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Article 9: Secured Transactions

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checked a financial statement of Great Security and that he had no intention of paying Russell if the judgment in the present case proved unsatisfactory to him. The lower court found that the issue was unauthorized, that at the time Gwatney bought the stock Great Security was insolvent, that Gwatney should have known of this since he had checked its financial statement, and that Gwatney was not a bona fide purchaser. It therefore found no reason not to order cancellation. On appeal, affirmed. In light of the definition of bona fide purchaser in Black's Law Dictionary, it could not be said that the lower court's finding was against the preponderance of the evidence. Gwatney not being a bona fide purchaser, he could not take advantage of Arkansas case law prohibiting cancellation in the hands of a bona fide purchaser. Section 8-301(2) was quoted verbatim by the court. That section provides: "A bona fide purchaser in addition to acquiring the rights of a purchaser also acquires the security free of any adverse claim."

COMMENT

It is not clear from the court's opinion whether Section 8-301(2) was relied on or not. If it was, then the court would have done well to look to Section 8-302 for its definition of bona fide purchaser, instead of to Black's Law Dictionary. The test is the same but the statutory wording is obviously preferable.

Assuming that the Code is applicable, there is still a question whether the plaintiff's insistence that the stock be cancelled is the type of "adverse claim" contemplated by the draftsmen in Section 8-301(2). "Adverse claim" is not defined in the Code. Certainly, however, the plaintiff's claim is not adverse in the sense that he is claiming the defendant's stock as his own. In short, if the plaintiff's claim were considered to be something other than "adverse," the defendant could not take free of it under Section 8-301(2) even if he were a bona fide purchaser.

The court, in placing the burden of establishing bona fide purchase on the holder, adopted a rule similar to that in Section 3-307(3) for holders in due course. Once a defense is established, as here by plaintiff, the entire burden is on the holder.

G.E.F.

ARTICLE 9: SECURED TRANSACTIONS

SECTION 9-102. Policy and Scope of Article

JACOBS V. NORTHEASTERN CORP.

206 A.2d 49 (Pa. 1965)

Northeastern Corp. entered into two construction contracts, one with the General State Authority for the construction of a state building and the other with the Secretary of Highways for the construction of state roads. Each contract required Northeastern to furnish a performance bond and a bond for the payment of labor and materials, and each gave unpaid labor and materialmen a right of action against Northeastern and the sureties on

the bond. The bonds were expressly made a part of the contracts. Northeastern failed to pay certain labor and materialmen on each project and the sureties made payment in compliance with the bonds. When a Northeastern shareholder had the corporation placed in receivership, final payments under both contracts were due and owing from the state. The sum of these payments was less than the amounts which the sureties were required to pay under the bonds. In this action the sureties and Northeastern's receivers both claim the payments due from the state. The trial court held that the sureties were entitled to the payments under the doctrine of subrogation.

On appeal, the receivers contended, *inter alia*, that a security interest was all that the sureties possessed in the payments due Northeastern under the construction contracts, and that since they had not perfected their interests in accordance with the Uniform Commercial Code, their interests were subordinate to the rights given the receivers by that Code.

The court, in affirming the decision, held that under Pennsylvania law sureties were entitled to the payments due from the state under the doctrine of equitable subrogation. Payment of labor and materialmen was an obligation imposed upon Northeastern by the contracts. The funds which the state rightfully withheld were to insure that Northeastern would meet this obligation, and in the event that it did not the state could have paid such claims directly. Northeastern was entitled to the payment involved only if it had paid the claims of labor and materialmen. Therefore, since it had not, the payment should go to the sureties once they performed under the bonds, just as it would have gone to the labor and materialmen (rather than the general creditors) in the absence of the bonds.

In discussing the inapplicability of the Uniform Commercial Code, the court concluded that under Section 9-102(2), Article 9 applies only to security interests *created by contract*, and that "rights of subrogation, although growing out of a contractual setting . . . do not depend for their existence on a grant in the contract, but are created by law to avoid injustice." The court also noted that a filing under the Code could have served no useful purpose because Northeastern, once having defaulted, was not entitled to the payments.

A dissenting opinion agreed with the majority as to the sureties' rights of subrogation but nevertheless contended that the Code was applicable.

COMMENT

In *United States v. Fleetwood & Co.*, 165 F. Supp. 723 (W.D. Pa. 1958), the Federal District Court for the Western District of Pennsylvania held that Article 9 applied to a surety's interest in contract rights assigned to it by a contractor as partial consideration for a performance bond, and also that the surety's interest was subordinate to that of the contractor's trustee in bankruptcy because of the surety's failure to perfect its interest in accordance with the Code. The instant court footnoted the *Fleetwood* decision and, after pointing out that *Fleetwood* involved only a performance bond and not a bond for payment of labor and material and that the surety in that case sought to prevail on the basis of the contractor's assignment and

not on a subrogation theory, stated that it was not necessary for it to determine how it would have decided *Fleetwood*.

Despite the apparent conflict, the decisions in *Fleetwood* and the present case are distinguishable and each is correctly decided. In the present case, Northeastern was contractually obligated to pay the claims of labor and materialmen and this contractual obligation gave the state agencies an implied right to withhold monies if they determined that there were unsatisfied claims for labor and material. Therefore, once Northeastern defaulted in payment, it was not entitled to the money withheld by the state agencies, at least to the extent of the unpaid claims. Thus, to apply the doctrine of subrogation under these circumstances deprives Northeastern's general creditors of nothing to which they are entitled; not to apply the doctrine would result in a windfall to them.

In *Fleetwood*, the payments involved were admittedly due the bankrupt-contractor. They had not been withheld to insure performance of a specific obligation of the contractor. They had already been conditionally earned. Under these circumstances application of the doctrine of subrogation would have allowed the surety to claim, at the expense of the contractor's creditors, a fund which it could have reached in no other way. Certainly, if the surety were to prevail as a secured creditor because of the assignment, it would have had to meet the requirements of the Code. This it did not do, and an application of the doctrine of subrogation would clearly have worked an injustice. A surety who has assumed the risk of the contractor's default should not be placed in a preferred position because the risk insured has occurred. But where the surety performs in accordance with its bond and pays a claim, for the payment of which there exists a fund in which the contractor has no rights because of default, the nonapplication of the doctrine of subrogation would work an injustice.

V.A.S.

SECTION 9-104. Transactions Excluded From Article

FIRESTONE TIRE & RUBBER CO. V. DUTTON

205 A.2d 656 (Pa. Super. 1964)

In an action to replevy a stereo and television set, the plaintiff alleged in its complaint that it had sold the set to defendant Dutton on a bailment lease; that without notice to the plaintiff, Dutton had then moved from his residence and had taken the set with him; and that Dutton having refused to pay the plaintiff the balance due, the plaintiff was entitled to the immediate possession of the set under the bailment lease. In its answer defendant Amberson Gardens set out as new matter that it had leased an apartment to William DiSantis; that because of DiSantis' defaults in rental payments, it had authorized a constable to distrain on all personalty in DiSantis' apartment; that at the constable's sale it had purchased all the personalty, including the stereo and television set; and that the plaintiff had failed to give Amberson Gardens notice of its interest in the set within ten days of the time that the set had been placed on the premises of Amberson Gardens, as required by the Pennsylvania Landlord and Tenant Act of 1951. The plain-

tiff's reply denied all of the new matter except the averment that the plaintiff had failed to give notice. The lower court granted judgment on the pleadings for Amberson Gardens.

In reversing the lower court and remanding, the appellate court held that no judgment could be had on the pleadings since there were controverted fact issues as to the defendant's compliance with the Landlord and Tenant Act. The appellate court also held that under Section 9-104 the Code did not apply to landlord's liens. The Landlord and Tenant Act governed the situation and under this act the plaintiff's right to replevy the set from Amberson Gardens depended on whether the plaintiff had notified Amberson Gardens of its interest within ten days of the time that the set had been placed on the premises of Amberson Gardens.

COMMENT

The instant case is unclear as to how DiSantis obtained possession of the set from Dutton. Compare *In re Einhorn Bros., Inc.*, 272 F.2d 434 (3d Cir. 1959).

R.G.K.

SECTION 9-306. "Proceeds"; Secured Party's Rights on Disposition of Collateral

RODI BOAT CO. v. PROVIDENT TRADESMENS BANK & TRUST CO.

236 F. Supp. 935 (E.D. Pa.), aff'd, 339 F.2d 259 (3d Cir. 1964)
Annotated under Section 9-401, *infra*.

SECTION 9-310. Priority of Certain Liens Arising by Operation of Law

CORBIN DEPOSIT BANK v. KING

384 S.W.2d 302 (Ky. Ct. App. 1964)

After the effective date of the Code, Floyd Foreman gave the appellant-bank a security interest in his motor vehicle, which the bank perfected by appropriate filing under Section 9-302. While Foreman's obligations under his security agreement with the bank were still in full force and unpaid, Foreman had the appellee King make certain repairs on his car which resulted in a statutory lien in favor of King for the value of the repairs. Foreman did not pay either King or the bank and the bank repossessed the car from King and sold it. King contended that under Section 9-310 his artisan's lien took priority over the bank's security interest, even though the bank's interest was perfected. The court agreed, basing its decision on Section 9-310 and the additional fact that the statute creating the artisan's lien contained no provision subordinating the lien to an earlier perfected security interest. Since the Code was in effect at the time of all relevant transactions and since its provisions were deemed to be incorporated into any contract executed after its effective date, the court rejected the bank's contentions that Section 9-310, as interpreted, unconstitutionally impaired the obligations of contract and that the decision amounted to a denial of

due process. The court also rejected the argument based on Kentucky Revised Statute, sections 376.440, 376.445, and 376.450 that its "security interest" was a "mortgage" which could not be subordinated to King's artisan's lien without certain procedural steps being taken.

COMMENT

Where all relevant transactions are completed before the effective date of the Code, the Code has expressly provided against the possibility that its provisions will unconstitutionally impair the obligations of contract. Section 10-102(2) provides that the rights, duties and interests flowing from transactions entered into before the effective date of the Code remain valid thereafter and "may be terminated, completed, consummated or enforced as required or permitted by any statute or other law amended or repealed by this Act as though such repeal or amendment had not occurred."

In *First Nat'l Bank v. Bahan*, 198 N.E.2d 272 (C.P. Ohio 1964), annot. 6 B.C. Ind. & Com. L. Rev. 105 (1964), the plaintiffs perfected security interests in a motor vehicle before the Code became effective. After the Code became effective, an artisan repaired the vehicle and acquired an artisan's lien. Under pre-Code law, a perfected security interest took priority over a subsequently acquired artisan's lien. The court held that under the circumstances priority should be determined by pre-Code law. Not only did Section 10-102(2) require it, but also, if the decision were otherwise, the adoption of the Code would have the effect of unconstitutionally impairing the value of the security interests which the plaintiffs had perfected before the effective date of the Code.

P.J.N.

SECTION 9-401. Place of Filing; Removal of Collateral

RODI BOAT CO. V. PROVIDENT TRADESMENS BANK & TRUST CO.

236 F. Supp. 935 (E.D. Pa.), aff'd, 339 F.2d 259 (3d Cir. 1964)

Stuempfig bought a boat pursuant to a retail installment contract which reserved title in the plaintiff-seller. This contract was filed in Florida. Approximately one year later, Stuempfig sold the boat in Maryland and deposited the proceeds in his account with the defendant-bank, which was located in Pennsylvania. The defendant-bank set off a portion of the proceeds in Stuempfig's account against a debt he owed the bank. The present action was brought by the plaintiff-seller against the defendant-bank for the amount still owed the seller by Stuempfig. The court held that the sale of the boat by Stuempfig was a conversion and that the proceeds were impressed with a constructive trust. Hence, when the bank set off a portion of the money in Stuempfig's account, it unlawfully appropriated the seller's property. The court stated that it was immaterial that the plaintiff-seller did not file the contract in Pennsylvania under Section 9-401 et seq. and that the boat was never in Pennsylvania.

COMMENT

Assuming that Pennsylvania law applies, the court's use of a constructive trust was both unnecessary and unfortunate in view of the provisions of the Code.

The plaintiff-seller, by reserving title, possessed a security interest in the boat. Section 2-401(1). By operation of law, the security interest continued to exist in identifiable proceeds derived from the sale of the boat. Section 9-306(2). Even assuming that the plaintiff-seller's security interest in the proceeds was unperfected, it would still, by implication of Section 9-301, prevail over the bank's interest, since Section 9-301 does not subordinate an unperfected security interest to the type of interest held by the bank which was, at best, that of an unsecured general creditor.

R.W.D.

SECTION 9-402. Formal Requisites of Financing Statement; Amendments

ALLOWAY v. STUART

385 S.W.2d 41 (Ky. Ct. App. 1964)

In January, 1962, Schneider sold Stuart certain bowling alley equipment. A chattel mortgage was executed in Schneider's favor and filed on January 31. On June 26, 1962, a creditor of Stuart attached the equipment, and two days later, when judgment was given, acquired a lien on the property. More than a year later, the creditor amended his complaint to allege that Schneider was asserting a conflicting interest in the equipment. Schneider answered, setting up the mortgage. The creditor argued that Schneider's lien was subordinate to his since the chattel mortgage which Schneider had filed as a financing statement did not contain the signature of Schneider as Section 9-402(1) required. The court, in affirming a judgment giving Schneider's lien priority, held that Schneider's failure to sign the financing statement was not, in view of the statement's "detailed nature," important. Since the statement substantially complied with Section 9-402(1), it was effective under Section 9-402(6). Such a holding was consistent with Section 1-102 which provides that the Code should be liberally construed to promote its underlying purposes. The court concluded by saying that during the transitional period when the bar is familiarizing itself with the changes made by the Code, a certain degree of indulgence was to be expected from the bench.

COMMENT

Section 9-402(1) says, in part, two things: first, that a copy of a security agreement may be filed as a financing statement, and second, that a financing statement, unlike a security agreement, must contain the signature of the secured party. The court, in excusing the secured party's failure to sign in the present case, emphasized that the financing statement actually filed was of a "detailed nature" and that its notice giving function was not, therefore, compromised. What the court failed to consider, however, was that

the absence of the secured party's signature left the financing statement without an authenticating symbol of small importance. Compare *In re Kane*, 55 Berks Co. L.J. 1 (Pa. 1962) in which a referee in bankruptcy held that a photocopied signature of the secured party was insufficient to satisfy the requirement of a signature.

S.L.P.

SECTION 9-503. Secured Party's Right to Take Possession After Default

FORT KNOX NAT'L BANK V. GUSTAFSON
385 S.W.2d 196 (Ky. Ct. App. 1964)
Annotated under Section 1-208, supra.

SECTION 9-504. Secured Party's Right to Dispose of Collateral After Default; Effect of Disposition

FORT KNOX NAT'L BANK V. GUSTAFSON
385 S.W.2d 196 (Ky. Ct. App. 1964)
Annotated under Section 1-208, supra.

SECTION 9-507. Secured Party's Liability for Failure to Comply With This Part

FORT KNOX NAT'L BANK V. GUSTAFSON
385 S.W.2d 196 (Ky. Ct. App. 1964)
Annotated under Section 1-208, supra.