

The National Agricultural
Law Center



University of Arkansas School of Law
NatAgLaw@uark.edu • (479) 575-7646

An Agricultural Law Research Article

U.C.C. Section 9-307(1) and the Non-Possessory Buyer: Is the Good Faith Purchaser Always Right?

by

Clay D. Land

Originally published in *GEORGIA LAW REVIEW*
19 GA L. REV. 123 (1984)

www.NationalAgLawCenter.org

NOTE

U.C.C. SECTION 9-307(1) AND THE NON-POSSESSORY BUYER: IS THE GOOD FAITH PURCHASER ALWAYS RIGHT?

INTRODUCTION

According to Professor Grant Gilmore, a principal drafter of the Uniform Commercial Code, almost all of those involved in the Code's drafting shared the opinion "that the good faith purchaser is always right."¹ Professor Gilmore has suggested, however, that by giving broad protection to a good faith purchaser of goods the drafters may have codified a policy which is now partially obsolete.² One example of over-extension of the drafters' buyer protection policy, not specifically addressed by Professor Gilmore, is the application of U.C.C. section 9-307(1) to non-possessory buyers. Section 9-307(1) states that "A buyer in ordinary course of business . . . other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence."³

The usual application of section 9-307(1) can best be illustrated by the following hypothetical. *A*, the owner of a retail appliance store, wants to buy refrigerators to resell. Since he does not have the funds to pay cash for the refrigerators, he signs a security agreement giving the manufacturer *B* a security interest in the refrigerator inventory.⁴ The security agreement provides that upon

¹ Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 605 (1981).

² *Id.* at 605-06 (Professor Gilmore speculates about what courts should "do with a mid-twentieth century codification of a mid-nineteenth century idea whose time has long since gone").

³ U.C.C. § 9-307(1) (1978).

⁴ For purposes of this hypothetical, assume that the security interest is a valid article 9 security interest (that is, all of the formal requisites set out in U.C.C. § 9-203 have been met) and that all the requirements for perfection and filing, as set out in part 4 of article 9, have been satisfied.

sale of each refrigerator, *A* will remit to *B* the amount owed for that particular refrigerator. *C*, a buyer in ordinary course of business,⁵ purchases one of the refrigerators from *A* and takes possession, installing it in his home. Due to financial difficulties, however, *A* does not remit any of the proceeds to *B*. Thereafter *A*'s financial problems force him to default on the financing extended by *B*. Under these facts, *B* will not be allowed to repossess the refrigerator purchased by *C*. Section 9-307(1) enables *C* to take the refrigerator free of *B*'s prior perfected security interest, even if *C* knew of the security interest.⁶

A more troublesome case arises when the buyer *C* prepays for the goods, either partially or in full,⁷ and instead of taking posses-

⁵ The UCC defines a buyer in ordinary course of business as:

[A] person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind but does not include a pawnbroker . . . "Buying" may be for cash or by exchange of other property or on secured or unsecured credit and includes receiving goods or documents of title under a pre-existing contract for sale but does not include a transfer in bulk or as security for or in total or partial satisfaction of a money debt.

U.C.C. § 1-201(9) (1978).

⁶ U.C.C. § 9-307(1) (1978). Professors White and Summers have summarized the requirements of § 9-307(1) as follows:

- (1) He must be a buyer in the ordinary course
- (2) who does not buy in bulk and does not take his interest as security for or in total or partial satisfaction of a pre-existing debt (that is, he must give some form of "new" value),
- (3) who buys from one in the business of selling goods of that kind (that is, cars from a car dealer, i.e., inventory),
- (4) who buys in good faith and without knowledge that his purchase is in violation of others' ownership rights or security interests, and
- (5) does not buy farm products from a person engaged in farming operations, and
- (6) the competing security interest must be one "created" by his seller.

J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* § 25-13, at 1067 (2d ed. 1980). *See, e.g.,* Rome Bank & Trust Co. v. Bradshaw, 143 Ga. App. 152, 237 S.E.2d 612 (1977) (buyer of used car from dealer on floor-plan financing satisfied requirements of § 9-307(1) and thus took free of bank's security interest).

Section 9-307(1) also applies in the wholesale context, enabling a retailer to purchase goods from a wholesaler free of any security interest that the wholesaler may have given to a manufacturer. *See, e.g.,* First Nat'l Bank, Martinsville v. Crone, 157 Ind. App. 665, 301 N.E.2d 378 (1973) (applying § 9-307(1) to protect merchant buyer in logging business); Bank of Utica v. Castle Ford, Inc., 36 A.D.2d 6, 317 N.Y.S.2d 542 (1971) (applying § 9-307(1) to auto dealers).

⁷ For purposes of this Note, the non-possessory buyer is not a creditor, although his prepayment of the purchase price may assist in the financing of the transaction. A non-possessory buyer is one who does not take possession of the purchased goods.

sion of the goods, leaves them in the possession of the debtor *A*⁸ or secured creditor *B*.⁹ Extending section 9-307(1) to allow *C*, now a non-possessory buyer, to take the goods free of *B*'s security interest can be inequitable.¹⁰ When a secured creditor relies on the possession of the debtor or on his own possession as evidence of his continued priority in the collateral, application of section 9-307(1) to the non-possessory buyer allows an interest, *secret* to the secured creditor (assuming he does not know of the sale), to defeat his priority and thus frustrate his reasonable commercial expectations.¹¹ Apparently, the drafters of the U.C.C. formulated section 9-307(1) without considering the shift in equities in favor of the secured creditor that results when a debtor or secured creditor retains possession.¹²

The courts, despite any unfairness to secured creditors, have consistently held that non-possessory buyers have the same right as possessory buyers to take goods under section 9-307(1) free of any prior perfected security interest.¹³ This application of the section has elicited much criticism, and some legal scholars have urged that a person should not become a buyer for purposes of section 9-307(1) until he takes delivery of the goods.¹⁴ Although the approach taken by the courts is unjustified, reliance on a

⁸ Retention of goods by the debtor could occur for various reasons. *See, e.g.*, *Serra v. Ford Motor Credit Co.*, 463 A.2d 142 (R.I. 1983) (debtor retains goods until his buyer pays full purchase price); *Holstein v. Greenwich Yacht Sales, Inc.*, 404 A.2d 842 (R.I. 1979) (debtor retains because goods have not yet been completed); *Integrity Ins. Co. v. Maine Midland Bank-Western*, 90 Misc. 2d 868, 396 N.Y.S.2d 319 (Sup. Ct. 1977) (debtor retains for convenience of buyer).

⁹ *See, e.g.*, *Tanbro Fabrics Corp. v. Deering Milliken, Inc.*, 39 N.Y.2d 632, 350 N.E.2d 590, 385 N.Y.S.2d 260 (1976) (creditor as ordinary part of its business retained goods because buyer lacked storage space).

¹⁰ *See infra* text accompanying note 140.

¹¹ For a discussion of the unfairness which results when a secured creditor's commercial expectations are defeated by a secret interest, see *infra* pp. 150-51.

¹² *See infra* text accompanying notes 61-67.

¹³ *See infra* note 68.

¹⁴ *See, e.g.*, *Baird & Jackson, Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175, 210 (1983) (one should become a buyer for purposes of § 9-307(1) when he takes possession of goods and not before); *Dolan, The Uniform Commercial Code and the Concept of Possession in the Marketing and Financing of Goods*, 56 TEX. L. REV. 1147, 1189 (1978) (non-possessory buyer should not prevail over secured creditor who is in possession of collateral). *But cf.* *Skilton, Buyer in Ordinary Course of Business Under Article 9 of the Uniform Commercial Code (And Related Matters)*, 1974 WIS. L. REV. 1, 20-21 (1974) (§ 9-307(1) does not require delivery before a buyer can take free of a security interest).

mechanical solution, which looks only to delivery of the goods, is also undesirable. This Note proposes an alternative solution which allows courts to look to the reasonable commercial expectations of the parties. This solution is supported by the ancient legal principle of ostensible ownership¹⁵ which is the basis for the principal policy behind section 9-307(1): protecting the reasonable commercial expectations of the buyer. Just as possession of refrigerators by a retailer creates the expectation that he has the right to sell them clear of any other person's interest, retention of goods by a debtor or secured creditor in certain circumstances creates the expectation that the secured creditor still has a superior interest in the goods. The reasonable commercial expectations of the secured creditor deserve the same protection given to the expectations of the possessory buyer.

Part I of this Note examines the historical development of section 9-307(1), tracing its foundation to the ancient principle of ostensible ownership. Part II analyzes the current judicial application of section 9-307(1) to non-possessory buyers. The analysis reveals that the courts have ignored the foundation of section 9-307(1) and its significance in the non-possessory buyer context. Part III contends that the ostensible ownership principle not only justifies allowing a possessory buyer to take goods free of any security interest created by his seller, but can also justify allowing a secured creditor to prevail over a non-possessory buyer in certain circumstances. Finally, Part IV proposes an amendment to the U.C.C. based on this argument and, alternatively, provides an analysis useful to courts in the absence of that amendment. Both proposals provide a nonmechanical solution to the problems which arise when section 9-307(1) is applied to the non-possessory buyer. This solution allows courts to prevent unfairness by protecting the expectations of *both* parties.

I. THE HISTORICAL DEVELOPMENT OF SECTION 9-307(1)

The shielding of a buyer in ordinary course of business from a security interest created by his seller is supported by two policies: protecting the reasonable commercial expectations of the buyer and minimizing transaction costs. Examination of the historical de-

¹⁵ See *infra* text accompanying notes 16-22.

velopment of section 9-307(1) suggests that those policies, particularly the former, are related to the principle of ostensible ownership. Analysis of the early drafts of section 9-307(1) also suggests, however, that the drafters considered the importance of the policies derived from the ostensible ownership principle only in relation to a buyer who takes possession. They did not consider the analogous application of the principle to protect the reasonable expectations of the secured creditor when the buyer does not take possession of the goods.

A. *The Emergence of Two Broad Policies*

1. *Origin in the Common Law.* The legal theory of ostensible ownership "estops an owner of property who clothes another with apparent title from later asserting his title against an innocent third party who has been induced to deal with the apparent owner."¹⁶ When a seller has apparent ownership of certain goods, manifested by his possession of them, a potential buyer has a reasonable expectation that the seller has the rights to convey those goods. Therefore, upon purchasing the goods, the buyer should be protected from the claim of some third party who claims "actual ownership" of the goods. It would be unfair to allow the "actual owner's" secret interest to defeat the reasonable commercial expectations of the buyer who relied on the possession and ostensible ownership of the apparent owner.¹⁷

This doctrine dates back to the English common law as manifested in *Twyne's Case*.¹⁸ In *Twyne's Case*, Pierce was indebted to Twyne. To satisfy this debt, Pierce attempted to make a gift to Twyne. Since Pierce, however, retained possession of the goods that he allegedly had given Twyne, the court found the gift fraudu-

¹⁶ *Domarad v. Fisher & Burke, Inc.*, 270 Cal. App. 2d 543, 552, 76 Cal. Rptr. 529, 535 (1969).

¹⁷ The ostensible ownership principle can be applied to an article 9 situation. Although the debtor may not be the actual owner of the goods, he has the apparent power to sell those goods unencumbered by any interest of a third party. The secured creditor, however, does have an encumbrance or, arguably, an "ownership interest" in those goods. Therefore, one could argue that under the ostensible ownership principle, any buyer purchasing goods from the debtor should not be defeated by the secured creditor's "secret interest" because the debtor's possession of the goods created a reasonable expectation that the debtor had full rights to convey.

¹⁸ 3 Co. Rep. 80b, 76 Eng. Rep. 809 (Star Chamber 1601).

lent and invalid.¹⁹

The courts of this country have also recognized the doctrine of ostensible ownership.²⁰ As the court stated in *Clow v. Woods*,²¹ "In every case where possession is not given, the parties must leave nothing unperformed, within the compass of their power, to secure third persons from the consequences of the apparent ownership of the vendor."²²

2. *Statutory Development Under the Uniform Codes.* Influenced by the policies underlying the common law ostensible ownership principle, the National Conference of Commissioners on Uniform State Laws drafted section 9 of the Uniform Conditional Sales Act.²³ Section 9 provided that when a seller (wholesaler) expressly or impliedly allowed his conditional buyer (retailer) to resell goods prior to satisfaction of the condition, the reservation of title in the wholesaler became void as to subsequent purchasers for value in the ordinary course of business.²⁴ The drafters of this

¹⁹ *Id.* at 80b-81a, 76 Eng. Rep. at 811-13.

²⁰ See Helman, *Ostensible Ownership and the Uniform Commercial Code*, 83 COMM. L.J. 25 (1978) (recognizing that the drafters of the Code incorporated the doctrine of ostensible ownership into the Code, but arguing the drafters erred in doing so).

²¹ 5 Serg. & Rawle 275, 9 Am. Dec. 346 (Pa. 1819).

²² *Id.* at ___, 9 Am. Dec. at 351.

²³ In drafting this provision the Commissioners attempted to state a rule of law that was widely recognized. See UNIF. CONDITIONAL SALES ACT § 9, 2 U.L.A. 15 note (1922). Although the cases upon which this provision was based do not explicitly mention the term "ostensible ownership," they are obviously based upon the policies which underlay this doctrine. As the court stated in *Bass v. International Harvester Co.*, 169 Ala. 154, 53 So. 1014 (1910), one of the cases upon which this provision was based:

"Where the owner, by his act or consent has given another such evidence of the right to sell or otherwise dispose of his goods as, according to the customs or the common understanding of the world, usually accompanied the authority of sale or disposition, as where a manufacturer delivers property, retaining title, to a retail dealer for the purpose of sale by the latter, a sale by the person thus intrusted with the possession of the goods, and with the indicia of ownership, or authority to sell or otherwise dispose of them, in violation of his duty to the owner, to an innocent purchaser for value, will prevail against the reserved title of the owner."

Id. at 159, 53 So. at 1015 (citations omitted).

²⁴ UNIF. CONDITIONAL SALES ACT § 9, 2 U.L.A. 15 (1922). Section 9 stated:

When goods are delivered under a conditional sale contract and the seller expressly or impliedly consents that the buyer may resell them prior to performance of the condition, the reservation of property shall be void against purchasers from the buyer for value in the ordinary course of business, and as to them the buyer shall be deemed the owner of goods, even though the contract or a copy thereof shall be filed according to the provisions of this act.

Id.

early provision considered the wholesaler's reservation of title and consent to resell to be inconsistent acts.²⁵ The retailer's possession of the goods created the purchaser's expectation that the retailer had full rights to convey the goods.²⁶ Therefore, the drafters allowed the good faith purchaser to take the goods free of any secret ownership interest that the wholesaler reserved.²⁷ In addition, the drafters sought to minimize transaction costs. Requiring a buyer to search for the secret interest or negotiate for its release would probably cause a drastic increase in the cost of commercial activity and prohibit many buyers from participating. Thus, the drafters spared the buyer the burden of searching the records to determine who had title to the goods.²⁸

The Commissioners later promulgated the Uniform Trust Receipts Act.²⁹ Section 9(2) of the Act³⁰ provided that when an en-

²⁵ *Id.*, 2 U.L.A. at 16 note.

²⁶ The Commissioners stated: "[T]hat the goods have been put into the retailer's stock with the consent of the wholesaler is conclusive evidence that they are there for sale and that *the retailer has title or right to convey.*" *Id.* (emphasis added).

²⁷ *Id.*

²⁸ *Id.* It should be noted that the non-possessory buyer problem, the main subject of this Note, would not arise under section 9 of the Uniform Conditional Sales Act. Section 9 only applied when the wholesaler *authorized*, either expressly or impliedly, the resale of the goods by the retailer. *See id.*

U.C.C. § 9-307(1), however, applies only when the sale to a buyer in ordinary course is *unauthorized*. *See* U.C.C. § 9-307(1) comment 2; *cf.* U.C.C. § 9-306(2) (applying to the situation in which resale is authorized).

²⁹ UNIF. TRUST RECEIPTS ACT, 9A U.L.A. 284 (1951). Section 2 stated:

1. A trust receipt transaction within the meaning of this act is any transaction to which an entruster and a trustee are parties . . . whereby

(a) the entruster or any third person delivers to the trustee goods, documents or instruments in which the entruster

(i) prior to the transaction has, or for new value

(ii) by the transaction acquires or

(iii) as the result thereof is to acquire promptly, a security interest; or

(b) the entruster gives new value in reliance upon the transfer by the trustee to such entruster of a security interest in instruments which are actually exhibited to such entruster, or to his agent in that behalf, at a place of business of either entruster or agent, but possession of which is retained by the trustee; provided that the delivery under paragraph (a) or the giving of new value under paragraph (b) either

(i) be against the signing and delivery by the trustee of a writing designating the goods, documents or instruments concerned, and reciting that a security interest therein remains in or will remain in, or has passed to or will pass to, the entruster, or

(ii) be pursuant to a prior or concurrent written and signed agreement of the trustee to give such a writing.

truster³¹ consents to the placing of goods subject to a trust receipts transaction in the inventory of the trustee,³² and the trustee sells the goods to a buyer in ordinary course of trade,³³ then the buyer takes the goods free of the entruster's security interest.³⁴ Like section 9 of the Uniform Conditional Sales Act, this provision of the Uniform Trust Receipts Act did not require the purchaser to search the public records to find the reserved interest.³⁵ The section thus appears to have been based on the same underlying policies—the buyer's expectations based on possession should not be

The security interest of the entruster may be derived from the trustee or from any other person, and by pledge or by transfer of title or otherwise.

Id. § 2, 9A U.L.A. at 289.

³⁰ *Id.* § 9(2), 9A U.L.A. at 304. Section 9(2) stated in pertinent part:

(a) . . .

(i) Where the trustee, under the trust receipt transaction, has liberty of sale and sells to a buyer in the ordinary course of trade, . . . whether or not filing has taken place, such buyer takes free of the entruster's security interest in the goods sold, and no filing shall constitute notice of the entruster's security interest to such a buyer.

(ii) No limitation placed by the entruster on the liberty of sale granted to the trustee shall affect a buyer in the ordinary course of trade, unless the limitation is actually known to the latter.

. . . .

(c) . . .

If the entruster consents to the placing of goods subject to a trust receipts transaction in the trustee's stock in trade or in his sales or exhibition rooms, or allows such goods to be so placed or kept, such consent or allowance shall have like effect as granting the trustee liberty of sale.

Id.

³¹ The Act defined "entruster" as: "the person who has or directly or by agent takes a security interest in goods, documents or instruments under a trust receipt transaction, and any successor in interest of such person," excluding persons who sell goods or instruments to buyers on credit and retain title or other security interest under a purchase money mortgage or conditional sales contract. *Id.* § 1, 9A U.L.A. at 285.

³² Trustee is defined in § 1 of the Act as: "the person having or taking possession of goods, documents or instruments under a trust receipt transaction, and any successor in interest of such person." *Id.*, 9A U.L.A. at 286.

³³ Under the Act, "buyer in the ordinary course of trade" is defined as:

a person to whom goods are sold and delivered for new value and who acts in good faith and without actual knowledge of any limitation on the trustee's liberty of sale, including one who takes by conditional sale or under a pre-existing mercantile contract with the trustee to buy the goods delivered, or like goods, for cash or on credit. Buyer in the ordinary course of trade does not include a pledgee, a mortgagee, a lienor, or a transferee in bulk.

Id., 9A U.L.A. at 284-85.

³⁴ *Id.* § 9(2), 9A U.L.A. at 304.

³⁵ *Id.*

frustrated by another party's reservation of a non-possessory interest and transaction costs should be minimized.³⁶ Unlike section 9 of the Conditional Sales Act, however, the Trust Receipts Act did subject a buyer to a security interest when he knew of limitations placed on the trustee's liberty of sale.³⁷

In the May 1949 tentative draft of the Uniform Commercial Code, the Commissioners and the American Law Institute completely revised the two uniform Acts, superseding them with section 7 of the tentative draft of the Code. Section 7-314 read in relevant part: "A good faith buyer of goods in ordinary course of business takes free of an inventory lien *even though it has been perfected and even though such buyer knows of the terms of the lien or of the financing statement . . .*"³⁸ While purporting to

³⁶ These two policies are not specifically stated in the Uniform Trust Receipts Act but they appear to have influenced the drafters. In the prefatory note to the Act, the Commissioners state that "[t]he Act works to the interest of purchasers by protecting, despite filing, all transactions in ordinary course of trade." *Id.*, 9A U.L.A. at 283 prefatory note. It could be reasonably inferred that the drafters here were referring to the protection of the purchaser's expectations based on the possession of his seller.

Moreover, the Commissioners did not require the purchaser to search the public record. As they stated, the Act should be adopted "because the cheapening, regularizing, clarifying, and clear definition of the parties' rights in trust receipt transactions will lower the cost of financing securities, imports and domestic merchandise—and so the cost to the consumer or investor." *Id.* Therefore, the Commissioners were concerned about minimizing transaction costs, and it could be argued that this policy underlay not only § 9(2) but the entire Act.

While the policies underlying the Uniform Conditional Sales Act and the Uniform Trust Receipts Act appear the same, the two relevant provisions differ in three ways. First, the reserved interests affected by these provisions are different. Section 9 of the Conditional Sales Act applied to the reservation of an "ownership interest," *see supra* notes 24-26 and accompanying text, whereas § 9(2) of the Trust Receipts Act applied to the reservation of a security interest, *see supra* note 30. Second, § 9 of the Conditional Sales Act made a distinction between authorized and unauthorized sales, *see supra* note 28, whereas § 9(2) of the Trust Receipts Act did not make such a distinction, *see supra* note 30. Finally, and perhaps most importantly for purposes of this Note, if a buyer knew of limitations placed on a trustee as to "liberty of sale" under the Trust Receipts Act, the buyer would be subjected to the security interest, whereas under the Conditional Sales Act it appears the buyer would still take free of a security interest. *See infra* note 37 and text accompanying notes 39-40.

³⁷ Compare UNIF. TRUST RECEIPTS ACT § 9(2), 9A U.L.A. at 304 ("No limitation placed by the entruster on the liberty of sale granted to the trustee shall affect a buyer in ordinary course of trade, unless the limitation is actually known to the latter.") with UNIF. CONDITIONAL SALES ACT § 9, 2 U.L.A. at 15 ("the reservation of property shall be void against purchasers from the buyer for value in the ordinary course of business").

³⁸ U.C.C. § 7-314 (Tent. Draft May 1949) (emphasis added). The draft defined a "buyer in ordinary course of business" to mean "a person who buys goods in ordinary course from a person engaged in the business of selling such goods . . . for cash or on secured or unsecured credit. Buying in ordinary course of business does not include a transfer in bulk or as secur-

protect good faith buyers in the ordinary course, the drafters of this tentative draft rejected the policy of section 9(2) of the Uniform Trust Receipts Act that "permitted a financier to defeat a buyer in ordinary course if the buyer knew of limitations on the dealer's liberty of sale."³⁹ Instead, the policy of section 9 of the Uniform Conditional Sales Act, which had no such restriction, was adopted "on the ground that a buyer from a person in the business of selling ought not to have the risk of such person defrauding the financier unless the buyer conspires with the borrower or otherwise acts in bad faith."⁴⁰ By extending protection to the buyer even though he knew of the security agreement and knew that the sale to him violated its terms, the drafters of section 7-314 could no longer rely on the ostensible ownership principle as justification for buyer protection. According to the ostensible ownership rationale, if a buyer's seller possesses goods and attempts to sell them, the buyer is justified in expecting that the seller has full rights to convey these goods.⁴¹ A buyer cannot claim, however, that he had reasonable expectations that his seller had full rights to convey when he knew the sale to him violated the terms of a security agreement. It appears, therefore, that the drafters of the May 1949 draft viewed section 7-314 as simply a device to protect the buyer.⁴²

The drafters subsequently rewrote section 7-314, resulting in section 8-307 of the October 1949 tentative draft of the Code.⁴³ Section 8-307 read in pertinent part that "[i]n the case of inventory, a buyer in ordinary course of business takes free of a security interest even though the buyer knows of the terms of the security agreement."⁴⁴ Regarding inventory sales, the new section followed

ity. *Id.*

³⁹ *Id.* comment 1.

⁴⁰ *Id.*

⁴¹ For a discussion of the ostensible ownership doctrine, see *supra* notes 16-23 and accompanying text.

⁴² See U.C.C. § 7-314 comment 1 (Tent. Draft May 1949). The drafters explained that buyers should not have to bear the risk of a seller defrauding the financier except when the buyer acts in bad faith. *Id.*

⁴³ U.C.C. § 8-307 (Tent. Draft Oct. 1949).

⁴⁴ *Id.* Section 8-307 carried forward the May 1949 draft's definition of a "buyer in ordinary course of business," discussed *supra* note 38. The October draft added a subsection which stated:

(2) In the case of any other collateral [besides inventory], a buyer of the collateral takes free of the security interest when the secured lender has authorized the debtor to dispose of it free of the security interest. A financing statement in which the se-

the position of two of its predecessors, section 7-314 and the Uniform Conditional Sales Act, that a buyer's knowledge of limitation on sale is immaterial.⁴⁵ Section 8-307(1) also clarified that a buyer must be in ordinary course and that the seller must be engaged in the business of selling such goods.⁴⁶ The rewritten provision also added subsection (2) that states the normal rule that a secured lender's consent to sale allows a buyer of the collateral to take free of the security interest.⁴⁷

In the spring of 1950, a Proposed Final Draft of the Uniform Commercial Code was published. Section 8-307 of the October 1949 tentative draft was renumbered section 9-307. Although the text remained the same,⁴⁸ the comments did not. As under prior law and previous drafts of the Code, the final draft stated that the

cured lender claims a security interest in proceeds . . . is such authority to sell.

Id.

⁴⁵ See *id.* comment 1. It stated:

1. Subsection (1) states a special rule covering the case of goods held for resale and follows Section 2-405(c) in providing that the borrower has power to sell to buyers in ordinary course of business free of any claim of a secured lender. The Uniform Conditional Sales Act rather than the Trust Receipts Act is followed in that *a buyer's knowledge of limitation on sale is immaterial*. It makes it clearer that the buyer must be in ordinary course and the seller must be engaged in selling such goods. A consumer buying goods from a manufacturer who does not ordinarily sell direct to consumers would not be a buyer in ordinary course. Whether it is ordinary course for one retail dealer to buy from another would depend on the customs and usages in the business involved.

Id. (emphasis added).

⁴⁶ *Id.*

⁴⁷ See *id.* comment 2. The drafters explained that "[s]ubsection (2) states the normal rule that if a secured lender consents to sale, a buyer of the collateral takes free of the security interest. It provides that if a secured lender claims a lien on proceeds, he has given his authority to sell." *Id.* See *supra* note 44 for the text of the subsection.

⁴⁸ See U.C.C. § 9-307 (Proposed Final Draft 1950). It stated:

(1) In the case of inventory, a buyer in ordinary course of business takes free of a security interest even though perfected and even though the buyer knows of the terms of the security agreement. A "buyer in ordinary course of business" means a person who buys goods in ordinary course from a person in the business of selling goods of that kind. "Buying" may be for cash or on secured or unsecured credit and includes receiving goods or documents under a pre-existing contract for sale but does not include a transfer in bulk or as security or in satisfaction of a money debt.

(2) In the case of other goods limitations on the debtors authority to sell are effective against a buyer with constructive notice including from the records except that a filed financing statement under which the secured lender claims a security interest in proceeds (defined in preceding section) gives the debtor unlimited authority to sell free of the security interest.

Id.

buyer in ordinary course takes the collateral free of the security interest even though it has been filed.⁴⁹ But the comments to section 9-307 stated, "Subsection (1) continues this rule, only making clear that the rule applies even though the buyer knows of the security interest."⁵⁰ The drafters must have intended the language in the Code, "even though the buyer knows of the terms of the security agreement," to mean that the buyer takes free if he knows of the *existence* of the security interest but *not* if he knows the sale to him violates the security agreement.⁵¹ Consequently, this version of section 9-307, read in light of the comments, *can* be justified under the principle of ostensible ownership,⁵² whereas the earlier tentative drafts could not.⁵³

After minor changes, section 9-307 became part of the 1952 Official Draft of the Uniform Commercial Code. As stated in section 9-307(1):

(1) In the case of inventory, and in the case of other goods as to which the secured party files a financing statement in which he claims a security interest in proceeds, a buyer in ordinary course of business takes free of a security interest even though perfected and even though the buyer knows of the terms of the security agreement.⁵⁴

According to the comments, the buyer in ordinary course takes

⁴⁹ See *id.*

⁵⁰ *Id.* comment 2(a).

⁵¹ As stated in the comments, this point was not clear under prior law. See *supra* text accompanying note 50. The explanation in the comments that the language of § 9-307 meant that a buyer took free if he knew of the security interest and the absence of any comment on the effect of a buyer knowing the sale to him violated the security agreement can be construed to mean that a buyer does not take free of the security interest if he knows of any violation.

⁵² A buyer's knowledge of the existence of a security interest in the goods he purchases does not mean that he should not expect his seller to have a right to convey the goods. The purchaser could reasonably expect that the security interest only affects the debtor/creditor relationship with no effect on the purchaser. Therefore, this knowledge can be reconciled with the ostensible ownership principle, whereas knowledge of a violation of a security agreement could not be. See *supra* notes 16-23 and accompanying text for a discussion of the ostensible ownership principle.

⁵³ Unlike the prior tentative drafts, discussed *supra* text accompanying notes 38-45, the Proposed Final Draft did not mention the Uniform Conditional Sales Act's or the Uniform Trust Receipts Act's position on the effect of a buyer's knowledge of limitations on sale. See U.C.C. § 9-307 (Proposed Final Draft 1950).

⁵⁴ U.C.C. § 9-307(1) (1952).

free, even when he knows of the security interest, because, by placing goods in the debtor's inventory or by filing a financing statement that claims an interest in proceeds, the secured creditor gives notice that he expects his debtor to sell part of the collateral.⁵⁵ Buyers in ordinary course, therefore, are entitled to expect the debtor to have authority to sell the collateral.⁵⁶ This rationale is not based on assumption of risk by the secured creditor in placing goods in the debtor's inventory but rather rests on the commercial expectations created by the secured creditor.⁵⁷

The 1957 Official Draft of the Code continued this principle, only more explicitly. Section 9-307(1) of the 1957 Code,⁵⁸ un-

⁵⁵ See *id.* comment 2 which stated:

Under subsection (1) a buyer in ordinary course of business (defined in Section 1-201) takes free of a perfected security interest in goods, even though he knows its terms, in two stated situations: (1) when the goods are inventory of the debtor, (2) when the financing statement filed by the secured party claims a security interest in proceeds. The theory is that when the goods are inventory or when proceeds are claimed the secured party contemplates that his debtor will make sales, and so the debtor has effective power to do so, even though his buyers know the goods they buy were subject to the security interest. Notice that this power exists even if the particular sale is a violation of the debtor's duty under the security agreement. (Indeed it is only in that case that reference to the subsection is needed; if the sale is in fact authorized of course the buyer gets good title).

Although the second situation stated seems on the face of this subsection to cover all varieties of goods, the definition of "buyer in ordinary course of business" (Section 1-201) restricts it, for practical purposes, almost exclusively to inventory. It cannot, in the first place, cover buyers of farm products from a farmer, for one buying from a farmer is not a "buyer in ordinary course of business." (Section 1-201(9)). Consumer goods bought from a consumer are not covered, for the consumer-seller is not "in the business of selling goods of that kind." (Section 1-201(9)). And even goods bought from a merchant, if they are, for instance, the merchant's discarded equipment and not part of his inventory, will not often fall within the subsection, for few merchants could be found to be "in the business of selling" their own old equipment. So in most of the cases covered the goods will in fact be inventory.

The statement of the second situation is nevertheless of importance. When a secured party files a financing statement claiming an interest in proceeds, he in effect gives public notice that he expects his debtor to sell part of the original collateral. Buyers from the debtor, in the ordinary course of the debtor's business, are entitled therefore to believe that the debtor has authority to sell. Claim to proceeds implies that the debtor has authority to sell. Unless he has, the statement should refrain from claiming proceeds.

Id.

⁵⁶ *Id.*

⁵⁷ See *id.*

⁵⁸ See U.C.C. § 9-307(1) (1957) which stated:

A buyer in ordinary course of business (subsection (9) of Section 1-201) other than a person buying farm products from a person engaged in farming operations takes free

changed in the present Code,⁵⁹ allows a buyer in ordinary course to take free of a security interest, even if it is perfected and even if he knows of its existence, but not if he knows the sale to him violates the security agreement.⁶⁰

As the preceding analysis indicates, the drafters of the Code recognized that one who purchases goods from someone in possession of them has a reasonable expectation that the seller has full rights to convey the goods. Moreover, it would be unfair and impractical to burden the buyer with the responsibility of searching the public record for a security interest before entering into a sales transaction. Consequently, section 9-307(1) protects the reasonable commercial expectations of a buyer in ordinary course and minimizes transaction costs by allowing this buyer to take the goods free of any security interest created by his seller. Although not specifically mentioned in the earlier drafts, the ancient doctrine of ostensible ownership provides the foundation upon which this protection rests.

B. Delivery and the Buyer in Ordinary Course

For a purchaser to take goods free of a security interest created by his seller, he must be a "buyer in ordinary course of business," which is defined in section 1-201(9) of the Code. This definition, unlike the one in the Uniform Trusts Receipts Act, does not specifically require delivery of goods for one to be a buyer in ordinary course.⁶¹ Section 1-201(9) simply states that a "buyer in ordinary course of business" is "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

of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

⁵⁹ See U.C.C. § 9-307(1) (1978).

⁶⁰ See *id.* comment 2 which states in part:

This section provides that such a buyer takes free of a security interest, even though perfected, and although he knows the security interest exists. Reading the two provisions together, it results that the buyer takes free if he merely knows that there is a security interest which covers the goods but takes subject if he knows, in addition, that the sale is in violation of some term in the security agreement

Id.

⁶¹ See UNIF. TRUST RECEIPTS ACT § 9(2)(a), 9A U.L.A. 284 (1951) (protecting buyers "to whom goods were sold and delivered").

that kind.”⁶² The definition continues:

“Buying” may be for cash or by exchange of other property or on secured or unsecured credit and includes receiving goods or documents of title under a pre-existing contract for sale but does not include a transfer in bulk or as security for or in total or partial satisfaction of a money debt.⁶³

Some courts have pointed to the drafters’ failure to specifically require delivery as proof that they deliberately intended for section 9-307(1) to be applied unequivocally to both possessory and non-possessory buyers.⁶⁴ No evidence has been found, however, which would suggest that the drafters deliberately omitted the requirement of actual delivery. More important, it appears that when the drafters of the U.C.C. formulated section 9-307(1), they failed to consider the shift in equities in favor of the secured creditor which results when a debtor or creditor retains possession.

The drafters of the Code have expressed their position toward the retention of possession by a seller in U.C.C. section 2-402(2) which states:

A creditor of the seller may treat a sale or an identification of goods to a contract for sale as void if as against him a retention of possession by the seller is fraudulent under any rule of law of the state where the goods are situated, except that retention of possession in good faith and current course of trade by a merchant-seller for a commercially reasonable time after sale or identification is not fraudulent.⁶⁵

As one court explained, the purpose of this section is to “protect creditors against debtors who give a deceptive appearance of ownership by retaining possession after title has passed to a stranger to the creditor-debtor relationship.”⁶⁶ The drafters did recognize, however, that retention by a debtor in some situations should be expected. Therefore, if the retention is in good faith, in the current course of trade, and for a commercially reasonable time, it should

⁶² U.C.C. § 1-201(9) (1978).

⁶³ *Id.*

⁶⁴ See *Holstein v. Greenwich Yacht Sales, Inc.*, 404 A.2d 842, 845 (R.I. 1979).

⁶⁵ U.C.C. § 2-402(2) (1978).

⁶⁶ *Graves Const. Co. v. Rockingham Nat’l Bank*, 220 Va. 844, 850-51, 263 S.E.2d 408, 413 (1980).

not be considered fraudulent according to section 2-402(2).⁶⁷

Admittedly section 2-402(2), which applies to unsecured creditors, should not be applied to an article 9 situation. It does demonstrate, however, that the drafters did not approve of the debtor retaining possession for an unreasonable time. Unfortunately this skepticism did not surface when the drafters debated the scope of section 9-307(1). Thus, while the drafters were probably aware of the possibility that a buyer might not take possession, they focused on the equities of the buyer in ordinary course while ignoring the special equities of a secured creditor which arise in the non-possessory buyer scenario. Perhaps the reason for this focus was that section 9-307(1) was designed primarily to protect retail buyers of inventory, and retail buyers of inventory generally take possession. Moreover, the drafters may not have addressed this issue because the Code was drafted by different groups and coordination among them was not as efficient as it should have been.

If by analogy the drafters had applied the policies of the ostensible ownership doctrine to protect the expectations of a secured creditor in the non-possessory buyer scenario, they might have been more reluctant to give the buyer as much protection as they apparently gave him. When a buyer does not take possession of purchased goods, the secured creditor continues to rely on the debtor's possession or his own possession of the goods as evidence that he still has a protected security interest in them. This reliance is analogous to the expectation of the purchaser that his seller has full rights to convey when the seller has possession of certain goods. Furthermore, the non-possessory buyer's ownership interest can be viewed as a secret interest since the secured creditor has no notice of it. Therefore, to allow the non-possessory buyer's secret interest to defeat the secured creditor's legitimate commercial expectations would appear as unfair as allowing a secured creditor's secret security interest to defeat a buyer's legitimate commercial expectations. Not only did the drafters fail to consider the effect of a non-possessory buyer's secret interest on the application of section 9-307(1), but the courts have also failed to adequately address this problem.

⁶⁷ See U.C.C. § 2-402(2) (1978).

II. THE NON-POSSESSORY BUYER IN THE COURTS

The courts uniformly conclude that since one need not take possession of goods to be a buyer, a non-possessory buyer may take goods free of any security interest created by his seller under section 9-307(1).⁶⁸ A retail purchaser becomes a buyer, absent any agreement between the parties, either when the goods are identified to the contract⁶⁹ or at the time of contracting.⁷⁰ This conclu-

⁶⁸ See *In re Fitz-Mair Mfg. Co.*, 16 Bankr. 417 (Bankr. N.D. Tex. 1982) (rejecting contention that one cannot be a buyer in ordinary course prior to taking delivery of goods); *International Harvester Credit Corp. v. Associates Fin. Servs. Co.*, 133 Ga. App. 488, 211 S.E.2d 430 (1974) (no physical delivery necessary if seller evidences final commitment to the sale by delivery of documents or making contract); *Farmers State Bank v. Webel*, 113 Ill. App. 3d 87, 446 N.E.2d 525 (1983) (possession of goods not controlling factor in determining whether buyer is buyer in ordinary course of business); *Wilson v. M & W Gear*, 110 Ill. App. 3d 538, 442 N.E.2d 670 (1982) (location of product irrelevant because the Code diminished importance of title); *Herman v. First Farmers State Bank*, 73 Ill. App. 3d 475, 392 N.E.2d 344 (1979) (one can become buyer at time of contracting even if goods not yet identified to contract); *Tanbro Fabrics Corp. v. Deering Milliken, Inc.*, 39 N.Y.2d 632, 350 N.E.2d 590, 385 N.Y.S.2d 260 (1976) (buyer allowed to take goods free of security interest even though goods left in possession of secured creditor); *Integrity Insur. Co. v. Marine Midland Bank-Western*, 90 Misc. 2d 868, 396 N.Y.S.2d 22 (Sup. Ct. 1977) (when mobile home identified to contract, proof of manual delivery not necessary for buyer to take free under § 9-307(1)); *Chrysler Credit Corp. v. Sharp*, 56 Misc. 2d 261, 288 N.Y.S.2d 525 (Sup. Ct. 1968) (implying that delivery not prerequisite for being buyer in ordinary course because focus should not be on technicalities involving passage of title); *Serra v. Ford Motor Credit Co.*, 463 A.2d 142 (R.I. 1983) (buyer in ordinary course once goods identified to contract); *Holstein v. Greenwich Yacht Sales, Inc.*, 404 A.2d 842 (R.I. 1979) (no physical delivery necessary when goods identified to contract and assert specific requirement of physical delivery).

⁶⁹ See, e.g., *International Harvester Credit Corp. v. Associates Fin. Servs. Co.*, 133 Ga. App. 488, 211 S.E.2d 430 (1974) (sale occurred when security agreements and notes executed, even though goods not delivered); *Tanbro Fabrics Corp. v. Deering Milliken, Inc.*, 39 N.Y.2d 632, 350 N.E.2d 590, 385 N.Y.S.2d 260 (1976) (buyer when goods identified to contract); *Serra v. Ford Motor Credit Co.*, 463 A.2d 142 (R.I. 1983) (buyer in ordinary course once goods identified to contract); *Holstein v. Greenwich Yacht Sales, Inc.*, 404 A.2d 842 (R.I. 1979) (no physical delivery necessary when goods identified to contract); see also U.C.C. § 2-501 which states in part:

(1) The buyer obtains a special property and an insurable interest in goods by identification of existing goods as goods to which the contract refers even though the goods so identified are non-conforming and he has an option to return or reject them. Such identification can be made at any time and in any manner explicitly agreed to by the parties. In the absence of explicit agreement identification occurs

a) when the contract is made if it is for the sale of goods already existing and identified;

U.C.C. § 2-501 (1978).

⁷⁰ See, e.g., *Wilson v. M & W Gear*, 110 Ill. App. 3d 538, 442 N.E.2d 670 (1982) (no need for goods to be identified to contract before § 9-307 protects plaintiff-buyer); *Herman v.*

sion is consistent with the intent of the drafters that less emphasis be placed on "title."⁷¹ Although not expressly requiring delivery, courts in the merchant buyer context examine the transaction more closely and focus on whether the merchant buyer satisfied the "good faith" requirement of being "in the ordinary course." Some courts have adopted a subjective "honesty in fact" standard,⁷² while others have announced an objective standard that requires a merchant to observe reasonable commercial standards of fair dealing to be in good faith.⁷³

After determining that an individual is a "buyer in ordinary course," the courts conclude that he should be afforded the protection of section 9-307(1). Some courts elaborate by stating that the secured creditor is better able to bear the risk of debtor insolvency⁷⁴ or that section 9-307(1) is a pro-buyer provision designed

First Farmers State Bank, 73 Ill. App. 3d 475, 392 N.E.2d 344 (1979) (one can become buyer at time of contracting even if goods not identified to contract). *Contra M & W Gear*, 110 Ill. App. 3d at 547-48, 442 N.E.2d at 679 (Heiple J., dissenting) (identification to contract crucial and since not present, plaintiff not a buyer).

⁷¹ According to the drafters of the Code, "[t]he purpose is to avoid making practical issues between practical men turn upon the location of an intangible something, the passing of which no man can prove by evidence and to substitute for such abstractions proof of words and actions of a tangible character." U.C.C. § 2-101 comment (1978); *see also* U.C.C. § 2-401. It states in pertinent part: "Each provision of this Article with regard to the rights, obligations, and remedies of the seller, the buyer, purchasers or other third parties applies *irrespective of title* to the goods except where the provision refers to such title." U.C.C. § 2-401 (1978) (emphasis added). The deemphasis of title concept has expressly been extended to article 9. U.C.C. § 9-101 comment (1978).

For an interesting discussion of the interrelationship between article 2 and article 9 with regard to when one becomes a buyer, *see* Dolan, *supra* note 14, at 1154-59.

⁷² *See, e.g.,* *Martin Marietta Corp. v. New Jersey Nat'l Bank*, 653 F.2d 779 (3d Cir. 1981); *Frank Davis Buick AMC-Jeep, Inc. v. First Alabama Bank*, 423 So. 2d 855 (Ala. Ct. App. 1982); *Sherrock v. Commercial Credit Corp.*, 290 A.2d 648 (Del. 1972); *Massey-Ferguson, Inc. v. Helland*, 105 Ill. App. 3d 648, 434 N.E.2d 295 (1982); *Cessna Fin. Corp. v. Skyways Enter., Inc.*, 580 S.W.2d 491 (Ky. 1979).

⁷³ *See, e.g.,* *Sherrock v. Commercial Credit Corp.*, 277 A.2d 708 (Del. Super. Ct. 1971), *rev'd*, 290 A.2d 648 (Del. 1972); *Swift v. J.I. Case Co.*, 266 So. 2d 379, *modified per curiam on reh'g*, 266 So. 2d 381 (Fla. App.), *cert. denied*, 271 So. 2d 147 (Fla. 1972).

⁷⁴ *See* *Rex Fin. Corp. v. Mobile Am. Corp.*, 119 Ariz. 176, 178, 580 P.2d 8, 10 (1978) ("If this [non-possessory buyer prevailing over secured creditor] exposes an inventory financier to certain risks, they are risks which he is in a better position to guard against"); *Farmers State Bank v. Webel*, 113 Ill. App. 3d 87, 446 N.E.2d 525 (1983) (inventory financier better able to guard against risk of loss than unwary buyer); *Herman v. First Farmers State Bank*, 73 Ill. App. 3d 475, 480-81, 392 N.E.2d 344, 347 (1979) ("the risks involved in situations such as that at bar [non-possessory buyer context] should be placed on the inventory financier . . . because it is better able to guard against those risks"); *Chrysler Credit Corp. v. Sharp*, 56 Misc. 2d 261, 270, 288 N.Y.S.2d 525, 534 (Sup. Ct. 1968) ("If [non-possessory

to protect unwary purchasers.⁷⁵ The courts fail to consider the foundation of section 9-307(1), the policies derived from the ostensible ownership principle. These policies not only support a finding in favor of the buyer in ordinary course when the buyer takes possession, but they also support protecting the secured creditor's expectations when the buyer does not take possession.

A. *The Retail Buyer*

The decision in *Holstein v. Greenwich Yacht Sales, Inc.*⁷⁶ exemplifies how a court will allow the non-possessory retail buyer to take goods free of a security interest when the goods have been identified to the contract. In *Holstein*, the secured creditor loaned money to a boat dealer on the floor plan financing method.⁷⁷ The buyer purchased a yacht and left it in the dealer's possession because it was not fully built. When the dealer defaulted and began selling inventory in violation of the security agreement, the creditor sued for repossession of the collateral. The non-possessory buyer also sought possession of the unfinished yacht he had purchased.⁷⁸

The secured creditor argued that a buyer must take delivery before becoming a buyer in ordinary course and receiving the protection of section 9-307(1).⁷⁹ The court rejected this argument on

buyer scenario] exposes entruster on floor to certain risks, these are risks against which he can guard").

⁷⁵ See *Commercial Credit Equip. Corp. v. Bates*, 154 Ga. App. 71, 267 S.E.2d 469 (1980) (§ 9-307 is device to protect buyer from reservation of title or other hidden interest in goods); *Wilson v. M & W Gear*, 110 Ill. App. 3d 538, 442 N.E.2d 670 (1982) (§ 9-307 is device to protect "innocent purchasers from zealous and unilateral actions of secured creditors"); *Herman v. First Farmers State Bank*, 73 Ill. App. 3d 475, 392 N.E.2d 344 (1979) (§ 9-307 is device to protect buyer); see also *In re Fiesta Corp.*, 25 Bankr. 236 (Bankr. W.D. Wisc. 1982) (purpose of § 9-307(1) is to protect innocent purchaser who cannot reasonably be expected to check for prior security interest every time a purchase is made).

⁷⁶ 404 A.2d 842 (R.I. 1979).

⁷⁷ *Id.* at 843. The court explained "floor plan financing" as:

[A] common method of lending money to an automobile or boat dealer, so that the dealer may purchase the goods which make up its inventory. The lender secures the loan by the filing of a financing statement, and as the goods are sold, the dealer is expected to pay the bank from the proceeds of the sale. Ordinarily the lender periodically checks the state of the inventory to insure that the dealer is abiding by the loan agreement

Id. at 843 n.2.

⁷⁸ *Id.* at 843.

⁷⁹ *Id.* at 845.

two grounds. First, the court looked to section 2-103(1)(a), which defines a buyer as one who "buys or contracts to buy goods" and mentions neither title nor delivery,⁸⁰ and pointed out that the buyer had signed a sales contract for the yacht. The court elaborated that under section 2-501, the buyer has a "special property interest" once the goods have been identified to a contract of sale. Second, the court noted that section 9-307(1) was patterned after section 9(2) of the Uniform Trust Receipts Act except for the latter's requirement of actual delivery.⁸¹ The court argued that the deletion of "delivery" from section 9-307(1) was intentional and further evidence that one need not take delivery to be a buyer in ordinary course.⁸² The court concluded, therefore, that delivery was not required after the sales contract was concluded and the goods were identified.⁸³

As the court explained, if the contract is for the sale of goods already existing and identified, the identification occurs when the contract is made. If the contract relates to the sale of future goods, then the goods are identifiable "when they are shipped, marked or otherwise designated by the seller as goods to which the contract refers."⁸⁴ The court further explained that to be identifiable, the goods do not have to be ready for delivery.⁸⁵ Instead, the court found that the parties specifically referred to the boat as hull "#551" in the sales contract,⁸⁶ and this provided sufficient evidence to identify the boat at the time of the contract. Consequently, the buyer obtained a "special property interest" in the yacht superior to the creditor's security interest.⁸⁷

In its discussion of policy, the *Holstein* court contended that when inventory is delivered to a debtor, the secured creditor gives implicit, if not express, authorization for the sale of the collateral, thereby surrendering any claim in the inventory to a buyer in ordinary course of business. The court found that reliance on a debtor's possession of inventory has its risks, and inventory

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.* at 844.

⁸⁵ *Id.* (citing U.C.C. § 2-501 comment 4).

⁸⁶ *Id.*

⁸⁷ *Id.* at 845.

financiers who want to protect themselves must become better acquainted with the inventory and marketing practices of their borrowers. The risk of loss, according to the court, should be "on the lender rather than on the buyer."⁸⁸

Although appealing to those who favor the buyer, the court's analysis has several weaknesses. First, it justifies the application of section 9-307(1) based on the policies of section 9-306(2).⁸⁹ Second, it does not apply section 9-307(1) in light of its underlying policies to protect reasonable commercial expectations and minimize transaction costs. Finally, it ignores the equities of a secured creditor and the propriety of protecting his reasonable commercial expectations.

Although the Rhode Island Supreme Court in *Holstein* overlooked several important issues, it reaffirmed its reasoning in the more difficult case of *Serra v. Ford Motor Credit Co.*⁹⁰ In *Serra*, the plaintiff purchased a car from a car dealer by making a partial down payment, getting an allowance for his trade-in, and promising to pay the balance. He could not take possession until he paid the balance. The car was a collector's item, and the plaintiff planned to store it for several years, but he had no storage room in his garage. The dealer therefore agreed to retain possession and store it for him. Under a financing agreement the defendant had a perfected security interest in the dealer's inventory, including the plaintiff's car. When the dealer defaulted on its agreement, the defendant repossessed the dealer's inventory, including the plaintiff's car.⁹¹

Upon learning of the repossession approximately a year after he had purchased the car, the plaintiff sued the defendant seeking possession of the car.⁹² The court, expressly adopting its reasoning in *Holstein*, concluded that the goods were identified to the contract and held that the buyer was in ordinary course even though

⁸⁸ *Id.*

⁸⁹ See U.C.C. § 9-306(2) (1978) which states:

Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

Id.

⁹⁰ 463 A.2d 142 (R.I. 1983).

⁹¹ *Id.* at 143.

⁹² *Id.* at 144.

the car had been left in the dealer's possession for more than a year.⁹³ The buyer thus had priority over the creditor's security interest and was entitled to possession. The court reiterated its rationale that the risk of loss should be placed on the financier rather than the buyer.⁹⁴

In *Herman v. First Farmers State Bank*,⁹⁵ the Illinois appellate court determined that one can become a buyer in ordinary course at the time of contracting, even if the goods have not been identified to the contract.⁹⁶ In *Herman*, the plaintiff purchased fertilizer from a farm supply company but did not take possession. The defendant, a secured creditor of the farm supply company, foreclosed and took possession of the company's inventory, selling the plaintiff's fertilizer.⁹⁷ The plaintiff sued for the amount she had paid for the fertilizer, and the court awarded her damages, explaining that she was protected under section 9-307(1).⁹⁸

The court based its discussion on the premise that the purpose of section 9-307(1) is "to protect the buyer in ordinary course of business and the Code is to be liberally construed and applied to promote its underlying purpose and policies."⁹⁹ The proper focus, according to the court, should be on the "ordinary course of business" requirement of section 9-307(1). The court then explained that the transaction at issue was customary in the business and concluded that the goods did not need to be identified to the contract for the buyer to take free of the security interest. The existence of a contract was sufficient.¹⁰⁰ The court supported its decision by stating that the risks involved in those circumstances should be placed on the inventory financier as the party better able to guard against the risk of loss than the unwary buyer.¹⁰¹

In a more recent case, *Wilson v. M & W Gear*,¹⁰² the Illinois court followed the reasoning of *Herman*, expressly stating that the goods do not need to be identified to a contract before section

⁹³ *Id.*

⁹⁴ *Id.* at 148.

⁹⁵ 73 Ill. App. 475, 392 N.E.2d 344 (1979).

⁹⁶ *Id.* at 478, 392 N.E.2d at 346.

⁹⁷ *Id.* at 477, 392 N.E.2d at 344-45.

⁹⁸ *Id.* at 479, 392 N.E.2d at 347.

⁹⁹ *Id.* at 479, 392 N.E.2d at 346 (citing U.C.C. § 1-102(1) (1978)).

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 481, 392 N.E.2d at 347.

¹⁰² 110 Ill. App. 3d 538, 442 N.E.2d 670 (1982).

9-307(1) will protect the non-possessory buyer.¹⁰³ In *Wilson*, a manufacturer sold farm equipment to a dealer and took a security interest in the dealer's inventory. The security agreement required the dealer to remit payments to the manufacturer upon sale of the equipment. The plaintiff had purchased a drill from the dealer but did not take possession. Upon the dealer's default, the manufacturer seized the drill pursuant to his security agreement. The plaintiff subsequently sued for the drill or, in the alternative, for its value.¹⁰⁴ The court held that "when a person contracts to buy goods and those goods are in the dealer's inventory, awaiting delivery or being prepared for delivery, that purchaser is a buyer in the ordinary course of business within the meaning of section 9-307,"¹⁰⁵ and awarded the plaintiff the value of the drill.¹⁰⁶

The court elaborated on its rationale in *Herman* that the concept of "title" has been de-emphasized under the Code.¹⁰⁷ Consequently, the court concluded that title to the goods does not have to pass to the purchaser and the goods do not need to be identified before section 9-307 will protect the retail purchaser.¹⁰⁸ The court also reaffirmed its pro-buyer policy announced in *Herman* that the financier is in the best position to protect against risks involved in inventory financing and that section 9-307 is designed to protect "innocent purchasers from the zealous and unilateral actions of secured creditors."¹⁰⁹

In dissent, Justice Heiple characterized the majority's opinion in *Wilson* as "a carelessly reasoned opinion . . . that defies rational analysis, states bad law, and republishes an earlier erroneous decision of this court in the 1979 case of *Herman v. First Farmers State Bank of Minier*."¹¹⁰ Pointing to several Code sections,¹¹¹ he

¹⁰³ *Id.* at 543, 442 N.E.2d at 673.

¹⁰⁴ *Id.* at 539-40, 442 N.E.2d at 671.

¹⁰⁵ *Id.* at 546, 442 N.E.2d at 675.

¹⁰⁶ *Id.* The court awarded value instead of the actual drill because the defendant no longer had possession of the drill. *Id.*

¹⁰⁷ *Id.* at 542, 442 N.E.2d at 672-73.

¹⁰⁸ *Id.* at 546, 442 N.E.2d at 675.

¹⁰⁹ *Id.* at 545, 442 N.E.2d at 675.

¹¹⁰ *Id.* at 546, 442 N.E.2d at 675-76 (Heiple, J., dissenting).

¹¹¹ Justice Heiple specifically relied on § 2-401(1) which states that "[t]itle to goods cannot pass under a contract for sale prior to their identification to the contract." *Id.* at 551, 442 N.E.2d at 678 (Heiple, J., dissenting). He also pointed to U.C.C. § 2-105(2) which states in part: "Goods must be existing and identified before any interest in them can pass." *Id.* at 552, 442 N.E.2d at 679 (Heiple, J., dissenting).

argued that one cannot become a buyer for purposes of section 9-307(1) before the goods have been identified to the contract.¹¹² Section 9-307(1) should not operate to protect all persons who have paid money to a seller. There must be a buyer and this presupposes a sale, but the mere payment of money does not constitute a sale. He concluded that under the Code some ownership interest must pass, and this interest cannot pass prior to identification of goods to the contract.¹¹³

B. *The Merchant Buyer*

Unlike the preceding retail buyer cases, in merchant buyer cases some courts¹¹⁴ will focus on whether the merchant acted in "good faith" to determine whether he is a buyer in ordinary course for purposes of section 9-307(1).¹¹⁵ The court in *Swift v. J.I. Case Co.*,¹¹⁶ relying on the objective standard stated in section 2-103(1)(b) of the Code, explained that a merchant must observe reasonable commercial standards of fair dealing to be in good faith.¹¹⁷ The plaintiff in *Swift* had a prior perfected security interest in a tractor which the defendant had purchased. The defendant, a merchant buyer, had not searched the record for any security interest prior to purchasing the tractor. Consequently, the court found that the defendant had not observed reasonable commercial behavior, had not acted in good faith, and could not take the tractor free of the security interest.¹¹⁸

Not all courts hold merchant buyers to an objective standard of conduct.¹¹⁹ The court in *Sherrock v. Commercial Credit Corp.*¹²⁰

¹¹² *Id.* at 551, 442 N.E.2d at 678-79 (Heiple, J., dissenting).

¹¹³ *Id.* at 551, 442 N.E.2d at 678 (Heiple, J., dissenting).

¹¹⁴ See, e.g., *Martin Marietta Corp. v. New Jersey Nat'l Bank*, 653 F.2d 779 (3d Cir. 1981); *Frank Davis Buick AMC-Jeep, Inc. v. First Alabama Bank*, 423 So. 2d 855 (Ala. Civ. App. 1982); *Sherrock v. Commercial Credit Corp.*, 290 A.2d 648 (Del. 1972); *Swift v. J.I. Case Co.*, 266 So. 2d 379, *modified per curiam on reh'g*, 266 So. 2d 381 (Fla. App.), *cert. denied*, 271 So. 2d 147 (Fla. 1972); *Massey-Ferguson, Inc. v. Helland*, 105 Ill. App. 3d 648, 434 N.E.2d 295 (1982); *Cessna Fin. Corp. v. Skyways Enter., Inc.*, 580 S.W.2d 491 (Ky. 1979).

¹¹⁵ See U.C.C. § 1-201(9) (1978).

¹¹⁶ 266 So. 2d 379 (Fla. App.), *modified per curiam on reh'g*, 266 So. 2d 381 (Fla. App.), *cert. denied*, 271 So. 2d 147 (Fla. 1972).

¹¹⁷ *Id.* at 381.

¹¹⁸ *Id.*

¹¹⁹ See, e.g., *Martin Marietta Corp. v. New Jersey Nat'l Bank*, 653 F.2d 779 (3d Cir. 1981); *Frank Davis Buick AMC-Jeep, Inc. v. First Alabama Bank*, 423 So. 2d 855 (Ala. Civ.

concluded that the drafters of the Code did not intend for the objective good faith standard stated in article 2 to apply to a transaction involving article 9. Instead the court adopted the subjective standard of U.C.C. section 1-201(19) which defines "good faith" as "honesty in fact."¹²¹ The lower court in *Sherrock* had applied the objective standard and found that the merchant buyer was not in ordinary course.¹²² The experienced merchant buyer did not observe reasonable commercial standards when he prepaid a seller of automobiles with whom he had never done business, relied on the seller to deliver automobiles, and did not inquire into his financial stability.¹²³ The appellate court in *Sherrock*, applying the subjective standard, reversed the lower court and remanded.¹²⁴

A final, extreme illustration of section 9-307(1)'s application to the non-possessory merchant buyer is *Tanbro Fabrics Corp. v. Deering Milliken, Inc.*,¹²⁵ in which the court extended the section's protection to allow a purchaser to defeat a secured creditor who

App. 1982); *Sherrock v. Commercial Credit Corp.*, 290 A.2d 648 (Del. 1972); *Massey-Ferguson, Inc. v. Helland*, 105 Ill. App. 3d 648, 434 N.E.2d 295 (1982); *Cessna Fin. Corp. v. Skyways Enter., Inc.*, 580 S.W.2d 491 (Ky. 1979).

¹²⁰ 290 A.2d 648 (Del. 1972).

¹²¹ *Id.*

¹²² 277 A.2d 708 (Del. Super. Ct. 1971).

¹²³ *Id.* at 709-10.

¹²⁴ 290 A.2d 648 (Del. 1972), *rev'g* 277 A.2d 708 (Del. Super. Ct. 1971).

At least one federal court has addressed this issue and concluded that the subjective standard should apply. *See, e.g.*, *Martin Marietta Corp. v. New Jersey Nat'l Bank*, 653 F.2d 779 (3d Cir. 1981). In *Martin Marietta* the buyer purchased sand from a seller whose inventory was encumbered by a creditor's security interest. The buyer took possession of part of the purchased sand and stockpiled the rest, leaving it in the possession of the seller-debtor. The sand left in the seller-debtor's possession was part of his inventory and thus covered by the creditor's security interest. When the seller-debtor defaulted, the creditor authorized its agent to sell the sand subject to the security interest. The buyer, claiming the creditor sold its sand, sued for conversion. *Id.* at 780.

While adopting a subjective good faith standard based on whether the buyer knew the sale was not in ordinary course, the court, ironically, declined to establish a test for determining "buying in the ordinary course." *Id.* at 781. The court instead focused on whether the sale was a bulk transfer. *Id.* at 781-82. Concluding that it was not, the court held for the buyer, affording him "buyer in ordinary course" status. The court thus allowed him to take free of the security interest and recover based on conversion. *Id.* at 784.

The court also considered whether retention by the debtor-seller was fraudulent, thus making the sale void. *Id.* at 782-84. The court concluded that the sale to the buyer was bona fide with no intention to defraud or trick the creditor. *Id.* at 783. Therefore, the court also affirmed for the buyer on this point. *Id.* at 784.

¹²⁵ 39 N.Y.2d 632, 350 N.E.2d 590, 385 N.Y.S.2d 260 (1976).

retained possession of the encumbered property.¹²⁶ In *Tanbro*, Mills Fabrics, a fabric converter, purchased fabric from Milliken, which perfected a security interest in the fabric and retained possession. Since Mills Fabric did not need all of the fabric, it sold the excess to Tanbro while Milliken still possessed it. The selling of excess fabric was customary, not only for Mills but also in the trade. After selling the excess, Mills defaulted on its obligation to Milliken which, claiming a valid security interest in the fabric, refused to deliver it to Tanbro. Tanbro then sued for conversion.¹²⁷

The court in *Tanbro* did not address the issue of whether a buyer must take possession to be a buyer under section 9-307(1). Nor did the court focus on the commercial status—merchant or consumer—of the buyer. The court instead considered whether the purchase of goods was in the ordinary course of Mill's business.¹²⁸ After determining that it was, the court summarily concluded that Tanbro should take the goods free of the security interest.¹²⁹ The court reasoned that section 9-307(1) requires only that the sale be reasonably expected in "the regular course of an on-going business."¹³⁰ Finding that this type of transaction was "ordinary" in the fabric converter business, the court held for the buyer, allowing it to take free of the defendant's security interest.¹³¹

The merchant buyer cases are plagued with the same problems presented in the retail buyer cases. The courts focus on phrases such as "good faith" or "ordinary course" instead of examining the surrounding circumstances. Moreover, since section 9-307(1) is framed from a buyer's perspective, the courts ignore the equities of a secured creditor. If those equities are addressed at all, they are summarily dismissed as unpersuasive with no further explanation. Protecting the expectations of a secured creditor can only be accomplished by interpreting section 9-307(1) in light of its drafting history and by balancing the equities of both parties—the non-possessory buyer and the secured creditor.

¹²⁶ *Id.* at 637, 350 N.E.2d at 593, 385 N.Y.S.2d at 262.

¹²⁷ *Id.* at 634, 350 N.E.2d at 590-91, 385 N.Y.S.2d at 260.

¹²⁸ *Id.* at 634, 350 N.E.2d at 591, 385 N.Y.S.2d at 261.

¹²⁹ *Id.* at 634-35, 350 N.E.2d at 591, 385 N.Y.S.2d at 261.

¹³⁰ *Id.* at 637, 350 N.E.2d at 593, 385 N.Y.S.2d at 263.

¹³¹ *Id.*

III. THE SECURED CREDITOR V. THE NON-POSSESSORY BUYER—BALANCING THE EQUITIES

The *Tanbro* decision has elicited much criticism and caused many to reevaluate the application of section 9-307(1) to the non-possessory buyer, especially when the goods are left in the possession of the secured creditor. The commentators who disapprove the application of section 9-307(1) to the non-possessory buyer argue that expectations based on possession should govern.¹³² Placing a high value on possession and ostensible ownership, some legal scholars contend that one should not become a buyer for purposes of section 9-307(1) until one takes possession of the goods.¹³³ According to its advocates, this rule provides clear guidance and eliminates inquiry into issues relating to ownership.¹³⁴ Proponents of this view argue that a secured creditor should be able to rely on spot inspections of his debtor's inventory, which would still include the purchased goods of the non-possessory buyer, to ensure his continued priority. If the debtor or creditor is in possession of the goods and the filing system reveals no superior interest, then the secured creditor should prevail.¹³⁵

Those who support the application of section 9-307(1) to protect the non-possessory buyer, however, contend that the creditor is better able to and should bear the risk of debtor insolvency.¹³⁶ Some view section 9-307(1) simply as a pro-buyer provision designed to protect the unwary purchaser.¹³⁷ Others argue that sec-

¹³² See, e.g., Baird & Jackson, *supra* note 14, at 210 (arguing that one should become a buyer for purposes of § 9-307(1) when he takes possession of goods and not before); Dolan, *supra* note 14, at 1150, 1189 (arguing that non-possessory buyer should not prevail over secured creditor who is in possession of collateral, and § 9-307(1) should be based on general respect for reasonable expectations based on possession, not some abstract notion of pro-buyer policy).

¹³³ See, e.g., Baird & Jackson, *supra* note 14, at 210. Other commentators agree that a buyer in ordinary course should prevail when the debtor retains possession, but argue that the secured creditor should prevail when he retains possession. See Dolan, *supra* note 14, at 1189; Kreindler, *The Uniform Commercial Code and Priority Rights Between the Seller in Possession and a Good Faith Third Party Purchaser*, 82 Com. L.J. 86 (1977). Although it is reasonable for a debtor to retain possession, it is not reasonable for a secured creditor to do so. Therefore, the critical question becomes not whether delivery occurred but who retained possession.

¹³⁴ See Baird & Jackson, *supra* note 14, at 210.

¹³⁵ *Id.* at 211-12.

¹³⁶ See *supra* note 74.

¹³⁷ See *supra* note 75; see also Skilton, *supra* note 14, at 3 (protecting buyer who partici-

tion 9-307(1)'s application to *all* buyers facilitates the movement of goods at the retail level from the merchant to the consumer.¹³⁸ Finally, at least one commentator contends that by leaving the collateral in the control of the debtor, the creditor assumes the risk of losing to a buyer in ordinary course.¹³⁹

While the policies advanced on both sides have merit, neither the courts' approach nor that of the courts' critics satisfactorily solves the problem of the non-possessory buyer. Just as an approach which ignores the equities of the secured creditor is unjustified, a solution which ignores the realities of commercial life and relies on a mechanical delivery rule is also unjustified. To resolve the issue, the analysis in this section will focus on the equities of the secured creditor in the non-possessory buyer scenario and the equities of the non-possessory buyer in ordinary course of business.

A. *Equities of Secured Creditor—Protecting His Reasonable Commercial Expectations*

When a secured creditor periodically checks his collateral in the debtor's possession, he reasonably expects to have continued priority in that collateral as long as it continues in the debtor's possession and the records reveal no superior interest. Likewise, when the creditor maintains possession of the collateral, he expects to have priority, unless he releases the collateral or consents to its sale. In both situations, however, the current application of section 9-307(1) allows a non-possessory buyer to defeat the secured creditor and frustrate his reasonable commercial expectations.¹⁴⁰ As an

pates in unauthorized sale but who is buyer in ordinary course rests on principles of justice and utility).

¹³⁸ See *Martin Marietta Corp. v. New Jersey Nat'l Bank*, 25 U.C.C. Rep. Serv. 1458, 1466 (D.N.J.), *rev'd on other grounds*, 612 F.2d 745 (3d Cir. 1979).

¹³⁹ See Skilton, *supra* note 14, at 4.

¹⁴⁰ See Baird & Jackson, *supra* note 14 (discussing the frustrated expectations of a secured creditor when his debtor sells the collateral to a buyer in ordinary course, his debtor retains possession, and the non-possessory buyer is allowed to prevail); see also Kreindler, *supra* note 133 (arguing that policy reasons compel affording greater protection to the unpaid seller in possession); Kripke, *Should Section 9-307(1) of the Uniform Commercial Code Apply Against a Secured Party in Possession?*, 33 Bus. Law. 153 (1977) (the author, a member of the U.C.C. Permanent Editorial Board, explains that § 9-307(1) was not intended to achieve the *Tanbro* result); cf. Dolan, *supra* note 14 (discussing the equities of a secured creditor when the creditor retains possession and thus criticizing the *Tanbro* result). But see Gottlieb, *Section 9-307(1) and Tanbro Fabrics: A Further Response*, 33 Bus. Law. 2611 (1978) (the author, the lawyer who tried and won the *Tanbro* case, responds to Kripke

underlying policy of section 9-307(1), the ostensible ownership principle justifies shielding a buyer in ordinary course from a creditor's *secret* security interest. This doctrine can also be applied by analogy to protect the secured creditor from a non-possessory buyer's secret interest.

The secured creditor relies on his debtor's or his own possession as evidence of his continued priority in the collateral in the same way a purchaser relies on his seller's possession of goods as evidence that the seller has full rights to convey. Moreover, when a buyer does not take possession of goods which he has purchased, his ownership interest in those goods will be secret to the secured creditor. This secret interest is similar to the secret interest created when one places goods in the possession of a seller and yet reserves an ownership or security interest. In both situations, one party has possession of certain goods, and his possession creates reasonable commercial expectations. The purchaser's reasonable commercial expectations will be protected under the ostensible ownership principle, and he will be shielded from the reserved secret interest. Similarly, the secured creditor should also be afforded this protection in certain circumstances. It is unfair to allow the non-possessory buyer's secret interest to defeat the secured creditor's commercial expectations. The buyer's failure to take possession of the purchased goods shifts the equities in favor of the secured creditor.

B. Equities of the Non-possessory Buyer

The equities of the secured creditor in the non-possessory buyer context appear compelling, and his expectations should be frustrated only if overcome by more important policies. Careful examination of the reasons given for protecting the non-possessory buyer reveals that they do not always overcome the compelling interests of the secured creditor.

Some commentators contend that by placing goods in his debtor's inventory, the creditor assumes the risk of losing to a

and argues the *Tanbro* result was correct); Birnbaum, *Section 9-307(1) of the Uniform Commercial Code Versus Possessory Security Interests—A Reply to Professor Homer Kripke*, 33 Bus. Law. 2607 (1978) (disagreeing with Kripke and supporting the *Tanbro* result).

buyer in ordinary course.¹⁴¹ This assumption of risk argument fails on two grounds. First, this rationale by its terms does not apply when a secured creditor retains the collateral. Second, it implies that the mere placing of goods in the debtor's inventory constitutes specific authorization to resell the goods. Section 9-307(1), however, was not intended to address the authorization issue. Instead, section 9-306(2), which suggests that a security interest does not continue in collateral if the secured creditor authorizes the disposition, applies to the authorization situation.¹⁴²

Some courts suggest that a creditor is better able to protect against the loss from debtor insolvency—and to bear it if necessary.¹⁴³ When a creditor obtains an appropriate security agreement, perfects the security interest, or takes possession of the collateral, he has done all that he can legally do. Although the secured creditor may know more about the financial status of his debtor, this knowledge does not put him in a better position to protect himself from a secret interest created by a purchaser who does not take possession. The secured creditor's knowledge only allows him to make sure that he satisfies the requirements of article 9, so that he can have priority upon debtor default. While a secured creditor may be able to anticipate debtor default, he cannot protect himself against a buyer's secret interest after the default has occurred. Requiring the secured creditor to absorb the loss is unjustifiable beyond compensatory "deep pocket" grounds, unless insurance of buyer recovery is the goal of commercial law.¹⁴⁴

Advocates of shielding the non-possessory buyer also argue that such protection minimizes the transaction costs.¹⁴⁵ They contend that the buyer has done all that he can reasonably be expected to

¹⁴¹ See, e.g., Skilton *supra* note 14, at 4.

¹⁴² U.C.C. § 9-306(2) (1978).

¹⁴³ See *supra* note 74.

¹⁴⁴ One may argue that the secured creditor should bear the loss because § 9-307(1) is designed as a consumer protection measure. The comments to the Code suggest otherwise. See U.C.C. § 9-101 comment (1978) (expressing drafters' intent that consumer protection issue is addressed in other sections of the Code and in non-Code laws).

Moreover, requiring creditors to be insurers contradicts the two policies that underlie § 9-307(1). First, allowing the buyer to prevail in every situation will frustrate the commercial expectations of the secured creditor. Second, if the creditors are forced to act as insurers, they will adjust their charges accordingly. Therefore, borrowing costs will go up, a result which contradicts the goal of minimization of transaction costs.

¹⁴⁵ This is one policy underlying § 9-307(1).

do. Requiring him to search the records for a security interest would be too costly and impractical. Since this point has merit, any solution should not require a buyer in ordinary course to search the public record for a security interest.

Another superficially valid argument involves the "new money doctrine."¹⁴⁶ According to this doctrine, a prepaying buyer is similar to a financier, providing his seller with advanced funds to produce the goods. Consequently, he deserves special protection.¹⁴⁷ This argument, while plausible, is not persuasive. The secured creditor, like the prepaying buyer, has also advanced funds to the debtor. Moreover, the secured creditor has taken all necessary steps to assure his priority in case of debtor insolvency. To frustrate the expectations of this secured creditor simply because a buyer, who is not a purchase money secured creditor, has made a later advancement would be unjust.¹⁴⁸

IV. THE SOLUTION: AMENDING SECTION 9-307(1) OR REINTERPRETING BUYER IN ORDINARY COURSE

Mechanical application of section 9-307(1) to the non-possessory buyer achieves an unfair result. It frustrates the reasonable commercial expectations of a secured creditor by defeating his valid security interest with the buyer's secret ownership interest. Although any solution to the problem should not disregard the expectations of a buyer, the expectations of the secured creditor also should not be overlooked. Consequently, a fair compromise should involve "reasonable" protection of the commercial expectations of both parties and minimization of transaction costs. This objective can be accomplished either by judicial construction of "buyer in ordinary course" or by amendment of section 9-307(1).

Section 2-402(2)¹⁴⁹ of the Code, while not directly applicable to

¹⁴⁶ See Jackson & Kronman, *A Plea for the Financing Buyer*, 85 YALE L.J. 1 (1975).

¹⁴⁷ *Id.* at 7.

¹⁴⁸ The Code has provided protection for a person who makes advances to a debtor enabling him to acquire rights in the collateral. See U.C.C. § 9-107(b) (1978). That section explains that "[a] security interest is a 'purchase money security interest' to the extent that it is . . . (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or use of collateral if such value is in fact so used." *Id.* The holder of a purchase money security interest is given special protection under the Code. See U.C.C. § 9-312 (1978).

¹⁴⁹ U.C.C. § 2-402(2) (1978).

an article 9 situation, provides guidance as to which party should prevail in the non-possessory buyer context. Section 2-402(2) allows a creditor of a seller to treat a sale as void if the seller's retention of possession is fraudulent.¹⁵⁰ Although section 9-307(1) does not involve fraudulent conveyances between debtors and purchasers, the policy of section 2-402(2) suggests that a secured creditor should not be defeated by a secret interest created when a debtor retains possession of sold goods for an unreasonable time. Retention places apparent ownership in the seller when actual ownership rests in another party, thus creating a secret interest in the actual owner. Moreover, because of the extensive steps which he must take to perfect his security interest, the article 9 secured creditor has stronger expectations than the unsecured creditor contemplated in section 2-402(2). When the buyer leaves the goods in the debtor's possession for a commercially unreasonable period of time and the secured creditor has no notice of the sale, the sale should be *prima facie* void as to the secured creditor, and the buyer should not take free of the security interest.

A. *Amendment of Section 9-307(1)*

Since the courts are inclined to construe section 9-307(1) mechanically, the application of this section to the non-possessory buyer, especially the retail buyer, will likely continue. The most effective solution, therefore, is to amend section 9-307(1). With the proposed amendment in italics, the new section, based on the policies discussed in this Note and section 2-402(2), should read as follows:

1. A buyer in ordinary course of business (subsection (9) of Section 1-201) other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence, *unless*

- a) *the purchased goods subject to the security interest are in the possession of the secured creditor at the time of the sale or identification of goods to the contract, or*
- b) *the debtor retains possession of the goods subject*

¹⁵⁰ *Id.*

to the security interest and retention is
i) for a commercially unreasonable period of time
after the sale or identification of the goods to the
contract, or
ii) not in good faith, or
iii) not in current course of trade;
and the secured creditor had no notice of the sale by
the debtor.

This proposal protects the secured creditor under the circumstances in which he most reasonably expects that he has priority. It also protects a purchaser by allowing a non-possessory buyer to take free when his commercial expectations are the most reasonable, that is, as long as the debtor's retention is not unreasonable and as long as possession is not in the secured creditor. Moreover, since this proposal does not require the buyer to search the public record for a security interest, it should not increase transaction costs.

This amendment would change the results of some, but not all, non-possessory buyer cases. Subsection (a) is explicitly designed to reverse the result in a case like *Tanbro*,¹⁵¹ in which the secured creditor retains possession of the collateral. Subsection (b), a variation of section 2-402(2), should alleviate the secret interest problems discussed earlier.¹⁵² This variation, however, unlike section 2-402(2), does not require a showing of fraud. When the debtor remains in possession for a commercially unreasonable period of time or retention is not in good faith or not in current course of trade, then the equities of a secured creditor are so compelling that he should prevail even in the absence of fraud. Subsection (b) contemplates allowing a secured creditor to prevail in a case like *Serra v. Ford Motor Co.*,¹⁵³ in which possession by the debtor lasted over a year simply because the buyer had no place to store the antique car. The amendment also gives the buyer a safe harbor even if retention continues in the debtor for an unreasonable time. If the debtor or buyer gives notice of the sale to the secured creditor, then the buyer will still prevail regardless of the satisfaction of (b)(i-iii).

¹⁵¹ For a discussion of *Tanbro*, see *supra* notes 125-31 and accompanying text.

¹⁵² See *supra* pp. 153-54.

¹⁵³ For a discussion of *Serra*, see *supra* notes 90-94 and accompanying text.

B. *Judicial Construction of "Buyer in Ordinary Course"*

Although amendment of section 9-307(1) would be the most effective solution to the non-possessory buyer problem, courts can resolve the current dilemma by carefully construing "buyer in ordinary course" under the present statute. The focus should be on whether a purchaser is "in ordinary course" and not, as some commentators suggest, whether he is a "buyer."¹⁵⁴ Delivery would be a factor in determining whether one is a buyer in ordinary course but would not be dispositive of the issue.¹⁵⁵ Therefore, under certain circumstances, the non-possessory buyer should and would take free of the security interest. When the secured creditor's equities outweigh those of the non-possessory buyer, however, the secured creditor should prevail.

The new standard would be modeled after the proposed amendment just discussed. For a buyer to be "in ordinary course" under section 9-307(1), the secured creditor must not retain the goods, and retention by the debtor must be for a reasonable period of time, in good faith, and in the ordinary course. This nonmechanical test provides courts with wide latitude in deciding whether a buyer should take free of a security interest created by his seller. Factors to be considered would include the length of retention, status of purchaser (that is, merchant or consumer), type of transaction, reason for retention, prevailing practice in the trade, and notice of sale to the secured creditor.¹⁵⁶

This new standard enables the court to examine the entire commercial context rather than focus on an isolated event such as delivery. Like the proposed amendment, it allows the secured creditor to prevail when his commercial expectations are the most compelling but also protects the reasonable expectations of a buyer. Furthermore, the proposed standard is consistent with the drafting history of section 9-307(1), thus effectuating the intent of the drafters better than the present construction of section 9-307(1).

¹⁵⁴ See *supra* note 14.

¹⁵⁵ *Id.*

¹⁵⁶ These factors are similar to factors which would be considered by courts who have adopted the objective good faith standard under § 9-307(1). See *supra* note 73.

CONCLUSION

This Note establishes that most courts mechanically apply section 9-307(1) to the non-possessory buyer, allowing him to take purchased goods free of any security interest created by his seller. An examination of the drafting history of section 9-307(1) reveals that the drafters did not consider such application to the non-possessory buyer. Moreover, this analysis shows that the application in some circumstances frustrates the underlying purposes of section 9-307(1) and produces an inequitable result. Therefore, this Note proposes that section 9-307(1) be amended consistent with those underlying policies. In absence of an amendment, this Note suggests how courts can correct the problem by carefully construing "buyer in ordinary course."

The proposed amendment and judicial standard will doubtless not eliminate *all* problems involving section 9-307(1)'s application to the non-possessory buyer. Both the standard and amendment will be subject to the individual, and sometimes inconsistent, interpretation of each court which applies them; nor does this proposal represent an analytically or theoretically pure solution. It is a compromise. The proposed solution, however, will calm an unsettled area of commercial law. Moreover, it should cause one to reevaluate the relevance and fairness of the once widely accepted notion that the good faith purchaser is *always* right.

Clay D. Land