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Section 9-307(1) of the U.C.C.: A Provision
in Need of an Articulated Policy**

by

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The "Created by His Seller" Limitation of Section 9-307(1) of the U.C.C.: A Provision in Need of an Articulated Policy

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INTRODUCTION

Courts and commentators for years have been confused about the policy that underlies the "created by his seller" language of section 9-307(1) of the Uniform Commercial Code. Courts most often simply apply the statutory provision in a mechanical fashion without any attempt to address the policy considerations.¹ Occasionally they have complained that the clause creates an unjust result that is nevertheless dictated by the statute;² a few courts have even implied that the provision should be circumvented.³ Several scholars have vigorously attacked the provision as unsound and unjustifiable,⁴

* Professor, University of Toledo College of Law. The author wishes to thank two of his colleagues, Professors Phillip J. Closius and William M. Richman, University of Toledo College of Law, for their helpful comments on an earlier draft of this article, and to recognize the able research assistance of Mr. Kenneth Direktor, third-year law student, University of Toledo. The University of Toledo supported this project through a Faculty Research Grant.

1. *E.g.*, *National Shawmut Bank of Boston v. Jones*, 108 N.H. 386, 236 A.2d 484 (1967); *Muir v. Jefferson Credit Corp.*, 108 N.J. Super. 586, 262 A.2d 33 (Super. Ct. Law Div. 1970); *Lindsay v. Financial Collection Agencies, Inc.*, 97 Misc. 2d 263, 410 N.Y.S.2d 1002 (Sup. Ct. 1978).

2. "We recognize that the result which flows from this construction of the statute may seem unjust. . . . However, this is consistent with the general rule set forth in the Code. . . . Furthermore, our holding is in accord with the decisions rendered in other states" *Martin Bros. Implement Co. v. Diepholz*, 109 Ill. App. 3d 283, 290, 440 N.E.2d 320, 325, (1982).

This court recognizes that this is a harsh result, since the purchaser . . . had no means to learn . . . that the property he purchased was subject to a security interest. It may be that legislative action is necessary to prevent such results in the future. Since we are bound by enacted laws . . . no other course is open to us here.

Exchange Bank v. Jarrett, 180 Mont. 33, 39, 588 P.2d 1006, 1009 (1979). "[I]f a hardship results from our interpretation, it is for the Legislature to remove it." *General Motors Acceptance Corp. v. Troville*, 6 U.C.C. Rep. Serv. (Callaghan) 409 (Mass. App. 1969).

3. *E.g.*, *General Elec. Credit Corp. v. Western Crane & Rigging Co.*, 184 Neb. 212, 166 N.W.2d 409 (1969) (dicta); *Adams v. City Nat'l Bank & Trust Co.*, 565 P.2d 26 (Okla. 1977); *Al Maroone Ford, Inc. v. Manheim Auto Auction, Inc.*, 205 Pa. Super. 154, 208 A.2d 290 (1965) (dicta).

4. Dugan, *Buyer-Secured Party Conflicts Under Section 9-307(1) of the Uniform Commercial Code*, 46 U. COLO. L. REV. 333, 347, 364 (1975) ("difficult to perceive any compelling justification for the prevailing interpretation of the created-by-his-seller language in Section 9-307(1)"; "senseless" provision); Knapp, *Protecting the Buyer of Previously Encumbered Goods: Another Plea for Revision of UCC Section 9-307(1)*, 15 ARIZ. L. REV. 861, 864 (1973) (results produced are "wrong"); Vernon, *Priorities, The Uniform Commercial Code and Consumer*

but most commentators, like the courts, either have avoided discussion of the policy⁵ or have indicated uncertainty about the underlying rationale.⁶

Section 9-307(1) governs priorities in goods between secured parties and buyers in ordinary course of business.⁷ The subsection in its entirety provides:

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.⁸

Financing, 4 B.C. INDUS. & COM. L. REV. 531, 536 (1963) (results produced are "unjustifiable and improper"); Special Project, *The Priority Rules of Article 9*, 62 CORNELL L. REV. 834, 963 (1977) ("requirement is difficult to justify") [hereinafter cited as Special Project]; Comment, *Section 9-307(1) of the U.C.C.: The Scope of the Protection Given a Buyer in Ordinary Course of Business*, 9 B.C. INDUS. & COM. L. REV. 985, 989 (1968) ("apparent anomaly") [hereinafter cited as Comment, *Scope of Protection*]. Three of these commentators have recommended deletion of the "created by his seller" language from section 9-307(1). Knapp, *supra*, at 892; Vernon, *supra*, at 546; Comment, *Scope of Protection, supra*, at 996.

5. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 26.6-12 (1965); R. HENSON, HANDBOOK ON SECURED TRANSACTIONS (2d ed. 1979); A. SCHWARTZ & R. SCOTT, COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES 597-608 (1982).

6. J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 1075 (2d ed. 1980) ("Why the drafters were more protective of the secured creditor's interest in 9-307 than of an owner's equity in 2-403, we cannot say."); Special Project, *supra* note 4, at 963 ("Perhaps this result can be justified.").

Professors Jackson and Kronman have observed that "the analytical justification for many of article 9's most important priority rules remains obscure." Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1144 (1979) [hereinafter cited as Jackson & Kronman, *Priorities Among Creditors*]. These authors previously made a similar observation which, while directed toward the preference of purchase money secured parties, is equally applicable in this context: "[t]he economic or jurisprudential rationale for the existence of that preference has never been explored fully." Jackson & Kronman, *A Plea for the Financing Buyer*, 85 YALE L.J. 1, 2 n.8 (1975) [hereinafter cited as Jackson & Kronman, *Financing Buyer*].

7. The term "buyer in ordinary course of business" is defined in section 1-201(9) which reads:

"Buyer in ordinary course of business" means 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. All persons who sell minerals or the like (including oil and gas) at wellhead or minehead shall be deemed to be persons in the business of selling goods of that kind. "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). Reading the definition in conjunction with the last clause of section 9-307(1) makes it clear that a buyer can still qualify for protection against the security interest even with knowledge of the existence of the security interest, but that the status of "buyer in ordinary course of business" and the protection that goes with that status is lost when the buyer knows that the sale violates the terms of the security agreement.

8. "This section states when buyers of goods take free of a security interest even though perfected. A buyer who takes free of a perfected security interest of course takes free of an unperfected one." *Id.* § 9-307(1) comment 1.

Since the qualifying buyer must buy "in ordinary course from a person in the business of selling goods of that kind,"⁹ section 9-307(1) applies to buyers purchasing from the inventory of dealers.

The consequences of applying the "created by his seller" language can be illustrated by comparing two typical cases. Assume a secured party takes a security interest in the inventory¹⁰ of a dealer-debtor. A buyer in ordinary course who purchases from that inventory will take free of the security interest since the security interest was "created by his seller" (the dealer-debtor). In the other case the debtor is not a dealer. The secured party finances non-inventory collateral such as equipment¹¹ or consumer goods,¹² and the debtor wrongfully sells it to a dealer who sells the same kind of goods. A subsequent buyer from the dealer may qualify as a buyer in ordinary course, but the buyer cannot take free of the security interest because it was not "created by his seller."

Although wooden application of the clause has led the courts to the correct result in most cases, the paucity of policy analysis in the reported opinions has left a deficient legacy in the interpretation of section 9-307(1). "The task of the judges is . . . to implement the legislative will and help it achieve its goal."¹³ By practicing "mechanical jurisprudence"¹⁴ with a statutory provision whose application is clear in most cases,¹⁵ judges may satisfy their task of implementing the will of the legislature, but they cannot advance the goal of the statute when they continually neglect to identify the goal.¹⁶

For analysis of the farm products provision of section 9-307(1) see Dolan, *Section 9-307(1): The UCC's Obstacle to Agricultural Commerce in the Open Market*, 72 NW. U.L. REV. 706 (1977).

9. U.C.C. § 1-201(9) (1978).

10. In this context, "inventory" is goods "held by a person who holds them for sale or lease or to be furnished under contracts of service or if he has so furnished them. . . ." *Id.* § 9-109(4).

11. "Equipment" is essentially goods "used or bought for use primarily in business." *Id.* § 1-109(2).

12. "Consumer goods" are goods "used or bought for use primarily for personal, family or household purposes." *Id.* § 9-109(1).

13. W. REYNOLDS, *JUDICIAL PROCESS IN A NUTSHELL* 196 (1980).

14. Pound, *Mechanical Jurisprudence*, 8 COLUM. L. REV. 605 (1908).

15. "The phrase 'created by his seller' is a key limitation upon the operation of section 9-307(1) that cannot be easily manipulated or interpreted away." Skilton, *Buyer in Ordinary Course of Business Under Article 9 of the Uniform Commercial Code (And Related Matters)*, 1974 WIS. L. REV. 7.

16.

A final explanation for the reasoned opinion requirement comes from the value of the judge's exploration—for himself, in writing, for review by a critical audience—of his own analytic processes. Richard Wasserstrom, in his illuminating book, *The Judicial Decision* (1961), called this the "process of justification", one that insures that the opinion be as accurate as possible, and the conduct undertaken as beneficial as possible. Thus, the requirement of a reasoned opinion also tried

The words of many statutory provisions, including the one that is the subject of this article, do not alone convey the goals they are designed to achieve.¹⁷ Courts in such instances must look beyond the mere words to the context of their adoption in order to construe the statute in ways that will achieve its legislative purpose.¹⁸ The Uniform Commercial Code itself mandates a "purpose" approach¹⁹ to its application. Section 1-102(1) provides that the Code "shall be liberally construed and applied to promote its underlying purposes and policies."²⁰

The deficiency of judicial opinions decided in a policy vacuum becomes most apparent when cases arise that do not fit into the typical patterns described earlier.²¹ For example, when cases arise in which articles 2 and 9 overlap,²² it is impossible to reconcile fully all of the statutory commands

to force a judge to "think," rather than merely to "react," in order best to explain himself to his public. Wasserstrom differentiated what he styled "the process of discovery" from that of justification. The distinction is important, for it focuses attention on the need to articulate and explain a result, no matter how that result was "discovered".

W. REYNOLDS, *supra* note 13, at 59-60.

17. "[I]t is one of the surest indexes of a mature and developed jurisprudence not to make a fortress out of the dictionary; but to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning." *Cabell v. Markham*, 148 F.2d 737, 739 (2d Cir. 1945) (L. Hand, J.).

18.

[Courts] should give sympathetic attention to indications in the legislative history of the lines of contemplated growth, if the history is available. It should give weight to popular construction of self-operating elements of the statute, if that is uniform. Primarily, it should strive to develop a coherent and reasoned pattern of applications intelligibly related to the general purpose.

2 H. HART & A. SACKS, *THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND THE APPLICATION OF LAW* 1417 (1958).

19. Professors Hart and Sacks have been influential in developing the purposive approach to judicial process.

In interpreting a statute a court should:

1. Decide what purpose ought to be attributed to the statute and to any subordinate provision of it which may be involved; and then

2. Interpret the words of the statute immediately in question so as to carry out the purpose as best it can, making sure, however, that it does not give the words either—

(a) a meaning they will not bear, or

(b) a meaning which would violate any established policy of clear statement.

Id. at 1411.

20. The official comment elaborates even further on this principle of statutory construction:

The Act should be construed in accordance with its underlying purposes and policies. The text of each section should be read in the light of the purpose and policy of the rule or principle in question, as also of the Act as a whole, and the application of the language should be construed narrowly or broadly, as the case may be, in conformity with the purposes and policies involved.

U.C.C. § 1-102 comment 1, para. 4 (1978).

21. See *supra* notes 10-12 and accompanying text.

22.

One transaction that recurrently crosses article lines is a contract for the sale of goods that can either become, or come into confrontation with, a security interest The difference in orientation between Articles 2 and 9 is pervasive. There is

and official comments that direct their interrelationship.²³ Stripped of a policy basis for decisionmaking, judges are left impotent to decide these cases rationally.²⁴ However, if the statutory policy is discerned for the typical, relatively straightforward case, it will then be available to resolve cases raising more difficult questions.²⁵

This article is based on the premise that the "created by his seller" language of section 9-307(1) is supported by a sound, legitimate policy. Part I articulates that policy by analyzing section 9-307(1) in the context of other article 9 provisions and analogous principles of agency law. Part II provides a two-prong evaluation of the policy. The first prong addresses the arguments of commentators who have attacked the provision as unjustifiable and have urged repeal of the clause on consumer protection grounds. The second prong is a risk-allocation analysis that rejects loss prevention and loss spreading as alternative policies for allocating losses between secured parties and buyers in ordinary course. Part III is an application of the policy articulated in part I to four fact patterns in which policy analysis is essential to assure a proper outcome. It shows that even though correct results may be achieved in many cases through mechanical application, situations inevitably will arise that fall between the cracks.

I. ARTICULATION OF THE POLICY

The rationale underlying the "created by his seller" language in section 9-307(1) can be ascertained by examining the provisions of the Code that section 9-307(1) affects and some analogous principles of agency law. Section 9-307(1) enables a buyer in ordinary course of business (essentially a good faith buyer from the inventory stock of a dealer) to take free of certain security interests. For these buyers the section provides one of two exceptions to the general rule that a security interest continues in collateral notwith-

some attempt at accommodation in the principal bridging section, section 9-113, but that section, while acknowledging the likelihood that commercial transactions will encounter inconsistent regulation under the two articles, offers guidance that is too skeletal and imprecise to resolve the varieties of conflict that regularly arise. Nowhere else is there a systematic effort to mesh the two articles or to cope with their differing orientations and styles.

Jackson & Peters, *Quest for Uncertainty: A Proposal for Flexible Resolution of Inherent Conflicts Between Article 2 and Article 9 of the Uniform Commercial Code*, 87 YALE L.J. 907, 908-09 (1978).

23. Consider the relationship of the following UCC provisions: section 9-307(1); section 9-201 ("Except as otherwise provided by this Act"); section 9-306(2) ("Except where this Article otherwise provides"); section 9-307 comment 1, para. 2; section 2-403(1), (2), (4); section 2-403 comment 2, para. 1 and the last sentence of para. 2; and section 2-402(3)(a).

24. One author has referred to judges who engage in mechanical jurisdiction as "sterile" judges. Craven, *Paean to Pragmatism*, 50 N.C.L. REV. 977, 979 (1972).

25. "The purpose of statute [sic] must always be treated as including not only an immediate purpose or group of related purposes but a larger and subtler purpose as to how the particular statute is to be fitted into the legal system as a whole." H. HART & A. SACKS, *supra* note 18, at 1414.

standing its sale or other disposition.²⁶ The "created by his seller" language, however, limits the scope of this exception. The policy supporting the limitation is tied to the rationales underlying the general rule and its two exceptions in the context of sales of goods.²⁷ It is also revealed through consideration of several fundamental provisions of agency law that have been largely overlooked in the context of article 9 interpretation.²⁸

A. Examination of U.C.C. Provisions

Article 9 establishes the general validity of security agreements between the immediate parties and against third parties. Section 9-201 broadly recognizes the effectiveness of a security agreement "according to its terms between the parties, against purchasers of the collateral and against creditors."²⁹ The protection of secured parties is similarly advanced by the section 9-306(2) provision that "a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof . . ."³⁰ Without assurances as to the basic validity and priority of their secured interests, lenders either would not be willing to engage in secured financing or would lend only at higher interest rates.³¹ Therefore, this principle of the general validity of security interests, even though subject to numerous exceptions provided in the Code,³² is crucial to the practical success of secured financing.

26. U.C.C. § 9-306(2) (1978).

27. The text of the official comments to section 9-307(1) is not enlightening on the policy of the limitation in subsection (1). It does not discuss the purpose of limiting the buyer's protection to security interests created by the buyer's seller. An observation by Professor Gilmore is relevant to the policy pursuit: "For an understanding of Article 9 it is essential to realize that almost all of its specific content—the detail and verbiage of its fifty sections—was a faithful copying-out of historical models. Almost nothing new was added." Gilmore, *Security Law, Formalism and Article 9*, 47 NEB. L. REV. 659, 671 (1968). For discussion of relevant pre-Code statutes, see *infra* notes 40 and 52.

28. A few commentators have identified the estoppel and agency doctrinal roots to the codification of section 2-403(2) (provision in article 2 on sales of goods protecting the buyer in the ordinary course of business). Dolan, *The Uniform Commercial Code and the Concept of Possession in the Marketing and Financing of Goods*, 56 TEX. L. REV. 1147, 1170-71 (1978); Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1057-60 (1954); Warren, *Cutting Off Claims of Ownership Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 469, 470-75 (1963). These authors, however, do not focus on the relationship of agency law principles to the provisions of section 9-307(1). For an explanation of the relationship between section 2-403(1) and (2) and section 9-307(1), see *infra* notes 78-101 and accompanying text.

29. U.C.C. § 9-201 (1978).

30. *Id.* § 9-306(2).

31. "The ultimate reason for a secured party's taking a security interest is to give him assurance that in the event the debtor does not or cannot pay, the secured party will be able to realize the indebtedness due to him out of the collateral." Coogan, *A Suggested Analytical Approach to Article 9 of the U.C.C.*, 63 COLUM. L. REV. 1, 2 (1963). See also Baird & Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175 (1983).

32. See the priority provisions of sections 9-301, 9-304(2), 9-306(5), 9-307 through 9-310, and 9-312 through 9-316.

Section 9-306(2) itself includes an exception to its basic rule that governs most of the cases involving sales of goods from the financed inventory stock of a dealer. The security interest does not continue in the collateral sold when the sale has been authorized by the secured party.³³ Commonly the parties to the security agreement envision payment by the debtor-dealer from the proceeds of sales of the encumbered inventory;³⁴ and section 9-306(2) provides for automatic attachment of the security interest to any identifiable proceeds received by the debtor.³⁵ The severance of the security interest in collateral authorized to be sold is based on the concept of waiver.³⁶ The lender relinquishes the security interest in the collateral and looks to the proceeds of the sale to satisfy the debt.

Section 9-307(1) establishes the second exception to the continuance of a security interest in goods sold from the financed inventory stock of a dealer. The section protects buyers in ordinary course of business even when the debtor makes an unauthorized sale.³⁷ Private agreements between the secured party and the debtor that either prohibit or condition the sale of the collateral are not given effect against a qualified buyer.³⁸ To qualify for this exception, the buyer must purchase "from a person in the business of selling goods of that kind";³⁹ thus, section 9-307(1) applies to sales from debtors' inventories.⁴⁰

33. "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. . . ." U.C.C. § 9-306(2) (1978).

34. Proceeds are defined in the Code to include "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." *Id.* § 9-306(1).

35. "[A] security interest . . . also continues in any identifiable proceeds including collections received by the debtor." *Id.* § 9-306(2).

36. *Swift & Co. v. Jamestown Nat'l Bank*, 426 F.2d 1099, 1104 (8th Cir. 1970).

37.

The limitations which this section imposes on the persons who may take free of a security interest apply of course only to unauthorized sales by the debtor. If the secured party has authorized the sale in the security agreement or otherwise, the buyer takes free without regard to the limitations of this section.

U.C.C. § 9-307 comment 2, para. 2 (1978).

38.

[T]he security agreement may contain restrictions on the time, place or manner of sale, the persons to whom sales are permitted, or the handling of proceeds from such sales. It may also provide that any sale shall be deemed unauthorized if made when the debtor is in default under some provision of the security agreement (which would of course include the obligation of repayment, but might also refer to other duties, such as the proper storage and handling of goods, the furnishing of sales reports or the payment over of proceeds).

Knapp, *supra* note 4, at 874.

39. The language quoted in the text is part of the definition of "buyer in ordinary course of business." U.C.C. § 1-201(9) (1978). For the complete text of the definition, see *supra* note 7.

40. The comments to section 9-307 indicate that the "prior uniform statutory provisions" are section 9 of the Uniform Conditional Sales Act and section 9(2) of the Uniform Trust

This exception to the general rule of validity of security agreements against third parties reflects the desire to remove obstacles that would unduly impede the free flow of commerce in goods.⁴¹ When buying in ordinary course through established business channels, buyers rely upon the integrity of the marketplace to pass them good title.⁴² Customers who buy goods from the inventory of debtor-dealers are relieved by section 9-307(1) of the burden of checking the filing system for public notices of security interests in the goods.⁴³ To require otherwise would unduly impede the free flow of commerce in goods because of the number of these purchases and because most secured parties financing inventory actually authorize sales of the collateral by their debtors.⁴⁴

Section 9-307(1), however, does not cut off all security interests in favor of buyers in ordinary course. The buyer will prevail only if the security interest is "created by his seller." The draftsmen's objective of protecting the buyer's reliance on the integrity of the marketplace was not absolutely adhered to because buyers rely on the appearance of authority for merchants to sell stocked goods, irrespective of whether the merchant-seller was the party who created the security interest. The reasoning behind the "created by his seller" limitation thus cannot be discerned by comparing the transactional perspectives of protected and unprotected buyers in ordinary course. Rather the differing results under section 9-307(1) depend upon the actions of the secured party and upon the business status of the debtor. The buyer

Receipts Act. The Uniform Conditional Sales Act was concerned with transactions in goods now described in the UCC as purchase money security interests that are taken or retained by the seller of the goods to secure their price. See U.C.C. § 9-107(a) (1978). Section 9 was concerned essentially with conditional sales of inventory. The Uniform Trust Receipts Act dealt with inventory financing. It was the forerunner to the UCC purchase money security interest in which the secured party provides an enabling loan for the debtor to acquire the collateral. See *id.* § 9-107(b).

41. In a report to the New York Law Revision Commission, the Special Committee on the Uniform Commercial Code of Commerce and Industry Association of New York, Inc., specifically approved "[t]he policy of the free movement of goods expressed in Section 9-307(1)" 2 LAW REVISION COMM'N, REPORT 1018 (1954).

42. Section 9-307(1) "encourages the marketability of goods" and "supports the reliance interest of buyers who assume that they have clear title to the goods they purchase." B. CLARK, *THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* ¶ 3.4, at 3-18 (1980). See also Knapp, *supra* note 4, at 887; Comment, *Scope of Protection*, *supra* note 4, at 990-91; Note, *The Buyer-Secured Party Conflict and Section 9-307(1) of the UCC: Identifying When a Buyer Qualifies for Protection as a Buyer in Ordinary Course*, 50 *FORDHAM L. REV.* 657, 668-69 (1982).

43. Professor Gilmore has observed that the good faith purchaser "is protected not because of his praiseworthy character, but to the end that commercial transactions may be engaged in without elaborate investigation of property rights and in reliance on the possession of property by one who offers it for sale or to secure a loan." Gilmore, *supra* note 28, at 1057.

44. R. SPEIDEL, R. SUMMERS & J. WHITE, *TEACHING MATERIALS ON COMMERCIAL AND CONSUMER LAW* 226 (3d ed. 1981).

in ordinary course prevails in cases of inventory financing in which the secured party leaves the collateral in the hands of a person in the business of selling goods of that kind. Yet, the secured party prevails when the collateral is goods other than inventory, even if the debtor wrongfully passes the goods to a dealer who sells to a buyer in ordinary course. Buyers rely on their dealers' appearances in both cases, but section 9-307(1) mandates differing results based essentially on the extent of the secured party's responsibility for creating the appearance.

The reason for the inclusion of the "created by his seller" language in section 9-307(1) is now ascertainable. The language plays a crucial role in the furtherance of the policy underlying section 9-307(1). It limits the application of its exception favoring buyers to those cases in which the buyer in ordinary course can establish apparent authority to sell.

A variety of factors help create apparent authority when a secured party provides nonpossessory inventory financing. First, and foremost, entrusting the collateral to debtors in the business of selling goods of the kind comprising the collateral facilitates sales in ordinary course because the secured party entrusts the goods to a person with the inherent power to sell the collateral directly to a buyer in ordinary course. In this context, the secured party's responsibility is analogous to that of an entruster of goods to a merchant under section 2-403(2).⁴⁵ A subsequent sale of the entrusted goods conveys all of the entruster's rights to a buyer in ordinary course of business, even if the sale violates the merchant's agreement with the entruster.⁴⁶ Sim-

45. Professor Gilmore's development of the commercial or mercantile theory of good faith purchase and Professor Warren's later study both discuss the application of the theory to sales of goods.

The commerciality of the good faith purchase doctrine can be demonstrated by a brief history of its growth in the law of sales of goods. The intangible evidences of property, with which the balance of this article will be concerned, are by their nature almost exclusively commercial. Goods, however, lead a double life: as inventory, they are the subject matter of commercial transactions; as possessions, the things we live by, they have passed out of the stream of commerce and come to rest. Although Anglo-American law does not purport to distinguish between commercial and non-commercial transactions, good faith purchase in the law of sales has, in fact, a very different operation in the two cases.

Gilmore, *supra* note 28, at 1057.

The widespread acceptance of the Code represents substantial progress in the long journey toward the attainment of a mercantile or commercial theory regarding goods, documents and instruments. . . . The Code's inclusion of section 2-403, granting a measure of negotiability to goods in a commercial setting, has been the most dramatic step forward.

Warren, *supra* note 28, at 492. Interestingly, neither of the authors developed the relevance of the commercial theory to the provisions of section 9-307(1).

46. "Any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in ordinary course of

ilarly, financiers who entrust merchant-debtors with possession of inventory collateral lose their security interests to buyers in ordinary course of business. Second, the intended result of inventory financing is sale of the collateral to third persons.⁴⁷ Given the active involvement in financing collateral in which a sale is the intended result, the secured party rightly should lose the security interest in the goods when the inevitable sale occurs. Finally, most sales from a debtor's financed inventory are made pursuant to actual secured party authorization. Section 9-307(1) is essentially a codification confirming apparent authority to sell based on the regularity of business practice that overrides even the secured party's express prohibition of sales of inventory collateral.⁴⁸ By placing a debtor in possession of goods when the debtor is in the business of selling goods of the same kind, the secured party vests the debtor with indicia of apparent authority.

The basis for the debtor's apparent authority to sell is missing when the collateral is goods other than inventory (such as equipment or consumer goods).⁴⁹ Even if the secured party entrusts the debtor with possession of non-inventory collateral, the entrustment does not occur in a context in which the debtor's only purpose for holding the goods is to sell them. Additionally, the secured party's entrustment of possession is not an act that empowers the debtor to sell to a buyer in ordinary course. By definition, buyers in ordinary course must purchase from a seller in the business of selling goods of the kind that are sold.⁵⁰ Although a debtor's transfer of the collateral to a dealer and its subsequent sale to a buyer in ordinary course of business is foreseeable, it is not expected to happen. The transfer of equipment and consumer goods, unlike inventory, is not anticipated and generally is not allowed by secured parties.⁵¹

The policy underlying the "created by his seller" language is thus discoverable by examining the relationship between the two exceptions to the

business." U.C.C. § 2-403(2) (1978). "Entrusting" is defined to include "any delivery and any acquiescence in retention of possession regardless of any condition expressed between the parties to the delivery or acquiescence and regardless of whether the procurement of the entrusting or the possessor's disposition of the goods have been such as to be larcenous under the criminal law." *Id.* § 2-403(3).

47. "Inventory" consists of goods "held by a person who holds them for sale or lease . . ." *Id.* § 9-109(4).

48. Compare this codification with the concept of conclusive evidence that the retailer had title or the right to convey embodied in section 9 of the Uniform Conditional Sales Act. See *infra* note 52.

49. See *supra* notes 11 and 12.

50. U.C.C. § 1-201(9) (1978).

51. R. SPEIDEL, R. SUMMERS, & J. WHITE, *supra* note 44, at 114-15, 156-57.

article 9 general rule of continued validity of security interests. It is a limitation that serves to correlate the section 9-307(1) exception with the more explicit authorization exception in section 9-306(2); secured party authorization for the sale of the collateral, whether actual or apparent, is the policy basis for discontinuing the security interest in the collateral after its sale by the debtor.⁵²

B. Examination of Agency Law Principles

Several agency law principles are analogous to the concepts codified in section 9-307(1) and they should be recognized as valuable sources to explain the policy reflected in the section. A debtor and a secured party generally do not stand in an agent-principal relationship.⁵³ Nonetheless, agency law principles are consistent with the "created by his seller" limitation. The

52. The prior statutory provisions cited in the official comments to section 9-307(1) reflect the principles of entrustment, authorization, and estoppel that support the two exceptions which cut off a security interest when encumbered goods are sold. See *supra* note 40. The Uniform Conditional Sales Act § 9 provided:

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 the goods, even though the contract or a copy thereof shall be filed according to the provisions of this act.

The reference to express consent to resell correlates with U.C.C. § 9-306(2) authorization to dispose of collateral, although the protection provided under the Code is broader since it extends to all transferees and not just to buyers in ordinary course of business. The Commissioners' notes to section 9 of the Uniform Conditional Sales Act make clear the relationship between the reference to implied consent and U.C.C. § 9-307(1): "That the goods have been put into the retailer's stock with the consent of the wholesaler [the secured party] is conclusive evidence that they are there for sale and that the retailer has title or the right to convey." UNIF. CONDITIONAL SALES ACT § 9, 2 U.L.A. 16 (1922).

Section 9(2) of the Uniform Trust Receipts Act is closely related to U.C.C. § 9-307(1). Section 9(2) provided that when the debtor has "liberty of sale and sells to a buyer in the ordinary course of trade . . . such buyer takes free of the entruster's security interest in the goods so sold, and no filing shall constitute notice of the entruster's security interest to such a buyer." UNIF. TRUST RECEIPTS ACT § 9(2)(a)(i), 9C U.L.A. 255 (1957). Section 9(2)(c) elaborated on the concept of "liberty of sale":

If the entruster consents to the placing of the goods subject to a trust receipt 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. § 9(2)(c), 9C U.L.A. 256.

53. "Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." RESTATEMENT (SECOND) OF AGENCY § 1(1) (1957). A debtor

provisions of the Restatement (Second) of Agency dealing with the entrustment of possession of a chattel to an agent demonstrate the relationship of agency principles to the policy of section 9-307(1). Section 174 of the Restatement indicates that an agent's possession of a chattel is not enough to subject the entrusting principal to the loss of its interest;⁵⁴ and, when authority to sell the chattel is added to possession, section 175(1) provides that the principal's interest is affected only by a transaction of the kind authorized.⁵⁵ Section 175(3), on the other hand, binds the principal who *delivers chattels to a dealer in such chattels* to an *unauthorized sale* made to a person acting in normal business practices under the reasonable belief that the dealer

may be under certain contractual controls of the secured party, but the debtor-dealer selling inventory is acting on his own behalf and not on behalf of the secured party. "It is the element of continuous subjection to the will of the principal which distinguishes the agent from other fiduciaries and the agency agreement from other agreements." *Id.* § 1(1) comment b.

With the facility to take action that will cut off a security interest, the dealer-debtor has what the Restatement (Second) of Agency refers to as a power, which it defines as "an ability on the part of a person to produce a change in a given legal relation by doing or not doing a given act." *Id.* § 6. The comments elaborate by pointing out that "[a]ll agents are power holders but many power holders are not agents." *Id.* § 6 comment b, para. 2. Section 9-307(1) creates a power holder because it essentially empowers a dealer-debtor to cut off the creditor's security interest wrongfully.

54.

Aside from statute, a disclosed or partially disclosed principal who entrusts an agent with the possession of a chattel, other than a commercial document representing a chattel or chose in action, but who does not authorize him to sell it, display it for sale, or otherwise affect the principal's interest in it, is not thereby bound by an unauthorized transaction with reference to the chattel between the agent and a third person.

RESTATEMENT (SECOND) OF AGENCY § 174 (1957).

The Comment to § 174 provides the following illustration:

P contracts to sell a horse to T. In execution of his promise P tells A to take the horse to T, to whom he is to transfer possession and from whom he is to receive the purchase price. Instead of doing as ordered, A sells the horse to X, who reasonably believes A to be authorized. X acquires no title to the horse.

Id. § 174 comment a, illus. 3.

Section 200 of the Restatement provides a corresponding rule for entrustment by an undisclosed principal. The result under the rule is the same, but the language is changed slightly to reflect the undisclosed principal situation: "an undisclosed principal . . . is not thereby bound by a transaction with respect to the chattel between the agent and a third person who believes the agent to be the owner." *Id.* § 200. For a discussion on the distinction between disclosed and undisclosed principals, see *infra* notes 57-63 and accompanying text.

55.

Apart from statute, and except as stated in Subsection (3), the interests of a disclosed or partially disclosed principal who entrusts an agent with the possession of a chattel, other than a commercial document representing a chattel or chose in action, with directions to deal with it in a particular manner, as by sale, barter, pledge or mortgage, are not thereby affected by a transaction of a kind different from that authorized.

RESTATEMENT (SECOND) OF AGENCY § 175(1) (1957).

The Comment to section 175(1) provides the following illustration:

P gives possession of an automobile to A, not a dealer, authorizing him to display but not to sell it. Nevertheless, A sells it to T. In the absence of other evidence, P is not bound by the sale.

Id. § 175(1) comment e, illus. 3.

Section 201(1) provides a corresponding rule for entrustment by an undisclosed principal.

is authorized to sell the chattel.⁵⁶ The exception of subsection (3) requires both entrustment to a dealer in the same kind of chattels and a purchase in normal course.

The section 9-307(1) exception is similarly restricted. The "created by his seller" provision limits the secured party's vulnerability to those situations in which the collateral is sold from the debtor-dealer's inventory stock. A buyer in ordinary course of business correlates with a person buying in normal business practices.

The Restatement draws a relevant distinction between disclosed and undisclosed principals.⁵⁷ Restatement section 175(3) requires the buyer to reasonably believe that the dealer is authorized to sell the chattel and thus provides analogous support for recognition of the apparent authority concept.⁵⁸ However, apparent authority cannot be created by an undisclosed principal, because the basis for the buyer's reasonable belief that the sale was authorized is missing.⁵⁹ Restatement section 201(3) provides a similar

For discussion on the distinction between disclosed and undisclosed principals, see *infra* notes 57-63 and accompanying text.

56.

If the principal delivers a chattel to a dealer in such chattels to be sold or exhibited for sale, an unauthorized sale of the chattel in accordance with the normal business practices to one who reasonably believes the dealer to be authorized to sell the chattel, binds the owner although the dealer was not authorized to sell it without the consent of the owner, or was not authorized to sell it to the person to whom it was sold, or at the price at which it was sold.

RESTATEMENT (SECOND) OF AGENCY § 175(3) (1957).

For the corresponding rule for an undisclosed principal, see *id.* § 201(3) and *infra* note 60.

U.C.C. § 9-307(1) corresponds to Restatement § 175(3) since the Code section applies to sales from debtors' inventories and goods are "inventory" "if they are held by a person who holds them for sale or lease. . . ." U.C.C. § 9-109(4) (1978). However, U.C.C. § 9-307(1) covers any entrustment of inventory collateral to the possession of a dealer, whereas Restatement § 175(3) requires the principal to deliver a chattel to a dealer. U.C.C. § 2-403(2) and (3) deletes the requirement that the chattel be delivered to the dealer to be sold or exhibited for sale. Any entrusting of possession of goods to a merchant who deals in that kind of goods gives the merchant power to transfer all of the rights of the entruster to a buyer in ordinary course of business. For an explanation of the relationship between U.C.C. §§ 2-403(2) and 9-307(1), see *infra* notes 78-101 and accompanying text.

57.

(1) If, at the time of a transaction conducted by an agent, the other party thereto has notice that the agent is acting for a principal and of the principal's identity, the principal is a disclosed principal.

(2) If the other party has notice that the agent is or may be acting for a principal but has no notice of the principal's identity, the principal for whom the agent is acting is a partially disclosed principal.

(3) If the other party has no notice that the agent is acting for a principal, the one for whom he acts is an undisclosed principal.

RESTATEMENT (SECOND) OF AGENCY § 4 (1957).

A similar distinction applies to article 9 since a buyer in ordinary course may know that the goods sold are collateral for a loan or may be completely unaware of any secured financing arrangement.

58. "Apparent authority is the power to affect the legal relations of another person by transactions with third persons, professedly as agent for the other, arising from and in accordance with the other's manifestations to such third persons." RESTATEMENT (SECOND) OF AGENCY § 8 (1957).

59.

This follows necessarily from the fact that all representative authority in an agent

rule for situations where chattels are entrusted to a dealer by an undisclosed principal who does not authorize the sale of the chattels.⁶⁰ The requirements and the result under section 201(3) are identical with those of section 175(3), except that rather than showing reasonable belief as to the dealer's authority, the buyer must reasonably believe that the dealer is the owner.⁶¹ If the buyer establishes this reasonable belief, the owner is estopped from arguing unauthorized disposition because the owner should know that entrustment of goods to a dealer in such goods is likely to lead to detrimental reliance and that a good faith purchase in the normal course of business provides such reliance.⁶² Sections 175(3) and 201(3) thus provide analogous theories for terminating the security interests of both disclosed and undisclosed secured parties.⁶³

is derived from the objective consent of the principal to the third party, either actual consent through the agent's permitted acts or apparent consent directly to the third party. An undisclosed principal, being one whose agent poses as dealing for himself, creates no direct appearances to the third party. Thus he can never be charged with appearing to consent that his agent has a certain scope of authority.

Conant, *The Objective Theory of Agency: Apparent Authority and the Estoppel of Apparent Ownership*, 47 NEB. L. REV. 678, 686 (1968). "[T]he agent of an undisclosed principal, by definition, never appears to be an agent." *Id.* at 691.

60.

If the principal delivers a chattel to a dealer in such chattels to be sold or exhibited for sale, an unauthorized sale of the chattel by such dealer in accordance with the normal business practices to one who reasonably believes the dealer to be the owner, binds the owner, although the dealer was not authorized to sell it without the consent of the owner or was not authorized to sell it to the person to whom it was sold or at the price at which it was sold.

RESTATEMENT (SECOND) OF AGENCY § 201(3) (1957). For the corresponding rule for a disclosed or partially disclosed principal, see *id.* § 175(3) and *supra* note 56.

61.

The undisclosed principal directs, permits or enables his agent in dealing with third parties to pose as the owner of assets which in fact belong to the principal. If third parties extend credit or purchase goods in reliance on the apparent ownership of the agent, when the principal is ultimately responsible for causing such appearance, the principal is estopped to deny contractual liability.

Conant, *supra* note 59, at 687.

62. The estoppel and apparent authority concepts are closely related in the context of section 9-307(1). "In most of the situations in which apparent authority exists, estoppel also exists although it is unnecessary as a basis for the principal's liability. If the claim of a party to a transaction is based solely upon estoppel, he must prove a change of position which is not required in the case of apparent authority." RESTATEMENT (SECOND) OF AGENCY § 8B comment b (1957). In the section 9-307(1) context, buyers in ordinary course will have changed their position by making the purchase.

A long controversy has raged over whether apparent authority is true authority or creates liability based on estoppel. See Cook, "Agency by Estoppel," 5 COLUM. L. REV. 36 (1905); Cook, "Agency by Estoppel": A Reply, 6 COLUM. L. REV. 34 (1906); Ewart, "Agency by Estoppel," 5 COLUM. L. REV. 354 (1905). Compare Montrose, *The Basis of the Power of an Agent in Cases of Actual and Apparent Authority*, 16 CAN. BAR REV. 757 (1938) with F. TIFFANY, AGENCY § 16 (2d ed. 1924), and R. POWELL, LAW OF AGENCY 68-72 (2d ed. 1952).

63. Although the comments to the Restatement (Second) of Agency (§ 8A comment b and § 175 comment a) indicate that the rules of sections 175(3) and 201(3) are illustrative of an inherent agency power, the use of that concept is not appropriate in drawing analogies to U.C.C. § 9-307(1). The term "inherent agency power" refers to power derived exclusively from an agency relation when the power cannot be derived from apparent authority or estoppel

The language of U.C.C. § 9-307(1) reflects both situations. A buyer in ordinary course takes free of a security interest created by his seller "even though the buyer knows of its existence."⁶⁴ Hence, the qualifying buyer is protected whether or not the secured party is disclosed. The buyer, however, cannot qualify with "knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods."⁶⁵ Similar knowledge would serve to defeat a buyer under both section 175(3) and section 201(3) of the Restatement.⁶⁶ With one exception,⁶⁷ the analysis that follows does not draw upon the distinction between disclosed and undisclosed secured parties; therefore, the discussion is generally limited to apparent authority.⁶⁸

Thus, the policy underlying the "created by his seller" language is to limit the exception to security interest validity codified in section 9-307(1) to cases in which the secured party has clothed the debtor with the indicia of apparent authority to sell the goods. Nonpossessory inventory financing establishes apparent authority in dealer-debtors to sell to buyers in ordinary course because (1) the intended result of inventory financing is sale of the collateral to third persons, (2) the sale is facilitated by entrusting the collateral to dealer-debtors in the business of selling goods of the kind comprising the collateral, and (3) most of these sales are made pursuant to actual secured party authorization. Debtor sales of consumer goods and equipment are distinguishable. Improper sales of these categories of collateral generally do not occur, nor are they expected to occur; therefore, secured parties have been relieved of the burden of policing such sales. The absence of apparent authority to sell is the justification for continuing the validity of the security interest in such situations even against a buyer in ordinary course of business.

principles. RESTATEMENT (SECOND) OF AGENCY § 8A (1957); W. SEAVEY, HANDBOOK OF THE LAW OF AGENCY 15 (1964). The absence of an agency relationship between the debtor and the secured party makes the use of the agency term of "inherent agency power" inappropriate.

The use of the concepts of apparent authority and apparent ownership furthermore seems preferable in utilizing analogous agency law principles to explain the underlying policy of section 9-307(1). Use of the term "inherent agency power" has been far from universal even in agency law cases. "In many of the cases involving these situations the courts have rested liability upon the ground of 'apparent authority', a phrase which has been used by the courts loosely." RESTATEMENT (SECOND) OF AGENCY § 8A comment b, para. 3 (1957). "Whether or not the term inherent agency power becomes part of the legal vocabulary will depend upon whether the courts believe it to be the most appropriate term." W. SEAVEY, *supra*, at 16. Professor Seavey had noted its use in only two cases. *Cote Bros. v. Granite Lake Realty Corp.*, 105 N.H. 111, 193 A.2d 884 (1963); *Holman-O.D. Baker Co. v. Pre-Design, Inc.*, 104 N.H. 116, 179 A.2d 454 (1962). For an argument against use of the term, see Conant, *supra* note 59.

64. U.C.C. § 9-307(1) (1978).

65. *Id.* § 1-201(9). This knowledge would defeat the status of buyer in ordinary course of business.

66. The buyer with this knowledge could not establish a reasonable belief that the seller had authority to sell or was the owner of the goods.

67. See *infra* notes 144-46 and accompanying text.

68. For an explanation of how estoppel concepts underlie both apparent authority and apparent ownership see *supra* note 62 and Conant, *supra* note 59.

II. EVALUATION OF THE POLICY

A. Consumer Protection

Bona fide purchasers have become favorites of the law. Buyers in ordinary course of business have paid value and have acted in good faith and without knowledge of any impropriety concerning the sale. They have purchased in established channels of trade where their expectations of legitimate sales transactions are highest. "Both under pre-Code law and the Code itself, the status of a buyer in ordinary course is as favorable as that accorded to any third-party claimant."⁶⁹

Several commentators believe that the favored status of buyers in ordinary course should allow them to prevail over all prior security interests and that the limitation contained in section 9-307(1) is therefore unwarranted.⁷⁰ The expectations of buyers in ordinary course are seen as equivalent, regardless of whether or not the security interest was created by the dealer-seller.⁷¹ The buyer in either instance is innocent of any wrongdoing and lacks knowledge that the sale is improper. The noncommercial buyer in either transaction is likely to be unaware of the relevant commercial legal standards or even that any risk is involved. Section 9-307(1) makes the buyers' rights depend entirely on the prior actions of their sellers, of which they "almost certainly [have] no knowledge, and over which [they] clearly [have] no control."⁷² Since the expectations are equivalent and the equities are equally appealing in both cases, protection arguably should be extended to buyers in ordinary course who purchase from dealers who have not created the security interest in the goods.⁷³

Analysis of this argument is enhanced by examining a schema of the component premises and conclusions. Argument I illustrates the reasoning behind the consumer protectionists' view of the policy supporting the exception favoring buyers that is codified in section 9-307(1).

- ARGUMENT I: (1) If Buyer in ordinary course purchases from a merchant who has created a security interest in the goods purchased, Buyer has no reason to expect that good title will not be conveyed.
- (2) Therefore, Buyer ought to take free of the security interest.

69. Jackson & Peters, *supra* note 22, at 955.

70. See *supra* note 4.

71. "If the debtor sells first to another dealer, who in turn resells to a BIOC [buyer in ordinary course], that buyer is just as innocent of knowledge about the security interest, and the equities in her favor seem similar to those of the buyer in the three-party situation." Knapp, *supra* note 4, at 884. See also Dugan, *supra* note 4, at 346-47.

72. Knapp, *supra* note 4, at 885.

73. See Dugan, *supra* note 4, at 362; Knapp, *supra* note 4, at 892; Vernon, *supra* note 4, at 536; Comment, *Scope of Protection*, *supra* note 4, at 996.

Argument II illustrates the consumer protectionists' reasoning behind their criticism of the "created by his seller" language of limitation in section 9-307(1).

- ARGUMENT II: (1) If Buyer in ordinary course purchases from a merchant who has received and sold goods subject to a prior security interest, Buyer again has no reason to expect that good title will not be conveyed.
- (2) Therefore, Buyer ought to take free of the security interest.

Both arguments are invalid. Both arguments depend upon the truth of the following suppressed premise: the buyer's factual expectations ought to control the legal risk of buyers in ordinary course. This premise is false.

The law in several circumstances leaves a buyer in ordinary course unfulfilled in the expectation of receiving good title. For example, neither a merchant who acquires goods from a thief nor one who acquires goods through wrongful sale by a bailee can pass good title to the buyer,⁷⁴ regardless of the buyer's good faith.⁷⁵ Thieves, bailees, and even lessees⁷⁶ have been held to lack even voidable title.⁷⁷ So when individuals in these categories sell goods, the true owners' prior interests take priority even over buyers in ordinary course. The suppressed premise of Arguments I and II, basing a buyer's legal risk on his or her expectations, is false. The law has never absolutely protected a buyer's expectation of receiving an unencumbered title in purchased goods.

The consumer protectionists argue that analogies to section 2-403 support a policy of extending buyer in ordinary course protection under section 9-307(1). Section 2-403(2) provides that "any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in ordinary course of business."⁷⁸ It envisions a bailment of goods to a merchant who in turn sells them to a qualifying buyer.⁷⁹ An entrustment occurs, for example, if an individual gives a merchant possession of goods for the purpose of repairing them.⁸⁰ One

74. See, e.g., *Schrier v. Home Indemnity Co.*, 273 A.2d 248 (D.C. 1971); *Johnny Dell, Inc. v. New York State Police*, 84 Misc. 2d 360, 375 N.Y.S.2d 545 (1975). For policy analysis of the rule on transactions in stolen goods see A. SCHWARTZ & R. SCOTT, *COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES* 476 (1982); Weinberg, *Sales Law, Economics, and the Negotiability of Goods*, 9 J. LEGAL STUD. 569 (1980).

75. *Toyomenka, Inc. v. Mount Hope Finishing Co.*, 432 F.2d 722 (4th Cir. 1970).

76. *McDonald's Chevrolet, Inc. v. Johnson*, 176 Ind. App. 399, 376 N.E.2d 106 (1978). *Contra United Road Machinery Co. v. Jasper*, 568 S.W.2d 242 (Ky. Ct. App. 1978).

77. "A person's title to goods is said to be voidable when he holds a legal title but his transferor has the right to avoid the transfer and reassert title in himself." Weber, *The Extension of the Voidable Title Principle Under the Code*, 49 KY. L.J. 437, 439 (1961).

78. See *supra* note 46 (defining "entrusting"). See generally Note, *The Good Faith Purchase of Goods and "Entrusting" to a Merchant Under the Uniform Commercial Code: Section 2-403*, 38 IND. L.J. 675 (1963).

79. R. NORDSTROM, *HANDBOOK OF THE LAW OF SALES* 516 (1970).

80. See, e.g., *Milnes v. General Elec. Credit Corp.*, 377 So. 2d 725 (Fla. Dist. Ct. App. 1979); *Doppelt v. Wander & Co.*, 19 U.C.C. Rep. Serv. (Callaghan) 503 (N.Y. Civ. Ct. 1976) (diamond entrusted to a jewelry merchant).

of the arguments of the consumer protectionists is that since the entrusting owner loses to a buyer in ordinary course even though the entruster never intended to convey any title, *a fortiori*, a secured party, who lacks complete ownership of the goods, should lose to all buyers in ordinary course.⁸¹

This argument, however, fails to recognize the close correlation between sections 2-403(2) and 9-307(1).⁸² The "created by his seller" language in section 9-307(1) was inserted in a 1956 revision of article 9 to conform with section 2-403(2)'s provision that entrustment gives the dealer power to transfer all rights of the entruster.⁸³ The proper comparison with an owner's entrustment of goods to a merchant under section 2-403(2) is a secured party's entrustment of collateral to a dealer of goods of the same kind under section 9-307(1); the buyer in ordinary course prevails in both situations.⁸⁴ On the other hand, if a bailee of goods were the person to entrust the owner's goods to a dealer, a buyer in ordinary course from the dealer would acquire only the bailee's rights under section 2-403(2), not the rights of the owner. A buyer in ordinary course who loses under section 9-307(1) because the security interest was not "created by his seller" cannot achieve superior priority through the provisions of section 2-403(2).⁸⁵ The analogy to section

81. Knapp, *supra* note 4, at 881.

82. See Skilton, *supra* note 15, at 34-35. "The correlation is not perfect. Buyers of farm products from a farmer are not protected by section 9-307(1), whereas there is no such limitation in section 2-403(2), once the court decides that the farmer is a 'merchant.'" *Id.* at 35 n.91. "As to entrusting by a secured party, subsection (2) is limited by the more specific provisions of section 9-307(1), which deny protection to a person buying farm products from a person engaged in farming operations." U.C.C. § 2-403 comment 2, para. 2 (1978). In addition, the definition of "entrusting" (section 2-403(3)) explicitly requires possession of the goods by the merchant seller before a buyer in ordinary course can prevail under section 2-403(2), whereas section 9-307(1) is silent on this matter. Professor Kripke has argued that the correlation between sections 2-403(2) and 9-307(1) should be strengthened by reading a possession requirement into section 9-307(1). Kripke, *Should Section 9-307(1) of the Uniform Commercial Code Apply Against a Secured Party in Possession?*, 33 BUS. LAW. 153, 157 (1977). *Contra* 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); Gottlieb, *Section 9-307(1) and Tanbro Fabrics: A Further Response*, 33 BUS. LAW. 2611 (1978).

83. The comments and recommendations of the New York Law Revision Commission were highly influential in the amendments to the 1952 version of the UCC, including the changes resulting in the present version of section 9-307(1). After noting that sections 9-307(1) and 2-403(2) were "parallel provisions," the Commission's report states:

There is a further question under Sections 1-201(9), 2-403(2) and 9-307(1) whether the sale to a buyer in ordinary course must be made by the debtor, or can be made by a third person, who is a merchant engaged in selling goods of that kind, if the secured party "entrusted" the goods to that third person.

LAW REVISION COMM'N, REPORT 67 (1956). The "created by his seller" language of section 9-307(1) was added following the Commission's report. See AMERICAN LAW INSTITUTE, 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE 52-53 [hereinafter cited as RECOMMENDATIONS].

84. Section 2-403(2) would give the buyer "all rights of the entruster," which would be the owner's title in the goods. Section 9-307(1) would protect the buyer because the security interest was "created by his seller."

85. Assume a secured party perfects a security interest in the debtor's tractor. The debtor entrusts the tractor to a tractor merchant for the purpose of performing scheduled maintenance, but the merchant wrongfully sells the tractor to a buyer in ordinary course. The buyer is unprotected under section 9-307(1) because the security interest was not "created by his seller."

2-403(2), rather than supporting an expanded scope of protection for buyers under section 9-307(1), demonstrates the error in reasoning from the premise that the legal risk of buyers in ordinary course of business under article 9 ought to be controlled by the buyer's expectations.

An additional argument based on an analogy to section 2-403 can be advanced. Section 2-403(1) empowers a person with voidable title⁸⁶ to transfer good title to a good faith purchaser for value.⁸⁷ The classic case of voidable title is the acquisition of goods by means of defrauding the owner.⁸⁸ The argument advanced is that "[i]f the closest competing analogies under the UCC are the robbery victim and the con man's dupe, the secured party clearly is closer to the latter."⁸⁹ Under section 2-403(1), if the debtor's rights in the goods were recognized as voidable title,⁹⁰ then the secured party's interest could be lost in a sale to a dealer who qualifies as a bona fide purchaser.⁹¹ The dealer then could pass unencumbered title to any subsequent

Under section 2-403(2) the buyer will receive "all rights of the entruster," meaning that the buyer is entitled to only the debtor's equity in the tractor. See J. WHITE & R. SUMMERS, *supra* note 6, at 1074-75. See also *Security Pac. Nat'l Bank v. Goodman*, 24 Cal. App. 3d 131, 100 Cal. Rptr. 763 (1972). Section 2-403(2) does not serve to enhance the buyer's position against the secured party. The debtor-entruster's rights transferred under section 2-403(2) are encumbered by the secured party's interest. However, on facts similar to those of the hypothetical, one court stated that under sections 2-403(2) and 9-307(1) the buyer in ordinary course would prevail over a prior perfected secured party. *General Elec. Credit Corp. v. Western Crane & Rigging Co.*, 184 Neb. 212, 215, 166 N.W.2d 409, 411 (1969). The opinion, however, is unpersuasive. The court provides no explanation beyond mere dicta, and totally ignores the "created by his seller" limitation of section 9-307(1) and the "all rights of his entruster" provision of section 2-403(2).

86. Weber, *supra* note 77, at 439.

87. The voidable title provisions of section 2-403(1) provide as follows:

A person with voidable title has power to transfer a good title to a good faith purchaser for value. When goods have been delivered under a transaction of purchase the purchaser has such power even though

- (a) The transferor was deceived as to the identity of the purchaser, or
- (b) the delivery was in exchange for a check which is later dishonored, or
- (c) it was agreed that the transaction was to be a "cash sale", or
- (d) the delivery was procured through fraud punishable as larcenous under the criminal law.

88. Weber, *supra* note 77, at 442. "In short, when delivery in a transaction of purchase is induced by a fraud or mistake, the 'rogue' has power to pass good title to a BFP." R. SPEIDEL, R. SUMMERS & J. WHITE, *supra* note 44, at 1172.

89. Knapp, *supra* note 4, at 891.

90. "The voidable title doctrine stipulates that in the event the common law vests the malefactor with voidable title, he can transfer good title to a good faith purchaser for value." Dolan, *The Uniform Commercial Code and the Concept of Possession in the Marketing and Financing of Goods*, 56 TEX. L. REV. 1147, 1172 (1978).

Arguably the rule, because of its imprecision, has no appeal. See Warren, *Cutting Off Claims of Ownership Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 469, 475 (1963). Yet that imprecision stems not from the policy of protecting buyers against true owners but from the difficulty of determining when the common law clothes the malefactor with voidable title.

Id. at 1172 n.135.

91. "There is no indication, however, that this insertion [of section 2-403(1)] was intended to broaden the protection accorded either to buyers in ordinary course under § 2-403(2) or to

buyer based on the shelter principle that a purchaser of goods acquires all title that the transferor had or had power to transfer.⁹² Through this construction, a buyer who loses to the secured party under section 9-307(1) might find greater protection in section 2-403(1).⁹³

This approach is both undesirable and inappropriate.⁹⁴ The voidable title concept is based on an estoppel theory: when an "owner transfers possession to a buyer in such a manner as to clothe him with sufficient indicia of title that the buyer can mislead an innocent purchaser, the owner is estopped from asserting replevin against the buyer."⁹⁵ Comparable protection for good faith purchasers is provided under the UCC when secured parties do not perfect their security interest in goods⁹⁶ and when sellers, rather than taking a security interest in the goods, simply reserve title in a credit sale.⁹⁷ The situation is quite different, however, when the secured party perfects the security interest by properly filing a financing statement. The public filing cures the problem of ostensible ownership in nonpossessory security interests⁹⁸

purchasers in general." Jackson & Peters, *supra* note 22, at 956 n.178. "[I]t is more likely that the drafters of the Code, having decided to emphasize the entrustment concept and having encountered difficulties in reducing the nuisances of bona fide purchaser to statutory form, had decided to leave the latter doctrine where it stood in the case law." McDonnell, *The Floating Lienor as Good Faith Purchaser*, 50 S. CAL. L. REV. 429, 449 (1977).

92. "A purchaser of goods acquires all title which his transferor had or had power to transfer except that a purchaser of a limited interest acquires rights only to the extent of the interest purchased." U.C.C. § 2-403(1) (1978).

93. Note that under this construction, however, even a buyer in ordinary course would lose if the debtor-seller did not qualify as a good faith purchaser. Even if section 2-403(1) were applicable and the debtor were held to have voidable title, "the way these subsections of the Code [(1) and (2) of § 2-403] are written, the buyer in ordinary course could not use the entrusting sections to ripen a voidable title held by the entruster into a good title." R. NORDSTROM, *supra* note 79, at 517. The expectations of the buyer in ordinary course that are relied upon by the consumer protectionists would be an inadequate policy basis to explain the results even under this analysis.

94. Section 2-402(3)(a) provides that "[n]othing in this Article shall be deemed to impair the rights of creditors of the seller under the provisions of the Article on Secured Transactions (Article 9)." Section 9-307(1) establishes the rights of a perfected secured party vis-a-vis buyers of goods. U.C.C. § 9-307(1) comment 1 (1978). Granting priority under section 2-403(1) to a buyer who loses under section 9-307(1) would impair the secured party's article 9 rights. *Accord*, *National Shawmut Bank v. Jones*, 108 N.H. 386, 236 A.2d 484 (1967). A perplexing contradiction appears in the White and Summers treatise. Based on the interpretation of the *National Shawmut Bank* opinion, the authors argue that a purchaser losing under section 9-307(1) should not achieve a superior right against the security interest under section 2-403. J. WHITE & R. SUMMERS, *supra* note 6, at 1073-74. An accompanying note, however, indicates that Professor Summers "would read 2-403 broadly to protect the innocent purchaser." *Id.* at 1074 n.100. Reasons for the latter position are not provided.

95. *Lang v. Harwood*, 145 S.W.2d 945, 951 (Tex. Civ. App. 1940).

96. A secured party who does not perfect the security interest can be defeated by good faith purchasers and lien creditors. U.C.C. § 9-301 (1978).

97. "Any retention or reservation by the seller of the title (property) in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest." *Id.* § 2-401(1). Without filing by the seller, the security interest is unperfected and thus susceptible under section 9-301.

98. Ostensible ownership problems arose when the common law deviated from the maxim that possession was nine points in the law. For early case law see *Clow v. Woods*, 5 Serg. &

by eliminating the secret aspects of the transaction.⁹⁹ The filed financing statement removes the estoppel basis against the secured party by serving as the surrogate for possession of the goods by the secured party.¹⁰⁰ It precludes subsequent purchasers from relying on the debtor's possession of the goods as a sufficient indicium of clear title.¹⁰¹

Section 9-307(1) creates a specific exception to the filing requirement necessary to protect a secured party's interest in goods by subordinating the perfected secured party's interest to the specified buyers in ordinary course. The rationale for this exception has been articulated in part I of this article. Although the public filing cures the ostensible ownership problem created in nonpossessory secured financing of the goods, principles of apparent authority justify precluding even a perfected secured party from prevailing over a buyer in ordinary course. However, when a buyer in ordinary course buys goods subject to a perfected security interest that was not "created by his seller," the buyer lacks the basis on which to establish apparent authority to sell. More than detrimental reliance inherent in the status of buyer in ordinary course is needed to defeat the secured party. The section 9-307(1)

Rawle 275 (Pa. 1819). Separation of ownership and possession interests in property created problems for ascertaining the extent of a possessor's interest. See generally Baird & Jackson, *supra* note 31; Helman, *Ostensible Ownership and the Uniform Commercial Code*, 83 COMM. L.J. 25 (1978).

Considerable litigation over several hundred years has led to a doctrine called "ostensible ownership," and two major lines of authority. The first regards the retention of possession by the seller as evidence of fraud on creditors, rebuttable by evidence showing bona fide reasons for permitting the seller to retain possession. Other courts regard the retention of possession as conclusive evidence of fraud on creditors. . . . In some states, purchasers from, as well as creditors of, the seller in possession may invoke the doctrine.

V. COUNTRYMAN, A. KAUFMAN, & Z. WISEMAN, *COMMERCIAL LAW* 233 (2d ed. 1982).

99. "Article 9 establishes a legal rule to deal with the ostensible ownership problem secured credit creates: The first secured party must take possession of the collateral or make a public filing before he can shift to subsequent creditors the risk of competing claims to the same property." Baird & Jackson, *supra* note 31, at 186.

100. "The filing system is, in effect, a place where secured creditors stake claims to the debtor's property." Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53, 62 (1983).

101. It is noteworthy that article 9 provides the perfection mechanism to cure the ostensible ownership problem associated with secured financing, whereas other transactions creating the same problem are not subject to the same cure. Professors Baird and Jackson have advanced a persuasive argument that these additional transactions also should be subject to a general requirement to cure the problem.

An ostensible ownership problem, however, exists whenever there is a separation of ownership and possession. Article 9's treatment of the ostensible ownership problem created by secured credit naturally leads one to ask whether the ostensible ownership problem created by leases or other bailments is different. We believe the answer is simple: The two ostensible ownership problems are not different in any relevant respect. They impose the same costs on third parties, and if a filing system is an appropriate response to the first problem, it is an equally appropriate response to the second.

Baird & Jackson, *supra* note 31, at 186.

policy analysis of the consumer protectionists gives undue weight to the expectations of buyers in ordinary course.

The appropriate schema of the analysis requires greater consideration of the secured party's manifestations. Argument IA better illustrates the true reasoning behind the policy supporting the exception favoring buyers that is codified in section 9-307(1).

ARGUMENT IA: (1) If Secured Party takes a perfected nonpossessory security interest in goods of the type comprising inventory of the debtor, Secured Party confers apparent authority to sell on the dealer-debtor.

(2) Therefore, a buyer in ordinary course ought to take free of the security interest.

Argument IIA shows the true reasoning underlying the policy of the "created by his seller" language in section 9-307(1).

ARGUMENT IIA: (1) If Secured Party takes a perfected security interest in goods other than the type comprising inventory of the debtor, Secured Party does not confer apparent authority to sell on the debtor or any subsequent dealer.

(2) Therefore, a buyer in ordinary course ought not to take free of the security interest.

The underlying premise of these arguments is as follows: the seller's apparent authority to sell ought to control the legal risk of buyers in ordinary course. The buyer's expectations, certainly important to section 9-307(1) protection, are tied to the status of buyer in ordinary course. However, they are not controlling. In focusing exclusively upon the buyer's expectations, the consumer protectionists overlook the nature of the secured party's manifestations and thereby overlook the basis to appreciate the policy that underlies the "created by his seller" limitation.

Moreover, the dilemma of buyers in ordinary course of business who are unprotected under section 9-307(1) is often overstated,¹⁰² since these buyers have an alternative method of protection. In contracts for the sale of goods the seller warrants not only that the title conveyed is good and the transfer

102. Advocates of expanded protection for buyers in ordinary course argue that the buyers unprotected by article 9 have fewer means to protect themselves than do protected buyers. A buyer could locate a properly filed financing statement indicating a security interest created by his seller because financing statements are indexed under the name of the debtor. On the other hand, the buyer of encumbered goods wrongfully transferred to the buyer's dealer-seller generally does not know the name of the debtor and thus cannot find the financing statement, even with a thorough search of the public records. See Dugan, *supra* note 4, at 346-47; Knapp, *supra* note 4, at 887.

The inability to locate the financing statement is an inadequate reason, however, to cut off prior security interests in favor of buyers in ordinary course. Most noncommercial buyers are unlikely to check the files anyway. To extend a preferred status to these buyers on the ground that they do not have a reliable discovery method available to them, even though they would not use it even if it were available, would be illogical.

rightful, but also that "the goods shall be delivered free from any security interest or other lien or encumbrance of which the buyer at the time of contracting has no knowledge."¹⁰³ Thus, aggrieved buyers can sue their sellers for the loss resulting from any undisclosed perfected security interests.¹⁰⁴ Sellers, in turn, can pass warranty of title liability to their transferors and thereby place ultimate liability on the debtor who wrongfully sells the collateral.

For the buyer of the goods who is unprotected under section 9-307(1), the difficulty occurs when the dealer becomes insolvent and cannot pay the breach of warranty damages. The secured party's cause of action against the dealer for conversion¹⁰⁵ is also imperiled. In these circumstances, the buyer will take whatever equity in the goods the debtor possessed,¹⁰⁶ the value of the warranty claim in the bankruptcy proceeding, and any surplus resulting from the secured party's disposition of the goods,¹⁰⁷ but the secured party will be able to take possession of the collateral to satisfy the debt or to hold the buyer liable for conversion.¹⁰⁸ Therefore, the secured party's interests predominate.

When neither the dealer nor the dishonest debtor is available or able to pay damages a new problem arises—how to allocate the loss between two innocent parties, the buyer in ordinary course and the secured party. The next subsection of this article analyzes the issue of risk allocation in this context.

B. Allocation of Risk

A principle the law has utilized often to allocate losses between innocent parties is to cast the loss upon the party whose act or omission caused it. This rule creates incentives: (1) to implement measures to eliminate or, at least, to reduce losses, and (2) to recognize and spread as widely as possible any resulting losses as part of the cost of engaging in the loss-causing activity. Strict tort liability for producing and selling defective products reflects this principle. The manufacturer who avoids negligent behavior nevertheless is held liable for marketing a product in an unreasonably dangerous, defective condition.¹⁰⁹ This strict liability standard encourages producers and sellers

103. U.C.C. § 2-312(1)(b) (1978).

104. See, e.g., *Christopher v. McGehee*, 124 Ga. App. 310, 183 S.E.2d 624 (1971); *American Container Corp. v. Hanley Trucking Corp.*, 111 N.J. Super. 322, 268 A.2d 313 (1970). See generally *R. NORDSTROM*, *supra* note 79, §§ 58, 59.

105. *First Nat'l Bank v. Stamper*, 93 N.J. Super. 150, 225 A.2d 162 (1966), *overruled on other grounds*, 147 N.J. Super. 212, 371 A.2d 84 (1977); *McGlynn v. Schultz*, 90 N.J. Super. 505, 218 A.2d 408 (1966).

106. See *Security Pac. Nat'l Bank v. Goodman*, 24 Cal. App. 3d 131, 100 Cal. Rptr. 763 (1972).

107. When a secured party takes possession of the goods after default by the debtor and then disposes of the goods, the secured party is required to account to the debtor for any surplus that results from the disposition. U.C.C. § 9-504(2) (1978).

108. *Id.* § 9-307 comment 3.

109. RESTATEMENT (SECOND) OF TORTS § 402A (1965).

to exercise additional care to ensure the safety of their products and prompts them to pass on the cost of uneliminated losses through increased prices. The subsequent discussion analyzes these risk allocation incentives of loss prevention and loss spreading as justifications for shifting the loss to the secured party in cases where the perfected security interest remains valid against buyers in ordinary course of business.

1. Loss Prevention

The loss allocation principle based on causation is advanced as a reason to place the loss on the secured party whenever goods serving as collateral are purchased by a buyer in ordinary course of business. By extending credit and permitting the debtor to possess the collateral, the secured party enables the debtor to wrongfully pass encumbered goods along in the stream of commerce.¹¹⁰ The secured party is identified as the party most responsible for any losses suffered by subsequent buyers in ordinary course.¹¹¹

Although the secured party initially facilitates the dishonest debtor's actions, that is not the only facilitation necessary for the debtor's success. Arguably, it is not even the main cause of the subsequent loss. The debtor may or may not have had the dishonest transfer in mind when entering into the security agreement with the lender, but the debtor is clearly a wrongdoer when making the improper transfer to the dealer. The dealer's conversion of the collateral is indispensable to the buyer in ordinary course taking goods subject to a perfected security interest. The buyer, who is something of a wrongdoer by purchasing converted goods, also acts after the debtor's wrongdoing. The buyer in ordinary course may be an innocent victim when he or she buys goods subject to a continuing perfected security interest, but such a buyer is a participating victim. Buyers certainly bear some responsibility for selecting the merchants with whom they deal. The secured party did not select the dealer in this instance; the buyer in ordinary course did. It is not unreasonable to require the buyer in these circumstances to look to his or her seller for relief when the seller is solvent.

The buyer's ability to prevent the loss is not sufficient, however, to justify allocating the loss to the buyer when the dealer becomes insolvent and the choice is between the innocent buyer and the secured party.¹¹² Generally, the buyer does not have access¹¹³ to sufficient information to enable detection

110. Dugan, *supra* note 4, at 361.

111. See Vernon, *supra* note 4, at 536.

112. *Contra* Special Project, *supra* note 4, at 963-64. "The 'created by his seller' requirement may reflect the Code's policy of placing the ultimate loss, as between two innocent parties, on the party who dealt most closely with the 'bad guy.'" *Id.*

113. In the more personal commercial world of the nineteenth century courts could more legitimately expect buyers to be more aware of the state of title of the goods they purchased. See, e.g., Warren, *supra* note 28, at 470.

of bad faith transactions in the dealer's acquisition of collateral.¹¹⁴ Other than in situations where the indications are obvious, the buyer also lacks the ability to determine whether a particular dealer is on the verge of insolvency. In choosing between the two innocent parties, the objective of loss prevention does not support allocating the loss to the buyer in ordinary course.

The objective also does not justify any further allocation of loss to secured parties than that already codified in section 9-307(1). In most instances secured lenders financing consumer goods and equipment lack efficient techniques to control debtor misbehavior. The prohibitive cost of monitoring collateral other than inventory precludes it as a viable option in most cases. Imagine the expense involved in policing thousands of security interests in relatively inexpensive consumer and business collateral located in even one metropolitan area. The cost of sending an inspector just once to each location of collateral would be enough to destroy the economic efficiency of policing the collateral. Furthermore, since one inspection would be inadequate to assure against subsequent debtor dishonesty, it would have to be repeated regularly.¹¹⁵ The predictable response of secured lenders operating in such an environment would be to ignore policing mechanisms and either to withdraw from financing equipment and consumer goods or to increase interest charges to cover losses occurring from debtor dishonesty.¹¹⁶ These alternative responses will be discussed in greater detail,¹¹⁷ but for purposes of the present discussion, neither of them establishes that the secured party is in a superior position to prevent losses from debtor dishonesty.

Even if a secured lender were to monitor collateral, the policing technique is likely to be less successful in many cases of financing consumer goods or equipment than it is in financing inventory. Inventory financing generally involves multiple items as collateral. By monitoring the collateral and the debtor's treatment of the proceeds, the lender often can detect dishonesty before all of the collateral is dissipated. When the security interest is created in one or only a few items, as is often the case in equipment and consumer

114. "The large quantity and value of goods stolen and the nature of many fencing operations suggest that a high percentage of the goods is ultimately resold to consumers. In many instances, purchasers have no reason to suspect the goods' legitimacy." Weinberg, *supra* note 74, at 573. See also *Criminal Redistribution Systems and Their Economic Impact on Small Business: Hearings Before the Senate Select Comm. on Small Business*, Part 1, 93d Cong., 1st Sess. 2, 4-9, 44-47, 53-55, 137, 153, 161, 182, 242 (1973); *id.*, Part 3, 93d Cong., 2d Sess. 473, 486-90, 562, 698, 717, 810 (1974).

115. For a good discussion that reflects the problems and expense of adequate inspection of inventory collateral, see Biborosch, *Floor Plan Financing*, 77 *BANKING L.J.* 725, 736-40 (1960).

116. For a discussion of the relationship between debtor misbehavior, monitoring costs, and secured credit, see generally Jackson & Kronman, *Priorities Among Creditors*, *supra* note 6, at 1149-58.

117. See *infra* notes 124-42 and accompanying text.

goods financing, the discovery of a wrongful transaction often comes too late to prevent the transfer of all of the collateral.

The current format of article 9 efficiently allocates the transaction costs of monitoring debtors' behavior.¹¹⁸ The secured party, aware that a non-possessory security interest has been created, must announce that interest by public filing.¹¹⁹ Prospective lenders and buyers of non-inventory collateral should protect their interests by consulting the files. It is certainly cheaper for a dealer-buyer to check the files than it is for the secured party to effectively monitor against wrongful transfers of collateral by a non-inventory debtor. Section 9-307(1), however, relieves buyers in ordinary course of the costs of monitoring against security interests created by their dealer-sellers. Because these secured parties finance goods intended for sale in ordinary course and because most of them have authorized the sale of the inventory collateral, buyers are not required to check the files before each purchase to identify the lender or to verify the debtor's authority to sell.¹²⁰ Monitoring debtors with relatively few inventory financiers is more efficient than requiring all buyers to police the transactions.¹²¹ Section 9-307(1) recognizes that without the apparent authority concept behind inventory financing, the ordinary channels of commerce would become hopelessly clogged.

In transactions in which the perfected security interest is not created by the buyer's seller, the party acquiring the goods from the debtor is in the best position to prevent the loss.¹²² Proper reliance on the filing system reveals to a dealer receiving goods from a debtor that the goods are encumbered.¹²³ The secured party and the subsequent buyer can each pass any loss from a wrongful transfer to the dealer—the secured party by an action for conversion and the buyer by an action for breach of warranty of title. Neither of these parties, however, appears to be in a superior position to

118. "Neither the acquisition and dissemination of information about competing property claims nor the assumption of the risk of an undiscovered superior property claim is costless." Baird & Jackson, *supra* note 31, at 188.

119. U.C.C. §§ 9-302(1), 9-401, 9-402 (1978).

120. The article 9 filing system adopts the system of "notice filing," so the location of a financing statement in the public files does not necessarily provide an accurate indication of the relationship between the alleged debtor and secured party. "The notice itself indicates merely that the secured party who has filed may have a security interest in the collateral described. Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs." *Id.* § 9-402 comment 2, para. 1. See 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 15.2-15.3 (1965).

121. Dolan, *supra* note 28, at 1180. *Cf. id.* at 1171 (discussing section 2-403(2): "Most often, buyers deal with more merchants, true owners with fewer; and buyers generally deal with their merchant sellers on an infrequent or casual basis, the true owner enjoying a more permanent relationship with his merchants.").

122. "The availability of reliable information about the debtor's property reduces the debtor's incentive to misbehave by removing opportunities to do so." Baird & Jackson, *supra* note 31, at 182.

123. An exception to this proposition follows from the provision of section 9-302(1)(d)

hold the dealer. In the event that the dealer and the wrongful debtor are both insolvent, the loss is allocated between the secured party and the buyer.

The rationale of loss prevention has limited utility in this context. The buyer in ordinary course generally cannot detect the conversions by a dealer or foresee a dealer's insolvency problems. In cases of non-inventory financing, allocation of loss to secured parties would create incentives to raise interest costs or to abandon financing. Measures taken by secured parties to prevent losses generally would be too expensive to be cost efficient. The loss prevention rationale justifies the current risk allocation to secured parties financing inventory, but it is not helpful in deciding which of the two innocent parties should bear the risk of loss in cases of non-inventory financing.

2. Loss Spreading

"[T]he most desirable system of loss distribution under a strict resource-allocation theory is one in which the prices of goods [or services] accurately reflect their full cost to society."¹²⁴ Losses resulting from activities are considered to be part of the true costs of those activities,¹²⁵ and the loss spreading theory requires the loss to be borne by the party or enterprise in the best position to reflect the loss in its prices.¹²⁶ Loss spreading thus is achieved by allocating the loss to an enterprise that can pass along the cost in the form of higher prices.¹²⁷ The principle is to lessen the impact by spreading the burden to more people and over longer periods of time.¹²⁸ In the context of secured financing, the lending institution is the entity that arguably should internalize the costs of unavoidable losses resulting from its lending activities.¹²⁹

that allows automatic perfection for purchase money security interests in consumer goods. For an analysis on the cost-effectiveness of the provision, see Baird & Jackson, *supra* note 31, at 192-93. Secured lenders should be cautious in relying upon automatic perfection since the failure to file exposes them to a loss of priority under section 9-307(2). This section does not aid a dealer acquiring the consumer goods from the debtor, however, since it only "protects the buyer of consumer goods from another consumer. . . ." *Everett Nat'l Bank v. Deschuiteneer*, 109 N.H. 112, 115, 244 A.2d 196, 198 (1968).

124. Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 *YALE L.J.* 499, 505 (1961).

125. *Id.* See also Gregory, *Trespass to Negligence to Absolute Liability*, 37 *VA. L. REV.* 359, 382-83, 386 (1951); James, *Social Insurance and Tort Liability: The Problem of Alternative Remedies*, 27 *N.Y.U. L. REV.* 537, 538 (1952); Morris, *Hazardous Enterprises and Risk Bearing Capacity*, 61 *YALE L.J.* 1172, 1173-74 (1952).

126. Calabresi, *supra* note 124, at 500-01; Douglas, *Vicarious Liability and Administration of Risk (I)*, 38 *YALE L.J.* 584, 586 (1929); Gregory, *supra* note 125, at 383; James, *supra* note 125, at 538; Morris, *supra* note 125, at 1172, 1176.

127. Calabresi, *supra* note 124, at 505.

128. *Id.* at 517.

129. See Dugan, *supra* note 4, at 351; Knapp, *supra* note 4, at 890; Comment, *Scope of Protection*, *supra* note 4, at 994.

However, just as the financing institution is not the exclusive cause of losses incurred by buyers in ordinary course who are unprotected under section 9-307(1),¹³⁰ it also is not the only enterprise capable of spreading losses through its price structure. The dealer again appears to be the entity better able to absorb the liability and to distribute losses incurred by buyers in ordinary course. Resource allocation theory recognizes the cost to society caused by sales of goods with defective title as surely as it recognizes the costs from debtor misbehavior in nonpossessory secured financing. Participants in both situations should be aware of the risk of transfer of encumbered goods, but the cost of protecting against the risk by checking the public files is less for the dealer.

Again, the difficult issue is how the risk of loss should be allocated between the innocent parties when neither the wrongdoing debtor nor the converting dealer is available as a solvent defendant. As between the buyer and the secured party, the choice under loss spreading is clear, since the buyer does not have an opportunity to distribute the loss to anyone. However, before embracing this theory and shifting the loss to secured parties in all cases of unrecoverable loss by buyers in ordinary course of business, the consequences of loss spreading should be analyzed.

Business practices associated with inventory financing provide clues as to how the financing community would respond to an expansion of its risk of losing additional security interests in goods to buyers in ordinary course. Most commercial finance houses do not find inventory financing desirable.¹³¹ The demands and expense of monitoring and the burden and reduced value of inventory in forced sales following default limit the attractiveness of inventory as a form of collateral.¹³² The fact that buyers in ordinary course can cut off the inventory security interest also contributes to the lack of enthusiasm for inventory financing. Commercial lenders generally prefer to wait until the dealer sells some of the inventory so that they can take the initial security interest in the personal property realized from the sale, such as accounts receivable, instruments or chattel paper.¹³³ The lender's

130. See *supra* notes 111-12 and accompanying text.

131. "Inventory is at best a secondary class of collateral; it is generally used only when the debtor's accounts are insufficient to support the needed advance." Scult, *Accounts Receivable Financing: Operational Patterns Under the Uniform Commercial Code*, 11 ARIZ. L. REV. 1, 28 (1969). See also Coogan & Gordan, *The Effect of the Uniform Commercial Code Upon Receivables Financing—Some Answers and Some Unresolved Problems*, 76 HARV. L. REV. 1529, 1567 (1963); Kripke, *Suggestions for Clarifying Article 9: Intangibles, Proceeds, and Priorities*, 41 N.Y.U. L. REV. 687, 716-17 (1966).

132. Reisman, *What the Commercial Lawyer Should Know About Commercial Finance and Factoring*, 79 COM. L.J. 146, 150 (1974).

133. "Accounts receivable are, by their nature, self-liquidating, and represent far better security than inventory which, as raw materials or finished goods, requires a knowledge of the borrower's industry, timing, and sometimes a great deal of effort to convert to cash." Scult, *supra* note 131, at 28-29 n.168.

interest is then in a form of collateral that can be more accurately valued, and the risks involved with obsolete merchandise, returned goods, forced sales, and loss of security interest to good faith purchasers are limited or eliminated.¹³⁴ So serious are the risks and the problems in controlling inventory that most commercial lenders limit their advances to approximately "twenty to forty per cent of cost, depending upon the quality and nature of the inventory,"¹³⁵ but they will advance approximately eighty-five percent for accounts receivable.¹³⁶ The adoption of a rule that would cut off security interests in consumer goods or equipment when purchased by buyers in ordinary course would dampen significantly the viability of using these forms of collateral for secured financing.

Many lenders finance a dealer's inventory only as a means to profit from purchasing chattel paper¹³⁷ created by sales of the inventory. The finance charges customers pay on chattel paper generally have fallen outside the usury laws.¹³⁸ To achieve access to this highly profitable paper, lending institutions finance the inventory floor plan of dealers, who in turn agree to discount all or most of their chattel paper with the lender.¹³⁹

If the "created by his seller" limitation of section 9-307(1) were deleted, secured financing of consumer goods and equipment would be substantially impaired. A reduction in the percentage of the cost of collateral that lenders are willing to finance would require businessmen to tie up more of their capital in equipment. Consumers would have to defer purchases until they could accumulate larger downpayments.¹⁴⁰ Combined with these limits on the extent of financing, the inevitable increase in interest charges would serve to put secured financing beyond the reach of many consumers and busi-

134. Reisman, *supra* note 132, at 150. Some economists refer to receivables as "near money"; some borrowers prefer receivables "because they represent the next to last stage in the cash-to-cash cycle." Coogan & Gordon, *supra* note 131, at 1529-30.

135. Reisman, *supra* note 132, at 151.

136. Scult, *supra* note 131, at 28-29 n.168.

137. "Chattel paper" means

a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods. . . . When a transaction is evidenced both by such a security agreement or a lease and by an instrument or a series of instruments, the group of writings taken together constitutes chattel paper.

U.C.C. § 9-105(1)(b) (1978).

138. R. SPEIDEL, R. SUMMERS & J. WHITE, *supra* note 44, at 210.

139. "In floor planning, the return on chattel paper is often the tail that wags the dog." *Id.* at 211.

140. Comparisons with other legal systems can provide some indications. Although the differences in large part are attributable to differing economic and political conditions, the law and legal institutions also affect the availability of commercial and consumer credit. See Kozolchik, *Law and the Credit Structure in Latin America*, 2 VA. J. INT'L L. 1 (1969). "In Mexico, a country which is frequently pictured as a model of political and economic development in Latin America, household appliances such as refrigerators, washing machines, television sets and even bicycles are still regarded as luxuries available to lower middle class and poor families only on a cash basis." *Id.* at 1.

nesses.¹⁴¹ The current chokehold that high interest rates have applied to business and consumer activities suggests the devastating effect that additional upward pressure on interest rates would have on national economic recovery.

The reaction from many lenders would be even more drastic. Predictably, they would simply refuse to finance transactions with non-inventory goods as the collateral. With increased risk for the lender, but without possible attractive incentives like the purchase of chattel paper, prospective borrowers would have a more difficult time enticing lenders to finance on the security of borrowers' goods. Consumer goods and equipment are not supposed to be sold, but when they are, through an improper sale by the debtor, the secured party's risk in the proceeds from such a sale is often greater than it is in proceeds from the sale of inventory. The security interest continues in any proceeds received by the debtor, but only if they are identifiable.¹⁴² The requirement of identification is easily met in sales of inventory which produce accounts receivable, chattel paper, or promissory notes. Cash and checks which can be converted promptly to cash are typical proceeds from sales of non-inventory goods. Cash is extremely vulnerable to prompt dissipation by the debtor, and unlikely to be kept separately identifiable. Lenders financing non-inventory goods are likely to demand more secure forms of collateral, such as real property, pledges of valuables, or commercial paper. These demands would preclude a large number of society's secured credit transactions.

Strict resource allocation theory clearly places the loss on the secured party. It recognizes the loss as a true cost of the lending activity and requires it to be recognized by the lending institution. The effect of this rule is to spread the loss among all borrowers from the enterprise, rather than allowing the loss to rest solely on the innocent buyer-victim.

Despite this theoretical justification for shifting losses to secured parties, the loss allocation system codified in section 9-307(1) is preferable. Every system should be analyzed in terms of its probable consequences as well as its theoretical basis, and it is in these terms that the section 9-307(1) approach does prevail. Quite frankly, the availability of financing, upon which so many people in our society depend, is subsidized in part by the occasional losses suffered by innocent good faith buyers purchasing goods from apparently reputable and financially sound dealers. Most of those purchasers are protected, but occasionally the buyer in ordinary course of business will lose to a secured party or to a prior owner who claims wrongful loss of the goods through bailment, lease, or theft. The loss of the buyer in ordinary

141. "Secured financing is of prime importance to the survival and growth of small and medium-sized businesses, and frequently is the only means whereby such enterprises can obtain working capital when neither risk capital nor unsecured credit is available in sufficient quantities." Scult, *supra* note 131, at 1.

142. U.C.C. § 9-306(2) (1978).

course clearly is unfortunate. However, the misfortune of a few buyers is not sufficient to justify expanding buyer protection against secured parties when such expansion would lead to increased credit charges and withdrawal of secured financing of non-inventory goods.

III. APPLICATION OF THE POLICY

Even though a literal application of the "created by his seller" language often produces the correct result under section 9-307(1), many situations can raise unique issues that are rationally answerable only with the guidance of the underlying policy objectives of the provision. This section of the article addresses four of those situations. The discussion does not exhaust all of the possible issues, but it does demonstrate both the need for policy orientation and the workability of the policy articulated in part I of this article.

Case 1

A secured party finances the purchase of a major appliance by a debtor. The debtor is a dealer in the business of selling similar appliances, but rather than buying this appliance as inventory, the debtor buys it either as consumer goods for personal use or as equipment for business use. Subsequently, the debtor wrongfully transfers the appliance to the inventory of the dealership and sells it to a buyer in ordinary course of business. Who prevails in a priority dispute between the secured party and the buyer in ordinary course?

The "created by his seller" limitation precludes the buyer from taking free of the security interest in all cases in which the dealer is someone other than the debtor who created the security interest. Under the hypothetical posed here, however, the consumer goods or equipment are moved to the debtor's own inventory.¹⁴³ A literal application of the statutory language

143. Comment 2, para. 1 to section 9-307 appropriately points out that subsection (1) applies "primarily to inventory." Prior to 1956, section 9-307(1) read as follows:

In the case of inventory, and in the case of goods as to which the secured party files a financing statement in which he claims 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.

U.C.C. § 9-307(1) (1952).

In support of the change to the current version of the subsection, the Editorial Board for the Uniform Commercial Code noted: "The former opening language has been omitted because the definition of 'buyer in ordinary course of business' limits subsection (1) to inventory cases." RECOMMENDATIONS, *supra* note 83, at 284. Another commentator already has pointed out that "the stated reason is argumentative and not completely satisfying." Skilton, *supra* note 15, at 13.

In addition to the concerns of the New York Law Revision Commission indicated *supra* note 83, the Commission also expressed concern about the correlation between section 2-403(2) and the prior codification of section 9-307(1) since section 2-403(2) appeared to apply to a broader category of goods: "Section 9-307(1) is confusing in applying only to 'inventory' or

would lead courts always to rule in favor of the buyer in ordinary course in this type of case because the security interest was "created by his seller."

The policy of the "created by his seller" language is to limit the section 9-307(1) exception to cases in which the secured party has clothed the debtor with the indicia of either apparent authority to sell the goods or apparent ownership of them.¹⁴⁴ Both apparent authority and apparent ownership are based on estoppel of the secured party.¹⁴⁵ Thus, the policy of section 9-307(1) is advanced by protecting buyers in ordinary course when a secured party finances goods that are transferred improperly to the debtor's inventory, because the estoppel element that gives rise to apparent authority and apparent ownership¹⁴⁶ is satisfied in the *Case 1*-type situation. The secured party has entrusted the goods to a person with the inherent power to sell them directly to a buyer in ordinary course.

One basic fact distinguishes the *Case 1*-type situation from straightforward inventory financing—the secured party finances the goods for use other than their sale as inventory. Note, however, that even an express prohibition against transfer of the collateral to the debtor's inventory would not effectively protect the secured party's interest. Section 9-307(1) applies only to cases in which debtors disregard express limitations on their authority to sell; a secured party authorizing the transfer to inventory would lose the security interest upon subsequent sale under section 9-306(2).

The decision in *Atlas Auto Rental Corp. v. Weisberg*,¹⁴⁷ however, raises a relevant issue under section 2-403(2), the entrustment provision of article 2 that is the correlate to section 9-307(1).¹⁴⁸ The court held that mere entrustment of the goods to a merchant is not enough alone to invoke section 2-403(2) protection for the buyer; the owner also must know that the person to whom the goods are transferred is a dealer.¹⁴⁹ The court in *Weisberg* thus read into that section a knowledge element that does not appear in the language of the Code.¹⁵⁰ The estoppel principle underlying section 2-403(2) supports the result in *Weisberg* and is equally applicable to section 9-307(1).

to goods as to which the secured party files a financing statement claiming proceeds [referencing the pre-1956 version of the subsection] since the parallel provisions of Section 2-403(2) are broad enough to cut off a security interest in any goods." LAW REVISION COMM'N, REPORT, *supra* note 83, at 67.

144. See *supra* notes 43-52, 57-68, and accompanying text.

145. See *supra* note 62.

146. See *supra* notes 43-46, 56, and accompanying text.

147. 54 Misc. 2d 168, 281 N.Y.S.2d 400 (N.Y. Civ. Ct. 1967).

148. See *supra* notes 45-46, 82-83, and accompanying text.

149. 54 Misc. 2d at 171, 281 N.Y.S.2d at 404.

150. Some commentators have suggested that the approach adopted in the *Weisberg* opinion is appropriate. R. BRAUCHER, DOCUMENTS OF TITLE 66 (1958); 2 G. GILMORE, *supra* note 5, § 26.8. Other commentators have adopted a contrary position. Skilton, *supra* note 15, at 38-39; Warren, *supra* note 28, at 473-74 (concerned that "a simple, easy-to-apply rule" will become "mired down in a tedious factual inquiry"); see also *infra* notes 152-55 and accompanying text.

The rationale behind estoppel is that persons, to be estopped, must say or do something that they *know or should know* can induce detrimental reliance on the part of another person.¹⁵¹ Merely doing the act—such as giving up possession of goods while retaining ownership or a perfected security interest—is not enough. To the extent that sections 2-403(2) and 9-307(1) are applied only on the basis of a secured party's act, without regard to what the actor knew or should have known, the estoppel principle is abandoned and the section is construed on the basis of an absolute rule of risk allocation. That approach would be inconsistent with the policy underlying section 9-307(1), and thus would violate legislative intent.

One commentator has opined that perhaps section 9-307(1) should be more liberally construed to favor buyers, in circumstances like those presented in *Case 1*, on the grounds that typical secured parties are professional lenders who should bear the risk of loss.¹⁵² The commentator states that “[s]ection 9-307(1) may be viewed as a further step in an orderly progression from common law and statutory antecedents, not subject to implied limitations based on common law estoppel considerations.”¹⁵³ Because the consumer-buyer is a legitimate beneficiary of the law's concern and protection, the author asks, “Is he not entitled to invoke section 9-307(1) without our reading in qualifications adverse to him?”¹⁵⁴

The argument is essentially an eloquent suggestion that we fall back on literal application of the statutory language in *Case 1*-type situations. The law on the matter arguably has evolved into its current form, which can be determined from the words in the statute. But this literal approach leaves us floundering for supportive policy. Why protect consumer-buyers in *Case 1*-type circumstances but deny similar protection for a consumer-buyer when the security interest was not “created by his seller”? The better approach is to remain consistent with the estoppel principle and the related apparent authority rationale and to recognize that most secured parties will not prevail under *Case 1* fact patterns. The foreseeability of these facts suggests that professional lenders should make reasonable efforts to determine the businesses of their debtors so that, in most instances, the secured party at least should know when the debtor is a dealer who deals in goods like the collateral.¹⁵⁵

151. D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES 42 (1973).

152. Skilton, *supra* note 15, at 37-38.

153. *Id.* at 38.

154. *Id.* at 39.

155. Occasionally, however, a case will arise in which the secured party cannot be estopped. One of the cases discussed by Professor Skilton appears to be just such a case. In *Michigan Nat'l Bank v. Grandberry*, 11 U.C.C. Rep. Serv. (Callaghan) 193 (Tenn. Ct. App. 1972) the court decided in favor of the buyer on the following facts:

R.C. Moore, Jr. testified [for the secured party] that Boales [the seller] was not in the business of selling house trailers, but that he rented house trailers. Moore knew that Boales had some six or eight house trailers in his backyard at Collierville,

Case 2

A secured party perfects a security interest in the debtor's inventory of stereo equipment. The debtor subsequently sells a stereo system to a customer who qualifies as a buyer in ordinary course. When the debtor-dealer defaults on several payments, the secured party traces possession of the stereo system to a neighbor who bought it from the buyer in ordinary course.

Even though the secured party loses if pitted against the buyer in ordinary course, a literal application of section 9-307(1) sustains the secured party's position against the neighbor because the security interest was created by the debtor-dealer and not by the neighbor's seller. Furthermore, the neighbor does not qualify as a buyer in ordinary course because the seller in the transaction was not in the business of selling goods of that kind. Nevertheless, the security interest was cut off in the initial sale, and the secured party would receive an unmerited windfall if the security interest were allowed to revive following the purely fortuitous subsequent sale. Having created apparent authority in the dealer-debtor to sell the goods free of the security interest, the secured party seemingly should not be allowed to reassert the interest based solely upon the subsequent disposition of the goods by the buyer in ordinary course.

The Fifth Circuit, in *Gary Aircraft Corp. v. General Dynamics Corp.*,¹⁵⁶ properly held that a subsequent purchaser from a buyer in ordinary course takes free of the perfected security interest.¹⁵⁷ Protection for the subsequent purchaser is attained through the shelter provision of section 2-403(1). That section grants to a purchaser of goods "all title which his transferor had or had power to transfer." The buyer in ordinary course took good title under section 9-307(1) and transferred that title through the shelter provision to

Tennessee, and that Boales had some house trailers on a lot at Red Bank, Mississippi. Moore testified these trailers were occupied by tenants. Moore proved he charged retail sales tax on the sale to Boales, which he said he would not have charged had Boales been a retailer of house trailers.

Id. at 194. The fact that the appellee-buyer was "twenty-seven years of age with a fifth grade formal education . . . [was] married and ha[d] six children," *id.* at 195, may well have been decisive in influencing the outcome in favor of the buyer. Unquestionably, however, the court's statement of the policy objective of section 9-307(1) is incomplete and inadequate: "[t]he purpose of [Tenn. Code Ann.] § 47-9-307 is to protect a buyer in ordinary course of business." *Id.* Professor Skilton already has identified the disturbing aspects of the decision:

There is little or nothing to indicate that the secured party should have known he was lending to one in the business of selling goods of that kind, and the buyer admitted that he did not know whether he was dealing with a dealer. And the case is not particularly strong on the basic point that the seller must in fact be one in the business of selling goods of that kind.

Skilton, *supra* note 15, at 40 n.102. Not surprisingly, commentators writing from the consumer protectionist perspective are not disturbed by the *Grandberry* decision. Knapp, *supra* note 4, at 875 n.81.

156. 681 F.2d 365 (5th Cir. 1982).

157. *Id.* at 377.

the subsequent purchaser. The court responded with cogent precision to the assertion that this approach violates the rule that section 2-403 cannot be used to evade the limitations of section 9-307(1).

But the rule is that section 2.403(a) [U.C.C. § 2-403(1)] is not available to save one who buys when the seller's title is subject to a security interest but who does not qualify under section 9.307(a) [U.C.C. § 9-307(1)]. It certainly does not mean that section 2.403(a) is not available to subsequent transferees from a successful section 9.307(a) buyer. . . . If General Dynamics were correct, section 9.307(a) would be of scant benefit to the "protected" buyer in the ordinary course, for good title means little if one cannot transfer it.¹⁵⁸

It is essential to recognize the policy relationship between sections 9-307(1) and 9-306(2). Standing alone, section 9-307(1) grants priority to the buyer in ordinary course from security interests "created by his seller." However, recognizing the apparent authority in the dealer-debtor and thereby cutting off the security interest under section 9-307(1) upon the initial sale to the buyer in ordinary course also breaks the continuity of the secured party's interest envisioned under section 9-306(2). That section provides that "[e]xcept where this Article otherwise provides, a security interest *continues* in collateral notwithstanding sale. . . ."¹⁵⁹ With the security interest discontinued under section 9-307(1) upon sale of the collateral to a buyer in ordinary course, the Code does not recognize any basis for automatic reattachment. The only way the secured party can reacquire a security interest in the goods sold is to enter into a new security agreement with a person who has an interest in the goods.¹⁶⁰

Case 3

A used-car dealer assigns the title to an automobile on its lot to one of its salesmen. The salesman (debtor) uses the title to secure a loan from a bank (secured party), and the latter perfects the security interest. The bank knows the debtor is a used-car salesman. The debtor-salesman wrongfully reassigns the title to the dealer who then sells the automobile to a buyer in ordinary course of business. When the bank learns of the sale it seeks to replevy the automobile from the buyer.

158. *Id.* at 377. An addition to the court's opinion that would be helpful is a reference to Code authority for its position that the subsequent sale could not resurrect the security interest of the lender. Most commentators that have addressed the issue have advocated the approach taken in *Gary Aircraft*, but likewise have not supported the claim of nonrevival with adequate Code authority. Knapp, *supra* note 4, at 884; Skilton, *supra* note 15, at 76; Comment, *Scope of Protection*, *supra* note 4, at 989. Another source discusses but does not resolve the issue. Special Project, *supra* note 4, at 962-63 n.642.

159. U.C.C. § 9-306(2) (1978) (emphasis added).

160. *Id.* § 9-203(1)(a).

The buyer's position under section 9-307(1) is inferior to the bank's because the security interest was not "created by his seller." The buyer's case would not be improved even if the debtor-salesman made the actual sale. The sale then would have been made on behalf of the dealer, the seller for purposes of the transaction, but the security interest was created by the debtor-salesman in his individual capacity. If the sale somehow were held to be on behalf of the debtor-salesman, the buyer then could not qualify as a "buyer in ordinary course of business" because a personal sale by the salesman from the dealer's car lot would not be "in ordinary course."¹⁶¹

One court has held on similar facts, however, that the buyer in ordinary course prevails over the perfected secured party. In *Adams v. City National Bank & Trust Co.*,¹⁶² the court clearly recognized the limitation imposed through the "created by his seller" language.

Under a strict construction of Article 9, the only way Adams as a buyer could receive the protection of § 9-307 would be for this court to find Clanton, as a used car salesman and owner of [sic] Ford was the actual "seller" who "created" the security interest, or if we would find *dealer* as "seller", "created" the security interest through his agent Clanton. Both of these circumventive tactics are exercises in legal gymnastics.¹⁶³

Rejecting both of these "circumventive tactics," the court adopted another one. It simply ruled in conclusory fashion: "[f]or the purpose of this decision under § 9-307, we find the same entity created the security interest and sold the Ford."¹⁶⁴ The court ignored the limiting effect of the "created by his seller" language by insisting that "[w]hether Dealer or Clanton, his salesman, created the security interest should not be the controlling factor."¹⁶⁵

The *Adams* decision is devoid of policy support. When a debtor grants a security interest in consumer goods and wrongfully transfers them to a dealer for sale to a buyer in ordinary course, the secured party has not created apparent authority for the sale and the security interest should remain intact. The secured party's knowledge that the debtor is a salesman-employee of a dealer who sells similar goods is not enough to create the estoppel element underlying apparent authority. Unlike the situation in *Case 1* where consumer goods were wrongfully transferred into the debtor's own inventory, the debtor here has transferred them to a dealer before the buyer purchased in ordinary course. The secured party who knows or should know that the debtor is a dealer in the type of goods financed is estopped in a *Case 1*-type situation because he entrusted goods to a debtor who personally can sell the goods to a buyer in ordinary course.

161. See Warren, *supra* note 28, at 473 n.22.

162. 565 P.2d 26 (Okla. 1977).

163. *Id.* at 30 (emphasis in original).

164. *Id.* at 31.

165. *Id.* at 30.

In addition, the buyer's position in the *Adams* case cannot be bolstered by an agency theory. The facts clearly demonstrate that the salesman was not acting as the dealer's agent in creating the security interest. Title to the automobile was assigned to the salesman and then reassigned to the dealer after the acquisition of financing. The dealer and salesman undoubtedly carried out the plan to deceive the lender. The facts do not suggest any basis for the bank to know that the salesman was acting as the principal on behalf of the dealer. The employment relationship alone is not a sufficient basis because activities in the normal scope of responsibilities of used-car salesmen do not include obtaining secured financing on a single automobile whose title has been assigned to the salesman. The contract embodied in the security agreement between the bank and the salesman was between those two parties only.

Case 4

A secured party acquires and perfects a security interest in a debtor's new automobile. The debtor defaults on several payments and the secured party takes possession of the automobile. Lacking the facilities to safeguard it adequately prior to arranging a sale, the secured party contracts with an automobile dealer who sells new and used cars to store the vehicle on the dealer's premises. The dealer later wrongfully sells the automobile to a buyer in ordinary course of business, and the secured party now seeks to replevy it.

Application of section 9-307(1) to these facts creates an undesirable result. Because the buyer in ordinary course purchased goods subject to a security interest that was not "created by his seller" (the automobile dealer) but by the debtor (the original purchaser of the automobile), section 9-307(1) does not cut off the security interest in favor of the buyer. Nevertheless, the secured party clearly established apparent authority to sell by placing the goods directly in the hands of a dealer who sells goods of the same kind. This entrustment empowers the dealer to pass the goods directly to a buyer in ordinary course.

On similar facts, a court has held that the secured party's rights are governed by section 2-403(2) rather than section 9-307(1). In *Commercial Credit Corp. v. Associates Discount Corp.*,¹⁶⁶ the secured party argued that the terms "entrustment" and "entruster" in sections 2-403(2) and 2-403(3) apply only to inventory financing and that its rights as a "lien creditor" through section 2-403(4)¹⁶⁷ are governed exclusively under section 9-307(1).¹⁶⁸

166. 246 Ark. 118, 436 S.W.2d 809 (1969).

167. "The rights of other purchasers of goods and of lien creditors are governed by the Articles on Secured Transactions (Article 9), Bulk Transfers (Article 6) and Documents of Title (Article 7)." U.C.C. § 2-403(4) (1978).

168. 246 Ark. at 126, 436 S.W.2d at 812.

The court disagreed.

We do not agree with Commercial's [secured party's] theory that its rights as a lien creditor with respect to repossessed property have been removed from subsection (2) and (3) of § 85-2-403 [U.C.C. § 2-403]. It clearly had possession with the right to transfer title without a certificate of title, and as pointed out by the committee comment [U.C.C. § 2-403 comment 2, para. 1], has no right to complain, whether it be considered as a consignor or a lender with a security interest, for the very purpose of placing goods in inventory is to turn them into cash by sale. Therefore, we think that the entrustment of possession is most applicable to a repossessing lien holder with right of sale.¹⁶⁹

The holding is correct and the relationship between sections 2-403(2) and 9-307(1) is left intact, although an explanation beyond the court's analysis is desirable. The secured party in this case entrusted possession of the automobile on two separate occasions: to the original purchaser under the financing agreement, and to the automobile dealer for storage following repossession from the purchaser. With the debtor in possession of the collateral, the secured party eliminated the ostensible ownership problem by perfecting the security interest. The entrustment transaction with the automobile dealer stands in a different light. The storage arrangement created a bailor-bailee relationship, precisely the type of transaction in goods contemplated by section 2-403(2), and it was not a secured transaction under article 9. The fact that the entrustor's rights in the goods were limited to a security interest to satisfy the debtor's outstanding obligation, rather than full ownership, is irrelevant. Entrustment to a merchant who is in the business of selling similar automobiles gives the merchant "power to transfer *all rights of the entruster* to a buyer in ordinary course of business." Entrustment to the merchant, although for purposes limited to a bailment, creates apparent authority for the merchant to sell the goods under section 2-403(2). A secured party who repossesses goods as collateral from a defaulting debtor cannot use section 9-307(1) as a shield from the consequences of section 2-403(2) if he subsequently entrusts the repossessed goods to a merchant who wrongfully sells them to a qualifying buyer in ordinary course.

CONCLUSION

The article 9 general rule of continued validity of security interests in goods despite their sale by the debtor is subject to two important exceptions tied to secured party authorization of the sale. Express authorization terminates the security interest under section 9-306(2) and a buyer in ordinary

169. *Id.* at 126, 436 S.W.2d at 813.

course of business takes free of security interests "created by his seller," even in the absence of express authority for the disposition, under section 9-307(1). The "created by his seller" language serves to limit the latter exception to those cases in which the secured party has clothed the debtor with the indicia of apparent authority to sell the goods. Fundamental principles of agency law provide support for this limitation. Nonpossessory inventory financing establishes apparent authority to sell to buyers in ordinary course because: (1) the sale is facilitated by entrusting the collateral to dealer-debtors in the business of selling goods of the kind comprising the collateral, (2) the intended result of inventory collateral is sale to third persons, and (3) most of these sales are made pursuant to actual secured party authorization.

Thus, the policy underlying the "created by his seller" language is discoverable within the relationship of the two exceptions to the article 9 general rule of continued validity of security interests. It is a limitation that serves to correlate the section 9-307(1) exception with the more explicit authorization exception in section 9-306(2); secured party authorization for the sale of the collateral, whether actual or apparent, is the policy basis for discontinuing the security interest in the collateral after its sale by the debtor.