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Federal Preemption of the U.C.C. Farm Products Exception: Buyers Must Still Beware

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FEDERAL PREEMPTION OF THE U.C.C. FARM PRODUCTS EXCEPTION: BUYERS MUST STILL BEWARE

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I. *INTRODUCTION*

It is quite common for a lender to finance the purchase by a debtor of collateral that the debtor expects to resell in order to pay off the loan. Typically, this arrangement is employed to finance purchases of inventory and farm products. With respect to farm products, for example, the lender supplies the funds to purchase cattle or seed that will ultimately be sold as livestock, milk or crops. Occasionally, for various reasons, the debtor is unable to repay the lender from the proceeds of the sale of the collateral. A conflict then arises between two innocent parties — the lender (the secured party) and the third party purchaser or auction house acting as an agent of the debtor (the third party transferee). This priority conflict is currently governed by Article Nine of the Uniform Commercial Code, as enacted by the states. Recently, the applicable provisions have been subject to a great deal of criticism by legal scholars for failing to properly address the problem of unauthorized dispositions of collateral, especially farm products.[1]

Section 9-306(2) of the U.C.C. provides that the "security interest continues in collateral notwithstanding sale, exchange or other disposition thereof," indicating that the secured party would prevail over the third party transferee, except in two instances: (1) where the U.C.C. provides otherwise and (2) where the disposition was authorized by the secured party in the security agreement or otherwise.[2] In

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1. *See generally* Babbitt, *Relief for Buyers of Farm Products under the Uniform Commercial Code*, 21 IDAHO L. REV. 35 (1985); Geyer, *Farmers who sell Mortgaged Farm Products and Don't Tell: Buyers Who Buy Farm Products and Dont' Pay—An Electrifying Solution*, 34 DRAKE L. REV. 429 (1984-85); Meyer, *The 9-307(1) Farm Products Puzzle: Its Parts and its Future*, 60 N.D.L. REV. 401 (1984); Uchtmaan, Bauer & Dudek, *The UCC Farm Products Exception—A Time to Change*, 69 MINN. L. REV. 1315 (1985); Note, *Ohio's Attempt to Remedy Security Interests in Farm Products Under the UCC*, U. DAYTON L. REV. 607 (1984).

2. U.C.C. § 9-306(2) (1972) states:

the case of the inventory financer, the first instance usually applies; the U.C.C. provides otherwise and the secured party loses to the third party transferee because of the provisions of section 9-307(1).[3] Section 9-307(1) protects most third party transferees from a security interest "created by his seller"[4] so long as the third party transferee can qualify as a buyer in the ordinary course of business.[5] One group of third party transferees excluded from the protection of 9-307(1) is buyers of "farm products from a person engaged in farming operations."[6] Thus, third party transferees of farm products would only take free of the security interest if they could come within the second exception; that is, if the secured party consented to disposition of the collateral.

As previously indicated, most conflicts between third party transferees and secured parties are resolved in favor of the third party transferee because of the provisions of section 9-307(1). Because buyers of farm products are excepted from the protection of that section, most of the litigation in this area involves farm products and turns on the issue of whether the secured party has authorized disposition of the collateral. Oftentimes, the secured party does not expressly authorize the sale or disposition of the collateral in the security agreement, but is aware that sales are being made and does not object because the proceeds from the sales are remitted to him by the debtor. In other instances, the secured party expressly authorizes sale of the collateral by the debtor, subject to certain conditions, such as the written consent of the secured party, but then acquiesces when the debtor disposes of the collateral without first having obtained written consent. In yet other cases, the secured party may authorize sales conditioned only on the debtor obtaining a sales price sufficient

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

3. U.C.C. § 9-307(1) (1972) states:

A buyer in ordinary course of business . . . other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence. *Id.*

4. *Id.*

5. U.C.C. § 1-201(9) (1972) defines a buyer in the ordinary course of business as "a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind . . . ." *Id.*

6. *See supra* note 3.

to cover the amount of the outstanding indebtedness and remitting those proceeds to the secured party. In each of the foregoing instances, if the debtor disposes of the collateral without satisfying the secured party's claim, the secured party may attempt to assert his security interest in the collateral against the purchaser. In such cases, courts must interpret the "or otherwise" language of section 9-306(2) in addition to the express and implied terms of the security agreement.

The "or otherwise" language and its interpretation have been the focus of numerous judicial opinions, beginning with *Clovis National Bank v. Thomas*[7] in 1967. As Justice Carmody predicted in his dissent in that case, "[t]he consequences and repercussions that [this] decision [has had] on security interests involving farm products and the applicability of the Commercial Code to such transactions [have been] incalculable."[8] Unfortunately, these decisions are confusing, inconsistent, not clearly distinguishable and, in some cases, very poorly reasoned.

In the face of inconsistent decisions and nonuniform amendments to the Code, Congress, by section 1324 of the Food Security Act of 1985,[9] preempted existing state law. Section 1324 is entitled "Protection for Purchasers of Farm Products," and is essentially a clear title statute, based on pre-notification. That is, the third party transferee of farm products takes free of the security interest unless he received notification of the security interest prior to the sale. A central filing alternative is also included in section 1324, and permits states to elect to establish a central filing system that will allow the secured lender to prevail over the third party transferee in most instances.

This Article discusses the relevant U.C.C. provisions, reviews judicial decisions under the Code, and surveys the nonuniform state legislative amendments enacted in response to the problem of unauthorized dispositions of collateral. Finally, this Article discusses section 1324 of the Food Security Act of 1985 and the likely results of

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7. Clovis Nat'l Bank v. Thomas, 77 N.M. 554, 425 P.2d 726 (1967). This case has been recognized as the first case involving an interpretation of the U.C.C. § 9-306(2) "or otherwise" language. *See* Coogan & Mays, *Crop Financing and Article 9: A Dialogue With Particular Emphasis on the Problems of Florida Citrus Crop Financing*, 22 U. MIAMI L. REV. 13, 23 (1967).

8. *Clovis Nat'l Bank*, 77 N.M. at 566, 425 P.2d at 734 (Carmody, J., dissenting).

9. Food Security Act of 1985, Pub. L. No. 99-198, § 1324, 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) 1354, 1535 (to be codified at 7 U.S.C. § 1631).

Congress' decision to preempt state law in this area.

II. CODE BACKGROUND

Section 9-306(2)[10] protects the secured party against the debtor's wrongful disposition of collateral by providing that the security interest continues in the collateral into the hands of the third party transferee, unless the secured party assents to the disposition or unless otherwise provided in Article Nine. Article Nine provides otherwise with respect to unperfected secured parties,[11] buyers in the ordinary course of business of "non farm product goods,"[12] certain purchasers of chattel paper and instruments,[13] and certain holders of instruments, documents and securities.[14] In these instances, the interests of the third party transferee outweigh the interests of the secured party.

The secured party may authorize sale of the collateral by the debtor to enable the debtor to pay off the secured party. Of course, if the secured party expressly consents in the security agreement or otherwise to disposition of the collateral by the debtor and the disposition is carried out pursuant to that authorization, then the secured party is deemed to have waived any interest in the collateral he might otherwise claim against a third party transferee.[15] The secured party's only recourse would be against the debtor "to collect the debt on the original instrument, or . . . to assert his rights under the security agreement against any identifiable proceeds in the hands of the debtor."[16]

Difficult questions arise when the consent to sell the collateral is implied either from a course of dealing or otherwise, where the sale of collateral is contrary to the express authority granted, or where the consent to sell is expressly conditional either under the terms of the security agreement or otherwise. In such cases, the interests of the disappointed secured party who has not expressly waived his rights in the collateral must be weighed against the interests of the good faith transferee for value. These cases often involve unauthorized dis-

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10. *See supra* note 1.
11. U.C.C. § 9-301 (1972).
12. U.C.C. § 9-307 (1972).
13. U.C.C. § 9-308 (1972).
14. U.C.C. § 9-309 (1972).
15. Matthews v. Artic Tire, Inc., 106 R.I. 691, 694, 262 A.2d 831, 833 (1970). *See also* 4 R. ANDERSON, UNIFORM COMMERCIAL CODE § 9-306:18, at 312 (2nd ed. 1971).
16. Beneficial Fin. Co. v. Colonial Trading Co., 81 York Legal Rec. 87, 87 (Pa. C.P. Aug. 1967), 1 U.C.C.L.J. 10 (Dec. 1967). *See also* U.C.C. § 9-306(2).

positions of "farm products" collateral[17] because the farm products exception in section 9-307(1) affords greater protection for the farm products secured lender than for other secured parties.

Several rationales for the farm products exception have been advanced. Professor Coogan took the position that:

> Essentially, the exception in 9-307 reflects a philosophy that a farmer who borrows on his inventory cannot be trusted to turn over the proceeds from its sale in the way a lender has learned to trust other businessmen to do. The buyer of farm products, not the lender, must take the risk that the seller does not live up to his promise.[18]

The difficulty with this rationale is that it does not reflect the reality of today's marketplace. As early as 1967, Professor Coogan recognized that "a relatively small part of farm financing involves a person who, like the Vermont hill farmer of a century ago, is primarily a 'consumer.' "[19] Rather, the modern farmer is "not only like other businessmen, but like other *large* businessmen."[20] Professor Hawkland, in reviewing the proposed 1972 amendments to Article Nine, criticized the continued failure to treat the farmer as a businessman as "a serious shortcoming" and argued that "present-day farming is a business operation that is practically indistinguishable functionally and economically from other forms of industry."[21]

Another rationale for the special treatment of farm products is based on the business expertise of the third party transferee: "[W]hile the buyer of widgets at the local hardware store is an amateur deserving the law's protection against a professional lender, the typical buyer of farm products is a purchaser at wholesale and more

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17. "Farm products" are defined in U.C.C. § 9-109(3) (1972), which states:

> Goods are
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> (3) "farm products" if they are crops or livestock or supplies used or produced in farming operations or if they are products of crops or livestock in their unmanufactured states (such as ginned cotton, wool-clip, male syrup, milk and eggs), and if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming operations. *Id.*

For an excellent discussion of cases dealing with the farm products definitions, see Meyer, *supra* note 1.

18. Coogan & Mays, *supra* note 7, at 19.

19. *Id.*

20. *Id.* at 20 (emphasis in original).

21. Hawkland, *The Proposed Amendment to Article 9 of the U.C.C.*, 76 COMM. L.J. 416, 418 (1971).

likely to be a 'professional' than is the local banker who financed the crop."[22] This theory is akin to the ostensible ownership distinction attributed to Professor Gilmore,[23] and illustrated as follows:

> A buyer coming off the street to purchase a refrigerator from a dealer certainly expects to acquire a free and clear title, but farmers customarily dispose of their produce through commission agents, brokers or auctioneers, people who are sophisticated with respect to financial arrangements under which the farmers' goods are encumbered, and these people, it is hinted, should not expect to take free and clear of agricultural mortgages or other security interests about which they know so much.[24]

Another basis for the distinction rests on the argument that "[T]he once-a-year wholesale professional buyer of the year's wheat crop was in a better position to search for liens on his seller's record than for the seller's lender to police his debtor."[25] This is particularly untrue in the case of dairy farm products where "the typical milk dealer buys from dozens, hundreds, or thousands of small producers,"[26] and in the case of a livestock sales barn that "auctions hundreds, if not thousands, of animals every day and cannot easily phone each county clerk to check for financing statements, then place a follow-up call to each secured party to determine whether the animals are collateral and whether consent has been given for the sale."[27] On the other hand, one can argue that it is reasonable to require the wholesale farm products buyer who is "fully as sophisticated as the growers' financer [and who] ordinarily buys at infrequent intervals . . . to search the record."[28] Because of the time and expense involved, however, this procedure is hardly ever used.[29]

Two other possible explanations for the farm products exception in section 9-307(1) are, first, that it was designed simply to "[encourage] farm financing secured with crops as collateral,"[30] and, sec-

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22. Coogan & Mays, *supra* note 7, at 20.

23. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY, § 26.10 (1965).

24. Hawkland, *supra* note 21, at 418.

25. Coogan & Mays, *supra* note 7, at 20.

26. *Id.*

27. Moffat County State Bank v. Producers Livestock Mktg. Ass'n, 598 F. Supp. 1562, 1569 (D. Colo. 1984).

28. Coogan & Mays, *supra* note 7, at 22.

29. *Id.*

30. Note, *Secured Interests in Growing and Future Growing Crops Under the Uniform Commercial Code*, 49 IOWA L. REV. 1269, 1287 (1964).

ond, that it "is basically a result of evolving pre-Code practice."[31]

Despite the disparity between the real world and the one on which the Code rules arguably were based, there have been relatively few amendments to sections 9-306(2) and 9-307(1) by the Permanent Editorial Board. The 1972 version of section 9-306(2) is essentially the same as the 1952 and 1962 versions, except that the reference to disposition "by the debtor" has been deleted.[32]

In 1967, the Article Nine Review Committee was established to recommend possible amendments to the 1962 Code.[33] Those amendments became what is referred to today as the 1972 Code. According to Professor Hawkland:

> The committee in its 1970 report had proposed to delete the words "other than a person buying farm products from a person engaged in farming operations" from § 9-307(1). Subsequently it modified this proposal by stating it as an optional amendment. But the Permanent Editorial Board of the Uniform Commercial Code rejected even this watered-down effort and the officially proposed amendments to Article 9 [made] no changes in 9-307(1).[34]

The Final Report of the Permanent Editorial Board contained the following observations:

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31. Note, *supra* note 1, at 609. The author of this Note attributes the theory espoused in the text to Professor Grant Gilmore, 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 32.2, at 858-60 (1965) and details the pre-Code history.

32. U.C.C. § 9-306(1) (1952) states:

> (1) When collateral is sold, exchanged, collected or otherwise disposed of by the debtor the security interest continues on any identifiable proceeds received by the debtor except as otherwise provided in subsection (2); the security interest also continues in the original collateral unless the debtor's action was authorized by the secured party in the security agreement or otherwise or unless it is otherwise provided in Sections 9-301, 9-303(2), 9-307, 9-308 and 9-309. *Id.*

U.C.C. § 9-306(2) (1962) states:

> (2) Except where this article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof by the debtor unless his action was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor. *Id.*

U.C.C. § 9-306(2) (1972) states:

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

33. Hawkland, *supra* note 21, at 416.

34. *Id.* at 419. *See also*, B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE, § 8.4[3][a] (1980).

> The Committee considered various possibilities, such as distinguishing between the first buyer and sub-buyers or between a buyer of an entire annual crop and multiple buyers of milk, eggs and the like. But no solution was found. Differences of opinion on basic policy seem to be so sharp that they are unlikely to be resolved by an appeal to the goal of uniformity.[35]

Federal opposition to the proposed changes in section 9-307(1) has been credited with defeating amendment efforts and preserving the preferred status of the farm lender.[36] The government's interest was based on the fact that a great deal of farm financing is obtained through the federal government, and its opposition was said to be particularly persuasive because of the possibility that the government could withhold credit or specify in its loans that federal common law was applicable.[37]

The amendment deleting "by the debtor" from section 9-306(2) had the effect of "[divesting] the [third party transferee] of his last argument that would free him from a security interest in farm products."[38] Under the 1962 Code it could be argued that the disposition was not "by the debtor" if the third party transferees bought through another party such as a commission agent. The deletion of "by the debtor" makes it "clear that any disposition, except as otherwise provided in cut-off sections such as [section] 9-307, carries the security

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35. *General Comment on the Approach of the Review Committee for Article 9* (1971), *reprinted* in B. CLARK, *supra* note 34, at 119 app. B. Recognizing the inevitable, the Permanent Editorial Board suggested, "For states that are determined to change the present policy, it is recommended that this be done by deleting the words in Section 9-307(1): 'other than a person buying farm products from a person engaged in farming operations.' " *Id.* at 119 n. 5 app. B. To date, only California has done so. *See infra* text accompanying notes 122-23.

36. Hawkland, *supra* note 21, at 420.

37. *Id.* The question of whether state or federal law applied in suits brought to enforce FHA farm mortgages had not been answered uniformly prior to 1979. The Fourth and Eighth Circuits had held in favor of state law. United States v. Union Livestock Co., 298 F.2d 755 (4th Cir. 1962); United States v. Kramel, 234 F.2d 577 (8th Cir. 1956). The remaining circuits that had addressed the issue had found federal law to be applicable. United States v. Hext, 444 F.2d 804 (5th Cir. 1971); United States v. Carson, 372 F.2d 429 (6th Cir. 1967); Cassidy Comm'n Co. v. United States, 387 F.2d 875 (10th Cir. 1967); United States v. Somerville, 324 F.2d 712 (3rd Cir. 1963), *cert.denied*, 376 U.S. 909 (1964); United States v. Matthews, 224 F.2d 626 (9th Cir. 1957). In 1979, the Supreme Court agreed with the majority of the Courts of Appeal. The Court held that federal law was controlling and that the proper source of federal law was nondiscriminatory state laws, i.e., U.C.C. Article 9. United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979). Adoption of the official version of the U.C.C. will not ensure the uniformity sought by the *Kimbell* court, however, because judicial interpretations of U.C.C. §§ 9-306(2) and 9-307(1) have been so varied and conflicting. *See infra* text accompanying notes 42-119.

38. Hawkland, *supra* note 21, at 419. *See also* B. CLARK, *supra* note 34, at § 8.4[3][a].

interest with the collateral."[39]

The comments to section 9-306(2), however, were changed significantly between the 1962 and 1972 versions. The 1962 official comments stated: "[A] claim to proceeds in a filed financing statement might be considered as impliedly authorizing sale or other disposition of the collateral, depending upon the circumstances of the parties, the nature of the collateral, the course of dealing of the parties and the usage of trade . . . ."[40] In the 1972 code, however, the official comments deleted any reference to the effect of course of dealing and trade usage, stating:

> The transferee will take free whenever the disposition was authorized; the authorization may be contained in the security agreement or otherwise given. The right to proceeds, either under the rules of this section or under specific mention thereof in a security agreement or financing statement, does not in itself constitute an authorization of sale.[41]

III. INCONSISTENT JUDICIAL TREATMENT

The courts have been inconsistent in determining whether authority to dispose of the collateral has been given under the "or otherwise" provision of section 9-306(2). Some courts relied on the "or otherwise" language of the Code to protect the third party transferee from double liability. Other courts construed the provision in favor of the secured party under indistinguishable facts. These inconsistent decisions undoubtedly contributed to Congress' decision to preempt state legislation.

In other cases, the court did not properly identify the issues. Theoretically, the court should first determine whether authority to dispose of the collateral has been given (expressly or impliedly, absolutely or conditionally) in the security agreement or otherwise. If no authority has been given, judgment must be for the secured party. If disposition of the collateral has been authorized, the court must next consider whether that authorization was conditional. If the authorization was not conditional, judgment must be for the third party transferee. If the court finds that the authorization was conditional, then the court must resolve a third issue — whether that condition has

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39. Hawkland, *supra* note 21, at 419-20.
40. U.C.C. § 9-306(2) Official Comment (1962).
41. U.C.C. § 9-306(2) Official Comment (1972).

been satisfied, waived or excused. If the condition attached to the authorization to dispose of the collateral has been satisfied, waived or excused, then judgment must be for the third party transferee; if not, judgment must be for the secured party.

A. *Express Authorization*

The courts have not always been careful to distinguish between language that amounts to a modification of an agreement that is silent on authorization and language that amounts to an implied waiver of a provision in the parties' agreement that either prohibits or conditions authorization. *North Central Kansas Products Credit Association v. Boese*[42] is an example of such a case. In *Boese*, the court held that the secured party's instruction to the debtor to forward a check upon disposition of the collateral amounted to express consent to sell the collateral and receive the proceeds.[43] The court did not address the provisions of the security agreement regarding disposition of collateral. If the security agreement prohibited disposition or conditioned disposition on joint payment, then the court should have determined whether the agreement had been modified, or whether the condition had been satisfied, waived or excused.

B. *Authorization Implied From Proceeds Clause*

It is not uncommon for careful lenders to insert in the security agreement a routine "right to proceeds" clause for protection against possible wrongful disposition of the collateral.[44] It has been argued that such a clause is evidence of authorization to sell the collateral so as to bring the transaction within the "or otherwise" language of section 9-306(2).[45] This argument found support in the 1962 official comments to the Code: "A claim to proceeds in a filed financing statement might be considered as impliedly authorizing sale or other disposition of the collateral, depending upon the circumstances of the parties, the nature of the collateral, the course of dealing of the parties and the usage of the trade."[46]

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42. 577 P.2d 824 (Kan. Ct. App. 1978).

43. *Id.* at 827.

44. T. QUINN, UNIFORM COMMERCIAL CODE COMMENTARY AND LAW DIGEST, § 9-306[A][13][a] at 9-179 (1978).

45. In re Cadwell, 10 U.C.C.R.S. 710, 716 (E.D. Cal. 1970); Vermilion County Prod. Credit Ass'n v. Izzard, 111 Ill. App. 2d 190, 249 N.E.2d 352 (1969).

46. U.C.C. § 9-306, Official Comment 3 (1962).

Grain elevator operators who purchased corn from the debtor relied on this argument in *Vermilion County Production Credit Association v. Izzard*,[47] contending that the secured party's claim to proceeds upon sale of the collateral coupled with an after-acquired property clause in the financing statement and security agreement evidenced the debtor's right to dispose of the corn without further approval by the secured party lender. The buyers argued that "the agreement as a whole suggests full utilization of the so-called 'floating or shifting' lien authorized by the Commercial Code under which new collateral is added under an after-acquired property clause and other collateral is eliminated through sale or other disposition."[48] The Appellate Court of Illinois, however, viewed the proceeds clause as one inserted by the secured party for his own protection against third parties and not "one of permission or consent to the borrower."[49] The court reasoned that such an interpretation would be unconscionable in light of the fact that the secured party had to include the proceeds clause in order to protect against the debtor's insolvency.[50] A contrary result was reached in *In re Cadwell*,[51] where the court was "convinced that the [secured party] impliedly authorized [the debtor] to sell his cattle . . . by covering 'proceeds of collateral' in the Financing Statement."[52]

The problem of implying authorization to dispose of collateral from a right to proceeds clause was addressed by the Permanent Editorial Board as part of the 1972 amendments.[53] Comment 3 to section 9-306(2) was amended to state: "The right to proceeds, either under the rules of this section or under specific mention thereof in a security agreement or financing statement, does not in itself constitute an authorization of sale."[54] Thus, a third party transferee can no longer argue implied authorization based on a right to proceeds clause in those jurisdictions that have adopted the 1972 amendments.

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47. 111 Ill. App. 2d 190, 249 N.E.2d 352 (1969).

48. *Id.* at 193, 249 N.E.2d at 353.

49. *Id.* at 194-95, 249 N.E.2d at 354. *Accord* Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. 668, 186 N.W.2d 99 (1971); Overland Nat'l Bank v. Aurora Coop. Elevator Co., 184 Neb. 843, 172 N.W.2d 786 (1969).

50. 111 Ill. App. 2d at 195, 249 N.E.2d at 354. Proceeds are automatically covered under the 1972 Code. The 1972 version of § 9-203(3) provides: "Unless otherwise agreed, a security agreement gives the secured party the rights to proceeds provided by 9-306." *Id.*

51. 10 U.C.C.R.S. 710 (E.D. Cal. 1970).

52. *Id.* at 716.

53. *See supra* text accompanying notes 40-41.

54. U.C.C. § 9-306(2) Official Comment 3 (1972).

C. *Authorization Implied from Course of Dealing*

Where the agreement between the parties is silent on the issue, the court may properly imply authorization from the parties' course of dealing, relying on section 1-205(3): "A course of dealing between parties and any usage of trade . . . give particular meaning to and supplement or qualify terms of an agreement."[55] In *Lisbon Bank & Trust Co. v. Murray*,[56] the Supreme Court of Iowa held that authorization to dispose of the collateral could be implied where the security agreement contained no express prohibition against disposition or express conditions on disposition authority.

The Supreme Court of Idaho, however, in *Western Idaho Products Credit Association v. Simplot Feed Lots, Inc.*,[57] implied authorization from the parties' course of dealing where the security agreement was not silent on disposition, but expressly conditioned it as follows: "Debtor agrees not to sell . . . any collateral without the consent of Secured Party."[58] In that case, the secured party "allowed [the debtors] to sell crops out of the field at the discretion of the [debtors] so long as the gross sales proceeds went to [the secured party]."[59] This case is inconsistent with *Lisbon*, which held that authorization implied from course of dealing is proper only where the security agreement is silent on disposition. The rationale is that course of dealing is used then to supplement, rather than to contradict, the express terms of the parties' agreement. Where, as in *Simplot*, the security agreement expressly prohibits or conditions the debtor's authority to dispose of collateral, the court should consider course of dealing not as evidence of implied authorization, but as evidence of waiver of the express conditions on or prohibition against disposition.

D. *Is the Authorization Conditional?*

If the court finds that the secured party has authorized disposition of the collateral by the debtor, it must next determine whether that authorization was by its terms absolute or conditional. Some courts have allowed the secured party to condition his authorization

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55. U.C.C. § 1-205(3) (1972).

56. 206 N.W.2d 96 (Iowa 1973).

57. 678 P.2d 52 (Idaho 1984).

58. *Id.* at 53-54.

59. *Id.* at 54. *See infra* text at notes 60-65 for a discussion of the effect of authorization conditioned on remittance of proceeds.

to dispose of collateral upon remittance of proceeds by the debtor.[60] Other courts have held that conditional authorization on remittance of proceeds is not a "true condition," but is merely an attempt to make the third party transferee an insurer.[61]

The Tenth Circuit rejected the sham conditional authorization argument made by the secured party in *First National Bank & Trust v. Iowa Beef Processors*, [62] stating:

> Consent to sell in the debtor's own name 'provided' the seller remits by its own check to the bank is not a true conditional sales authorization. In essence, such a condition makes the buyer an insurer of acts beyond its control. The bank has made performance of the debtor's duty to remit proceeds to the bank a condition of releasing from liability a third party acting in good faith. [The third party transferee] could not ascertain in advance whether this condition would be met, as it could if a condition precedent was involved; nor did [the third party transferee] have any control over the performance of the condition, as long as it paid [the debtor]. A secured party has an interest in protecting its security by conditioning its consent, but it can place [only such?] conditions that would afford it protection without great unfairness to the good faith purchaser.[63]

Other courts have followed *Iowa Beef Processors* and held that the secured party's authorization, if any, is "unaffected by [the debtor's] failure to remit the proceeds of the sale."[64] Similarly, "although the borrowers were supposed to bring the proceeds to the [secured party], the sale was expressly authorized within the purview of [section 9-306(2)]"[65]

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60. In re Coast Trading Co., 31 B.R. 670 (D. Or. 1983); Southwest Wash. Prod. Credit Ass'n v. Seattle First Nat'l Bank, 92 Wash. 2d 30, 593 P.2d 167 (1979).

61. *See infra* notes 64 and 65 for cases cited therein.

62. 626 F.2d 764 (10th Cir. 1980).

63. *Id.* at 769.

64. Moffat County State Bank v. Producers Livestock Mkt'g Ass'n, 598 F. Supp. 1562, 1568 (D. Colo. 1984). *See also* Western Idaho Prod. Credit Ass'n v. Simplot Feed Lots, Inc., 678 P.2d 52 (Idaho 1984); Lisbon Bank and Trust Co. v. Murray, 206 N.W.2d 96, 99 (Iowa 1973) (authorization to sell was "unaffected by a finding such as was made here that the authority to sell was conditioned upon the debtor's agreement to apply the proceeds to the debt"); Charterbank Butler v. Central Coop., 667 S.W.2d 463, 466 (Mo. Ct. App. 1984) ("Consent, though conditioned upon payment of proceeds to the mortgage, cuts off the lien.").

65. Ottumwa Prod. Credit Ass'n v. Heinhold Hog Mkt., Inc., 340 N.W.2d 801, 803 (Iowa Ct. App. 1983). In this case the court was actually dealing with whether there was a waiver of the express condition (written consent) based on the secured party's express authorization that was, according to the secured party, "conditional upon the borrower's bringing all proceeds [to the secured party]." *Id. Accord* Anon, Inc. v. Farmers Prod. Credit Ass'n., 446 N.E.2d 656 (Ind. Ct. App. 1983).

The secured party should be allowed to condition the debtor's authority to dispose of the collateral, but only if the conditions imposed are "true conditions" the satisfaction of which are within the control of the third party transferee. "True conditions" that have been recognized include: (1) joint payment to the secured party and debtor;[66] (2) honor and payment of third party transferee's draft drawn on secured party bank;[67] (3) lack of prior default;[68] and (4) prior written consent.[69] These conditions allow the secured party to protect his security interest without imposing unreasonable burdens on the third party transferee.

E. *Has the Condition Been Met, Excused or Waived?*

Even if the court finds that the authorization given by the secured party was conditional, the secured party is not automatically entitled to judgment. The third party transferee may be able to convince the court that the condition was met, waived or that it should be excused based on the circumstances of the case. If the court finds that the condition has not been met, excused or waived, the secured party prevails.[70]

Much of the recent litigation has focused on this last issue. In resolving this issue the courts should apply Article Nine as well as general principles of contract law relating to conditions, which are

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66. North Cent. Kan. Prod. Ass'n v. Washington Sales Co., 223 Kan. 689, 577 P.2d 35 (1978); National Livestock Credit Corp. v. Schultz, 653 P.2d 1243 (Okla. Ct. App. 1982).

67. Baker Prod. Credit Ass'n v. Long Creek Meat Co., 266 Or. 643, 513 P.2d 1129 (1973).

68. Farmers State Bank v. Edison Non-Stock Coop. Ass'n, 190 Neb. 789, 212 N.W.2d 625 (1973).

69. United States v. Central Livestock Ass'n, Inc., 349 F. Supp. 1033 (D.N.D. 1972); In re Cadwell, 10 U.C.C.R.S. (E.D. Cal. 1970); Anon, Inc. v. Farmers Prod. Credit Ass'n, 446 N.E.2d 656 (Ind. Ct. App. 1983); Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. 668, 186 N.W.2d 99 (1971); Benson County Coop. Credit Union v. Central Livestock Ass'n, 300 N.W.2d 236 (N.D. 1980); Nat'l Livestock Credit Corp., v. Schultz, 653 P.2d 1243 (Okla. Ct. App. 1982); Central Wash. Prod. Credit Ass'n v. Baker, 11 Wash. App. 17, 521 P.2d 226 (1974).

70. Central Cal. Equip. Co. v. Dolk Tractor Co., 78 Cal. App. 855, 144 Cal. Rptr. 367 (1978). The court in this case held for the secured party upon finding that the security agreement expressly conditioned disposition of the collateral upon written authorization, which was not given. The court stated:

> [W]hen a security agreement expressly prohibits the disposition of collateral without the written consent of the secured party, in order for a court to find an authorization permitting disposition free of the security interest within the meaning of § 9-306, subdivision (2), there must either be actual prior or subsequent consent in writing by the secured party manifesting a purpose to authorize the disposition free of the security interest. Mere acquiescence is insufficient.

Id. at 863, 144 Cal. Rptr. at 371.

incorporated through the supplemental law provisions of section 1-103.[71]

1. Implied Waiver From Course of Dealing

In determining whether the condition has been waived the court must again consider whether the condition was expressed in the security agreement or in some other agreement between the parties. Section 1-205(3) provides that course of dealing[72] and usage of trade[73] may be relied upon to "give particular meaning to and supplement or qualify terms of an agreement."[74] Therefore, course of dealing and usage of trade have been relied upon by some courts to establish a waiver by the secured party of a condition placed on the debtor's authorization to dispose of collateral.[75]

In the highly criticized[76] case of *Clovis National Bank v. Thomas*,[77] the court found that the secured party had consented to the sale of collateral covered by other security agreements "as a matter of common practice, usage and procedure."[78] The secured party

71. U.C.C. § 1-103 states:

Unless displaced by the particular provisions of this Act, the principles of law and equity . . . shall supplement its provisions. *Id.*

72. "Course of dealing" is defined in U.C.C. § 1-205(1) (1972) as "a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct." *Id.*

73. "Usage of trade" is defined in U.C.C. § 1-205(2) (1972) as "any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question." *Id.*

74. U.C.C. § 1-205(3) (1972).

75. United States v. Central Livestock Ass'n., Inc., 349 F. Supp. 1033, 1034 (D.N.D. 1972). The court in *Central Livestock* relies on the *Clovis* rationale, but the cases are distinguishable in that *Clovis* involved waiver based on course of conduct while *Central Livestock* involved waiver based on course of performance. *See infra* text at notes 100-02. *See also* In re Cadwell, 10 U.C.C.R.S. 710, 716 (E.D. Cal. 1970); Planters Prod. Credit Ass'n v. Bowles, 511 S.W.2d 645, 649-50 (Ark. 1974); Hedrick Savings Bank v. Myers, 229 N.W.2d 252, 255 (Iowa 1975); Larsen v. Warrington, 348 N.W.2d 637, 641 (Iowa Ct. App. 1984); Ottumwa Prod. Credit Ass'n v. Heinhold Hog Mkt., Inc., 340 N.W.2d 801, 802 (Iowa Ct. App. 1983); Baker Prod. Credit Ass'n v. Long Creek Meat Co., Inc., 226 Or. 643, 653, 513 P.2d 1129, 1134 (1973); Central Wash. Prod. Credit Ass'n v. Baker, 11 Wash. App. 17, 19, 521 P.2d 226, 227 (1974) (also involved course of performance).

76. *See, e.g.*, Baker Prod. Credit Ass'n v. Long Creek Meat Co., 266 Or. 643, 513 P.2d 1129 (1973); Hawkland, *supra* note 21, at 418. *See also, Commercial Law - Uniform Commercial Code - Security Interests in Livestock*, 8 NAT. RES. J. 183 (1968); Note, *Sales—Waiver of Security Interest Under the Uniform Commercial Code*, 20 BAYLOR L. REV. 136 (1967).

77. 77 N.M. 554, 425 P.2d 726 (1967).

78. *Id.* at 559, 425 P.2d at 729.

had no actual knowledge of the sales of collateral and had not expressly consented to the sales.[79] Nevertheless, the court found that the secured party, "if not expressly consenting to the questioned sales, certainly impliedly acquiesced and consented thereto," based on evidence that the debtor had made other sales of collateral of which the secured party was aware.[80] What the court failed to address was the fact that the security agreement expressly required written consent as a condition to the debtor's authorization to dispose of the collateral.[81] Thus, there was conflict between the express terms of the parties' agreement on the one hand, and trade usage and course of dealing on the other. The court stated:

> Since the Uniform Commercial Code . . . was adopted in New Mexico in 1961 and prior to the transactions here involved, the question arises as to whether or not the provisions of this code require application to the facts of this case of rules different from those above stated. We think not.[82]

The *Clovis* court has been criticized for not considering section 1-205(4) which states that "[t]he express terms of an agreement and an applicable course of dealing or usage of trade shall be construed wherever reasonable as consistent with each other; but when such construction is unreasonable, express terms control both course of dealing and usage of trade . . . ."[83] The dissenting opinion in *Clovis* was the first to point out the omission by the majority:

> The most serious and, in my view, far reaching effect of the majority opinion is the statement . . . that the Uniform Commercial Code does not displace the law of waiver, or waiver by implied acquiescence or consent . . . . [T]he only way in which the trial court and the majority have been able to arrive at a waiver is the finding that, by common practice, usage and procedure, [the debtor] was allowed to sell the cattle covered by the security agreement. Obviously, such a finding and such a conclusion by my brethren is contrary to [U.C.C. § 1-205(4)] . . . .[84]

Others followed with their criticism of the *Clovis* court's failure to

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79. *Id.* at 557-58, 425 P.2d at 728.
80. *Id.* at 560, 425 P.2d at 730.
81. *Id.* at 569, 425 P.2d at 736.
82. *Id.* at 562, 425 P.2d at 731.
83. U.C.C. § 1-205(4) (1972).
84. 77 N.M. at 569, 425 P.2d at 736 (Carmody, J., dissenting).

apply section 1-205(4).[85] The New Mexico legislature, in response to the *Clovis* decision, amended section 9-306(2) to provide: "A security interest in farm products and the proceeds thereof shall not be considered waived by the secured party by any course of dealing between the parties or by any trade usage."[86]

Despite the criticism of *Clovis* and later decisions rejecting it, several courts have chosen to follow the holding in *Clovis*.[87] As one scholar has noted,[88] the decisions are difficult to reconcile on the issues of whether a given sale is within the scope of the parties' prior course of dealing,[89] and whether the waiver based on course of deal-

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85. *See, e.g.*, Baker Prod. Credit Ass'n v. Long Creek Meat Co., 266 Or. 643, 513 P.2d 1129 (1973); *See also* authorities cited *supra* note 76.

86. N.M. STAT. ANN. § 55-9-306(2) (1978). Arkansas has amended its version of 9-306(2) to provide essentially the same protection to the secured party: "A security interest in farm products shall not be considered waived nor shall authority to sell, exchange, or otherwise dispose of farm products be implied or otherwise result from any course in dealing between the parties or by any trade usage." ARK. STAT. ANN. § 85-9-306 (Supp. 1983).

87. United States v. Central Livestock Ass'n, Inc., 349 F. Supp. 1033, 1034 (D.N.D. 1972); In re Cadwell, 10 U.C.C.R.S. 710, 716 (E.D. Cal. 1970); Planters Prod. Credit Ass'n v. Bowles, 511 S.W.2d 645, 649, 650 (Ark. 1974); Hedrick Savings Bank v. Myers, 229 N.W.2d 252, 255 (Iowa 1975); Larsen v. Warrington, 348 N.W.2d 637, 641 (Iowa Ct. App. 1984); Ottumwa Prod. Credit Ass'n v. Heinhold Hog Mkt., Inc., 340 N.W.2d 801, 802 (Iowa Ct. App. 1983). Baker Prod. Credit Ass'n v. Long Creek Meat Co., Inc., 266 Or. 643, 653, 513 P.2d 1129, 1134 (1973); Central Wash. Prod. Credit Ass'n v. Baker, 11 Wash. App. 17, 20-21, 521 P.2d 226, 228 (1974).

88. B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE, § 8.4[3][b] n.71.1 (Supp. 1985).

89. The Iowa Court of Appeals in *Larsen v. Warrington* held that:

> [I]n order for a buyer to take collateral free of a properly perfected security interest under the "course of dealing" doctrine recognized in the *Hedrick* case, that buyer must present proof of a course of dealing *and* show that the purchase involved was within that course of dealing. While we believe the secured party should bear the risk of loss when the buyer purchases the collateral in the ordinary course of dealing, the buyer should bear the risk that the disposition of the collateral is being made outside the course of dealing in a manner not impliedly authorized by the secured party. This holding is consistent with the prior Iowa decisions in this area.

348 N.W.2d 637, 641 (Iowa Ct. App. 1984). It is difficult to reconcile this holding with Hedrick Savings Bank v. Myers, 229 N.W.2d 252 (Iowa 1975), referred to by the court in *Larsen*. In *Larsen*, the court found that under the parties' course of dealing the debtor was "impliedly authorized to *sell* the feeder pigs for *cash* and apply the proceeds to the interest and principle [sic] of his loans from the bank and to pay his other debts and operating expenses." 348 N.W.2d at 641. He was not authorized to "transfer . . . the pigs . . . in partial satisfaction of his indebtedness to [third party transferee]." *Id.* On the other hand, in *Hedrick*, the debtor's sale of collateral without prior written consent and without remittance to the secured party was held to be within the prior course of dealing of the parties, which had allowed the sale of collateral by the debtor without prior written consent. 229 N.W.2d at 256.

The fact that the debtor in *Larsen* transferred the pigs to the third party transferee to satisfy an antecedent debt, rather than receiving payment from the third party transferee and then paying off the antecedent debt, hardly seems sufficient to distinguish the two cases and

ing may be split, resulting in a security interest enforceable against the debtor but not against the third party transferee.[90]

Later decisions have recognized section 1-205(4) and held that trade usage and course of dealing may not be used to find a waiver of express terms in the security agreement.[91] Trade usage and course of

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seems to be an example of a court placing form over substance. In both *Larsen* and *Hedrick*, the secured party had impliedly authorized sales with the expectation of remittance. The fact that there was no actual remittance to the debtor in *Larsen* that was then misapplied, as there was in *Hedrick*, seems irrelevant. As Professor Clark observed, "Why is it not out of the course of dealing to sell livestock for cash and fail to apply the cash to the secured debt? Although a sale in satisfaction of antecedent debt is more unusual, both transactions upset the expectations of the secured lender." B. CLARK, *supra* note 88.

The *Larsen* court should have reasoned that there was: (1) an authorization (2) conditioned on written approval (3) that was waived by prior course of dealing or performance. The consideration received by the debtor (cash or satisfaction of a pre-existing debt) is irrelevant to the determination of whether the disposition of the collateral was authorized.

90. In Humbolt Trust & Savings Bank v. Entler, 349 N.W.2d 778 (Iowa Ct. App. 1984), the court held that the parties' course of dealing constituted an authorization to dispose of collateral that waived the security interest in the *collateral*, which was in the possession of the *third party transferee*, but not the security interest in the *proceeds*, which were held by the *debtors*. The court reasoned that until the disposition in question, the debtors had always applied the proceeds of sale and "[i]t was this course of dealing upon which the [secured party] relied in not requiring the [debtors] to obtain prior written permission to sell collateral." *Id.* at 783. As Professor Clark has noted, "The trouble with the court's decision is that Article 9 provides no authority for 'splitting' the waiver; in fact, § 9-306(3) contemplates a continuing perfected interest in proceeds only if the security interest in the original collateral is properly perfected." B. CLARK, *supra* note 88. The court's decision would have rested on a sounder legal foundation if general contract principles had been applied through the supplemental law provision of U.C.C. § 1-103. The court then could have found (1) an authorization (2) conditioned on written consent (3) that was waived by the parties' course of conduct, but that (4) under general contract principles of estoppel, the debtor was estopped to assert that waiver against the secured party.

91. United States v. E.W. Savaga & Son, Inc., 343 F. Supp. 123 (D.S.D. 1972), *aff'd*, 475 F.2d 305 (8th Cir. 1973); Colorado Bank & Trust Co. v. Western Slope Inv., Inc., 36 Colo. App. 149, 539 P.2d 501 (1975); Vermilion County Prod. Credit Ass'n v. Izzard, 111 Ill. App. 2d 190, 249 N.E.2d 352 (1969); Wabasso State Bank v. Caldwell Packing Co., 308 Minn. 349, 251 N.W.2d 321 (1976).

In *Wabasso*, the parties dealt with each other for five years prior to the execution of the security agreement in question. During that five year period, many sales of collateral occurred without prior written consent of the secured party. Nevertheless, the court held that U.C.C. § 1-205(4) applied, so that express terms prevailed over course of dealing. The court did not address the possible existence and effect of course of performance. See the discussion of *Wabasso* in T. QUINN, QUINN'S UNIFORM COMMERCIAL CODE COMMENTARY AND LAW DIGEST, § 9-307(A)(11)(b) at S9-223 (1984 Supp. No. 2); *See also* Oxford Prod. Credit Ass'n v. Dye, 368 So. 2d 241, 242 (Miss. 1979); Garden City Prod. Credit Ass'n v. Lannan, 186 Neb. 668, 674, 186 N.W.2d 99, 103-04 (1971).

There have been two recent decisions from the Nebraska Supreme Court that indicate a change of position. That court in State Bank v. Scoular-Bishop Grain Co., 217 Neb. 379, 349 N.W.2d 912 (1984), reversed a directed verdict for the secured party and held that "the jury could find, under proper instructions, that the course of dealing between the [parties] was a waiver, that it implied consent and authority for the sale of grain . . . free of the . . . security

dealing may, however, be used to find a waiver of implied terms and to find authority to dispose of collateral where the security agreement is silent concerning disposition.[92]

2. *Implied Waiver From Course of Performance*

Finding express terms in the security agreement prohibiting or conditioning the disposition of collateral does not automatically result in a judgment for the secured party. The court may also consider evidence of course of performance as establishing waiver. Section 2-208 provides:

> Where the contract for sale involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other, any course of performance accepted or acquiesced in without objection shall be relevant to determine the meaning of the agreement.
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> . . . express terms shall control course of performance . . . .
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> Subject to the provisions . . . on waiver,[93] such course of per-

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interest, and that such *was reasonably consistent with the express terms of the agreement.*" *Id.* at 389, 349 N.W.2d at 918 (emphasis added). *Accord*, Five Points Bank v. Soular-Bishop Grain Co., 217 Neb. 677, 350 N.W.2d 549 (1984). *See also* B. CLARK, *supra* note 88, at § 8.4[3][b]. A third party transferee is now protected in Nebraska by a recent amendment to § 9-307(1), provided he inquires of the debtor as to existing liens and makes payment jointly to any disclosed secured party. NEB. REV. STAT. § 9-307(4) (Supp. 1984). *But see infra* note 152 and accompanying text.

See also Benson County Coop. Credit Union v. Central Livestock Ass'n, 300 N.W.2d 236, 241 (N.D. 1980); First Nat'l Bank of Atoka v. Calvin Pickle Co., 516 P.2d 265, 266 (Okla. Ct. App. 1973); Baker Prod. Credit Ass'n v. Long Creek Meat Co., 266 Or. 643, 513 P.2d 1129 (1973); First Tenn. Prod. Credit Ass'n v. Gold Kist, 653 S.W.2d 418 (Tenn. Ct. App. 1983); Fisher v. First Nat'l Bank, 584 S.W. 515 (Tex. Civ. App. 1979). *But see* Central Cal. Equip. Co. v. Dolk Tractor Co., 78 Cal. App. 855, 144 Cal. Rptr. 367 (1978), in which the court criticized the *Clovis* opinion and purported to recognize the applicability of U.C.C. § 1-205(4), but nevertheless suggested that course of dealing might override express terms. It is possible that the court meant course of performance when it used the term course of dealing. The court stated:

> While we interpret "or otherwise" in § 9306, subdivision (2), to permit an implied agreement, we believe that such an implied agreement should be found with extreme hesitancy and should generally be limited to the situation of a prior course of dealing with the debtor permitting disposition. The issue is a question of fact, but the trial court should carefully consider the written prohibition against disposition found in the security agreement as an important matter in favor of the written prohibition unless such conclusion is unreasonable under the circumstances. . . .

Id. at 863, 144 Cal. Rptr. at 371.

92. *See supra* text at note 56.

93. The relevant provisions on waiver referred to are U.C.C. § 2-209(4) and (5) (1972).

formance shall be relevant to show a waiver . . . of any term inconsistent with such course of performance.[94]

The provisions dealing with the effect of course of performance are found in Article Two of the Code, unlike the provisions on course of dealing and trade usage that are contained in Article One. Article One, by its terms, applies to all of the other articles of the Code. It is not so clear, however, that the provisions of Article Two apply to Article Nine transactions. In fact, section 2-102 supports the position that Article Two provisions on course of performance do *not* control Article Nine transactions. That section states: "Unless the context otherwise requires, this Article . . . does not apply to any transaction which . . . is intended to operate only as a security transaction nor does this Article impair or repeal any statute regulating sales to . . . farmers or other specific classes of buyers."[95] This argument was adopted by one court to hold that Article Two course of performance provisions do not apply to secured transactions.[96]

One argument in favor of considering course of performance was adopted by the Oklahoma Court of Appeals in *Livestock Credit Corp. v. Schultz*.[97] There, the court relied on section 1-201(3), which states: " 'Agreement' means the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance as provided in the Act (Sections 1-205 and 2-208)."[98] The court, however, did not address the qualifying language of section 2-102. If section 2-208 does not apply to Article Nine transactions, then the effect of any course of performance that is contrary to express terms of the security agreement must be decided under principles of common law contract and equity through the supplemental law provisions of section 1-103.[99]

The United States District Court for the District of North Da-

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94. U.C.C. § 2-208 (1972).

95. U.C.C. § 2-102 (1972).

96. Cox v. Bancoklahoma Agri-Serv. Corp., 641 S.W.2d 400, 404 (Tex. Civ. App. 1982). One can also argue that, had the drafters of the U.C.C. intended course of performance to affect Article Nine transactions, the provisions on course of performance would have been included in § 1-205(4) with those on course of dealing and usage of trade.

97. 653 P.2d 1243 (Okla. Ct. App. 1982).

98. U.C.C. § 1-201(3) (1972).

99. *See, e.g.*, National Livestock Credit Corp. v. Schultz, 653 P.2d 1243, 1247 (Okla. Ct. App. 1982)("Where one of two innocent persons must suffer by the act of a third, he who has enabled such third person to occasion the loss must suffer.")

kota found an implied waiver based on course of performance in *United States v. Central Livestock Association Inc.*[100] In *Central Livestock* the court purported to:

> . . . [adopt] the rationale of *Clovis* . . . that under the Uniform Commercial Code, a lender which permits its debtor to sell collateral from time to time as the debtor chooses, and relies upon the debtor to bring in the proceeds from the sale, declining to exercise its right to require the debtor to obtain written authority, acquiesces in and consents to the sale and loses its security interest pursuant to the "or otherwise" provisions of § 9-306(2) U.C.C., thus precluding any recovery on a conversion theory against the purchaser.[101]

Clovis and *Central Livestock* are distinguishable, however, insofar as *Clovis* relied on course of dealing to show waiver while *Central Livestock* dealt with course of performance,[102] even though the court never addressed it as such. The court also failed to specifically find a waiver of the express conditions requiring joint payment and written consent, although waiver was probably what the court contemplated when it noted that the secured party had declined to exercise his right to require written consent. The court should have found that: (1) authorization was given; (2) authorization was expressly conditional in the security agreement, requiring written consent, and was later modified to require joint payment; and (3) the conditions were impliedly waived by the course of performance in which the debtor made numerous sales without prior written consent and occasionally without joint payment.[103]

3. *Waiver Based on Express Authorization to Sell*

Express conditions placed on the debtor's authorization to dispose of the collateral may be waived by subsequent acts of the se-

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100. 349 F. Supp. 1033 (D.N.D. 1972).

101. *Id.* at 1034.

102. Only one loan was involved. Therefore, all prior sales by the debtor and acquiescence therein constituted the course of performance of that contract.

103. This analysis was properly applied to similar facts in Central Wash. Prod. Credit Ass'n v. Baker, 11 Wash. App. 17, 521 P.2d 226 (1974), where the court found that (1) authorization was given; (2) authorization was conditioned on written consent; and (3) a fact question remained as to whether the condition was waived by course of performance (although the court referred to it as "course of conduct"). *Id.* at 20-21, 521 P.2d at 228. Benson County Coop. Credit Union v. Central Livestock Ass'n, 300 N.W.2d 236, 241 (N.D. 1980), also allows consideration of "course of conduct" as evidence of implied waiver of a condition requiring written consent.

cured party expressly consenting to disposition by the debtor. Unfortunately, the courts do not always address the fact that the express authorization to sell not only satisfies section 9-306(2), but also constitutes an implied waiver of the express condition (usually written consent) contained in the security agreement.[104] Thus, the courts should find that: (1) authorization to dispose of the collateral was granted in the security agreement; (2) authorization was expressly conditioned on written consent; and (3) the secured party impliedly waived the condition by expressly authorizing disposition by the debtor during the course of performance of the contract. Using this analysis, the desired result is achieved and the reasoning is legally sound. Instead, however, courts have often held simply that the secured party expressly authorized the sale of the collateral,[105] without attempting to resolve the resultant conflict between the express terms in the security agreement conditioning sale and the subsequent, unconditional, express authorization to sell.

In *North Central Kansas Production Credit Association v. Washington Sales Co.*,[106] the Supreme Court of Kansas held for the defendant auction sales barn on the ground that the secured party had expressly consented to the disposition of the collateral by the debtor, thereby waiving its security interest.[107] The debtor's authority to dispose of the collateral under the security agreement was conditioned on obtaining written consent to the sale by the secured party or, in the alternative, on joint payment to the secured party and the debtor.[108] The court acknowledged that the secured party had the right to condition its authorization to dispose of the collateral and that the security interest would continue in the collateral if the conditions were not met.[109] The conditional authorization in the

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104. Anon, Inc. v. Farmers Prod. Credit Ass'n, 446 N.E.2d 656 (Ind. Ct. App. 1983); Hedrick Savings Bank v. Myers, 229 N.W.2d 252, (Iowa 1975); Ottumwa Prod. Credit Ass'n v. Heinhold Hog Mkt., Inc., 340 N.W.2d 801 (Iowa Ct. App. 1983). In *Ottumwa*, the Court of Appeals of Iowa recognized that "[t]here was no specific conclusion [by the trial court] as to waiver of the requirement that such authorization be written," but still failed to address the issue in its opinion. *Id.* at 802.

105. *See, e.g.*, Hedrick Savings Bank v. Myers, 229 N.W.2d 252, 254 (Iowa 1975) ("It is conceded plaintiff expressly authorized sale of the feeder pigs . . . ."); North Cent. Prod. Credit Ass'n v. Washington Sales, 223 Kan. 689, 697, 577 P.2d 35, 41 (1978) ("Thus, [debtor] was specifically authorized to sell . . . .").

106. 223 Kan. 689, 577 P.2d 35 (1978).

107. *Id.* at 697-98, 577 P.2d at 41.

108. *Id.* at 690, 577 P.2d at 36.

109. *Id.* at 693, 577 P.2d at 39.

security agreement was not dispositive of the case, however, because the court found that the debtor was "specifically authorized"[110] to sell the collateral based on the following testimony of the secured party: "We told him he could sell cattle *providing* he applied the proceeds from that sale or had the check made jointly."[111]

Whether this language amounts to an unconditional authorization to sell depends on the court's interpretation of the parties' intent. In determining the parties' intent, two interpretations of this language are possible. First, the court could find an express condition attached to the authorization to sell, as in "You may sell the collateral on the condition that you remit the proceeds." Or, the court could find an unconditional authorization coupled with a promise to remit the proceeds, as in "You may sell the collateral if you promise to remit the proceeds." The court in *Washington Sales Co.*, in holding that the debtor "was *specifically authorized to sell* cattle, and he was *entrusted to apply* the proceeds,"[112] apparently adopted the latter interpretation.

Perhaps it was reasonable to find that the secured party was willing to assume the risk of the debtor's fidelity, in addition to that of his solvency, when the disposition was authorized and that the use of the conditional term "provided" was not intended to convey a condition at all. It is at least equally likely, however, that the secured party meant what he said and that the use of the term "provided" was intended to convey a condition. In that case, the oral authorization making disposition conditional on application of proceeds or joint payment evidenced only the secured party's willingness to forego the requirement of written consent (contained in the security agreement) *on the condition that* the debtor remit the proceeds. At no point did the secured party evidence an intent to waive its security interest in the collateral. If the court had adopted this interpretation, it arguably would have held for the secured party, based on the following dicta:

> Nothing in the Uniform Commercial Code prevents a secured party from attaching conditions or limitations to its consent to sale of collateral by a debtor. If such conditions are imposed, then a sale by the debtor in violation of those conditions is an unauthorized sale

110. *Id.* at 697, 577 P.2d at 41.
111. *Id.* (emphasis added).
112. *Id.* (emphasis added).

and the security interest continues.[113]

The issue not directly addressed by the court was whether the secured party could require proper application of the proceeds as a condition to its consent to sale by the debtor. Other courts have held that remittance by the debtor is simply not a true condition.[114] The court did not address this issue, but held simply that the debtor was "specifically" authorized to sell the collateral.[115] The court also failed to consider whether the conditions contained in the security agreement had been waived.[116] This case could have been decided on

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113. *Id.* at 692, 577 P.2d at 35.

114. *See supra* text at notes 60-69.

115. 223 Kan. at 697, 577 P.2d at 41.

116. The courts do not agree as to whether the doctrine of implied waiver requires a showing of reliance by the third party transferee. The Code does not define waiver; the common law of contracts recognizes both waiver by election and waiver by estoppel. Waiver by election is based on a voluntary and intentional relinquishment of known rights and does not require reliance by the third party transferee. Colorado Bank & Trust Co. v. Western Slope Inv., Inc., 36 Colo. App. 149, 539 P.2d 501 (1975); First Tenn. Prod. Credit Ass'n v. Gold Kist, Inc., 653 S.W.2d 418, 421 (Tenn. Ct. App. 1983). Estoppel does not require an intentional relinquishment of rights by the secured party; instead he is deemed to have waived his rights because of the justifiable reliance on his conduct by the third party transferee. Baird v. Fidelity-Phenix Fire Ins. Co., 178 Tenn. 653, 162 S.W.2d 384 (1942).

Most courts have treated waiver implied from course of dealing, course of performance and express authorizations as waiver by election and have not required a showing of reliance by the third party transferee. In Cox v. Bancoklahoma Agri-Serv. Corp., 641 S.W.2d 400 (Tex. Civ. App. 1982), however, the court viewed the issue as one of waiver by estoppel and refused to consider a claim of implied waiver based on course of dealing or course of performance absent a showing of reliance by the third party transferee.

Another area of disagreement among the courts is whether acquiescence by the secured party in the debtor's disposition of collateral is sufficient to establish waiver. Certainly acquiescence should be sufficient where the third party transferee was claiming estoppel and could show reliance on the prior course of dealing or performance between the secured party and the debtor. Where the third party transferee is claiming waiver by election, however, the decisions are split on whether mere acquiescence by the secured party is sufficient.

In First Tenn. Prod. Credit Ass'n v. Gold Kist, Inc., 653 S.W.2d 418 (Tenn. Ct. App. 1983), the court held that "it would not be reasonable to find that the [secured party] had 'authorized' [debtor's] sales in the past when each time [secured party] was simply presented with a *fait accompli*." *Id.* at 421. Thus, the court required proof that the secured party "voluntarily and intentionally relinquished its right to demand compliance with the written consent provision." *Id.* The decision has been criticized on the ground that "there was no *'fait accompli'* with respect to future sales and the creditor could have required that all checks in the future be made payable jointly to the farmer and the creditor, or the loan would be called into default after the next sale." B. CLARK, *supra* note 88, at § 8.4[3][c].

Other courts have found an implied waiver based on the secured party's acquiescence. *See, e.g.*, In re Vaillancourt, 7 U.C.C.R.S. 748 (D. Maine 1970).

In *Washington Sales Co.*, there was no basis for finding a waiver. The evidence suggested that the sales barn was unaware of the oral authorization to sell prior to trial, and thus could not have changed its position in reliance upon it as would be required for a finding of waiver by

sounder principles had the court reasoned that: (1) authorization was given; (2) the security agreement conditioned the authorization; and (3) the condition contained in the security agreement (written consent to dispose of the collateral) was waived by the secured party's statement, and the requirement of remittance was not a true condition.

4. *Policy Considerations*

The real issue in these unauthorized disposition cases, of course, is who should bear the risk of the debtor's insolvency or dishonesty as between the two equally innocent parties — the secured party and the third party transferee. In broader terms, one might ask: Does the financial health of our farm economy require preferential treatment of farm lenders? And who, as a general proposition, is in a better position to absorb the risk of unauthorized dispositions — the secured party or the third party transferee? One writer has suggested that "the courts should bend over backwards to find a course of dealing, consent or waiver in most cases; otherwise the creditor has the best of both worlds and the law is out of phase with commercial practice."[117] Typically, the secured party argues that he should be able to rely on the notice filing provisions of the Code. The third party transferee argues that the filing system is unworkable because of the local filings[118] often required for farm products, the volume of transactions, and the time restraints placed on some third party transferees.[119] Absent amendment to the contrary, the Code intention to give preferred status to the farm should be recognized. The third party transferee should prevail only where there is a clear showing of waiver or where the secured party has expressly consented.

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estoppel. And, arguably, the secured party did not intend to waive its security interest in the collateral by orally granting the conditional authorization to sell any more than it did expressly granting the conditional authorization to sell in the security agreement. Hence, the secured party could not be found to have effected a waiver by election.

117. B. CLARK, *supra* note 88, at § 8.4[3][c] n.86.5.

118. U.C.C. 9-401 (1972). *See also* Hooser, *Farm Products: Recent Legislative Changes to Section 9-307*, 29 S.D.L. REV. 346, 358 n.75 (1984) (list of states adopting central filing provisions); Dolan, *Section 9-307(1): The U.C.C.'s Obstacle to Agricultural Commerce in the Open Market*, 72 N.W.U.L. REV. 706, 718 (1977) (observing that a local filing rule makes it almost impossible to search the records).

119. The Packers and Stockyards Act, 7 U.S.C. § 228b (1982), requires payment by the close of the next business day following the sale.

IV. NONUNIFORM LEGISLATIVE AMENDMENTS

Some cases have suggested that the solution to the problem of unauthorized dispositions of collateral should come from the state legislatures.[120] In fact, twenty state legislatures have revised their versions of sections 9-306(2) or 9-307(1) or added new sections in response to the problem of unauthorized dispositions of collateral.[121]

The Permanent Editorial Board recommended in its Final Report that nonuniform amendments designed to change the present policy do so by deleting from section 9-307(1) the words "other than a person buying farm products from a person engaged in farming operations."[122] Professor Barkley Clark has argued that the Commissioners on Uniform State Laws, rather than the individual states, should take this corrective action. He also notes that California adopted the Permanent Editorial Board's recommendation many years ago, without any great harm to that state's farm economy.[123] In fact, California was the only state that followed the advice of the Permanent Editorial Board.

Obviously, the problem with unauthorized dispositions of collateral only arises when the secured party is not paid. Consequently, some state legislatures have sought to avoid the problem altogether by attempting to ensure that the secured party is paid when the collateral is transferred. The methods adopted to ensure payment to the secured party include: (1) imposing criminal penalties against debtors who give false information on sworn statements requiring lien information,[124] or who dispose of collateral without paying the secured

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120. *E.g.*, Moffat County State Bank v. Producers Livestock Mktg. Ass'n, 598 F. Supp. 1562 (D. Colo. 1984).

121. *See* ARK. STAT. ANN. § 85-9-306 (Supp. 1983); CAL. COM. CODE § 9307 (West Supp. 1984); DEL. CODE ANN. tit. 6, § 9-307(2) (Supp. 1984); GA. CODE ANN., § 11-9-307(3) (1982); IDAHO CODE § 25-1117 (Supp. 1985); ILL. REV. STAT. ch. 26, §§ 9-307, 9-205.1 (Smith-Hurd Supp. 1985); IND. CODE ANN. § 26-1-9-307 (Burns Supp. 1984); KAN. STAT. ANN. § 84-9-307 (1983); KY. REV. STAT. ANN. § 355.9-307 (Bobbs-Merrill Supp. 1984); LA. REV. STAT. ANN. § 3:568 (West Supp. 1985); ME. REV. STAT. ANN. tit. 11, § 9-307 (Supp. 1984); MICH. COMP. LAWS ANN. § 440.9307 (West Supp. 1985); MONT. CODE ANN. § 81-8-301 (1983); NEB. REV. STAT. § 9-307 (Supp. 1985); N.M. STAT. ANN. § 55-9-306 (1978); N.D. CENT. CODE § 41-09-28 (1985); OHIO REV. CODE ANN. § 1309.26 (Page Supp. 1984) (*See also* Note, *supra* note 31, at 607, for an excellent discussion of this statute); OKLA. STAT. ANN. tit. 12A, § 9-307 (West Supp. 1984); 1983 OR. LAWS ch. 626; S.C. CODIFIED LAWS ANN. § 57 A-9-503.1 (Supp. 1984); TENN. CODE ANN. § 47-9-307 (Supp. 1984).

122. *General Comment on the Approach of the Review Committee for Article 9* (1971), *reprinted in* B. CLARK, *supra* note 34 at 119 app. B.

123. B. CLARK, *supra* note 88.

124. MICH. COMP. LAWS ANN. § 440.9307(4)(d) (West Supp. 1985) states:

party,[125] or who transfer collateral to persons other than those previ-

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A seller engaged in farming operations who signs and delivers a false statement under subdivision (a) is guilty of a felony punishable by imprisonment for not more than 3 years, or a fine of not more than $10,000.00, or both. In considering the appropriate penalty to impose under this subsection, the court may consider whether the indebtedness upon which the security interest is based has been repaid. *Id.*

OKLA. STAT. ANN. tit. 12A, § 9-307(3)(9) (West Supp. 1984) states:

The certificate shall include a warning that any false statement as to the identity of the lenders is a felony and is punishable by imprisonment in the state penitentiary for a period not to exceed three (3) years or in the county jail for a period not to exceed (1) year, or by a fine not to exceed Five Hundred Dollars ($500.00). *Id.*

LA. REV. STAT. ANN. § 3:568(F) (Supp. 1985) states:

F. No person shall provide any false or misleading information concerning the name of the owner of any livestock or concerning the existence of any security device affecting the livestock with intent to deprive the holder of any of his security under the security device. No person shall take any action with respect to the alienation, encumbrance, or other disposition of livestock which are subject to the security device with intent to deprive the holder of any of his security under a security device. Whoever violates the provisions of this Subsection shall be fined not more than five thousand dollars, or imprisoned, with or without hard labor, for not more than ten years, or both. *Id.*

125. ILL. REV. STAT. ch. 26, § 9-306.01 (Smith-Hurd Supp. 1985) states:

Debtor disposing of collateral and failing to pay secured party amount due under security agreement; penalties for violation.

(1) It is unlawful for a debtor under the terms of a security agreement (a) who has no right of sale or other disposition of the collateral or (b) who has a right of sale or other disposition of the collateral and is to account to the secured party for the proceeds of any sale or other disposition of the collateral, to sell or otherwise dispose of the collateral and willfully and wrongfully to fail to pay the secured party the amount of said proceeds due under the security agreement. Failure to pay such proceeds to the secured party within 10 days after the sale or other disposition of the collateral is prima facie evidence of a willful and wanton failure to pay.

(2) An individual convicted of a violation of this Section shall be guilty of a Class 3 felony.

(3) A corporation convicted of a violation of this Section shall be guilty of a business offense and shall be fined not less than two thousand dollars nor more than ten thousand dollars.

(4) In the event the debtor under the terms of a security agreement is a corporation or a partnership, any officer, director, manager, or managerial agent of the debtor who violates this Section or causes the debtor to violate this Section shall be guilty of a Class 3 felony. *Id.*

IND. CODE ANN. § 26-1-9-307(1)(c) (Burns Supp. 1984) states:

A debtor engaged in farming operations who has created a security interest in farm products must provide the secured party with a written list of potential buyers of the farm products at the time the debt is incurred if such a list is requested by the secured party. The debtor may not sell farm products to a buyer who does not appear on the list (if the list is requested by the secured party) unless the secured party has given prior written permission to the debtor to sell to someone who does not appear on the list, or the debtor satisfies the debt for that secured party on the farm products he sells within fifteen (15) days of the date of sale. A debtor who knowingly or intentionally sells to a buyer who does not appear on the list (if the list is requested

ously disclosed to the secured party;[126] (2) requiring third party

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by the secured party) and who does not meet one (1) of the above exceptions, commits a class C misdemeanor. A secured party commits a class C infraction if he knowingly or intentionally gives false or misleading information on the notice required by subdivision (a) or he fails within fifteen (15) days of satisfaction of the debt to notify purchasers to whom a written notice has been previously sent (under subdivision (a)) of the satisfaction of the debt. *Id.*

OKLA. STAT. ANN. tit. 12A, § 9-307(3)(a)(West Supp. 1984) states:

Before issuing an instrument in payment for farm products other than livestock, a merchant purchasing such products from a seller or a commission merchant selling such products as an agent for a seller shall require said seller to execute a certificate disclosing the names of all lenders, if any, to whom security interests have been given in such farm products. If no such security interests exist, the certificate shall so state. The certificate shall include a warning that any false statement as to the identity of the lenders is a felony and is punishable by imprisonment in the state penitentiary for a period not to exceed three (3) years or in the county jail for a period not to exceed one (1) year, or by a fine not to exceed Five Hundred Dollars ($500.00). *Id.*

126. ILL. REV. STAT. ch. 26, § 9-306.02(1)-(5) (Smith-Hurd Supp. 1985) states:

(1) Where, pursuant to section 9-205.1, a secured party has required that before the debtor sells or otherwise disposes of collateral in the debtor's possession he disclose to the secured party the persons to whom he desires to sell or otherwise dispose of such collateral, it is unlawful for the debtor to sell or otherwise dispose of the collateral to a person other than a person so disclosed to the secured party.

(2) An individual convicted of a violation of this Section shall be guilty of a Class A misdemeanor.

(3) A corporation convicted of a violation of this Section shall be guilty of a business offense and shall be fined not less than $2000 nor more than $10,000.

(4) In the event the debtor under the terms of a security agreement is a corporation or a partnership, any officer, director, manager of managerial agent of the debtor who violates this Section or causes the debtor to violate this Section shall be guilty of a Class A misdemeanor.

(5) It is an affirmative defense to a prosecution for the violation of this Section that the debtor has paid to the secured party the proceeds from the sale or other disposition of the collateral within 10 days after such sale or disposition. *Id.*

MICH. COMP. LAWS ANN. § 440-9307(7) (West Supp. 1985) states:

. . . A person engaged in farming operations who sells farm produce to a grain dealer or another person engaged in farming operations who was not identified in the sworn statement he or she has provided pursuant to this subsection without the prior written consent of the secured person is guilty of a felony, punishable by imprisonment for not more than 3 years, or a fine of not more than $10,000.00, or both. *Id.*

OHIO REV. CODE ANN. § 1309.26(B)(8) (Page Supp. 1984) states:

Any debtor who sells farm products in violation of division (B)(4) of this section is guilty of a misdemeanor of the first degree. *Id.*

OHIO REV. CODE ANN. § 1309.26(B)(4) (Page Supp. 1984) states:

A debtor engaged in farming operations shall provide, if requested by the secured party, [a] written list of its potential buyers of the farm products. Without the prior written consent of the secured party, the debtor shall not sell farm products to a buyer who does not appear on the list. The debtor may amend the list by a written notice received by the secured party not less than fifteen days prior to the debtor's sale of farm products to any person included by the amendment. *Id.*

See also IND. CODE ANN. § 26-1-9-307(1)(c) (Burns Supp. 1984), *supra* note 125.

transferees to inquire of the debtor regarding the existence of liens,[127] to notify the debtor of potential criminal liability,[128] and to make payment jointly to the debtor and known secured parties;[129] (3) re-

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127. MICH. COMP. LAWS ANN. § 440.0307(4)(a) (West Supp. 1985) states:

> A buyer in the ordinary course of business who is a grain dealer licensed pursuant to Act No. 141 of the Public Acts of 1939, being sections 285.61 to 285.82a of the Michigan Compiled Laws, and who buys farm produce, as defined in that act, from a person engaged in farming operations:
>
> (a) Except as provided in subdivision (c), takes free of a security interest in the farm produce purchased if created by his or her seller, and if the seller signs and delivers to the buyer a sworn statement at the time of the sale of the farm produce stating that there are not prior security interests created by the seller relating to the farm produce purchased. The sworn statement shall be on a form prescribed by the department of agriculture and shall include a notice stating the criminal penalties provided in subdivision (d) for making a false statement. *Id.*

NEB. REV. STAT. § 9-307(4) (Supp. 1984) states:

> A buyer who purchases farm products or a person who sells farm products for another for a fee or commission shall require that the seller identify the first security interest holder with regard to the farm products being sold. If such seller is then paid the total purchase price by means of a check payable to such seller and the named first security interest holder and if the named first security interest holder authorizes the cashing of such check, the buyer of such farm products so purchased shall take free of any security interest. Any endorsement for payment made on such check shall not serve to establish or alter in any way security interest priorities under Nebraska Law. *Id.*

See also OKLA. STAT. ANN. tit. 12A, § 9-307(3)(a) (West Supp. 1984), *supra* note 125.

128. Illinois requires the third party transferee to post a notice of potential criminal liability but the statute states no consequences for noncompliance by the third party transferee. ILL. REV. STAT. ch. 26, § 9-307.2 (Smith-Hurd Supp. 1985) states:

> A commission merchant or selling agent who sells farm products for others, and any person buying farm products in the ordinary course of business from a person engaged in farming operations, shall post at each licensed location where said merchant, agent or person buying farm products in the ordinary course of business does business a notice which shall read as follows:
>
> 'NOTICE TO SELLERS OF FARM PRODUCTS
>
> 'It is a criminal offense to sell farm products subject to a security interest without making payment to the secured party. You should notify the purchaser if there is a security interest in the farm products you are selling.
>
> 'Such notice shall be posted in a conspicuous manner and shall be in contrasting type, large enough to be read from a distance of 10 feet.' *Id.*

Michigan requires the third party transferee to obtain a sworn statement from the debtor on a form that contains a notice of possible criminal penalties. MICH. COMP. LAWS ANN. § 440.9307(4)(a) (West Supp. 1985), *supra* note 127. *See also* OKLA. STAT. ANN. tit. 12A, § 9-307(3)(a) (West Supp. 1984), *supra* note 125.

129. IND. CODE ANN. § 26-1-9-307(1)(d) (Burns Supp. 1984) states:

> A purchaser of farm products buying from a person engaged in farming operations must issue a check for payment jointly to the debtor and those secured parties from whom he has received prior written notice of a security interest as provided for in subdivision (a). A purchaser who fails to issue a jointly payable check as required by this subsection is not protected by this subsection . . . . *Id.*

quiring debtors to provide names of potential buyers upon request of the secured party;[130] and (4) requiring secured parties to notify potential third party transferees of existing security interests.[131]

OHIO REV. CODE ANN. § 1309.26(B)(1)(b) (Page Supp. 1984) states:

> (B) The provision of divisions (B) (1) to (8) of this section apply to persons engaged in farming operations and to persons buying farm products from persons engaged in farming operations.
>
> (1) A buyer in ordinary course of business, as defined in division (I) of section 1301.01 of the Revised Code, of farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence, unless both of the following apply:
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> * * *
>
> (b) The buyer fails to make payment for the farm products jointly, or otherwise in compliance with the instructions contained in such written notice, to the debtor and each notifying secured party. *Id.*

OKLA. STAT. ANN. tit. 12A, § 9-307(3)(b) (West Supp. 1984) states:

> The merchant shall enter the names of the lenders disclosed in the certificate on the instrument in payment for the farm products as joint payees. The endorsement of said lenders and the seller shall be required to negotiate said instrument. The instrument shall be issued as the net purchase price for payment for the farm products. *Id.*

See also LA. REV. STAT. ANN. § 3:568(c) (Supp. 1985); NEB. REV. STAT. § 9-307(4)(Supp. 1984), *supra* note 127.

130. ILL. REV. STAT. ch. 26, § 9-205.1 (Smith-Hurd Supp. 1985) states:

> A secured party may require that the debtor include as part of the security agreement a list of persons to whom the debtor desires to sell or otherwise dispose of the collateral. The debtor shall not sell or otherwise dispose of the collateral to a person not included in that list unless the debtor has notified the secured party of his desire to sell or otherwise dispose of the collateral to such person at least 7 days prior to the sale or other disposition. *Id.*

MICH. COMP. LAWS ANN. § 440.9307(7) (West Supp. 1985) states:

> A person making loans or extending credit to a person engaged in farming operations, and taking a security interest in farm produce with respect to farming operations, may require that person to sign a sworn statement, at the time of executing the loan or extension of credit, indicating the names and addresses of all grain dealers or persons engaged in farming operations to whom that person intends to sell the farm produce which is subject to the security interest . . . . *Id.*

N.D. CENT. CODE § 41-09-28(11)(1985) states:

> When a crop or livestock buyer issues a check or draft to a person engaged in farming operations in payment for crops or livestock in order to take free of security interests or liens against such crops or livestock, the crop or livestock buyer must issue the check or draft for payment jointly to the person engaged in farming operations and those secured parties or lienholders who have a security interest or lien in the crops or livestock sold and whose names appear on the most current list or lists distributed by the secretary of state at the time the check or draft is issued. *Id.*

See also IND. CODE ANN. § 26-1-9-307(1)(C) (Burns Supp. 1984), *supra* note 125; NEB. REV. STAT. § 9-307(4) (Supp. 1984), *supra* note 127; OHIO REV. CODE ANN. § 1309.26(B)(4) (Page Supp. 1984), *supra* note 126.

131. While most statutory amendments in this area provide that the secured party must give notice to the third party transferee in order to be protected, see *infra* note 137, Tennessee

If totally effective, these preventative and deterrent statutory provisions could virtually eliminate unauthorized dispositions of collateral. That is not the case, however, and situations still arise in which the relative rights of a secured party and a third party transferee must be decided under these nonuniform statutory amendments. The results vary greatly.

Some statutes are aimed at preserving the preferred status of the secured party. Maine, for instance, has increased the secured party's protection by extending the farm products exclusion of section 9-307(1) to persons "buying timber, logs or pulpwood from a person engaged in timbering operations."[132] Oklahoma has opted to treat sales of livestock differently from sales of other farm products. The secured party retains his preferred status under Oklahoma's version of section 9-307, but only as to sales of livestock.[133] In order to protect the secured party from unfavorable judicial interpretations of section 9-306(2), Arkansas and New Mexico have amended that sec-

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is the only state that requires the secured party to give notice in all cases. TENN. CODE ANN. § 47-9-307(2)(d)(Supp. 1984) states:

> The actual written notice required by subsections (2)(a), and (b), and (c) may be satisfied when posted in the United States mail and verified by records maintained by the creditor. The notice may be given for each individual debtor or provided in a list. The required notice must be given to the parties due same that are located in any county lying within a radius of seventy-five (75) miles of the principal office of the creditor. Such notices or lists shall be renewed annually. The actual notice shall include the individual name of the debtor, the address of the debtor, and the proper description of the property subject to the lien and the location of the property subject to the lien as of the date the lien is perfected. *Id.*

This burden is somewhat eased by the provision of TENN. CODE ANN. § 47-9-307(2)(f)(Supp. 1984), which states: The state department of agriculture shall furnish a list of all such marketing entities to each lender whose established place of business is located within seventy-five (75) miles of such lender upon request. *Id.*

132. ME. REV. STAT. ANN. tit. 11, § 9-307(1) (Supp. 1984) states:

> A buyer in ordinary course of business (section 1-201, subsection (9)), other than a person buying timber, logs or pulpwood from a person engaged in timbering operations or from a person dealing in timber, logs or pulpwood and 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. *Id.*

This amendment, of course, has no effect on the U.C.C. § 9-306(2) unauthorized disposition controversy other than to increase the types of collateral involved.

133. OKLA. STAT. ANN. tit. 12A, § 9-307(1)(West Supp. 1984) states:

> A buyer in the ordinary course of business other than a person buying livestock from a person engaged in farming or ranching operations hereinafter referred to as the seller for the purposes of this section, takes free of a security interest created by the seller even though the security interest is perfected and even though the buyer knows of its existence.

tion to provide that authority to dispose of farm products may not be implied from course of dealing or trade usage.[134]

Idaho and South Dakota have added sections designed to aid the third party transferee without affecting the preferred status of the secured party. Idaho provides for filing of notice of a security interest in livestock with the state brand board, which in turn may provide copies to livestock auction markets.[135] South Dakota imposes a two-year statute of limitations on the secured party's claim against third party transferees and requires that the secured party file a criminal complaint against the debtor as a condition precedent to a civil action against a third party transferee.[136]

Other states have legislated in favor of the third party transferee, allowing him to prevail over the secured party unless he receives what amounts to actual notice of the security interest.[137] The

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134. ARK. STAT. ANN. § 85-9-306(2)(Supp. 1983) states: "A security interest in farm products shall not be considered waived nor shall authority to sell, exchange, or otherwise dispose of farm products be implied or otherwise result from any course in dealing between the parties or by any trade usage." *See also* N.M. STAT. ANN. § 55-9-306(2)(1978), *supra* note 86, and accompanying text.

135. IDAHO CODE § 25-1117 (Supp. 1985). The filing of such notice or failure to file does not, however, affect the rights of the parties under Article Nine. *Id.* at § 25-1117(6).

136. S.D. CODIFIED LAWS ANN. § 57A-9-503.1 (Supp. 1984).

137. Delaware protects a buyer of grain who registers with the secretary of state unless the buyer receives written notice from the secured party. The secretary of state is required to maintain a Grain Buyer's Registry upon which the secured party may rely in giving notice. DEL. CODE ANN. tit. 6, § 9-307(2) (Supp. 1984).

Georgia subordinates the farm products secured party only to a commission merchant acting in the ordinary course of business and without knowledge of the security interests. GA. CODE ANN. § 11-9-307(3) (Supp. 1985) states:

> A commission merchant who shall sell livestock or agricultural products for another for a fee or commission shall not be liable to the holder of a security interest created by the seller of such livestock or products even though the security interest is perfected where the sale is made in ordinary course of business and without knowledge of the perfected security interest. *Id.*

Kentucky retains the farm products exception to U.C.C. § 9-307(1), but has amended the section to protect third party transferees of tobacco crops, grain or soybean crops, livestock and racehorses who act without actual notice and in the ordinary course of business. KY. REV. STAT. § 355.9-307 (Bobbs-Merrill Supp. 1984) states:

> (1) A buyer in ordinary course of business (subsection (9) of KRS 355.1-201) 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.
>
> (2) If any tobacco crop subject to the lien of a security interest is sold at public auction through a duly licensed tobacco warehouse in the ordinary course of business, a bona fide purchaser for value of such crop shall take title thereto free and clear of any such lien, and the warehouseman selling such tobacco crop shall not be liable to the holder of such lien, unless written notice by certified mail, return receipt re-

burden of providing notice is on the secured party. North Dakota ad-

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quested, of such lien, the name and address of the debtor and proper description of the property subject to lien, are given to the tobacco warehouseman prior to the payment of the proceeds of sale to the owner or producer of such tobacco crop.

(3) If any grain or soybean crop subject to the lien of a security interest is sold to any entity which is a bona fide purchaser for value and which holds a current grain storage license issued by the Commonwealth of Kentucky or a current federal warehouse storage license, in the ordinary course of business, such entity shall take title to such crop free and clear of any such lien, and shall not be liable to the holder of such lien, unless written notice by certified mail, return receipt requested, of such lien, the name and address of the debtor and proper description of the property subject to the lien is given to the entity purchasing said crop prior to the payment of the proceeds of purchase to the owner or producer of such grain or soybean crop.

(4) If any livestock subject to the lien of a security interest is sold at public auction through a stockyard licensed by the Commonwealth of Kentucky in the ordinary course of business, a bona fide purchaser for value of such livestock shall take title thereto free and clear of any such lien and the stockyard and selling agents selling such livestock shall not be liable to the holder of such lien, unless written notice by certified mail, return receipt requested, of such lien, the name and address of the debtor and proper description of the livestock subject to lien is given to the stockyard prior to the time of sale.

* * *

(6) If any registered breed of horse, the racing of which is regulated by KRS Chapter 230, subject to the lien of a security interest is sold at public auction in the ordinary course of business by an organization engaged in the value of such horse shall take title thereto free and clear of any such lien, and the organization selling such horse shall not be liable to the holder of such lien, unless written notice by certified mail, return receipt requested, of such lien and the amount thereof, the name and address of the debtor and proper identification of the horse subject to lien are given to the organization prior to the time of sale. *Id.*

Illinois protects the third party transferee acting in the ordinary course of business who has not received actual notice from the secured party prior to sale. ILL. REV. STAT. ch. 26, § 9-307(4)(Smith-Hurd Supp. 1985) states:

A person buying farm products in the ordinary course of business from a person engaged in farming operations takes free of a security interest created by the seller even though the security interest is perfected unless, within 5 years prior to the purchase, the secured party has given written notice of his security interest to the buyer, sent by registered or certified mail. Such notice shall contain the name and address of the seller, a statement generally identifying the farm products subject to the security interest, and an address of the secured party from which information concerning the security interest may be obtained. *Id.*

ILL. REV. STAT. ch. 26, § 9-307.1 (Smith-Hurd Supp. 1985) states:

A commission merchant or selling agent who sells livestock or other farm products for others shall not be liable to the holder of a security interest in such livestock or other farm products, even though the security interest is perfected, unless within 5 years prior to the sale, the secured party has given written notice of his security interest to such merchant or agent, sent by registered or certified mail. Such notice shall contain the name and address of the seller, a statement generally identifying the farm products subject to the security interest, and an address of the secured party from which information concerning the security interest may be obtained. *Id.*

IND. CODE ANN. § 26-1-9-307(1)(a)(Burns Supp. 1984) states:

ditionally requires the secured party to make a good faith effort to

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A buyer in ordinary course of business [IC 26-1-1-201(9)] 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. The following apply whenever a person is buying farm products from a person engaged in farming operations who has created a security interest on the farm products:

(a) A person buying farm products from a person engaged in farming operations is not protected by this subsection if he has received prior written notice of the security interest. "Written notice" means an original signed by the debtor or a carbon, photographic, or other reproduction of an original of a financing statement which had been signed by the debtor effective under IC 26-1-9-402, or a notice on a form prescribed by the secretary of state or a carbon, photographic, or other reproduction of the form that contains the following:

(i) The full name and address of the debtor.

(ii) The full name and address of the secured party.

(iii) A description of the collateral.

(iv) The date and location of the filing of the security interest . . . .

Michigan has amended U.C.C. § 9-307 to protect only licensed grain dealers and persons engaged in farm operations buying farm products for use in their own farming operations. Other third party transferees of farm products are subject to the original language of U.C.C. § 9-307. MICH. COMP. LAWS ANN. § 440.9307 (West Supp. 1985) states, in pertinent part:

(4) A buyer in the ordinary course of business who is a grain dealer licensed pursuant to Act No. 141 of the Public Acts of 1939, being sections 285.61 to 285.82a of the Michigan Compiled Laws, and who buys farm produce, as defined in that act, from a person engaged in farming operations:

* * *

(c) Takes subject to a perfected security interest created by his or her seller in the farm produce purchased if the buyer has actual knowledge of the security interest.

* * *

(5) A buyer in the ordinary course of business who is engaged in farming operations and who buys farm produce, as defined in Act No. 141 of the Public Acts of 1939, for his or her own use in farming operations and not for resale, from another person engaged in farming operations, takes free of a security interest in the farm produce purchased, if created by his or her seller, for up to $15,000.00 of encumbered farm produce purchased. However, if the buyer purchases farm produce, the value of which exceeds $15,000.00, the buyer shall keep records identifying the seller or sellers of the farm produce, the amount and type of farm produce purchased from each seller, and the date and time of each sale, or the buyer shall produce other suitable evidence to substantiate the order in time, amount, and type of farm produce purchased from each seller. For purposes of the subsection, a buyer takes free of any security interest only with respect to the first $15,000.00 of encumbered farm operations in a calender year.

(6) For purposes of subsections (4) and (5), a buyer has actual knowledge of a security interest if, prior to the sale, the person making loans or extending credit notifies the buyer by certified or registered mail of the security interest. The notification, including any renotification, shall identify the person who created the security interest and describe the type of farm produce with respect to which the security interest is claimed. A notification or renotification may be given separately for each security interest claimed or in a list which includes information pertaining to more than 1 security interest, and shall be effective for 1 year from the date the notifica-

collect from the debtor before he may proceed against the third party

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tion or renotification is issued.

Montana has not amended U.C.C. § 9-306 or 9-307, but it has added a provision protecting livestock markets that have not received notice of a security interest prior to sale. The statute requires the secured party to file a notice with the department of livestock, which then notifies the central livestock markets. MONT. CODE ANN. § 81-8-301 (1984).

Nebraska goes so far as to protect the third party transferee who simply inquires of the seller as to the existing liens and makes payment jointly to any secured parties so identified. *See* NEB. REV. STAT. § 9-307(4)(Supp. 1984), *supra* note 127.

N.D. CENT. CODE § 41-09-28(a) (1985) states:

> In order to appear on the lists, secured parties or lienholders must file with the secretary of state a form prescribed by him which contains all of the following information:
>
> a. The name and address of the person engaged in farming operations.
>
> b. The county of residence of the person engaged in farming operations.
>
> c. The social security number of the person engaged in farming operations.
>
> d. The name and address of the secured party or lienholder.
>
> e. A description of the crops or livestock and their amount, if known, subject to the security interest or lien.
>
> f. The legal description as to the location of the crops or livestock. *Id.*

Ohio allows the third party transferee to prevail even where he knows of the security interest so long as he has not received the prescribed written notice from the secured party. OHIO REV. CODE ANN. § 1309.26(B)(1)(a); (b) (Page Supp. 1984) states:

> (B) The provisions of divisions (B)(1) to (8) of this section apply to persons engaged in farming operations and to persons buying farm products from person as engaged in farming operations.
>
> (1) A buyer in ordinary course of business, as defined in division (I) of section 1301.01 of the Revised Code, of farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence, unless both of the following apply:
>
> (a) Within eighteen months prior to making payment to the person engaged in farming operations, the person buying farm products has received written notice complying with division (B)(2) of this section;
>
> (b) The buyer fails to make payment for the farm products jointly, or otherwise in compliance with the instructions contained in such written notice, to the debtor and each notifying secured party. *Id.*

Oklahoma allows a buyer in the ordinary course of business of all collateral other than livestock to prevail over the secured party. *See* OKLA. STAT. ANN. tit. 12A, § 9-3076(1) (West Supp. 1984), *supra* note 133. However, buyers who also qualify as merchants are required to make joint payments to any lienholders identified by the secured party in order to take free of the security interest. *See* OKLA. STAT. ANN. tit. 12A, § 9-307(3)(a)(West Supp. 1984), *supra* note 125.

TENN. CODE ANN. § 47-9-307(1) has eliminated the farm products exception from U.C.C. § 9-307(1), but has added several sections apparently to protect third party transferees who might not fall within the "takes free of a security interest created by his *seller*" language of U.C.C. § 9-307(1). TENN. CODE ANN. § 47-9-307 (Supp. 1984) states, in pertinent part:

> (1) A buyer in ordinary course of business (subsection (9) of § 47-1-201) 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.
>
> (2)(a) If any livestock subject to the lien of a security interest is sold at public

transferee.[138] This seems to be an attempt to further protect the third party transferee from needless litigation.

In addition to requiring lack of actual notice of the security interest, some states impose affirmative duties on the third party transferee to obtain lien information from the debtor,[139] to notify the

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auction through a public livestock market chartered in this state or through a buying station, community sale yard, or meatpacker licensed by the state of Tennessee in the ordinary course of business, a bona fide purchaser for value of such livestock shall take title thereto free and clear of any such lien, and the public livestock market, buying station, community sale yard, or meatpacker and selling agent selling such livestock shall not be liable to the holder of such lien, unless actual written notice as required hereinafter is given to such public livestock market, buying station, community sale yard, or meatpacker prior to the time of the sale.

(b) If any grain or soybean crop subject to the lien of a security interest is sold to any entity which is a bona fide purchaser for value and which holds a current public grain warehouse license issued by the state of Tennessee or a current federal warehouse storage license, in the ordinary course of business, such entity shall take title to such crop free and clear of any such lien, and shall not be liable to the holder of such lien, unless actual written notice as required hereinafter is given to the entity purchasing such crop prior to the payment of the proceeds of purchase to the owner or producer of such grain or soybean crop.

(c) If any tobacco crop subject to the lien of a security interest is sold at public auction through a tobacco warehouse pursuant to chapter 19 of title 43, in the ordinary course of business, a bona fide purchaser for value of such crop shall take title thereto free and clear of any such lien, and the warehouseman selling such tobacco crop shall not be liable to the holder of such lien, unless actual written notice as required hereinafter is given to the tobacco warehouseman prior to the payment of the proceeds of sale to the owner or producer of such tobacco crop. *Id.*

See also LA. REV. STAT. ANN. § 3:568(A),(B) (Supp. 1985).

138. The full text of N.D. CENT. CODE § 41-09-28(12) (1985) states:

No complaint by a secured party or lienholder shall be filed or served against a crop or livestock buyer for collection of any loss sustained by the secured party or lienholder through any transaction filed pursuant to subsection 9 until all of the following have been accomplished and alleged:

a. That a judgment has been obtained and a good faith effort made to collect that judgment against the person engaged in farming operations, or that proceedings against the person engaged in farming operations were stayed by federal bankruptcy proceedings, or that receivership or proceedings have been commenced under chapter 32-10.
b. That within eighteen months following the date of the check or draft, the notice required to be sent pursuant to subsection 11 was served upon the crop or livestock buyer and reciting or incorporating by reference all the information contained in that notice.
c. List any other collateral taken by the secured party or lienholder as security on the same debt from the person engaged in farming operations, including a statement of value, status, and plans for application of such collateral to the indebtedness of the person engaged in farming operations. *Id.*

139. *See supra* note 127 and accompanying text.

debtor of possible criminal penalties,[140] to make payments jointly to the debtor and any known secured parties,[141] to maintain records that can be used to prosecute the debtor,[142] and to check a central filing system for evidence of liens against the collateral.[143]

The Kansas legislature, on the other hand, imposes no obligations on the purchasers of milk, cream and eggs. These products have been eliminated from the definition of farm products in the Kansas version of section 9-307(1), so that a third party transferee of such collateral takes free of the security interest in all instances, provided he qualifies as a buyer in the ordinary course of business.[144] One possible justification for the dairy products exception is that these products are sold year-round, unlike other farm products that are sold one time only during a season. The frequent transactions involving dairy products would decrease the risk to the secured party on any one transaction and would increase the likelihood of his detecting

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140. *See supra* note 128 and accompanying text.

141. *See supra* note 129 and accompanying text.

142. Michigan requires recordkeeping by persons engaged in farming operations who buy farm produce in the ordinary course of business for use in farming operations where the value of the purchases exceed $15,000.00 in a calendar year. MICH. COMP. LAWS ANN. § 440.9307(5)(West Supp. 1985), *supra* note 137.

OKLA. STAT. ANN. tit. 12A, § 9-307(3)(d)(West Supp. 1984) states: "The merchant shall retain the certificate for a period of at least three (3) years. Such certificates shall be made available to such lenders during the regular business hours of such merchant." *Id.*

143. N.D. CENT. CODE § 41-09-28 (9) and (13) state:

9. If a secured party who has perfected a security interest in crops or livestock, or if a lienholder who has created a lien by statute or otherwise, which includes, but is not limited to, liens for threshing, crop production, fertilizer, farm chemicals, and seed, and landlord's lien, intends to impose liability for such security interest or lien against a crop or livestock buyer, the name of the secured party or lienholder must appear on the most current list or lists distributed by the secretary of state pursuant to subsection 4 of section 41-09-46.

* * *

13. A crop or livestock buyer takes free of any security interest created by, or any lien against crops or livestock of, the person engaged in farming operations if any of the following apply:

a. The crop or livestock buyer has complied with the requirements of subsection 11 of this section.

b. No evidence of security interests or liens appear [sic] on the most current lists prepared and distributed by the secretary of state pursuant to subsection 3 and 4 of section 41-09-46.

c. The name of the person represented to be the seller of the crops or livestock does not appear on the most current lists prepared and distributed pursuant to subsections 3 and 4 of section 41-09-46. *Id.*

144. KAN. STAT. ANN. § 84-9-307(1)(1983) states: "For purposes of this section only, 'farm products' does not include milk, cream and eggs." *Id.*

any unauthorized transactions before his loss became too great. The situation is more akin to sales of inventory and, thus, receives the same treatment.

California has gone so far as to completely eliminate the farm products exception in section 9-307(1), so that the third party transferee prevails in all instances, so long as he qualifies as a buyer in the ordinary course of business. Knowledge of the security interest is irrelevant.[145]

One advantage of legislative amendments in this area is that they often eliminate any controversy over whether the disposition of the collateral was authorized, and in so doing avoid the myriad of conflicting and confusing opinions.[146] The question becomes simply whether the secured party was paid and, if not, whether any relevant statutory obligations were met.[147]

The disadvantages of the various amendments are several. Most amendments fail to distinguish between degrees of potential criminal liability based on the value of the collateral.[148] Some make no provision for the secured party's acquisition of the names of debtors he is required to notify.[149] Others protect auction houses, but not buyers.[150] Problems may also arise where the third party transferee has been made aware of the existence of a lien but has not been notified that the lien has been satisfied. Only one statute requires the secured party to notify potential third party transferees of debt satisfaction.[151]

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145. CAL. COM. CODE § 9-307(1)(West Supp. 1984) states: ". . . A buyer in ordinary course of business (subdivision (9) of Section 1201) 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." *Id.*

146. *See supra* text accompanying notes 40-120.

147. Since much of the nonuniform state legislation is tied to purchases in the ordinary course of business, the 9-306(2) controversy may still arise in farm products cases where the sale is to a buyer not in the ordinary course of business and in cases involving transfers of other types of collateral to buyers not in the ordinary course of business. *See, e.g.*, Central Cal. Equip. v. Dolk Tractor Co., 78 Cal. App. 3d 855, 144 Cal. Rptr. 367 (1978) (farm equipment); Bitzer-Croft Motors v. Pioneer Bank and Trust Co., 82 Ill. App. 3d 1, 401 N.E.2d 1340 (1980) (airplane); Cessna Fin. Corp. v. Skyways Enter., Inc., 580 S.W.2d 491 (Ky. 1979) (airplane).

148. *See* ILL. REV. STAT. ch. 26 § 9-306.01 (Smith-Hurd Supp. 1985); MICH. COMP. LAWS ANN. § 440.9307(4)(d) (West supp. 1985); OKLA. STAT. ANN. tit. 12A, § 9-307(3)(9) (West Supp. 1984). *See also* LA. REV. STAT. ANN. § 3:568(f)(Supp. 1985).

149. *See* GA. CODE ANN. § 11-9-307 (Supp. 1985); KY. REV. STAT. § 355.9-307 (Bobbs-Merrill Supp. 1984).

150. *See* GA. CODE ANN. § 11-9-307(3)(1982); MONT. CODE ANN. § 81-8-301 (1983); NEB. REV. STAT. U.C.C. § 9-307 (Supp. 1985); 1983 OR. LAWS ch. 626.

151. IND. CODE ANN. § 26-1-9-307(1)(b) (Burns Supp. 1984) states:

Recognizing that its amendment to Section 9-307 might not be a panacea, the Nebraska Legislature provided for an automatic termination date and a review committee. Nebraska U.C.C. section 9-307(5) states:

> . . . this section shall terminate on September 1, 1987. In 1986 the Executive Board of the Legislature shall designate an appropriate committee of the Legislature to review the operation of . . . this section. The committee shall conduct such review and may postpone legislation to amend or postpone the termination date of . . . this section if the committee deems such action appropriate.[152]

The primary criticism of the numerous nonuniform amendments to the Code has been that they are just that — numerous and nonuniform.

V. FEDERAL PREEMPTION

Relying on the commerce clause, Congress, under section 1324 of the Food Security Act of 1985,[153] preempted state legislation dealing with the purchase of farm products. The express purpose of section 1324 is "to remove [the] burden on and obstruction to interstate commerce in farm products"[154] created by "expos[ing] purchasers of farm products to double payments."[155]

As the bill originated in the House of Representatives, it contained only a prenotification provision. Under the prenotification provision, a "buyer who in the ordinary course of business buys a farm product from a seller engaged in farming operations"[156] would

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(b) A secured party must within fifteen (15) days of the satisfaction of the debt inform in writing each potential buyer listed by the debtor whenever a debt has been satisfied and written notice, as required by subdivision (a), had been previously sent to that buyer. *Id.*

152. NEB. REV. STAT. § 90-307(5) (Supp. 1984).

153. Food Security Act of 1985, *supra* note 9, at § 1324. Section 1324 addresses the rights of buyers separately from those of commission merchants or selling agents, although the provisions are virtually identical. A commission merchant is defined in § 1324(c)(3), as "any person engaged in the business of receiving any farm product for sale, on commission, or for or on behalf of another person." *Id.* at § 1324(c)(3), 1986 U.S. CODE CONS. & AD. NEWS (99 Stat.) at 1536. A selling agent is defined in § 1324(c)(8) as "any person, other than a commission merchant, who is engaged in the business of negotiating the sale and purchase of any farm product on behalf of a person engaged in farming operations." *Id.* at § 1324(c)(8), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1537. Note that the selling agent must represent the farmer. The commission merchant has no such restriction so long as he works on commission. "Buyer" is not defined in § 1324.

154. *Id.* at § 1324(b), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1535.

155. *Id.* at § 1324(a)(3), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1535.

156. *Id.* at § 1324(d), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1538. The term

take free of the security interest unless he received written notice of the security interest, and any payment obligation imposed on the buyer within one year prior to the sale.[157] A Senate amendment was added providing for a central filing exception.[158] This amendment survived the Committee of Conference and provides that states may elect to institute a central filing system, subject to certification by the Secretary of the United States Department of Agriculture.[159] In

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"buyer in the ordinary course of business" is defined in § 1324(c)(1), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1535, as "a person who, in the ordinary course of business, buys farm products from a person engaged in farming operations who is in the business of selling farm products." *Id.* The term, however, does not appear anywhere else in § 1324. The closest reference is the one set out in the text. The other references in § 1324 are to "buyers," a term that is not defined. Unless the reference in § 1324(d) is deemed to incorporate the definition of a "buyer in the ordinary course of business," there is no requirement in § 1324(d) that the seller be in the business of selling farm products.

The choice of the term "buyer in the ordinary course of business" is an unfortunate one in that it differs substantially from the U.C.C. definition, which states: " '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." U.S.C. § 1-201(a) (1972). Thus, a buyer might qualify for protection under § 1324 even though he acts in bad faith or has knowledge from another source that the sale to him is in violation of the security agreement.

157. Food Security Act of 1985, *supra* note 9, at § 1324(e)(1)(A), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1538.

158. H.R. REP. No. 447, 99th Cong., 1st Sess. 486, *reprinted in* 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) 2251.

159. *See* Food Security Act of 1985, *supra* note 9, at § 1324(e)(3) and (g)(2)(C), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1538-39. In order for the central filing system to be certified it must meet the following requirements:

> (A) effective financing statements or notice of such financing statements are filed with the office of the Secretary of State of a State;
> (B) the Secretary of State records the date and hour of the filing of such statements;
> (C) The Secretary of State compiles all such statements into a master list -
> (i) organized according to farm products;
> (ii) arranged within each such product-
> (I) in alphabetical order according to the last name of the individual debtors, or, in the case of debtors doing business other than as individuals, the first word in the name of such debtors; and
> (II) in numerical order according to the social security number of the individual debtors or, in the case of debtors doing business other than as individuals, the Internal Revenue Service taxpayer identification number of such debtors; and
> (III) geographically by county or parish; and
> (IV) by crop year,
> (iii) containing the information referred to in paragraph (4)(D);
> (D) the Secretary of State maintains a list of all buyers of farm products, commission merchants, and selling agents who register with the Secretary of State, on a form indicating -

states maintaining such a system, the secured party has priority over the third party transferee if the secured party has filed an effective financing statement,[160] and the third party transferee either fails to

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(i) the name and address of each buyer, commission merchant, and selling agent in receiving the lists described in subparagraph (E); and

(E) the Secretary of State distributes regularly as prescribed by the State to each buyer, commission merchant, and selling agent on the list described in subparagraph (D) a copy in written or printed form of those portions of the master list described in paragraph (C) that cover the farm products in which such buyer, commission merchant, or selling agent has registered an interest;

(F) the Secretary of State furnishes to those who are not registered pursuant to (2)(D) of this section oral confirmation within 24 hours of any effective financing statement on request followed by written confirmation to any buyer of farm products buying from a debtor, or commission merchant or selling agent selling for a seller covered by such statement.

Id. at § 1324(c)(2), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1536. Additionally, the United States Department of Agriculture is required under § 1324(i), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1540, to "prescribe regulations . . . to aid States in the implementation and management of a central filing system." *Id.*

160. *Id.* at § 1324(e)(2)(B) and (g)(2)(C)(ii), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1538, 1539. The term "effective financing statement" is defined as: . . . a statement that —

(A) is an original or reproduced copy thereof;

(B) is signed and filed with the Secretary of State of a State by the secured party;

(C) is signed by the debtor;

(D) contains,

(i) the name and address of the secured party;

(ii) the name and address of the person indebted to the secured party;

(iii) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue Service taxpayer identification number of such debtor;

(iv) a description of the farm products subject to the security interest created by the debtor, including the amount of such products where applicable; and a reasonable description of the property, including county or parish in which the property is located;

(E) must be amended in writing, within 3 months, similarly signed and filed, to reflect material changes;

(F) remains effective for a period of 5 years from the date of filing, subject to extensions for additional periods of 5 years each by refiling or filing a continuation statement within 6 months before the expiration of the initial 5 year period;

(G) lapses on either the expiration of the effective period of the statement or the filing of a notice signed by the secured party that the statement has lapsed, whichever occurs first;

(H) is accompanied by the requisite filing fee set by the Secretary of State; and

(I) substantially complies with the requirements of this subparagraph even though it contains minor errors that are not seriously misleading.

Id. at § 1324(c)(4), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1537. The use of the term "effective financing statement" is confusing. The U.C.C. uses the term "financing statement" and states:

(1) A financing statement is sufficient if it gives the names of the debtor and the secured party, is signed by the debtor, gives an address of the secured party from

register with the Secretary of State[161] or fails to comply with the payment obligations imposed by the secured party as a condition to release of the security agreement.[162] Although the secured party may include any payment conditions in the financing agreement that is filed with the Secretary of State, such information is not required.[163] Apparently, the third party transferee is required to contact the secured party for payment conditions. This may pose serious problems in sales that are subject to the twenty-four hour payment rule of the Packers and Livestock Act.[164]

The prenotification provision favors the third party transferee. If he has not received[165] notice[166] of the security interest "and any pay-

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which information concerning the security interest may be obtained, gives a mailing address of the debtor and contains a statement indicating the types, or describing the items, of collateral. When the financing statement covers crops growing or to be grown, the statement must also contain a description of the real estate concerned.

U.C.C. § 9-402 (1972). The requirements are not the same. Thus, the financing statement filed by the secured party for purposes of perfecting his security interest against third parties *not* covered under § 1324 will not afford protection against third party transferees of farm products.

161. Food Security Act of 1985, *supra* note 9, at § 1324(e)(2)(A) and (g)(2)(C)(i), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1538, 1539.

162. *Id.* at § 1324(e)(3)(B) and (g)(2)(D)(ii), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1538-39, 1540.

163. *See supra* note 160 for the elements of an effective financing statement under § 1324(c)(4).

164. 7 U.S.C. § 228b (1982).

165. Receipt is determined by the state law of the third party transferee residence. Food Security Act of 1985, *supra* note 9, at § 1324(f) and (g)(3), 1986 U.S. Code Cong. & Ad. News (99 Stat.) at 1539, 1540. Section 1324(g)(3) refers to the buyer's residence, but it is clear from the rest of the section that this should refer to the commission merchant's or selling agent's residence. Otherwise, whether the selling agent or commission merchant received notice in any instance will turn on the residence of his buyer.

166. *See Id.* at § 1324(e)(1)(A) and (g)(2)(A), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1538, 1539. Under section 1324(e)(1)(A), notice is sufficient if:

> (1)(A) within 1 year before the sale of the farm products, the buyer has received from the secured party or the seller written notice of the security interest organized according to farm products that -
>
> (i) is an original or reproduced copy thereof;
>
> (ii) contains,
>
> (I) the name and address of the secured party;
>
> (II) the name and address of the person indebted to the secured party;
>
> (III) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue Service taxpayer identification number of such debtor;
>
> (IV) a description of the farm products subject to the security interest created by the debtor, including the amount of such products where applicable, crop year, county or parish, and a reasonable description of the property and

ment obligations imposed on the buyer by the secured party as conditions for waiver or release of the security interest,"[167] he takes clear title to the farm products. The burden is on the secured party to identify and notify the third party transferee. The Act allows the secured party to obtain prospective buyer identification from the debtor.[168] The only penalty, however, for selling to a third party transferee not previously identified by the debtor is a fine *not* payable to the secured lender.[169] The secured lender has no recourse against the third party transferee and probably will not be able to collect from the debtor.

The central filing alternative more evenly allocates the risk between the secured lender and the third party transferee. Under this system, both parties must act in order to be protected. The secured party must file an effective financing statement[170] and the third party transferee must either register with the secretary of state or make inquiry prior to each transaction.[171] This system, in most instances, protects both parties when they act affirmatively to protect themselves. The party who fails to act bears the loss. Exceptional circumstances would arise if the office of the Secretary of State makes a mistake or if the debtor misrepresents his identity; the statute does not address the allocation of risk of loss in these situations. It would seem equitable, in the case of the fraudulent debtor, to put the loss

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(iii) must be amended in writing, within 3 months, similarly signed and transmitted, to reflect material changes;

(iv) will lapse on either the expiration period of the statement or the transmission of a notice signed by the secured party and the statement has lapsed, whichever occurs first; and

(v) any payment obligations imposed on the buyer by the secured party as conditions for waiver or release of the security interest; . . . . *Id.*

Section 1324(g)(2)(A) is identical, except that "commission merchant or selling agent" is substituted for "buyer."

167. *Id.* at § 1324(e)(1)(A)(v), *supra* note 166.

168. *Id.* at § 1324(h)(1), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1540.

169. Section 1324(h)(3), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1540 provides:

(3) A person violating paragraph (2) shall be fined $5,000 or 15 per centum of the value or benefit received for such farm product described in the security agreement, whichever is greater.

The debtor may sell off-list under § 1324 without liability if he:

(A) has notified the secured party in writing of the identity of the buyer, commission merchant, or selling agent at least 7 days prior to such sale; or

(B) has accounted to the secured party for the proceeds of such sale not later than 10 days after such sale.

Id. at § 1324(h)(2), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1540.

170. *See supra* note 166 and accompanying text.

171. *See* § 1324(c)(2)(D) and (F), *supra* note 159.

on the party who is deceived. In the case of mistake by the Secretary of State, the regulations to be prescribed by the Secretary of Agriculture "to aid states in the implementation and management of a central filing system"[172] should require adequate insurance against such loss as a condition to certification.

The provisions of section 1324 have an effective date of December 23, 1986.[173] This one year hiatus between the passage of the bill and its effective date will give secured parties and buyers an opportunity to adapt their business procedures to the new statute. It will also provide the various state legislatures that meet during this period the opportunity to consider establishing a central filing system. Finally, and most importantly, it will give Congress an opportunity to reconsider some of the problems presented by the current provisions of section 1324.

The most glaring problem with section 1324 is that the statute, designed to remedy problems caused by the nonuniformity of state legislative provisions, nonetheless sanctions nonuniform procedures. Some states will determine disputes based on the prenotification provision, others will opt for central filing. This, obviously, could lead to inconsistent results. A buyer who takes no affirmative action and is without notice of a security interest in a prenotification state would take free of the security interest. That same buyer would take subject to the security interest in a central filing state, if the secured party had filed. Theoretically, the buyer in the prenotification state would know of the security interest if the secured lender had taken some affirmative steps similar to the filing by the secured lender in the central filing state. The difference is that in the prenotification state, the secured lender must rely on the debtor to provide accurate information regarding potential buyers.

Section 1324 promotes additional nonuniformity insofar as the individual states will determine when to send the lien information to third party transferees.[174] State law will also determine what constitutes "receipt" under section 1324.[175] This deference to state law apparently stems from Congressional sensitivity to the constitutional limitations on the use of the commerce clause to regulate the states

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172. *See* § 1324(i), *supra* note 159.

173. Food Security Act of 1985, *supra* note 9, at § 1324(j), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1540.

174. *See* § 1324(c)(2)(E), *supra* note 159.

175. *See supra* note 165.

as states.[176]

Moreover, under the central filing option, the secured party who files will still not be protected if the transaction occurs after the filing but prior to receipt of the notice of lien by the third party transferee. The Act provides that lien information will be mailed to registered third party transferees "regularly."[177] The third party transferee takes subject to the security interest, however, only if he has received written lien notice from the Secretary of State.[178] Therefore, if the secured party has filed with the Secretary of State prior to the sale but the sale occurs prior to the next regular distribution of lien information to the third party transferee, the secured party is not protected.

The most serious flaw in section 1324 is the "hidden lien," which can arise if the debtor produces his farm products in a central filing state and sells them to a third party transferee in a prenotification state. Section 1324(e)(2) provides that the central filing rules will apply to farm products *produced* in states that have established central filing systems. These rules do not expressly apply to farm products *sold* in a central filing state. If the third party transferee does not know that the farm products were produced in a central filing state, he will assume that he is buying with a clear title based on his lack of prenotification. Yet, he will take subject to the security interest filed in the central filing state in which the farm products were produced based on his failure to register.[179] The third party transferee is thus exposed to double liability based on a hidden lien of which he was unaware and the existence of which he had had no practical means of discovering. This, of course, is the very dilemma that section 1324 expressly purports to rectify:

> [C]ertain State laws permit a secured lender to enforce liens against a purchaser of farm products even if the purchaser does not know that the sale of the products violates the lender's security interest in the products, lacks any practical method for discovering the existence of the security interest, and has no reasonable means to ensure

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176. *See* National League of Cities v. Usery, 426 U.S. 833, *overruled*, Garcia v. San Antonio Metropolitan Transit Auth., 105 S. Ct. 1005 (1985).

177. Food Security Act of 1985, *supra* note 9, at § 1324(c)(2)(E), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1536.

178. *Id.* at § 1324(e)(3)(A) and (g)(2)(D)(ii), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1538, 1540.

179. *Id.* at § 1324(e)(2)(A) and (g)(2)(c)(i), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1538, 1539-40.

that the seller uses the sales proceeds to repay the lender.[180]

The hidden lien will also arise where the goods are produced in one central filing state and are sold in another central filing state. If the third party transferee is without knowledge that the farm products were produced in another central filing state, he will rely on the lack of lien information from his Secretary of State. The third party transferee will take subject to the security interest, again because of his failure to file in the central filing state where the goods were produced.[181]

The obvious solution to the problem of nonuniformity is for Congress to mandate one system or the other. Of the alternatives available under section 1324, the central filing option provides for a more equitable allocation of risk of loss in that both parties are required to act affirmatively in order to be protected. Inherent in the central filing system, however, is the problem of the secured party's exposure during the period between the filing by the secured party and the "regular" distribution of lien information by the Secretary of State to registered third party transferees. Central filing poses an additional problem — the need for two filing systems. The secured party will still have to comply with state Article Nine provisions and filing requirements for protection against parties who are not buyers, commission merchants or selling agents. Because of the expense involved and because ordering the states to set up central filing systems would offend the traditional reluctance of Congress to impose fiscal obligations on the states,[182] it is unlikely that the federal government will mandate such a system.

The prenotification option under section 1324 favors the buyer, but is still preferable to an alternative approach that would allow nonuniform treatment from state to state and hidden liens where farm products are produced in one state and sold in another. It is also preferable to central filing alone. Under either system — central filing alone, prenotification alone or the alternative approach set up by section 1324 — an innocent party suffers only when the debtor acts fraudulently. Under a system based solely on prenotification, the

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180. *Id.* at § 1324 (a)(1), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1535.

181. *Id.* at § 1324(e)(2)(A) and (g)(2)(C)(i), 1986 U.S. CODE CONG. & AD. NEWS (99 Stat.) at 1538, 1539-40.

182. Compare similar considerations underlying the adoption and construction of the eleventh amendment. D. CURRIE, FEDERAL COURTS CASES AND MATERIALS 538 (3rd ed.). *See also* Edelman v. Jordan, 415 U.S. 651, 660-72 (1974).

secured party would bear the risk of loss when the debtor sells off-list. Arguably, any such loss is a cost of doing business properly allocable to the lender. A system based solely on prenotification would also avoid the confusion that will inevitably result from the existence of two filing systems. Such a system might reduce the availability or increase the cost of farm credit, however, because of the greater risk incurred by farm products lenders in situations where the farm debtor sells all of the collateral at one time. This risk must be balanced against the risk borne by the third party transferee who is subjected to hidden liens.

A third possible solution is a *federal* central filing system operated by the Department of Agriculture, with separate files devoted to various categories of farm products. This alternative would eliminate the hidden lien problem created when the debtor produces farm products in one state and sells them in another. It would also eliminate the risk borne by the secured parties under a prenotification statute when the debtor sells off-list. Under this system all potential third party transferees of a particular category of farm products would receive lien information on all debtors. Obviously, the confusion of dual state filing systems would also be eliminated. The initial cost of the system would have to be borne by the federal government, but it could be reimbursed and the system maintained from filing fees.

VI. CONCLUSION

The dilemma of the farm products transferee was the result of inconsistent judicial opinions, various nonuniform state amendments to the U.C.C., local filing requirements and the provisions of the Packers and Stockyards Act. The dilemma turned into a crisis, however, with the failing farm economy of the 1980's.

The dramatic increase in the incidence of default by the farm debtor focused national attention on the problem. The result of this national attention is section 1324 of the Food Security Act of 1985. It represents an earnest Congressional attempt to resolve a national commercial crisis. It falls short, however, in several respects. First, section 1324 sanctions continued nonuniformity in the area of farm products secured lending by permitting states to opt for either prenotification or central filing. It also permits state law to determine critical issues, such as when lien information will be sent to third party transferees and what constitutes receipt under the Act. Finally, the Congressional scheme under section 1324 gives rise to a hidden lien

where a debtor produces farm products in a central filing state and sells them to a third party transferee in a prenotification state.

In the interest of providing a uniform national approach to the problem of unauthorized disposition of farm collateral, section 1324 should be amended to eliminate the prenotification-central filing option. Of the two alternatives, a system based on prenotification alone is preferable. A *federal* central filing system, however, would provide an even more equitable allocation of risk of loss and would virtually eliminate the problems caused by nonuniform state treatment of unauthorized dispositions of farm products collateral.