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LAPSE OF PERFECTION IN SECURED TRANSACTIONS: A SEARCH FOR A CONSISTENT APPROACH†

BARRY L. ZARETSKY*

Under article 9 of the Uniform Commercial Code,¹ a perfected secured creditor possesses rights in personal property that are superior to those of most other claimants of the property.² Consequently, it is important to a secured creditor to create and maintain a perfected interest. A security interest may be perfected by filing a financing statement³ or by taking possession of the collateral.⁴ Perfection also occurs automatically, in some instances, as soon as the security interest attaches.⁵ The availability of these methods of perfection in a

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¹ Unless otherwise noted, citations will be to the 1972 version of the Uniform Commercial Code.

² As a general rule, the secured creditor will have the right, upon the debtor's default, to use the collateral to satisfy his claim against the debtor. *See, e.g.*, U.C.C. § 9-201 (security agreement generally effective between the parties, and against purchasers and creditors interested in the collateral); U.C.C. § 9-501 to 9-507 (default procedures). Unsecured creditors do not possess such rights. U.C.C. § 9-301(1) provides:

(1) Except as otherwise provided in subsection (2), an unperfected security interest is subordinate to the rights of

- (a) persons entitled to priority under Section 9-312; (re: priorities among conflicting security interests in same collateral);
- (b) a person who becomes a lien creditor before the security interest is perfected;
- (c) in the case of goods, instruments, documents, and chattel paper, a person who is not a secured party and who is a transferee in bulk or other buyer not in ordinary course of business or is a buyer of farm products in ordinary course of business, to the extent that he gives value and receives delivery of the collateral without knowledge of the security interest and before it is perfected;
- (d) in the case of accounts and general intangibles, a person who is not a secured party and who is a transferee to the extent that he gives value without knowledge of the security interest and before it is perfected.

U.C.C. § 9-301(1) (parenthetical added). The perfected secured creditor may also have rights to fixtures that are superior to those of an owner or encumbrancer of the real estate, U.C.C. § 9-313, and may have rights to goods which are installed in, affixed, or commingled with other goods. U.C.C. §§ 9-314, 9-315.

³ A financing statement must contain the names and addresses of the debtor and the secured party, a description of the collateral, and the signature of the debtor. U.C.C. § 9-402(1). Rules concerning the proper place to file a financing statement are found in § 9-401 (intrastate) and § 9-103 (interstate).

⁴ U.C.C. § 9-305.

⁵ Under section 9-203(1) and 9-203(2), a security interest attaches when it becomes enforceable against the debtor. This occurs when the secured party has possession of the collateral or the debtor has signed a security agreement, and value has been given and the debtor has rights

particular transaction depends upon such factors as the type of collateral,⁶ the purpose of the transaction,⁷ and the nature of the parties involved.⁸

Once the creditor has perfected his security interest, he must then guard against a lapse of perfection. While such a lapse can occur in a variety of ways, the most common situation involves the expiration of the five-year period during which financing statements are effective.⁹ Perfection also may lapse after the goods are moved to another jurisdiction,¹⁰ or because a period of temporary perfection expires.¹¹ Finally, perfection by possession lapses as soon as the secured party surrenders his possession of the collateral.¹²

When perfection lapses, third parties who normally take priority over an unperfected secured creditor will seek priority over the lapsed secured creditor, now considered unperfected. These third parties typically will be either pur-

in the collateral. No action is required to perfect an attached security interest in the following situations:

- (a) a security interest in collateral in possession of the secured party under Section 9-305;
- (b) a security interest temporarily perfected in instruments or documents without delivery under Section 9-304 or in proceeds for a ten day period under Section 9-306;
- (c) a security interest created by an assignment of a beneficial interest in a trust or a decedent's estate;
- (d) a purchase money security interest in consumer goods; but filing is required for a motor vehicle required to be registered; and fixture filing is required for priority over conflicting interests in fixtures to the extent provided in Section 9-313;
- (e) an assignment of accounts which does not alone or in conjunction with other assignments to the same assignee transfer a significant part of the outstanding accounts of the assignor;
- (f) a security interest of a collecting bank (Section 4-208) or arising under the Article on Sales (see Section 9-113) or covered in subsection (3) of this section;
- (g) an assignment for the benefit of all the creditors of the transferor, and subsequent transfers by the assignee thereunder.

U.C.C. § 9-302(1)(a)-(g).

⁶ For example, a security interest in money or instruments can only be perfected by possession except in certain temporary perfection situations. U.C.C. § 9-304(1). A security interest in accounts or general intangibles may only be perfected by filing. U.C.C. §§ 9-302, 9-305, Comment 1.

⁷ For example, perfection by possession would be inappropriate in a transaction in which the debtor needs to be able to use the collateral. In addition, the temporary automatic perfection of § 9-304(5) is available only when collateral is returned to the debtor for particular purposes.

⁸ For example, when the debtor is a consumer, automatic perfection of a purchase money security interest is available. U.C.C. § 9-302(1)(d).

⁹ U.C.C. § 9-403(2). The financing statement is effective for five years from the date of filing. *Id.*

¹⁰ U.C.C. § 9-103.

¹¹ *See, e.g.*, U.C.C. § 9-103(1)(d) (reperfection required after goods moved to new jurisdiction); §§ 9-304(4), 9-304(5), 9-304(6) (action required to continue perfection in instruments, negotiable documents and collateral in possession of a bailee beyond the twenty-one-day grace period); § 9-306(3) (perfection action may be required to continue perfection beyond ten-day automatic period).

¹² U.C.C. § 9-305.

chasers¹³ or lien creditors.¹⁴ In some situations, the Code is explicit on the effect of the lapse. For instance, according to the Code, the lapse invariably destroys the secured creditor's rights as a perfected secured creditor against parties whose interests arise subsequent to the lapse.¹⁵ In such a situation, the creditor is simply treated as an unperfected secured creditor. Further, the Code provides that when a party whose interest arose before the lapse had priority over the secured creditor before the lapse, the party retains priority.¹⁶ When a party was subordinate to the secured creditor before the lapse and would have priority over an *unperfected* secured creditor, however, the Code offers no single response to the question of what effect lapse has on the third party. Instead, the Code indicates that the effect of lapse will depend on the cause of the lapse and the types of parties involved.¹⁷ In certain variations of this last situation, the impact of a lapse on third parties is quite clear under the Code,¹⁸ but in other variations of this scenario, the Code provides little or no guidance on the effect of a perfection lapse.¹⁹

On the face of the statute, there appears to be little justification for the different treatment accorded various types of lapse situations. Furthermore, the lack of a consistent theoretical approach to lapse means that there is no logical way to dispose of lapse problems arising under sections in which the Code is unclear about the proper resolutions. Consequently, after presenting the Code's treatment of lapse of perfection, temporary automatic perfection, and grace periods, this article will attempt to discover a consistent theme in the Code's approach to these areas. To the extent that such an approach cannot be found, it will propose changes that treat these related problems in a fair and uniform manner. More specifically, Part I of the article will describe the situations in which lapse, temporary automatic perfection, or grace period issues arise and explain the applicable Code sections. Part II will analyze the problems that must be addressed in any approach to lapse. Part III will propose a

¹³ A purchaser is one who takes by purchase. U.C.C. § 1-201(33). Purchase is defined as "taking by sale, discount, negotiation mortgage, pledge, lien, issue or re-issue, gift or any other voluntary transaction creating an interest in property." U.C.C. § 1-201(32). Although the definition includes taking by lien, this is modified by the words "any other voluntary transaction" and, therefore, would seem to encompass only consensual lien creditors, *i.e.*, secured creditors, and not involuntary lien creditors. *See, e.g.*, *Mazer v. Williams Bros. Co.*, 461 Pa. 587, 337 A.2d 559 (1975).

¹⁴ A lien creditor is one who "has acquired a lien on the property involved by attachment, levy or the like and includes an assignee for benefit of creditors from the time of assignment, and a trustee in bankruptcy from the date of the filing of the petition or a receiver in equity from the time of appointment." U.C.C. § 9-301(3).

¹⁵ *See, e.g.*, U.C.C. § 9-403(2) ("Upon lapse, the security interest becomes unperfected . . .").

¹⁶ U.C.C. § 9-201.

¹⁷ *See* text in Part I *infra*.

¹⁸ *See, e.g.*, U.C.C. § 9-403(2) (purchasers and lien creditors promoted upon lapse); § 9-103(1)(d) (purchaser promoted upon lapse); § 9-103(2) (non-professional bona fide purchaser for value promoted upon lapse). *See* text at notes 20-79 & 96-114 *infra*.

¹⁹ *See, e.g.*, U.C.C. § 9-103(1)(d) (no guidance as to rights of lien creditor); § 9-103(1)(c) (rights of third parties); § 9-103(2) (rights of professional buyers and lienors); § 9-305 (rights of third parties); § 9-306(3) (rights of third parties); § 9-304 (rights of third parties).

unified approach to lapse issues under the Code, and will illustrate its application to the different lapse situations.

I. THE PROBLEM SITUATIONS

A. Lapse Issues

1. Lapse Under Section 9-403(2)

Section 9-403(2) of the Code deals with the lapse of perfection in situations where the security interest was perfected by the filing of a financing statement. Under this section, a financing statement is effective for five years from the date of filing.²⁰ At the end of the five-year period, the effectiveness of the filing lapses unless a continuation statement has been filed within six months prior to the end of the period.²¹ The continuation statement "must be signed by the secured party, identify the original statement by file number and state that the original statement is still effective."²² The continuation statement differs from the original financing statement since it contains none of the information included in the original statement. It acts merely as a reference document.²³

Article 9's treatment of a lapse in the effectiveness of a financing statement was changed with the evolution of the Code. An early draft of article 9 contained a section which provided that upon lapse, a security interest "becomes unperfected, with regard to rights in the collateral which accrue *after such lapse . . .*"²⁴ Under this language, a junior purchaser or lien creditor would not gain priority upon lapse of the senior secured party's filing. Rather, the respective rights would be frozen as of the time that the junior interest arose. The only parties who could take priority over the secured creditor were those whose interests arose after the lapse and who could defeat an unperfected security interest.²⁵

This approach was consistent with the treatment of lapse in most jurisdictions prior to the passage of the Code. For example, in *In re Andrews*²⁶ appellant

²⁰ U.C.C. § 9-403(2). The 1962 version of § 9-403(2) provided, in addition to the five-year rule, that a "filed financing statement which states a maturity date of the obligation secured of five years or less is effective until such maturity date and thereafter for a period of sixty days." This provision proved to be a trap for the unwary, *see, e.g., In re Cohen*, 4 U.C.C. REP. SERV. 22 (E.D. Pa. 1967), served no useful purpose, and was eliminated in the 1972 revisions. The sixty-day grace period for filing a continuation statement, which was available if a maturity date five years or less was stated, also was eliminated in the 1972 revisions.

²¹ U.C.C. §§ 9-403(2), 9-403(3). Under the 1962 version, if the financing statement stated a maturity date of five years or less, there was a sixty-day grace period after the expiration date within which a continuation statement could be filed without a lapse.

²² U.C.C. § 9-403(3). If the original secured party has assigned his interest and the assignee signs the continuation statement, a separate statement of assignment is required. *Id. See* U.C.C. § 9-405.

²³ *Cf.* U.C.C. § 9-402(1) (financing statement need contain only names and addresses of debtor or secured party, description of collateral and debtor's signature).

²⁴ *See, e.g.,* Uniform Commercial Code (1950 Revisions) (emphasis added).

²⁵ *See* note 2 *supra*.

²⁶ 172 F.2d 996 (7th Cir. 1949).

held a chattel mortgage dated November 22, 1943 and properly filed on November 30, 1943. On November 12, 1946, appellee took a chattel mortgage on the same property and recorded it on November 14, 1946. Under the applicable Indiana statute,²⁷ appellant's filing was only effective for three years, after which time her mortgage would lapse unless she filed an extension statement. The statute provided, *inter alia*, that "[a] chattel mortgage executed under and pursuant to this act shall be invalid as against . . . junior mortgagees . . ." ²⁸ if an extension statement is not filed before expiration (three years). Since appellant did not file an extension statement until March 17, 1947, her mortgage lapsed on November 30, 1946. The federal Court of Appeals for the Seventh Circuit held that the Indiana statute did not promote an existing junior mortgagee upon lapse of a senior interest.²⁹ It compared the Indiana statute to a Wisconsin statute³⁰ that invalidated lapsed mortgages as against "subsequent mortgages" and had been interpreted as providing absolute priority for the mortgagee.³¹ The *Andrews* court reasoned that "junior" and "subsequent" are sufficiently close in meaning that the same result should occur under both statutes.³² It also noted that this absolute priority rule represented the majority view.³³ While the *Andrews* court's reasoning is questionable,³⁴ the case illustrates the strong preference in pre-Code cases for an absolute priority rule.

The 1956 draft of the Code did not contain the language concerning the rights of competing interests that had been in the 1952 version. It merely stated that upon lapse the security interest becomes unperfected.³⁵ Professor Gilmore, one of the drafters who preferred an absolute priority rule, suggested in his treatise that since the 1956 draft did not explicitly note the deletion, it may

²⁷ 1933 IND. CODE ANN. § 51-515 (Burns 1947 Cum. Supp.).

²⁸ 172 F.2d at 997 (quoting Indiana Chattel Mortgage Act, 1933 IND. CODE ANN. § 51-515 (Burns 1947 Cum. Supp.)).

²⁹ 172 F.2d at 999.

³⁰ WIS. STAT. § 241.11 (Brossard 1927).

³¹ 172 F.2d at 998-99.

³² *Id.* at 999.

³³ *Id.*

³⁴ The court's reasoning is questionable at best. The "subsequent" mortgagee referred to in the Wisconsin statute could have been one who arose subsequent to the mortgage that eventually lapsed or subsequent to the lapse. That statute was interpreted as meaning subsequent to the lapse so that the rights of parties whose interest arose prior to the lapse were frozen. *Graham v. Perry*, 200 Wis. 211, 215-17, 228 N.W. 135, 137 (1929). On the other hand, a "junior" mortgagee must have obtained his mortgage while a senior interest was effective since otherwise there would be nothing to be junior to. Arguably, the word junior could denote a mortgagee who would have been junior but for the lapse. This, however, could easily be covered by other language in the statute. Therefore, the language was probably intended to promote formerly junior mortgagees upon lapse.

The court's questionable reasoning, complete with citation to Funk and Wagnall's *New Standard Dictionary*, but also with citations to Jones on *Conditional Sales and Chattel Mortgage* for the general rule, would seem to indicate the strong pull towards an absolute priority rule that existed prior to the U.C.C.

³⁵ U.C.C. § 9-403(2) (1956 version). *But see* Braucher, *Book Review*, U. CHI. L. REV. 890, 892-94 (1966).

have been simply a "typist's or typesetter's error."³⁶ Gilmore conceded, however, that the comments, which first appeared after the 1956 draft, quite clearly indicated an intent by the drafters to promote a junior interest over a senior, lapsed interest.³⁷ Justice Braucher, another drafter, disputed Gilmore's "typist" theory and asserted that the drafters made a conscious decision to promote the junior interest upon lapse of the senior interest.³⁸ In view of these conflicting stories by those who were present at the deliberations, an attempt to determine where the truth lies is beyond the scope of this article.

The 1956 version of section 9-403(2) was retained in the 1962 Code as was the comment calling for promotion of the junior interest upon lapse of the senior interest's perfection. Undaunted, Professor Gilmore continued to assert that this section could be interpreted to provide absolute priority to the lapsed secured creditor.³⁹ He argued that in a priority dispute between a lien which arose prior to lapse and a lapsed security interest, the filing ought to constitute constructive knowledge. Moreover, he contended that such knowledge should be sufficient to defeat the lien creditor under section 9-301(1)(b).⁴⁰ This, however, requires substantial bending of the Code's distinction between knowledge and notice. Under the Code, knowledge means actual knowledge,⁴¹ while notice means reason to know.⁴² Since section 9-301(1)(b) requires knowledge, it would seem to require that the lien creditor actually be aware of the financing statement or the security interest before he could be defeated by an unperfected secured creditor. Gilmore maintained, however, that the knowledge requirement in section 9-301 was not intended to cover lapsed security interests since in the typical unperfected security interest situation there is no filing and, consequently, no notice.⁴³ Therefore, knowledge would be the proper term. Since lapse is an atypical situation, Gilmore argued, knowledge should be interpreted more broadly so that it would include notice of a lapsed security interest.⁴⁴ This interpretation would permit a lapsed senior secured creditor to defeat a lien that arose prior to the lapse. Unfortunately, Gilmore's approach also plays havoc with the Code's knowledge-notice distinction.

In a priority dispute between a prior-filed, lapsed security interest and a later-filed security interest, Gilmore claimed that the language of section 9-312(5)(a) merely gives the prior-filed interest priority over a later one, and

³⁶ G. GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* 589 n.4 (1965) [hereinafter cited as GILMORE].

³⁷ *Id.* U.C.C. § 9-403, Comment 3 (1962 version). *Cf.* U.C.C. § 9-103, Comment 7 (1962 version) (junior interest promoted over secured creditor whose perfection lapses four months after collateral moved to another jurisdiction).

³⁸ Braucher, *Book Review*, 33 U. CHI. L. REV. 890, 893 (1966); 48 ALI PROCEEDINGS 258-59 (1971).

³⁹ GILMORE, *supra* note 36, at 590.

⁴⁰ *Id.*

⁴¹ U.C.C. § 1-201(25).

⁴² U.C.C. § 1-201(27).

⁴³ GILMORE, *supra* note 36, at 593.

⁴⁴ GILMORE, *supra* note 36, at 590-92.

does not deal with the lapse problem.⁴⁵ Consequently a lapsed secured creditor could defeat a later-filed secured creditor if the later filing was made prior to the lapse. He made no attempt, however, to reconcile this with that section's requirement that both security interests be *perfected* by filing. In the lapse situation, only one interest, the junior one, is perfected at the time of the dispute and, arguably, section 9-312(5)(a)⁴⁶ does not apply. If so, section 9-312(5)(b)⁴⁷ would apply and the later-filed interest would have priority.⁴⁸ Alternatively, it could be argued that the section only requires that both security interests were at some time perfected by filing and that once this condition is met, priority is determined in the order of filing. Again, this requires considerable stretching of the statutory language and it is unlikely that this is what the drafters intended.

Those few courts that have considered the 1962 version of section 9-403(2) have followed Comment 3.⁴⁹ Thus, they refused to accord a lapsed secured creditor absolute priority over a pre-lapse claimant. To ensure the continuation of this interpretation, the section was amended in 1972 to state that a security interest that becomes unperfected as a result of a lapsed filing "is deemed to have been unperfected as against a person who became a purchaser or lien creditor before lapse."⁵⁰ This revision made it clear that upon lapse, formerly subordinate interests are promoted and take priority over the lapsed secured creditor. This meshes nicely with the deletion of the knowledge provision in section 9-301(1)(b). Under the 1962 Code, a lien creditor with actual knowledge of a security interest would be subordinate to the secured creditor even if the security interest was unperfected.⁵¹ Even a lapsed security interest would have priority over a lien creditor with knowledge of it. Moreover, Comment 3 to section 9-403 would apply only if the subordinate lien creditor had no knowledge of the security interest, and only then would he be promoted over the earlier security interest.

In revising the 1962 Code, there was some disagreement between the Article 9 Review Committee and the Permanent Editorial Board over the inclusion of lien creditors in the parties who could be promoted upon the lapse of a security interest under 9-403(2).⁵² A preliminary revision of section 9-403

⁴⁵ *Id.*

⁴⁶ U.C.C. § 9-312(5)(a) (1962 version).

⁴⁷ U.C.C. § 9-312(5)(b) (1962 version).

⁴⁸ *Id.* The later filed interest would be the only perfected interest at the time of the dispute.

⁴⁹ *See, e.g.,* United States v. Squires, 378 F. Supp. 798, 805 (S.D. Iowa 1974); *Cf. Mastan Co. v. Orax Realty Corp.*, 20 U.C.C. REP. SERV. 1076, 1078-79 (N.Y. Sup. Ct. 1976) (lapsed security interest retains priority over junior security interest since junior creditor had actual knowledge of senior interest prior to lapse); *Stearns Mfg. Co. v. National Bank & Trust Co. of Central Pennsylvania*, 12 U.C.C. REP. SERV. 189, 192-93 (Pa. Com. Pleas 1972); *General Electric Credit Corp. v. Isaacs*, 90 Wash. 2d 234, 581 P.2d 1032 (1978); *Morse Electro Products Corp. v. Beneficial Industrial Loan Co.*, 90 Wash. 2d 195, 579 P.2d 1341, 1343-44 (1978).

⁵⁰ U.C.C. § 9-403(2).

⁵¹ U.C.C. § 9-301(1)(b) (1962 version).

⁵² R. HENSON, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE 81-82 (2d ed. 1979) [hereinafter cited as HENSON].

stated that upon lapse, a security interest "is subordinate to conflicting claims as if it had never been perfected."⁵³ This was later changed to provide that upon lapse, the security interest becomes unperfected against a purchaser whose interest arose before the lapse.⁵⁴ The Permanent Editorial Board added the lien creditor language.⁵⁵ Under the 1972 version, then, the lien creditor's knowledge is irrelevant in determining his priority under section 9-301(1)(b) and section 9-403(2). Accordingly he will be promoted automatically upon lapse. This reasoning also applies when the competing party is another secured creditor. Under section 9-312(5),⁵⁶ knowledge is irrelevant in a priority dispute between two secured creditors. A junior secured creditor will, therefore, be promoted automatically upon lapse of a senior security interest.

It is interesting to note that this reasoning does not hold for a buyer not in the ordinary course of business, a bulk transferee, or a buyer of farm products in the ordinary course of business. Rather, section 9-301(1)(c) denies priority over an unperfected security interest if they have knowledge of the interest at the time they receive delivery of the collateral.⁵⁷ Even though the security interest "is deemed to have been unperfected as against a person who became a purchaser . . . before lapse"⁵⁸ these parties will remain subordinate to the lapsed interest if they have knowledge of it.⁵⁹ Further, if one accepts Professor Gilmore's tenuous transmutation of knowledge into notice, the lapse rule of section 9-403(2) is nullified when these parties are involved.

⁵³ *Preliminary Report No. 2 of the Review Committee on Article 9 of the Uniform Commercial Code*, 25 BUS. LAW. 1069, 1133 (1970).

⁵⁴ HENSON, *supra* note 52, at 81-82.

⁵⁵ *Id.*

⁵⁶ Section 9-312(5) provides:

In all cases not governed by other rules stated in this section (including cases of purchase money security interests which do not qualify for the special priorities set forth in subsection (3) and (4) of this section), priority between conflicting security interests in the same collateral shall be determined according to the following rules:

- (a) Conflicting security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither filing nor perfection.
- (b) So long as conflicting security interests are unperfected, the first to attach has priority.

Id.

⁵⁷ Specifically, § 9-301(1)(c) provides that an unperfected secured party is subordinate to:

in the case of goods, instruments, documents and chattel paper, a person who is not a secured party and who is a transferee in bulk or other buyer not in ordinary products in ordinary course of business, to the extent that he gives value and receives delivery of the collateral without knowledge of the security interest and before it is perfected.

Id.

⁵⁸ U.C.C. § 9-403(2).

⁵⁹ U.C.C. § 9-301(1)(c).

2. Lapse Under Section 9-103

a. Section 9-103(1)(d)

In addition to the lapse problems that exist under section 9-403(2), lapse issues can also arise under section 9-103, the choice of law section in article 9.⁶⁰ Section 9-103(1)(d) provides in general that when goods subject to a perfected security interest in one state are moved to another state, perfection continues in the second state for four months. Under this provision, lapse of perfection can occur in two instances. First, when perfection in the first state would have lapsed prior to the end of the four-month period, it will lapse in the second state unless action is taken prior to the lapse in the first state.⁶¹ Second, following the four-month period, if some action such as filing is required to perfect the security interest, perfection continues only if the action is taken in the new jurisdiction. If perfection does lapse as a result of goods being moved from one state to another, the security interest is deemed unperfected as against a purchaser who purchased after removal but prior to the lapse.⁶²

A difficult issue here concerns the effect of a failure to reperfect, within the four-month period, security interests that arose during the period. For example, if goods subject to a perfected security interest in state X are removed to state Y on January 1, perfection continues for four months without any action on the part of the secured creditor. If B buys the goods on March 1, he buys goods that are subject to a perfected security interest.⁶³ Similarly, if S takes a security interest or L gets a lien on the goods on March 1, they do so subject to the prior perfected security interest.⁶⁴ If the prior secured creditor does not reperfect by May 1, the parties' rights can be frozen as of March 1. Therefore, even though the earlier security interest is now unperfected, it can retain priority over competing interests that arose before May 1. Alternatively, the competing interests can be promoted and take priority over the lapsed interest.

⁶⁰ U.C.C. § 9-103 is entitled "Perfection of Security Interest in Multiple State Transactions."

⁶¹ U.C.C. § 9-103(1)(d). This corrects a problem in prior versions, that would have permitted an extension of the period of perfection merely by moving the collateral to another jurisdiction.

⁶² U.C.C. § 9-103(1)(d)(i). Section 9-103 has a long and sometimes rocky drafting history. The four-month rule and its approach to lapse, however, have not had quite as much difficulty as the rest of the section. From the 1950 revisions through the 1972 version, the Code provided that perfection of a security interest continues for four months after removal of the collateral. Thereafter, the interest may be reperfected in the new state.

⁶³ U.C.C. § 9-201 (general validity of security agreement against purchasers of collateral); U.C.C. § 9-301(1)(c) (see note 57 *supra* for the text of this provision). The hypothetical assumes that he is not a buyer in the ordinary course of business (who takes free of a perfected security interest even if he has knowledge of its existence under § 9-307(1)). Section 1-201(9) defines a buyer in the ordinary course of business 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 goods buys in ordinary course from a person in the business of selling goods of that kind but does not include a pawnbroker."

⁶⁴ U.C.C. § 9-201 (see note 63 *supra* for the text of this provision); § 9-312(5) (secured creditor); § 9-301(1)(b) (lien creditor).

Prior to 1972, the Code offered no guidance as to which approach was envisioned. Professor Gilmore preferred the absolute priority approach, which freezes the parties' rights as of the time their interests arose.⁶⁵ He argued that only parties whose interests arose after the four-month period had run could defeat the earlier security interest.⁶⁶ This argument was consistent with Gilmore's approach to lapse under section 9-403(2). Indeed, unlike cases concerning section 9-403(2), a majority of cases construing the 1962 version of section 9-103(1)(d) followed this absolute priority approach.⁶⁷

Nevertheless, the absolute priority approach was rejected in Comment 7 to section 9-103 in the 1962 Code. This comment stated that if the secured party fails to reperfect within four months after removal of the goods, his interest "is subject to defeat here by those persons who take priority over an unperfected security interest (see section 9-301). Under section 9-312(5) the holder of a perfected conflicting security interest is such a person"⁶⁸ Although the precise meaning of Comment 7 is unclear, the drafters apparently intended that both purchasers and lien creditors whose interests arose during

⁶⁵ GILMORE, *supra* note 36, at 627.

⁶⁶ *Id.*

⁶⁷ One case compared the concept of continuous perfection as embodied in section 9-103 with that of a grace period, and noted that while a grace period clearly provides only conditional priority (the condition being perfection before the end of the period), continuous perfection implies absolute priority until lapse. *Churchill Motors, Inc. v. A.C. Lohman, Inc.*, 16 A.D.2d 560, 229 N.Y.S.2d 570, 577-78 (1962). Other cases looked to pre-Code cases which generally provided absolute priority over subordinate pre-lapse interests. The following cases follow the absolute protection version: *Utah Farm Production Credit Ass'n v. Dinner*, 302 F. Supp. 897, 899 (D. Colo. 1969); *General Motors Acceptance Corp. v. Long-Lewis Hardware Co.*, 54 Ala. App. 188, 306 So. 2d 277, 279 (1974); *Pascack Valley Bank & Trust Co. v. Ritar Ford, Inc.*, 6 Conn. Cir. Ct. 489, 276 A.2d 800, 807 (1970); *American State Bank v. White*, 217 Kan. 78, 535 P.2d 424, 430-31 (1975); *Community Credit Co. v. Gillham*, 191 Neb. 198, 214 N.W.2d 384, 389 (1974); *First Nat'l Bank of Bayshore v. Stamper*, 93 N.J. Super. 150, 225 A.2d 162, 169 (1966); *Churchill Motors, Inc. v. A.C. Lohman, Inc.*, 16 A.D.2d 560, 229 N.Y.S.2d 570, 577-78 (1962); *Newton-Waltham Bank & Trust Co. v. Bergen Motors, Inc.*, 68 Misc. 2d 228, 231, 327 N.Y.S.2d 77, 81 (1971), *aff'd*, 75 Misc. 2d 103, 347 N.Y.S.2d 568 (1972); *Al Maroone Ford, Inc. v. Manheim Auto Auction, Inc.*, 205 Pa. Super. Ct. 154, 208 A.2d 290, 291 (1965); *First Bristol County Nat'l Bank v. Shirley*, 11 U.C.C. REP. SERV. 378, 381-82 (Tenn. App. 1972); *Phil Phillips Ford, Inc. v. St. Paul Fire & Marine Ins. Co.*, 454 S.W.2d 465, 483 (Tex. Civ. App. 1970), *aff'd on other grounds*, 465 S.W.2d 933 (Tex. 1971). The following commentators assert that section 9-103(3) gives four months of absolute protection, although not all agree that that is the better rule: 4 R. ANDERSON, UNIFORM COMMERCIAL CODE § 9-103:16 (2d ed. 1970); GILMORE, *supra* note 36, at 626-27; Coogan, *The New UCC Article 9*, 86 HARV. L. REV. 477, 535 (1973) [hereinafter cited as Coogan]; Hawkland, *The Proposed Amendments to Article 9 of the UCC — Part 6: Conflicts of Laws and Multistate Transactions*, 77 COM. L.J. 145, 150-51 (1972); Headrick, *The New Article Nine of the Uniform Commercial Code: An Introduction and Critique*, 34 MONT. L. REV. 218, 240 (1973); Weintraub, *Choice of Law In Secured Personal Property Transactions: The Impact of Article 9 of the Uniform Commercial Code*, 68 MICH. L. REV. 684, 712-13 (1970); Note, *Resolving Conflicts Arising From the Interstate Movement of Motor Vehicles: The Original UCC § 9-103 and Its Successor*, 35 OHIO ST. L.J. 990, 992 n.8 & 996 n.27 (1974). The following commentators support the conditional-protection version of § 9-103(3): J. WHITE & B. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 849 (1972) [hereinafter cited as WHITE & SUMMERS, 1st ed.]; Vernon, *Recorded Chattel Security Interests in the Conflict of Laws*, 47 IOWA L. REV. 346, 377-78 (1962) [hereinafter cited as Vernon]. See also U.C.C. § 9-103, Comment 7 (1962 version).

⁶⁸ U.C.C. § 9-103, Comment 7 (1962 version).

the four-month period would become senior to a secured creditor who fails to reperfect before the end of the period. The reference to section 9-301 within Comment 7 suggests an intention to include lien creditors within the ambit of the statement, even though the subsequent example in the comment concerns only competing security interests.⁶⁹ If lien creditors were not to be included in the comment, it presumably would mention only section 9-312. Therefore, it appears that although the 1962 Code itself is silent on the question of absolute versus conditional priority under the four-month rule, conditional priority over both purchasers and lien creditors was intended.

Most commentators considering the issue have favored the approach of Comment 7.⁷⁰ They have argued that the prior perfected secured party should retain priority over parties whose interests arose during the four-month period only if the security interest is reperfected before the end of the period.⁷¹ If it is not reperfected, they claim that the junior parties should be promoted over the secured creditor.⁷² It was thought that a secured creditor should have some duty to police his collateral, and that four months is sufficient time for a secured creditor to learn that his collateral has been moved and to file in the new jurisdiction.⁷³

The 1972 Code directly addresses the question of absolute versus conditional priority during the four-month period, at least with respect to purchasers whose interests arise during the period. Section 9-103(1)(d) states that there is no absolute priority over a purchaser.⁷⁴ Consequently, a purchaser who is subordinate to a secured creditor during the four-month period takes priority if the secured party fails to reperfect before the end of the period. The Code makes no mention, however, of the status of a lien creditor whose interest arises during the four-month period. This omission could be interpreted as indicating an intention to treat secured creditor-lien creditor disputes as they apparently were treated under Comment 7 to section 9-103 in the 1962 version: that is, giving the secured creditor conditional priority over the lien creditor. Nevertheless, there are three strong reasons for according the secured party absolute priority over lien creditors during the four-month period. First, from a comparison of section 9-103 and section 9-403 in the 1972 Code, it is obvious that when the drafters wanted to eliminate absolute priority over lien creditors, as they did in section 9-403, they knew how to do so. Because they failed to mention lien creditors in section 9-103, it is conceivable that they intended to provide absolute priority for them.⁷⁵ In addition, the discussion of sections 9-103 and 9-403 in the 1971 ALI Proceedings indicates that the drafters made a conscious decision to treat lapse differently in the two sections, largely because of

⁶⁹ See also WHITE & SUMMERS, 1st ed., *supra* note 67, at 849.

⁷⁰ See, e.g., VERNON, *supra* note 67, at 378; HENSON, *supra* note 52, at 221-22; WHITE & SUMMERS, 1st ed., *supra* note 67, at 848-50.

⁷¹ See, e.g., WHITE & SUMMERS, 1st ed., *supra* note 44, at 848-50.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ U.C.C. § 9-103(1)(d).

⁷⁵ "The Committee proposes in . . . 9-103(1)(d)(i) . . . to make clear that after the lapse purchasers — i.e., buyers and secured parties — have priority over the lapsed security in-

projected problems with the trustee in bankruptcy.⁷⁶ The drafters were concerned that if the secured creditor's priority over a lien creditor during the four-month period under section 9-103 was not absolute, the security interest could be defeated by a bankruptcy trustee anytime the goods were moved interstate and reperfecture occurred within four months of bankruptcy.⁷⁷ Lastly, much of the case law under the 1962 version of the Code, which took no position on the absolute priority issue, accorded secured creditors absolute priority over creditors who obtained liens during the four-month period.⁷⁸ Although the drafters probably did not favor those cases, they were undoubtedly aware of them. Thus the failure to mention lien creditors in section 9-103 permits a continuation of the interpretation adopted by those cases.⁷⁹ In summary, the 1962 version of section 9-103(1)(d) did not address the issue of conditional versus absolute priority under the four-month rule. Comment 7, however, indicated the drafters' intent to grant the secured creditor conditional priority over both purchasers and lien creditors. In contrast to the silence of the 1962 Code, the 1972 version specifically states that a secured creditor who has failed to reperfect has only conditional priority over purchasers whose interests arose during the four-month period. The 1972 Code does not focus on the issue of the secured creditor versus lien creditor, but strong reasons exist for assuming that under the 1972 version of section 9-103(1)(d) the secured creditor has absolute priority over a lien creditor.

b. Section 9-103(1)(c)

Section 9-103(1)(c) is another Code provision under which lapse problems may arise. According to this section, where the parties understand at the time of attachment of a purchase money security interest in goods that the goods are to be used in another jurisdiction, the law of the other jurisdiction governs for thirty days after the debtor receives possession, and thereafter if the goods are taken to the new jurisdiction within the thirty days.⁸⁰ Thus, if the parties to a

terest. The negative inference is that judgment lienors remain subordinate." Review Committee for Article 9 of the Uniform Commercial Code, Permanent Editorial Board for the Uniform Commercial Code, Final Report (April 25, 1971) at 245, *quoted in* Coogan, *supra* note 67, at 535.

⁷⁶ 48 ALI PROCEEDINGS 255-61 (1971). See text at notes 162-201 *infra*.

⁷⁷ See, e.g., Bankruptcy Act of 1898, § 60(a)(2), 11 U.S.C. § 96(a)(2) (1976), Bankruptcy Reform Act of 1978, § 547(e)(1)(B), 11 U.S.C. § 547(e)(1)(B) (Supp. II 1978). The new Bankruptcy Code has reduced the preference period to ninety days in most instances. *But see* Bankruptcy Reform Act of 1978, § 547(b)(4)(B), 11 U.S.C. § 547(b)(4)(B) (Supp. II 1978) (preference period one year for insiders).

⁷⁸ See cases cited in note 67 *supra*.

⁷⁹ See Coogan, *supra* note 67, at 535-36.

⁸⁰ Section 9-103(1)(c) states:

If the parties to a transaction creating a purchase money security interest in goods in one jurisdiction understand at the time that the security interest attaches that the goods will be kept in another jurisdiction, then the law of the other jurisdiction governs the perfection and the effect of perfection or non-perfection of the security interest from the time it attaches until thirty days after the debtor receives possession of the goods and thereafter if the goods are taken to the other jurisdiction before the end of the thirty-day period.

Id.

purchase money security interest understand that the goods will be utilized in another jurisdiction and the secured party files in that jurisdiction, he will be perfected for at least thirty days after the debtor receives possession of the goods.⁸¹ If the goods are not taken to the new jurisdiction before the end of the thirty-day period, the perfection will lapse.⁸² Comment 3 to section 9-103 notes that "thereafter the law of the jurisdiction where the collateral is controls perfection."⁸³

The effect of this lapse of perfection in the "new jurisdiction" upon a creditor who purchased or levied on the goods during the thirty-day period is unclear. For example, suppose P takes a purchase money security interest in goods in New York that the parties understand will be used in California. P files in California as required by section 9-103(1)(c). Ten days after the debtor receives possession of the goods, P gives B bank a non-purchase money security interest and B properly files in New York. The goods fail to reach California within thirty days after the debtor received possession. At the time of B bank's purchase, or of a levy if B were a lien creditor, the purchasing or levying creditor is clearly subordinate to the secured creditor.⁸⁴ Section 9-103(1)(c) gives no indication whether the rights are frozen as of that time or whether the subordinate interest is promoted upon lapse of perfection. An analogy to section 9-403 suggests that the subordinate interest is promoted upon the lapse of perfection. No basis exists, however, for analogizing to section 9-403 other

⁸¹ *Id.*

⁸² *Id.* "Further, this section uses the concepts that goods are kept in a state or brought into a state, and related terms. These concepts imply a stopping place of a permanent nature in the state, not merely transit or storage intended to be transitory." U.C.C. § 9-103, Comment 3.

⁸³ *Id.* The comment notes that one way to avoid this lapse is to file in both the original and the intended new jurisdiction. Nevertheless, this may create problems under the last event test of § 9-103(1)(b). For example, suppose D buys goods in New York that are to be used in California and gives A a purchase money security interest in the goods. A files in both New York and California. The law of California governs for 30 days, but if the goods fail to arrive in California within that period, California law ceases to govern. Now suppose the goods do not arrive in California in time, and in fact are in Kansas on a railroad siding when the 30-day period expires. In deciding which state's law takes over at that time one can argue that the "last event" is the expiration of the 30-day period and a filing in Kansas would be proper. Yet New York law might apply because while the goods were in New York, the four requisites for a perfected security interest agreement, value, rights in collateral, attachment under 9-203, and filing if required for perfection under 9-302 were met. This latter approach, favoring New York law, is the one that the Code drafters intended, particularly in light of Comment 3 to section 9-103. Since California law governed at that point, however, it is difficult to reach such a result under the language of the Code.

If the goods simply remain in New York, a similar problem arises. At the time of the filing in New York, California law governed so the New York filing could have no effect. At the end of the 30-day period, the only "event" that occurs is that California law ceases to govern. Unless this is considered an "event" under § 9-103(1)(b), a new filing in New York may be required at the end of the 30-day period. This, however, would duplicate the earlier filing. Hopefully, any court faced with such an unusual fact situation would look to substance over form and find the original New York filing sufficient. *Cf.* Coogan, *supra* note 67, at 537-44 (other problems with "last event" test).

⁸⁴ U.C.C. § 9-201 (general validity of security agreement against, *inter alia*, purchasers and creditors); § 9-301 (rights of lien creditor); § 9-312 (priorities among conflicting security interests in same collateral).

than that both sections involve some type of lapse of perfection. The analogy might more properly be made to section 9-103(1)(d) because, like section 9-103(1)(c), it involves multiple-state transactions. Such an analogy would lead to the promotion of a subordinate purchaser but not a lien creditor.⁸⁵ Nevertheless, the two sections deal with very different issues and there is little reason beyond convenience to apply the same lapse rule to both sections. In addition, analogizing to either section 9-403(2) or section 9-103(1)(d) is difficult because section 9-103(1)(c) contains none of the language of the other sections concerning the rights of intervening parties. It is possible, of course, that this is merely an oversight on the part of the Code drafters. The fact remains, however, that the language is not present. Thus, a priority dispute under section 9-103(1)(c) should not be resolved by reference to sections 9-403(2) or 9-103(1)(d).

Fortunately, the type of lapse problem presented by section 9-103(1)(c) and described above is in most instances unlikely to arise because it would require a proper filing in the new jurisdiction, no filing in the original jurisdiction, a finding that the goods didn't arrive in the new jurisdiction within thirty days after the debtor received possession, and a purchase or levy during that thirty-day period. The ease of the filing rules makes a proper filing likely in most cases. Furthermore, the debtor often will not even receive possession until the goods arrive in the new jurisdiction. The thirty-day period does not begin to run until that time and the secured creditor will be continuously perfected in the new jurisdiction. There are several situations, however, in which a lapse problem under section 9-103(1)(c) is probable. The first of these occurs when a debtor receives possession in the original jurisdiction and takes responsibility for shipment to the new location. In that case, there is a greater likelihood that before the goods arrive in the new jurisdiction, the debtor might sell them or borrow against them or a creditor might levy on the goods. If the debtor sells the goods, they probably will never reach the new jurisdiction, causing a lapse in perfection after the thirty-day period has expired. Similarly, if a creditor levies on goods after the debtor receives possession but before they arrive in the new jurisdiction, the levying creditor might be able to prevent the goods from completing their journey within thirty days, also causing a lapse in perfection. A lien creditor can accomplish this because a levy generally involves taking physical possession of the goods,⁸⁶ even where his lien is subordinate to the security interest at the time of the levy.⁸⁷ Although it seems inequitable to permit a lien creditor to gain priority through such a dilatory practice, the Code Comments accept the possibility that a levying creditor can extinguish the secured creditor's perfection by preventing the goods from reaching the new jurisdiction on time.⁸⁸ Adopting an absolute priority approach would avoid this

⁸⁵ See text at notes 74-79 *supra*.

⁸⁶ See, e.g., CAL. CIV. PROC. CODE § 488.320(a) (West Supp. 1978); MINN. STAT. ANN. §§ 550.12, 570.05 (West 1947); cf. McKearn v. Stevens, 321 Mass. 646, 648, 75 N.E.2d 1, 2 (1947) (failure to physically seize moveable goods invalidates levy).

⁸⁷ U.C.C. § 9-301(1)(b).

⁸⁸ See, e.g., U.C.C. § 9-103, Comment 3.

problem at least as between the secured creditor and the levying creditor, by freezing the secured creditor's priority as of the date of the levy.

Two other situations in which a lapse problem arises under section 9-103(1)(c) involve disputes between two secured creditors. For example, one creditor, S, may have a floating lien on the debtor's inventory or equipment and a second creditor, P, may take a purchase money security interest in inventory or equipment under facts that fall under section 9-103(1)(c). In most instances, P will perfect immediately, giving notice if it is inventory,⁸⁹ and gain priority over the floating lien because of his status as a perfected purchase money secured creditor.⁹⁰ In another scenario, P takes a purchase money security interest before the goods arrive in the new jurisdiction and another creditor, C, takes and perfects a security interest in the same goods. In either of these situations, P's perfection will lapse if the goods fail to arrive in the new jurisdiction within thirty days after the debtor received possession.⁹¹ Unlike sections 9-403(2) and 9-103(1)(d), however, section 9-103(1)(c) provides no solution to the resulting priority dispute. Instead, resolution must await a discussion of the policy issues underlying this area.⁹²

The difficulty of resolving lapse problems under section 9-103(1)(c) is complicated not only by the lack of clarity in that provision, as noted above, but also by the possible interaction of 9-103(1)(c) with section 9-103(1)(d).⁹³ Such interaction might occur in the following hypothetical. On January 2, S

⁸⁹ U.C.C. § 9-312(3).

⁹⁰ U.C.C. §§ 9-312(3), 9-312(4).

⁹¹ This fact situation suggests two other issues of interest. The first involves the fact that P will have filed in the new jurisdiction while S's or C's filing may be in the original jurisdiction. If the goods were to arrive in the new jurisdiction two months after the debtor received possession and rights in the collateral, and S or C filed at that time, P's filing would be the first in the new jurisdiction even though his perfection had lapsed. Under section 9-312(5)(a), P might receive priority. As Professor Kripke has noted elsewhere in discussing a similar problem, this would be an unfortunate result. The better rule would be to carry over S's or C's earlier filing in the original jurisdiction as the first continuously effective filing. See Kripke, *The "Last Event" Test for Perfection of Security Interest Under Article 9 of the Uniform Commercial Code*, 50 N.Y.U. L. REV. 47 (1975). It should be noted, particularly in cases involving a floating lienor, that a filing in a new jurisdiction is likely since the debtor generally will have a place of business in the jurisdiction to which the goods are headed.

The second issue arises because perfection under section 9-103(1)(d) lapses four months after the goods are removed from the jurisdiction in which there is a filing. The problem is illustrated by the following fact situation: D buys goods in New York for use in California. D borrows money from A and gives A a purchase money security interest in the goods. A properly files in California under 9-103(1)(c). Later, while the goods are still in New York, D grants a non-purchase money security interest in the goods to B and B properly files in New York. At this point, under Professor Kripke's first effective filing rule, A probably has priority to the goods. If the goods do not arrive in California within thirty days after the debtor receives possession, A's perfection lapses and B may or may not be promoted. See text at note 84 *supra*. If, however, the goods arrive in California two months after the debtor received possession, A's perfection probably dates only from the arrival of the goods in California. See U.C.C. § 9-303(2). Unless A has absolute priority under 9-103(1)(c), B will have priority. If B does not refile within four months after the goods arrive in California, his perfection lapses and A, who is a purchaser under § 1-201(32), (33), regains priority.

⁹² See text at notes 240-45 *infra*.

⁹³ See text at notes 60-62 *supra*.

takes a purchase money security interest in a machine located in New York. The parties understand that the machine is to be kept in Detroit. S files in Michigan pursuant to section 9-103(1)(c). D takes possession of the machine in New York on January 2 but the truck carrying the machine is late in leaving New York and is delayed in Pennsylvania from January 20 until February 9. On January 28, L levies on the machine in Pennsylvania. The debtor posts a bond and the machine arrives in Detroit on February 10. Analogizing to section 9-403(2), it would appear initially that although S had priority over L at the time of levy, L would be promoted on February 1. The reason for L's priority is that Michigan law ceased to govern perfection on that date, thereby rendering S's Michigan filing ineffective. S might argue, however, that when the goods arrived in Pennsylvania they were subject to a perfected Michigan security interest. Accordingly, section 9-103(1)(d) would give him four months to reperfect in Pennsylvania and absolute priority over lien creditors who arise within the four months. Based on this section 9-103(1)(d) argument, the security interest was perfected when L levied and remained perfected until May 20. Thus S would retain priority. Similarly, when the goods arrived in Michigan they were subject to a perfected Pennsylvania interest and it would appear that since there was a Michigan filing, no further action would be required to perfect the security interest. Nevertheless, this argument would fail because section 9-103(1)(d) governs only if the collateral was "subject to a security interest perfected under the law of the jurisdiction from which the collateral was removed."⁹⁴ Here the security interest was perfected under Michigan law but the collateral was removed from New York. Thus, the four-month rule would apparently not apply. S might argue that he perfected under New York law by following New York's version of section 9-103(1)(c) but this seems to go beyond the intent of the statute.⁹⁵ The reasoning also would fail if the goods had been levied upon in New York. In such a case, the goods were not "brought into and kept in this state" so that the four-month rule again would not apply. It is in such an unlikely situation that it would be necessary to resolve the question of the effect of lapse on an intervening interest. This will be attempted in Part III of this article. Thus, although it first seems that section 9-103(1)(d) would resolve the priority dispute presented here, the above analysis indicates that it is inapplicable. Consequently, as in the other situations outlined in this section where lapses of perfection occur under the thirty-day rule of section 9-103(1)(c), the decision as to who has priority remains uncertain.

c. Section 9-103(2)

Section 9-103(2), like the Code provisions discussed above, presents problems involving lapse of perfection. In section 9-103(3), however, unlike the sections previously noted, the focus is on goods covered by certificates of title.⁹⁶

⁹⁴ U.C.C. § 9-103(1)(d) (emphasis added).

⁹⁵ Comment 3 to § 9-103 reveals that the drafters did not intend perfection to continue beyond thirty days unless the goods reach their destination.

⁹⁶ Certificates of title are a means of recording property interests in certain mobile goods. All claims to the property should be ascertainable upon examination of the certificate. See Vernon, *supra* note 67, at 348, 357.

The 1972 Code drafters hoped that the certificate of title could "provide a sure means of controlling property interests in goods like automobiles, which because of their nature cannot readily be controlled by local or statewide filing alone."⁹⁷ Yet, the Code drafters recognized that the certificates were not successful as control mechanisms for a variety of reasons. First, not all states have uniform certificate of title legislation.⁹⁸ In some jurisdictions, notation of a security interest on the certificate of title is not necessary in order to perfect a security interest in a vehicle, while in others it is required.⁹⁹ Further, it has been possible, often through fraudulent means, to obtain clean certificates¹⁰⁰ for vehicles subject to perfected security interests.¹⁰¹

The conflicts rules contained in section 9-103(2) concerning goods covered by certificates of title have gone through some evolution. In the 1962 Code, the problem arguably was covered by section 9-104(4).¹⁰² That section merely provided that if goods were covered by a certificate of title issued by a jurisdiction that required notation on the certificate of a security interest in order to perfect the interest, the law of that jurisdiction would govern perfection.¹⁰³ Section 9-104(4) was not well thought out, perhaps because many states did not have certificate of title legislation at the time it was drafted,¹⁰⁴ and consequently the provision presented several problems. First, it was unclear exactly when goods were "covered" by a certificate of title.¹⁰⁵ Second, once section 9-103(4) became applicable to a particular case there was no indication of when it might cease to govern.¹⁰⁶ Thus, even if the car were reregistered in a new jurisdiction, section 9-103(4) could continue to govern perfection requirements. This would result in continued effectiveness of a certificate issued by a state other than the one in which the car was registered. Third, even if section 9-103(4) were interpreted so that it ceased to govern after reregistration of the car or surrender of the certificate, the 1962 version did not indicate what impact this would have on competing parties whose claims arose while the certificate was effective. Fourth, there was considerable confusion under the 1962 Code concerning whether to apply 9-103(4) or 9-103(3). Some courts applied section 9-103(3)'s

⁹⁷ U.C.C. § 9-103, Comment 4(b).

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ A "clean certificate" is one on which no liens or security interests are recorded.

¹⁰¹ U.C.C. § 9-103, Comment 4(b).

¹⁰² It should be noted that some cases that involved certificates of title and probably should have been decided under section 9-103(4) were decided under section 9-103(3) instead. *See, e.g.*, cases cited in note 107 *infra*.

¹⁰³ U.C.C. § 9-103(4) (1962 version).

¹⁰⁴ As of 1962, the following states had no certificate systems: Alabama, Georgia, Kentucky, Maine, Massachusetts, Minnesota, Mississippi, New Hampshire, New York, Rhode Island, Vermont. Vernon, *supra* note 67, at 348 n.6. Professor Gilmore has stated: "Subsection (4) [of section 9-103] was a last minute addition to Article 9; it appears to have been imperfectly thought through and is clearly defective in its drafting." GILMORE, *supra* note 36, at 328.

¹⁰⁵ *See, e.g.*, J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE, 977 (2d ed. 1980) [hereinafter cited as WHITE & SUMMERS, 2d ed.].

¹⁰⁶ Under section 9-103(4), the certificate could continue to govern long after the goods left the issuing jurisdiction and after they were reregistered elsewhere. U.C.C. § 9-103(4) (1962 version).

four-month rule to cases in which the goods were moved from a noncertificate to a certificate state even though the new state had issued a clean certificate covering the goods.¹⁰⁷ Use of section 9-103(3) in this situation, however, increased the possibility that an innocent third party could be misled by his reliance on the clean certificate since an unnoted interest could take priority. Thus, the problems associated with section 9-103(4) in the 1962 Code led the 1972 drafters to revise the conflicts rules for goods covered by certificates of title.

Under the 1972 Code, section 9-103(2), the provision dealing with goods requiring certificates of title, states that the law of the jurisdiction issuing the certificate governs as long as the certificate is outstanding and the vehicle is not reregistered.¹⁰⁸ Upon surrender of the certificate, the law of the issuing jurisdiction ceases to govern.¹⁰⁹ If the car is reregistered in another jurisdiction, the certificate becomes ineffective four months after the car is removed from the issuing jurisdiction or upon reregistration, whichever is later. Comment 4(c) to section 9-103 states that during this period the secured party has the same protection as others have under section 9-103(1)(d). This statement, however, is not supported by the statute. Rather, the rules of section 9-103(1)(d) apply only if the security interest was "perfected in another jurisdiction otherwise than by notation on a certificate of title."¹¹⁰ When the security interest is perfected by notation, there is no rule in 9-103(2) similar to the rule of 9-103(1)(d), that promotes purchasers upon lapse of the earlier security interest. Yet it can be argued that the last sentence of 9-103(2) refers to 9-103(1)(d) because once a four-month period expires and the vehicle is registered, it is no longer covered by the certificate of title. Therefore, section 9-103(2) no longer applies and unless the vehicle is considered mobile goods under section 9-103(3),¹¹¹ section 9-103(1)(d) and its lapse rule could control.¹¹² Finally, if a clean certificate is issued by the new jurisdiction, the security interest is subordinate to a non-professional buyer who¹¹³ receives delivery after the certificate is issued, to the extent that value is given without knowledge of the security interest.¹¹⁴

¹⁰⁷ See, e.g., *First Nat'l Bank of Bayshore v. Stamper*, 93 N.J. Super. 150, 225 A.2d 162, 169 (1966); *Churchill Motors, Inc. v. A.C. Lohman, Inc.*, 16 A.D.2d 560, 229 N.Y.S.2d 570, 577-78 (4th Dep't 1962); WHITE & SUMMERS, 1st ed., *supra* note 67, at 857-58.

¹⁰⁸ U.C.C. § 9-103(2).

¹⁰⁹ U.C.C. § 9-103(2)(b).

¹¹⁰ U.C.C. § 9-103(2)(c).

¹¹¹ Section 9-103(3)(a) provides:

goods which are mobile and which are of a type normally used in more than one jurisdiction, such as motor vehicles, trailers, rolling stock, airplanes, shipping containers, road building and construction machinery and commercial harvesting machinery and the like, if the goods are equipment or are inventory leased or held for lease by the debtor to others, and are not covered by a certificate of title described in subsection (2).

Id. Perfection requirements and effects for mobile goods are governed by the law of the jurisdiction where the debtor is located. U.C.C. § 9-103(3)(b).

¹¹² See generally Coogan, *supra* note 67, at 548-49.

¹¹³ As used in this article, a non-professional buyer is one who is not in the business of selling goods of the kind involved. See, e.g., U.C.C. § 9-103(2)(d).

¹¹⁴ U.C.C. § 9-103(2)(d).

Perfection of a security interest in goods covered by a certificate of title can lapse, therefore, if the certificate is surrendered or if the vehicle is reregistered. The effect of this lapse on parties whose interests arose prior to the lapse is only partly clear. If the lapse involves reregistration and issuance of a clean certificate in a new jurisdiction, the security interest clearly will be subordinate to the rights of a non-professional buyer even though it may be considered perfected under the four-month rule. Conversely, the security interest would be effective against a professional buyer and other purchasers and lienors during the four-month period or until registration. Where the security interest is not reperfected before the end of the period, it may be appropriate, due to the absence of any clear guidance in the statute, to look to section 9-103(1)(d) for guidance concerning the rights of parties, other than non-professional buyers, whose interests arose while the secured creditor was still perfected.

In summary, section 9-103(2) provides the conflicts rules for goods covered by certificates of title. Yet like the provisions of the 1972 Code already discussed, this section does not offer precise guidelines for resolving all priority disputes. Thus, the status of certain parties after a lapse of perfection under 9-103(2) remains unclear.

3. Lapse of Perfection by Possession

A security interest in certain collateral¹¹⁵ may be perfected by the secured party's taking possession of the collateral.¹¹⁶ In general, the perfection is only effective from the time possession is taken until the secured party surrenders the collateral.¹¹⁷ Thus, the secured creditor's perfection will lapse when possession of the collateral is surrendered. The 1972 Code drafters did not delineate the consequences of the lapse of a possessory security interest. For instance, section 9-305 does not indicate what should happen if a secured party surrenders possession and becomes unperfected after a purchaser or lien creditor obtains an interest in the collateral. Section 9-403(2) also fails to address the issue. Rather, it deals only with the effect of a lapse of perfection by filing.

As in the lapse situations already discussed, there are two methods of dealing with the rights of parties whose interests predate the lapse. Their rights can be considered as either frozen at the time they came into existence or promoted over the possessory secured creditor once the creditor surrenders possession.

In a priority dispute between two secured creditors upon lapse of perfection by possession, section 9-312(5) may be helpful in deciding which method to employ. For example, suppose S-1 takes a security interest in goods and perfects by possession. Subsequently, S-2 takes a security interest in the same goods and files a financing statement to perfect his security interest. S-1, as the first to perfect, will have priority over S-2. If S-1 then surrenders possession of the goods, his interest becomes unperfected. The issue now is whether S-1's security interest will continue to have priority over that of S-2, or whether S-2's

¹¹⁵ Perfection by possession is available for security interests in letters of credit, advices of credit, goods, instruments, money, negotiable documents, chattel papers. U.C.C. § 9-305.

¹¹⁶ U.C.C. § 9-305.

¹¹⁷ *Id.*

interest will now be promoted. Under section 9-312(5), the general rule is that the first to file *or* perfect, has priority. This rule applies, however, only if "there is no period thereafter when there is neither filing nor perfection." Although section 9-312(5) does not explicitly state the effect of a period in which there is neither filing nor perfection, the implication is that the party having priority would lose it once the filing or perfection lapses. Thus, in the dispute between S-1 and S-2, a reading of section 9-312(5) indicates that once S-1 surrenders possession, S-2's interest is promoted over that of S-1.

Resolving this lapse problem is more difficult if S-2 is a lien creditor instead of a secured creditor. Such a situation could occur if the creditor levies under a statute that does not require physical seizure of the goods.¹¹⁸ Section 9-301, which states the priority rules for disputes between lien creditors and secured creditors, gives no indication of whether S-1's priority under this fact pattern would be conditional or absolute. Further, it is impossible to tell how purchasers other than secured creditors would fare in this situation. It might be possible to apply section 9-312(5) by analogy to these other situations so as to give the possessory secured creditor only conditional priority. Unfortunately, there is no support in the case law or the legislative history of the Code for this or any other approach to this lapse problem. Thus it is evident that the resolution of certain priority disputes following a lapse in perfection by possession will create problems because of the lack of statutory or judicial guidance.

B. *Temporary Automatic Perfection*

1. Proceeds — Section 9-306(3)

A security interest in collateral continues in the proceeds of the collateral.¹¹⁹ If the original security interest was perfected, the interest in proceeds is automatically perfected for ten days and thereafter if certain requisites are met.¹²⁰ Under the 1962 Code, the security interest continued in proceeds if the financing statement expressly covered proceeds.¹²¹ Where the financing statement did not do so, the security interest in the proceeds could be perfected by a new filing or possession before the end of the ten-day period.¹²² The 1972 revisions eliminated the requirement that the financing statement cover proceeds. As a result, a security interest in proceeds now is continuously perfected if a financing statement covering the original collateral is filed and the proceeds are

¹¹⁸ See, e.g., CAL. CIV. PROC. CODE §§ 488.340, 488.350, 488.360 (West Supp. 1978); N.Y. CIV. PRAC. LAW § 6214(a).

¹¹⁹ U.C.C. § 9-306(2) provides:

"Proceeds" includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds. Insurance payable by reason of loss or damage to the collateral is proceeds, except to the extent that it is payable to a person other than a party to the security agreement. Money, checks, deposit accounts, and the like are "cash proceeds". All other proceeds are "non-cash proceeds".

U.C.C. § 9-306(1).

¹²⁰ U.C.C. § 9-306(3).

¹²¹ U.C.C. § 9-306(3)(a) (1962 version).

¹²² U.C.C. § 9-306(3)(b) (1962 version).

a type of collateral in which a security interest could be perfected by a filing in the same office.¹²³ Additionally, if the proceeds are acquired with cash proceeds, the financing statement must describe the type of collateral that the ultimate proceeds are.¹²⁴ Further, perfection will continue in the proceeds where such proceeds are identifiable cash proceeds¹²⁵ and a financing statement covers the original collateral.¹²⁶ Finally, if the interest in proceeds meet none of these criteria, it may be continuously perfected by a new filing or possession during the ten-day period.¹²⁷

The nature of the ten-day period of automatic continuous perfection is not spelled out in the Code. Assuming that the requisites for perfection beyond the ten-day period are met, the secured creditor clearly will have priority over any interests that arise during the ten-day period if the interests would normally be subordinate to a perfected security interest.¹²⁸ If the requisites for continued perfection are not met, and perfection in proceeds lapses at the end of the ten-day period, the effect of temporary perfection is unclear. As in the lapse situations already discussed, the rights of competing parties can be frozen as of the time they arose, or the subordinate party can be promoted upon lapse of the senior interest. In deciding who has priority here, one could analogize to section 9-403(2) and adopt what appears to be a Code policy of promoting formerly subordinate interests over lapsed senior secured creditors. This would make the ten-day period of automatic perfection a grace period,¹²⁹ since the secured creditor would be considered perfected during the ten-day period only if he takes the required action prior to the end of the period. It could be argued, however, that subordinate interests arising during the ten-day period should remain subordinate even if the action required to extend perfection beyond the ten days is not taken. The ten-day perfection would lose much of its vitality if upon lapse at the end of the ten-day period the perfection was no longer effective against purchasers or lien creditors who arose during the period.

Since most security interests in proceeds are perfected automatically even beyond the ten-day period without any action on the part of the secured creditor, it is not surprising that there has been no flood of litigation concerning the nature of the ten-day period of automatic perfection. Nevertheless, the question of the effect of lapse at the end of ten days has arisen in at least two cases. In *Security Savings Bank of Marshalltown, Iowa v. United States*,¹³⁰ the court held that the ten-day period did not provide absolute protection. In that case, the plaintiff bank loaned money to a debtor and took a purchase money security interest in a truck that the debtor bought. Subsequently, the debtor traded

¹²³ U.C.C. § 9-306(3)(a).

¹²⁴ *Id.*

¹²⁵ Identifiable cash proceeds are cash proceeds that can be traced to the original collateral. *See, e.g.,* Universal CIT Credit Corp. v. Farmers Bank of Portageville, 358 F. Supp. 317, 324 (E.D. Mo. 1973).

¹²⁶ U.C.C. § 9-306(3)(b).

¹²⁷ U.C.C. § 9-306(3)(c).

¹²⁸ In conflicts between competing secured creditors, the date of filing as to the original collateral is considered the date of filing as to the proceeds. U.C.C. § 9-312(b).

¹²⁹ *See* text at notes 158-61 *infra*.

¹³⁰ 22 U.C.C. REP. SERV. 1260 (S.D. Iowa 1977).

this truck for another truck. He received title to the latter on June 30, 1975. On July 7, 1975, the government seized this truck for delinquent taxes.¹³¹ On July 28, 1975, the bank's security interest was noted on the new truck's certificate of title. The federal district court found that the government obtained its interest in the truck during the ten-day period of continuous perfection provided by section 9-306(3).¹³² The plaintiff bank's perfection lapsed three days later and it did not reperfect until almost a month after the lapse. The government argued that its lack of priority as a lien creditor could change at the end of the ten-day period so that it could be promoted upon the lapse of perfection of the bank's senior interest.¹³³ Agreeing with the government, the court viewed the ten-day period of continuous perfection as a grace period.¹³⁴ Consequently, it held that where the plaintiff failed to reperfect before the period expired, its perfection lapsed, the lapse related back to July 1, and the government was promoted to a first priority creditor.¹³⁵ In support of its holding that the government was promoted in priority at the end of the ten-day period, the court also analogized to section 9-403(2),¹³⁶ which promotes purchasers and lien creditors upon a lapse in perfection of a senior security interest.¹³⁷

The earlier decision of *Blair Milling & Elevator Co. v. Wehrkamp*¹³⁸ held that the ten-day period was one of absolute protection to the secured creditor. In that case, the debtor in a secured transaction was unable to make his payments and the collateral was sold pursuant to an agreement between the parties. Immediately thereafter, another creditor levied on the proceeds of the sale. Since the secured creditor's financing statement did not cover proceeds,¹³⁹ its perfection in the proceeds lapsed ten days after the sale. In determining the respective rights of the secured creditor and the lien creditor, the court noted that section 9-306 offers no guidance concerning the priority of interests that arise during the ten-day period if perfection lapses at the end of the period. The *Blair* court thus looked to pre-Code law which granted a secured creditor absolute priority over a lien creditor whose rights arose prior to the lapse of perfection of a security interest. Using this approach to resolve the section 9-306 ambiguity, the court concluded that the secured creditor had a superior interest in the proceeds.

Although case law provides no uniform answer to the issue of priority under section 9-306(3), an interpretation of that provision according to its plain meaning indicates that the ten-day period of automatic perfection accords a secured creditor absolute priority over a junior claimant whose interest arose during the ten-day period. If the Code drafters had intended otherwise — that the secured creditor would be perfected as to proceeds during the ten-day

¹³¹ The seizure was pursuant to 26 U.S.C. §§ 6331-6344 (1976).

¹³² 22 U.C.C. REP. SERV. at 1262.

¹³³ *Id.*

¹³⁴ *Id.* at 1264.

¹³⁵ The court incorrectly referred to the Bank as unsecured at the end of ten days. In fact, the proceeds interest would continue beyond the ten-day period, but as an unperfected security interest. U.C.C. § 9-306.

¹³⁶ See text at notes 20-57 *supra*.

¹³⁷ 22 U.C.C. REP. SERV. at 1265.

¹³⁸ 16 U.C.C. REP. SERV. 1421 (Kan. 1975).

¹³⁹ The 1962 version of the Code was in effect in Kansas at that time.

period only if he filed before the end of that period — they could have said so. Yet they did not. Rather, the wording¹⁴⁰ of the section suggests that regardless of what happens after the ten-day period, the secured creditor is protected at least during that period. Moreover, analogizing to section 9-403(2), as the court in *Security Savings Bank* did,¹⁴¹ does not necessarily lead to the conclusion that the ten-day period provides something less than absolute perfection. In section 9-403(2), the drafters expressly provided for conditional perfection. If they intended conditional perfection in section 9-306(3), they could have expressly provided for it there too. Section 9-103(1)(d) also illustrates the drafters' tendency to provide expressly for conditional priority. In that section, which provides a four-month period to reperfect that is analogous to a period of temporary automatic perfection, explicit language was used to grant only conditional priority over purchasers. The omission of lien creditors from that section arguably implies absolute priority over them. Similarly, the omission of any conditional priority rule in section 9-306(3) may also imply a grant of absolute priority.

In conclusion, the effect of a lapse of perfection on the purchasers and lien creditors whose interests arise during the ten-day period is not expressly stated in section 9-306(3). Moreover, the two cases to have considered the issue offer no definitive resolution of the problem since each reached a different result. An analysis of Code provisions other than section 9-306(3), however, gives support to the view that the drafters intended the creditor whose perfection has lapsed to achieve absolute priority over another party, whose interest was created during the ten-day period.

2. Certain Instruments, Negotiable Documents, Goods — Section 9-304

Sections 9-304(4) and (5), like section 9-306(3), provide for a period of temporary automatic perfection. In section 9-304(4), a twenty-one-day period of perfection is granted for a security interest in instruments to the extent it is given for new value under a written agreement.¹⁴² According to section 9-304(5), the same perfection period also applies to security interests in instruments, negotiable documents, and goods held by a bailee that are not covered by a negotiable document. Section 9-304(5) is utilized when a secured party with a perfected security interest makes the instrument, document, or goods available to the debtor for certain limited purposes.¹⁴³ These two provisions of

¹⁴⁰ "The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a perfected security interest and becomes unperfected ten days after receipt of the proceeds by the debtor unless [exceptions not applicable]" U.C.C. § 9-306(3).

¹⁴¹ See note 137 *supra*.

¹⁴² "A security interest in instruments (other than certificated securities) or negotiable documents is perfected without filing or the taking of possession for a period of 21 days from the time it attaches to the extent that it arises for new value given under a written security agreement." U.C.C. § 9-304(4).

¹⁴³ U.C.C. Section 9-304(5) provides:

A security interest perfected for a period of 21 days without filing where a secured party having a perfected security interest in an instrument (other than a certificated security), a negotiable document or goods in possession of a bailee

9-304, derived from sections 3 and 8 of the Uniform Trust Receipts Act,¹⁴⁴ are intended to permit certain short-term transactions without necessitating a filing and consequent cluttering of the files, or without forcing a break in a secured creditor's perfection.¹⁴⁵ The twenty-one-day limit on this temporary perfection was intended to conform with the limit in section 60(a)(7) of the Bankruptcy Act.¹⁴⁶

Under 9-304, as under 9-306(3), there is a question concerning the actual effect of this period of temporary perfection. Suppose, for example, that Bank takes a security interest in a negotiable document of title covering 1,000 bushels of wheat. There is a written security agreement and Bank gives new value. Bank neither files nor takes possession of the document. Ten days after the security interest attaches and is perfected under 9-304(4), lien creditor, L, levies on the document. Neither party takes any further action until a month later when Bank seeks to obtain the document from the sheriff, who is holding it pursuant to the levy. At the time L levied, the document clearly was subject to Bank's perfected security interest¹⁴⁷ and L was subordinate to Bank.¹⁴⁸ Yet twenty-one days after the security interest attached, Bank's perfection lapsed. In this situation, does Bank have absolute priority over L or does Bank lose its priority once its perfection lapses? As a preliminary matter, if L had been a purchaser to whom the document had been duly negotiated,¹⁴⁹ L would have priority over Bank notwithstanding Bank's perfection.¹⁵⁰ Since L is a lien creditor, however, the document could not be duly negotiated to him.

Neither the Code nor the comments indicate whether absolute or condi-

other than one who has issued a negotiable document therefor

- (a) makes available to the debtor the goods or documents representing the goods for the purpose of ultimate sale or exchange or for the purpose of loading, unloading, storing, shipping, transshipping, manufacturing, processing or otherwise dealing with them in a manner preliminary to their sale or exchange, but priority between conflicting security interests in the goods is subject to subsection (3) of Section 9-312; or
- (b) delivers the instrument to the debtor for the purpose of ultimate sale or exchange or of presentation, collection, renewal or registration of transfer.

U.C.C. § 9-304(5).

¹⁴⁴ Uniform Trust Receipts Act §§ 3, 8.

¹⁴⁵ See, e.g., U.C.C. § 9-304, Comment 4; WHITE & SUMMERS, 2d ed., *supra* note 105, at 928-33.

¹⁴⁶ U.C.C. § 9-304, Comment 4; GILMORE, *supra* note 36, at 456. Cf. Bankruptcy Reform Act of 1978, § 547(e)(2) (ten-day limit).

¹⁴⁷ U.C.C. § 9-304(4).

¹⁴⁸ U.C.C. §§ 9-201 (general validity of security agreement against creditors), 9-301(1)(b) (by implication, lien creditor is subordinate to prior perfect secured parties).

¹⁴⁹ U.C.C. § 7-501(4) provides:

A negotiable document of title is "duly negotiated" when it is negotiated in the manner stated in this section to a holder who purchases it in good faith without notice of any defense against or claim to it on the part of any person and for value, unless it is established that the negotiation is not in the regular course of business or financing or involves receiving the document in settlement or payment of a money obligation.

Id.

¹⁵⁰ U.C.C. § 9-309. See also U.C.C. § 7-503(1).

tional priority was intended in such a fact pattern. Comment 4¹⁵¹ does state that section 9-304 is derived from the Uniform Trust Receipts Act (UTRA), and a study of the analogous sections in the Act sheds some light on the issue. Section 8 of the UTRA validated a security interest in goods, documents or instruments against "all creditors" for thirty days.¹⁵² It also stated that "[s]ave as provided in Subsection 1, the entruster's security interest shall be void as against lien creditors who become such after such thirty-day period and without notice of such interest and before filing."¹⁵³ The negative implication of this provision was that the entruster retained priority even beyond the thirty-day period over a lien creditor whose interest arose during the period. Professor Gilmore notes that "[u]nder UTRA § 8 the entruster is protected for 30 days against 'all creditors' (which includes lien creditors) *without any requirement that he file within that period or ever.*"¹⁵⁴ This interpretation of section 8 makes sense since the thirty-day period was designed to relieve the entruster of the burden of filing in short-term transactions.¹⁵⁵ Absolute priority assured the entruster that he was protected against any interests that arose during the thirty-day period.¹⁵⁶ Of course the entruster, relying on the thirty-day period, undoubtedly envisioned a transaction that would be completed with the loan paid or the collateral liquidated within thirty days. In such cases, the question of an intervening claimant's rights after the thirty-day period would be insignificant. There are certain situations, however, where the security interest must survive thirty days, and then the effect of the temporary perfection becomes important. For example, an intervening lien creditor could prevent completion of the transaction within thirty days by inducing the sheriff to take and retain possession of the collateral. In addition, the debtor's bankruptcy could occur during the thirty-day period. Finally, there could be a dispute over proceeds. In any of these situations, the entruster's rights will depend on whether the temporary perfection provides absolute or conditional priority. Thus, if the analogy of the UTRA is accepted, the priority accorded a secured creditor who takes advantage of the temporary automatic perfection under 9-304(4) would be absolute. Nevertheless, since both the UTRA provision and section 9-304(4) were meant to cover only short-term transactions, there may be no need for absolute priority. As a result, any transaction that stretches beyond the twenty-one-day period could leave a secured creditor at his peril unless he otherwise perfects.

¹⁵¹ U.C.C. § 9-304, Comment 4.

¹⁵² Uniform Trust Receipts Act § 8(1).

¹⁵³ Uniform Trust Receipts Act § 8(2).

¹⁵⁴ GILMORE, *supra* note 36, at 494 (emphasis added). Professor Gilmore cites two cases which seem to indicate that the priority received by an entruster during the 30-day period is absolute. In *Industries Sales Corp. v. Reliance Mfg. Co.*, 243 Miss. 463, 138 So. 2d 484 (1962), the court granted the entruster priority over a lien creditor whose interest arose during the 30-day period even though the entruster failed to file before the end of the period. In *In re McManus Motors, Inc.*, 27 F. Supp. 113 (D. Mass. 1939), the court held that payments made to an entruster during the 30-day period were not preferential even though the entruster never filed. This implies that the court believed that the entruster would have had priority over a lien creditor whose interest arose during the 30-day period. See Bankruptcy Act of 1898, § 60(a)(2), 11 U.S.C. § 96(a)(2) (1976).

¹⁵⁵ GILMORE, *supra* note 36, at 493-94.

¹⁵⁶ *Id.*

As under 9-304(4), the question of absolute versus conditional priority can be important under 9-304(5). The latter section permits a secured creditor with a possessory or possessory-type interest to maintain his perfection under certain circumstances for twenty-one days notwithstanding his surrender of possession.¹⁵⁷ In most instances, the collateral will be sold, processed, or otherwise liquidated during the twenty-one-day period. Nevertheless, if this does not occur the question of conditional versus absolute priority is presented when a competing interest arises during the period and the secured creditor's perfection lapses. Arguably, a secured creditor who temporarily releases collateral to a debtor has an obligation to police that collateral, and to retake it if it has not been liquidated within the period. Further, if the secured creditor fails to police or retake the collateral, it is not unreasonable to subordinate him even to interests that arose during the period of temporary perfection. Alternatively, the temporary perfection becomes considerably less meaningful if it is only effective in the absence of a lapse. Unfortunately, as with section 9-304(4) and the other Code provisions already presented, section 9-304(5) fails to specify whether the secured party, upon a lapse in perfection, is granted conditional or absolute priority over a third party whose interest arose before the lapse.

C. *Grace Periods — Sections 9-301(2) and 9-312(4)*

In sharp contrast to temporary automatic perfection, sections 9-301(2) and 9-312(4) establish grace periods for reperfecting. Under section 9-301(2), a purchase money secured party will take prior to a bulk transferee or a lien creditor whose interest arises between the time of the security interest attaches and the time of filing if a financing statement is filed within ten days after the debtor receives possession of the collateral.¹⁵⁸ Under this section, the rights of competing intervening claimants are clear. If the secured creditor fails to file before the end of the ten-day period, he is treated as having never had a perfected security interest and, therefore, is subordinate to a lien creditor or bulk transferee whose rights arose during the ten-day period. There is no absolute priority since the secured creditor is not deemed to have been perfected during this period. If he files within ten days, the secured creditor is treated as if he had perfected on the date the security interest attached as against the lien creditor or bulk transferee, and he receives priority over such parties even though he had not filed until after their interests arose.¹⁵⁹

A similar grace period is provided by section 9-312(4).¹⁶⁰ It gives a pur-

¹⁵⁷ See text of U.C.C. § 9-304(5) at note 143 *supra*.

¹⁵⁸ U.C.C. § 9-301(2) states:

If the secured party files with respect to a purchase money security interest before or within ten days after the debtor received possession of the collateral, he takes priority over the rights of a transferee in bulk or of a lien creditor which arise between the time the security interest attached and the time of filing.

Id.

¹⁵⁹ *Id.*

¹⁶⁰ U.C.C. § 9-212(4) provides:

A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral or its proceeds if the pur-

chase money secured creditor in noninventory collateral ten days after the debtor receives possession of the collateral to perfect his security interest and receive priority over otherwise prior security interests. Once again, the rights of competing claimants are plain. If the purchase money secured creditor perfects within ten days, he receives priority. If he waits more than ten days, he loses to any prior perfected secured creditors, including those who may have perfected during the ten-day period.

It is evident from the wording of sections 9-301(2) and 9-312(4) that when the drafters intended to provide a grace period, they did so expressly. They employed the concept of a grace period when there was no prior perfection to be continued. The grace period permits an unperfected secured creditor to take priority over a competing claimant to whom he would normally lose as long as he perfects within a specified time. According to Professor Gilmore, the grace period provided for purchase money security interests is merely a recognition "of the factual . . . impossibility of advance filing in many typical purchase-money transactions, particularly those arising out of sales of consumer goods and commercial equipment."¹⁶¹

The grace period does not present a true lapse problem. If a secured creditor acting within a grace period perfects in the requisite time, he receives the benefit of the grace period and of continuous perfection. If he fails to perfect in time, he simply loses the protection afforded by the grace period. Since there will have been no perfection during the grace period, there is no perfection to lapse. Nevertheless, the grace period is relevant to a discussion of lapse because it is the opposite of temporary automatic perfection. The grace period begins with the absence of perfection and permits eventual perfection to relate back. Temporary automatic perfection begins with perfection and permits subsequent acts to continue that perfection with no break in continuity.

If the purpose of giving a period of time within which a secured party can perfect is to provide certain rights for him during that period, regardless of his future actions, temporary automatic perfection is appropriate, and the secured party's rights should be absolute during the period. If the purpose is merely to permit a filing to relate back to an earlier date, then the grace period is the proper approach. It limits the rights of perfection to those creditors who act within the period. Those who fail to act within the allowed time lose the benefit of the relation back.

II. ISSUES UNDERLYING THE PROBLEM

Three issues underlie the Code's treatment of lapse of perfection, temporary automatic perfection, and grace periods: (1) the effect of a trustee in bankruptcy's status as a lien creditor, (2) preference problems, and (3) circular priority problems. While these issues were considered important by the Code

chase money security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter.

Id.

¹⁶¹ GILMORE, *supra* note 36, at 498.

drafters, there is no indication that a comprehensive evaluation of these issues preceded the drafting of the sections involved. An attempt at such an analysis follows.

A. Trustee as a Lien Creditor

Under both the old Bankruptcy Act and the new Bankruptcy Reform Act (Bankruptcy Code), the trustee has the status of a creditor who acquired a judicial lien on the date of bankruptcy.¹⁶² According to the Uniform Commercial Code, a perfected secured creditor takes priority over a subsequent judicial lien creditor while an unperfected secured creditor is subordinate to a lien creditor.¹⁶³ Thus, the trustee, as a lien creditor, can defeat any security interest that is unperfected on the date of bankruptcy. If a security interest is perfected on the date of commencement of a bankruptcy proceeding, however, and for some reason the perfection lapses while the estate is still open, a troublesome issue is presented. In this situation, the question is whether the trustee in bankruptcy, as a lien creditor, might defeat the lapsed security interest even though it was perfected on the date of bankruptcy.

Prior to the 1972 revisions of article 9, it was unclear whether a trustee in bankruptcy could defeat such a security interest. Commentators thought the respective rights of claimants were frozen on the date of bankruptcy so that subsequent lapse would not affect the status of a secured creditor perfected at bankruptcy.¹⁶⁴ This view received support from a pre-Code decision, *Lockhart v. Garden City Bank & Trust Co.*,¹⁶⁵ in which the court held that the rights of a mortgagee vis-a-vis a trustee in bankruptcy are fixed as of the date of bankruptcy.¹⁶⁶ In that case, a re-filing of the mortgage which was required by state law¹⁶⁷ was not required after the debtor had filed a bankruptcy petition.¹⁶⁸ Other courts, however, have differed in resolving this matter. Some courts have held that a mortgagee's failure to refile as required by state law after the date of bankruptcy permits the trustee to avoid the creditor's lien.¹⁶⁹ Two relatively recent cases disclosed doubts about whether a secured creditor's

¹⁶² Bankruptcy Act of 1898, § 70(c), 11 U.S.C. § 110(c) (1976); Bankruptcy Reform Act of 1978, § 544(a)(1), 11 U.S.C. § 544(a)(1) (Supp. II 1978).

¹⁶³ U.C.C. §§ 9-201, 9-301(1)(b).

¹⁶⁴ See 4A W. COLLIER ON BANKRUPTCY § 70.81(6) (1978); Kripke, *Mr. Levenberg's Criticism of the Final Report of the Article 9 Review Committee: A Reply*, 56 MINN. L. REV. 805, 811-12 (1972); Levenberg, *Comments on Certain Proposed Amendments to Article 9 of the Uniform Commercial Code*, 56 MINN. L. REV. 117, 125-26 (1971).

¹⁶⁵ 116 F.2d 658 (2d Cir. 1940).

¹⁶⁶ *Id.* at 661-62.

¹⁶⁷ N.Y. LIEN LAW § 235 (McKinney 1966).

¹⁶⁸ *Accord*, In re Delia Brothers, 29 U.C.C. REP. SERV. 1446 (S.D.N.Y. 1980); In re South County Motel Corp., 439 F. Supp. 252 (D.R.I. 1976). See also In re Lake County Fuel & Supply Co., 70 F.2d 391 (7th Cir. 1934), cert. denied, 293 U.S. 577 (1935). Cf. Grana v. Mehs, 152 Misc. 828, 274 N.Y.S. 341 (1934) (chattel mortgagee has priority over judgment creditor who purchased chattel before lapse of mortgagee's filing even though filing subsequently lapsed).

¹⁶⁹ See, e.g., In re Lukas, 24 F.2d 254 (E.D.N.Y. 1928); Benedict v. Zutes, 88 Misc. 214, 150 N.Y.S. 147 (1914).

rights under the Code are frozen as of the date of bankruptcy if perfection subsequently lapses.¹⁷⁰

The 1972 Code helped resolve the lapse problem with respect to a trustee in bankruptcy. Section 9-403(2) contains language indicating that upon lapse of perfection, a lien creditor is promoted over the lapsed interest.¹⁷¹ Then, to ensure that this would not be interpreted to benefit a trustee in bankruptcy asserting lien creditor status, the revised section 9-403(2) also provides that a security interest perfected by filing on the date of initiation of insolvency proceedings remains perfected until after the proceedings are terminated.¹⁷² The trustee's status as a lien creditor is not, therefore, a basis for avoiding a security interest perfected by filing even though the effectiveness of the filing may lapse after a bankruptcy petition is filed. This will obtain, however, only if section 9-403(2) applies to bankruptcy. Arguably, a provision that dispenses with the need to refile in the event of insolvency proceedings but requires refiling in all other circumstances conflicts with the Bankruptcy Code. Since the Bankruptcy Code envisions the trustee as a lien creditor with all of the rights accorded a lien creditor by state law, a state law that discriminates against the trustee in particular may fall in the face of the federal statute under the Supremacy Clause.¹⁷³ Nonetheless, since section 9-403(2) is not limited to bankruptcy proceedings or to trustee-lien creditors and since it does not affect the rights of creditors but merely dispenses with a ministerial act, it is probably valid. Certainly no case to date has held otherwise.

One could argue more convincingly for freezing the respective priorities as of the date of bankruptcy if the automatic stay¹⁷⁴ would prevent a creditor from filing a timely continuation statement. The automatic stay enjoins most acts to collect debts and most acts to "create, perfect, or enforce liens."¹⁷⁵ If the filing of a continuation statement were not permitted and the secured creditor's rights were not frozen as of the commencement of the bankruptcy proceeding, all security interests could eventually be invalidated merely by delaying the close of the bankruptcy case. This obviously would be an absurd result. Under the Bankruptcy Act¹⁷⁶ and the Rules,¹⁷⁷ the automatic stay did not prevent the

¹⁷⁰ *Eastern Indiana Production Credit Ass'n v. Farmers State Bank*, 31 Ohio App. 2d 252, 254-55 (1972). The dispute in that case was between two secured creditors who both claimed certain property that had been abandoned by the trustee. Although the case can be read as only applying to abandoned property, the court's discussion seems to cover even property claimed by the trustee. *See also* *In re Sheets*, 7 U.C.C. REP. SERV. 893 (Bankr. Ct. W.D. Okla. 1970). *Contra*, *In re Delia Brothers*, 29 U.C.C. REP. SERV. 1446 (S.D.N.Y. 1980); *In re South County Motel Corp.*, 439 F. Supp. 252 (D.R.I. 1976). *Cf.* *Chrysler Corp. v. United States*, 24 U.C.C. REP. SERV. 794 (E.D. Va. 1978) (filing suit tolled any obligation of plaintiff to defendant to file continuation statement upon expiration of financing statement since defendant had notice of security interest).

¹⁷¹ See text at notes 52-55 *supra*.

¹⁷² U.C.C. § 9-403(2).

¹⁷³ U.S. CONST. art. 6, cl. 2.

¹⁷⁴ Bankruptcy Reform Act of 1978, § 362, 11 U.S.C. § 362 (Supp. II 1978).

¹⁷⁵ *Id.*

¹⁷⁶ Bankruptcy Act of 1898, § 11, 11 U.S.C. § 29 (1976).

¹⁷⁷ Rules of Bankruptcy Procedure §§ 401, 601.

filing of a continuation statement or, if necessary, a new financing statement. There is some question under the Bankruptcy Code, however, as to whether the automatic stay applies to a post-petition filing. Section 362(a)(4) provides that "any act to create, perfect, or enforce any lien against property of the estate" is stayed.¹⁷⁸ Arguably the filing of a continuation statement or of a new financing statement is not an "act to create, perfect, or enforce" a security interest, but rather merely *continues* the perfection. In addition, section 362(b)(3) excepts from the stay any act to perfect an interest if the trustee would be subject to the perfection under section 546(b). Section 546(b) makes the trustee "subject to any generally applicable law that permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of such perfection." If filing a continuation statement to prevent a lapse comes within the terms of section 546(b), then such a filing would be exempted from the automatic stay, and conceivably could be required in order to retain rights against the trustee notwithstanding section 9-403(2). It appears that Congress was concerned in section 546(b) mainly with certain grace periods that are accorded to secured creditors.¹⁷⁹ For example, a purchase money secured creditor has ten days after the debtor receives possession of the collateral to file. By filing, the secured creditor obtains priority over a lien creditor whose interest arose after the security interest attached but before the filing. Section 546(b) recognizes this grace period as valid against the bankruptcy trustee. The provision probably is not intended to permit filing of a continuation statement. Assuming section 9-403(2) is valid, or taking the more traditional view that all rights are frozen as of the date of the petition, no filing should be necessary and, therefore, the stay can apply, to the filing of continuation statements. If section 546(b) is interpreted to apply to, and, therefore, permit the filing of, a continuation statement, it may by implication *require* such a filing to retain rights against the trustee. Section 546(b) would thereby create the grounds for invalidating section 9-403(2).

The section 9-403(2) argument that perfection continues if insolvency proceedings intervene is not available in other lapse situations. Under section 9-103(1)(d), the issue of a perfection lapse in insolvency proceedings is not likely to be a problem since a creditor who obtains a lien during the four months after goods are moved to another jurisdiction probably is not promoted over a secured creditor who fails to refile before the end of the period.¹⁸⁰ Therefore the trustee in bankruptcy would receive no benefit even if perfection lapsed under section 9-103(1)(d). In other situations, however, such as sections 9-103(1)(c) or 9-306(3), it is possible that a lien creditor is promoted upon lapse.¹⁸¹ If the perfection existing on the date of bankruptcy lapses, and the acts required to continue perfection are not taken, promotion of lien creditors would permit the trustee to assert priority over the secured creditor. This would be unfortunate because creditors may be lulled by the existence of a bankruptcy proceeding in-

¹⁷⁸ Bankruptcy Reform Act of 1978, § 362(a)(4), 11 U.S.C. § 362(a)(4) (Supp. II 1978).

¹⁷⁹ See, e.g., H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 371 (1977).

¹⁸⁰ See text at notes 75-79 *supra*.

¹⁸¹ See text at notes 88 & 130-37 *supra*.

to a failure to refile or may be enjoined from filing by section 362(a) of the Bankruptcy Code. It is difficult to discern the drafters' intent regarding the possibility of the trustee achieving priority upon a lapse of perfection. Since the drafters specifically confronted this issue in section 9-403(2), they may have intended a different approach in the sections in which they were silent on the matter. Yet it seems more likely that the drafters simply overlooked this issue, along with the entire issue of lapse in most of these sections. In this event, there may have been no intent to promote trustees in bankruptcy or any lien creditors upon lapse in sections such as 9-103(1)(c) and 9-306(3). Alternatively, even if lien creditors are to be promoted, the rights of the bankruptcy trustee as a lien creditor may differ from other lien creditors because they may be frozen on the date of bankruptcy. While the matter may be the most reasonable approach, there is little support in the wording of the Bankruptcy Act or the Bankruptcy Code for discriminating against the trustee as a lien creditor.¹⁸² Nevertheless, there is some support for freezing rights as of the date of bankruptcy¹⁸³ and that would be the most appropriate resolution.

A similar issue regarding the priority of the trustee in bankruptcy arises when a secured creditor has a possessory security interest at the commencement of bankruptcy proceedings. According to section 542 of the Bankruptcy Code,¹⁸⁴ the creditor may be required to turn over the property to the trustee under certain circumstances. If the creditor were deemed to be unperfected once the property was turned over, and if a lien creditor — the trustee — were promoted over the possessory secured creditor upon lapse, the trustee could avoid virtually all possessory security interests. This would be a ridiculous result and apart from the dictates of the Uniform Commercial Code, it would seem to be proscribed by the Bankruptcy Code. The Bankruptcy Court is a court of equity and would not be party to such an inequitable transaction.

In summary, the effect of a lapsed security interest on a trustee in bankruptcy depends upon the statutory provision governing perfection. Under section 9-403(2) of the Uniform Commercial Code, the interest of a trustee, as lien creditor, is subordinate to a lapsed security interest, perfected at the date of bankruptcy. Under Code sections 9-103(1)(c) and 9-306(3), however, it is conceivable that the interest of a trustee in bankruptcy, considered a lien creditor, is promoted upon lapse. Finally, where a secured creditor has a possessory security interest at the initiation of bankruptcy proceedings, but later is required to turn the property over to the trustee, the secured creditor's interest will remain perfected. Thus, in this situation, the trustee's interest will remain subordinate to that of the secured creditor.

¹⁸² In one sense, there is no discrimination against the trustee. That is, if rights are to be frozen as of the date of bankruptcy, they presumably would be frozen for all creditors. See U.C.C. § 9-403(2) ("security interest remains perfected until termination of the insolvency proceedings" (emphasis added)). There is a problem, however, since perfection continues without further action by the secured party beyond the time when it normally would lapse only when there is an insolvency proceeding. Thus the secured creditor receives an advantage in insolvency proceedings that is not available in the absence of such proceedings.

¹⁸³ See notes 165 & 168 *supra*.

¹⁸⁴ Bankruptcy Reform Act of 1978, § 542, 11 U.S.C. § 542 (Supp. II 1978).

B. Preference Problems

In addition to the problem of determining the status of a trustee in bankruptcy's interest, there is a second factor pervading the lapse of perfection area. It is the desire to avoid a finding that a reperfecting might constitute a preference under the Bankruptcy Code. A preference is a transfer of the debtors' property, to or for the benefit of a creditor, on account of an antecedent debt. The transfer must have been made while the debtor was insolvent and within ninety days of bankruptcy. Further, it must enable the creditor to receive a greater percentage of his debt than he would have received in a liquidation without the transfer.¹⁸⁵ A transfer is deemed to be made at the time it takes effect if it is perfected within ten days, at the time of perfection if it is not perfected within ten days, or immediately before bankruptcy if it is never perfected.¹⁸⁶ The transfer is considered perfected "when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee."¹⁸⁷

It is the lien creditor test for perfection that creates a potential preference problem in lapse situations. Justice Braucher described this problem in terms of the four-month rule of section 9-103(1)(d).¹⁸⁸ Initially, he observed that under 9-103(1)(d), a security interest in goods moved to another jurisdiction, if not refiled within four months, is considered unperfected against one who purchases after removal.¹⁸⁹ Yet a security interest in the same goods is deemed absolutely perfected against a lien creditor levying during this four-month period.¹⁹⁰ He explained this contrast in priority between a purchaser and lien creditor by referring to the drafters' concern that conditional priority over a lien creditor would not adequately protect the secured party against the lien

¹⁸⁵ Bankruptcy Reform Act of 1978, § 547(b), 11 U.S.C. § 547(b) (Supp. II 1978). If the creditor is an insider and had reasonable cause to believe that the debtor was insolvent on the date of the transfer the 90-day preference period is increased to a year. Section 60 of the Bankruptcy Act of 1898, 11 U.S.C. § 96 (1976), was substantially the same as § 547 of the new Code. The preference period was four months instead of 90 days, the greater percentage requirement was worded as needing a creditor to receive a "greater percentage of his debt than some other creditor of the same class," and the trustee needed to show that the creditor had reasonable cause to believe the debtor was insolvent on the date of the transfer in order to avoid it.

¹⁸⁶ Bankruptcy Reform Act of 1978, § 547(e)(2), 11 U.S.C. § 547(e)(2) (1978). Under the old Bankruptcy Act, if the transfer was for new and contemporaneous consideration, there was a grace period in which the interest could be perfected. This grace period extended for 21 days or, if the state provided a grace period, for the length of the state grace period, whichever was shorter. Bankruptcy Act of 1898, § 60(a)(7), 11 U.S.C. § 96(a)(7) (1976). It has been argued that the Uniform Commercial Code, rather than not providing a grace period (which would under section 60(a)(7) give a secured creditor 21 days to perfect), grants a grace period of zero days, and that therefore any delay in perfection could be preferential. *See, e.g.*, GILMORE, *supra* note 36, at 1327-29.

¹⁸⁷ Bankruptcy Reform Act of 1978, § 547(e)(1)(b), 11 U.S.C. § 547(e)(1)(b) (Supp. II 1978). *See also* Bankruptcy Act of 1898, § 60(a)(2), 11 U.S.C. § 96(a)(2) (1976); U.C.C. § 9-301(b).

¹⁸⁸ 48 ALI PROCEEDINGS 255-61 (1971).

¹⁸⁹ *Id.* at 255.

¹⁹⁰ U.C.C. § 9-301(1)(d).

creditor until the secured party filed in the new jurisdiction.¹⁹¹ Justice Braucher shared the drafters' concern because he theorized that unless the filing was made immediately upon the arrival of the goods, the transfer, being deemed made when the filing occurs, would be on account of an antecedent debt and would satisfy the other elements of a preference. If filing occurred immediately upon the goods' arrival, there would be no break in the perfection from the original jurisdiction and therefore there would be no new transfer. Justice Braucher maintained that by making the four-month period of temporary perfection one of absolute priority, the drafters ensured continuous perfection as long as the secured creditor refiled during the period,¹⁹² and thus avoidance of a preference problem.

Braucher's suggestion that conditional priority would constitute a preference is questionable. The purpose of the preference section of the Bankruptcy Code is to foster an equitable distribution of a debtor's assets¹⁹³ and to prevent the enforcement of secret liens on the debtor's property.¹⁹⁴ The four-month period of temporary perfection in section 9-103(1)(d) hinders neither of these goals, even if the perfection is merely conditional. Admittedly there is a period of time during which a secured creditor can have a consensual lien without having a filing in the state where a filing would be expected. The creditor, however, will have perfected in the original jurisdiction and therefore is not purposely keeping the lien secret. In addition, a thorough investigation of the collateral's history by any interested third party most likely would lead to a discovery of the original filing. Moreover, the short period of perfection without filing within the jurisdiction was provided because it would take even a good faith secured creditor some time to learn that the goods have been moved and to refile in the new jurisdiction.¹⁹⁵ It is unrealistic to assume that secured creditors can learn of the removal and file before or at the very moment that the goods are removed. Any such requirement obviously would make secured creditors very insecure. Certainly Congress did not intend to require such a result nor did it desire absolute rather than conditional perfection as a condition for the effectiveness of the four-month period. The lien creditor language of the preference provision, section 547, was added to the bankruptcy law for reasons totally unrelated to problems of temporary perfection.¹⁹⁶

Although the lien creditor language should not be applied to the problem of temporary perfection, the Code drafters, obviously aware of other strained and inappropriate interpretations of the Bankruptcy Act,¹⁹⁷ elected to take no chances. Accordingly, section 9-103(1)(d) takes no position on the status of in-

¹⁹¹ 48 ALI PROCEEDINGS 259-60 (1971).

¹⁹² *Id.*

¹⁹³ H.R. 8200, H.R. REP. NO. 595, 95th Cong., 1st Sess. 177-78 (1977).

¹⁹⁴ Freedman, *The Bankruptcy Preference Challenge to After Acquired Property Clauses under the Code*, 108 U. PA. L. REV. 194, 202 (1959).

¹⁹⁵ U.C.C. § 9-103, Comment 7.

¹⁹⁶ *See, e.g.*, W. COLLIER ON BANKRUPTCY § 60.38 (14th ed. 1977).

¹⁹⁷ *See, e.g.*, *Porter v. Searle*, 228 F.2d 748 (10th Cir. 1955); *Constance v. Harvey*, 215 F.2d 571 (2d Cir. 1954), *cert. denied*, 348 U.S. 913 (1955).

tervening lien creditors, with the implication that it provides absolute protection against lien creditors during the four-month period. This permits a court to interpret the section equitably without running afoul of the preference section. In contrast to section 9-103(1)(d), however, the drafters clearly provided only conditional priority to the secured creditor under section 9-403(2), the general lapse provision of the Code. While Justice Braucher was concerned that conditional priority under 9-103(1)(d) would result in a preference, he defended the grant of conditional priority¹⁹⁸ in 9-403(2) on two grounds. First, he noted that most property or transactions involved would not last five years so that lapse could not occur.¹⁹⁹ Second, he assumed that the preference section of the Bankruptcy Code would not apply to a five-year filing period as it might to a four-month period of temporary perfection.²⁰⁰ Neither defense survives careful scrutiny. First, for purposes of determining whether a transfer is a preference, the question whether the property or transaction is to last five years is irrelevant. If the property or transaction *could* last five years, so that a filing *could* lapse, then under section 9-403(2) the interest is never completely protected against a lien creditor. Undoubtedly, there are some situations in which the property or transaction cannot possibly last more than five years so that the perfection is effectively absolute. These, however, seem to be exceptional cases. Consequently, the fact that the property or transactions often do not last five years is no defense to the preference problem. Second, Braucher's distinction between the effect of a five-year period and a four-month one is without support. As support for the proposition that section 9-403(2) is not preferential, Braucher cites the absence of any cases, under the old conditional-sale and chattel-mortgage statutes, that found preferences where a filing was effective for only a finite time period. The problem with this argument is that most of the old statutes did not promote a junior lien creditor upon lapse of the senior interest.²⁰¹ Since the conditional seller or chattel mortgagee had absolute priority over pre-lapse lien creditors, there could be no preference problem. The lender could be sufficiently perfected as to defeat a lien creditor. It is the elimination of this absolute priority that has engendered this preference problem.

Although neither of Braucher's arguments against characterizing conditional perfection as preferential is convincing, his conclusion here seems correct. Conditional perfection should not be construed as a preference since the preference section of the Bankruptcy Code was not aimed at the types of transactions in which conditional perfection exists. Moreover, such a construction would immediately invalidate almost all security interests presently in existence by viewing them as unperfected under the Bankruptcy Code's definition of perfection. Such a result is unacceptable. The possibility of such a construction, however, while outrageous, should give pause to those who oppose absolute perfection.

¹⁹⁸ 48 ALI PROCEEDINGS 260-61 (1971).

¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ *See, e.g.,* GILMORE, *supra* note 36, at 582-84.

C. The Circular Priority Problem

A final factor important in the lapse of perfection area is the drafters' attempt, especially in section 9-403, to avoid circular priority.²⁰² The problem of circular priority is illustrated by the following example: S takes a security interest in personal property and files on March 1, 1974. M takes a security interest in the same property and files on October 1, 1975. At this point, S has priority over M.²⁰³ S fails to file a continuation statement before March 1, 1979, however, so that her perfection lapses on that date.²⁰⁴ On May 1, 1979, the debtor files a bankruptcy petition, giving the trustee in bankruptcy the status of a lien creditor as of that date.²⁰⁵ If S were permitted to retain her priority over M notwithstanding the lapse of perfection, S would beat M,²⁰⁶ M would beat the trustee in bankruptcy,²⁰⁷ and the trustee would beat S.²⁰⁸ In the bankruptcy situation the circle is easily broken because S's avoided lien is automatically preserved for the benefit of the estate²⁰⁹ and M's interest is thereby avoided to the extent that S could have avoided it. Thus the trustee receives first up to the amount of S's interest, then M receives up to the amount that his interest exceeds S's, and the trustee then receives the remainder.

Outside of the bankruptcy, a true circular priority is established if a lien creditor, L, levies on the property after S's perfection lapses. In that case, S beats M, M beats L, and L beats S. To break this circle, it is useful to distinguish between the different types of circular priorities that can arise. Professor Gilmore, in his comprehensive chapter on the topic,²¹⁰ suggests three possibilities. The first arises when one party contractually subordinates himself to another. For example, A, B, and C all have liens on the same property and are entitled to priority in alphabetical order. The value of the property is insufficient to satisfy all three claims. A agrees to subordinate his claim to C. Therefore, A has priority over B, B has priority over C, and C has priority over A, a circular priority puzzle. Gilmore notes that this puzzle is easily solved by the following procedure:

1. Set aside from the fund the amount of A's claim.
2. Pay the amount so set aside to
 - a) C, to the amount of his claim;
 - b) A, to the extent of any balance remaining after C's claim is satisfied.

²⁰² See, e.g., U.C.C. § 9-403, Comment 3.

²⁰³ U.C.C. § 9-312(5).

²⁰⁴ U.C.C. § 9-403(2).

²⁰⁵ Bankruptcy Reform Act of 1978, § 544(a)(1), 11 U.S.C. § 544(a)(1) (Supp. II 1978).

²⁰⁶ U.C.C. § 9-312(5).

²⁰⁷ None of the trustee's avoidance powers would be effective against M's perfected security interest. Bankruptcy Reform Act of 1978, §§ 544-551, 11 U.S.C. §§ 544-551 (Supp. II 1978).

²⁰⁸ Bankruptcy Reform Act of 1978, § 544(a)(1), 11 U.S.C. § 544(a)(1) (Supp. II 1978). U.C.C. § 9-301(1)(b).

²⁰⁹ Bankruptcy Reform Act of 1978, § 551, 11 U.S.C. § 551 (Supp. II 1978).

²¹⁰ GILMORE, *supra* note 36, at 1021-23. See also G. OSBORNE, THE LAW OF MORTGAGES 532-39 (1951) [hereinafter cited as OSBORNE].

3. Pay B the amount of the fund remaining after A's claim has been set aside.
4. If any balance remains in the fund after A's claim has been set aside and B's claim has been satisfied, distribute the balance to
 - a) C,
 - b) A.²¹¹

The second circular priority possibility arises when one party fails to do some act necessary to ensure his priority over some, but not all, other claimants. For example, under a mortgage filing system in which failure to file subordinates the mortgagee to subsequent mortgagees who take without knowledge, but has no effect on subsequent mortgagees who take with knowledge, the following circle can result: A takes a mortgage and fails to file; B takes a filed mortgage on the same property with knowledge of A's interest; C takes a filed mortgage on the same property without knowledge of A's interest. The result is that A is prior to B, B is prior to C, and C is prior to A. This problem is not as easily resolved as the first situation. Here Professor Gilmore favors a variation of the subordination rule under which A would be the subordinate party.²¹² He reasons that since A failed to file, he was at fault and should be subordinated. Thus A's share would be set aside for C, with the remainder, if any, going to A. Remaining property would go first to B, then to C, if C hasn't yet been satisfied, and then to A. There have been other solutions proposed,²¹³ but they are generally too complicated to be workable.

The third type of circular priority problem involves the operations of inconsistent statutory schemes. Although all of the parties have acted properly under these statutory provisions, a circle nevertheless results. A classic example arose under the old Federal Bankruptcy Act.²¹⁴ According to section 67(c)(1), certain statutory liens were subordinated to administrative expenses and wage claims.²¹⁵ These liens, however, often had priority under state law over consensual mortgages or security interests.²¹⁶ Therefore, a circle was created in which the lien had priority over the mortgage, the mortgage had priority over the administrative expenses and the wage claims had priority over the lien.

Gilmore analyzed the circular priority cases that arose after 1940, almost all of which involved the third situation. He found that "[t]he most popular solution"²¹⁷ was to apply the analysis used in situations involving subordination agreements.²¹⁸ According to Gilmore, this analysis was utilized even in those cases involving "true circular priorities" in which no party was at fault and in which the circle resulted strictly from inconsistent statutory schemes.

²¹¹ GILMORE, *supra* note 36, at 1021.

²¹² *Id.* at 1022.

²¹³ See note 222 *infra*.

²¹⁴ Bankruptcy Act of 1898, § 67(c)(1), 11 U.S.C. § 107(c)(1) (1976).

²¹⁵ *Id.*

²¹⁶ GILMORE, *supra* note 36, at 1023.

²¹⁷ *Id.* at 1032.

²¹⁸ *Id.*

Where a circularity is due to one party's fault, it is easier to equate that party with one who has given a subordination agreement, and to treat him accordingly. Yet in the "true circular priority" cases, there is no logical basis for determining which of the parties should be subordinated because no party stands out as subordinated or at fault. Consequently, use of the subordination rule causes the circle to be broken arbitrarily. The difficulty of determining where to break the circle is illustrated by cases that contained similar fact situations but still reached different solutions.²¹⁹ Nevertheless, the fact that courts use the subordination rule in the face of this difficulty indicates a strong preference for this means of resolving circular priority problems.

While courts that have considered the circular priority problem prefer the subordination rule, it is not the approach adopted by the Code drafters. In section 9-403(2), they purport to avoid the circular priority problem by promoting the junior secured creditor upon lapse of the senior interest.²²⁰ If A is the senior, lapsed secured creditor, B the junior perfected secured creditor, and C a lien creditor whose lien arose after A's lapse, the distribution would be to B first, then to C, and finally to A. This approach, however, does not avoid the circular priority problem.²²¹ Rather, it breaks the circle once it has formed by putting B ahead of A and then ranking everyone. The question, then, is whether this resolution is preferable to the subordination rule or some other approach.

As a preliminary matter, it would appear that the suggested approaches, other than subordination, should be rejected.²²² They do not provide equitable solutions and are so complicated that they would have little practical application in the courts.²²³

There are, generally, three approaches to the circular priority problem. Each of these provides a windfall to one of the three parties involved. In a scenario involving a senior secured creditor whose perfection has lapsed, a junior secured creditor whose interest arose before the lapse, and a lien creditor whose interest arose after the lapse, the three approaches are as follows: (1) Pay the parties in the order in which their claims arose. This, in effect, ignores the

²¹⁹ *Id.*

²²⁰ U.C.C. § 9-403(2).

²²¹ *See, e.g.*, OSBORNE, *supra* note 210, at 533.

²²² *See, e.g.*, BENSON, *Circuity of Lien — A Problem in Priorities*, 19 MINN. L. REV. 139 (1935); KOCOUREK, *A First-Rate Legal Puzzle — A Problem in Priorities*, 29 ILL. L. REV. 952 (1935); Note, *Circuity of Liens — A Proposed Solution*, 38 COLUM. L. REV. 1267 (1938).

²²³ The approaches generally involve some variation of the one suggested by Judge Dixon in *Hoag v. Sayre*, 33 N.J. Eq. 552 (1881). Judge Dixon's approach involved treating the "nongUILTY" parties as junior lienors. Thus, if A is a mortgagee who failed to file, B a second mortgagee with knowledge of A's interest (*i.e.*, subordinate to A), and C a lien creditor (prior to A but subordinate to B), the distribution would be made as follows:

1. Pay C the amount of the fund less B's claim.
2. Pay B the amount of the fund less A's claim.
3. Residue to A.

GILMORE, *supra* note 36, at 1025-26. For the three variations on this approach, see articles cited in note 222 *supra*.

lapse. Under this approach, the senior secured creditor receives first, then the junior secured creditor, then the lien creditor. (2) Promote the junior secured creditor upon the senior's lapse. The junior creditor receives first, then the lien creditor, then the senior secured creditor. (3) Freeze the secured creditors' priorities as of the time their interests arose but set aside the amount of the senior's interest and use it to pay the lien creditor, who has priority over the senior security interest since the lien arose after the lapse. This is the subordinate rule. Under this rule, the lien creditor receives first up to the amount of the senior secured creditor's claim. The senior will receive next if any of the amount set aside remains, then the junior secured creditor, then the lien creditor if any more is due him, and finally the senior secured creditor.

The first approach has the virtue of simplicity. Its justification is that the lien creditor cannot be paid until the junior secured creditor is paid, and the junior creditor cannot be paid until the senior has been paid.²²⁴ The effect of this resolution, however, is to provide a windfall for the senior secured creditor — the party who created the problem by letting his perfection lapse. In addition, it penalizes the lien creditor who normally would have priority over the lapsed interest. This seems to be the least acceptable of the possible approaches since the party who caused the circle certainly should not benefit from it.

Neither of the remaining two approaches is dismissed so easily. The circle can be broken either by promoting the junior creditor as section 9-403(2) does or by using the subordination rule, under which the first secured party is treated as the subordinated party. Promoting the junior secured creditor upon a senior creditor's lapse provides a windfall to the junior creditor, since at the time he took his interest, he expected to be subordinate. Nevertheless, the Code's filing requirements are so simple that there is little excuse for a secured party's failure to file a continuation statement in order to prevent a lapse. It is arguably fair, therefore, to penalize the creditor who permits a lapse to occur. In fact, such a penalty would provide further incentive for secured parties to keep their filings up to date. Moreover, the lien creditor has at least constructive knowledge of the junior secured creditor's interest at the time he obtains his lien. Consequently, it seems equitable that the junior secured creditor recovers prior to the lien creditor.

Use of the subordination rule also provides a windfall, but in this case it would be for the lien creditor. This windfall occurs because the lien creditor receives as much of the senior secured party's share as is necessary to satisfy his lien. He, however, has had at least part of his claim satisfied prior to the junior secured party's receipt of payment, even though the lien creditor expected to be subordinate to that party. This windfall has been the major objection to the subordination rule. Yet, in defense of this approach, it should be noted that the two secured parties are left in the positions that they expected to be in at the time they obtained their interests. The senior party is prior to the junior party, thereby supporting and enhancing the operation of the filing system.

Which of these approaches is preferable depends on whether it is better to

²²⁴ OSBORNE, *supra* note 210, at 533.

give a windfall to the junior secured party or to the lien creditor. This article takes no position on this question other than to note that, according to Justice Braucher, the issue was fully debated by the Code revisers and they opted for the former position.²²⁵ The point of this discussion is to demonstrate that the Code's approach in section 9-403(2) does not avoid circular priority, but rather adopts a means of breaking the circle. Thus, if the policy of the Code is avoidance of circular priorities,²²⁶ it is no better served by its rule of conditional priority than by an absolute priority rule. If the present Code approach creates inconsistencies within the statutory scheme, avoidance of circular priority does not provide a reason to retain the approach and the inconsistency.

In fact, the present approach to conditional and absolute priority does create inconsistencies within the Code. Although section 9-403(2) provides only conditional priority to a secured creditor, section 9-103(1)(d) arguably provides absolute priority over lien creditors, albeit only conditional priority over other secured creditors. Moreover, other Code sections, such as 9-306(3) and 9-103(1)(c), take no position on the type of priority accorded a secured creditor. Thus the relative priorities of parties upon lapse of perfection seem unduly dependent upon the type of lapse involved. Perhaps the various sections involving lapse can be interpreted in a manner that provides internal consistency. This will be the subject of the remainder of this article.

III. A CONSISTENT APPROACH TO LAPSE CASES

Article 9 of the U.C.C. contains numerous provisions that potentially result in lapse of perfection. Although superficially these provisions disclose no logical or consistent approach to the problem, closer analysis discloses a means of reconciling most of the provisions. It appears that although much of the thought given to the lapse provisions involved the bankruptcy and circular priority problems, these problems are in fact insignificant or non-existent. The main concern of these lapse provisions should be to find the most equitable solution to the problems raised by a lapse of perfection. Such an analysis would take into account the source of the lapse, the types of parties competing for payment, the reasonable expectations of the parties, and the party who was in the best position to avoid the conflict. This need not be done on a case-by-case basis, but rather can be done for each lapse section since there are only a limited number of possible scenarios under each section. Such an analysis follows.

A. *Lapse Sections*

1. Section 9-403(2)

Section 9-403(2) provides that a filing lapses five years after it is made if a continuation statement is not filed prior to the lapse. Upon lapse, purchasers and lien creditors may treat the security interest as if it had never been

²²⁵ 48 ALI PROCEEDINGS at 258-59 (1971).

²²⁶ U.C.C. § 9-403, Comment 3.

perfected. In view of the respective equities of the parties involved, section 9-403(2) contains the correct approach to this situation. Because the statute clearly states that the filing lapses in five years and because the secured creditor has a six-month period within which to file,²²⁷ there is no excuse for his failing to file a continuation statement at the proper time. Certainly where both pre- and post-lapse purchasers or lien creditors exist, creating a potential circular priority problem, the approach of 9-403(2) is sensible. It penalizes the lapsed creditor, who could have filed with ease, rather than the other innocent parties.²²⁸

Where only a pre-lapse purchaser or lien creditor and the lapsed secured creditor are competing, however, section 9-403(2) is not as easily justified. Since the pre-lapse party took with at least constructive knowledge of the security interest, the respective rights arguably should be frozen as of that time. On the other hand, the pre-lapse purchaser or creditor should be entitled to assume that the failure to file a continuation statement indicates that the senior party is no longer claiming any interest in the property. Perhaps an even more compelling reason to promote the junior party in such a situation is the difficulty of administering different rules depending on the number of claimants or the times the claims arose. It seems appropriate, therefore, to promote purchasers and lien creditors when a filing lapses under the five-year rule.

Section 9-403(2)²²⁹ also resolves any problem that might arise concerning the trustee in bankruptcy's status as a lien creditor by continuing perfection until after termination of a bankruptcy proceeding. Consequently, those few cases²³⁰ that promoted the trustee upon lapse are no longer viable. Hopefully any preference argument with respect to 9-403(2) will be rejected as well.²³¹ Admittedly, the conditional priority of this provision offers support to the preference argument because with such priority, the secured creditor is never completely perfected against a lien creditor.²³² Nevertheless, a reasonable interpretation of the Bankruptcy Code will permit security interests perfected under 9-403(2) to survive bankruptcy.²³³

Section 9-403(2) elects a circular priority solution under which a secured creditor after lapse becomes subordinate to all parties who have priority over an unsecured creditor. This approach permits a purchaser or lien creditor —

²²⁷ The secured party does not need the debtor's signature on the continuation statement. U.C.C. § 9-402(2)(a).

²²⁸ In this context, an innocent party is one who uses sound business practices and has reasonable expectations.

²²⁹ U.C.C. § 9-403(2) provides:

If a security interest perfected by filing exists at the time insolvency proceedings are commenced by or against the debtor, the security interest remains perfected until termination of the insolvency proceedings and thereafter for a period of sixty days or until expiration of the five year period, whichever occurs later.

Id.

²³⁰ See cases cited in notes 169 & 170 *supra*.

²³¹ See text at notes 198-201 *supra*.

²³² *Id.*

²³³ *Id.*

aside from a trustee in bankruptcy — to receive a windfall, even though they expected to be subordinate. Given the ease with which the secured creditor could prevent a lapse, this does not seem at all inappropriate.

2. Section 9-103

a. Section 9-103(1)(d)

Section 9-103(1)(d) provides that if collateral subject to a perfected security interest is moved from one jurisdiction to another, the security interest remains perfected for four months after the collateral arrives in the new jurisdiction, and thereafter if the security interest is reperfected in the new jurisdiction. If the security interest is not reperfected during the four-month period, it becomes unperfected at the end of the period and is then deemed to have been unperfected as against a purchaser whose interest arose during the period.²³⁴

The respective equities of the parties are different in this section than in section 9-403, the filing lapse provision. Under 9-403, the secured party would or should know at all times exactly when lapse would occur if a refile was not made.²³⁵ Thus, since a secured party could easily avoid lapse under this five-year rule, he deserves little protection from the effect of a lapse.²³⁶ The secured creditor is not as likely to know about a 9-103(1)(d) lapse, however, which would be caused by moving the goods from one jurisdiction to another. Unless the secured creditor is constantly policing his collateral, it is possible for a debtor to move the collateral and for the secured creditor to fail to learn of the move for some time. Moreover, where a financially desperate or unscrupulous debtor is involved, the collateral not only may be moved, but also may be sold or used as collateral for a loan in the new jurisdiction. Since there will be no filing in the new jurisdiction, a purchaser who relies on the files will not know of the security interest. The Code drafters felt that the risk that an innocent purchaser might be misled during the four-month period was an acceptable risk and necessary to ensure the secured creditor a reasonable time within which to act.²³⁷ The protection for the purchaser would lie in his investigation of the recent history of the collateral. The four-month period of continued perfection, does, to some extent, interfere with the integrity of the filing system, however, and it does not seem unreasonable to require a secured creditor who is claiming the benefit of this period against a party who may have relied on the filing system to maintain sufficient interest in his collateral so that he would learn of the move and act within four months. In balancing the equities of the secured creditor and the purchaser, it is appropriate that the purchaser be permitted to defeat a secured creditor who is not diligent enough to act within four months. Section 9-103(1)(d) does this by deeming the security interest that is not reperfected within four months as having been unperfected during the four-month period.

This reasoning is not as persuasive when the intervening party is a lien

²³⁴ See Part I-A-2 *supra*.

²³⁵ See text at notes 227-28 *supra*.

²³⁶ *Id.*

²³⁷ U.C.C. § 9-103, Comment 7.

creditor. The lien creditor is not a "reliance creditor" because credit is typically not extended by him based on the absence of filings against the debtor. Rather, the lien creditor, by extending credit without security, undertakes the risk that no unencumbered property will be available to satisfy his claim. Even if the lien creditor relies on an absence of filings in extending credit, it is still unlikely that there will be reliance, or any meaningful change in position, based on the state of the files at the time of levy. Since a secured creditor's failure to refile in a new jurisdiction is unlikely to mislead a lien creditor, there is little reason to promote a lien creditor whose lien arose during the four-month temporary perfection period. The secured creditor is not likely to have learned that the collateral has been moved; the Code has given him a four-month period of perfection; the lien creditor is not likely to have relied on the files. Therefore, it is appropriate to give the secured creditor absolute priority over lien creditors under section 9-103(1)(d).

Absolute priority over a lien creditor avoids the potential, albeit unlikely, bankruptcy problems that were discussed previously.²³⁸ A circular priority could arise, however, where the secured party fails to refile in the new jurisdiction, a creditor levies on the property, and a purchaser takes an interest subsequent to the levy, but within the four-month period. In this case, the secured party has priority over the lien creditor, the lien creditor has priority over the purchaser, and the purchaser has priority over the secured party. The circle should be broken by using the subordination rule. Thus the secured party's share should be set aside and paid to the purchaser, with any remainder paid to the secured party. The lien creditor should be paid next, then the purchaser, and lastly the secured party, to the extent the purchaser and secured party were unsatisfied in the initial distribution. This solution is preferable to that provided by conditional priority, which would involve paying the lien creditor, then the purchaser, then the secured party. Certainly, as a nonreliance creditor, the lien creditor should not receive a windfall. He obtained a lien subject to a security interest and his lien should not be paid until an amount equal to the value of the security interest is set aside. This view is strengthened by the difficulty that the secured party may have in learning of the collateral's removal. Furthermore, although the purchaser is subordinate to the lien creditor; it is appropriate to permit the former to receive a windfall by paying him before the lien creditor. Since he is not taking any proceeds that the lien creditor expected to receive, and since the purchaser could not know of the security interest before the filing, he is the most innocent of the three. If someone must receive a windfall, the purchaser is the strongest candidate in this situation.

In section 9-103(1)(d), therefore, the drafters reached an equitable solution in granting the secured creditor only conditional priority over a purchaser. It seems appropriate, however, to allow the secured creditor absolute rather than conditional priority over lien creditors; although the Code does not specifically address this issue. Absolute priority may result in a circular priority, but it can be resolved by use of the subordination rule.

²³⁸ See text at notes 162-201 *supra*.

b. Section 9-103(1)(c)

Section 9-103(1)(c) provides that if parties who create a purchase money security interest in goods understand at the time of attachment that the goods are to be kept in another jurisdiction, the law of that other jurisdiction governs perfection matters for thirty days after the debtor receives possession of the goods and thereafter if the goods are brought into the other jurisdiction before the end of the thirty-day period. The lapse question involves the effect on parties whose interests arose during the thirty-day period of a failure of the goods to arrive in the new jurisdiction before the end of the period. Thus, assuming the secured creditor filed in the new jurisdiction, that state's law would govern perfection requirements and the interest would be perfected during the thirty-day period. At the end of the period, however, that state's law would cease to apply and the perfection would lapse. If a purchaser or lien creditor obtained an interest before the lapse that would be subordinate to the security interest at that time, the effect of the lapse on the competing party is unclear.

While the Code fails to resolve this issue, reference to the respective equities of the parties suggests an answer. The short duration of the transaction indicates that the secured creditor should be carefully monitoring the location of the goods. If it appears that the goods will not arrive in the new jurisdiction in time, the diligent secured creditor can refile wherever the goods are and prevent a lapse.²³⁹ Alternatively, and more realistically, the creditor initially can file both in the jurisdiction to which the goods are headed and in the jurisdiction where the goods are when the security interest attaches.²⁴⁰ Whichever option he selects, it is a lesser burden for the secured creditor to police the collateral for thirty days than for the life of a security interest. Consequently, since his burden is minimal, extensive protection of the secured creditor's interest is not necessary. For example, a purchaser who takes an interest in the goods while they are in the original jurisdiction, and who relied on the absence of a filing in the original jurisdiction, should prevail over the secured creditor if the creditor fails to ensure compliance with section 9-103(1)(c).

Because of the different burden on the secured creditor, the position of the lien creditor under section 9-103(1)(c) would seem to fall somewhere between that creditor's position in section 9-403(2), where the secured creditor always knows when the five years will expire and his filing will lapse, and section 9-103(1)(d), under which the secured creditor has greater difficulty learning when a lapse has resulted from movement of the collateral to another jurisdiction. Since the burden is greater on the secured creditor in 9-103(1)(c) than in 9-403(2), conceivably the lien creditor, who presumably has not relied on the files, should not be promoted over the lapsed secured creditor. Yet the secured creditor's burden is less cumbersome under 9-103(1)(c) than under 9-103(1)(d). Thus it can be argued that a different result should ensue in the two sections and the lien creditor should be promoted over the lapsed creditor.

²³⁹ U.C.C. § 9-103, Comment 3.

²⁴⁰ *Id.*

Of these two possible approaches, the latter has the most appeal. The perfection requirements are so easily complied with that it is fair to penalize one who fails to comply rather than an innocent third party.

The proposed conditional priority for the secured creditor under section 9-103(1)(c) resolves the circular priority problem by placing any interests arising during the thirty-day period ahead of the secured party. This is appropriate because the secured creditor, by policing the collateral, is in the best position to prevent the problem. Conditional priority under this provision does raise the spectre of bankruptcy problems,²⁴¹ however, particularly since the initial perfection is for only thirty days. If bankruptcy occurs during the thirty-day period, the trustee could assert lien creditor status to defeat the security interest when the period expires and perfection lapses.²⁴² If bankruptcy occurs after the thirty-day period, the trustee in bankruptcy may argue that since the transfer is not fully perfected against a lien creditor until the goods arrive in the new jurisdiction, the transfer is on account of an antecedent debt and is preferential.²⁴³ These bankruptcy problems may be solved by multiple filings that assure the secured creditor continuous perfection.²⁴⁴ Beyond that, reliance must be placed on a reasonable approach by courts construing bankruptcy law. The bankruptcy arguments are not meritorious²⁴⁵ and should not be the basis for deciding important policy issues. In conclusion, under the thirty-day rule of section 9-103(1)(c), the Code fails to resolve whether conditional or absolute priority is to be granted a secured creditor upon lapse of perfection. Equitable considerations suggest that the secured creditor be allowed only a conditional priority over a purchaser or lien creditor whose interest arose during the thirty-day period of perfection. While conditional priority under this Code provision may result in a bankruptcy problem, such a factor should not be determinative in resolving the issue of priority in section 9-103(1)(c).

c. Section 9-103(2)

Perfection of a security interest in goods covered by a certificate of title may lapse because the certificate is surrendered,²⁴⁶ or because the goods are re-registered in another jurisdiction and four months have elapsed since their removal from the original jurisdiction.²⁴⁷ If a purchaser or lien creditor obtains an interest in the goods prior to the lapse, the effect of the lapse on that party may be determined by considering the respective equities of the parties involved.

The secured creditor is in a position to prevent a lapse resulting from surrender of the certificate because he can and generally will retain possession of

²⁴¹ See text at notes 162-201 *supra*.

²⁴² See text at notes 162-84 *supra*.

²⁴³ See text at notes 185-201 *supra*.

²⁴⁴ U.C.C. § 9-103, Comment 3.

²⁴⁵ See text at notes 181 & 201 *supra*.

²⁴⁶ U.C.C. § 9-103(2)(b).

²⁴⁷ *Id.* The effect of perfection lapses as against a nonprofessional buyer if a clean certificate is issued in the new jurisdiction. U.C.C. § 9-103(2)(d).

the certificate of title on which his lien is noted.²⁴⁸ It is substantially more difficult to prevent a lapse through reregistration since the secured creditor will rely on the new state's registering authority which may not always operate efficiently. In addition, although the creditor has four months after removal to reperfect, he may not learn in time that the goods have been removed from the original jurisdiction.²⁴⁹ Further, even if he knows the goods have been removed — as he might, for example, if the debtor stopped making payments — he must also find out where they have been taken. This task in itself will be difficult.

These burdens of the secured creditor can be contrasted with those of the three types of purchasers who might take an interest in the goods: lenders, professional buyers, and nonprofessional buyers. Lenders and professional buyers typically are sophisticated parties who can be expected to understand the complications concerning interstate movement of certain goods and the resulting rules. Moreover, it usually will be easier for such parties to review the recent history of the vehicle than for the secured party to learn of the movement and reperfect immediately. It seems fair, therefore, to put a burden on such parties to investigate carefully before acting. In keeping with this view, section 9-103(2) does favor the original secured party over an intervening lender or professional buyer in some circumstances.²⁵⁰ In particular, the lender or professional buyer does not receive the protection under the Code that a nonprofessional buyer receives when he relies on a clean certificate of title.²⁵¹ The drafters apparently assumed that professionals would not be misled by a clean certificate.

Beyond the rules concerning clean certificates, however, the secured party who fails to reperfect within four months or before reregistration, whichever is later, seems to receive little protection against any intervening buyers or lenders, whether or not they are professionals. If the vehicle is moved from a noncertificate state to a certificate state, section 9-103(2)(c) refers to the four-month rule of 9-103(1)(d).²⁵² If the vehicle is moved from a certificate state to either a certificate or noncertificate state, section 9-103(2)(b) provides that after the later of four months or reregistration — or in any event after surrender of the certificate — the goods are no longer covered by a certificate of title. Thus, either 9-103(3) or, more commonly, the four-month rule of 9-103(1)(d) will govern.²⁵³ If the four-month rule of 9-301(1)(d) is applied, the secured party

²⁴⁸ U.C.C. § 9-103, Comment 4(c).

²⁴⁹ See, e.g., *In the Matter of White*, 266 F. Supp. 863 (N.D.N.Y. 1967). Cf. *In re Dennis Mitchell Industries, Inc.*, 419 F.2d 349 (3d Cir. 1969) (secured creditor failed to learn of movement of equipment until long after move).

²⁵⁰ U.C.C. § 9-103(2)(d).

²⁵¹ *Id.*

²⁵² U.C.C. § 9-103(2)(c).

²⁵³ Section 9-103(3) will apply if the vehicle is equipment or inventory leased or held for lease. U.C.C. § 9-103(3)(a). In that case, the law of the jurisdiction in which the debtor is located will govern perfection requirements. This raises another complex lapse issue. Suppose a third party takes an interest in the vehicle while it was covered by a certificate of title. If perfection under the certificate lapses and the law of the jurisdiction in which the debtor is located takes over, perfection is likely to lapse. The question is whether the third-party interest that formerly

who fails to reperfect in time is subordinated to any purchaser whose interest arose after the goods were moved, even though the secured party was considered perfected at the time the interest arose.²⁵⁴ Moreover, if the perfection lapses because the secured party surrenders the certificate and fails to reperfect, section 9-103(1)(d) again will promote an intervening purchaser because the period of perfection in the original jurisdiction will have expired.

It is unclear why section 9-103(2) refers back to 9-103(1)(d) for the rights of intervening purchasers instead of providing its own rules. While the two sections deal with similar problems, there are some substantial differences. Unlike the typical fact situation arising under 9-103(1)(d), a professional lender or buyer is on notice that the recent history of goods covered by a certificate of title should be investigated carefully. In addition, it may be much more difficult for a secured creditor to police the easily moveable collateral covered by 9-103(2) than it would be for him to guard the type of collateral usually covered by 9-103(1)(d). Thus, rather than the 9-103(1)(d) conditional protection, the equities favor absolute protection under 9-103(2) for secured creditors against professional lenders and buyers during the period in which the original perfection is effective. Section 9-103(2) should either be amended or interpreted to provide such protection.²⁵⁵

Where the competing claimant is a nonprofessional buyer, however, the drafters of 9-103(2) resolved the priority issue correctly. A nonprofessional buyer is not likely to know or understand the complex conflicts rules involved. Thus, section 9-103(2) protects such a buyer when he relies on a clean certificate.²⁵⁶ This will cover many of the cases involving nonprofessionals. Nevertheless, where the certificate is not clean, or where there is no certificate, even the nonprofessional should be required to protect himself, at least initially. Section 9-103(2) requires the nonprofessional buyer to act responsibly by permitting the secured creditor's perfection to continue until the certificate is surrendered or until the later of four months or reregistration. If the secured creditor fails to reperfect, the nonprofessional buyer will be promoted upon the lapse under the four-month rule of 9-103(1)(d). This conditional priority is more acceptable when nonprofessional buyers are concerned, since they typically have little sophistication. As between the nonprofessional buyer and the secured party, the greater burden should be placed on the secured party.

Where the competing claimant is a lien creditor levying after the goods are

was subordinate would be promoted or whether the rights would be frozen as of the time the interest arose. Section 9-103(3) does not contain a rule comparable to the four-month rule of section 9-103(1)(d). It may, nevertheless, in the unlikely event that this situation were to arise, be easiest to apply the four-month rule in the same manner that it would be applied if the goods were not mobile goods.

²⁵⁴ U.C.C. § 9-103(1)(d). See text at note 74 *supra*.

²⁵⁵ Arguably the section should provide absolute protection only if the certificate is not surrendered. Since the secured party generally holds the certificate, he will know when it is surrendered and can take appropriate steps to reperfect in the new jurisdiction. If he fails to do so, it seems proper to penalize him. Fortunately, this situation is not likely to occur often because it is so easily avoidable.

²⁵⁶ U.C.C. § 9-103(2)(d).

moved but during the period in which the secured creditor's perfection continues, the levying creditor is subordinate to the security interest.²⁵⁷ The secured creditor apparently would retain priority over the lien creditor even if perfection subsequently lapses.²⁵⁸ While this reading is not clear on the face of the statute, section 9-103(2) seems to refer back to 9-103(1)(d) which apparently grants absolute perfection.²⁵⁹ When the competing claimant is a lien creditor, absolute protection is even more appropriate under 9-103(2) than under 9-103(1). The secured creditor is in a more difficult position when the collateral is as easily moveable as that involved in 9-103(2) situations and generally will not be able to police it effectively. Moreover, the lien creditor has not relied on the existence of this property, and there is no reason to provide him with a windfall.

Thus section 9-103(2), dealing with the perfection of a security interest in goods covered by a certificate of title, grants a secured creditor only conditional priority against any type of purchaser and fails to specify the secured creditor's status with respect to a lien creditor. A consideration of the parties' equities indicates that while this Code provision rightly accords the secured creditor conditional priority over the nonprofessional purchaser, it should grant the secured creditor absolute priority where a professional purchaser, professional lender or lien creditor is the competing party. This grant of absolute priority would prevent the bankruptcy problems discussed previously, which arise when a secured creditor has only conditional priority over lien creditors. A circular priority problem could arise, however, and if so, it should be resolved as under 9-103(1)(d), with the subordination rule.²⁶⁰

3. Section 9-305

Section 9-305 provides that a security interest in certain collateral may be perfected by taking possession of the collateral. Perfection lapses when the secured creditor surrenders possession. In general, the secured party will not surrender possession until he is paid by the debtor and the transaction is ended. A third party who obtains an interest in the collateral while the secured party is perfected will no longer be competing with the secured party and no lapse problem arises. However, if the secured party surrenders possession to the debtor while he still claims a security interest, his interest becomes unperfected and junior secured creditors or lien creditors may now claim priority over him.

The secured creditor who perfects by possession should be treated in the same manner as one who perfects by filing and permits a lapse under section 9-403(2).²⁶¹ In both situations the secured creditor knows exactly when lapse will occur and can protect himself.²⁶² Therefore, the conditional priority ap-

²⁵⁷ U.C.C. §§ 9-103(2)(b), (d).

²⁵⁸ See text at notes 110-11 *supra*.

²⁵⁹ *Id.*

²⁶⁰ See text following note 238 *supra*.

²⁶¹ See text at notes 227-33 *supra*.

²⁶² The secured creditor can protect himself by retaining possession of the collateral. If the collateral is goods, negotiable documents, or chattel paper, the secured creditor can prevent a

proach of 9-403(2) should be read into 9-305. Since section 9-305 is silent on the lapse issue, conditional priority does no violence to the statute. Moreover, it permits internal consistency with the treatment of lapse in the other major means of perfection, filing.

As with conditional priority in 9-403(2), this interpretation could present problems with a trustee in bankruptcy.²⁶³ If the secured creditor surrenders possession after the initiation of bankruptcy proceedings, the trustee could assert priority as a lien creditor.²⁶⁴ However, if rights are frozen on the date of bankruptcy, this would not be a problem.²⁶⁵ Similarly, potential preference problems should be dismissed as lacking merit.²⁶⁶ Finally, the potential circular priority is resolved as in 9-403(2) by putting the lapsed creditor last.²⁶⁷

B. *Temporary Automatic Perfection*

1. Section 9-306(3)

A perfected security interest in collateral becomes a perfected security interest in the proceeds of that collateral.²⁶⁸ The proceeds interest is automatically perfected for ten days and thereafter, if certain requirements are met.²⁶⁹ Where these requirements are not met prior to the end of the ten-day period, the proceeds perfection lapses. As against a purchaser or lien creditor whose interest arises after the lapse, the interest in proceeds then is treated as unperfected. If a purchaser or lien creditor's interest arises during the ten-day period, however, the Code does not specify who has priority upon a lapse of perfection. Yet, the respective equities of the parties once again may provide a resolution of the resulting priority dispute.

It should first be noted that a perfection lapse and subsequent priority dispute can occur under 9-306(3) only in the presence of one of the following conditions: (a) if the proceeds are not a type of collateral that could have a security interest perfected by a filing in the same office as the original filing, (b) if the proceeds are not cash proceeds, or (c) if the proceeds are acquired with cash proceeds and are not described in the original financing statement.²⁷⁰ In most situations, therefore, perfection in proceeds will be automatic and extend beyond the ten-day period. Thus, the secured party will not need to take any additional measures to maintain perfection and priority will not be an issue.

When perfection is not automatic, however, the secured creditor must file a new financing statement before the end of the ten-day period.²⁷¹ Here, the

lapse by filing a financing statement prior to surrendering possession. Perfection will then be continuous. U.C.C. § 9-303(2).

²⁶³ See text at notes 162-201 *supra*.

²⁶⁴ See text at notes 162-84 *supra*.

²⁶⁵ See text at note 165 *supra*.

²⁶⁶ See text at notes 198-201 *supra*.

²⁶⁷ See text following note 233 *supra*.

²⁶⁸ U.C.C. §§ 9-306(2), 9-306(3).

²⁶⁹ See text at notes 120-27 *supra*.

²⁷⁰ U.C.C. § 9-306(3).

²⁷¹ U.C.C. § 9-306(3)(c).

burden on the secured creditor depends on the nature of the transaction. For example, a creditor with a floating lien on inventory generally knows that at least some of the proceeds are likely to be accounts. If the debtor and the inventory are located in different jurisdictions, the secured creditor should know that an accounts filing will be necessary in the debtor's location.²⁷² Consequently, the burden on the secured creditor is small. Yet in the less likely situation in which the debtor sells inventory, receives cash, and uses the cash to buy equipment,²⁷³ the requirement that the secured creditor have filed for equipment may indeed be quite burdensome because he may not know about the entire transaction.

The effect on purchasers will also depend on the transaction. For instance, a purchaser of accounts who finds no filing at the debtor's location nevertheless might look in the jurisdiction where the debtor's inventory is located. In this situation, the secured creditor's failure to file as to proceeds is not unreasonably misleading. The secured creditor's failure to file as to equipment obtained with cash proceeds, however, may be seriously misleading.

Thus in balancing the respective equities of the secured party and a purchaser, a case-by-case analysis may seem appropriate at first. Yet this would lead to different results under section 9-306(3). While this could produce the most equitable solutions, it could easily lead to nonuniform interpretations as various jurisdictions balance the equities differently. Such an analysis also would reduce the ability of parties to predict results under the statute. These two adverse effects suggest that a uniform approach to lapse under section 9-306(3) is necessary. Since there will be situations in which the secured party will have difficulty learning that he should file as to proceeds,²⁷⁴ and the period of temporary perfection is so short, the sole approach proposed here is that the secured party should be given absolute priority during this period. This conclusion does not contradict the statute, which lacks any direction on the matter. The Code drafters explicitly mandated conditional priority in several contexts.²⁷⁵ Therefore, their failure to mention it here may imply that absolute priority was intended. In addition, the nature of temporary automatic perfection is such that it should provide absolute protection. The value of the perfection is small indeed if upon lapse after a mere ten days it is treated as having never existed.

Similar grounds support absolute priority against lien creditors whose interests arise during the ten-day period. The period is short, the secured creditor may need more time to learn that he must file, and, further, the lien creditor as a nonreliance creditor need not be favored. Again, absolute priority avoids potential bankruptcy problems.²⁷⁶ Any circular priority could be resolved by using the subordination rule, as under 9-103.²⁷⁷

²⁷² U.C.C. §§ 9-103(3), 9-302, 9-306(3).

²⁷³ This assumes that the secured creditor can trace the proceeds all the way to the equipment, a not inconsiderable burden.

²⁷⁴ See text at note 273 *supra*.

²⁷⁵ See, e.g., U.C.C. § 9-403(2) (subordinate parties promoted upon lapse); § 9-103(1)(d) (subordinate purchaser promoted upon lapse where goods are moved to new jurisdiction).

²⁷⁶ See Parts II-A and II-B *supra*.

²⁷⁷ See Part II-C *supra*.

2. Section 9-304

Section 9-304(4) provides a twenty-one-day period of automatic perfection for instruments or negotiable documents where the security interest is for new value given under a written security agreement. Section 9-304(5) establishes a similar twenty-one-day period of automatic perfection without filing for previously perfected security interests in instruments, negotiable documents, or goods not covered by a negotiable document but in the possession of a bailee. This latter section is employed where the collateral is released to the debtor for certain legitimate reasons.²⁷⁸

The periods of automatic perfection specified in 9-304(4) and (5) are intended to permit certain common, short-term transactions without requiring filings.²⁷⁹ In view of this underlying purpose, perfection during the temporary period should be absolute as against third parties. The secured party is invited to forego filing during this period and should not be penalized for doing so, particularly in transactions that may extend just a few days beyond the twenty-one-day period. Another reason for not denying the secured party absolute priority is the existence of three sanctions, which may be imposed on a secured party who allows the transaction to extend beyond the twenty-one days without filing. These sanctions are as follows: (1) there may be a preference if a bankruptcy petition is filed;²⁸⁰ (2) a third party whose interest arises after the twenty-one-day period is subject to an unperfected interest;²⁸¹ and (3) certain parties, such as a purchase money secured creditor, will defeat the secured party even if the interest is considered perfected.²⁸² The third sanction, the defeat of a perfected security interest by certain parties, coupled with the shortness of the period, reduces any unfairness to third parties. Lien creditors, particularly the trustee in bankruptcy, may be adversely affected by being subordinated to a "secret" security interest, but they are not reliance creditors and, again, the period of automatic perfection is very brief. Therefore, this period should be considered to be one of absolute perfection for the secured creditor as against both purchasers and lien creditors.

CONCLUSION

Article 9 of the Uniform Commercial Code contains a variety of instances in which protection of a security interest may lapse. If protection lapses, there

- ²⁷⁸ The automatic perfection occurs under U.C.C. § 9-304(5) when the secured party
- (a) makes available to the debtor the goods or documents representing the goods for the purpose of ultimate sale or exchange or for the purpose of loading, unloading, storing, shipping, transshipping, manufacturing, processing or otherwise dealing with them in a manner preliminary to their sale or exchange, but priority between conflicting security interests in the goods is subject to subsection (3) of Section 9-312; or
 - (b) delivers the instruments to the debtor for the purpose of ultimate sale or exchange or of presentation, collection, renewal or registration of transfer.

U.C.C. § 9-304(5).

²⁷⁹ See, e.g., U.C.C. § 9-304, Comment 4; WHITE & SUMMERS, 2d ed., *supra* note 105, at 928-33; GILMORE, *supra* note 36, at 455-61.

²⁸⁰ Bankruptcy Reform Act of 1978, § 547, 11 U.S.C. § 547 (Supp. II 1978).

²⁸¹ U.C.C. § 9-304(6).

²⁸² See, e.g., U.C.C. § 9-312(3).

may be problems concerning the rights of parties whose interests arose prior to the lapse and who were subordinate to the secured creditor at that time. Although some of the relevant sections²⁸³ contain rules for resolving the rights of pre-lapse creditors, these rules apparently have not been developed with an eye towards the lapse problem. Rather, their aim has been to short-circuit certain bankruptcy and circular priority problems that are unlikely to arise.²⁸⁴ Moreover, many Code sections involving lapse contain no guidance concerning the rights of pre-lapse creditors.²⁸⁵

The Code can be interpreted to provide efficient equitable rules on the effect of lapse. Arriving at such an interpretation involves a study of the respective equities of each party. It is necessary to consider the source of the lapse, the types of parties competing for priority, and the reasonable expectations of the parties. This article has presented such an analysis and applied it to the relevant Code sections in a manner that supports the purposes and policies behind the sections. It is to be hoped that this analysis can provide a consistent approach to the lapse dilemmas that arise under article 9.

²⁸³ See, e.g., U.C.C. §§ 9-403(2), 9-103(1)(d), 9-103(2).

²⁸⁴ See Part II *supra*.

²⁸⁵ See, e.g., U.C.C. §§ 9-103(1)(c), 9-305, 9-306(3), 9-304.

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