the protection given a "buyer in ordinary course of business." The losses presently being incurred by such buyers may possibly be eliminated through a minimum of effort and expense on the part of secured parties. One method by which a secured party may prevent the loss of his security interest through a sale to a "buyer in ordinary course of business" is a more selective screening of applicants for credit. Furthermore, he may conduct selective periodic investigations concerning the whereabouts of his collateral, giving greater attention to those debtors who are poor risks and have great outstanding indebtedness.

II. The Knowledge Criteria for Buying in Ordinary Course of Business.

As noted above, a "buyer in ordinary course of business" takes free under section 9-307(1) "if he merely knows that there is a security interest which covers the goods but takes subject if he knows, in addition, that the sale is in violation of some term in the security agreement not waived by the words or conduct of the secured party."[39] The effect of this apparent distinction was considered in the recent case of *Cash Loan Co. v. Boser*,[40] in which the Wisconsin Supreme Court was called upon to decide whether a buyer's knowledge would bar him from the protection of section 9-307(1).

Cash Loan held a security interest in a roto drill which was unperfected due to a lack of filing. The defendant, Boser, purchased the drill from one Bembinster, who had possession of the machine on consignment to sell it for Neuheisel, Cash Loan's debtor. The court accepted the lower court's finding that Bembinster had not purchased the drill from Neuheisel. Prior to purchasing the drill, Boser had been told by representatives of Cash Loan that it held a chattel mortgage in the drill. Sometime after Boser purchased the chattel, Cash Loan brought an action of replevin. The primary question was framed by the court in terms of "whether the fact that Boser had actual knowledge of Cash Loan's mortgage precludes him from claiming priority even though the mortgage was unperfected . . . ."[41] The court rendered judgement for the plaintiff on the basis that "Boser here was put on notice by statements of the representatives of Cash Loan that he would be violating the ownership rights of Cash Loans if he purchased the roto drill from Bembinster; hence he cannot be considered a 'buyer in ordinary course of business'. . . ."[42]

[39] U.C.C. § 9-307, Comment 2.
[40] 34 Wis. 2d 410, 149 N.W.2d 605 (1967).
[41] Id. at 417-18, 149 N.W.2d at 609.
[42] Id. at 419, 149 N.W.2d at 610.

It is critical to note that the court's holding that Boser was not a "buyer in ordinary course of business" was based upon a finding that he knew of the security interest and thus had *notice* that he would be violating Cash Loan's ownership rights by purchasing the drill. Due to the interplay of the Code's definition of "buyer in ordinary course of business" and section 9-307(1), however, a buyer is disqualified from protection under section 9-307(1) only if he *knows* that the sale is in violation of the secured party's interest. The court, therefore, appears to have equivocated "notice" and "knowledge" for purposes of the definition of "buyer in ordinary course of business."

However, these terms are specifically defined and distinguished in the Code. "A person 'knows' or has 'knowledge' of a fact when he has actual knowledge of it."[43] On the other hand, a person has "notice" of a fact when he has actual knowledge of it, or should have known of it from all the facts and circumstances.[44] Due to the far more extensive coverage of the definition of notice, the unqualified use of the term "without knowledge" in the definition of "buyer in ordinary course of business" must be taken to exclude situations wherein the buyer has anything less than actual knowledge that the sale is violative of the security interest of the secured party.

Due to the fact that under the Code "notice" does include "actual knowledge," however, it is arguable that the court meant that the buyer had "actual knowledge" that the sale to him was violative of the secured party's rights when it stated that he had "notice" of that fact. However, further statements by the court would appear to indicate that the buyer's notice consisted of something less than actual knowledge of the violative nature of the sale. The court stated that "[i]f the defendant did not believe Cash Loan's claim that it had a prior mortgage, he could have requested production of the document by Cash Loan."[45] This statement indicates that the court felt that the only actual knowledge the buyer had was that the plaintiff "had a prior mortgage" and not that the buyer had knowledge that the sale was in violation of the plaintiff's rights.

The above statement is also indicative of a feeling by the court that a buyer who knows of the existence of a security interest in the goods has a duty to check the security agreement for terms prohibiting the sale. However, such a conclusion would appear contrary to the entire thrust and purpose of section 9-307(1). The section is applicable only where there is an unauthorized sale by the debtor,[46] for if the secured party authorizes the sale in the security agreement or otherwise the buyer takes free irrespective of the terms in the security agreement.[47] With this restriction on the application of the section in mind, an interpretation that the buyer has the burden of examining the security agreement for terms prohibiting the sale would render meaningless the phrase "even though the buyer knows of its existence" in section 9-307(1). This follows because, under the court's reasoning in *Boser*, if the sale violated some term in the security agreement, all buyers

[43] U.C.C. § 1-201(25).
[44] Id.
[45] 34 Wis. 2d at 420, 149 N.W.2d at 610.
[46] U.C.C. § 9-307, Comment 2.
[47] U.C.C. § 9-306, Comment 3.

who knew of the existence of the security interest would also be presumed to "know" that the sale violated the security interest, and thus would take subject to the interest. Consequently, the section would never protect a "buyer in ordinary course of business" who knew of the existence of the security interest prior to his purchase.

From this interpretation it is clear that the Code has expressly provided that a "buyer in ordinary course of business" has no duty to examine the security agreement even if he knows that his seller has encumbered the goods. This determination by the Code draftsmen would appear to conform, in most instances, to the intentions of the parties. One who extends credit on the inventory of a dealer generally expects that the inventory will be sold to repay the loan.[48] One who buys from the dealer, therefore, should be able to rely upon his authority to sell.

III. Suggested Amendment and Interpretation.

Due to the fact that the protection afforded a "buyer in ordinary course of business" under section 9-307(1) is limited to those security interests "created by his seller," the buyer must search the title and files for possible security interests created by one not his seller. This would appear to contradict the Code's overall policy toward the "buyer in ordinary course of business" as embodied in section 9-307(1), for as to his own seller such a buyer is protected irrespective of whether he searches the title or files. To eliminate this apparent inconsistency, it is suggested that section 9-307(1) be amended by deleting the words "created by his seller."[49] With such a change, a buyer in ordinary course would take free no matter who created the security interest, and the Code would truly set forth "a single principle protecting persons who buy in ordinary course out of inventory."[50] In addition, the Code's underlying objective of promoting the free flow of goods would be promoted, for as to any possible security interest in the goods the buyer could rely upon his status as a "buyer in ordinary course of business" for his protection. Such a change would place an extra burden upon secured parties, yet it would not be an undue burden in light of the fact that such parties are paid to assume a risk of default by the debtor and should be able to protect their interests sufficiently by a minimum amount of policing.

Furthermore, in light of the construction of section 9-307(1), courts should insist upon a finding of whether the buyer had "actual knowledge" that the sale was in violation of the security interest of a third party before

[48] See U.C.C. § 2-403, Comment 2.

[49] One commentary appears to ignore the words "created by his seller" and contends that the present formulation of § 9-307(1) would protect a "buyer in ordinary course of business" from a perfected but unfiled security interest which was created by his seller's transferor. Wiseman & King, Perfection, Filing and Forms Under Article 9 of the Uniform Commercial Code, 9 Wayne L. Rev. 580, 590-91 & n.37 (1963). See also Al Maroone Ford, Inc. v. Manheim Auto Auction, Inc., 205 Pa. Super. 154, 208 A.2d 290 (1965), in which a consumer-debtor sold a car to the defendant auto auction. At the time the secured party brought suit the defendant had already sold the car. The court, in finding for the plaintiff, stated by way of dicta that a buyer in the ordinary course from the defendant dealer would take free of the security interest. Id. at 160, 208 A.2d at 293.

[50] U.C.C. § 2-403, Comment 2.

denying a buyer protection under the section on the basis of the knowledge he possessed at the time he purchased. Section 9-307(1) places no affirmative duty upon the buyer to examine the terms of the security agreement covering a security interest created by his seller, and expressly provides that a buyer who does not *know* that the sale violates such a security interest shall take free. Should a buyer with knowledge of a security interest created by his seller be forced by such a "notice" concept as envisioned in *Boser* to trace and examine the security agreement, the free flow of goods which the Code is designed to achieve could be severely restricted.[51] Furthermore, such precautionary action by the buyer would in most instances prove to be unnecessary, for generally a debtor-dealer is given authority to sell the secured inventory by the secured party. By purchasing from such a debtor, the "buyer in ordinary course of business" performs the necessary function of converting the inventory to cash and thus enables the debtor to repay the secured party. To encourage and promote his performance of this function, the "buyer in ordinary course of business" should be protected in his purchase when he has less than actual knowledge that the sale violates the ownership rights of a third party. When he has such knowledge, he is justly denied protection.

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[51] See Warren, supra note 26, at 472-73.