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# UCC Article Nine Revised: Priorities, Preferences, and Liens Effective Only in Bankruptcy

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Richard L. Barnes*

# UCC Article Nine Revised: Priorities, Preferences, and Liens Effective Only in Bankruptcy

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## I. INTRODUCTION

When is a security interest really just a lien that is "effective only in bankruptcy?" The revised Article Nine of the Uniform Commercial Code (hereinafter the "U.C.C." or the "Code") accomplished much, but it also expanded the number of instances in which security interests have more to do with grabbing the assets of the bankruptcy estate than they have to do with genuine, arms length bargains. Priority rules that are meant to remove assets from the bankruptcy estate rather than to confirm reasonable commercial expectations are ones that may violate principles found in section 545 of the Bankruptcy Code. Section 545 is one of the powers given to the trustee in bankruptcy. It allows the trustee to avoid statutory liens that only become effective when the debtor institutes insolvency proceedings. The thesis of this Article is that several of the perfection and priority rules in revised Article Nine amount to security interests that are really liens whose practical effects are limited to use in insolvency situations. While these provisions of the uniform law do not explicitly challenge section 545, they do amount to stealthy grabs at bankruptcy estate assets, grabs that would not be part of the ordinary and reasonable expectations of commercial parties dealing at arms length. As such, they should be viewed with suspicion in a bankruptcy proceeding. They also appear to be part of a growing trend. The proposal offered here is for an examination of U.C.C. priorities in light of commercial realities and actual bargained-for-exchanges. Bankruptcy policy should declare preferential an interest that has only one effect, that of stripping an asset from the estate in favor of a party who did not reasonably rely on it as collateral.

Secured credit is a rather obsessive-compulsive approach to the problem of repayment. First, one lends money, not just hoping, but expecting to be paid back.[1] The decision to lend is first based on information generated and put into use to the end of assuring repayment.[2] Often this credit worthiness evaluation includes credit character and representation, as well as financial ability. At the same time, the lender will usually scratch and massage the problem with duties, covenants, conditions, penalties, and various other remedies and punishments for a second layer of protection that will assume the worst, that is, not only the inability, but the unwillingness to repay the debt.

1. 2 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 45.1-.10 (1965).
2. Randal C. Picker, *Perfection Hierarchies and Nontemporal Priority Rules*, 74 CHI.-KENT L. REV. 1157, 1169-70 (1999).

These will typically include secondary default rights that will be needed only if the debtor becomes insolvent.

While there may be times when a contractual dispute, an attachment problem in the parlance of Article Nine,[3] is the root of the transactional breakdown, this will be unusual. Not all disputes arise within insolvencies, but scratching the surface of the vast majority of these cases strikes one with a near truism. A solvent debtor will almost always repay the loan. The need to establish priorities among creditors arises outside of bankruptcy only in unusual circumstances. Even if two secured creditors have a legitimate dispute about who attached and perfected first, this is not worth litigating if the debtor concedes that both debts are due and owing and the debtor has adequate assets to pay all debts. What dignity right needs to be pursued if there is sufficient money to pay both? However, add insolvency to the mixture and defenses that were not relevant loom large when asserted by a desperate debtor or the trustee in bankruptcy.

Article Nine of the U.C.C. recognizes this. While attachment is universal,[4] priority focuses on the levels of perfection and on the failure to perfect. Article Nine uses the bankruptcy trustee as a lien creditor,[5] and in the general priority scheme of Article Nine the lien creditor gets priority over unperfected interests, so that the universal attachment is not sufficient.[6] Every creditor seeks a state of perfection to reach the safe harbor against lien creditors, including bankruptcy trustees.[7] This neatly encompasses the bankruptcy trustee who fills the place of a lien creditor in the priority scheme.[8] In this general priority scheme, the lien creditor has roughly the same priority value as a creditor who became a secured creditor at the same time as the creditor became a lien creditor.[9] The true competition is that of perfected (lienor) versus unperfected (lienor).[10] Thus, the trustee is someone whose power is greatest against those who are unperfected. Conversely, the trustee is least powerful, and will almost always lose, when competing with those who are perfected.[11] The trustee's duty is to seek out the weakness of non-perfection. To accomplish this, the

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3. *See* U.C.C. § 9-201 (2000).
4. *See id.* § 9-201(a).
5. *See id.* § 9-317(a)(2) (2000).
6. *See id.* § 9-322 (2000) (discussing the priority of liens).
7. *Id.*
8. *See id.* § 9-317 (2000).
9. *Id.*
10. *Id.* §§ 9-317, -322 (2000).
11. *Id.* Into this general priority scheme, the trustee is injected to find and topple interests that are unperfected, ones that a lien creditor could defeat. 11 U.S.C. § 544 (2000) (providing the strong arm provision which reinforces the section 9-317 rule of unperfected interests losing to a lien creditor).

trustee has powerful grants that amount to the truism that bankruptcy cares only about those situations in which there is no perfection. Perfection means little unless the trustee or other lien creditor is involved. Who cares about priority if there is adequate money to pay all debts? What the debtor has left, if it is adequate to cover all debts, will be enough for the secured party. Unless the creditor has an unusual personality, it should not matter the order in which the creditor is paid so long as he or she is fully paid. What the creditor seeks is receipt of a full share of the money. It should not concern the creditor that this is accomplished in any particular order or only after bankruptcy adjudication. However, it should concern the creditor very much if there is inadequate money to cover the debts and the creditor's priority is low.

This Article will explore two straightforward concepts, one from bankruptcy, and one from the priority scheme of Article Nine. Together these concepts will show that the current revised version of Article Nine continues and even expands a conflict between Article Nine and the federal Bankruptcy Code which should cause some Article Nine provisions to be questioned. The bankruptcy provision is section 545. The expansive approach of Article Nine is most obvious in sections 9-331, 9-325, and 9-334. This Article is divided into four Parts. Part I describes the conflict by looking at the origin and scope of section 9-306 of the pre-revision version of Article Nine. That section dealt with proceeds and was seen by the Drafters of the original Article Nine to raise the controversy now blossoming within the revised sections of Article Nine. Section 9-306 generated a number of significant cases and this group of cases was recognized to contain at least one aspect of the conflict that has surfaced. The text of section 9-306 and Bankruptcy Code section 545 will be parsed and several opinions will be analyzed. Part II lays out the historical understanding of what constitutes a "lien" under section 545, its origins, and why some liens are suspect. It will also look at how the U.C.C. Drafters, both the initial and most recent Drafters, may have viewed this creation of law and equity, this thing called lien. Part III will explore how and where the conflict has been expanded and deepened by the 2000 Revision of Article Nine. In this section, the thesis will be advanced that Article Nine is knowingly being pushed by the Drafters toward the commercially unsupported proposition that secured creditors should win in bankruptcy even though they would lose against reliance creditors, thereby offering the secured creditor a windfall of protection that is not likely to be the basis of a bargained-for-exchange.

## II. THE EMERGENCE OF THE CONFLICT: A LOOK AT PROCEEDS UNDER THE U.C.C. AND BANKRUPTCY LAW

The text of Bankruptcy Code section 545 reads as follows:

> The trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien
>
> (1) first becomes effective against the debtor —
>
> (A) when a case under this title concerning the debtor is commenced;
>
> (B) when an insolvency proceeding other than under this title concerning the debtor is commenced;
>
> (C) when a custodian is appointed or authorized to take or takes possession;
>
> (D) when the debtor becomes insolvent;
>
> (E) when the debtor's financial condition fails to meet a specified standard; or
>
> (F) at the time of the execution against property of the debtor levied at the instance of an entity other than the holder of such statutory lien.[12]

The elements of the section are: (1) the trustee's power is to (2) avoid the (3) fixing of a (4) lien to the (5) extent that such lien (6) first becomes effective (7) against the debtor when a (8) case under this title concerning the debtor is commenced, or (9) when an insolvency proceeding concerning the debtor is commenced. This Article will leave for the moment the additional basis for avoidance stated in subsection (2) of section 545.[13] This Article will instead begin with a look at the collateral when it consists of commingled proceeds.

The predecessors of section 545[14] were found in section 67 and particularly subparagraph eight of the former Bankruptcy Reform Act.[15] The former law, which will be referred to as the "Act" or "Bankruptcy Act," was supplanted by the current Bankruptcy Code in 1978, which will be referred to as the "Code" or "Bankruptcy Code." Section 67 of the former Act gave the trustee power to avoid the fixing of some liens. This power is analyzed by looking at two cases and their progeny.

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12. 11 U.S.C. § 545(1) (2000).
13. The statutory language for subsection (2) of § 545 is: "The trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien . . . (2) is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists." This additional stumbling block is beyond the scope of this Article.
14. 11 U.S.C. § 545 (2000).
15. 11 U.S.C. § 67 (repealed 1978).

### A. Case Analysis of the Code to Code Connection

Two cases, *In re Gibson Products*[16] and *In re Guaranteed Muffler Supply Co., Inc.*,[17] illustrate the common understanding of liens in bankruptcy and commercial law. Judge Hufstedler's opinion in *Gibson* for the three-judge Ninth Circuit panel[18] should be considered alongside bankruptcy judge Kahn's opinion in *Muffler*.[19] Judge Kahn had the advantage of responding to the *Gibson* opinion while Judge Hufstedler wrote a ground-breaking opinion in *Gibson*.[20] This Article starts with *Gibson* and notes that what the *Gibson* court felt was a "collision"[21] was seen by Judge Kahn in *Muffler* as an opportunity to interpret Article Nine in a limited fashion to avoid a "false conflict."[22]

*Gibson* involved a retailer who became insolvent.[23] The financier, Arizona Wholesale, sold appliances to the debtor on credit and had a noncontroversial, perfected security interest in Gibson's inventory by way of a filed financing statement.[24] Even without an express interest in the proceeds of this inventory, Article Nine gave, and still would give, Arizona Wholesale an *automatically attached* and *automatically perfected* interest in the proceeds that are collateral.[25] Proceeds are defined as "whatever is acquired upon the sale, lease, license, exchange or other disposition of collateral."[26] What the former section 9-306(4) attempted to do at one level is noncontroversial. If the creditor could show that its collateral was sold and the proceeds deposited in a commingled account, the proceeds remained attached as proceeds so long as they were still "identifiable" by the typical accounting fictions of first-in, first-out or lowest-intermediate-balance.[27] If the proceeds were identifiable, then they were automatically perfected as well.[28] This allowed the creditor to establish priority and, as importantly, remain perfected. As noted, a perfected secured party defeats the trustee in bankruptcy who has the power to avoid unperfected interests[29] and preferential transfers.[30] A preferential transfer is a

16. *In re* Gibson Prods., 543 F.2d 652 (9th Cir. 1976).
17. *In re* Guaranteed Muffler Supply Co., 5.B.R. 236 (Bankr. N.D. Ga. 1980).
18. *In re Gibson Prods.*, 543 F.2d at 653.
19. *In re Guaranteed Muffler Supply Co.*, 5 B.R. at 236.
20. *Gibson* was decided in 1976. *Muffler* was decided in 1980.
21. *In re Gibson Prods.*, 543 F.2d at 653.
22. *In re Guaranteed Muffler Supply Co.*, 5 B.R. at 238.
23. *In re Gibson Prods.*, 543 F.2d at 654.
24. *Id.*
25. U.C.C. § 9-306(2) (1978); U.C.C. § 9-315(a)(2), (d) (2000).
26. U.C.C. § 9-102(64)(A) (2000).
27. Comment 2(a) of U.C.C. section 9-306 (1978) was oblique, but said: "Whatever the formulation of the rule, the secured party, if he could identify the proceeds, could reclaim them or their equivalent from the debtor or his trustee in bankruptcy."
28. *Id.* §§ 9-306(2), -312 (providing a priority rule with the trustee in bankruptcy only defeating unperfected interests).
29. *See* 11 U.S.C. § 544 (2000).

transfer that was made in ninety days (or 120 days under the former Bankruptcy Act) before the bankruptcy filing and accomplishes an unfair advantage for the secured party by preferring the secured party to other creditors.[31] No last-minute change in status means that there is no preference.[32]

The *Gibson* court found such a preference in Arizona Wholesale's attempts to take cash proceeds based on its inventory security interest. Specifically, the court found that the only proven disposition was a $10 appliance sold within the limitation period of section 9-306(4)(d). This $10 was deposited into Gibson's account, where it became commingled with other funds in the account. It is not clear from the opinion whether the court found that the $10 appliance was the only collateral or the only deposit made from collateral sold. It appears from the opinion that $19,505.27 worth of collateral was sold, although the receipts were not necessarily deposited in the period before bankruptcy. Only $10 of that amount was proven to be proceeds and deposited. This interpretation of the court's findings is consistent with the plain reading of section 9-306(4)(d) as then written.[33] An assumption that only $10 was proven to be proceeds, although the difference is insignificant given the court's rationale, is all that is required for the purposes of this Article. What section 9-306(4)(d) plainly stated was that the secured party is "limited to an amount not greater than the amount of any cash proceeds received by the debtor."[34] The Comment to section 9-306 reiterates the language of receipt rather than focusing on deposit.[35] This reinforces the assumption here that the court determined the amount in controversy was the amount received rather than the amount actually deposited.[36]

What complicates the analysis of the former section 9-306 with which *Gibson* dealt is the implicit, but rather plain expectation that accounting fictions will typically be used. The word identifiable was clearly used by the Drafters as a term of art for those fictions referred to as "general principles of tracing."[37] This is apparent in the ready acceptance by the courts, such as the *Gibson* court, that identifiability

30. *See id.* § 547 (2000).

31. *See id.* § 547(b) (2000); 11 U.S.C. § 60 (repealed 1978).

32. *Id.*

33. *In re* Gibson Prods., 543 F.2d 652, 654 (9th Cir. 1976).

34. *Id.*

35. U.C.C. § 9-306(4) cmt. 2(a) (1978). This comment is essentially identical to the same argument in the 1962 Code.

36. *See id.*

37. *Id.*

meant tracing as the Comment suggests and tracing meant the accounting fictions.[38]

These fictional accounting methods are called for in section 9-306(3). That subsection deals with noninsolvency situations. Consequently, it was readily obvious to the *Gibson* court that subsection (4) of section 9-306, which uses a complicated, but non-fictional series of mathematical operations, must have been intended to lead to something different.[39] Subsection (3)'s use of those fictions was seen as a paradigm and therefore displacement of that paradigm by the statement of a different rule in subsection (4) had to mean that the fictional tracing was neither intended nor permitted in subsection (4).[40] This language meant a rejection of the Seventh Circuit's earlier decision in *Fitzpatrick v. Philco Finance Corporation.*[41] The *Fitzpatrick* opinion used the "proceeds" language to create two tiers of identifiability.[42] The first level was the identification of the collateral sold as that belonging to the secured party, without this identification the money received was not proceeds. In the second level, the secured party must identify the current asset as the progeny of the collateral by the tracing methods appropriate to the inquiry.[43]

The *Gibson* court chose not take this conservative approach; instead it advanced an interpretation of commingled as synonymous with "not identifiable."[44] To put it another way, only non-commingled proceeds were identifiable.[45] This seems to be the heart of the *Gibson* court's error. "If the cash proceeds could be 'identified,' i.e., had not been commingled, the secured party would have a perfected security interest in the whole fund under § 9-306(4)(b), just as he did in the pre-Code days, without the limitation imposed by § 9-306(4)(d)."[46] The next sentence demonstrates the court's mistake. The *Gibson* court wrote, "[u]nder the code scheme, the secured creditor also has a perfected security interest under subsection (d) when he cannot identify his proceeds in a commingled fund, as long as he can show that some of his proceeds were among those in the commingled fund."[47] This error is twofold. First, there is a great difference between "can-

38. *In re Gibson Prods.*, 543 F.2d at 656. Note that the Court relied on Grant Gilmore's treatise, which lays out the first-in-first-out and lowest-intermediate-balance methods of "tracing."
39. *In re Gibson Prods.*, 543 F.2d at 656.
40. *Id.*
41. Fitzpatrick v. Philco Fin. Corp., 491 F.2d 1288 (7th Cir. 1974), *superseded by* Global Distribution Network, Inc. v. Star Expansion Corp., 949 F.2d 910 (7th Cir. 1991).
42. *Fitzpatrick*, 491 F.2d at 1291-92.
43. *Id.*
44. *In re Gibson Prods.,* 543 F.2d at 656.
45. *Id.*
46. *Id.*
47. *Id.*

not" and "not allowed."[48] The Drafters of Article Nine did not use the phrase "non-identifiable," which is a true polar opposite of identifiable. The Drafters instead used the word "commingled,"[49] a complementary term which could partake of either category of meaning. That is, the proceeds could either be "identifiably commingled" or "so commingled as to become non-identifiable."[50] Second, the section does not require deposit, merely receipt.[51]

Accordingly, the *Gibson* court erred in not establishing how much was received on the sale of collateral. This was an "identifiable" amount. Yet, the statute does not require the court to determine the amount of the proceeds commingled in the account. Here lies the true conflict. It was logical for the Drafters to think, Forensic accounting in bankruptcy is always difficult (recent headlines from Enron and MCI should convince us that their conclusions, time-honored, are still relevant). Why not give the secured party, whose collateral has been sold and whose collateral has demonstrably created proceeds, a shot at the proceeds received in the last ten days?[52] This would relieve the secured party of the burden of fulfilling fictions through the cumbersome and uncertain accounting methods and maybe even achieve a rough justice.[53]

While the *Gibson* court erred in not accepting this as the gist of Article Nine's provision, the court was justified in its conclusion. The court understood that section 9-306 rested on a premise at odds with bankruptcy policy. This opposition is seen if the inverse question is posed: "Why should the secured creditor who could not have beaten another secured creditor, because of an inability to trace the proceeds under § 9-306(3)(b), win against the trustee and unsecured creditors?"[54] If the lack of perfection, a perfection provided by statute that

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48. The language of the Code is to the effect of "not allowed." U.C.C. § 9-306(4) (1978). Subsection (4) reads as follows: "In the event of insolvency proceedings . . . a secured party with a perfected security interest in proceeds has a perfected security interest *only in the following proceeds*: . . . (d) *in all cash and deposit accounts* . . . in which proceeds have been commingled . . . *limited* to an amount not greater than the amount . . . received within ten days before the . . . insolvency proceedings." *Id.* (emphasis added).

49. *Id.*

50. *Compare id.* § 9-306(3), *with* § 9-306(4).

51. U.C.C. section 9-306(4)(d) (2000) stated: "in all cash and deposit accounts of the debtor *in which proceeds have been commingled* . . . (ii) limited to an amount not greater than the *amount of any cash proceeds received* . . . within ten days . . . ." U.C.C. § 9-306(4) (1978) (emphasis added).

52. Grant Gilmore, the Chief Reporter of the original version of Article Nine supports this as the Drafters' intent. GILMORE, *supra* note 1, § 26.1, at 678 n.1.

53. *Id.*

54. This is not a novel question and there has been a good deal of discussion that such a perfected lien would be a violation of bankruptcy policy. *See, e.g.*, Vern Countryman, *Code Security Interest in Bankruptcy*, 4 UCC L.J. 35, 48-49 (1971). As early as 1954, it was observed that the then-proposed section 9-306(4) would

is only good in this particular context, is given validity it violates the spirit, if not the language of the Bankruptcy Code. Why provide these secured creditors with perfection automatically? This seems justifiable in bankruptcy only if it is determined that the secured party who lacked perfection deserves to be treated as perfected and given priority over all unsecured creditors.

In the following section, this question will be explored as part of a broader policy of commercial and bankruptcy law. It is clear from both secondary sources and the effect of section 9-306 that it was not an isolated oversight that Article Nine and the Bankruptcy Code takes as much as possible from the unsecured creditor. Indeed, the Code is trending toward expanding the envelope even at the expense of the contrary bankruptcy policy, and this trend also comes at the expense of historical Code integrity.

This inherent conflict is highlighted by *In re Guaranteed Muffler Supply Company, Incorporated*,[55] a Georgia bankruptcy court opinion. Judge Kahn, who decided this case, had the advantage of the prior *Gibson* opinion and thus could address the Ninth Circuit's central point.[56] The *Muffler* court concluded that the section 9-306(2)'s limitation of identifiable proceeds[57] meant that the creditor had to first prove that the interests sought were the "fruit of the sale or other disposition . . . ."[58] No creditor could claim cash proceeds without showing that these proceeds were collected upon the disposition of the secured party's collateral. Judge Kahn also drew on the Seventh Circuit's opinion in *Fitzpatrick v. Philco Finance Equipment*.[59] *Fitzpatrick* is the primary support for *Muffle*r and like cases. Although not as distinct in its linkage about the apparent conflict, it can be viewed as tethered to the opposite view as *Gibson*.[60] *Fitzpatrick* impliedly rejected *Gibson* by requiring that any cash proceeds mentioned in section 9-306(4) must be from the sale of the creditor's collateral.[61]

Unlike the *Muffler* opinion,[62] the Seventh Circuit's opinion in *Fitzpatrick* was not a bare-knuckled disagreement with the *Gibson* opinion. Nonetheless, the fundamental point of disagreement was clear.[63]

likely be attacked for its ten day provision as one giving a preference to creditors in bankruptcy. Harry R. Levy, *Effect of the Uniform Commercial Code Upon Bankruptcy Law and Procedure*, 60 COM. L.J. 9, 10 (1955).

55. *In re* Guaranteed Muffler Supply Co., 5 B.R. 236 (Bankr. N.D. Ga. 1980).
56. *In re Guaranteed Muffler Supply Co.*, 5 B.R. at 238.
57. *Id.*
58. *Id.*
59. Fitzpatrick v. Philco Fin. Equip., 491 F.2d 1288 (7th Cir. 1974), *superseded by* Global Distribution Network, Inc. v. Star Expansion Corp., 949 F.2d 910 (7th Cir. 1991).
60. *Fitzpatrick*, 491 F.2d at 1292.
61. *Id.*
62. *In re Guaranteed Muffler Supply Co.*, 5 B.R. 236.
63. *Fitzpatrick*, 491 F.2d at 1291.

And it is this fundamental point of disagreement that points to the conflict created by Article Nine. If Article Nine's tracing rule had been intended as an expansion of the amount allowed it would have made any deposit available, regardless of whether traceable to the secured party's proceeds. Any cash deposited could have been included as perfected in section 9-306(4)(b). On the other hand, *Fitzpatrick* offered the more plausible interpretation. It seems far more likely that section 9-306(4)(b) was an attempt at "substitution."[64] In return for giving up the right to make a forensic accounting effort, which would usually be hopeless because of the state of the books of the debtor, it was seen as better for the secured creditor to be given ten days of proceeds generated from its collateral. This assumption seems neither unfair nor outrageous. Money placed into the hands of the debtor, generated by collateral sales in the last ten days, plausibly might be still there.[65]

The *Fitzpatrick* court, the more diplomatic court of the two, got the statutory analysis correct although it left a view of the subsection that is flawed. What follows in Part IV is proof that the analysis is a clue to the Code logic replicated in a number of current sections. Uncharitably it can be characterized as "grab what you can" advice to the secured creditor in competition with the unsecured creditors. More prosaically phrased, it encourages the pushing of the envelope by creditors by adjusting fundamental concepts of what is a secured transaction, collateral, and when a security interest is effective. Is it less of a security device if it is effective only against a single, nearly defenseless group known as unsecured creditors? If it is only effective against the lien creditors, and not against the stronger group of secured and perfected creditors, does it effectively create a security interest valid only in bankruptcy? If the answer to these questions is "yes," then Article Nine fosters dangerous behavior by offering a victory over the trustee that is not available where any other secured party is present. This victory would be Pyrrhic because this fictional interest in proceeds has not been shown to come from the secured party's collateral. Instead, the Drafters permit the secured party this victory without regard to what proceeds were actually deposited into the account during the last ten days.

## B. The Conflict Lives on in Revised Article Nine

None other than Grant Gilmore originally noted the problem in his 1962 text on Article Nine. His comments, though bleak, proved prophetic because he was well acquainted with the proceeds issue from

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64. *Id.*
65. *Id.*

the former Uniform Trust Receipts Act (hereinafter the "UTRA").[66] He wrote in his landmark text:

> It appears, however, that the 'mere' claim to proceeds can be promoted to something more than a 'mere' claim and that, when this is done, the first sentence and not the second will regulate the priorities. Unfortunately, there is nothing in the statutory text that states at which point the 'mere' claim becomes something more than 'mere.'[67]

This provision on commingled proceeds had a predecessor in the old UTRA and Professor Frank Kennedy identified the UTRA controversy in a 1962 article.[68] Professor Kennedy noted that the provision's effect, one only seen in bankruptcy, made it vulnerable to criticism. Had it been given a broader effect, one beyond bankruptcy, it might have survived the scrutiny given the provisions that disproportionately affect bankruptcy.[69] If the security interest was effective outside of bankruptcy as a limitation on the identifiability principle of section 9-306(3) and further limited that automatic interest, it would be less suspicious.[70] Heightened suspicion should be expected if subsection (4) is viewed as an expansion of what was a limited lien in subsection (3).[71] Then add to it the factual predicate of insolvency[72] and it becomes difficult not to smell a preference, even if it is one created by statute rather than the parties.

Here is the significant tension that the Drafters attempted to relieve with what became the 1972 amendments to Article Nine. As originally written, section 9-306(4) was an unpretentious, but thorough grab at insolvency assets. What was not "a perfected interest" in the proceeds[73] became perfected and available upon insolvency, limited to a shortened ten-day time period. Partly because of the UTRA history[74] and its influence on the early Code cases, the Drafters radically rewrote section 9-306(3) for the 1972 revision. The revised subsection made available what had been unavailable. Because of the difficulty in using the accounting fictions to identify and trace collateral, the Drafters made these assets available as proceeds even though there was no direct perfection in the proceeds as collateral.[75]

66. GILMORE, *supra* note 1, § 27.3, at 728-29.
67. *Id.* § 27.3, at 730.
68. Frank R. Kennedy, *Impact of the UCC on Insolvency: Article 9*, 67 COM. L.J. 113 (1962).
69. *Id.* at 117.
70. *Id.*
71. *Id.*
72. *See* U.C.C. § 9-306(4) (1962) (providing in its introductory clause: "In the event of insolvency proceedings . . . .").
73. *Id.* § 9-306(3) (1962).
74. For a good history of the UTRA problem, see Richard W. Duesenberg, *Lien or Priority Under Section 10, Uniform Trust Receipts Act*, 2 B.C. INDUS. & COM. L. REV. 73 (1960). For a discussion of the origins of section 9-306(4), see *id.* at 83-84.
75. U.C.C. § 9-306(3) (1972).

The trade-off was the ten-day-limitation. Thus, it appears, reasonably, that the Drafters took seriously Professor Kennedy's advice.[76] As a limitation on an interest that was theoretical rather than practical, but was at least theoretically probable, the new section did not "grant" anything and therefore might not have been seen as preferential.[77] Yet, this became the Code's view. From 1972 through the 1978 revision, the provisions remained static, while the controversy was stirred by *Gibson*,[78] *Muffler*,[79] and similar cases. With the 2000 revision, others began to question whether the problem was one of comprehension or simple greed.[80]

The current proceeds section, section 9-315, has dropped the differential treatment in bankruptcy.[81] So, the question about the character of the former section 9-306(4) as a substantial and important provision in the debate about permissible preferential transfers has lost some of its strength.[82] Section 9-315 avoids the debate by allowing the new lien to become available in all contexts and only after linking the security interest to the creditor's collateral through tracing. The cryptic current statement is that "the debtor's entry into bankruptcy does not affect a secured party's right to proceeds."[83] Of course, the question is how to treat proceeds. It is now the task of every secured creditor to be prepared to identify proceeds, which will necessarily include forensic accounting, which at one time could be avoided through use of the former section 9-306(4). Section 9-315 and its current comments are explicit that it is the burden of every secured party who claims an interest in proceeds to make that identification through the fictions of tracing.[84] The lowest intermediate balance rule is even mentioned in the current commentary to the section.[85] What controversy that was lost in going from section 9-306 to section 9-315 has been heightened in other provisions of the new and revised Article Nine in its year 2000 version.

Any change to Article Nine must take into account both existing bankruptcy law and its policies. For instance, section 545 only deals with statutory liens, but because Article Nine is a statute, the Drafters must be at least cognizant of the limitation set forth in that section. In addition, section 547 of the Bankruptcy Code attacks

76. *See* Kennedy, *supra* note 68, at 116-17.
77. *See id.*
78. *In re* Gibson Prods., 543 F.2d 652 (9th Cir. 1978).
79. *In re* Guaranteed Muffler Supply Co., 5 B.R. 236 (Bankr. N.D. Ga. 1980).
80. Julian B. McDonnell, *Is Revised Article 9 a Little Greedy?* 104 COM. L.J. 241, 260-64 (1999).
81. U.C.C. § 9-315 (2000).
82. *Id.*; *see also id.* § 9-315 cmt. 8.
83. *Id.* § 9-315 cmt. 8.
84. *Id.* § 9-315(b).
85. *Id.* § 9-315(b) cmt. 3.

preferences generally and raises the deeply confused question of what is not an actual "preference." Given the nature of security as the fall back position after a debtor's failure to pay, it is obvious that any security interest that is successful must survive bankruptcy. Only in bankruptcy is the issue of preference and statutory liens inquired into by virtue of the policies of Bankruptcy Code sections 545 and 547. Because the classic test of perfection is one with peculiar meaning in bankruptcy, this is where the test of a security interest really should be made.[86] Congress can change this all by amending statutory definition sections. For instance, the judicial lien, which is defined in 11 U.S.C. § 101(53), defines statutory liens and can be easily modified by adapting the transfer definition of § 547(e)(1)(b), which will add bona fide purchaser or judicial lienor as those who will defeat a "nontransfer." In other words, it can be expanded to make a transfer effective only when a bona fide purchaser cannot also be defeated.

From 1950 to 1960 Article Nine and the Bankruptcy Act existed in parallel, but different, universes. They were akin to distant radio wave transmissions, competing for air space, but nothing close to approaching dialogue.[87] This changed with the drafting of Article Nine followed by its promulgation in 1962. During this period, the Drafters of Article Nine were well aware of the bankruptcy chiaroscuro and laid down over this what they conceived of as a complementary foreground of commercial transactions. They took into account the need to avoid preferential transfers. Of course, the primary concern was validation of the floating lien that seemed to be a political necessity, as well as a commercial reality, to the Drafters.[88] Thus, the Drafters' understanding of the history and intent of the Bankruptcy Act, and later the Code, is critical for understanding Article Nine itself. To better understand what the Drafters were thinking, the following Part explores the bankruptcy law background to this uniform commercial law drafting effort.

## III. THE HISTORY AND INTENT OF SECTION 545

There are four stages of development in bankruptcy which, when understood as sequential, makes clear the nature of the current section 545's limitation on Article Nine and even more importantly better explains the broader clashes of policy between the two sets of laws.

86. A purchaser for value will defeat either interest. *See id.* §§ 9-320, -330, -331; 11 U.S.C. § 544 (2000).

87. *See generally* Gilmore, *supra* note 1, § 45.7, at 1322.

88. *See id.* § 45.7, at 1322-25.

### A. Stages One and Two: The 1898 Bankruptcy Act and Its Revisions

The original Bankruptcy Act was a creature of the emerging economy of the late 19th century. Many of the current industrial and retail patterns were only foreshadowed and many were even inconceivable at the time of the Bankruptcy Act in 1898. In this Act it is fair to say, though perhaps overgeneralized, that the trustee took the estate as the debtor held it.[89] The trustee essentially stepped into the shoes of the debtor as surrogate for the debtor. The trustee's job was to close the business and make what payments could be made with little room to aggressively administer.[90] With a couple of major exceptions, this is the overgeneralized but fair statement of the trustee's role between 1898 and the 1938 revision of the Act.[91]

It became the task of the 1938 Drafters to acknowledge and validate this acceptance of judicial liens and statutory liens as part of the landscape the trustee would have to accept. Former section 67 of the 1938 Act recited Congress' acceptance of both types of liens and resolved the developing customary law over the ability to create a lien or to perfect a lien after the intervention of the bankruptcy filing.[92] While the 1938 revision resolved several controversies that had developed in the first forty years, it was not radical. Contemporaneous with the developing reservation about the power of liens and state control over those liens, this revision was more reactive than innovative. Clearly, Congress was considering the Depression and the overuse of liens by the states, without a rejection of the liens themselves. It appears that it was the abuse, not the mere existence, of liens by taxing authorities and landlords that played a heavy role in Congress' reaction.[93] There was a growing sense that liens, if not contained, would expand to the point that there would be nothing for unsecured creditors and perhaps even bankruptcy fees of administration would go unpaid.[94]

Although the principle of validating judicial and statutory liens continued to govern after the 1938 Act, the notion of invalidation began to solidify, if not take hold.[95] The Chandler Act of 1938 presaged the true break. Using the structure of section 67(c) of the Chandler Act, the 1966 amendments to the Chandler Act completed the shift to

89. *See* 5 Collier on Bankruptcy 545-16 (Alan N. Resnick et al. eds., 15th ed. 2001).

90. *See id.* Perhaps most significant was the right of the trustee to preserve an invalidated interest, subrogate to them and then attack other interests vulnerable to the invalidated interest. These were found in sections 60, 67, and 70 of the former Act. *See id.*

91. *See generally* 11 U.S.C. §§ 60, 67, 70 (1938).

92. *See* COLLIER, *supra* note 89, at 545-16, -17.

93. *See id.* at 545-18.

94. *See id.* at 546-15, -16; *see also* GILMORE, *supra* note 1, § 45.3, at 1288.

95. *See* COLLIER, *supra* note 89, at 545-16, -17.

invalidation. The 1966 amendments, which coincided with many of the Article Nine promulgation and enactment debates, brought together the two bodies of developing law and heightened the reservations about liens and their role in bankruptcy. For the first time Congress undertook to describe some liens as "invalid,"[96] rather than "postponed or subordinated."[97] This was a dramatic shift away from what had been a fostering attitude toward liens, a policy present from 1898 through the early 1960s. It set the stage for the 1978 Bankruptcy Code and outlined the policy issue that would confront the Drafters of Article Nine during the late 1960s and for the 1972 revisions of Article Nine.[98] It also helped shape the discussion that surrounded the adoption of Article Nine by the various states during the middle-to-late 1960s.

### B. The Third Period: The 1966 Amendments and Revised Article Nine and the Emergence of the Present Conflict

This third period encompasses the dance of Article Nine and bankruptcy law in which each system sought position on the national floor of policy. Both cooperated with the other while attempting to establish position, preening and posturing to establish the final policy that each carried as the two reached something akin to equipoise. This point came when section 545 of the 1978 Bankruptcy Code was laid over the top of the 1972 revisions to Article Nine. The Article Nine 2000 draft continues this dance, but shifts into a new period of conscious advantage taken by the Article Nine Drafters. The remainder of this Part of the Article illustrates that this dance of mutual respect and advantage taking has been replaced with one in which Article Nine has taken the upper hand. First, consider the Bankruptcy Code of 1978, the most important revision since the 1898 original Act. A good illustration of the equilibrium reached during the 1960s and '70s, or perhaps "dynamic tension" is a better phrase, is section 547 of the Bankruptcy Code, which answered Grant Gilmore's most fundamental concerns in his 1965 treatise. Gilmore was concerned about the fundamental programmatic issue of Article Nine's floating lien which he believed to be at risk,[99] because of bankruptcy's rejection of all preferential transfers.[100] In 1978, the Bankruptcy Code accepted the floating lien of Article Nine as not preferential,[101] and bankruptcy even

96. *See* 11 U.S.C. § 67(a) (1966).
97. *See id*; COLLIER, *supra* note 89, at 545-19, -20.
98. Gilmore felt that the developing conflict was worthy of mention in the final chapter of his treatise. *See generally* GILMORE, *supra* note 1, § 45, at 1281-1346.
99. *See id.* § 45.7, at 1318-20.
100. 11 U.S.C. § 547 (1978).
101. 11 U.S.C. § 547(c)(5) (2000).

adapted its preference law to Article Nine by using the nomenclature of "perfection" within the section.[102]

Even with this significant bow to Article Nine, the Bankruptcy Code replaced section 60 in significant part with section 547 and left no room to wonder about the development of bankruptcy law and its growing distaste for statutory liens that become valid only upon insolvency and that eviscerated the estate. The combination of devices adopted by the 1978 Bankruptcy Code was acceptance of Article Nine's security interest because it was based on consent while rejecting "nonconsensual" liens. The developing law made clear that most of the liens in the context of landlords and taxes had been statutory and nonconsensual, while the U.C.C.'s version of its security interest, even though a product of state law, was based on consent. The Bankruptcy Code now contains a definition of lien that makes this clear:

> (53) "statutory lien" means a lien arising solely by force of the statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on the statute and whether or not such interest or lien is made fully effective by statute;[103]

First, this definition eliminated judicial liens from the questing reach of section 545.[104] Second, it made explicit the origins of bankruptcy's distrust of liens in the greed of state legislatures who chose to tip their hands at insolvency. Call it a variation on the secret lien, so thoroughly despised in bankruptcy. This definition meant that a statute could not provide for an interest that became valid only upon insolvency without running afoul of section 545. Yet, there remains a substantial disconnection here that leads to the frisson of the Bankruptcy Code/U.C.C. dance. The challenge laid down by the 1978 Bankruptcy Reform Act was to the Drafters of Article Nine to craft a security interest that arose by consent yet attached and became perfected as to certain goods only upon insolvency.

Was it enough that there was a consensual relationship as to the collateral which, when sold, generated proceeds and therefore could be attached automatically? Did Article Nine's automatic attachment and perfection in favor of the secured party go too far? As a result of these questions, the 1962 version of section 9-306(3) and (4) was quite suspect. Absent insolvency under the 1962 Code, that is, in the typical situation between the debtor and secured party, there was no attachment and therefore no perfection in the commingled proceeds.[105] Only segregated noncommingled proceeds were available to the se-

102. *See id.* § 547(e)(1)-(2).

103. *Id.* § 101(53).

104. *See* COLLIER, *supra* note 89, at 101-47, -48, -48.1.

105. *See* U.C.C. § 9-306(3)(b) (1962).

cured party unless the security agreement provided otherwise. Upon insolvency, the secured party was able to dip into the commingled cash receipts without regard to what category of collateral was specified in the security agreement.[106]

Gilmore suggested a defense of this 1962 scheme,[107] but the Code moved on and the 1972 revisions set up the *Gibson* and *Muffler* conflict by making commingled proceeds available outside of insolvency.[108] The 1972 revisions sidestepped Gilmore's initial question and defense, but did nothing to resolve the underlying question. No longer could it be said that the Code offered a lien valid only in bankruptcy.[109] Yet, even after the 1972 revisions the inherent criticism remained. Article Nine offered a perfected security interest in commingled accounts without proof of identifiability.[110] No such security interest in commingled accounts was available outside bankruptcy unless there was some identifiability. Identifiability was no more than a fictional accounting, at least outside of insolvency, a presumptive tracing that suggests strongly the role of the secured party's collateral, but which does not truly separate and assign the proceeds as physically the property of the creditor.[111] The 1972 amendments to section 9-306(4) were to Gilmore a cutting back, a limitation, by the restriction of the interest to those proceeds received during the final ten days.[112] This appears to be the only defense available after the 1972 amendments.

While the 1972 amendments to Article Nine were intended to address the weakness by expanding the section 9-306 interest to commingled proceeds, outside of insolvency they should be seen in context. The substantive fix of 1972 came at the end of twenty years of linguistic gloss in which Gilmore and the other Drafters tried to work around the teachings of the bankruptcy cases under the UTRA. The direct lineal antecedent of Article Nine,[113] the UTRA, gave a similar right to trace to the entruster.[114] Article Nine first limited the UTRA to only "cash proceeds received."[115] Perhaps more importantly, while the Drafters of Article Nine adapted the language of the UTRA to Article

106. *See id.* § 9-306(2)(3).
107. *See generally* GILMORE, *supra* note 1, § 45.9, at 1341-43.
108. *See* U.C.C. § 9-306(3) (1972).
109. *See* Vern Countryman, *Code Security Interests in Bankruptcy*, 4 UCC L.J. 35, 47 (1971); Harold Marsh, Jr., *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 715-16 (1967).
110. *See* U.C.C. § 9-306(4) (1972).
111. *See id.* § 9-306(3) cmt. 2.
112. *See* GILMORE, *supra* note 1, § 45.9, at 1339-40.
113. *See id.*
114. *See* UNIF. TRUST RECEIPTS ACT § 10(c) (1933). It is important to think secured party instead of entruster by "entitlement" to proceeds received within ten days before insolvency.
115. U.C.C. § 9-306(4) (1972); GILMORE, *supra* note 1, § 45.9, at 1341.

Nine, they clarified the UTRA concepts to avoid some of the previous interpretations.

Drafted during the 1920s when bankruptcy would permit almost any lien and validate it, the UTRA was not controversial, even when it provided the entruster a "priority." It did not matter that the interest granted appeared like the creation of the lien with special priority only in bankruptcy. The time frame of the 1920s and the relatively undeveloped policy of bankruptcy permitted this overreaching by the UTRA. This became untenable as bankruptcy policy matured. With maturation, the UTRA became more controversial and the Code Drafters changed the language to make clear that no special treatment, no special priority, was extended. Rather than seek a special priority as the UTRA seemed to, Article Nine spoke in terms of attachment and perfection of a garden variety security interest which would depend on other provisions for its "priority."[116] Thus, the Drafters avoided the loaded language of priority which had drawn the attention of bankruptcy scholars and courts during the decades prior to 1960. Gilmore's defense along these lines, written in the early 1960s, offered a plausible account and reasonable differentiation between the UTRA and Code, but it did not sell.[117]

Why this defense did not sell is straightforward. There was a serious disconnect between the maturing concern in bankruptcy law and the rather facile linguistic fixes offered by the Drafters. The Bankruptcy Code of 1978 saw this problem for what it was, a preference given to the secured party available only in bankruptcy. This is true because the collateral in which the secured party had its original interest no longer existed. What was now present in the insolvency were only proceeds. Absent bankruptcy, there was no such interest available to the secured party. While changing the language from "priority" to "perfected security interest," section 9-306(3) got rid of the loaded language of the UTRA, it did not answer the fundamental question of why the secured party, who had not bargained for or achieved a consensual interest in cash proceeds and would not have such an interest outside of bankruptcy, should receive an interest in cash proceeds in the bankruptcy proceeding. The linguistic fixes of section 9-306(3) and (4) addressed the conflict in terms of the lineal ancestor statute and the cases under it, but they did not adequately address the policy of bankruptcy law as it developed.

Some proof of this is in the removal of section 9-306(4) in the current version of the Code,[118] the 2000 revision. In the 2000 revision of the U.C.C., the secured party gets the same interest inside bank-

116. *See* GILMORE, *supra* note 1, § 45.9, at 1342-43.

117. Witness the controversy generated by the *Gibson* and *Muffler* split. *See generally supra* notes 51-64 and accompanying text.

118. U.C.C. § 9-315 cmt. 8 (2000).

ruptcy as out. This is the current statement of the proceeds role in section 9-315. This section offers a perfected security interest only in proceeds identifiable by the secured party, that is traceable proceeds, and does not differentiate between non-insolvency and insolvency situations.[119]

### C. The Fourth Period: Post-1978 Bankruptcy and Post-1972 U.C.C. - How the Code Arrived Here

The fourth period is that which overlaps the post-1972 and 1978 Article Nine revisions and the post-1978 Bankruptcy Code revision. When courts split over section 9-306(4), they were left to choose between bankruptcy policy and Article Nine policy. This fourth period ended with the 2000 revision of Article Nine, which resolved the split by eliminating the insolvency preference for commingled proceeds. While this might be seen as a concession or even a capitulation by the Drafters, it is important to look at what was happening elsewhere in Article Nine before reaching this conclusion.

In this Fourth Period, it became obvious that Judge Hufstedler and the *Gibson* position had been influential, but the substitution approach of *Fitzpatrick* was accepted as the basic interpretation of section 9-306(4).[120] While judges mention the *Gibson* opinion and its argument that tracing still applies in the section 9-306(4) insolvency context[121] it has become clear that the *Fitzpatrick* court's decision has captured the day.[122] This means, that for the most part, when a secured creditor found itself making a claim to proceeds in an insolvency proceeding he or she was limited to the amount actually deposited in the commingled account in the ten days just prior to the insolvency

119. *See id.* § 9-315.

120. *See* Maxl Sales Co. v. Critiques, Inc., 796 F.2d 1293, 1300 (10th Cir. 1986).

121. *See, e.g.*, Stoumbos v. Kilimnik, 988 F.2d 949, 957 (9th Cir. 1993); *Maxl Sales Co.*, 796 F.2d at 1300; Charter First Mortgage, Inc. v. Oregon Bank, 56 B.R. 838, 849 (Bankr. D. Or. 1985). With the exception of the two decisions from the Ninth Circuit that stated *Gibson* to be controlling precedent, there is little regard paid, more a tip of the judicial hat, to the Ninth Circuit's decision.

122. *See, e.g., Maxl Sales Co.*, 796 F.2d at 1300; *In re* Oriental Rug Warehouse Club, Inc., 205 B.R. 407, 412-13 (Bankr. D. Minn. 1997); *In re* Mark Twain Marine Indus., Inc., 115 B.R. 948, 951-52 (Bankr. N.D. Ill. 1990); *In re* Intermountain Porta Storage, Inc., 74 B.R. 1011, 1013-14 (D. Colo. 1987); *In re* Datair Systems Corp., 42 B.R. 241, 244-45 (Bankr. N.D. Ill. 1984); *In re* Trans-Texas Petroleum Corp., 33 B.R. 67, 69 (Bankr. N.D. Tex. 1983). In addition, although dicta, because no commingling occurred or because of some other reason section 9-306(4) was not applied, these courts suggest that *Fitzpatrick* rather than *Gibson* is the better interpretation. *See, e.g., In re* Buesinger, 2000 WL 33960803, at *3 (Bankr. C.D. Ill 2000); *In re* Armstrong, 56 B.R. 781, 787-88 (Bankr. W.D. Tenn. 1986); *In re* Mewes, 56 B.R. 108, 111-12 (Bankr. D. S.D. 1985).

proceeding's institution.[123] This suggests that the lobbyists and drafters in the revision process leading to the 2000 amendments decided to redirect the courts. Without much explanation in the comments, the Code has done away with the ten-day limitation and returned to the common law methods of tracing for all commingled funds.[124] The historical analysis leads to this question: Did the 2000 revision return to the common law or run from the limited efficacy of the 10-day limitation as it had come to be viewed in bankruptcy proceedings?

## III. CRACKING THE CODE LOGIC: LIENS AT COMMON LAW, LIENS IN REAL ESTATE, AND THE COMMON LAW HOLDER IN DUE COURSE

To illustrate the Code logic involved in Article Nine, this section will take up two different classifications of collateral and breakdown the perfection and priority rules attendant to those transactions. The first category is fixtures and the second is that of negotiable instruments. Both are instances in which there has been a significant evolution in the Code provisions, yet very little explanation of the need for change. In both situations, the modifications made by the Drafters are offered on the basis of clarification and developing commercial practices. This section first discusses fixtures, a classification that has drawn a good deal of attention from the Drafters and has resulted in significant and complex revisions. The area of fixtures illustrates a Code judgment that either there is a need for revision or the cases have in fact reached essentially the same conclusion without the revision. In other words, the revision duplicates or replicates what the Code had led the courts to decide in first place. In the second area, that of negotiable instruments, the changes wrought are substantial but are even more lacking in rational explanation of the need for the particular changes made. What is troubling about both areas is that while both presented issues, the Drafters went to great lengths to adjust provisions in ways that affected settled issues, as well as the purportedly unsettled issues identified for treatment.[125]

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123. *See, e.g., Maxl Sales Co.*, 796 F.2d at 1300; *In Re Buesinger*, 2000 WL 33960803, at *3; *In re Oriental Rug Warehouse Club, Inc.*, 205 B.R. at 412-13; *In re Mark Twain Marine Indus., Inc.*, 115 B.R. at 951-52; *In re Intermountain Porta Storage, Inc.*, 74 B.R. at 1013-14; *In re Armstrong*, 56 B.R. at 787-88; *In re Mewes*, 56 B.R. at 111-12; *In re Datair Sys. Corp.*, 42 B.R. at 244-45; *In re Trans-Texas Petroleum Corp.*, 33 B.R. at 69.

124. *See* U.C.C. § 9-315 cmt. 3 (2000). Perhaps most germane, comment 8 of section 9-315 cryptically states: "This Article deletes former Section 9-306(4), which dealt with proceeds in insolvency proceedings. Except as otherwise provided by the Bankruptcy Code, the debtor's entering into bankruptcy does not affect a secured party's right to proceeds."

125. In addition to these two areas, the new sections dealing with the problem of transferred collateral are also of concern. Transferred collateral can occur by

Of the two examples offered here, it is fixtures that have the longest and most controversial history. For this reason, it is difficult to call the current state of the Article Nine fixture provisions an outright grab by financiers against interests in bankruptcy. Nonetheless, the subtlety introduced by multiple layers of problems and statutory fixes does not disguise the current advantage given to Article Nine secured parties over the trustee in bankruptcy and therefore the general lien creditor. A discussion of the foundation in the origin, definition, and concept of a "lien" is important in understanding this advantage.

## A. A Short History of Liens

The security device that has become known as a lien existed long before the name lien "attached" to it.[126] One document indicates that the Greeks and Egyptians used liens as early as 537 A.D.[127] According to the New Oxford American Dictionary, the word lien originated in the mid-16th century around 1531 from the Middle French via the old French word *loien*.[128] *Loien* is itself derived from the Latin *ligamen* meaning bond.[129] The Latin *ligamen* more precisely refers to

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sales of assets and by the debtor, transmuting itself into a new debtor yet retaining the collateral that was subject to the security interest granted by it in its former guise. This had been handled in section 9-402(7) (1978) as part of the misleading changes and amendments section.

This problem is laid out in four provisions, sections 9-325, 9-326, 9-507, and 9-508. These are collectively known as the new debtor problem. This problem arises when a debtor who is already committed to a secured transaction with one creditor changes its structure to such a degree that it is in effect a new entity and then enters into a new transaction with a second secured party. To the extent the new entity has collateral that would have gone to the first secured party, but is now claimed by the new secured party, there is an intractable conflict. The new Code resolves this by giving priority to the former debtor not only as to transferred collateral but all collateral acquired within four months of the change. While this seems "fair," to split the collateral, it ignores the classic problem of attachment and perfection. There cannot be perfection and priority without first having attachment.

A look at the cases to which the Drafters were responding to shows that there is no "good" and demonstrably fair answer, but the one chosen seems particularly bad because it ignores the classic Code logic and therefore is fundamentally flawed with little or no explanation for the change. The glaring explanation is that this result is hard on the second creditor, but even harder on the trustee in bankruptcy. It is the trustee who loses all chance at the assets, further diminishing the estate without genuine reliance on the new debtor's assets by the old secured party, who if he had relied could simply have asked for a new security agreement and avoided the whole problem.

126. Pun intended. Sorry.
127. TRAIANOS GAGOS & PETER VAN MINNEN, SETTLING A DISPUTE: TOWARD A LEGAL ANTHROPOLOGY OF LATE ANTIQUE EGYPT 23-26 (1994).
128. THE NEW OXFORD AMERICAN DICTIONARY 985 (2001).
129. What is the Roman law concept of a lien? Liens have existed since ancient times. In Rome, liens came in three forms: (1) *pignus*; (2) *hypothec*; and (3) true lien or *ius retentionis*. The first of these versions of lien, *pignus*, was what is known in

a fasten, tie, string, or a bandage.[130] *Ligamen* results from the combination of the word *ligo*, meaning fasten and when combined with something specific, implied a bandaging of wounds or something similar.[131] The suffix *men* indicated non-abstract objects.[132]

Conceptually, liens arose out of the sense of natural equity to secure a marketplace that revolved around barter.[133] They satisfied the vendor's need for security for payment or for services rendered or goods sold.[134] Essentially, a lien was an agreement between a buyer and seller that the one who labored or the one who sold goods would retain possession of the specific article upon which his time, labor, and energy were expended until the seller received compensation.[135]

A lien could arise in one of two ways: (1) from the voluntary performance of labor upon the property of another while in the debtor's possession or (2) from the imposition by law or custom of a compulsory duty upon the party in his favor it operates.[136] The various meanings of the word "lien" including its origins, its usage in English common

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the law today as a pledge. *See* W.W. BUCKLAND & ARNOLD D. MCNAIR, ROMAN LAW AND COMMON LAW: A COMPARISON IN OUTLINE 314 (2d ed. 1952). *Pignus* essentially was anything given as security for a debt, bond, good conduct, etc. *Id.* at 315. It applied to any person, thing, or event that secured anything. *Id. Pignus* acted like a surety or a guarantee in the given situation. *Id.*

The second lien-like concept is *hypothec*, which arose during the time of Justinian. *Id.* at 315. *Hypothec* has no modern equivalent in the law; it was broadly security for a loan or a debt. *Id.* Originally, maritime liens were *hypothec*, but the addition of notice requirements for maritime liens has since rendered them different from *hypothec*. *Id.* at 318. *Hypothec* was unique because the possession of the thing offered for security remained in the hands of the debtor. *Id.* at 317. The arrangement thus made it possible for the same collateral to be saddled with subsequent charges. *Id.* Roman law recognized this arrangement as binding for rents, but later expanded *hypothec* to cover other obligations. *Id.* at 317-18 *Hypothec* were good against all except for a prior charges. *Id.* at 317. Even though *hypothecs*, like equitable liens, did not depend on actual possession, their range was more like that of common law liens. *Id.* Yet, unlike common liens, *hypothec* conveyed a possessory right. *Id.* Whereas, under common law liens once possession was lost the right of lien likewise dissipated, Roman law allowed the seizure of the attached goods wherever they were. *Id.* at 318.

Under Roman law, there was such a thing as a true lien, which existed, in the third form, *ius retentionis*. *Id.* at 319. This form of security carried with it no right of sale. *Id.* As its name indicates, it was the right to retain goods until payment of a debtor owed to the possessor was paid. *Id.* The subject matter of both *pignus* and *ius retentionis* was a chattel, but since under either system people could promise things other than those that they owned outright it was possible to bind an interest less than ownership or an obligation. *Id.*

130. OXFORD LATIN DICTIONARY 1029 (1982).
131. *Id.*
132. *Id.*
133. D.Y. OVERTON, A TREATISE ON THE LAW OF LIENS AT COMMON LAW, EQUITY, STATUTORY & MARITIME 2 (1883).
134. *Id.*
135. *Id.* at 3.
136. *Id.*

law, and the early law of the United States make a unitary definition impossible. It is too much a situational concept. In England, for example, a lien existed as a right under the name "right of retainer" as early as the reign of Edward IV,[137] but it was not called a "lien" until

137. What are Blackstone's observations of liens? Under English law an interest in land could be "gaged" or pledged in payment of debtor. This pledge was of two types, either "living" or "dead" (i.e., the mortgage). 2 SIR WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 157-58 (Garland ed. 1978). The "living" pledge reverted to its borrower but the mortgage had to be reconveyed upon payment. *Id.* at 158. The mortgagee would in either case take the land into his possession in the character of a pledge, or the *pignus* of Roman law. *Id.* But during the period that it remained in the mortgager's possession it was more akin to the *hypothec*. *Id.* "In Glanvil's time when the universal method of conveyance was by livery of seizin, or corporeal tradition of the lands, no gage or pledge of lands was good unless possession was also given to the creditor." *Id.* at 159-60. Possession was favored in order to prevent latter fraudulent pledges of the same land. *Id.* at 160.

As English law evolved, different methods for securing payment of debts came into use. These systems took the form of deeds which were not intended to transfer property, but were intended to charge or burden lands and naturally to discharge them again upon satisfaction of a condition. *Id.* at 340. These deeds were in the nature of obligations or bonds, recognizances, and discharges of them both. *Id.* An obligation or bond was a type of deed whereby the obligor obliged himself and his estate to pay a certain sum to another at an appointed time. *Id.* Where the deed promised payment alone it was called a "simple obligation," but usually a condition would be added to the deed, with the effect that if the condition were satisfied the debt would be canceled. *Id.* at 480. An obligation was a collateral rather than direct charge on the lands in the sense that the debt, if still standing upon the day appointed, would be taken out of the lands only if there were not enough personal assets of the obligor to satisfy it. *Id.* at 340-41. Examples of obligations include: payment of rent; performance of covenants in a deed; or repayment of a principal sum of money loaned to the obligor by the obligee, including interest. *Id.*

Whereas obligations created fresh debts, recognizances were acknowledgments of former debts upon the record. *Id.* at 341. The distinction between a bond and a recognizance is that the former is a part of the original deed and the latter arises between the same parties in a separate deed. *Id.* Recognizances further divided into two types, public and private. *Id.* Public recognition took the form of the debtor admitting in writing an unsettled debt to another and acknowledging the encumbrance on his lands unless the debt or performance owed were satisfied first. *Id.* at 341-42. Since it was affirmed only by the court record and not under the party's seal it was not strictly a deed, but it did have greater effect than a common duty, being allowed a priority in payment, and binding on the lands of the cognizor (i.e. the debtor) from the time recording. *Id.*

There were two types of private recognizances. First, the statute staple, which was entered into before the mayor of the staple in accordance with the statute 23 Hen. VIII. ch. 6. *Id.* at 341-42. The merchant entered into a private recognizance before the chief magistrate of a trading town commensurate with the statute 13 Edw. I. de *mercatoribus*. *Id.* at 160. Since these forms of security were intended to benefit commerce, they were originally allowed only between traders. *Id.* In order to satisfy the debt, the debtor could be incarcerated, his possessions could be seized, and his lands given to the creditor until the debt could be discharged out of the rents and profits. *Id.* at 342. While the creditor

approximately the beginning of the 18th Century.[138] Just as the right of retainer at common law implied possession, a lien also implied possession.[139] But, unlike the right of retainer, the term "lien" came to embrace other rights that did not depend upon possession, as in statutory, equitable, or maritime liens.[140]

Under English common law, a lien was defined as an obligation tied to, or claim annexed or attached upon property, without satisfying which, the owner could not demand the property subjected to the lien.[141] It was not considered a property interest in the thing itself or a cause of action for the thing itself, thus it was a legal charge against the property, but a mere a right to retain the property until the debt was satisfied.[142] Though this version of a lien gave the seller the right to retain the article, it was wholly dependent upon the lienholder's possession and once delivered to a third party it could not be recovered again.[143] Actual or constructive possession was required for the lien to exist, so the surrender of possession was fatal to it.[144] In contrast, the Roman law lien was similar to a common law vendor's lien in that the failure to pay gave the seller the right to retain possession as a promise for payment, but the Roman lien additionally gave the seller the right to seize the goods in the hands of the buyer, or even the subsequent buyers, upon default.[145]

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held the lands he was a tenant in statute staple or merchant. The statute of 23 Hen VIII. Ch 6 expanded a version of statute staple to all of the king's subjects. *Id.* at 342. This statutory extension further allowed the acknowledgment of recognizances before either of the chief justices, or before their substitutes if the justices were out of term. *Id.* at 342.

The use of devices of statute staple and statute merchant dwindled in England and were replaced by the remedy of the writ of elegit, which was created by the statute of Westm. 2. *Id.* at 161. Estate by elegit existed when the creditor would get a judgment for his debt at law, and then the sheriff would give the creditor possession of the debtor's lands and tenements, which creditor could then occupy until his debt was fully paid. *Id.* Blackstone points out that these interests are only chattel interests and not freeholds because they go to the executor of the estate and not to the heirs. *Id.*

Statutory liens, judicial liens, and security interests all come within the scope of the Bankruptcy definition of lien. S. REP. No. 95-989 (1977), *reprinted in* 1977 U.S.C.C.A.N. 5787, 5811. Except for certain common law liens, these three categories of lien are mutually exclusive and exhaustive. *Id.*

138. 1 LEONARD A JONES, A TREATISE ON THE LAW OF LIENS 3 n.2 (3d ed. 1914).

139. *Id.*

140. *Id.*

141. *Id.* at 4.

142. It could also take the form of a suit in rem to enforce payment. *Id.*

143. *Id.* at 17-20.

144. *Id.* at 3, 17-20.

145. *Id.* at 3-4.

The common law of the United States tracked somewhere between the English common law lien and the vendor's lien of Roman law.[146] The United States common law version of a lien was generally a charge or encumbrance upon property that secured payment of the debt or performance of the duty. While it was separate from the obligation that it secured, in the absence of a debt or obligation there could be no lien.[147] Whereas the English common law lien implied a right to retain possession of the property until the debt was satisfied, United States lien law has permitted more extensive meaning, in that it came to designate all of the different contractually created charges

146. Liens predicated upon judgments arose from the right, granted by early statutes, to take out an elegit or to subject the property to seizure and sale upon execution. Brown v. Vonnhame, 343 N.W. 2d 445, 448 (Iowa 1984) ("Consequently, *such liens are creatures of statutory provisions*, owe their life and force entirely to legislation, and do not exist except by its authority.").

What is the United States case law view of a lien? Absent legislative intent to define lien in another way, a lien may generally be defined as a claim, encumbrance, or charge on property for payment of some debt, obligation or duty. Westwood Homeowners Ass'n, Inc. v. Lane County, 864 P.2d 350, 355-56 (Or. 1993) (holding that the Association's power to make assessments is not a lien). A lien is basically a security right that is given to persons which allows them to sell or seize the collateral that is the subject of the lien. *See id.* at 355.

Liens are distinct from the debt they secure and therefore there is a remedy in the nature of security. *See* Kalio Universal, Inc. v. B.A.M. Inc., 231 A.2d 376, 379 (N.J. Super. Ct. App. Div. 1967). "A lien is a property right." *In re* Penrod, 50 F.3d 459, 462 (7th Cir. 1995). The Code looks to state law to determine the extent of the property interest represented by lien. *See* Barnhill v. Johnson, 503 U.S. 393, 398 (1992). Though the method of enforcing common law liens is statutorily supplied, the common law rules for creating such liens still prevail. *See Kalio,* 231 A.2d at 379. According to *Kalio,*

> to establish a common law lien an artisan must prove that [1] the chattel was bailed to him, [2] that he expended his skill and labor in the improvement of the chattel, [3] that he conferred upon it an additional value, [4] that he had the expressed or implied consent of the owner to do the work, and [5] that he was employed for the purpose of doing the work.

*Id.* (citing White v. Smith, 44 N.J.L. 105, 109-10, 112 (N.J. Super. 1882)).

"A lien can only be created with the owner's consent, that is, by a contract express or implied with the owner of the property or with someone by him duly authorized, or without his consent by the operation of some positive rule of law, as by statute." Harriss v. Parks, 187 P. 470, 471 (Okla. 1920). On the other hand, a common law possessory lien cannot exist without consent between the owner of the property and the person performing services on the property. Capson v. Superior Court of the State of Arizona, 677 P.2d 276, 278-79 (Ariz. 1984) (finding that a towing company had neither a statutory nor a common law lien for the cost of towing and storage of an automobile parked on private property without permission). The bankruptcy definition of the term "lien" is broad enough to encompass both a vendor's lien and a vendor's privilege under Louisiana law as well as judicial liens, security interests, and statutory liens. *In re* Hughes, 9 B.R. 251, 257 (Bankr. W.D. La. 1981) (holding that the Louisiana vendor's privilege is avoidable by the trustee in bankruptcy as a bona fide purchaser).

147. *See* United States v. Phillips, 267 F.2d 374, 377 (5th Cir. 1959).

on land or personalty.[148] Modern bankruptcy law continues to follow this understanding of the lien and defines it as a "charge against or interest in property to secure payment of a debt or performance of an obligation."[149]

### B. Common Law Within the Code's Priority Structure for Fixtures

In summary, the current Code provisions take this concept of a lien and its rich and diverse history and try to place it within the Code framework of consensual security interests. This is accomplished in two separate priority provisions that were first seen in the 1962 Code. First, a secured party who was perfected before the lien attached had the victory in the original version. Second, if the goods were classified as fixtures, the priority rule remained the same so long as the security interest was filed as a fixture filing. What is necessary, is a way of describing the lien found in the common law of the United States and in Article Nine that also connects with the understanding of Bankruptcy Code section 545.

Article Nine offers some important clues. First, there is U.C.C. section 9-317's treatment of the lien creditor. Second, there is the general priority treatment for possessory liens. The combination is instructive. In general, a lien is given priority dating from its "becoming" a lien and if this attachment or creation occurs before perfection then the secured party loses.[150] If the lien is possessory it dates from, and depends on possession,[151] and is given a presumptive priority over even an earlier filed security interest.[152] This is a telling combination because it assigns priority to make "effective" the possessory lien, yet leaves the general lien creditor dependent upon date of taking the lien similar to the general first in time, first in right rule of Article Nine.[153]

### C. Here of *Choate* and *In Choate* and How the Drafters Resolved the Issue

In summary, the current Code provisions take this concept of lien and its rich and diverse history and try to peg it within the Code framework. This is accomplished in two separate priority provisions that were first seen in the 1962 Code. A secured party, who was perfected before the lien attached, had the victory in the original ver-

148. *See, e.g.*, Mobile Bldg. & Loan Ass'n v. Robertson, 65 Ala. 382, 390 (1880).
149. 11 U.S.C. § 101(37) (2000).
150. U.C.C. § 9-317(a) (2000).
151. *Id.* § 9-333(a)(3) (2000).
152. *See id.* § 9-333(b).
153. *See id.* § 9-322(a) (2000).

sion.[154] Second, if the goods were classified as fixtures, the priority rule remained the same so long as the security interest was filed as a fixture filing.

In large part, this special treatment of fixtures with dual filings owes its complexity to the rich history of fixtures.[155] The 1962 draft responded to this well developed, but chaotic system by sidestepping the issue of definition in favor of a general principle of allowing removal of the fixture by the secured party, but otherwise not attempting to fit the personalty interest within the real estate and lien system.[156] By simply calling the new interest a security interest and giving the secured party priority where the perfection occurred first,[157] the Code allowed the secured party to defeat any encumbrancer or owner no matter the classification of the goods as fixtures or non-fixtures.[158] In other words, Article Nine as originally offered to the states allowed the fixture law as real estate to continue and run parallel. Whichever interest was first, real estate interest in fixtures or personalty interest by the secured party, gained priority over the other.[159] The first to perfect by real estate recording or Article Nine filing ruled the day.[160]

Gilmore observed that the controversy generated by the 1962 Code's provisions on fixtures was as unexpected as it was intense.[161] Predictably, the real estate bar was the most agitated because, even though its meaning was apparent,[162] the real estate lobbyists waited until promulgation and attacked the provision before the state legislatures as unworkable and "wrong as a matter of policy."[163] This seems to have surprised and befuddled the Drafters who saw the controversy as largely having been worked out during former law.[164] The Drafters intended to cleave to the existing majority rule and made the concession that in the world of parallel filings it would take a real estate records filing to defeat the real estate encumbrancer.[165] A real estate

154. *See* U.C.C. § 9-301(1) (1962).
155. Gilmore devoted a full chapter, thirty-three pages, in his treatise to the pre-code and non-code history and development of fixture law in the United States. *See generally* GILMORE, *supra* note 1, § 28, at 743-76.
156. *See* U.C.C. § 9-313(5) (1962).
157. *See id.* § 9-313(4).
158. *Id.*
159. *Id.*
160. *See id.* Subsection (1) of section 9-313 made it clear that real estate filings were possible, subsection (2) gave the priority to the secured party except as in subsection (4), as subsection (4) gave it to the real estate encumbrancer if recorded before the interest was perfected.
161. *See* GILMORE, *supra* note 1, § 30.1, at 801-02.
162. *See id.*
163. *Id.* § 30.2, at 802-03.
164. *Id.* § 30.2, at 803-06.
165. *See id.*; U.C.C. § 9-402 (1962).

lawyer need not become proficient in Article Nine because a validly perfected security interest in fixtures would only occur with a real estate filing.[166] Yet, the 1962 text was controversial on the issue of pri-

166. *See id.* § 9-402. By the time of the 1972 amendments the section had a different look. The following is a lined version of the changes made for the 1972 amendments. Additions to the previous text in all U.C.C. sections provided herein are underlined. Deletions in all U.C.C. sections provided herein are in brackets.

§ 9-402. Formal Requisites of Financing Statement; Amendments; <u>Mortgage as Financing Statement</u>

(1) A financing statement is sufficient if it <u>gives the names of the debtor and the secured party</u>, is signed by the debtor [and the secured party], gives an address of the secured party from which information concerning the security interest may be obtained, gives a mailing address of the debtor and contains a statement indicating the types, or describing the items, of collateral. A financing statement may be filed before a security agreement is made or a security interest otherwise attaches. When the financing statement covers crops growing or to be grown [or goods which are or are to become fixtures], the statement must also contain a description of the real estate concerned. <u>When the financing statement covers timber to be cut or covers minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or when the financing statement is filed as a fixture filing (Section 9-313) and the collateral is goods which are or are to become fixtures, the statement must also comply with subsection</u> (5). A copy of the security agreement is sufficient as a financing statement if it contains the above information and is signed by [both parties.] <u>the debtor. A carbon, photographic or other reproduction of a security agreement or a financing statement is sufficient as a financing statement if the security agreement so provides or if the original has been filed in this state</u>.

(2) A financing statement which otherwise complies with subsection (1) is sufficient [although] <u>when</u> it is signed [only] by the secured party <u>instead of the debtor</u> if it is filed to perfect a security interest in

(a) collateral already subject to a security interest in another jurisdiction when it is brought into this state, <u>or when the debtor's location is changed to this state</u>. Such a financing statement must state that the collateral was brought into this state <u>or that the debtor's location was changed to this state</u> under such circumstances; <u>or</u>

(b) proceeds under Section 9-306 if the security interest in the original collateral was perfected. Such a financing statement must describe the original collateral; or

(c) <u>collateral as to which the filing has lapsed; or</u>

(d) <u>collateral acquired after a change of name, identity or corporate structure of the debtor (subsection (7)).</u>

(3) A form substantially as follows is sufficient to comply with subsection (1):

Name of debtor (or assignor) ..........
Address ..........
Name of secured party (or assignee) ..........
Address

1. This financing statement covers the following types (or items) of property:
(Describe) ..........

2. (If collateral is crops) The above described crops are growing or are to be grown on:
(Describe Real Estate) ..........

ority, specifically because it gave what seemed to be a counterintuitive

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[3.] [(If collateral is goods which are or are to become fixtures) The above described goods are affixed or to be affixed to: (Describe Real Estate) ..........

3. (If applicable) The above goods are to become fixtures on*
   *Where appropriate substitute either "The above timber is standing on . . . ." or "The above minerals or the like (including oil and gas) or accounts will be financed at the wellhead or minehead of the well or mine located on . . . ."
   (Describe Real Estate) .......... and this financing statement is to be filed [ [for record] ] in the real estate records. (If the debtor does not have an interest of record) The name of a record owner is ..........
4. (If [proceeds or] products of collateral are claimed) [Proceeds-] Products of the collateral are also covered.

use whichever is applicable

..........................................................................
Signature of Debtor (or Assignor)

..........................................................................
Signature of Secured Party (or Assignee)

(4) A financing statement may be amended by filing a writing signed by both the debtor and the secured party. An amendment does not extend the period of effectiveness of a financing statement. [The term "financing statement" as used in this Article means the original financing statement and any amendments but if] If any amendment adds collateral, it is effective as to the added collateral only from the filing date of the amendment. In this Article, unless the context otherwise requires, the term "financing statement" means the original financing statement and any amendments.

(5) A financing statement covering timber to be cut or covering minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or a financing statement filed as a fixture filing (Section 9-313) where the debtor is not a transmitting utility, must show that it covers this type of collateral, must recite that it is to be filed [[for record]] in the real estate records, and the financing statement must contain a description of the real estate [[sufficient if it were contained in a mortgage of the real estate to give constructive notice of the mortgage under the law of this state]]. If the debtor does not have an interest of record in the real estate, the financing statement must show the name of a record owner.

(6) A mortgage is effective as a financing statement filed as a fixture filing from the date of its recording if (a) the goods are described in the mortgage by item or type, (b) the goods are or are to become fixtures related to the real estate described in the mortgage, (c) the mortgage complies with the requirements for a financing statement in this section other than a recital that it is to be filed in the real estate records, and (d) the mortgage is duly recorded. No fee with reference to the financing statement is required other than the regular recording and satisfaction fees with respect to the mortgage.

(7) A financing statement sufficiently shows the name of the debtor if it gives the individual, partnership or corporate name of the debtor, whether or not it adds other trade names or the names of partners. Where the debtor so changes his name or in the case of an organization its name, identity or corporate structure that a filed financing statement becomes seriously misleading, the filing is not effective to perfect a security interest in collateral acquired by the debtor more than four months after the change, unless a new appropriate financing statement is filed before the expiration of that time. A filed financing statement

remains effective with respect to collateral transferred by the debtor even though the secured party knows of or consents to the transfer.

(8) [(5)] A financing statement substantially complying with. the requirements of this section is effective even though it contains minor errors which are not seriously misleading.

Note: *Language in double brackets is optional.*

Note: *Where the state has any special recording system for real estate other than the usual grantor-grantee index (as, for instance, a tract system or a title registration or Torrens system) local adaptations of subsection (5) and Section 9-403(7) maybe necessary. See Mass. Gen. Laws Chapter 106, Section 9-409.*

Reasons for the 1972 Change

Certain changes are conforming changes to new requirements of Section 9-401 that certain financing statements covering such collateral as timber and minerals be filed in the real estate records. Persons interested in real estate have complained with some justice that the provisions of the 1962 Code failed in several ways to tie the fixture filings to the real estate search system. Among these was the absence of clear specification that the fixture security interest was to be indexed in the real estate records. On this point, a responsive change has been made in Section 9-403. Other objections related to the adequacy of the real estate description and to the fact that the debtor might not be an owner of an interest of record in the real estate. The optional language in subsection (5) is designed to meet the objection as to real estate descriptions but without imposing on a fixture-secured party the duty of obtaining a "legal description" unless the state's recording system requires it. While no doubt a full "legal description" is proper practice in conveyancing, it is believed that something significantly less, like a street address, would be adequate in most states, and would frequently be a guide to a recorded map. Where a state has a tract index system or other special system not dependent on a grantor-grantee index, special adaptations may be required and no attempt is made in the Code to deal with all such situations.

Another objection of real estate parties has been that the name of the debtor might not be in the real estate chain of title and there have been numerous non-uniform amendments to Sections 9-401, 9-402, or 9-403 designed to require the showing of the name of the record owners of the real estate in the financing statement. Since Section 9-313(4) (a) and (b) permit fixture filing against persons in possession of the real estate who do not have interests of record, Section 9-402 requires the naming of an owner of record of the real estate in such cases, and Section 9-403(7) requires indexing the fixture filing against the name.

Subsection (6) makes it possible for a real estate mortgage to serve as a financing statement, and a related change in Section 9-403(6) makes it unnecessary to file continuation statements for such a financing statement.

Subsection (1) has been changed to require only the signature of the debtor rather than that of the secured party. The requirement of signatures of secured parties has sometimes misled secured parties, who are accustomed to pre-Code practice and real estate practice under which only the debtor, not the secured party, need sign such instruments as chattel mortgages and real estate mortgages. Thus, when the security agreement was used as the financing statement, it might have been defective under the 1962 Code for failure to have the signature of the secured party. This change also fits in with the provisions of Section 9-403(6), under which a real estate mortgage (customarily signed only by the debtor) may be effective as a financing statement.

answer. It appeared to allow an Article Nine fixture filing to defeat an earlier filed real estate encumbrance.[167]

In actual operation, the Drafters' logic is readily apparent and is not counterintuitive. Assume that State Bank (hereinafter "SB") finances the purchase of an existing shopping mall and takes a mortgage on the mall property. Then assume the debtor goes to a Computer Dealer (hereinafter "CD") to obtain a computer operated climate control system. CD installs the system and files a fixture filing in the records where SB's record clearly and already exists. It seems obvious that although first in time, SB is not a reliance creditor, at least not to the same extent as CD. In fact, it does no harm to the expectation of SB to give CD the victory as to the computerized equipment even though fixtures under state law are covered by the mortgage so long as any injury done to remove the fixtures by CD is repaid to SB. Section 9-313(1) in the initial draft later became section 9-313(4) in the 1962 version of the Code. It provided for this result by allowing the later fixture filing to win so long as there was no "subsequent advance." It appears that this is a reliance based priority and, as importantly, a decision not to favor the earlier filed interest because of this party's lack of "reliance."[168] And given reliance by one party, but not by the real estate lender, the result was identical in logic to the result in the purchase money security interest situation. The later filing purchase money secured party is given priority over any earlier filed security interests.[169]

While the 1962 version of the Code labored through the evaluation, criticism, and adoption process, Gilmore came to accept a resolution of the conflict proffered by Professor Kripke, one of the consultants and later Drafters of revised Article Nine. Kripke, who would succeed Gilmore as the Chief Reporter by the time of the 1972 amendments, had suggested that perfection should not mean priority. This would allow the existing real estate lender to defeat the later security interest,[170] even though properly perfected. The 1972 revision reflected this

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> Changes in the form of financing statement in subsection (3) conform to the foregoing and are also intended to have the secured party make clear when a financing statement is intended to be filed in real estate records. This had been a matter of some concern when the parties used the term "fixture" loosely in their description of goods.
>
> Some of the changes in section 9-402 are not related to real estate filings. The changes in paragraph (2)(a) conform to section 9-103(3), which requires refiling when the debtor's location changes. Additions in subsections (2)(d) and (7) relating to the problem of the name of the debtor against which a filing should be made and the effect of transfer are discussed in the related Comments.

167. GILMORE, *supra* note 1, § 30.5, at 802 n.2.
168. *Id.*
169. U.C.C. § 9-312(3)(4) (1962). This was part of the Drafters' rationale. *See* U.C.C. § 9-313 cmt. 4 (1978).
170. *See* Gilmore, *supra* note 1, § 30.5, at 820-21.

change in two significant ways. First, the real estate filing method was made more clear.[171] Second, the prior real estate lender was

171. *See generally* U.C.C. §§ 9-402, 313(4)(a) (1972). The text of 9-402 in the 1972 version was:

> Section 9-402. Formal Requisites of Financing Statement; Amendments; Mortgage as Financing Statement.
>
> (1) A financing statement is sufficient if it gives the names of the debtor and secured party, is signed by the debtor, gives an address of the secured party from which information concerning the security interest may be obtained, gives a mailing address of the debtor and contains a statement indicating the types, or describing the items, of collateral. A financing statement may be filed before a security agreement is made or a security interest otherwise attaches. When the financing statement covers crops growing or to be grown, the statement must also contain a description of the real estate concerned. When the financing statement covers timber to be cut or covers minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or when the financing statement is filed as a fixture filing (Section 9-313) and the collateral is goods which are or are to become fixtures, the statement must also comply with subsection (5). A copy of the security agreement is sufficient as a financing statement if it contains the above information and is signed by the debtor. A carbon, photographic or other reproduction of a security agreement or a financing statement is sufficient as a financing statement if the security agreement so provides or if the original has been filed in this state.
>
> (2) A financing statement which otherwise complies with subsection (1) is sufficient when it is signed by the secured party instead of the debtor if it is filed to perfect a security interest in
>
> (a) collateral already subject to a security interest in another jurisdiction when it is brought into this state, or when the debtor's location is changed to this state. Such a financing statement must state that the collateral was brought into this state or that the debtor's location was changed to this state under such circumstances; or
>
> (b) proceeds under Section 9-306 if the security interest in the original collateral was perfected. Such a financing statement must describe the original collateral; or
>
> (c) collateral as to which the filing has lapsed; or
>
> (d) collateral acquired after a change of name, identity or corporate structure of the debtor (subsection (7)).
>
> (3) A form substantially as follows is sufficient to comply with subsection (1):
>
> Name of debtor (or assignor)
> Address
> Name of secured party (or assignee)
> Address
>
> 1. This financing statement covers the following types (or items) of property:
> (Describe)
> 2. (If collateral is crops) The above described crops are growing or are to be grown on:
> (Describe Real Estate)
> 3. (If applicable) The above goods are to become fixtures on* (Describe Real Estate)and this financing statement is to be filed [for record] in the real estate records. (If the debtor does not have an interest of record) The name of the record owner is

given substantial protection where he or she was a "construction lender" and therefore likely to be relying on the integration of fixtures as part of construction project.[172]

In foreshadowing the 1972 changes Gilmore, in his 1965 treatise, offered this telling statement:

> The author has been persuaded by Mr. Kripke's analysis. His separation of the problem of perfection from the problem of priorities is consistent with the basic structure of Article Nine. The article recognizes a great variety of situa-

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4. (If products of collateral are claimed) Products of the collateral are also covered.

(use whichever is applicable) Signature of Debtor (or Assignor) or Signature of Secured Party (or Assignee)

(4) A financing statement may be amended by filing a writing singed by both the debtor and the secured party. An amendment does not extend the period of effectiveness of a financing statement. In this Article, unless the context otherwise requires, the term "financing statement" means the original financing statement and any amendments.

(5) A financing statement covering timber to be cut or covering minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or a financing statement filed as a fixture filing (Section 9-313) where the debtor is not a transmitting utility, must show that it covers this type of collateral, must recite that it is to be filed [for record] in the real estate records, and the financing statement must contain a description of the real estate [sufficient if it were contained in a mortgage of the real estate to give constructive notice of the mortgage under the law of this state]. If the debtor does no have an interest of record in the real estate, the financing statement must show the name of a record owner.

(6) A mortgage is effective as a financing statement filed as a fixture filing from the date of its recording if

(a) the goods are described in the mortgage by item or type; and
(b) the goods are or are to become fixtures related to the real estate described in the mortgage; and
(c) the mortgage complies with the requirements for a financing statement in this section other than a recital that it is to be filed in the real estate records; and
(d) the mortgage is duly recorded.

No fee with reference to the financing statement is required other than the regular recording and satisfaction fees with respect to the mortgage.

(7) A financing statement sufficiently shows the name of the debtor if it gives the individual, partnership or corporate name of the debtor, whether or not it adds other trade names or names of partners. Where the debtor so changes his name or in the case of an organization its name, identity or corporate structure that a filed financing statement becomes seriously misleading, the filing is not effective to perfect a security interest in collateral acquired by the debtor more than four months after the change, unless a new appropriate financing statement is filed before the expiration of that time. A filed financing statement remains effective with respect to collateral transferred by the debtor even though the secured party knows of or consents to the transfer.

(8) A financing statement is substantially complying with the requirements of this section is effective even though it contains minor errors which are not seriously misleading.

172. *See* U.C.C. § 9-313(6) (1972).

tions in which a security interest, although perfected (and therefore good against lien creditors and trustees in bankruptcy), may nevertheless be subordinated to other interests. Mr. Kripke's proposal is, essentially, to add the chattel interest in fixtures to the list of such situations. He would then impose, as a condition of priority (but not as a condition of perfection), the additional requirement of real estate filing (or "notification") much has § 9-312(3) imposes conditions of priority for the purchase money security interest in inventory which have nothing whatever to do with the perfection of the inventory security interests. To Mr. Kripke's suggestion of a real estate notification-by-filing, the author would add, for reasons which are developed in the following discussion, a requirement of actual notification to certain prior or distant real estate interests - but this would be an additional condition of priority in certain situations, not one of perfection.[173]

The heart of Gilmore's argument, or his self-persuasion, lies in the statement: "The article recognizes a great variety of situations in which a security interest, although perfected . . . may nevertheless be subordinated to other interests."[174] Gilmore accurately portrayed the original and sound policy of Article Nine in the 1962 version. Secured transactions ought to require attachment and perfection, and perfection often means something in terms of priority. Gone were concerns for the intricacies of *choate* and *in choate*. Also, largely gone was the distinction made between possessory and non-possessory interests. One need look no further than the complementary basic provisions and section 9-301, which deals with an "unperfected" security interest and section 9-312(5), which is the basic priority world in the former Article Nine. It is possible to call these two provisions the "stick" and the "carrot" articulation of secured transactions policy. An unperfected secured party lost to the bankruptcy trustee and this was stated as the rule of section 9-301.[175] On the other hand, a perfected secured party, by negative implication, beat the trustee.[176] Thus, the secured party gained the protection, the reward of perfection,[177] although he or she might still lose to others who were also perfected earlier.[178]

The carrot offered by section 9-312 was that once perfected, the perfected security interest gained first in time, first in right priority over all other perfected security interests and by clear implication defeated unperfected security interests and lien creditors. Thus, there was a reward to complement the punishment of section 9-301. In this way, secured parties were not only encouraged to perfect, but to perfect early.[179] Perfection gained a reward, but not a guarantee of prior-

173. GILMORE, *supra* note 1, § 30.5, at 820-21.
174. *Id.* § 30.5, at 821.
175. U.C.C. § 9-301(1)(b) (1962).
176. *Id.*
177. *Id.*
178. U.C.C. § 9-312(5) (1972).
179. The rule of first to file or perfect encourages early filing even though, technically, perfection comes later. U.C.C. §§ 9-301(1), 312(5) (1962).

ity. This is so basic that examples need not be given.[180] Perhaps it is obvious, so obvious as to be a truism, but it bears emphasis here. Perfection does not mean absolute priority. In this sense, Professor Kripke's proposal that Gilmore bought into was a continuation, but it was also much more. First, Kripke's proposal represents a significant policy resolution of a priority conflict that could have gone either way. The half-loaf given to personal property financiers by the Kripke resolution was a victory over the lien creditor, but not the real estate encumbrancer. Gilmore saw this half-loaf as an acceptable trade to quiet the real estate rebellion. This eventually became the Code position with the 1972 revision.[181] The changes this revision accom-

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180. Just to show it can be done, consider section 9-312(3)-(4) (purchase money security interest parties defeat otherwise earlier perfected secured parties), section 9-307(1)-(2) (buyers defeat perfected secured parties), and sections 9-308 and 9-309 (transferees and certain purchasers of negotiable instruments and chattel paper defeat perfected secured parties). All are from the 1972 version of the Code.

181. Is there any coincidence that Professor Kripke, then attorney Kripke was the Chief Reporter for the 1972 Revision? The full text of the new priority rules contained in the 1972 version is as follows:

§ 9-313. Priority of Security Interests in Fixtures

. . . .

(4) A perfected security interest in fixtures has priority over the conflicting interest of an encumbrancer or owner of the real estate where

(a) the security interest is a purchase money security interest, the interest of the encumbrancer or owner arises before the goods become fixtures, the security interest is perfected by a fixture filing before the goods become fixtures or within ten days thereafter, and the debtor has an interest of record in the real estate or is in possession of the real estate; or

(b) the security interest is perfected by a fixture filing before the interest of the encumbrancer or owner is of record, the security interest has priority over any conflicting interest of a predecessor in title of the encumbrancer or owner; and the debtor has an interest of record in the real estate or is in possession of the real estate; or

(c) the fixtures are readily removable factory or office machines or readily removable replacements of domestic appliances which are consumer goods, and before the goods become fixtures, the security interest is perfected by any method permitted by this Article; or

(d) the conflicting interest is a lien on the real estate obtained by legal or equitable proceedings after the security interest was perfected by any method permitted by this Article.

(5) A security interest in fixtures, whether or not perfected, has priority over the conflicting interest of an encumbrancer or owner of the real estate where

(a) the encumbrancer or owner has consented in writing to the security interest or has disclaimed an interest in the goods as fixtures; or

(b) the debtor has a right to remove the goods as against the encumbrancer or owner. If the debtor's right terminates, the priority of the security interest continues for a reasonable time.

(6) Notwithstanding paragraph (a) of subsection (4) but otherwise subject to subsections (4) and (5), a security interest in fixtures is

plished were two-fold: (1) they made clear that only a real estate filing would defeat real estate financiers[182] and (2) they reversed the victory of Article Nine financiers over real estate encumbrancers where the Article Nine filing came later and put in its place the purchase money security interest analogy with construction mortgage real estate financiers trumping even these.[183] The Drafters provided only a vague

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subordinate to a construction mortgage recorded before the goods become fixtures if the goods become fixtures before the completion of the construction. To the extent that it is given to refinance a construction mortgage, a mortgage has this priority to the same extent as the construction mortgage.

(7) In cases not within the preceding subsections, a security interest in fixtures is subordinate to the conflicting interest of an encumbrancer or owner of the related real estate who is not the debtor.

(8) When the secured party has priority over all owners and encumbrancers of real estate, he may, on default, subject to the provisions of Part (5), remove his collateral from the real estate but he must reimburse any encumbrancer or owner of the real estate who is not the debtor and who has not otherwise agreed for the cost of repair of any physical injury, but not for any diminution in value of the real estate caused by the absence of the goods removed or by any necessity of replacing them. A person entitled to reimbursement may refuse permission to remove until the secured part gives adequate security for the performance of this obligation.

Reasons for 1972 Change

As the Code came to be widely enacted, the real estate bar came to realize the impact of the fixture provisions on real estate financing and real estate titles. They apparently had not fully appreciated the impact of these provisions of Article 9 on real estate matters during the enactment of the Code, because of the commonly-held assumption that Article 9 was concerned only with chattel security matters.

The treatment of fixtures in pre-Code law had varied widely from state to state. The treatment in Article 9 was based generally on prior treatment in the Uniform Conditional Sales Act, which, however, had been enacted in only a dozen states. In other states the word "fixture" had come to mean that a former chattel had become real estate for all purposes and that any chattel rights therein were lost. For lawyers trained in such states the Code provisions seemed to be extreme. Some sections of the real estate bar began attempting with some success to have Section 9-313 amended to bring it closer to the pre-Code law in their states. In some states, such as California and Iowa, Section 9-313 simply was not enacted.

Even supporters of Article 9 and of its fixture provisions came to recognize that there were some ambiguities in Section 9-313, particularly in its application to construction mortgages, and also in its failure to make it clear that filing of fixture security interests was to be in real estate records where they could be found by a standard real estate search.

Section 9-313 and related provisions of Part 4 have been redrafted to meet the legitimate criticisms and to make a substantial shift in the law in favor of construction mortgages. The specific changes are described in the 1972 Comments to Section 9-313, and the Comments to the several sections of Part 4.

182. U.C.C. § 9-313(4) (1972).

183. *Id.* § 9-313(6).

definition of fixture, which urged courts to look to real estate law for the character of assets.[184]

Most telling is the subtle alteration in these 1972 revisions that was worked by the revised section 9-401.[185] It quietly provided an option to the Article Nine secured party. A secured party, not interested in engaging the real estate interests in a priority battle, was given the option of priority outside of real estate and solely within the personal property scheme of Article Nine. By making a filing not "filed as a fixture filing," this secured creditor was sent to the non-real estate records.[186] It seems this was a good bit broader than necessary to accomplish Gilmore's purposes. First, Gilmore seemed to offer the priority and perfection solution as replacement for a definition of fix-

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184. *Id.* § 9-313(1) cmt. 1.
185. The text of U.C.C. § 9-401 (1972) is as follows:

§ 9-401 Place of Filing; Erroneous Filing; Removal of Collateral
*First Alternative to Subsection (1)*
(1) The proper place to file in order to perfect a security interest is as follows:
(a) when the collateral is timber to be cut or is mineral or the like (including oil and gas) or accounts subject to a subsection (5) of Section 9-103, or *when the financing statement is filed as a fixture filing* (Section 9-313) and the noncollateral is goods which are or are to become fixtures, then in the office where a mortgage on the real estate would be filed or recorded;
(b) in all other cases, in the office of the [Secretary of State].

. . . .
*Second Alternative Subsection (1)*
(b) when the collateral is timber to be cut or is minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or *when the financing statement is filed as a fixture filing* (Section 9-313) and the collateral is goods which are or are to become fixtures, then in the office where a mortgage on the real estate would be filed or recorded;
(c) in all other cases, in the office of the [Secretary of State].

. . . .
*Third Alternative Subsection (1)*
(b) when the collateral is timber to be cut or is minerals or the like (including oil and gas) or accounts subject to subsection (5) of Section 9-103, or *when the financing statement is filed as a fixture filing* (Section 9-313) and the collateral is goods which are or are to become fixtures, then in the office where a mortgage on the real estate would be filed or recorded;
(c) in all other cases, in the office of the [Secretary of State] and in addition, if the debtor has a place of business in only one county of this state, also in the office of . . . . . of such county, or if the debtor has no place of business in this state, but resides in the state, also in the office of . . . . . of the county in which he resides.

Note: *One of the three alternatives should be selected as subsection (1).*

. . . .
Note: *Subsection (6) should be used only if the state chooses the Second or Third Alternative Subsection (1).* emphasis added.

186. U.C.C. §§ 9-401(1)(a), -402 (1) (1972).

tures.[187] The definition, such as it was, was one, intended or not, that made real estate law preeminent.[188] Then, there is the priority reform itself. The 1972 changes brought fixtures in line with the general priority world. First in time, first in right with a purchase money security interest exception that can trump that purchase money security interest[189] with a construction mortgage. So, why the acceptance of a dual perfection method except as solace to the Article Nine personal property financiers? Further, among these personal property financiers priority continued to be based on the first in time, first in right rule. The significant gain is that by including dual methods of perfection, all Article Nine secured parties would be perfected, and therefore defeat the trustee in bankruptcy.[190]

This is a fairly blatant statement of purpose, the purpose being to defeat the trustee and other "lien creditors" in the real estate.[191] While great deference is given to real estate encumbrancers, no deference is given to real estate lien holders. "Reliance" for protecting encumbrancers reenters the picture as the reason offered for their protection and the commensurate lack of protection for lienors.[192] The lack of protection of these lien creditors stands out.[193] Again, this seems to overshoot the target of redressing the real estate bar's concerns by such a distance as to suggest a different motivation. The one offered was probably the most ingenuous statement that one can hope for. It amounts to granting perfection, and in this case, priority, against the trustee. Since the trustee is the quintessential lien creditor, granting perfection means an automatic win, but it is a win not needed to assuage the real estate bar.

It is a victory only in bankruptcy and thus is a "lien" which takes effect only in bankruptcy. It is meaningless outside of bankruptcy because a genuine real estate interest or reliance real estate financier will have priority. What respectable lawyer, when asked for an opinion about the strength of security, would answer that it is secure because it beats only non-reliance creditors? This is an important question in a body of law that exists to provide for "secure transactions." Security must be equated with priority and priority is mea-

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187. GILMORE, *supra* note 1, § 30.5, at 820. This was codified in U.C.C. § 9-313(4) (1972).

188. *See* U.C.C. § 9-313(1)(a)(1972). *see also id.* § 9-313 cmt. (discussing the meaning of "fixture").

189. U.C.C. § 9-313(3)-(4) (1972). There is the added gloss of a super purchase money security interest in the guise of the construction mortgage that can trump even the fixture purchase money security interest if the fixtures are added during construction. *Id.* § 9-313(6) (1972).

190. *See* U.C.C. § 9-313(4)(d) (1978); *see also* § 9-313 (Reasons for Changes) (1978) (discussing criticisms leading to the amendment of § 9-313(4)).

191. *See* U.C.C. § 9-313(4)(d) (1978).

192. *Id.* § 9-313 cmt. 4(c) (1978).

193. *See id.*

sured pretty much the same as any other victory. One either wins, finishes in second place, or worse. Even second place is not a place to be when a financier seeks a secured transaction. It is a rare financier-client who will see a second-place finish as an effective security interest.[194] So, as a lien, it is functionally a lien only in bankruptcy and is a poor substitute for the desired security interest. Since it has such limited effect, it is far from the historical understanding of a "lien." In the United States, this interest only becomes consistent with its historical role when it becomes effective to defeat the trustee in bankruptcy.[195] Although the Bankruptcy Code cases have not squarely met this issue, this Article offers the following as a test of when state law goes too far and becomes suspect under Bankruptcy Code section 545: If the lien is one that would not be negotiated and paid for by the secured party as a good faith interest in the personal property, because it is ineffective against those seen as direct competitors to the secured party, then it is a lien truly "effective" only in bankruptcy and should be invalidated under federal principles.

### D. The Common Law Holder in Due Course and Consensual Security Interests

Negotiable instruments are defined in U.C.C. section 3-104 as:

> (a) Except as provided in subsections (c) and (d), "negotiable instrument" means an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it:
>
> (1) is payable to bearer or to order at the time it is issued or first comes in to the possession of a holder;
> (2) is payable on demand or at a definite time; and
> (3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money, but the promise for order may contain (i) undertaking or power to give, maintain, or protect collateral to secure payment, (ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, or (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor.[196]

While Article Nine does not provide a definition of negotiable instruments, it makes reference to the section 3-104 definition as a definition provided by another Article of the Code.[197] Most simply, the definition takes in the common forms of negotiable instruments seen in everyday practice as checks and promissory notes.[198] Going back even further, perhaps a generation or two, the Commercial Paper

194. *Id.* § 9-313(4)(a)(b) (1972).
195. *See supra* notes 143-46 and accompanying text.
196. U.C.C. § 3-104 (2002).
197. U.C.C. § 9-102(b) (2000).
198. *See* U.C.C. § 3-104 (2002).

course was known as Bills & Notes.[199] What all negotiable instruments have in common is negotiability, that is, the unique quality of making it possible for a holder of an instrument to become a holder in due course.[200] A "holder" is a person in possession of bearer paper or order paper made to his order.[201] As a holder of that paper, one who has given value, in good faith, and without notice of unauthorized signatures or any claims or defenses to the paper or that it is overdue or has been dishonored, can be elevated to holder in due course status.[202] Thus named, the holder in due course is given preemptive ownership rights and defeats all others with the exception of limited "real defenses."[203] All claims and defenses, even claims based on equitable and legal title, as well as all liens and like interests, are subordinated to the holder in due course.[204] This powerful status truly makes this holder in due course a favored of the law, so favored that it is even higher than the vaunted buyer in the ordinary course found in sales law. So favored that Gilmore coined an oxymoron to describe the status. He described the holder in due course in terms of having an "intangible" that was not only "pledgeable," but *must* be pledged. Although it sounds like an oxymoron, a "pledgeable intangible" was a recognition of the common law world's demand that possession be preeminent by requiring pledge of the negotiable instrument.[205]

The two provisions of Article Nine, sections 9-309 and 9-304(1),[206] also made possession everything. In doing so, they reinforced within

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199. For instance, the American Law Reports Digest Index still refers to the subject as Bills and Notes. ALR INDEX, ALR 2D, 3D, 4TH, 5TH, FED at 269 (1999); Negotiable Instruments, 7 A.L.R. DIGEST TO 3D, 4TH, 5TH, FED 262 (1995) (The Digest entry for "Negotiable Instruments" refers the user to "Bills and Notes.").

200. *See* U.C.C. § 3-302 (2002).

201. U.C.C. § 1-201(20) (2000).

202. U.C.C. § 3-302 (2002).

203. *Id.* §§ 3-305, 306; *Id.* § 3-305 cmt. 1 (2002).

204. *Id.* § 3-305 (a)-(b) (2002); *see also id.* § 3-306 (2002) (noting that a holder in due course takes an instrument free of claim).

205. GILMORE, *supra* note 1, § 12.7, at 387-88.

206. The text of U.C.C. § 9-304 (1978) is as follows:

> § 9-304. Perfection of Security Interest in Instruments, Documents, and Goods Covered by Documents; Perfection by Permissive Filling; Temporary Perfection Without Filing or Transfer of Possession
>
> (1) A security interest in chattel paper or negotiable documents may be perfected by filing. A security interest in money or instruments (other than certificated securities or instruments which constitute part of chattel paper) can be perfected only by the secured party's taking possession, except as provided in subsections (4) and (5) of this section and subsections (2) and (3) of Section 9-306 on proceeds.
>
> . . . .
>
> Official Comment
>
> Prior Uniform Statutory Provision: Sections 3 and 8(l), Uniform Trust Receipts Act.
>
> Purposes:

the Article Nine scheme the holder in due course rules of Article Three. The result in section 9-309[207] was a priority scheme that subordinated even the perfected secured party perfection to the holder in due course.[208]

Under section 9-304(1), filing is ineffective to perfect a security interest in instruments (including securities) except those instruments that are part of chattel paper, and of course, is ineffective to constitute notice to subsequent purchasers. Although filing is permissible as a method of perfection for a security interest in documents, this section follows the policy of the UTRA in providing that the filing does not constitute notice to purchasers. Logically the two rules are closely tied, so closely tied as to be mutually exclusive. Here, we see true Code logic as announced in the earlier drafts of Article Nine. Every

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1. For most types of property, filing and taking possession are alternative methods of perfection. For some types of intangibles (i.e., accounts and general intangibles) filing is the only available method (see Section 9-305 and point 1 of Comment thereto). With respect to instruments subsection (1) provides that, except for the cases of "temporary perfection" covered in subsections (4) and (5), taking possession is the only available method; this provision follows the Uniform Trust Receipts Act. The rule is based on the thought that where the collateral consists of instruments, it is universal practice for the secured party to take possession of them in pledge; any surrender of possession to the debtor is for a short time; therefore it would be unwise to provide the alternative of perfection for a long period by filing which, since it in no way corresponds with commercial practice, would serve no useful purpose. [Comments 2-4 not included].

For similar reasons, filing is not permitted as to money. Perfection of security interests in certificated securities, which are covered by the definition of instruments, is governed by Section 8-321 and, therefore, excluded from this section.

207. U.C.C. § 9-309 (1978) provided:

§ 9-309. Protection of Purchasers of Instruments, Documents and Securities

Nothing in this Article limits the rights of a holder in due course of a negotiable instrument (Section 3-302) or a holder to whom a negotiable document of title has been duly negotiated (Section 7-501) or a bona fide purchaser of a security (Section 8-302) and the holders or purchasers take priority over an earlier security interest even though perfected. Filing under this Article does not constitute notice of the security interest to such holders or purchasers.

Official Comment

Prior Uniform Statutory Provision: Section 9(a), Uniform Trust Receipts Act.

Purposes:

1. Under this Article as at common law and under prior statutes the rights of purchasers of negotiable paper, including negotiable documents of title and investment securities, are determined by the rules of holding in due course and the like which are applicable to the type of paper concerned. (Articles 3, 7, and 8.) This section, as did Section 9(a) of the Uniform Trust Receipts Act, makes explicit the rule which was implicitly but universally recognized under the earlier statutes.

208. U.C.C. § 9-309 (1978).

provision seems to work to create a seamless whole that provided a set of rules to cover the subject matter. To be a "holder" meant possession was essential,[209] and to be a perfected secured party also required possession and made possession essential to that status.[210] Thus, the victory went to the possessor by virtue of section 9-309.[211]

The same basic rule applies in favor of a purchaser of other instruments who claims priority against a proceeds interest therein of which he or she has knowledge. Thus, a purchaser of a negotiable instrument might prevail under clause (b) even though the purchaser's knowledge of the conflicting proceeds claim precluded the purchaser having holder in due course status under section 9-309. Both the elegance and unwavering nature of the rule that is embodied in the former rules is admirable. It constructed a Code that reinforced what a good commercial lawyer would advise, "grab the paper and hold onto it." In this way it recognized history and commercial practice, as well as providing an accessible lesson for students.

So why the drastic change in the scheme worked by the 2000 amendments? Here is a Drafter's comment suggestive of an answer:

> Under subsection (a), a security interest in instruments may be perfected by filing. This rule represents an important change from former Article Nine, which under the secured party's taking possession of an instrument was the only method of achieving long-term perfection. The rule is likely to be particularly useful in transactions involving a large number of notes that a debtor uses as collateral but continues to collect from the makers. A security interest perfected by filing is subject to defeat by certain subsequent purchasers (in-

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209. U.C.C. § 3-302 (2000).

210. *Id.* § 9-304(1) (2000).

211. Even the complementary provision dealing with chattel paper and instruments was a part of this programmatic solution. U.C.C. § 9-308 (1978) provided:

> § 9-308. Purchase of Chattel Paper and Instruments
>
> A purchaser of chattel paper or an instrument who gives new value and takes possession of it in the ordinary course of his business has priority over a security interest in the chattel paper or instrument
>
> (a) which is perfected under Section 9-304 (permissive filing and temporary perfection) or under Section 9-306 (perfection as to proceeds) if he acts without knowledge that the specific paper or instrument is subject to a security interest; or
>
> (b) which is claimed merely as proceeds of inventory subject to a security interest (Section 9-306) even though he knows that the specific paper or instrument is subject to the security interest.
>
> Official Comment
>
> 2. Although perfection by filing is permitted as to chattel paper, certain purchasers of chattel paper allowed to remain in the debtor's possession take free of the security interest despite the filing.
>
> Clause (b) of the section deals with the case where the security interest in the chattel paper is claimed merely as proceeds — i.e., on behalf of an inventory financier who has not by some new transaction with the debtor acquired a specific interest in the chattel paper. In that case a purchaser, even though he knows of the inventory financier's proceeds interest, takes priority provided he gives new value and takes possession of the paper in the ordinary course of his business.

> cluding secured parties). Under section 9-330(d), purchasers for value who take possession of an instrument without knowledge that the purchase violates the rights of the secured party generally would achieve priority over a security interest in the instrument perfected by filing. In addition, section 9-331 provides that filing a financing statement does not constitute notice that would preclude a subsequent purchaser from becoming a holder in due course and taking free of all claims under section 3-306.[212]

The scope of the change is self-evident, but lets be explicit about its significance as well. A security interest in negotiable instruments can now be perfected by filing.[213] Yet, the rest remains the same. A holder in due course is still a holder who meets the special test of Article Three,[214] and a holder in due course still defeats any perfected security interest.[215] In other words, the change reiterates Gilmore's observation that there are many places in Article Nine where priority is not the same as perfection.[216] Perhaps this is just another instance, but other than the reference to the fairly specialized financing arrangement mentioned in the comments to section 9-312 alone, there is no explanation offered.

Why such a sharp break from the clear and programmatic former Code logic? What was broken that needed to be fixed? The Drafters saw fit only to hint at their purposes, but look at the identification of the only competitor who now suffers defeat at the hands of a creditor whose interest is completely ineffective against any perfected Article Nine financier.[217] Within this group of competitors, only the bankruptcy trustee is that significant competitor. Only the trustee is beaten by this quasi-perfected secured party. This can be referred to as quasi-perfection because it is meaningless against all purchasers and holders who meet the test of Article Nine purchasers.[218] Even other financiers can defeat this quasi-perfection by taking possession, in good faith, for value, and after meeting the other requirements of "purchase" under Article Nine. In other words, a financier need not be a holder in due course to defeat this filed interest. One only need be a good faith purchaser in possession.[219] Take note that this filing does not necessarily constitute notice of the defense or claim. Then this competitor could even be a holder in due course and thus entitled to

212. U.C.C. § 9-312 cmt. 2 (2000).
213. *Id.* § 9-312(a) (2000).
214. U.C.C. § 3-305 (1978).
215. U.C.C. § 9-331 (2000).
216. *See supra* notes 166-78 and accompanying text.
217. There is no suggestion in the comments of what was not working properly under the old code, instead the code speaks of ease and efficiency in large scale transactions involving paper financing where the paper is left in the possession of the debtor. U.C.C. § 9-312 cmt. 2 (2000).
218. *See* U.C.C. § 9-331(a) (2000).
219. U.C.C. § 9-330 (2000).

the separate priority treatment for interests outside of Article Nine.[220]

While the reason offered for the change is weak, if not implausible, the damage done to Code logic is significant. Article Three thoughtfully builds the elements and structure for a holder in due course and those elements and structure strongly suggest, if not compel, the conclusion that the holder in due course should be a victor where the competitor is the run-of-the-mill security interest attaching to the instrument as proceeds. Even Article Nine seems to accept this as an unchallenged predicate. Surely there would have been a great hue and cry had there been a suggestion of a change in this fundamental doctrine of holder in due course in the redraft of Article Three. Yet, there is a risk that an unselfconscious change has been wrought. The combination of allowing a filing to perfect security interests in negotiable instruments and the deeply conflicted test of knowledge of competing claims used to destroy holder in due course status may work to do more than just make perfection easier in "bulk" transactions as the Comment to the new Article Nine suggests.[221]

Section 9-309 in the former Article Nine[222] helped to explain why simple notice of a security interest filing was inadequate and should continue to be inadequate. First, filing only suggested the existence of an interest not a present claim. Second, filing suggested no violation of the prior security interest. These comments suggest the holder in due course is protected because of value generated in the purchase of the commercial paper assets.

This is illustrated by a simple hypothetical. Assume that Cameraland, the debtor, and First National Bank, the secured party, enter into a security agreement. The security agreement between these two parties, subjects all the inventory of Cameraland, both present and after acquired property, to the security interest and also covers all proceeds of the inventory. No specific interest in promissory notes is contemplated or bargained for except as proceeds of the inventory. Any interest by First National Bank in promissory notes has to be seen as a derivative or proceeds interest. After First National Bank has perfected its security interest, Second State Bank enters the picture as a specialist lender in accounts receivable and promissory notes. Cameraland receives capital from Second State Bank by "discounting" (selling) to First National Bank the accounts receivable and promissory notes given to it by its customers. For simplicity, assume that Second State Bank paid ninety percent of the value of these

220. *See* U.C.C. § 9-331(c) (2000). Subsection (a) of section 9-331 makes reference to rights for holders and others arising out or Articles 3, 7, and 8. Subsection (c) states the rule of no limitation on those rights.

221. *See* U.C.C. § 9-312 cmt. 2 (2000).

222. U.C.C. § 9-309 cmt. 2 (1978).

notes, did so in good faith, and took possession expecting to collect them in due course. Under Article Three, past and present, and under the former Article Nine, the critical issue was the state of Second State Bank's level of notice or knowledge about First National Bank's interest.[223] Essentially, Article Three gave the victory to Second State Bank so long as it did not have "knowledge," actual or attributable, of the interest of First National Bank. For this purpose, the public filing of First National Bank was not enough to give this knowledge. The cases were not in absolute agreement, but there was near consensus that notification by filing, sometimes called constructive notice, was insufficient.[224]

Former section 1-201(25) through (27),[225] now codified as section 1-202,[226] differentiate among "actual knowledge," "receiving notice," and having "reason to know." Notice encompassed all three but actual knowledge was subjective and narrower.[227] The upshot of this was that it took fairly explicit and specific information about the security interest of the senior creditor such as First National Bank, for Second State Bank to lose its holder in due course status. Public filing, that is constructive notice, was almost certainly not enough to give "notice of claim,"[228] as required to defeat holder in due course status.[229] Simple knowledge, what is sometimes referred to as direct notice, as opposed to public or attributed notice, of the competing interest might be enough in limited circumstances.[230] However, the termination of holder in due course status generally occurs because there was knowledge or notice of the interest, coupled with some type of advantage taking such as double-dealing or misrepresentation by the debtor.[231]

223. The issue is the state of knowledge at the time when the Second State Bank satisfied or attempted to satisfy the elements of holding in due course, and the critical time is when the instrument is issued or negotiated to the holder. U.C.C. § 3-302(a) (2002). Notice that the "without notice" requirement of (b) is conjunctive making negotiation the critical time for both. In other words, a holder could learn damaging information after having acquired the note by negotiation and having met the other elements, and it would be too late to affect holder in due course status.

224. *See, e.g., infra* note 282: *see also* LARY LAWRENCE, AN INTRODUCTION TO PAYMENT SYSTEMS 86-87 (1997) (discussing tests used by courts to determine if a person has reason to know of an infirmity to notice).

225. U.C.C. § 1-201 (25)-(27) (1978).

226. U.C.C. § 1-202 (2001).

227. *Id.*

228. *See infra* note 282.

229. U.C.C. § 3-302 (2002).

230. *See* McCook County Nat'l. Bank v. Compton 558 F.2d 871, 874 (8th Cir. 1977) (finding either no direct notice or a case of forgotten notice under the code, but noting that direct notice of a superior interest might under other circumstances be sufficient to destroy holder in due course status).

231. *See In re* Joe Morgan, Inc., 985 F.2d 1554, 1560-62 (11th Cir. 1993) (finding that the holder failed to satisfy the good faith requirement by its 'objective lack of good

The heightened level of notice that was required to destroy the holder in due course had the effect of ameliorating the power of the secured transaction and gave the buyer of the commercial paper a better shot at victory.[232] To accomplish this amelioration, the former Code sections reiterated that notice by the filing of a financing statement was not enough.[233] In addition, sections 9-308 and 9-309 operated as a package in this context to expand and complement one another. For instance, remember that for First National Bank to have a "perfected" security interest it had to have possession under the former Code.[234] Second, section 9-308 made it clear that temporary perfection was permitted in only very unusual circumstances and perfection by virtue of proceeds filings were ineffective against a junior purchaser who gave the value and took possession. *A fortiori*, a holder in due course would easily have triumphed even with knowledge. Here, is the resolution to the troublesome problem of differentiating levels of knowledge. Absent a direct interest, that is a non-proceeds security interest in the instruments held by the senior secured party, the senior lost to the holder in due course. Even one who had knowledge and might not technically be a holder in due course could still met the abbreviated test of value and good faith under section 9-308. Here the value was the equivalent of that needed to be a purchaser or buyer in the ordinary course of business.

Was Article Nine more "generous" than Article Three? The answer is no, rather it simply reiterated a consistent Code logic of rewarding the purchaser of an asset, even one held as security by a prior perfected secured party for other and overriding commercial purposes. Purchasers generate cash and cash is the only way in which the perfected senior secured party will be repaid. It is easy to forget that the perfected security interest is not the "end." It is the "means" and collateral, literally and figuratively, to the end of being repaid the loan amount. So, for the Drafters of the former Article Nine, logic must have dictated that this be viewed as just another version of their basic theme: It is not perfection that is the issue, because both interests are perfected, rather it is the relative priority of these two perfected interests. Article Nine gave to the new value purchaser,[235] a priority simi-

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faith in failing to take steps to investigate that it had taken in other transactions with other companies; by doing so it was consciously or unconsciously taking advantage of its own ignorance); *see also* Fin. Mgmt. Servs., Inc, v. Familian, 905 P.2d 506, 510 (Ariz. Ct. App. 1995) (discussing a similar issue of conscious advantage taking, but ultimately finding none).

232. *See* U.C.C. §§ 9-308, 309 (1972).

233. U.C.C. § 9-309 (1978).

234. *Id.* § 9-304 (1978) (filing versus possession and possession required for negotiable instruments).

235. U.C.C. § 9-308 (1978); U.C.C. § 9-330 (2000).

lar to that given to the buyer in the ordinary course,[236] because both contemplated the availability of new value.[237]

On the other hand, Article Three, which in the abstract might seem more likely to be friendly toward the holder in due course since that Article is the home of the Code concept,[238] is at first glance actually less friendly.[239] This difference is due to the very different logic of Article Three.

The very powerful concept of holder in due course is designed to favor the free exchange of commercial paper. Consider the above hypothetical again. Second State Bank is given the extraordinary status of holder in due course because it is the stated policy of Article Three to make the paper created by the makers and drawers of that paper flow freely in commerce,[240] in effect increasing their credit opportunities at the risk of cutting off some of their defenses and claims.[241] In addition, the truly distant and disinterested financier such as Second State Bank can confidently cut off ownership claims by those who may have financed the business and taken an interest in the paper.[242] Those in the position of First National Bank, competitors whose "claims" are in the nature of security interests, must lose if they had neither possession nor gave direct notice of its claim. To do this, Article Three wraps up title with possession for a stronger admixture than the simple security interest or lien.[243] It is the holder in due course who not only gives new value, but takes possession, thereby defeating all other claimants.[244]

This powerful mixture of historical policy, historical practice, and commercial reason had limits. First, there were the real defenses. Instances in which the makers and drawers (customers) might be defrauded in the most egregious circumstances were allowed some defenses, which are referred to as real defenses.[245] When a real defense exists the holder's needs are far less appealing. The commercial issue is why protect a holder who was not distant and disinterested,[246] or even was aware that the cheating was occurring.[247]

236. U.C.C. § 9-307 (1978); U.C.C. § 9-320 (2000).
237. U.C.C. § 9-320 (2000) (purchaser who gives new value); *Id.* § 1-201(9) (2000) (buyer in ordinary course). To be a buyer in the ordinary course requires new value and the taking of possession. This is because to be a "buyer in the ordinary course" one must be a buyer and to buy one must buy for "cash" or other new value and may not buy "in bulk" or for satisfaction of a preexisting debt. *Id.*.
238. U.C.C. § 3-302 (2002).
239. *See id.*
240. *See* U.C.C. § 3-302 cmt. 4 (2002).
241. *See id.* §§ 3-305, -306 (2002).
242. *See id.* § 3-305.
243. *Id.* § 3-302 cmt. 4 (2002).
244. *Id.* § 3-305.
245. *Id.* § 3-305 cmt. 1.
246. *Id.* § 3-305 cmt. 3.

These are very different issues from priority concerns of Article Nine and should be cared for within Article Three. Holders in due course are protected because of their special qualities. If these special qualities are not present, their status reverts to the status of a mere transferee subject to claims, defenses, and claims in recoupment, as would be any other transferee of a contract right. With insulation stripped away, the holder in due course is simply a transferee who takes all of the inherent risks of the transaction. The negotiable instrument[248] might as well have been a simple contract or account receivable if the transferee is not a holder in due course.[249]

### E. The Cases Struggle to Integrate Holders with Secured Parties

It is helpful to examine a group of cases to see how the unitary concept of holder in due course status by the 2000 Revision was bifurcated. In these opinions, the courts struggled with the nature of notice and knowledge, especially in the context of notice of a competitor's security interest and how that affected holder in due course status to negotiable instruments. Almost all of these cases involve the second and related issue of the relative priority given to the parties in Article Nine where the holder in due course may have known or had actual notice of the competitor's security interest.

These cases are divided into two groups. In the first group are cases in which the critical decision is made with reference to Article Three and the general concepts of holder in due course, that the transferee takes in good faith and without notice of the defenses and claims. In this group there are no significant concerns for the Article Nine priority scheme.[250] The second group is the smaller, but very powerful set of cases in which the courts attempt to deal not only with the holder in due course concept and issues of notice, but also with the Article Nine priority rules.[251]

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247. *Id.*

248. *See id.* § 3-104 (2002).

249. *See* U.C.C. § 9-102(2) (2000); U.C.C. §§ 9-403, -404 (2000) (discussing rights and duties of account receivable transferees).

250. "Significant," as it is used here, means that there must be more than just passing references to the 1972 Code sections 9-308 and 9-309, which set out the secured transaction priorities.

251. Allstate Fin. Corp. v. Financorp, Inc., 934 F.2d 55 (4th Cir. 1991); McCook County Nat'l Bank v. Compton, 558 F.2d 871 (8th Cir. 1977); Fin. Mgmt. Servs., Inc. v. Familian Corp., 905 P.2d 506 (Ariz. Ct. App. 1995); N. Cent. Kansas Prod. Credit Ass'n. v. Boese, 19 UCC Rep. Serv. 179 (D. Kan. 1976); Farns Assocs. Inc. v. S. Side Bank, 417 N.E.2d 818 (Ill. App. Ct. 1989); Bowles v. City Nat'l Bank & Trust Co., 537 P.2d 1219 (Okla. Ct. App. 1975); Dallas Bank & Trust Co. v. Frigiking, Inc., 692 S.W.2d 163 (Tex. App. 1985).

The Fourth Circuit case of *Allstate Financial Corp. v. Financorp, Inc.*[252] is representative of the first group of cases. In this case Kane, the debtor, received a loan from Allstate and in return gave Allstate a security interest in and right to purchase proceeds of Kane's delivery business.[253] Later, Financorp loaned money to Kane and took an assignment of a specific account receivable. Laidlaw, the account debtor, made periodic payments to Kane and some of those checks were endorsed to Financorp.[254] All the evidence at trial showed that Financorp had no knowledge, either actual or constructive,[255] of Allstate's interest. Allstate argued that the filing alone was notice of its claim. This was quickly rejected.[256] The court rightly determined that nothing in Article Three precludes a junior lien holder from also being a holder in due course.[257] The court concluded that Article Nine's priority rules were not controlling given the holder's status as a holder in due course.[258] The court reasoned that the plain language of Article Nine is to give priority to a junior lien holder if he or she is a holder in due course under Article Three.[259]

The Eighth Circuit reached the same result in the *McCook County National Bank v. Compton.*[260] Without even mentioning section 9-309, the court determined that the bank that "cashed" the check claimed the check as a genuine holder in due course.[261] Even knowledge of the senior secured party's perfection did not give the holder bank notice of the defense or notice of the senior's claim to the check.[262] The senior's filing alone was not enough.[263]

To a similar effect was *Farns Associates, Inc. v. Southside Bank,*[264] where the court held that the secured party had a superior interest in check proceeds of accounts receivable, but did so on the limited ground

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252. Allstate Fin. Corp. v. Financorp, Inc., 934 F.2d 55 (4th Cir. 1991).
253. *Id.* 934 F.2d at 57.
254. *Id.* at 57.
255. *Id.* at 58-59.
256. *Id.* at 59.
257. *Id.*
258. *Id.* at 61.
259. *Id.*
260. McCook County Nat'l Bank v. Compton, 558 F.2d 871 (8th Cir. 1977).
261. *Id.* at 876.
262. *Id.*
263. *Id.* at 876-77. This is similar to the holding in *North Central Kansas Production Credit Association v. Boese*, 19 U.C.C. Rep. Serv. (CBC) 179 (D. Kan. 1976). There the court noted that the hotel cashing the PCA check was more knowledgeable than the typical holder, but still a holder. *Id.* The court followed what appears to be the minority rule of pure subjective knowledge rather than the excitement-to-inquiry rule of a reasonable person. *Id.* at 184. The court saw no basis for an inquiry by the PCA where even the existence of a security interest was speculative. *Id.* at 184-85 (filing alone was not sufficient.)
264. Farns Associates, Inc. v. S. Side Bank, 417 N.E.2d 818, 823-24 (Ill. App. Ct. 1981).

that the bank failed its test of holder in due course as there was not a proper endorsement by the debtor. Accordingly, it was not knowledge or notice that destroyed the special status, but rather a simple failure in the steps needed for proper negotiation that left the secured party with priority as to the identifiable proceeds and left the holder in due course in the position of a mere contractual claimant.[265]

One of only two cases cited in the comments to new section 9-331 is *Financial Management Services, Inc. v. Familian, Corp.*[266] In this case, FMSI financed a group of customers of a supplier known as Stapley Wholesale.[267] Using a series of promissory notes and security agreements, FMSI provided financing to a plumbing business, Pima Plumbing Contractors (Pima).[268] Stapley gave a guarantee of full payment on the accounts that Pima used as collateral. This allowed Stapley's account customers to buy from Pima on credit. FMSI became the financier with Pima taking up the promise of the individual customers through their guarantee of payment.[269] FMSI filed its financing statement in 1986.[270] In 1988, Pima entered into another financing arrangement with Familian, who sold Pima materials and supplies and also took a security interest in its accounts receivable.[271] After learning of a large payment to FMSI in August 1989, Familian negotiated with Pima an arrangement in which the debt to Familian would be reduced over time.[272] They jointly notified the accounts debtors to make all further payments as joint payee checks to Familian and Pima together. Between September 25th and November 30th, 1989, payments totaling a little over $1.1 million were received. The debt was reduced by some $300,000 and about $800,000 was remitted to Pima.[273] In the meantime, on September 20th, a copy of FMSI's filing statement showed up in a search report.[274] When FMSI learned of the joint payment arrangement, it first requested that Stapley repurchase the Pima accounts involved in the joint payment checks.[275] Stapley was not able to do so.[276] Its financial condition continued to worsen during this time, although it was not evident to the two outside parties.[277] FMSI then sued Familian, claiming the superior right to the approximately $350,000 received in joint

265. *Id.* at 823-24.
266. Fin. Mgmt. Services, Inc. v. Familian Corp., 905 P.2d 506 (Ariz. App. Ct. 1995).
267. *Id.* at 508.
268. *Id.*
269. *Id.*
270. *Id.*
271. *Id.*
272. *Familian*, 905 P.2d at 509.
273. *Id.*
274. *Id.*
275. *Id.*
276. *Id.*
277. *Id.*

checks.[278] Familian defended claiming holder in due course status in the checks.

The Arizona Court of Appeals reversed the trial court and found Familian to be a holder in due course.[279] The court applied a subjective good faith test and found no dishonesty or bad faith in Familian's knowledge of FMSI's security interest and the surrounding circumstances.[280] Familian was not aware that Pima was in trouble financially,[281] only that it had been slow to pay. This was an observation that could have been made about most of Pima's industry at the time.[282] In an interesting collapse of the notice of claim question into that of good faith,[283] the court applied the actual knowledge test for defense or claim with the addition of the duty to inquire upon knowledge of facts that would cause a reasonable person to inquire into the defense or claim.[284]

The court's decision that knowledge of the senior secured party's claim was not present has found its way into permanent Editorial Board Commentary Number 7.[285] In fact, the court seemed to say that without knowledge of a "violation" of the security agreement by Pima or knowledge of the default on the FMSI security agreement by Pima, Familian knew of no claim by FMSI.[286] Knowledge of the prior security agreement did not, alone, give Familian reason to inquire further about violations that might lead to FMSI being more of a claimant.[287]

The Drafters of the revised section 9-331 which replaced section 9-309, did not disapprove of *Familian*.[288] The Drafters cryptically observed,

> Whether the junior secured party qualifies as a holder in due course is fact-sensitive and should be decided on a case-by-case basis in the light of those circumstances. Decisions such as *Financial Management Services, Inc. v.*

278. *Familian,* 905 P.2d at 509.
279. *Familian,* 905 P.2d at 514.
280. *Id.* at 511-12.
281. *Id.* at 513.
282. *Id.* at 508-09
283. *Id.* at 511-512.
284. *Id.* at 512.
285. *Permanent Editorial Board Commentary on the Uniform Commercial Code, Commentary No. 7, in* 3B UNIFORM LAWS ANNOTATED 626 (March 10, 1990); *see also Familian,* 905 P.2d at 512. The *Familian* court stated as a flat rule, knowledge of existence of a senior lienholder is inadequate. *Id.* Add to this two further cases with similar holdings. Bowles v. City Nat'l Bank & Trust Co., 537 P.2d 1219, 1222 (Okla. Ct. App. 1975); Dallas Bank & Trust. Co. v. Frigiking, Inc., 692 S.W.2d 163, 166-67 (Tex. Ct. App. 1985).
286. *Familian,* 905 P.2d at 513.
287. *Id.*
288. U.C.C. § 9-331 cmt. 5 (2000).

> *Familian* could be determined differently under this application of the good-faith requirement. (citation omitted)[289]

The other case cited in the comments to section 9-331 is *In re Joe Morgan, Inc.*[290] In this case, Sunburst Bank had a perfected security interest in the accounts of Joe Morgan, Incorporated (hereinafter "JMI").[291] To secure its revolving credit line Sunburst filed a security interest covering equipment, general intangibles, and accounts receivables.[292] Although the loan was made in October 1988, the filing to perfect was not made until March 15, 1989.[293] Because of poor performance the loan was quickly downgraded, Sunburst informed JMI that no new credit would be extended and that JMI should find other financing.[294] JMI found Utility Contractors Financial Services (hereinafter "UCON"), a newly formed Nevada corporation created to purchase accounts receivable from telephone utility contractors.[295] UCON agreed to purchase JMI's accounts receivable at a five percent discount from the face value and began the factoring in March or April of 1989.[296] Although Sunburst's financing statement was on record, the principal investor of UCON, who was new to factoring and did not know about searching Article Nine filings, was without direct knowledge of Sunburst's interest.[297] On July 17th, 1989, there was a chance meeting between the agents of Sunburst and the principal of UCON.[298] Some misunderstandings and vague understandings led to an agreement that UCON would continue to factor through August 1989.[299] JMI used the UCON funds to meet payroll and its then current expenses, but it was known to both of the financiers that additional receivables would be needed to cover the loans to UCON and Sunburst.[300] Approximately $2.5 million in accounts had been factored by UCON and almost $850,000 of that amount came after its direct knowledge of Sunburst's interest.[301] The bankruptcy court found that the earlier $1.65 million was not in controversy, as UCON was indisputably a holder in due course until the July 17th meet-

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289. *Id.* § 9-331 (2000).
290. *In re* Joe Morgan, Inc., 985 F.2d 1554 (11th Cir. 1993) was a decision in an adversary proceeding in the larger *Joe Morgan* bankruptcy case.
291. *In re Joe Morgan, Inc.*, 985 F.2d at 1555-56.
292. *Id.*
293. *Id.* at 1555-56.
294. *Id.* at 1556.
295. *Id.*
296. *Id.* at 1556.
297. *Id.*
298. *Id.*
299. *Id.* at 1557.
300. *Id.*
301. *Id.*

ing.[302] As to the later $850,000 the court considered two issues: (1) whether UCON was a holder in due course and (2) whether estoppel might prevent Sunburst's assertion of an interest.[303]

Stepping through the requirements of section 3-302 for holder in due course status,[304] the court quickly got to the crux of the issue at hand, whether the holder in due course took in good faith and without notice.[305] First, it is important to note that the Eleventh Circuit court observed that Alabama courts were not in the majority,[306] at least not at that time.[307] The Alabama courts applied a compound test of good faith.[308] To be in good faith, the holder must be both honest-in-fact and *not* possessed of such knowledge or facts as to amount to a lack of good faith. Some have called this "objective" bad faith burying one's head in the sand or "turning a blind eye."[309] The issue is not, however, one of notice alone.[310] That requirement is separate in the section 3-302 requirement of lack of notice. Instead, the requirement is one of "fair dealing."[311] With the revised definition of good faith in

302. *In re* Joe Morgan, Inc., 985 F.2d 1554, 1557 (11th Cir. 1993). Note that the public filing alone was insufficient to destroy the good faith of UCON or to give it notice of Sunburst's claim.
303. *Id.* at 1558.
304. Of little relevance here, but of great interest on policy argument grounds to be discussed below, is the finding of value. The court determined that UCON had given value for the checks by acquiring them by negotiation from the individual account debtors. *Id.* at 1559-60. Each holder must have value in his or her own right. U.C.C. § 3-303 (2000). Here, JMI clearly was owed the money for services rendered. This created the account. Next, the check was taken in payment of this antecedent debt. The issue though is whether UCON acquired the assignment as a chance at recovery on an account that remained the property of JMI, or whether UCON acquired an assignment of the property interest of JMI. *In re Joe Morgan, Inc.*, 985 F.2d at 1559-60. The Court determined the latter was closer to reality. *Id.* UCON "purchased" the antecedent claim of JMI then took checks in exchange for that claim owed by individual account debtors. *Id.* Although the reasoning could have been clearer, UCON gave value. *Id.* The value given was the loan amounts owed by JMI which were paid by negotiating the checks 95 cents on the dollar. *Id* at 1559. This is significant for two reasons. First, it tracks the policy of Article Three that the holder in due course be a contributor of value, not necessarily new value, but more than consideration, a genuine value so that the extraordinary status of holder in due course is justified by value added to the commercial world. U.C.C. § 3-303 cmt. 1 (2000). Second, by this standard the new value was a validation of purchaser exaltation of the higher priority status of buyer and purchaser found in Article Nine. *See id.* §§ 9-320, 9-330. These Article Nine rules are predicated on the higher economic good created by value added to the debtor's enterprise, which will likely increase the chance of repayment to the secured party whose proceeds interests is lost. *See id; see also infra* notes 317-19.
305. *In re* Joe Morgan, Inc., 985 F.2d 1554, 1560-61 (11th Cir. 1993).
306. *Id.* at 1560.
307. *Id.*
308. *Id.*
309. *Id.* at 1561-62; *see also* U.C.C. § 9-331 cmt. 5 (2000).
310. *See* cases cited *supra* note 282 and accompanying text.
311. 2 WHITE & SUMMERS, UNIFORM COMMERCIAL CODE 166-70 (4th ed. 1995).

section 3-103(a)(7), the Alabama minority rule has now become the statutory rule. To the extent that observation of reasonable commercial standards covers the same ground as an objective judgment about fair dealing, the tests have become one and the same. Section 3-103(a)(7) is probably even broader and deeper though. It appears to require more than willful blindness or choosing to ignore some concern. Instead, it appears to go further by requiring actual observance of reasonable standards of behavior in making an inquiry if an issue arises even though there is not actual knowledge.[312]

Because of this evolution in the law of good faith under Article Three, the use of the *JMI* case in the comments to section 9-331 with something akin to approval makes sense.[313] The Comment focuses almost exclusively on the role of good faith in the relationship of the junior creditor to the senior creditor's pre-existing filed financing statement.[314] Moreover, the *JMI* court noted that with an objective test of good faith "the good faith and notice elements of the holder in due course test will frequently merge."[315] While there is a vanishing point where overlap obscures the differences between the two, they are indeed different and the new comments to section 9-331 exacerbate the problem of differentiating them.

> Likewise, a junior secured party who collects accounts when it knows or should know under the particular circumstances that doing so would violate the rights of a senior secured party, because the debtor had agreed not to grant a junior security interest in, or sell, the accounts, may not meet the good-faith test. Thus, if a junior secured party conducted or should have conducted search and a financing statement filed on behalf of the senior secured party states such a restriction, the junior's collection would not meet the good-faith standard. On the other hand, if there was a course of performance between the senior secured party and the debtor which placed no such restrictions on the debtor and allowed the debtor to collect and use the proceeds without any restrictions, the junior secured party may then satisfy the requirements for being a holder in due course.[316]

Frankly this is not particularly helpful. The issue is fair dealing. Any notice given a junior secured party by the mere presence of a senior financing statement is simply that he or she is junior. How likely is it that the financing statement, which is required only to contain three items, the name of secured party, the name of the debtor and a description of the collateral, is going to specify something as elaborate as the circumstances for sale of the account proceeds? What the comments seem to suggest is that every secured party would be benefited

312. *Id.* at 170-77.
313. U.C.C. § 9-331 cmt. 5 (2000).
314. *Id.* §§ 9-102(43) and 3-103(4) (2000) are in agreement that good faith is now objective in the relevant settings of secured transactions (Article Nine) and commercial paper (Article Three).
315. *Morgan*, 985 F.2d at 1562.
316. U.C.C. § 9-331 cmt. 5 (2000).

by adding such a technical phrase to the financing statement to assure that later junior secured parties cannot become holders in due course. And if it was the intent of the Drafters to encourage this practice, why should Article Nine suggest and foster this preemptive strike through the financing statement? It seems out of line with other basic principles of Article Nine, including the buyer in the ordinary course test of section 9-320. In that section, the buyer must be aware of a violation of the secured party's financing rights and that requirement dovetails nicely with the authorized disposition of inventory mentioned in section 9-315(a)(1):

> [Disposition of collateral: continuation of security interest or agricultural lien; proceeds.] Except as otherwise provided in this article and in section 2-403(2): (1) a security interest or agricultural lien continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest or agricultural lien . . . .[317]

The comments add:

> For example, the general rule does not apply, and a security interest does not continue in collateral, if the secured party authorized disposition, in the agreement that contains the security agreement or otherwise . . . likewise, the general rule that a security interest survives disposition does not apply if the secured party entrusts goods collateral to a merchant who deals in goods of that kind and the merchant sells the collateral to a buyer in the ordinary course of business.[318]

In other words, when the prior lien creditor "purchases," he or she gives value sufficient to become a holder in due course, which used to be treated as the equivalent of a new value purchaser in the buyer in the ordinary course situation.[319] Only the circumstance stated in the second part of the comment offer insight into the original, but rapidly disappearing commercial logic:

> Generally, the senior secured party would not be prejudiced because the practical effect of such payment to the junior secured party is little different than if the debtor itself had made collections and subsequently paid the secured party from the debtor's general funds. Absent collusion, the junior secured party would take the funds free of the senior security interests. In contrast, the senior secured party is likely to be prejudiced if the debtor is going out of business and the junior secured party collects the accounts by notifying the account debtors to make payments directly to the junior. Those collections may not be consistent with "reasonable commercial standards for fair dealing.[320]

This is truly bad faith. Where collusion or intentional disadvantaging are present the party should not be given a superior right.[321]

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317. *Id.* § 9-315(a)(1) (2000).
318. *Id.* 9-315 cmt. 2.
319. Buyers in the ordinary course are the clear models for the purchasers found in the former Article Nine provisions. *See* U.C.C. §§ 9-308, -309 (1978).
320. U.C.C. § 9-331, cmt. 5 (2000) (citation omitted).
321. *Id.*

The problem with the fifth Comment to section 9-331 is that it waffles. First, it waffles between the efficacy of knowledge based on a search,[322] then it waffles on the requirement of knowledge of "prejudice" to the senior secured creditor.[323] Second, and even worse, the Comment encourages courts to waffle between extreme and discordant positions. The section states the classic, and what had been clear, rule: notice by filing "does not constitute notice of a claim or defense."[324] The Comment, without referencing this distinction, collapses the "notice" discussion into considerations of "good faith." Again, this is suggested by the recent change to the objective test of good faith now included within the new provision.[325] Yet, it does a disservice to those courts attempting to sort out the effect of actual knowledge of a predecessor security interest. Is simple notice destructive or must it be coupled with something more? The former statement of the rule is classic holder in due course doctrine. Notice that simple knowledge of an adverse claim was enough. Actual knowledge or notice in a number of ways.

On the other hand, a filing alone would not do any damage because it was not direct knowledge of the filing and not deemed to be knowledge of the secured party's interest, unless it was also known by the junior secured party. It was actual knowledge of the filing, that is direct knowledge, that did the damage in the classic formulation.[326]

322. The Comment reads:

> Consider, for example, a junior secured party in the business of financing or buying accounts who fails to undertake a search to determine the existence of prior security interests. Because a search, under the usages of trade of that business, would enable it to know or learn upon reasonable inquiry that collecting the accounts violated the rights of a senior secured party, the junior may fail to meet the good-faith standard.

*Id.* § 9-331, cmt. 5.

323. The Comment states:

> On the other hand, if there was a course of performance between the senior secured party and the debtor which placed no such restrictions on the debtor and allowed the debtor to collect and use the proceeds without any restrictions, the junior secured party may then satisfy the requirements for being a holder in due course. This would be more likely in those circumstances where the junior secured party was providing additional financing to the debtor on an on-going basis by lending against or buying the accounts and had no notice of any restrictions against doing so. Generally, the senior secured party would not be prejudiced because the practical effect of such payment to the junior secured party is little different than if the debtor itself had made the collections and subsequently paid the secured party from the debtor's general funds.

*Id.* § 9-331, cmt. 5.

324. *Id.* § 9-331(c); *see also* U.C.C. § 9-309 (1978).

325. U.C.C. § 9-102(c) (2000) (referencing Article One for general definitions). Section 1-201(20) (2000) is both objective and subjective. In addition, negotiable instruments have the same double layer definition as referenced in the rule. *See id.* § 3-103(d) (2000).

326. *See supra* notes 302-14 and accompanying text.

The Comment launches into good faith and fails to establish the important point that even direct knowledge of a filing should be inadequate when moved from holder in due course doctrine to Article Nine doctrine. That is, instead of becoming more limiting in Article Nine, conflicting notice and knowledge should have even less impact. This was the former provision section 9-308.[327] Even though largely car-

327. The language of U.C.C. sections 9-308, 9-309 (1978) is as follows:

§ 9-308. Purchase of Chattel Paper and Instruments

A purchaser of chattel paper or an instrument who gives new value and takes possession of it in the ordinary course of his business has priority over a security interest in the chattel paper or instrument

(a) which is perfected under Section 9-304 (permissive filing and temporary perfection) or under Section 9-306 (perfection as to proceeds) if he acts without knowledge that the specific paper or instrument is subject to a security interest; or

(b) which is claimed merely as proceeds of inventory subject to a security interest (Section 9-306) even though he knows that the specific paper or instrument is subject to the security interest.

Official Comment

2. Although perfection by filing is permitted as to chattel paper, certain purchasers of chattel paper allowed to remain in the debtor's possession take free of the security interest despite the filing.

Clause (b) of the section deals with the case where the security interest in the chattel paper is claimed merely as proceeds — i.e., on behalf of an inventory financier who has not by some new transaction with the debtor acquired a specific interest in the chattel paper. In that case a purchaser, even though he knows of the inventory financier's proceeds interest, takes priority provided he gives new value and takes possession of the paper in the ordinary course of his business.

The same basic rule applies in favor of a purchaser of other instruments who claims priority against a proceeds interest therein of which he has knowledge. Thus a purchaser of a negotiable instrument might prevail under clause (b) even though his knowledge of the conflicting proceeds claim precluded his having holder in due course status under Section 9-309.

§ 9-309. Protection of Purchasers of Instruments, Documents and Securities

Nothing in this Article limits the rights of a holder in due course of a negotiable instrument (Section 3-302) or a holder to whom a negotiable document of title has been duly negotiated (Section 7-501) or a bona fide purchaser of a security (Section 8-302) and the holders or purchasers take priority over an earlier security interest even though perfected. Filing under this Article does not constitute notice of the security interest to such holders or purchasers.

Official Comment

Prior Uniform Statutory Provision: Section 9(a), Uniform Trust Receipts Act.

Purposes:

1. Under this Article as at common law and under prior statutes the rights of purchasers of negotiable paper, including negotiable documents of title and investment securities, are determined by the rules of holding in due course and the like which are applicable to the type of paper concerned. (Articles 3, 7, and 8.) This section, as did Section 9(a) of the Uniform Trust Receipts Act, makes explicit the rule which was implicitly but universally recognized under the earlier statutes.

ried forward in the revised section 9-331 the new version seems blunted or even lost in the new commentary.[328]

Since the senior secured party would almost always be asserting a proceeds interest, only direct knowledge of the interest, for instance by stamping the paper with a notice of the property claim, would have destroyed the protection of a purchaser under the former section 9-308. In this way, section 9-308 clearly offered even broader protection than was found in the section 9-309 adoption of the holder in due course doctrine. Why? The new value analogy to buyers in the ordi-

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2. Under section 9-304(1) filing is ineffective to perfect a security interest in instruments (including securities) except those instruments which are part of chattel paper, and of course is ineffective to constitute notice to subsequent purchasers. Although filing is permissible as a method of perfection for a security interest in documents, this section follows the policy of the Uniform Trust Receipts Act in providing that the filing does not constitute notice to purchasers.

328. The language of U.C.C. section 9-331 (2000) is as follows:

9-331. Priority of Rights of Purchasers of Instruments, Documents, and Securities Under Other Articles; Priority of Interests in Financial Assets and Security Entitlements Under Article 8.

(a) [Rights under Articles 3, 7, and 8 not limited.] This article does not limit the rights of a holder in due course of a negotiable instrument, a holder to which a negotiable document of title has been duly negotiated, or a protected purchaser of a security. These holders or purchasers take priority over an earlier security interest, even if perfected, to the extent provided in Articles 3, 7, and 8.

(b) [Protection under Article 8.] This article does not limit the rights of or impose liability on a person to the extent that the person is protected against the assertion of a claim under Article 8.

(c) [Filing not notice.] Filing under this article does not constitute notice of a claim or defense to the holders, or purchasers, or persons described in subsections (a) and (b).

Official Comment

1. Source. Former Section 9-309.

2. "Priority." In some provisions, this Article distinguishes between claimants that take collateral free of a security interest (in the sense that the security interest no longer encumbers the collateral) and those that take an interest in the collateral that is senior to a surviving security interest. See, e.g., Section 9-317. Whether a holder or purchaser referred to in this section takes free or is senior to a security interest depends on whether the purchaser is a buyer of the collateral or takes a security interest in it. The term "priority" is meant to encompass both scenarios, as it does in Section 9-330.

3. Rights Acquired by Purchasers. The rights to which this section refers are set forth in sections 3-305 and 3-306 (holder in due course), 7-502 (holder to whom a negotiable document of title has been duly negotiated), and 8-303 (protected purchaser). The holders and purchasers referred to in this section do not always take priority over a security interest. *See, e.g.,* Section 7-503 (affording paramount rights to certain owners and secured parties as against holder to whom a negotiable document of title has been duly negotiated). Accordingly, this section adds the clause, "to the extent provided in Articles 3, 7, and 8" to former section 9-309.

(Comments 4 and 5 not included).

nary course and purchase money security interests is obvious.[329] A purchaser and, *a fortiori*, the special party known as a holder in due course will be one who takes the instruments for new value, which could be pursued as proceeds in lieu of the paper proceeds he or she took out of the debtor's enterprise.[330] So, there is cash available to ameliorate the loss the senior secured party faced.

This then explains the other direction of the Comment's waffle. The Comment is replete with references to "unfair" practices by the junior secured party and these references amount to collusion to withdraw funds from the debtor's failing enterprise.[331] Even here, the limp conclusion is that it "may not be consistent with 'reasonable commercial standards of fair dealing.'"[332] As a limiting concept on the holder in due course doctrine, this substantial unfairness, collusion, or bad faith inquiry is more than that necessary to terminate the status of holder in due course carried here by Article Three doctrines. So this is an unhelpful, even obfuscating, discussion of the collapsed good faith and notice elements which only serves to induce courts to think somehow that mere knowledge of a security interest might be both destructive of both holder in due course status and the requirement of good faith for the purchaser to be similar to a buyer in the ordinary course of business.

To make a case that the ordinary behavior of a junior secured creditor who tries to take paper and become a holder in due course might cross the line of bad faith, suggests to courts that it is, alone, knowledge of the senior's claim, rather than the collusive behavior, that is sanctioned. Simple knowledge, without collusion or an intent to double-deal, should not flow back to destroy holder in due course status in the competitive situation of multiple financiers.[333] Any contrary conclusion seems unsound. The Comments to section 9-331 would be a better fit in the section 9-330 discussion of subsection (d) of that section. This general priority rule, which favors purchasers, is the broad policy of Article Nine. In this, it is better suited to the broader coverage of section 9-330.

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329. For buyer in the ordinary course under the former code, see U.C.C. § 9-307(1) (1972), and under the current code section see U.C.C. § 9-320 (2000). For a definition of buyer in the ordinary course that remains largely unchanged, see U.C.C. § 1-201(9) (2000).

330. U.C.C. § 9-308 (1978).

331. U.C.C. § 9-331 cmt. 5 (2000).

332. *Id.*

333. *In re* Halmar Distrib., Inc., 116 B.R. 328, 335 (Bankr. D. Mass. 1990). A bit stronger is the knowledge of the security interest, and the bank did not honor payment to the senior secured party even though the bank itself did not offset the loan in the proceeds check. *See* Case Credit Corp. v. Portales Nat'l Bank, 966 P.2d 1172 (N.M. 1998).

Because of the peculiar history and mixed policy of Article Three's holder in due course doctrine, that holder protection will be less useful to most junior secured parties than will the purchaser protection ideas introduced and fostered by the Article Nine based rules. One needs to be more resistant of crushing the holder in due course status in the competitive scenarios of Article Nine than one would be in Article Three defense, claim, and counter claim situations. It is not the maker seeking relief under Article Three against a distant and powerful commercial entity attempting to insulate itself from some cheat in the original making of the note. Rather, it is two sophisticated and relatively equal players in the commercial world vying for priority to an asset which one or the other will take. In this setting, it is the junior creditor who is adding value to the enterprise and who in doing so takes possession of the paper against another secured party who has only a proceeds interest or bulk exchange. This other secured party can pursue the value, the proceeds introduced into the enterprise by the junior creditor, rather than the paper itself. The Code ought to be more free in releasing the claim of that senior secured party and in finding good faith in the junior where new value or at least additional value substitutes for the proceeds.[334]

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334. The following is a suggestion for a comment to § 9-331 that better integrates the policies of Articles 3 and 9:
This section, is intended to clarify and add to the priority rules of § 9-330. That section states it is subject to the rule in (a). Subsection (a) is intended to make it clear that nothing in Article Nine should be seen as limiting the rights of a Holder in Due Course of negotiable instruments, negotiable documents of title and certain securities. While § 9-330 sets forth the rules of priority between secured parties who do not take possession and those who as purchasers do take possession, that section adds to that priority scheme by ensuring that neither group will have a greater claim than a Holder in Due Course. In some cases the holder may be both a holder and a junior secured party. As either, if this person qualifies as both a purchaser and a holder, which ever is the broader protection should be the rule. While it may seem complex, the intent is to simplify and this should be the guiding principle in applying these interlocking sections. Even though different case law and approaches have led to these complementary principles of holding and purchasing the intent is to simplify concepts such as "notice of a defense or claim" and one clear rule is that notice of a filing is not sufficient. Similarly actual knowledge of the senior secured party as prior in time will not in most cases affect holder or purchaser status so that the junior creditor may qualify for protection under both § 9-330 and this section. However, should the junior creditor's knowledge include information that would demonstrate commercial unfairness, collusion, intentional advantage taking or similar bad faith. (Good Faith is defined in § 9-102(43). There can be no holder in due course status where there is no good faith purchaser. If we accept as effective the idea that a junior creditor can be a good faith purchaser or Holder in Due Course we must at a minimum accept that what constitutes notice of claims and bad faith is fact specific and dependent on the nature of the financial setting as well as the knowledge of virtually every purchaser and holder that a senior secured party is likely to exist. The purchaser or holder should be free to acquire the paper because of the value added to the debtor's enterprise. This is similar to the § 9-320 concepts

## IV. SUMMARY OF NEGOTIABLE INSTRUMENTS

While the unsettled nature of the case law under the former sections 9-308 and 9-309 justified clarification, the new sections lack Code logic. What had been a unified logic of complementary provisions giving the greatest possible, synergistic protection to the holder or purchaser, has become much less forceful. The new rule of section 9-330(d) downplays the role of new value, but also comes frighteningly close to making the issue turn on whether the purchaser is a holder in due course. This seems too high a price to pay for the new and weakly supported rule of perfection by filing. Despite the language of violation, which continues the gist of section 9-309, the new Comment to section 9-330[335] destroys this by allowing actual knowledge of the financing statement to destroy the good faith requirement of purchaser. Now, section 9-330 does not complement and expand section 9-331,[336] instead it restricts section 9-331 by allowing both to be defeated by the same knowledge of an interest asserted by the senior with no apparent showing of violation of the security interest by the junior. By doing so, the sections cut-back on both holder in due course[337] and on value added purchasers.[338] Both lost the special status of priority against a

of buyers in the ordinary course and the § 9-315 authorized disposition principle. The senior secured party is left with proceeds to pursue either through fresh value or by the loosening of debt and the making of other assets available to the debtor, the inherent function of a holder or purchaser for value. Here the connection to §9-332 and transfers of money should also be noted as reinforcing this complementary priority scheme.

In an interesting irony, U.C.C. § 9-330(e) (2000) provides: "(e) [Holder of purchase-money security interest gives new value.] For purposes of subsections (a) and (b), the holder of a purchase-money security interest in inventory gives new value for chattel paper constituting proceeds of the inventory."

This appears to be a novel expression. The provision, which was intended to replace some of the ideas contained in the former 9-108 (1978), adds this innovative gloss to the 9-103 definitions. It makes the point that "new value" can be found in credit expansion.

335. U.C.C. § 9-330 cmt. 7 (2000) (discussing instruments and incorporating the test of "knowledge" from having seen a statement in the financing statement of Comment 6).

336. Former U.C.C. § 9-308 (1978) complemented and actually sharpened the tools available to the holder under U.C.C. § 9-309 (1978).

337. The holder in due course protection is substantially narrowed by the loss of the former provision, U.C.C. § 9-309 (1978) with its uncomplicated statement that nothing in Article Nine was intended to interfere with the protections of Article Three in the context of purchasers and holders.

338. *Compare* U.C.C. § 9-308 (1978) ("new value"), *with* the current U.C.C. § 9-330 (2000) ("value"). This actually works to restrict the protection offered by § 9-330 because while the new section increases the number of those who might qualify and tracks the doctrine of "value" found in Article 3, it does so while lessening dramatically the protections offered this broader class. Section 9-308 was much friendlier to the purchaser competing with a mere proceeds secured party.

secured party with an interest in the paper which interest is merely the proceeds of the actual collateral.

What this accomplishes, aside from securing the position of the financier who is first to file with regard to accounts, chattel paper, and negotiable instruments is unclear. The rule now gives greater protection to the senior secured party in accounts receivable, chattel paper and negotiable instruments than is given to the senior secured creditor in inventory.[339] The purchase money security interest can break the inventory lender's monopoly with simple notice and a filing by the purchase money party.[340] Yet, the senior paper lender can tie up the assets by making a specific statement of direct interest and non-release in its filed financing statement, which if seen or known to the junior secured creditor will destroy "good faith."[341] It is particularly ironic that the new provisions work this change to make negotiable instruments less "negotiable" than the inventory that is so often sold to generate the instrument. This is a tremendous price to pay for this small and greedy change of allowing a filed financing statement to cover negotiable instruments. All done for the apparent purpose of allowing the generic filing against "all personal property of the debtor" to defeat the trustee in bankruptcy as to negotiable instruments held in the estate. It is especially greedy given the nearly fantastic nature of any claim of genuine reliance by the "bulk financier" of negotiable instruments posited by the comment to section 9-312.[342]

## V. CONCLUSION

It may be time for federal bankruptcy judges to dust off the text of section 545 and revitalize its policy by calling these apparently consensual security interests what they are. They are not genuine consensual security interests, but rather liens, in the guise of security interests created by state law, albeit uniform state law. They are more akin to liens that are effective only in bankruptcy than they are the commercially reasonable bargained for exchange that is the central concept of Article Nine.[343] It may also be time for us, as commercial lawyers and academics, to renew the Code logic commitment of Gilmore and the earlier Drafters and to seek the higher plan of commercial reason. In the process of drafting and commenting on uniform law, it has become too easy to answer the natural, but greedy call of

339. *Compare* U.C.C. § 9-330 (2000) *with* U.C.C. § 9-324 (2000).

340. *Id.* § 9-324(b) (2000).

341. *Id.* § 9-330, cmt. 6.

342. *Id.* § 9-312, cmt. 2.

343. *Id.* § 9-109 cmt. 2. This is the same substance as the former U.C.C. § 9-102 (1978). The scope of Article Nine is "all consensual security interests in personal property and fixtures." *Id.* § 9-109 cmt. 2.

secured creditors to gather all the assets of the debtor no matter how tenuous their reliance.