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Possession and Ownership: An Examination of the Scope of Article 9

Douglas G. Baird*
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A potential creditor wants to know whether and to what extent any security interest he takes in specific property of his debtor will have priority over other claims to that property. To the extent that the creditor is uncertain about the priority of his security interest, and thus about whether he will recover his loan in full if the debtor defaults, he will require a higher interest rate from the debtor.¹ In order to reduce this uncertainty, and thereby to facilitate secured credit, the Uniform Commercial Code normally requires a creditor either to take possession of the property or to make a public filing, if he wants a security interest in his debtor's property that is effective against competing property claimants.² This requirement, coupled with a simple "first-in-time" rule, enables a creditor who wants to lend money on a secured basis to assume that, if the property in question is in the debtor's possession and if no other creditors have filed a financing statement, his claim to that property can have priority over those of other existing and future creditors. The Code assumes that this benefit outweighs the costs imposed upon secured parties by the requirement that they take possession or file.³

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1. See Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1149-50 (1979).

2. See, e.g., U.C.C. §§ 9-302(1), 9-305 (1972) [All citations to U.C.C. hereinafter cited by section number only.]

3. See, e.g., § 9-101 official comment ("The aim of this Article is to provide a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward with less cost and with greater certainty."); § 9-205 official comment (discussing benefits conferred on creditors by Article 9's filing requirements). For a development of the argument that secured creditors are the primary beneficiaries of the Article 9

But even under Article 9, the absence in the pertinent files of notice of a prior claim to the debtor's property does not eliminate the risk that someone will take priority over the secured creditor.⁴ Some of these risks are "internal" to the structure of Article 9. A secured creditor may search the files but still be unable to find the financing statement of an earlier creditor. For example, an earlier secured party may have filed in another filing system because, at the time his security interest attached, the collateral was located in another jurisdiction or the debtor lived in a different place or put the collateral to a different use.⁵ Moreover, even if an earlier secured party has filed in the same filing system, the creditor may be unable to locate the filing because the debtor has changed his name⁶ or because the filing officer registered the filing improperly.⁷

But under Article 9, a secured party can avoid at least some of these risks by taking certain precautions.⁸ In addition to checking the files, he can further protect himself by determining that the debtor has possessed the property for more than four months and has neither moved himself or the collateral nor changed his name during

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filing system, see Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53 (1983). See also Baird & Jackson, *Information, Uncertainty, and the Transfer of Property*, 13 J. LEGAL STUD. — (forthcoming 1984).

4. A number of types of risks are discussed in the text, but in addition to these, a secured party, like all other purchasers, is subject to the risk that there is a thief in its chain of title. The justifications for subjecting purchasers to this risk are explored in A. SCHWARTZ & R. SCOTT, *COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES* 476-479 (1982); Weinberg, *Sales Law, Economics, and the Negotiability of Goods*, 9 J. LEGAL STUD. 569 (1980); Baird & Jackson, *supra* note 3. For cases applying the rule, see O'Keefe v. Snyder, 83 N.J. 478, 416 A.2d 862 (1980); Menzel v. List, 24 N.Y.2d 91, 246 N.E.2d 742, 298 N.Y.S.2d 979 (1969).

5. See, e.g., § 9-103 (proper state for filing depends on debtor or collateral location); § 9-401 (proper office within state for filing depends on use of collateral); *In re Hammons*, 614 F.2d 399 (5th Cir. 1980); *In re Knapp*, 575 F.2d 341 (2d Cir. 1978); *Sequoia Mach., Inc. v. Jarrett*, 410 F.2d 1116 (9th Cir. 1969).

6. See § 9-402(7); *In re West Coast Food Sales*, 637 F.2d 707 (9th Cir. 1981); *In re Pubs, Inc. of Champaign*, 618 F.2d 432, 440-41 (7th Cir. 1980); *In re Kittyhawk Television Corp.*, 516 F.2d 24 (6th Cir. 1975); *In re Taylorville Eisner Agency*, 445 F. Supp. 665 (S.D. Ill. 1977); *In re The Grape Arbor*, 6 U.C.C. Rep. Serv. (Callaghan) 632 (Ref. E.D. Pa. 1969). Similarly, the financing statement initially may have incorrectly listed the debtor's name in a fashion that a court might deem "not seriously misleading," even though a search under the correct name might not turn up the financing statement. See, e.g., *In re Glasco, Inc.*, 642 F.2d 793 (5th Cir. 1981).

7. See § 9-403 (1) and official comment 1 (filing effective upon presentation to filing officer); *In re Royal Electroltype*, 485 F.2d 394 (3d Cir. 1973). The filing may be held valid even though the earlier secured party was partially responsible for the filing officer's error. *In re Bengston*, 3 U.C.C. Rep. Serv. (Callaghan) 283 (Ref. D. Conn. 1965).

8. In some instances, such as a transfer of collateral to the debtor that was subject to an existing security interest that survived perfected under §§ 9-306(2), 9-307(2), the risk is avoidable only at great cost.

that period.⁹ These rules are a compromise between placing the risk on an earlier secured party and placing the risk on a later secured party. If the earlier secured party bears the risk, he has an incentive to monitor the debtor after extending credit in order to ensure that subsequent creditors will have reliable and readily available information when seeking security for their loans; if the later secured party bears the risk, he has to adjust his behavior to the incompleteness of the information imparted by possession and the files. Though one could quarrel with the actual balance struck by Article 9, some sort of compromise is inevitable. Secured parties must accept both a risk that the filing system incompletely or inaccurately records earlier secured claims and a duty, after they extend credit, of imparting or updating information about their interests for the benefit of subsequent secured parties. Reducing the risk that parties face from earlier creditors requires increasing the duties that they themselves must bear. Conversely, reducing those duties requires increasing the risk of losing a property interest to an earlier creditor.

In this article, we examine a second class of risks that a secured party faces—risks that are “external” to the structure of Article 9. A secured party’s rights are sometimes junior to those of holders of non-Article 9 property interests, even though such interests are not observable from possession or from the files. Earlier holders of certain non-Article 9 interests, such as “true” lessors or bailors, hold rights superior to those of a perfected secured creditor even though they neither possess the property nor have made a proper filing.¹⁰ Similarly, subsequent parties, such as buyers, may acquire property free of the claim of a perfected secured creditor even though they do not take possession of the property, make an Article 9 filing, or notify existing secured creditors.¹¹

That we tolerate the ostensible ownership problems created by

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9. Section 9-402(7)'s four-month reperfession rule for name changes, however, applies only to after-acquired property. A security interest in property acquired by the debtor within four months after a name change will remain perfected even though a subsequent creditor will have difficulty discovering the interest from the files.

10. *See, e.g.*, § 1-201(37) (reservation of title under a “true” lease is not a security interest, and thus is not subject to Article 9's possession or filing requirement); *In re Sitken Smelting & Refining*, 639 F.2d 1213 (5th Cir. 1981); *In re Medomak Canning Co.*, 25 U.C.C. Rep. Serv. (Callaghan) 437 (Bankr. D. Me. 1977), *aff'd*, — (D. Me. April 21, 1978), *aff'd*, 588 F.2d 818 (1st Cir. 1978). South Carolina requires the recording of personal property leases. *See* S.C. CODE ANN. § 27-23-80 (1976); Note, *Mandatory Recording of Personal Property Leases in South Carolina: An Examination of the South Carolina Statute as Affected by U.C.C. Article Nine*, 30 S.C.L. REV. 557 (1979).

11. *See* note 102 *infra*.

these transactions is largely an accident of history. In all of these cases, the law has developed largely from unexamined notions that divisions of property rights between lessor and lessee, bailor and bailee, and buyer and seller ought to be respected even though third parties have no easy way of discovering these divisions. Yet, for hundreds of years, our law of security interests in personal property has been shaped by the problems of ostensible ownership.¹² Judges and legislators have refused to respect property divisions between a secured party and a debtor without first considering the costs that such divisions might impose on third parties.

Instead of either relying on metaphysical ideas about where "title" to particular property rests or deferring to the contractual divisions of property rights between two parties, judges and legislators should be sensitive to the costs imposed on third parties by the separation of ownership and possession whenever these costs exist.¹³ In this article, we argue that a failure to appreciate these costs is responsible for a number of the most troublesome problems that have arisen under Article 9. Yet, once one realizes that these problems have a common source, simple solutions to them become apparent. In proposing these simple solutions to problems that have consumed hundreds of pages of law review commentary,¹⁴ we are not advocating a radical departure from established wisdom. Rather, we are urging only that rulemakers apply more generally the principle that has shaped the law of security interests in personal property for four hundred years: A party who wishes to acquire or retain a nonpossessory interest in property that is effective against others must, as a general matter, make it possible for others to discover that interest.¹⁵

Part I of this article examines the problem of ostensible ownership—the problem that arises when parties separate ownership and possession of personal property. It examines the general rule that parties asserting nonpossessory property interests must give notice of

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12. See note 15 *infra* and accompanying text.

13. See, e.g., *Clow v. Woods*, 5 Serg. & Rawle 275, 278 (Pa. 1819) (Gibson, J.) (invalidating a security interest because the contract is a "secret matter" between the parties themselves and can afford no notice to creditors).

14. See, e.g., note 91 *infra* (discussing reclamation rights). Commentary discussing other problems addressed in this article is cited below where relevant.

15. See, e.g., *Sturtevant v. Ballard*, 9 Johns. 337 (N.Y. 1812); *Clow v. Woods*, 5 Serg. & Rawle 275 (Pa. 1819); 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 14.1 (1965); cf. *Davis v. Turner*, 45 Va. (4 Gratt.) 422 (1848) (separation of ownership and possession is prima facie evidence of fraud, but not fraud per se). A number of states continue the "fraud by possession" rule, see, e.g., CALIF. CIV. CODE § 3440, but in all states it is tempered by § 2-402(2). See note 102 *infra*.

their interests for those interests to be effective against third parties. It also argues that exceptions to this general rule should turn on whether the duty to give notice imposes costs without producing corresponding benefits, not on how the parties characterize their transaction.

The next two parts of this article explore the Code's treatment of the problem of ostensible ownership arising from property interests not considered to be security interests. Part II argues that the exclusion of "true" leases and other bailments from the coverage of Article 9's third-party notification rules is unwarranted, and Part III argues that the drafters of the Code did not pay sufficient heed to the important role that possession should play in determining the rights of the buyer in ordinary course of business and the rights of the unpaid seller.

I. THE PROBLEM OF OSTENSIBLE OWNERSHIP

A. *The General Rule*

The essential difference between secured and unsecured creditors is the relative priority of their respective claims to particular assets. Whatever the proffered justifications for secured credit, its existence depends on the secured creditor having a level of assurance of repayment that surpasses that of the unsecured creditor. The more certain a creditor is that his interest is in fact superior to that of other creditors with respect to particular collateral, the more sharply defined are the advantages of being a secured creditor. This assurance of a superior claim requires that the secured party be able to ascertain with precision the status of existing creditors and the amount of their claims, as well as the risks posed by subsequent parties.

One of us has previously noted that a general first-in-time rule is necessary for implementing a system of secured credit.¹⁶ But because of the possibility of debtor misbehavior, it is undesirable to rely on the debtor for information about claims to his own assets. Article 9 and its precursors implemented this first-in-time principle by forcing the first secured party to make his claim known to others if he wanted to ensure his priority.¹⁷ By placing the burden of notice on the first secured party, any creditor will be able to determine who ranks ahead of him. A creditor will also be able to decide whether and to what extent he should inform subsequent creditors of his in-

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16. See Jackson & Kronman, *supra* note 1, at 1161-64.

17. Baird, *supra* note 3.

terest, knowing that he will bear the risk of their taking priority if he does not make public the required information.

The legal system's original method of providing this information was to give primacy to possession. At common law, a debtor's possession of personal property assured a prospective creditor that the debtor could give him an unencumbered interest in that property.¹⁸ Possession was indeed nine points in the law. As a corollary, of course, that creditor could be certain of the priority of his claim only as long as he took and maintained possession of the collateral.

The reason for this approach was simple. Since *Twyne's Case*,¹⁹ decided shortly after the passage of the Statute of 13 Elizabeth in 1570,²⁰ possession has been viewed as the best available source of information concerning "ownership" of most types of personal property.²¹ Separation of ownership and possession has been viewed as a source of mischief toward third parties and, for that reason, as fraudulent. Moreover, permitting the creation of nonpossessory property interests by contract would have had few advantages absent a rule deterring debtor misbehavior, for no creditor (other than a purchase money seller)²² could establish with certainty and at low cost whether the debtor had previously encumbered the property. Therefore, the doctrine that deemed "ostensible ownership" to be fraudulent may be viewed as a simple legal rule that, by deeming an externally observable event (possession) to be the sole relevant criterion, transmitted the necessary information to third parties and thereby enabled

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18. See *Clow v. Woods*, 5 Serg. & Rawle 275 (Pa. 1819); 1 G. GILMORE, *supra* note 15, at § 14.1.

19. 76 Eng. Rep. 809 (1601) (transfer of property without a transfer of possession is fraudulent as to third parties and hence void).

20. 13 Eliz., ch. 5 (1570).

21. See note 15 *supra*. Real estate and certain other unique, fixed types of property may be better suited to a system in which filing, rather than possession, is given primacy. The attributes of property that lead to one mix of possession- and filing-based rules or another are explored in Baird & Jackson, *supra* note 3. For a discussion of types of personal property that are not suited to possession-based systems of ownership, see Coogan, *Article 9—An Agenda for the Next Decade*, 87 YALE L.J. 1012, 1030-53 (1978).

22. The seller of goods has typically been able to take (or retain) an interest in the goods sold that took precedence, not only against subsequent creditors of the buyer, but also against previously existing creditors of the buyer claiming under an after-acquired property clause. See *United States v. New Orleans R.R.*, 79 U.S. (12 Wall.) 362, 364-65 (1870); *Pennock v. Coe*, 64 U.S. (23 How.) 117 (1860); Gilmore, *The Purchase Money Priority*, 76 HARV. L. REV. 1333 (1963); Note, *The Priority Conflict Between a Purchase Money Security Interest and a Prior Security Interest in Future Accounts Receivable*, 22 VAND. L. REV. 1157, 1159-60 (1969). Article 9 accepts this "superpriority" and expands it to cover "enabling" lenders. See §§ 9-107, 9-312(3), (4) and official comment 3.

them to order their affairs with certainty. It thus facilitated a first-in-time rule and a rudimentary system of secured credit.

Although a "possession only" rule provides relevant information at a low direct cost, it has enormous indirect costs.²³ Other systems of providing information, while directly more expensive, may actually minimize total costs. Consider the case of someone who wishes to make a secured loan to finance a manufacturer's production of goods. A system in which possession is the sole source of information, and hence of rights, has a serious drawback. If the lender wants only a contingent right to take the collateral should repayment not be forthcoming, the manufacturer will have a current interest in the property and a right, subject to future defeasance by the lender, to remain the "owner" of the goods being manufactured. In this case, *both* parties simultaneously assert some of the elements of ownership of the goods. No possession-based system can easily accommodate this split of rights between two parties. Should the lender cure the "ostensible ownership" problem by taking possession of the property himself, the focus of the ostensible ownership problem shifts from creditors of the manufacturer to creditors of the lender. Unless the lender is "known" to engage in possessing the assets of another,²⁴ his action does nothing to solve the ostensible ownership problem.²⁵

23. This argument can be seen animating the court in *Davis v. Turner*, 45 Va. (4 Gratt.) 422 (1848) (recognizing problems of ostensible ownership but permitting separation of title and possession for fear that contrary holding would be a "remedy worse than the disease"). Other costs to a possession-based system are explored in *Baird & Jackson*, *supra* note 3.

24. This would be the case with a pawnbroker. Perhaps some other purely financial institutions would also be generally known to be holding the goods of others. *See* text accompanying notes 48-49 *infra*.

25. This is not to say that there would be no way for the lender and the manufacturer to structure the transaction so as to achieve the desired result within the confines of a system that permitted only possessory security interests. The two parties could, for example, merge their operations and solve the ostensible ownership problem by removing the division of ownership. Alternatively, the lender could establish some sort of "field warehousing" arrangement so as to take "possession" of the collateral at the site formerly considered to be the manufacturer's.

However, neither of these solutions is costless. Even apart from the cost savings that derive from the separation of (and thus the specialization in) financing and manufacturing functions, it may be inefficient for the lender and the manufacturer to merge. To the extent a lender needs to diversify its loan portfolio, and wishes to do so on a secured basis, it would require an enormous monolithic enterprise simply to cure the ostensible ownership problem. The advantages of diversification are explored in R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 112-29 (1981).

A field warehousing arrangement would have its own set of inefficiencies. In addition, a possession-based system presumably would require enough external evidence of a change in possession to alert creditors of the manufacturer looking at the manufacturer's operations; signs might not be sufficient. *See* Harrington, *The Law of Consignments: Antitrust and Commercial Pitfalls*, 34 BUS. LAW. 431 (1979); notes 89-90 *infra* and accompanying text.

Because of the high costs of a rule that bans the separation of ownership and possession of property, one ought to examine the alternatives. One alternative, of course, is simply to abandon all efforts to formulate a rule for controlling the problem of ostensible ownership. First, one can argue that the benefits of secured credit are not large and that a legal regime that leaves some creditors less secure (and others more secure) than the present one is therefore not particularly objectionable. Second, one can argue that the costs of the ostensible ownership problem, even in the absence of an applicable legal rule, are small: To the extent that creditors need to know which property the debtor owns, private markets will develop to provide the optimal amount of such information.²⁶

This approach to the ostensible ownership problem has some attractions. Uncontroverted benefits of secured credit are not easy to identify,²⁷ and private parties may be able to acquire sufficient information without relying on legal rules. Nevertheless, we think this approach is the wrong one. First, as we have argued elsewhere, there are several ways in which secured credit seems to bring significant benefits to all the parties to a transaction—to the debtor and secured and unsecured creditors alike.²⁸ Second, private markets in information ultimately rely on a third party monitoring the debtor to ensure that he does not misbehave. Although this private monitoring may reduce some costs imposed by debtor misbehavior, monitoring itself is costly. In some situations, legal rules can benefit all parties by channeling private behavior in ways that would reduce the overall need for monitoring. We believe that legal rules can be shaped to make relevant information publicly available at low cost. The availability of reliable information about the debtor's property reduces the debtor's incentive to misbehave by removing opportunities to do so. For these reasons, an approach relying solely on private markets seems less desirable than one that ensures priority status to a creditor

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26. This is the basis of the argument, made periodically, that Article 9's filing rules should be replaced by accountants' statements—perhaps combined with liability on the secured parties if information concerning their claims is not adequately disseminated. See, e.g., 1 G. GILMORE, *supra* note 15, § 15.1, at 463–64. For a brief, yet cogent, critique of this argument, see Phillips, *Flawed Perfection: From Possession to Filing Under Article 9* (pt.1), 59 B.U.L. REV. 1, 39–41 (1979).

27. See Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981). Professor Schwartz also catalogues the various reasons that might explain why secured credit exists in spite of its alleged inefficiency and finds them all wanting.

28. See Jackson & Kronman, *supra* note 1, at 1146–61; see also D. BAIRD & T. JACKSON, CASES, PROBLEMS, AND MATERIALS ON SECURITY INTERESTS IN PERSONAL PROPERTY at ch. 4 (forthcoming 1983); Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, — YALE L.J. — (1982).

under defined conditions, provided he complies with certain information-producing formalities that themselves make that status easily determinable.²⁹

Thus, as a general matter, we endorse the approach the Uniform Commercial Code takes to the problem of ostensible ownership and secured credit: A secured creditor need not take possession of the collateral, but if he does not, he must make a public filing in a designated place before he can shift the risk of competing claims to other property claimants.³⁰ A filing system places fewer restrictions on the use of collateral than does a possession-based solution to the ostensible ownership problem, yet it still provides information that allows a creditor to avoid the uncertainty caused by the possibility of debtor misbehavior. A secured creditor can determine if there are competing claims to his collateral by examining both the property that the debtor possesses and the public filings.³¹ After determining whether there are competing claims against the asset, a creditor can establish his own claim either by taking possession of the asset or by filing appropriate notice of his property interest in the asset. This claim will, in turn, be effective against third parties not then entitled to priority.

Our assertion that filing systems are valuable sources of information whose use ought to be expanded ultimately rests on empirical assumptions about the need parties have for information and the ability of a filing system to provide it cheaply. Filing systems may offer few benefits to creditors who do not take a security interest in their debtor's assets; some general creditors may be content to rely on a debtor's unaudited financial statements or the reports of such independent credit agencies as Dun and Bradstreet. But creditors that secure their loans with an interest in specific property of a debtor stand in a fundamentally different position.

The secured creditor is able to offer a lower rate of interest precisely because he does not rely solely on the debtor's honesty and general financial health. He is thus necessarily interested in discovering which assets a debtor owns and what claims others might have

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29. See Baird, *supra* note 3, at 63-65.

30. §§ 9-302(1), 9-305.

31. The official comments to § 9-302 suggest that the drafters of the Code viewed filing as the principal means of imparting information: "Subsection (1) [of § 9-302] states the general rule that to perfect a security interest under this Article a financing statement must be filed." They quickly add, however, that filing is not required when the secured party takes possession of the collateral. Transactions are exempted from the filing requirement when "suitable alternative systems for giving public notice of a security interest are available." *Id.*

upon those assets. Unlike general creditors, secured creditors under the present legal regime require information about specific property, even if they are lending on the basis of all of a debtor's assets rather than on the basis of specific collateral.³² Those that do not do enough to verify the existence of collateral frequently live to regret it: The great salad oil swindle and the Billy Sol Estes affair are only two of many colorful examples.³³ Secured creditors want reliable information about their debtor's collateral and the competing claims to it. Legal rules can insure the reliability of that information.

Both public recording files and possession share one central feature: Information about competing property interests is concrete and trustworthy. It is trustworthy because the information is conveyed by events—making a filing or taking possession—that themselves determine legal rights. Unlike private information gathering, public systems convey information both when there is a filing and when there is not.³⁴ A creditor who files, after determining that the debtor possesses the property and that no other filings cover it, knows that rival claimants will not defeat his interest in the collateral. A legal rule—Section 9-312(5) of the Uniform Commercial Code—dictates that a creditor who has perfected a security interest in collateral by taking possession of it or by filing will have priority over the interest of a creditor who neither files nor possesses the collateral.³⁵

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32. Commercial lawyers and loan officers constantly guard against the temptation to lend solely on the basis of the financial strength of the debtor rather than on the basis of the collateral that secures the debt. Secured creditors may not themselves check to see if the debtor in fact possesses the property it claims to own; they often rely upon the expertise of auditors, who not only check the debtor's books, but also inspect its physical plant.

33. For an account of the massive scam that involved hundreds of millions of dollars and a small amount of vegetable oil, see N. MILLER, *THE GREAT SALAD OIL SWINDLE* (1965). A summary of the Estes affair, in which auditors did not realize that they were inspecting the same assets over and over again, is contained in *Estes v. United States*, 335 F.2d 609, 612 (5th Cir. 1964).

34. In a private system, unassisted by a legal rule, a creditor who does not discover interests superior to his own does not know whether such interests do not exist or whether they do exist but are not reflected in the private files. This reflects a fundamental problem a debtor has in convincing creditors that he has been telling the truth; in the absence of an ability to check the debtor's story, creditors will be inherently suspicious of a debtor, who can gain advantage by misbehaving. Private remedies, such as liquidated damages clauses to assure reliability of the information imparted, see A. KRONMAN & R. POSNER, *THE ECONOMICS OF CONTRACT LAW* 224 (1979), provide little solace when the debtor is insolvent and unsecured claims will receive but a fraction of their face amount. See text accompanying note 47 *infra*. In a public system, however, because of the existence of a legal rule, the absence of a record of a superior interest is unambiguous, because unless the interest is recorded, it cannot be superior. It therefore provides a reliable check on the veracity of the information provided by the debtor.

35. Legal rules determine where a filing must be made and what information must

Under a filing system, a creditor who wishes to discover whether others rank ahead of him, and thus whether he can capture the benefits of secured credit, need not rely on his debtor to reveal the existence of conflicting security interests. A debtor will be deterred from misbehaving, since a filing system deprives him of the possibility of gaining from such misbehavior. Thus, whether or not the first secured creditor, *A*, chooses to file, the second secured creditor, *B*, knows that if he cannot find an earlier filing, he may rely on the debtor's possession of the property in deciding whether to extend credit.³⁶ Similarly, if *A*, after checking the files for the existence of prior claims, chooses to file (or take possession), he will be secure in the knowledge that his interest will be superior to *B*'s.

Unless a creditor cures the ostensible ownership problem, the risk of losing priority to subsequent property claimants remains on him. Placing the risk on the first secured party is sensible because it creates an incentive for that creditor to make reliable information accessible to others.³⁷ But it does not follow that the first party will, in fact, file or take possession of the asset, for neither of those events is costless.³⁸ The secured party must weigh the cost of possible loss of priority against the cost of filing (or possession) and decide upon the less costly route. Conversely, since it is not costless to check files (or even

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appear in the filing. The clearer and more precise these legal rules, both with regard to the initial establishment of files and the handling of subsequent claims, the lower should be the costs of the file search. There is likely, however, to be a residual level of imprecision that cannot be cost-effectively removed—for example, the imprecision that results from changes in the data around which the files are organized (i.e., the debtor or collateral change jurisdictions, names, or use).

The legal rules would also need to specify what constitutes possession. Normally, possession is viewed as being coextensive with the extent of the debtor's real estate (fee or leasehold) rights, which themselves can be determined by resort to the real estate files. Here, too, residual uncertainty can come from several sources. For example, in a number of states neither leasehold interests nor a business executive's office space are recorded. Furthermore, allowing parties to use field warehousing or consignments by setting up signs or by relying on general public knowledge, *see* §§ 2-326(3)(a),(b), undermines the external reliability of possession. *See* Harrington, *supra* note 25, at 437 ("[P]ermitting consignors to use the alternative of 'signs' or of showing that a consignee is 'generally' known by his creditors to be such dilutes an important principle . . .").

36. *See* Jackson & Kronman, *supra* note 1, at 1149-64.

37. *See* Dunham, *Inventory and Accounts Receivable Financing*, 62 HARV. L. REV. 588, 612 (1949) ("[P]ublic-filing statutes allocate the risk to the secured lender but permit him to relieve himself of such risk by giving public notice . . .").

38. In addition to the direct cost imposed by the keeper of the files for filing or searching, *see, e.g.*, CAL. COM. CODE § 9-403(5) (West Supp. 1982) (\$3.00 fee for both filing and searching), there are the costs of preparing financing statements or search requests and the costs of ascertaining information such as the correct name of the debtor, the correct location of the files, and so forth.

to check possession), it sometimes may be less costly for a subsequent creditor to bear the risk of the existence of earlier claims than to eliminate that risk by checking the files.

The Code responds to the ostensible ownership problems secured credit creates by trying to minimize the costs of making and of searching a filing. The cost of making an Article 9 filing is quite small,³⁹ as are the costs of examining those files. Article 9 lets each secured creditor choose between ensuring (at minimal cost) that he has priority over other creditors and assuming the risk that he does not.

Article 9 establishes a legal rule to deal with the ostensible ownership problem secured credit creates: The first secured party must take possession of the collateral or make a public filing before he can shift to subsequent creditors the risk of competing claims to the same property. An ostensible ownership problem, however, exists whenever there is a separation of ownership and possession. Article 9's treatment of the ostensible ownership problem created by secured credit naturally leads one to ask whether the ostensible ownership problem created by leases or other bailments is different. We believe the answer is simple: The two ostensible ownership problems are not different in any relevant respect. They impose the same costs on third parties, and if a filing system is an appropriate response to the first problem, it is an equally appropriate response to the second.

Indeed, because secured creditors may have property conflicts with non-Article 9 claimants, one cannot adequately address the ostensible ownership problem of secured credit without also addressing it elsewhere. To the extent that a creditor, even after checking his debtor's possession and the appropriate files, still bears some risk of losing to earlier claimants, he will raise the debtor's interest rate. Of course, it may not be sensible to establish a perfectly ironclad system that allocates *all* risks on the basis of externally available information. Indeed, at some point, a rule placing the risk of competing claims to property on subsequent parties may actually minimize the total costs to all parties. But the decision on where to place the risk should address the costs of ostensible ownership and the relative costs

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39. *But see* TENN. CODE ANN. § 67-4102, Item S(b) (privilege tax of ten cents on each \$100 of secured debt over \$2,000, payable at time of filing); FLA. STAT. § 199.032(1). Recent cases suggest that those taxes significantly change the nature of the notice filing system because they hold that both filing and timely payment of the tax are necessary to prevail against later property claimants. *See In re Ken Gardner Ford Sales, Inc.*, 23 Bankr. 743 (E.D. Tenn. 1982); *In re Sel-O-Rak Corp.*, 26 Bankr. 223 (Bankr. S.D. Fla. 1982).

of protecting against it; the decision should not depend on a contractual allocation of rights between two parties.

With the exception of secured transactions and certain other transactions that are generally perceived to serve a similar function (such as consignments), courts and legislatures generally have respected contractual divisions of rights in personal property.⁴⁰ Thus, they have upheld divisions of rights between bailor and bailee, lessor and lessee, and buyer and seller, even though third parties (principally potential creditors) could not easily discover these divisions. One can argue that a bailor and a bailee, a lessor and a lessee, and a buyer and a seller should be able to allocate ownership rights between themselves as they please. But such an argument loses force when at stake are the rights of a third party who asserts a competing claim to the property. We do not respect transfers of ownership of real property (as against the rights of a bona fide purchaser for value) unless the parties comply with certain information-producing formalities. These formalities (such as recordation of the transfer of title) ensure that third parties do not bear excessive risks or have to engage in costly information gathering.⁴¹ Nor do we respect property divisions between debtors and creditors of personal property, at least insofar as those divisions affect third parties, unless they similarly comply with formalities that publicize those contractual divisions.⁴² The same reasoning justifies imposing similar burdens on parties that receive or retain non-Article 9 interests in personal property.

The exclusion of a transaction from Article 9's filing system is nothing more than a determination that the risks arising from ostensible ownership should be placed, in the first instance, on subsequent secured parties. Yet there are no fundamental differences between these non-Article 9 transactions and Article 9 transactions that would justify treating them differently with respect to their effects on third parties. For example, the differences between "true" leases and secured transactions are sufficiently obscure that lawyers routinely make an Article 9 filing for what they think is a true lease to guard against the possibility that a court might later recharacterize the deal as a secured transaction.⁴³ Not only are the differences between these

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40. See, e.g., cases cited in note 10 *supra*.

41. See Baird & Jackson, *supra* note 3.

42. Indeed, rights between the parties as opposed to rights against third parties is the principal difference between attachment and perfection of a security interest.

43. Under the 1972 version of Article 9, a lessor can file a financing statement and the filing itself will not be a factor in determining whether the lease is intended as security. § 9-408; see notes 44, 65 *infra* (discussing tests for distinguishing "true" and "security" leases).

categories obscure, but more importantly, the attributes of a transaction that determine how it should be classified, and thus whether a filing is needed, have nothing to do with the problem of ostensible ownership.⁴⁴ These attributes focus on the specific details of how the contracting parties have allocated risks and obligations between themselves; yet, the function of the filing requirement is to warn subsequent creditors of the very existence of an earlier property interest. The subsequent creditor's need for this information is in no way diminished by the fact that the earlier interest was acquired through a bilateral agreement that had the attributes of a lease. Therefore, these attributes should not affect the filing requirement.⁴⁵

Neither the acquisition and dissemination of information about competing property claims nor the assumption of the risk of an undiscovered superior property claim is costless. These burdens should

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44. *In re Brookside Drug Store, Inc.*, 3 Bankr. 120, 122 (Bankr. D. Conn. 1980), lists the following sixteen factors as those that have been used, in one combination or another, to resolve the "true" versus "security" lease distinction:

(1) whether there was an option to purchase for a nominal sum, (2) whether there was a provision in the lease granting the lessee an equity or property interest in the equipment, (3) whether the nature of the lessor's business was to act as a financing agency, (4) whether the lessee paid a sales tax incident to acquisition of the equipment, (5) whether the lessee paid all other taxes incident to ownership of the equipment, (6) whether the lessee was responsible for comprehensive insurance on the equipment, (7) whether the lessee was required to pay any and all license fees for operation of the equipment and to maintain the equipment at his expense, (8) whether the agreement placed the entire risk of loss upon the lessee, (9) whether the agreement included a clause permitting the lessor to accelerate the payment of rent upon default of the lessee and granted remedies similar to those of a mortgagee, (10) whether the equipment subject to the agreement was selected by the lessee and purchased by the lessor for this specific lease, (11) whether the lessee was required to pay a substantial security deposit in order to obtain the equipment, (12) whether the agreement required the lessee to join the lessor, or permit the lessor by himself, to execute a UCC financing statement, (13) whether there was a default provision in the lease inordinately favorable to the lessor, (14) whether there was a provision in the lease for liquidated damages, (15) whether there was a provision disclaiming warranties of fitness and/or merchantability on the part of the lessor, (16) whether the aggregate rentals approximate the value or purchase price of the equipment.

45. Parties generally should minimize the costs their transactions impose on others. Moreover, the Code's minimal notice filing requirement should be no more of a burden on a lessor or a bailor than it is on a secured creditor. As we have noted, the relationship between lessor and lessee is in fact much like that between secured creditor and debtor. While a secured party will frequently be in a long-term contractual relationship with a debtor, this characteristic does not distinguish secured transactions from leases. Much equipment leasing involves a similar long-term relationship between lessor and lessee, *see* B. FRITCH & A. REISMAN, *EQUIPMENT LEASING—LEVERAGED LEASING* 1118 (2d ed. 1980). Many individual transactions can take place over a period of years that are governed in large part by a master lease agreement into which the parties initially entered. Both types of transactions produce chattel paper that is used in further financing, and the Code treats chattel paper arising under lease and security agreements the same way. *See* § 9-105(b).

be placed on the holder of the property interest who can handle them most cheaply. The manner in which two parties allocate rights to an asset between themselves says nothing about the relative abilities of one of them and a third party to bear the burdens of ostensible ownership. It would be odd to discover that the conditional seller or consignor generally was well-positioned to file and thus to minimize the risk that subsequent property claimants would not be able to learn about his interest but the lessor or bailor was not.

We think that, as a general rule, the party wishing to take or retain a nonpossessory property interest should bear the burden of curing the ostensible ownership problem, regardless of the type of relationship that party has with the party in possession of the collateral. This general rule would reduce the risks associated with acquiring security interests in personal property and therefore would enhance the advantages of a system of secured credit.⁴⁶ In the absence of such a legal rule, it would be difficult for the parties contractually to create an equally reliable means of providing information at a comparable cost, even if it were in their aggregate interest to do so.

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46. Some scholars think that the exclusion of leases from Article 9's filing requirements is so consistent with our jurisprudence that they dismiss a filing requirement out of hand. *See, e.g.*, R. SPEIDEL, R. SUMMERS & J. WHITE, *COMMERCIAL AND CONSUMER LAW: TEACHING MATERIALS* 255 (3d ed. 1981) ("It would be easiest to say that all true owners who are not in possession must file public documents to show their ownership if they are to defeat competing creditors. Such a rule is so foreign to our general ideas of ownership that no one would agree to it. . . . For that and other reasons we reject that result as outrageous."). At the very least, however, those who question the usefulness of a filing requirement in the case of leases should explain why there should be a filing requirement in the case of secured transactions that are identical from the point of view of third parties.

Others, however, have recognized the wisdom of extending the filing system to transactions not presently covered by Article 9. *See, e.g.*, Coogan & Boss, *Uniform Commercial Code Treatment for All Leases*, in P. COOGAN, W. HOGAN, D. VAGTS & J. McDONNELL, *SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* at ch. 4.3 (1983); Coogan, *Is There a Difference Between a Long-Term Lease and an Installment Sale of Personal Property?*, 56 N.Y.U. L. REV. 1036, 1047 n.61 (1981) (Coogan changes his mind, in at least some respects, from Coogan, *Leases of Equipment and Some Other Unconventional Security Devices: An Analysis of UCC Section 1-201(37) and Article 9*, 1973 DUKE L.J. 909, 954-61); Kripke, Book Review, 37 BUS. LAW. 723, 728 (1982). Mr. Coogan, however, questions the value of possession-based rules for many kinds of modern commercial transactions. *See* Coogan, *supra* note 21. Professor Kripke suggests a de minimis rule for leases of less than a year's duration, but does not explain why a de minimis rule should not be the same for both leases and secured transactions. *See also* Note, *Recording of Equipment Leases: A Proposed Amendment to the Uniform Commercial Code*, 47 NOTRE DAME LAW. 993 (1973).

Our proposal goes no further than to incorporate leases, bailments, and the like into Article 9's filing rules and other third-party oriented rules. We do not suggest that inherently two-party rules—such as many of the rules in part 5 of Article 9—should be brought into play. The Code already treats true consignments in something like the fashion we propose. *See* §§ 2-326, 9-114; *see also* § 9-113 (security interests arising under Article 2).

No single creditor would have an easy way of ensuring that his debtor did not subsequently misbehave (or had not already misbehaved) by failing to provide information about another transaction. A common law action against the debtor for breach of contract or fraud is of little value if, as is nearly always the case when it matters, the debtor is insolvent.⁴⁷

B. *Exceptions to the General Rule*

We have argued that lessors, other bailors, and secured parties should *generally* have an obligation to cure ostensible ownership problems as a condition of making their property rights effective against third party claimants. But this is not to say that in *every* instance they must either ensure that subsequent parties can discover their property interests or risk losing to those subsequent parties. Nor is it to say that all nonpossessory property interest holders should have the *same* obligation. What we do contend is that whether and to what extent a transaction that creates a nonpossessory property right in an asset is included in the risk allocation scheme of Article 9 should not turn on how the contracting parties divide rights and obligations between themselves. The doctrine of ostensible ownership assumes that such contractual divisions are irrelevant insofar as third party rights are concerned. What matters is that third parties be able to observe the division easily and accurately.

The transactions that should be excluded from Article 9's general rules respecting ostensible ownership are likely to cut across such metaphysical notions as "leases," "bailments," and "security interests." Some transactions are (and should be) excluded from Article 9's filing rules because another legal regime solves the ostensible ownership problem. A rent-a-car company does not need to file every time it rents out an automobile because certificates of title control virtually all nonpossessory ownership interests in automobiles not owned by a manufacturer or dealer. To buy an automobile or to acquire a perfected security interest in one, it is necessary to make an appropriate notation on the certificate of title.⁴⁸

Another situation in which the informational value of a filing requirement would be insignificant is where there is widespread knowl-

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47. See note 34 *supra*. Under 11 U.S.C. § 523(a)(2) (Supp. V 1981), credit obtained fraudulently is not dischargeable in bankruptcy proceedings under Chapter 7 of the Bankruptcy Code, but fraud is notoriously difficult to prove. In addition, 11 U.S.C. § 523(a)(2) does not apply to proceedings under Chapters 11 or 13. 11 U.S.C. §§ 1141(d), 1328(a) (Supp. V 1981).

48. See, e.g., UNIF. MOTOR VEHICLE CERTIFICATE OF TITLE ACT § 6.

edge that the possessor of an asset is not the owner. In such a situation there really is no ostensible ownership problem. For example, until relatively recent changes in applicable F.C.C. regulations, virtually all telephone equipment was "owned" by Bell Telephone and "leased" to the customers, and this fact was certainly known to almost all lenders. Under a legal regime that required all lessors to make a public filing to protect their interests from their lessees' creditors, Bell would, in many instances, almost certainly decide to file. That decision would be particularly compelling when it leased to offices, retail stores, or manufacturing concerns because the value of such leased telephone equipment might be quite high and because a creditor might often hold a security interest in "all equipment." Yet the informational value of having Bell file to cover such transactions would surely be trivial. Completely apart from any filing, subsequent parties would know about Bell's interests in the telephone equipment. Thus, exempting Bell from filing would appear sensible as it would lower Bell's costs without imposing extra costs or uncertainties on subsequent parties.

Our general rule would require a debtor whose creditor takes possession of property as security for a loan to make a filing if he wants to protect himself from his creditor's creditors. But, like those who possessed Bell Telephone equipment, there are many cases where creditors who take possession of their debtor's goods are generally known not to own a substantial portion of the goods that they possess. In those cases, significant ostensible ownership problems again do not arise. Thus, for example, it might be appropriate to free a debtor from a filing requirement when his creditor is a pawnbroker. A general exception for those in the business of holding goods of others might likewise be appropriate. The creditors of warehousemen could not reasonably rely on the property warehousemen possess to secure their loans.

Other types of transactions may be excluded from Article 9's filing rules because the filing system is not an efficient way to impart information. For example, certain ostensible ownership problems last for so short a time that cost considerations may justify excluding the transactions from the filing system. Thus, if a person lends a lawnmower to a neighbor, subsequent secured parties could easily bear the risk that the neighbor had borrowed the lawnmower by ensuring that the neighbor had been in possession of it for more than a few days. Moreover, an exclusion from Article 9 of transactions that create momentary ostensible ownership problems would be consis-

tent with Article 9's requirement that a subsequent secured party bear for a certain period of time other risks, such as the risk that his debtor's collateral has been moved into the jurisdiction from another jurisdiction where it was subject to a perfected security interest.⁴⁹

In some situations a filing requirement would be inconsistent with the notion of negotiability that is the essential virtue of certain kinds of property, such as money or bearer instruments. Indeed, under the present legal system, one can acquire ownership interests in these types of property that will be effective against third parties only by taking possession. Given this legal rule, we can have the benefits of negotiability without an ostensible ownership problem since subsequent parties can fully rely on possession as an indicator of their rights. Thus, a debtor that gives a bank negotiable instruments as collateral for a loan must ultimately rely on the honesty of the bank. He cannot prevent it from transferring superior rights in the instrument to third parties.⁵⁰

The Code's rule providing for automatic perfection of purchase money security interests in consumer goods may also be a justified exception to the burden a secured creditor bears of curing the ostensible ownership problem.⁵¹ In the typical case of a purchase money security interest in consumer goods, the value of the collateral would be low, second security interests in such property would be uncommon, and both the cost of filing and the cost of searching the files would be high relative to the value of the property. Other things being equal, the filing requirement would not seem troublesome because the purchase money lender who decided not to file would face only a relatively low risk that a subsequent creditor might take an interest in the property, make a proper filing, and acquire rights superior to his own. But other things are not always equal. In spite of the property's low value, if there was not an exception to the filing

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49. Under Article 9, subsequent secured parties must bear the risk for four months that collateral, now in one jurisdiction, had been properly perfected by a filing in another jurisdiction. § 9-103(1)(d); *see also* § 9-103(3)(e) (similar rule when filing is tied to the location of the debtor). Secured parties also must bear the risk, for 10 days, that new collateral (other than inventory) will be subject to a purchase-money security interest entitled to priority under § 9-312(4). For other rules permitting temporary ostensible ownership problems, *see* §§ 9-401(3) (alternative section) (allowing four months for reperfecting "after a change to another county of the debtor's residence or place of business or the location of the collateral, whichever controlled the original filing"), 9-402(7) (requiring filing within four months of when debtor changes his name in order to perfect as to after-acquired property).

50. *See* §§ 9-308, 9-309. *See generally* Baird & Jackson, *supra* note 3 (discussion of negotiability and transfer rules).

51. § 9-302(1)(d).

requirement, a secured creditor might nevertheless file because his failure to file would give the debtor an incentive to encumber the property (perhaps along with other property) to a willing subsequent party who, upon filing, would have priority. Moreover, the purchase money lender might file even if there was no chance at all of a subsequent secured creditor relying on the debtor's apparent outright ownership of encumbered property because the filing is necessary to prevail against lien creditors (if the property is not exempt from execution) and the trustee in bankruptcy, who has the rights of a hypothetical lien creditor.⁵² The costs filing imposes on the purchase money lender of consumer goods may thus exceed the informational benefits filing provides.

Therefore, automatic perfection may, on balance, be cost-effective. That legal rule, by making it extremely difficult for a subsequent party to discover prior encumbrances on the collateral, may, however, make secondary financing of consumer goods rare. While this rarity of secondary secured financing reduces the seriousness of the ostensible ownership problem, in terms of detrimental reliance, it is important to note that here there may be more significant costs to the no-filing rule than in the Bell Telephone example. Because uncertainty is imposed on subsequent parties who might nonetheless wish to acquire a property interest in a debtor's consumer goods, a no-filing rule may eliminate subsequent secured financing that would have existed in the absence of debtor misbehavior or a filing rule.⁵³

Cases might also arise in which there is ambiguity about which of two parties is in possession of property. For example, one might have to determine which property in a residential apartment is "possessed" by the landlord and which by the tenants. Should either the landlord or the tenant have to file to protect his interests? Should both? What about the case in which a bank has a security interest in all the assets (including the furniture and office equipment) of a company, and some of the furniture in the corporate headquarters is in fact owned by employees? Should these employees have to choose between filing to protect their interests and bearing the risk that their

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52. 11 U.S.C. § 544(a) (Supp. V 1981). Lien creditors take priority over unperfected security interests under § 9-301.

53. It is difficult to say whether the rarity of secondary financing of consumer goods is due to the low value of the goods or to the legal rule that, by exempting the purchase money seller from the filing requirement, makes it difficult for a subsequent party to discover prior encumbrances on the collateral. *See* Baird, *supra* note 3, at 65. Such interests may become even rarer because of the impact of 11 U.S.C. § 522(f)(2) (Supp. V 1981) (allowing debtors in bankruptcy to avoid non-purchase money interests in certain types of exempt property).

company will become insolvent or default? Should one ask if the bank relied on the furniture in making the loan? As in other commercial law problems, one may have to balance the virtues of clear rules against those of flexible standards as well as balance competing equities of two innocent parties.⁵⁴

These and other problem cases might be put forward as objections to a general rule that makes a great deal turn on possession. We emphasize, however, two points. First, although the question of whether a party is in possession of property might be difficult in some cases, at least when goods are involved the inquiry will be quite straightforward. Whether a debtor is in "possession" of his drill press is generally going to be a much easier question to resolve than whether he is its "owner." Second, many problem cases do not have to be resolved on a case-by-case basis as do inquiries into title. For example, once one decides that debtors do not have to file to protect their interests from the claims of creditors of warehousemen and pawnbrokers, the issue is largely settled and litigation will rarely arise.

C. *Ostensible Ownership and the Priority of Subsequent Claimants*

The usefulness of secured credit depends on the ability of a secured creditor to determine, with relative precision, the risks he faces from competing claimants. It is for this reason that a system of secured credit needs a method for providing a potential claimant with knowledge of the existing interests that will take priority over his own. As we have seen, the doctrine of ostensible ownership provides potential claimants with a method for obtaining this knowledge: If a debtor is in possession of property, and there is no filing, potential claimants can be confident they will prevail over earlier claimants. Any earlier parties who wished to have priority over potential claimants had to take possession of the collateral or make a public filing. But a system of secured credit also needs to have a method for allowing the earlier secured creditor to determine the risks that he faces from *subsequent* property claimants.

Despite the necessity of a general first-in-time rule, a secured creditor will not take priority over all property claimants whose interests arise subsequent in time. The conditions under which earlier

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54. For a discussion of the role of rules and standards in commercial law, see Baird & Weisberg, *Rules, Standards and the Battle of the Forms: A Reassessment of § 2-207*, 68 VA. L. REV. 1217 (1982).

property claimants lose out to later ones vary.⁵⁵ Article 9 permits the holder of a purchase money security interest in equipment to prevail over earlier secured parties simply by filing a financing statement within ten days after his debtor receives possession of the equipment.⁵⁶ Holders of purchase money security interests in inventory, however, not only have no ten-day grace period for filing, but also are required to notify earlier secured parties that they are taking or expect to take a purchase money security interest in inventory.⁵⁷ Finally, the precise requirements that a buyer in ordinary course of business must meet before he can take free of earlier security interests are uncertain.⁵⁸

We believe that, just as with a secured claimant's ability to take priority over most subsequent parties, the ability of a particular "favored" subsequent claimant to take priority over an earlier secured party should turn, in the first instance, on the subsequent claimant's curing the ostensible ownership problem that his interest may create for the earlier secured party. The subsequent party may cure the ostensible ownership problem either by taking possession of the collateral or by notifying the earlier secured party that an interest entitled to priority has been acquired. Such a rule would permit the earlier secured party—for purposes of monitoring, extending new loans, or engaging in other forms of reliance—to gain all relevant information from his debtor's possession of collateral. A rule permitting a subsequent party to acquire priority simply by filing a financing statement, however, would require an earlier secured party, before relying on the existence of collateral, to check the files repeatedly. If taking possession of the property is impractical for the subsequent party—as it will be in many cases of purchase money security interests—then the subsequent party, as a condition of priority, should generally be required to cure the ostensible ownership problem by actually notifying earlier secured parties of his interest.

Thus, we favor as a general rule the approach taken by Section 9-312(3), which requires notification of earlier secured parties at or before the time the ostensible ownership problem is created. A rule

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55. For the rationale underlying the rule giving priority to buyers in ordinary course of business, see text accompanying note 100 *infra*; for the rationale underlying the rule giving priority to purchase money lenders, see Jackson & Kronman, *supra* note 1, at 1164-82.

56. See § 9-312(4).

57. See § 9-312(3).

58. Section 9-307 provides that certain buyers in ordinary course of business take property free of security interests. While § 1-201(9) defines "buyer in ordinary course of business," the conditions that must be met before that status is achieved for § 9-307 purposes are unclear. See notes 101-105 *infra* and accompanying text.

permitting a subsequent party to obtain priority without notification can be justified only on aggregate cost-reduction grounds—for example, if reliance by earlier secured claimants were considered unlikely.⁵⁹ Although these exceptions might occasionally apply with respect to certain types of collateral, we doubt that a blanket rule eschewing notification (such as Section 9-312(4)'s rule for purchase money security interests in collateral other than inventory) is more sensible than a rule that directly addresses the ostensible ownership problem.⁶⁰

II. OSTENSIBLE OWNERSHIP AND THE SCOPE OF ARTICLE 9

In Part I, we argued that, as a general matter, in order to acquire an interest in property that will be effective against subsequent claimants, one should either have to take possession or cure ostensible ownership problems by making a public filing. We also argued that subsequent property claimants, in order to acquire special priority over earlier secured parties, should have to cure ostensible ownership problems by taking possession of the property or by notifying the earlier parties. In this part and the next, we argue that the Uniform Commercial Code fails to apply these principles broadly enough. Instead of treating ostensible ownership problems consistently, the Code sometimes uses a metaphysical concept (such as "title") to determine property rights or to allocate risks. In doing so, it upholds two-party allocations of rights despite their impact on third parties and, accordingly, places the risk of their existence on the third parties. This part deals with the exclusion from Article 9 of certain transactions, such as leases and bailments, which create ostensible ownership problems. Part III deals with Article 9's inadequate treatment of the ostensible ownership problems created by certain transactions that, although within the scope of Article 9, involve parties other than secured creditors. Examples of such transactions include a sale in which the seller is not paid immediately or a sale to a buyer in ordinary course of business.

The Uniform Commercial Code explicitly eschews inquiry into

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59. The justifications here depend on the same factors that would excuse earlier secured parties from curing the ostensible ownership problem for subsequent creditors. *See* notes 48–53 *supra* and accompanying text.

60. The need for any rule change, however, must be viewed in light of the monitoring burdens a secured creditor already bears from other sources. For example, a secured party that makes future advances (covered by an existing filing) or that has an interest in after-acquired property must already check the files every 45 days for federal tax liens. *See* I.R.C. § 6323 (1976 & Supp. IV 1980).

title as a general method of determining rights and allocating risks.⁶¹ For example, the Code's definition of a security interest provides that a seller who reserves title after delivery of the goods merely retains the security interest in the goods sold.⁶² Consequently, a seller who delivers possession of goods to his buyer bears the risk that competing property claimants may take priority over the seller's "residual" right to the goods. The seller can transfer this risk to subsequent claimants only by making a public filing and can prevail against existing claimants with after-acquired property clauses only by complying with Article 9's special rules for purchase money lenders. The moment at which the debtor receives possession of the collateral determines not only the point from which the "owner" runs the risk of being defeated by subsequent claimants but also whether the filing is timely for purposes of defeating preexisting claimants. Here possession, not title, determines the risks and rights of competing claimants with a property interest in the same collateral.

Nevertheless, Article 9 occasionally requires courts to determine which party to a transaction has title to an asset. By its terms, Article 9 applies only to transactions intended to create a security interest in personal property.⁶³ Therefore, among all leases and consignments, only those intended for security fall within the scope of Article 9.⁶⁴

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61. See §§ 2-401, 9-202; § 9-101 official comment ("Rights, obligations and remedies under the Article do not depend on the location of title . . .").

62. § 1-201(37); see § 2-401(1). The holder of a purchase money security interest, § 9-107, can obtain priority over secured parties with an earlier filing covering the same collateral only by complying with § 9-312(3) or (4).

Sections 1-201(37) and 2-401 both describe the retention of title after "shipment or delivery" as nothing more than a security interest. Since shipment itself creates no ostensible ownership problem, however, we believe that delivery should be the event that determines legal rights. Before delivery, the buyer may have sufficient rights in the collateral to permit parties claiming through him to have their interests "attach," but until the buyer receives possession, these rights should remain derivative of the buyer's rights. That is to say, until the buyer receives possession of the goods, the claimant should have no greater rights against the seller with respect to those goods than the buyer has. See notes 82-87 *infra* and accompanying text.

63. See § 9-102.

64. See § 1-201(37) ("Unless a lease or consignment is intended as security, reservation of title thereunder is not a 'security interest' . . ."). Other forms of bailments, although not explicitly mentioned by § 1-201(37), are considered to be outside the scope of Article 9 unless intended as security. See § 9-102(1); *In re Medomak Canning Co.*, 25 U.C.C. Rep. Serv. (Calaghan) 437 (Bankr. D. Me. 1977), *aff'd*, — (D. Me. April 21, 1978), *aff'd*, 588 F.2d 818 (1st Cir. 1978).

Almost all consignments, regardless of whether they are intended as security, end up subject to Article 9's filing rules via § 2-326(3)(c). See Harrington, *supra* note 25, at 431. The 1972 revisions to Article 9 added a section to make the prerequisites for consignment priority roughly equivalent to those for purchase money security interests in inventory under § 9-312(3). See § 9-114.

Deciding whether a transaction involves a "true" lease or a lease intended for security—the polar categories for allocating risk—almost certainly requires asking which party really "owns" the collateral in question.⁶⁵ An inquiry into ownership necessitates a search for rights which a third party cannot observe because they are determined in large part by contract between the "lessor" and "lessee."

*Brodie Hotel Supply, Inc. v. United States*⁶⁶ illustrates the inconsistency between the ostensible ownership principle and the Code's exclusion from Article 9 of all transactions that are not intended to create a security interest in personal property. In *Brodie Hotel*, Lyon first took possession of an asset under a true lease, and then, several months later, arranged to buy the asset from the "owner" in a conditional sale. At the time of the sale, the owner attempted to take a purchase money security interest in the asset. Yet, to obtain the special priority position of a purchase money seller under Article 9, the owner had to perfect its interest by filing no later than ten days after the "debtor" obtained "possession" of the asset.⁶⁷ The owner filed a financing statement within ten days of concluding the conditional sale arrangement, but Lyon had already "possessed" the asset for several months under the lease. Nonetheless, the owner prevailed over the claim of an existing secured creditor of Lyon; the court reasoned that the ten-day time period did not begin to run until Lyon both had received possession of the collateral *and* had become a debtor by entering into the conditional sale agreement.⁶⁸

From the perspective of Article 9's concern with ostensible ownership, the case is troubling. Section 9-312(4) tells us the time within which the purchase money lender must act to preserve his superpri-

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65. Section 1-201(37) itself provides some guidance. Most courts have concluded that if a lease contains an option to purchase for a "nominal" amount, it is in effect a disguised conditional sale and hence governed by Article 9. *See, e.g., In re J.A. Thompson & Sons*, 665 F.2d 941 (9th Cir. 1982); *Peco, Inc. v. Hartbauer Tool & Die Co.*, 262 Or. 573, 500 P.2d 708 (1972). Recently, the Seventh Circuit carried the analysis further by recognizing the importance of an option to cancel in determining whether a transaction was a "true" lease or a disguised conditional sale. *In re Marhoefer Packing Co.*, 674 F.2d 1139 (7th Cir. 1982). *See also Coogan, Leases of Equipment*, *supra* note 46. For a list of the factors which courts have used to determine how to characterize a lease, see note 44 *supra*.

66. 431 F.2d 1316 (9th Cir. 1970).

67. *See* § 9-312(4).

68. *See* 431 F.2d at 1319 ("Although Lyon might have been liable for the reasonable rental of the equipment or for its return to Brodie, he did not owe performance of an 'obligation secured' by the collateral in question until November 12, 1964, and therefore was not a 'debtor' for purposes of [§ 9-312(4) until then]."); *see also In re Prior Brothers, Inc.*, 29 Wash. App. 905, 632 P.2d 522 (1981) ("possession alone, without a concomitant obligation to perform, is not sufficient to call into play the provisions of article 9.").

ority (ten days), and it seems to say that this time begins to run when the ostensible ownership problem comes into being (when a party such as Lyon takes possession of the property). With the signing of the conditional sale document, Lyon and the owner of the property changed their legal relationship to each other (from lessor-lessee to debtor-creditor) by agreeing to alter their respective rights concerning the property. But it does not follow that the rights of third parties should change as well. None of the policies underlying Article 9 suggest that the time limit for obtaining purchase money priority should start to run upon an event, such as the signing of a conditional sales contract, that no third party can observe.

The problem brought to light by *Brodie Hotel*, however, is not the simple one of a court misinterpreting the Code. Although Article 9, once applied, implements the ostensible ownership principle, the decision whether Article 9 applies at all turns, in the first instance, not on ostensible ownership but on title location. Thus, the court in *Brodie Hotel* was simply attempting to implement the line that the Code draws between "true" leases and conditional sales; the court, under this view, decided not to require compliance with Article 9 principles before Article 9 applied at all.⁶⁹

Our argument is not that the court should have drawn this line somewhere other than where it did, but rather that, as far as the rights of third parties are concerned, Article 9 can be faulted for requiring that the line be drawn at all. There should be no two-party test, based on title or any other metaphysical notion, for determining when third parties can enjoy the protection of the ostensible ownership principle. To use such a test defeats Article 9's goal of allocating risks on the basis of externally observable events. Under the facts of *Brodie Hotel*, the Code should protect the owner's interest only if he filed (and notified Lyon's earlier secured creditors) when he entered into the lease transaction and transferred physical possession of the property to Lyon. Had the owner filed when possession was transferred, no ostensible ownership problem would have arisen and no

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69. Because "true" leases are excluded from Article 9, the ostensible ownership problem created by the lease transaction in *Brodie Hotel* is not one for which Article 9 supplies a remedy. One can argue that parties should bear no greater burden when a "true" lease is converted into an Article 9 security interest than when an Article 9 security interest is created outright. Only at the time of conversion should the risks created by ostensible ownership shift from subsequent claimants to the "lessor/seller." The lessor/seller, the argument runs, should not be disadvantaged by an ostensible ownership problem that was not his problem initially because the transaction that created the problem was explicitly excluded from the scope of Article 9.

further action would have been necessary at the time the parties decided to turn the transaction from a lease into a conditional sale.

Extending the filing provisions and the priority rules of Article 9 to *all* divisions of ownership and possession has an advantage besides making it easier for parties to ensure that their claims to their debtors' assets have priority: Like the introduction of any clear rule, such an extension would reduce litigation. For example, in *In re Medomak Canning Co.*,⁷⁰ the court determined that Underwood was a bailor of raw goods and packing material in Medomak's plant.⁷¹ The court held that because Underwood was a bailor rather than a secured lender, it had no obligation to file, and as a bailor, Underwood had a property interest in the goods superior to anyone claiming a property interest through Medomak (such as a lender with a security interest in Medomak's inventory). In determining that Underwood was in fact a "true" bailor, the court did not rely on the labels that the parties themselves had used. To be a "bailor," Underwood had to remain the "true" owner of the materials, i.e., it had to bear more of the incidences of ownership than did Medomak. Thus, the court examined the contractual arrangements between Medomak and Underwood.⁷²

This inquiry is objectionable for two reasons. First, as we have already observed, the financier of the inventory had no independent means of learning about the contractual arrangements between Medomak and Underwood. Second, an inquiry into which party bears more of the incidences of ownership in a given transaction is a difficult one. In *Medomak*, the court, in order to locate "title," engaged in an extensive inquiry into the probable rights of the parties

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70. 25 U.C.C. Rep. Serv. (Callaghan) 437 (Bankr. D. Me. 1977), *aff'd*, — (D. Me. April 21, 1978), *aff'd*, 588 F.2d 818 (1st Cir. 1978).

71. In that case, Medomak canned and froze various food products, usually under its own labels. Medomak had a line of credit from the Depositors Trust Company that was secured by Medomak's inventory. William Underwood Company, a producer of food products, entered into an arrangement with Medomak for Medomak to process and can pork and bean products for Underwood. Under the arrangement, third parties delivered raw materials (presumably paid for by Underwood) directly to Medomak. Medomak would then process and can those raw materials and store the finished goods for eventual shipping to distributors, as Underwood directed.

72. "Fundamentally . . . a contract of sale requires a meeting of the minds of both parties, not alone the will of one. The circumstances and conduct of Medomak are inconsistent with an intention to acquire title to the ingredients and packaging and shipping materials, thereby obligating itself for the purchase price, only to process them and sell them back to Underwood at a net differential rate per unit which was determined by deducting the costs of the ingredients and other supplies from the full market price of the finished goods." 25 U.C.C. Rep. Serv. (Callaghan) at 446-47.

and the probable reasons for structuring the transaction as they did. Despite this analysis, the conclusion was far from given, and, in fact, the case has been criticized for incorrectly locating title.⁷³

Had the court been able to focus instead on ostensible ownership, the outcome would have been clear and noncontroversial. Because Medomak, and not Underwood, possessed the raw goods and packing material, the parties created an ostensible ownership problem for Medomak's other property claimants. From those claimants' perspective, the problem is identical to that arising from a conditional sale of the raw goods and packing material to Medomak—a transaction that unquestionably would have been subject to Article 9. Consequently, Underwood should have been required to bear the risk that other property claims existed unless it, at a minimum, noted its interest in the public files.⁷⁴ Because it did not file, a creditor with a perfected security interest in Medomak's inventory should have prevailed over Underwood.⁷⁵

"True" leases and "true" bailments do not possess attributes that justify excluding them completely from the filing and priority rules of Article 9. Nor is such an all-or-nothing rule justified by the high costs of devising or using a more precise rule. After all, more precise rules that exempt only certain secured transactions from Article 9's filing requirements do exist.⁷⁶ The Code could exclude, for example, low-value consumer leases or bailments, just as it presently excludes low-value consumer secured transactions. Filing under such circumstances might not cost-effectively convey information, which would justify these transactions' exclusion; their exclusion, however, would *not* be justified simply by their categorization as "leases," "bailments," or "secured transactions."

III. OSTENSIBLE OWNERSHIP PROBLEMS WITHIN ARTICLE 9

In this part, we apply the principles developed in Part I to three

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73. See R. SPEIDEL, R. SUMMERS & J. WHITE, *supra* note 46, at 257; Comment, "Bailment for Processing": Article Nine Security Interest or Title Retention Contract?, 61 OR. L. REV. 441 (1982).

74. To prevail against earlier property claimants in inventory, Underwood should probably also have been required to notify the bank at the time it consummated the transaction in order to take priority as it would have had to do had the transaction been characterized as a "sale" or "consignment." See §§ 9-312(3), 9-114; text accompanying notes 58-60 *supra*.

75. The court acknowledged that the transaction created ostensible ownership problems but noted that ordinary entrustment transactions have escaped regulation under the Uniform Commercial Code. 25 U.C.C. Rep. Serv. (Callaghan) at 448.

76. See, e.g., § 9-302(1)(d) (purchase money security interests in consumer goods), discussed in text accompanying note 51 *supra*.

disputes that have arisen under Article 9. First, under Article 9, security interests exist, and hence Article 9's filing and priority rules apply, only if the debtor has acquired "rights in the collateral."⁷⁷ This requirement has led some judges to enter upon metaphysical inquiries into incidences of ownership without examining whether the issue was the *attachment* of a security interest, in which case only the interests of the contracting parties are at issue, or the ability of a subsequent claimant to take *priority* over a person claiming ownership of collateral, in which case the issue is a third party's interests. Second, the Code does not clearly define the rights of secured creditors against unpaid sellers of goods, and courts have neglected ostensible ownership problems in trying to identify these rights. Third, rather than examining possession, judges sometimes attempt to locate title to goods in order to determine whether they have been sold and thus to determine whether a person has become a "buyer" eligible for the special privileges of a buyer in ordinary course of business.

A. *The Defaulting Buyer's Power to Convey Property Interests to Third Parties*

Imagine that Chrysler finances Global, which sells Chrysler's boats.⁷⁸ Chrysler can protect itself in several ways from most other claims, both earlier and subsequent, that arise through Global. First, Chrysler can retain a purchase money security interest in the boats it sells to Global by filing publicly and giving notice to others with previously-existing security interests in Global's inventory.⁷⁹ Second, Chrysler can deliver the boats to Global on consignment. Here too, Chrysler would almost certainly have to file and give notice to earlier secured creditors in order to take priority.⁸⁰ Under both of these approaches, however, Chrysler runs some risk that Global will sell the boats to a buyer who will take free of Chrysler's claim. To avoid this, Chrysler might follow one of two other approaches. First, Chrysler could retain possession of each boat until Global paid for it in full. Second, Chrysler could create a field warehouse on Global's lot and instruct the field warehouse company to release a boat only after Global paid for it in full.⁸¹

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77. Under the 1972 version of Article 9, a security interest attaches and becomes enforceable only if the debtor has "rights in the collateral," § 9-203(1)(c).

78. The facts of this example are based on *Chartered Bank of London v. Chrysler Corp.*, 115 Cal. App. 3d 755, 171 Cal. Rptr. 748 (1981).

79. See § 9-312(3).

80. See §§ 2-326(3), 9-114.

81. Field warehousing is discussed in 1 G. GILMORE, *supra* note 15, at ch. 6; McGuire,

Under either of these arrangements, we face two questions. First, when does Global have the power (if not the right) to convey a boat, or a property interest in a boat, to a third party? Second, assuming that Global can convey a boat or an interest in a boat, when is Chrysler's interest in the boat going to be superior to the one Global conveys to a third party—when, in other words, do the third party's rights remain but derivative of Global's rights and thus inferior to Chrysler's? Courts often confuse these two separate inquiries.⁸²

As for the first question, Article 9 provides that a debtor cannot pass a security interest in property on to a third party until the debtor has "rights in the collateral,"⁸³ an issue that involves an examination into whether the debtor has *any* rights to which a secured party may succeed. A secured party (or other property claimant) may hold rights that are derived from the debtor and yet may nonetheless find that he enjoys no greater rights against the "owner" of the goods than does the debtor himself. As long as the rights of the secured party (or other property claimant) to the collateral remain only derivative of the debtor's, the "rights in the collateral" issue seems largely uncontroversial. Regardless of whether the rights in the collateral asserted by a debtor are those of the holder of a "special property interest" in the goods or of "title" to the goods,⁸⁴ the debtor has *some* rights in the collateral. However limited those rights may be, there is no reason that a secured party (or other property claimant) should not be able to succeed to them.⁸⁵

The Impact of the UCC on Field Warehousing, 6 U.C.C. L.J. 267 (1974); Skilton, *Field Warehousing as a Financing Device*, 1961 WIS. L. REV. 221; Skilton, *Field Warehousing as a Security Device*, 1961 WIS. L. REV. 403; Note, *Financing Inventory Through Field Warehousing*, 69 YALE L.J. 663 (1960); see also notes 88–90 *infra* and accompanying text (arguing that field warehousing should not be considered an adequate surrogate for possession).

82. See, e.g., *Mother Lode Bank v. General Motors Acceptance Corp.*, 46 Cal. App. 3d 807, 120 Cal. Rptr. 429 (1975); *Manger v. Davis*, 619 P.2d 687 (Utah 1980); see also Anzivino, *When Does a Debtor Have Rights in the Collateral Under Article 9 of the Uniform Commercial Code?*, 61 MARQ. L. REV. 23 (1977).

83. See § 9-203(1)(c). For the debtor's power to convey other sorts of property interests, see § 2-402; § 2-403; Jackson & Peters, *Quest for Uncertainty: A Proposal for Flexible Resolution of Inherent Conflicts Between Article 2 and Article 9 of the Uniform Commercial Code*, 87 YALE L.J. 907 (1978).

84. See § 2-401 (at the latest, buyer acquires title to goods upon shipment or delivery); §§ 2-501, 2-502 (buyer has a "special property" interest in existing goods identified to a contract).

85. For example, assume that Boeing leases aircraft to Pan Am on twenty-year leases at \$100,000 per month. Does Pan Am enjoy "rights in the collateral" sufficient to pass on to a third party a security interest in the aircraft? If we assume that Boeing's consent to an assignment of the leases is not required, the answer seems to be yes. See, e.g., *In re Holiday Airlines Corp.*, 647 F.2d 977 (9th Cir. 1981). But to say that a third party can obtain a security interest in the aircraft is not to say that its security interest entitles it to prevail against Boe-

The only problem we can see concerning "rights in the collateral" for *attachment* purposes arises when a purported "owner" asserts that the debtor had but "naked" possession of the collateral under, say, a bailment. Here, the owner would argue that the debtor had no "rights" of any sort to the collateral, and therefore that the secured party could assert no security interest at all, derivative or otherwise.⁸⁶ We believe, however, that under the notions of ostensible ownership that should animate resolution of competing property claims in collateral, possession by the debtor should always constitute sufficient "rights in the collateral" to pass the hurdle of whether or not a security interest (or other property right) has *attached*.⁸⁷

Therefore, Global's power to convey a property interest in a boat to a third party (either a buyer or a secured party) should depend on the ostensible ownership problems created by the arrangements between Global and Chrysler. Global should gain the power to convey an interest in a boat, at the latest, when it first possesses that boat, notwithstanding contractual provisions between Chrysler and Global to the contrary. Global should have "voidable title" (to use the rubric of Article 2) and "rights in the collateral" (to use the rubric of Article 9) whenever it takes possession of the boat. This is not to say that Chrysler, if it gives up possession, would lose to a competing claimant, but only that third parties should be able to acquire some rights in the boat—albeit, perhaps, only derivative rights—beginning no later than the time Global takes possession of the boat.

The more critical, but conceptually distinct, question concerns the circumstances under which the subsequent property claimant

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ing. Rather, "attachment" of the third party's interest means nothing more than that upon Pan Am's default against the third party, the latter can assert whatever rights Pan Am enjoys in the aircraft against Boeing. The secured party may take possession of the aircraft by stepping into the shoes of Pan Am and assuming both its rights and obligations under the lease. The secured party will acquire not the aircraft but rather Pan Am's right to use them. Assuming that the secured party's rights to the aircraft are but derivative of Pan Am's, when Pan Am loses its right to possess the aircraft as against Boeing, so too will the secured party lose its rights to possess the aircraft as against Boeing. Because Pan Am has the right to use the airplanes only if it pays Boeing \$100,000 a month, the secured party will be able to use the airplanes only if it pays Boeing the same amount. Thus, the right the third party acquires to secure its debt (the right to rent airplanes from Boeing at \$100,000 a month) will prove valuable only if the \$100,000 rental price is below the prevailing market rate for airplanes of that type at the time of Pan Am's default.

86. See, e.g., *In re Toppo*, 474 F. Supp. 48, 53 (W.D. Pa. 1979); *Himes v. Cameron County Constr. Corp.*, 29 U.C.C. Rep. Serv. (Callaghan) 264, 268 (Pa. Super. Ct. 1980); *Manger v. Davis*, 619 P.2d 687, 691 (Utah 1980).

87. See, e.g., *Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc.*, 127 Ariz. 70, 73-74, 618 P.2d 240, 243-44 (Ariz. Ct. App. 1980) ("debtor has sufficient rights in collateral for the attachment of a security interest when the debtor obtains possession of the collateral").

can assert greater rights against the earlier claimant than the debtor himself. In other words, when will the debtor, even though he would lose to the "owner" in a two-party dispute, be able to pass on to a third party a right to the collateral that will take priority over the owner's claim? We believe the answer should once again turn, in the first instance, on resolution of the ostensible ownership problem. Once Global gains possession of the boats, subsequent property claimants should be able to take priority over Chrysler's rights, unless Chrysler first cures the ostensible ownership problem by filing. They should be able to take priority even when Global's action in allowing such property interests to come into being was wrongful as against Chrysler. Article 9 provides this result by making the retention of title by a seller after delivery tantamount to a security interest. Hence Chrysler's position, after delivery of boats to Global, would be similar to the position of a bank who financed Global's acquisition of the boats and took a purchase money security interest in the boats under Section 9-107(b). This is as it should be since, from the perspective of third parties, the arrangements are identical.

Suppose Chrysler (or a bank financing Global's acquisition of boats from Chrysler) decided to create a field warehouse rather than simply retain a nonpossessory security interest in the goods. In a field warehouse transaction, the creditor arguably retains "possession" of the collateral.⁸⁸ Because there was no transfer of possession to Global, Chrysler (or the bank) would argue, no ostensible ownership problems were created, and thus there would be no reason to upset the contractual allocation of property rights with Global. Therefore, even without Chrysler complying with Article 9's filing requirements, competing claimants' rights, even if they attach, should remain derivative of Global's and hence subordinate to Chrysler's rights.

But treating Chrysler as being in "possession" of the boat because of its field warehouse exalts form over substance. But for the presence of a few signs, which may not be seen, or, if seen, may not be understood,⁸⁹ third parties cannot distinguish Chrysler's boats from

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88. In establishing a field warehouse, Chrysler might also argue that it never gave Global any "rights" in the boat, so Global could not have passed rights on to third parties. This argument should lose for the reasons we have just explored. Chrysler's argument takes the same form as that of purchase money sellers who argue that they never conveyed "title" to their buyers. Both the seller that claims that it has retained title after delivery to the buyer and the seller that claims that it has granted no rights in the collateral despite transferring possession to the buyer have created ostensible ownership problems. Neither claim should be recognized because third parties have insufficient means of discovering the contractual allocation of rights. *See* text accompanying notes 89-90 *infra*.

89. *See* *Ribaud v. Citizen's Nat'l Bank of Orlando*, 261 F.2d 929, 933-35 (5th Cir.

inventory held on consignment or held subject to a nonpossessory security interest. Field warehousing, although a valuable method of monitoring untrustworthy debtors, creates substantial ostensible ownership problems. Consequently, unless Chrysler files under Article 9, courts should deem its interest unperfected and subordinate to a security interest for which there is a proper Article 9 filing.⁹⁰ Unless Chrysler files, Global, upon taking possession of the property, should have the power (if not the right) to pass on greater "rights in the collateral" than Global itself enjoys. That power can be limited only if Chrysler takes legal steps to cure the ostensible ownership problem its nonpossessory property interest brings with it.

B. *Reclamation Rights of the Seller*

Although the ostensible ownership problem sets forth an operative principle that we have argued should apply more broadly, it is also true that there may be instances in which exceptions are justified on one ground or another. A sensible system, however, cannot free parties from the duty to take possession of the property or file simply because in a particular instance it turns out that there was no *actual* reliance on the debtor's ostensible ownership. Although external indicia of ownership are critical to guard against the reliance engendered by ostensible ownership, fact-based inquiries, turning on the subjective decisions of a particular individual, are bound to be costly and error-prone.

Although deciding whether to create an exception to the general filing or possession requirement ultimately will depend on difficult empirical questions, the relevant questions in each type of case seem fairly evident. The troublesome case of the conflict between a seller's

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1958) ("possession" by field warehousing company upheld despite the constant passage of debtor's employees and visitors through the warehouse and the existence of certain goods within the posted area that were not intended to be covered by the warehouse receipt); *Chartered Bank of London v. Chrysler Corp.*, 115 Cal. App. 3d 755, 758-59, 171 Cal. Rptr. 748, 749-50 (1981) ("possession" by field warehousing company upheld even though signs stated, incorrectly, that all goods within the area were in the "possession" of the warehouse company).

90. Just as many true lessors file to protect themselves from a subsequent court's recharacterization of their lease as a secured transaction, many parties using field warehousing file to protect their interests even though Article 9 does not require them to do so. Field warehousing companies seem to have won their battle to remain "outside" of Article 9; field warehousing allows a party to assert a perfected security interest without making a public filing. Compare § 9-305(2) (1952) (security interest in goods stored under field warehousing arrangement can be perfected only by filing) with § 9-205 comment 6 (1972). However, field warehousing companies still advise secured parties to file. See McGuire, *supra* note 81, at 278-79.

reclamation rights and the rights of a secured party of the buyer illustrates this point.⁹¹

If Chrysler makes a cash sale of a boat and Global pays for it with a rubber check, or if Chrysler sells a boat to Global on credit while Global is insolvent, Chrysler has the right under Article 2 to reclaim the boat by giving notice to Global within ten days of delivery.⁹² Under Article 2, Chrysler's right to reclaim is subject to the rights of a buyer in ordinary course of business.⁹³ The Code, however, is not clear about whether Chrysler's reclamation right is subject to the rights of a creditor, such as a finance company, secured by an interest in Global's after-acquired inventory,⁹⁴ or to the rights of other subsequent purchasers.

Chrysler's principal argument must be that the rights accorded holders of these competing interests remain only derivative of Global's.⁹⁵ For that reason, even though a competing security interest in Global's inventory has "attached," the seller's reclamation

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91. Scholarly analysis of this problem has been profuse, yet divided. See, e.g., Braucher, *Reclamation of Goods from a Fraudulent Buyer*, 65 MICH. L. REV. 1281 (1967); Dolan, *The Uniform Commercial Code and the Concept of Possession in the Marketing and Financing of Goods*, 56 TEX. L. REV. 1147 (1978); Henson, *Reclamation Rights of Sellers Under Section 2-702*, 21 N.Y.L.F. 41 (1975); Kennedy, *The Interest of a Reclaiming Seller Under Article 2 of the Code*, 30 BUS. LAW. 833 (1975); McDonnell, *The Floating Lienor as Good Faith Purchaser*, 50 S. CAL. L. REV. 429 (1977); Wiseman, *Cash Sellers, Secured Financiers and the Meat Industry: An Analysis of Articles Two and Nine of the Uniform Commercial Code*, 19 B.C.L. REV. 101 (1977).

92. See § 2-507(2) and official comment 3 (cash sale where debtor fails to pay upon delivery of goods); § 2-702(2) (credit sale where buyer has received goods while insolvent).

93. See § 2-702(3); see also § 2-403. The historical development of the rules governing good faith purchasers is traced in Dolan, *The U.C.C. Framework: Conveyancing Principles and Property Interests*, 59 B.U.L. REV. 811 (1979); Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057 (1954). For a discussion of the competing rights of buyers in ordinary course and perfected secured parties, see notes 99-105 *infra* and accompanying text.

94. This problem has spawned a fair amount of litigation. See, e.g., *In re Samuels*, 526 F.2d 1238 (5th Cir.) (en banc), cert. denied, 429 U.S. 834 (1976).

95. Chrysler can also argue that the finance company or other purchaser did not obtain an interest in the boat because, under Article 9, an enforceable security interest cannot arise unless the debtor has "rights in the collateral." Since Global took possession by tendering a defective check or by misrepresenting its ability to pay for the boat, it arguably did not acquire "rights" in the boat. One court has adopted this argument. *In re Samuels*, 510 F.2d 139 (5th Cir. 1975), rev'd en banc, 526 F.2d 1238, cert. denied, 429 U.S. 834 (1976).

Two flaws mar this argument. First, Chrysler's definition of "rights in the collateral" prevents Global from conveying a partial interest in the property even though Global could convey "good title" to an outright buyer (even if that buyer is not one "in ordinary course of business"). See § 2-403(1). Moreover, sections 1-201(37) and 2-401(1) provide that, in a sale, title to goods automatically passes upon delivery to the buyer. It is odd to say that title passes without "rights in the collateral" passing as well.

Second, and more important, this argument makes the rights of the finance company or subsequent purchaser turn on a division of ownership rights between two parties that is buried in a contract. We believe that possession by the debtor should always constitute sufficient

right retains priority. From the perspective of ostensible ownership, this argument seems dubious. Chrysler is asserting a property interest in its buyer's goods even though it does not possess them and has not filed.

Nevertheless, there are arguments that an exemption from Article 9's general possession or filing requirements may be appropriate.⁹⁶ The burdens that a seller's reclamation right puts on the secured party are not different in principle from the burdens that a purchase money security interest puts on a secured party with a security interest in equipment.⁹⁷ In the latter situation, the secured party must ensure that its debtor has possessed the collateral for ten days and that no new filing covering the collateral has been made in that time period. For this reason, the seller's reclamation right does not necessarily put a new burden on the secured party.

But this argument is somewhat weakened by the fact that the Code's reclamation right, with its ten-day grace period, exists both for sellers of inventory and sellers of equipment. In contrast, the Code's ten-day grace period for filing purchase money security interests applies only to the seller or financier of equipment; a seller or financier of inventory must file before its debtor receives possession of the collateral.⁹⁸ Therefore, the seller's reclamation right does create an additional risk to a secured party in the case of inventory, but not in the case of equipment.

The seller, for his own part, may gain substantial benefits that offset the costs created by the temporary ostensible ownership problem. For example, with a reclamation right, a seller might be willing to deliver goods without waiting for his buyer's check to clear and without making an Article 9 filing. Either alternative might cost the seller more than the cost of the added risk to the secured party created by the debtor's inability to grant him superior rights to the col-

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"rights in the collateral" for a security interest to attach. *See* text accompanying note 87 *supra*.

96. One of us has argued elsewhere that the seller's timely exercise of its reclamation rights should take precedence over a security interest in after-acquired inventory, provided that the secured party has not extended new value after the debtor's receipt of the new inventory. In other words, the secured party should lose when it has not in fact relied on the debtor's possession of the seller's goods. *See* Jackson & Peters, *supra* note 83, at 966-69. As the text suggests, we still think reliance is the crucial question, but we no longer think it should be searched for on a case-by-case basis.

97. Other "short-term" burdens exist by virtue of Article 9's four-month reperfecton rules for changes in debtor name, debtor location, and collateral location. *See* note 49 *supra*.

98. *See* § 9-312(3). We criticize § 9-312(4)'s approach in the text accompanying notes 55-60 *supra*.

lateral until ten days elapse. In addition, imposing a notification requirement on the seller may impose a cost that produces few informational advantages. A financier of inventory or other purchases may simply "know" that virtually all sellers of inventory (those who are not paid in cash or cash-equivalents) enjoy a reclamation right, and that this right exists only for a limited time. In the likely event that this knowledge is widespread, a notification requirement would impose additional costs with no associated benefits. Thus, the Code may be justified in granting the seller a ten-day reclamation right without requiring that he notify earlier secured parties when goods subject to that right have been delivered to the debtor.

The Code's reclamation right does, however, have a major defect: The Code provides that for a seller to exercise his reclamation right he only need *notify* the *buyer* within ten days. There is no limit on when, following the notification, the seller must in fact remove the property from the buyer's possession, nor is there any requirement that other claimants be notified. From the perspective of ostensible ownership, this is perhaps the most troubling weakness of the Code's reclamation right, since it extends indefinitely the buyer's ostensible ownership of the goods.

C. *The Buyer in Ordinary Course of Business*

A buyer in ordinary course of business (e.g., a consumer who buys a boat from Global) takes his goods free of an earlier party's interest, even if that interest is a perfected security interest.⁹⁹ This is an important exception to the protection accorded earlier parties who, because they have filed, are entitled to the benefits on the principle that claimants through a debtor generally acquire no greater rights than the debtor had to give.

The exception may be justified as reflecting the relative interests of all parties. An individual buyer cannot easily determine how his sellers finance their inventories nor can he afford to negotiate subordination agreements with his sellers' lenders for each purchase he makes. The secured lender, on the other hand, expects a constant flow of inventory in and out of his debtor's possession. Thus, the secured lender's desire to keep an interest in inventory after it leaves his debtor's hands may not be as strong as the buyer's desire to take

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99. See § 2-403(2); § 9-307(1). A buyer in ordinary course of business is defined as "a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of the kind." § 1-201(9).

free of that interest after he has taken possession of the goods and committed himself to paying for them. The rule that allows the buyer in ordinary course to take an asset free of a preexisting security interest thus, by operation of law, may reflect the relative interests of buyers and lenders and may replicate the agreement that would emerge from face-to-face bargaining between them.¹⁰⁰

But to say that a buyer in ordinary course of business from Global takes priority over Chrysler, even if Chrysler has cured the ostensible ownership problem, does not tell us when someone becomes a "buyer" for purposes of determining rights against other property claimants. The Code provides no explicit guidance here. Presumably, for there to be a "buyer," there must be a sale. Although generally refusing to rely on title to define the rights of various parties, Article 2 defines a "sale" as the "passing of title . . . for a price."¹⁰¹ Using this definition of "sale" to determine when someone acquires property free of the competing claim of a secured creditor is unwise; a clear rule that introduces no new ostensible ownership problems is preferable to an uncertain one that invites inquiry into incidents of ownership that are hidden from affected third parties.

A party should become a "buyer," for purposes of determining when he can assert priority over third parties, at the moment he takes possession of the goods and not before.¹⁰² If Chrysler or Global re-

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100. See Weinberg, *supra* note 4.

101. § 2-106(1). See, e.g., *Weishart & Co. v. First Nat'l Bank of Dalhart*, 568 F.2d 391 (5th Cir. 1978); *Chrysler Corp. v. Adamatic, Inc.*, 59 Wis. 2d 219, 238-39, 208 N.W.2d 97, 106 (1973).

102. See text accompanying notes 55-60 *supra*. The court reached this result in *Chrysler Corp. v. Adamatic, Inc.*, 59 Wis. 2d 219, 239, 208 N.W.2d 97, 107 (1973). However, that court also noted that "[i]t seems clear that, if there is a sale and the buyer has obtained title to the goods, his status as a buyer in ordinary course will not be defeated merely because he has not taken possession." *Id.* At least one commentator agrees with us that a party should not achieve "buyer" status until he takes possession of the goods. See Smith, *Title and the Right to Possession Under the Uniform Commercial Code*, 10 B.C. INDUS. & COM. L. REV. 39, 59-61 (1968); cf. *Chartered Bank of London v. Chrysler Corp.*, 115 Cal. App. 3d 755, 171 Cal. Rptr. 748 (1981) (no buyer in ordinary course status when seller of goods was never in possession because of field warehousing arrangement). *Contra* *Wilson v. M & W Gear, Inc.*, 110 Ill. App. 3d 538, 442 N.E.2d 670 (1982) (one can become a buyer in ordinary course of business within the meaning of § 9-307(1), even if the goods had not been identified to the contract, as long as the goods were within the seller's possession awaiting delivery or being prepared for delivery); *Herman v. First Farmers State Bank*, 73 Ill. App. 3d 475, 392 N.E.2d 344 (1979); Skilton, *Buyer in the Ordinary Course of Business Under Article 9 of the Uniform Commercial Code (and Related Matters)*, 1974 WIS. L. REV. 1, 20; Note, *When Does a Buyer Become a Buyer in the Ordinary Course?* UCC §§ 1-201(9), 9-307(1): *A Test and a Proposal*, 60 NEB. L. REV. 848, 875 (1981) ("Since there are no particularly compelling reasons for refusing to recognize buyer in ordinary course at much earlier stages of the transaction, there is much less reason for conditioning buyer in ordinary course status upon delivery or acceptance."). The pre-Code rule was that, between

mains in possession of the boat, a buyer should take subject to Chrysler's security interest.¹⁰³ This is the only rule that permits Chrysler, through a device such as a field warehouse arrangement, to retain sufficient control over Global's disposition of the collateral. And even if Chrysler held only a purchase money security interest in Global's inventory, without the field warehouse arrangement, it should be entitled to rely on its spot inspections of Global's store to ensure its continued priority. As long as Global remains in possession of the collateral, Chrysler should be able to assume that any parties with interests superior to its own¹⁰⁴ would have been revealed by the

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two buyers from the same seller, the one first taking possession prevailed. *See, e.g.,* Cottman v. Wagner, 213 Md. 73, 130 A.2d 749 (1957).

Under the Uniform Trust Receipts Act, there was an explicit requirement that someone could become a "buyer in the ordinary course of trade" and prevail over the secured party only if delivery took place before he learned that the sale violated the rights of the secured party, Uniform Trust Receipts Act §§ 1, 9(2)(a). As late as the 1950 draft of Article 9, § 2-403(4) defined a "buyer in ordinary course" as one "to whom goods are shipped pursuant to a pre-existing contract or one to whom they are delivered on credit." The language was dropped, without comment, when the definition was moved to Article 1. The late Justice Robert Braucher thought that when the issue came up in preparing the 1956 revisions of Article 9, Karl Llewellyn agreed with him "that the 'buyer' must 'buy,' and that making a contract is not 'buying' unless the buyer receives the goods or documents of title." Letter from Robert Braucher to Homer Kripke (Jan. 25, 1978).

Fraudulent conveyance law is available to strike down egregious cases of retention of possession following a sale. *See, e.g.,* CALIF. CIV. CODE § 3440 (transfer of personal property "not accompanied by an immediate delivery followed by an actual and continual change of possession" is conclusively fraudulent); *but see* § 2-402(2) (retention of possession for commercially reasonable time not fraudulent). We believe, however, that an explicit possession or notice rule is preferable to the blunt use of fraudulent conveyance law, which varies from jurisdiction to jurisdiction. *See, e.g.,* CALIF. CIV. CODE § 3441(h) (requiring public notice in cases of sales and leasebacks).

103. Professor Kripke, animated by the result in *Tanbro Fabrics Corp. v. Deering Milliken, Inc.*, 39 N.Y.2d 632, 350 N.E.2d 590 (1976) (holding that buyer in ordinary course takes free of security interest of secured party in possession), has argued that a party should not be entitled to the status of buyer in ordinary course of business when a secured party of the seller was in possession of the goods at the time of sale. Kripke, *Should Section 9-307(1) of the Uniform Commercial Code Apply Against a Secured Party in Possession?*, 33 BUS. LAW. 153 (1977). But Professor Kripke does not believe that, generally, the status of buyer in ordinary course of business should be dependent upon possession. *Id.* Although he criticizes *Tanbro Fabrics* for not paying sufficient heed to the fact of possession by the secured party, Professor Kripke is unwilling to require a buyer to take possession of goods before he can prevail over a creditor's nonpossessory interest. He thinks it would be an "unnecessarily broad proposition" to require a buyer in ordinary course to first gain possession. Instead, Professor Kripke thinks a buyer who has paid should be protected if the merchant has the goods and is in a position to make a delivery. Letter from Homer Kripke to Charles D. Breitel (Feb. 11, 1978). Of course, once one decides that someone does not qualify as a buyer in ordinary course, he must still ask if the buyer prevails against the prior secured party, nevertheless, on the grounds that the secured party, by direction or indirection, has authorized the transfer under § 9-306(2).

104. Because Chrysler is a purchase money seller, there would be no parties with a superior interest.

filing system at the time Chrysler filed its interest.¹⁰⁵

IV. CONCLUSION

Possession of personal property is the best evidence of its ownership. The law of secured transactions has ordered itself around this principle for nearly four hundred years. Filing systems reinforce the primacy of possession, and together they ensure that potential secured creditors can discover, without having to rely on the debtor, whether their interests in the debtor's property will have priority over the claims of others. As is the case with any statute that tries to impose order upon a complicated body of law, Article 9 occasionally fails to execute the principles it embodies. In addition, its scope is tied too narrowly to its historical roots. In this article, we have tried to find common themes that underlie some of the most troublesome problems that have arisen under Article 9, and we have traced them to a common source: The drafters of the Code did not go far enough either in abolishing metaphysical and unobservable distinctions based on concepts such as "title" or in adopting the more concrete concept of possession as their benchmark.

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105. This rule protects Chrysler without imposing on it a duty to re-check the files. *See* text accompanying notes 55-60 *supra*. Requiring a buyer not in possession to give direct notice to preexisting secured parties (such as a purchase money secured party must provide under § 9-312(3)) would also provide Chrysler with the relevant information but might not allow Chrysler to enjoy the monitoring control made possible by a field warehouse arrangement or a possessory security interest. *See* Kripke, *supra* note 103. A notification rule would be less troublesome where the existing security interest was nonpossessory.

Like any legal rule, a possession-based test may create troublesome cases at the fringes. For example, a buyer who purchased a computer and received possession of it, taking free of a security interest in his seller's inventory, § 9-307(1), might return the computer for repairs a few days later and not be required to file a notice of his interest, even under our proposal, because of its brief duration, *see* text accompanying note 49 *supra*, whereas a buyer who never picked the computer up in the first place for a few days would lose because of the ostensible ownership principle. *See, e.g.*, *Chrysler Corp. v. Adamatic, Inc.*, 59 Wis. 2d 219, 208 N.W.2d 97 (1973). The question, however, is not whether such troublesome cases exist, but rather whether the system, on balance, seems more cost-effective and trustworthy than the alternatives.