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Reforming Article 9 Priorities in Light of Old Ignorance and New Filing Rules (Symposium: 'Managing the Paper Trail': Evaluating and Reforming the Article 9 Filing System)

James J. White
University of Michigan Law School, jjwhite@umich.edu

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James J. White*

The other papers in this Symposium demonstrate that we have the technical capacity to build a filing system that will exceed the expectations of Grant Gilmore in every dimension.¹ With more thought about what is put into the system and more clever software to get it out, the most sophisticated system possible under current technology will store and produce enough information about a debtor to give the ACLU a fright.

All of the issues on improving the filing system are important, but I do not concern myself with any of them directly. I am

* Robert A. Sullivan Professor of Law, University of Michigan Law School, Ann Arbor, Michigan.


Of course, there are many questions and doubtless many trade offs involved with the construction of a new filing system. But I am certain our federalist politics will keep us from achieving all that technology will offer. First among the Federalists is the National Conference of Commissioners on Uniform State Laws. Its determined insistence on making these filings state law and state governed is a stumbling block to the kind of nationwide system that a national and international economy demands. See Walter F. Armstrong, Jr., A Century of Service, A Centennial History of the National Conference of Commissioners on Uniform State Laws 129-31 (1991) (describing the need to draft and enact uniform state laws in the area of commercial law). Even if the states can be persuaded to adopt modern flexible computer based systems, and even if all states adopt Professor LoPucki's filing at the place of incorporation, we will have a system still short of our technological capacity but far beyond today's paper-bound systems. See LoPucki, supra, at 581, 591.

Some states have already made great strides. In Louisiana, creditors may make a UCC filing for all security interests, except those in motor vehicles, with the clerk of court of any parish regardless of the location of the property. La. Rev. Stat. Ann. § 10:9-401(1)(b) (West 1993). All filings are put into a central database accessible from all parishes. Searchers may access the database through the clerk of court of any parish and receive filing information for interests filed anywhere in the state. In Nebraska, all filings at the state level are made at one central location, and local filings are made in each county. Neb. Rev. Stat. § 9-401 (Reissue 1980). Both state and local filing information is put into one database and can be searched through any office of the Secretary of State.
here to discuss a different question. In light of the proposed new filing system, this Article asks what legal rights should accrue to the first to file. One might argue that my essay is out of place in a Symposium that deals with filing. But filing does have legal purpose, not so? There is no filing for filing's sake. At minimum, the energy that the filing project deserves might be influenced by the legal consequences, and the propriety of certain legal consequences may depend on the nature of the available filing system. One of my hypotheses is that reform in filing may call for reallocation of risks between filers and searchers.

I approach the issue of what legal rights should flow from filing with three questions. I first ask what we know about the uses of the system. I then ask what rights should be granted based on that knowledge and based on our ideas of fairness and efficiency. Finally, I ask how those rights should change in the face of new filing systems that will make the collection and dissemination of reliable information cheaper and easier.

I. WHAT DO WE KNOW ABOUT CREDITOR BEHAVIOR? HOW IS THAT KNOWLEDGE RELEVANT?

One of the Ten Commandments of Mercantile Law is that an effective filing system is the center pole that holds up the entire personal property security tent. When I recall thirty years of teaching Article 9, I can hear myself in October classes extolling the Article 9 filing system:

This filing system is an integral part of the most sophisticated secured lending known to mankind. Only by an effective filing system can a secured lender know of other lenders and only by it can later secured lenders and unsecured lenders be encouraged to lend. Without such a system, lenders would grow wary, commerce would be hobbled, and the manifold commercial ends that are met by commercial lenders would be stunted, rendered more costly, or stymied altogether. Every day thousands or tens of thousands of secured and unsecured lenders search the files and act in reliance on the information found there. I can see generations of law students writing this down and repeating this incantation in negotiations, in court, and elsewhere. This view even extends to Americans abroad who approach the English, Dutch, and Germans with an air of superiority, asserting the superiority of our filing system and belittling the European efforts2 to put together a filing system worthy of the name.

2. See generally Security on Movable Property and Receivables in Europe (Michael G. Dickson et al. eds., 1988) (discussing systems for obtaining security interests in Europe); Enrico Gabrielli, Security over Movables in Italy, J. Bus. L., Sept. 1992, at 525, 531, 542 (Italy) (discussing security interests and

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These encomiums of the Article 9 filing system rest on two assumptions that are seldom challenged. First is the assumption that a significant percentage of lenders, secured and unsecured, rely on the state of the filing records to find out about prior perfected secured creditors. Second is the assumption that the behavior of these creditors would be different if there were no such system. For many creditors in modern industrial society, these assumptions are not accurate. It would come as some surprise to find that the mine run trade lender in the Bronx ever checks the files in Albany. It is similarly doubtful that the plumber, the carpenter, or even the general or sub-contractor, checks the files or collects data from the files through a reporting service such as Dun & Bradstreet. Surely, the mainline secured creditors, the banks, GMAC, GECC, who file to perfect their own interests must also check the files. One would expect any filer to have checked the files.

But what reliance do these filers place on the filing system? And more to the point, how would they behave in the absence of a filing system? Any creditor that is to be the principal inventory, equipment, or account receivable lender to a substantial mercantile enterprise will have many sources of information about the prospective borrower; the filing system is unlikely to be the most important source. The debtor and the debtor’s records are obvious sources of information. Even if the debtor is not forthcoming, there may be signs in its books and records. Doubtless creditors collect information from one another. None of these is a perfect source of information, but of course neither is the filing system. That secured financing can flourish in modern industrial European economies in the absence of an effective filing system should also cause us to question our assumptions. Because filing is usually necessary to defeat a trustee in bankruptcy, one cannot even infer from the large number of filings that filers rely upon the system to defeat other secured creditors. Their filings may be mostly insurance against bankruptcy.

If the only function of the filing system is to enable a creditor to defeat a trustee in bankruptcy, and if no creditor relies upon filings or the absence of filings, we should abolish the filing system. We could save time and effort by direct subordination of the trustee in bankruptcy to any effective security interest, whether
or not perfected. Indeed, if that is the state of nature, almost every penny spent in drafting laws for filing systems and operating those systems is wasted.

Given the assertions of secured creditors about the importance of the filing system, it seems unlikely that the world in the United States is as I describe it. It is more plausible that many secured creditors and perhaps even some unsecured creditors rely on the filing system to inform them about their debtor's liens and about their probable priority.

I raise these questions not because I believe there are no creditors who rely on the filing system, but because by hyperbole I hope to emphasize our ignorance about the behavior of creditors. I want us to confront the issue about what law is best adopted when one must legislate in the absence of good information about existing creditor behavior and about potential creditor response to new laws. Creditors are not potted plants; they can and surely will react in many and unpredictable ways to new law. Recognizing that there are effective and apparently efficient lending systems in Europe, in countries that do not have filing systems like our own, and understanding that there are alternative sources for much of the information that a filing system provides, the drafters should approach the assertions of secured creditors with some skepticism, and should at least understand that they are drafting law based on assumptions about and in considerable ignorance of creditor behavior.

II. EXAMINING THE CONSEQUENCES OF A PERFECT FILING SYSTEM: GOOD COMMERCIAL LAW AND BAD

At least as important as the qualities of the filing system itself is the consequence of a proper filing. What rights should attach to the first to file? Should that person beat all others, beat most people, or should the first to file achieve superiority over only low lying snakes like the trustee in bankruptcy and lien creditors?

At the highest level of generality most of us would agree that the legal consequences that attach to the first filing should be fair and efficient. What is fair? For this purpose I define a rule as fair if it meets legitimate expectations of a reasonable business person who is not necessarily familiar with the rule. If, for example, every banker, debtor, and business person would expect a purchase money lender to take priority over a prior perfected security interest, then purchase money priority is fair. If, on the
other hand, the expectations are reversed, by my definition the converse is fair. Because the expectations of the fully informed are necessarily affected by the rule itself, I test fairness by the reaction of reasonably intelligent but uninformed players.

What is efficient? An efficient system is easy and inexpensive to use. Filing requirements that are quirky, cranky, or expensive are not efficient. In addition, the rules of priority must be certain. Certainty promotes efficiency because it allows the parties who do not wish to be governed by the rule to know what and how to negotiate to avoid the rule. Certainty minimizes litigation and the cost of litigation because outcomes are predictable. Finally, an efficient system facilitates socially desirable transactions. If it is socially desirable that security and priority be easy to get, our system should facilitate that. If, however, the same transactions would occur at no greater cost without a filing system, then even an inexpensive filing system may be inefficient.

To understand the difficulties that a legal drafter of a filing and priority system encounters, let reality intrude a little. Although there will be wide agreement on the goals of efficiency and fairness, that apparent consensus will give way to disagreement and even bitter conflict when one considers specific proposals based upon these theories.

Our ignorance about the actual use of the system helps disagreement. We have no clear idea about the number and kind of persons who rely on the filing system in making decisions. Second, we are ignorant, except in the grossest way, of the true expectations of the parties to this system. Do purchase money lenders expect to be first? Do others expect them to be first? Or do purchase money lenders expect to be first only when they have procured a subordination agreement from a prior lender? Does this differ from region to region and among types of collateral?

Moreover, we are almost completely ignorant about and would fall into quick disagreement over the effect of a sophisticated filing system on mercantile transactions. We see countries with the most sophisticated filing systems, such as Norway's,3

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3. John Schjelderup Olaisen, of Norway Group, A.S., provided the following information on the Norwegian filing system.

Under the Collateral Law of 1980, Norway has two separate systems of registers—one for real estate and another for movable assets. Real estate registration covers real estate, land, buildings, and other assets that can be identified by a particular assigned property identification number. Real estate registration is mandatory and must be made locally by filing documents in one of the 88 local court offices. All local filings are updated daily onto one central register. Com-
and nearby countries such as the Netherlands and Germany with crude—some would say nonexistent—systems.\(^4\) It is hard to argue that Germany's or Holland's commerce, much less Britain's, suffers for want of a good filing system. The filing system hardly looks like a significant variable in the formula for a successful mercantile economy (but for the purpose of this Symposium, let's disregard that lugubrious possibility).

This Paper cannot define fairness and efficiency in Article 9. My model for measuring fairness is not the only choice. Should we measure fairness by the expectations of the person I have posed, the reasonably intelligent but uninformed player, or should it be a person who knows the law and acts in response to it? Fairness to one is not necessarily fairness to the other.

Note, too, that there is no reliable testimony on what is efficient. The Drafting Committee for the revision of Article 9 will be assailed at every meeting by representatives of secured creditors, unsecured creditors, subsets of each, and perhaps even debtors. Each of these representatives will feel free to characterize various players' motivation and behavior and to predict how some like and others unlike themselves will behave in the face of new law. Many of these statements will be self-serving. None of them will be backed up by the kind of rigorous examination of practice that would satisfy social scientists. For both of those

mercials can access the system through an online communication system and retrieve all Norwegian registrations by named person or property identification number regardless of the location of the local filing. The general public can access the system at no charge by visiting, faxing, or phoning any local court office.

Registration of movable assets is voluntary and includes assets such as inventory, receivables, machinery, livestock, and automobiles. Security interests in these items are recorded in a central registry by sending the documents to a central location where they are scanned into the system and returned to the sender as certified originals—no documents or copies are maintained in hard copy. Although the movable asset registry is not integrated with the real estate registry, the two can be reached through the same online system by commercial users. The general public can access the central registry directly by fax, phone, or letter.

This computerization of the Norwegian filing system has greatly increased the availability of quick, direct access by the commercial market to reliable and updated information on security interests. This in turn has led to improved security on lending and greater access to capital for Norwegian businesses. Norway Group, A.S. has recently been assigned export rights to the Norwegian filing systems and software, and has been selected to design and implement the computerization of the Polish filing system.

reasons, most of these assertions deserve limited credence. The drafters of the filing system and of the priority system that depends upon it must grope their way in ignorance and in the face of confusing, if earnest, assertions about the state of nature, about parties' intentions, and about the effect of legal revision on that behavior.

How should a drafter of commercial law respond to this kind of ignorance? Perhaps the drafters should leave well enough alone. After all, secured creditors, unsecured creditors, and debtors have all accommodated in one way or another to the existing Article 9. If one must concede ignorance about the consequence of one's action, perhaps no action should be taken. Whatever the virtue of that argument, it has been left in the dust. The caravan is now in motion and Article 9, for better or worse, will be redrafted.

Like the physician, at the least we should do no harm. That means that the new law should be simple, easily changed by agreement, and should impose the smallest transaction costs possible. At minimum we can draft law that does not increase transaction costs—whether or not the law is wise in other respects. Perhaps we can reduce transaction costs; that alone is a worthy aim for a drafter otherwise ignorant of the law's impact. I think ignorance argues in favor of my proposal: to grant priority to the first to file and to force others to defend their right to superiority over the first to file. My proposal has the virtue of certainty and ease of understanding. It imposes the most modest of transaction costs, and it is likely to cause little litigation.

III. FIRST TO FILE, THE KING?

As a touchstone against which to measure proposals for priority and in the face of our ignorance about the state of parties' motivations and intentions, I start with the hypothesis that the first to file should defeat all others, both those coming before and those coming after. I propose that we examine each exception to that rule by testing it against our ideas of fairness and efficiency, recognizing always that we are making these decisions in considerable ignorance.

A priori, making the first to file victorious over all others has much to commend it. Every priority system that I know of has some form of first-in-time first-in-right rule. Crudely, therefore, it meets the expectations of many persons in many circumstances. It is efficient too. At minimum it facilitates one transaction that is probably socially desirable, namely, a loan by the first
to file. Like all rigid rules it is certain to a fault and, if the filing proposals that are before this Symposium are adopted, will be inexpensive. Certainty will make it easy to know when and how one must negotiate out of the rule and will make the outcome of litigation so predictable that one expects priority litigation to melt away to nothing.

A. Rights of the First to File under Current Law

I group the parties who challenge the first to file into three sets. The first is prior parties. The second is later claimants to the same collateral. The third is later claimants to derivative or after-acquired collateral.

Many whose rights arise prior to the first to file enjoy priority over the first to file under current law. First of these prior parties is the holder of a title to collateral that was never transferred to the debtor. This group includes the lessor who leases goods to the debtor, the true owner of the collateral whose goods are stolen and passed to the debtor, and possibly others who have rights to reclaim the goods from the debtor and from third parties. Another party whose rights arise earlier than the first

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6. Here the thief has void title and thus cannot pass good title to the debtor under UCC § 2-403(1). See, e.g., United States v. Michaels Jewelers, Inc., 42 U.C.C. Rep. Serv. (Callaghan) 141, 145 (D. Conn. 1985) (title for stolen goods did not pass); Justice v. Fabey, 541 F. Supp. 1019, 1022 (E.D. Pa. 1982) (where truck seized by police on grounds that it was stolen property was later sold to third party who in turn sold to plaintiff, good title was destroyed by initial theft); Anderson Contracting Co. v. Zurich Ins. Co., 448 So. 2d 37, 41 (Fla. Dist. Ct. App. 1984) (innocent purchaser of stolen property has no rights against rightful owner); Brown & Root, Inc. v. Ring Power Corp., 450 So. 2d 1245, 1249 (Fla. Dist. Ct. App. 1984) (possessor by theft cannot convey good title to bona fide purchaser); Bay Springs Forest Prods., Inc. v. Wade, 435 So. 2d 690, 692 (Miss. 1983) (trespasser who cut timber on plaintiff's land acquired void as opposed to voidable title); Allstate Ins. Co. v. Estes, 345 So. 2d 265, 266 (Miss. 1977) (bona fide purchaser of stolen vehicle received void title); Touch of Class Leasing v. Mercedes-Benz Credit, Inc., 591 A.2d 661, 666 (N.J. Super. Ct. App. Div.) (seller was thief unable to pass good title), cert. denied, 599 A.2d 1069 (N.J. 1989). In this case, the court affirmed a replevin order directing a buyer of silver from Goodwill Industries to return the silver to the plaintiffs, from whom Goodwill acquired possession of the silver. Id. at 580.
to file, but who takes priority under Article 9, is the secured creditor who has perfected its security interest by taking possession. Section 9-312(5) gives that person priority.\footnote{8}

But there are many other prior parties subordinate to the first filer. Among those are the takers of an earlier, but unperfected, security interest,\footnote{9} and sellers of goods on unsecured credit under section 2-702 who are not paid.\footnote{10} They also include

\begin{itemize}
  \item Goodwill acquired the silver when plaintiffs unknowingly left the bags containing the silver with Goodwill (at the time, plaintiffs believed the bags contained only clothes). \textit{Id.} Relying on comments added by the Illinois legislature, the court ruled that “entrustment” under UCC § 2-403(2) and (3) requires a “voluntary” transfer of possession. \textit{Id.} at 581-82. Therefore, the court reasoned, the plaintiffs’ mistake did not constitute entrustment and they were entitled to a replevin order against the buyers from Goodwill. \textit{Id.} at 582; see, e.g., Textile Supplies, Inc. v. Garrett, 687 F.2d 123, 127 (5th Cir. 1982) (where plaintiff’s salesman stole carpet from plaintiff and then sold carpet to defendant, defendant did not acquire title under UCC § 2-403(1)(d) because plaintiff never dealt with wrongdoer in the transaction); \textit{In re} Woods Farmers Coop. Elevator Co., 107 B.R. 678, 680 (Bankr. N.D. 1989) (bailee has no rights in collateral); \textit{In re} Shamrock Coal Co., 47 B.R. 887, 868 (E.D. Pa. 1985) (equipment installed by construction company in debtor’s plant not subject to creditor’s security interest in equipment because equipment had been installed on purely experimental basis, experiment failed, and no contract of sale to debtor existed); Youngblood v. Bailey, 459 So. 2d 855, 858 (Ala. 1984) (plaintiff defrauded defendant out of winning lottery ticket by bad check, then transferred winnings of ticket to third party; court held that third party received void as opposed to voidable title, and thus winnings reverted to defendant); Chartered Bank v. Chrysler Corp., 171 Cal. Rptr. 748, 750-51 (Ct. App. 1981) (where seller never had interest in boat, purchaser could not acquire rights in boat and security interest of purchaser’s financier thus never attached); State Bank of Young Am. v. Wagener, 479 N.W.2d 92, 95 (Minn. Ct. App. 1992) (debtor only had possession of pigs in order to fatten them and had no rights in the collateral); Disch v. Raven Transfer & Storage Co., 561 P.2d 1097, 1098 (Wash. Ct. App. 1977) (tenant in furnished house had no power to pledge furnishings); Chrysler Corp. v. Adamic, Inc., 208 N.W.2d 97, 103 (Wis. 1973) (seller did not acquire rights in goods returned by buyer for adjustment), \textit{overruled on other grounds}, Daniel v. Bank of Hayward, 425 N.W.2d 416 (Wis. 1988).

8. “Conflicting security interests rank according to priority in time of filing or perfection.” U.C.C. § 9-312(5). Possession is one means of perfecting a security interest. \textit{Id.} § 9-305.


10. An unsecured seller’s right to reclaim goods that buyer received on credit while insolvent is subject to rights of a buyer in the ordinary course and good faith purchasers. \textit{Id.} § 2-702(3); see \textit{In re} MacMillan Petroleum (Arkansas), Inc., 115 B.R. 175, 179 (Bankr. W.D. Ark. 1990) (unpaid seller seeking to reclaim under § 2-702 loses to a good faith purchaser from the debtor under § 2-702(3); under § 1-201(32)-(33), floating lienor is a good faith purchaser); \textit{In re} Lawrence Paperboard, Corp., 52 B.R. 907, 910 (Bankr. D. Mass. 1985) (interest of an unpaid seller in goods delivered to buyer is subordinate to interest of a secured party who qualifies as a good faith purchaser); Petroleum Specialities, Inc. v. McLouth Steel Corp., 22 B.R. 722 (Bankr. E.D. Mich. 1982) (seller’s right to reclaim is subject to claims of a good faith purchaser).
others who somehow grant voidable title in a fraudulent transfer to the debtor, who then passes good title to the secured creditor acting as a good faith purchaser. These secured creditors are protected by section 2-403.11

The final group of prior parties is the earlier secured creditor who has done an improper filing that is somehow discovered by the first to file. That klutz is saved by the diligence of our first to file creditor when the King discovers the improperly filed financing statement. Section 9-401(2) says so.12

All of these groups have one thing in common: their claims arise prior to the King's filing. They are mixed willy nilly with a number of other persons, such as prior but unperfected secured creditors and prior unsecured creditors, who are subordinated to the first to file King.

A second set that currently has priority over the King is later claimants to the same collateral. There are at least three classes whose claims to the collateral arise after the King's filing as to the very same collateral, but who still enjoy superiority over the King's claim. Most prominent of these is the buyer in the ordinary course under section 9-307.13 Also superior are certain

11. U.C.C. § 2-403(1). See, e.g., Shell Oil Co. v. Mills Oil Co., 717 F.2d 208, 211-12 (5th Cir. 1983) (owner of voidable title cannot transfer good title to one who lacks good faith); Los Angeles Paper Bag Co. v. James Talcott, Inc., 604 F.2d 38, 40 (9th Cir. 1979) (delivery of goods to third party was sufficient to pass buyer's rights and title, perfecting floating lien); In re Samuels & Co., 526 F.2d 1238, 1241 (5th Cir.) (perfection of security interest prevails over interest of an unpaid seller in delivered goods), cert. denied, 429 U.S. 834 (1976); General Elec. Credit Corp. v. Tidwell Indus., 565 P.2d 868, 870-71 (Ariz. 1977) (en banc) (defaulting buyer has the power to transfer title to a good faith purchaser); Charles Evans BMW, Inc. v. Williams, 355 S.E.2d 650, 651-52 (Ga. Ct. App. 1990) (imposter bought car from owner with fraudulent check, thus acquiring voidable title which became good title on resale to car dealer under UCC § 2-403(a)(1)); Western Idaho Prod. Credit Ass'n v. Simplot Feed Lots, Inc., 678 P.2d 52, 54-55 (Idaho 1984) (where farmer never received payment for barley sold to third party who in turn sold to bona fide purchaser, voidable title passed to bona fide purchaser); Peck v. Augustin Bros. Co., 279 N.W.2d 397, 399-400 (Neb. 1979) (conditional sales of cattle, paid by draft in commercially immediate time frame and treated as money by parties, were cash sales governed by the UCC); Gus Z. Lancaster's Stock Yards, Inc. v. Williams, 246 S.E.2d 823, 826-27 (N.C. Ct. App. 1978) (corporate defendant who accepted pigs in satisfaction of pre-existing debts was acting as an agent and could not be a good faith purchaser); Big Knob Volunteer Fire Co. v. Lowe & Moyer Garage, Inc., 487 A.2d 953, 956-58 (Pa. Super. Ct. 1985) (seller who ordered and received, but did not pay for, chassis of fire truck, had power to transfer all rights to buyer).


13. Id. § 9-307(1) ("A buyer in ordinary course of business . . . takes free of a security interest created by his seller . . . ").
REALLOCATING RISK

lien creditors\textsuperscript{14} and some nonordinary course buyers\textsuperscript{15} A second
group of candidates who also take priority is ordinary course pur-
chasers of chattel paper and instruments,\textsuperscript{16} and holders in due
course of negotiable instruments.\textsuperscript{17} In some cases these parties
take priority despite their knowledge of the King's claims. Last
are creditors whose interests arise after the goods move across
state lines or, with respect to intangibles, after the debtor moves
across a state line. Section 9-103 elevates these persons as to the
very same collateral.

A third group, later claimants to derivative or after-acquired
collateral, also currently takes priority over the first to file.
There are three classes here, too. The most important are
purchase money creditors. They enjoy priority under sections 9-
312(3) and 9-312(4) to the extent they finance new purchasers
and promptly perfect and, with respect to inventory, give notice
to prior secured creditors.\textsuperscript{18} Second are persons with perfected
security interests in proceeds in circumstances where filing
should be made in another state, or in the rare case, where the
original filing was local as to the collateral but should have been
in the Secretary of State's office with respect to proceeds or vice
versa. The final class is secured creditors who take security in-
terests in debtor's collateral more than four months after the
plaintiff has reorganized or changed its name. These enjoy prior-
ity by virtue of section 9-402(7), which invalidates the King's
early filing when the original filing becomes substantially
misleading.

When one summarizes the rights of the first to file under
current law, it is hard to see the principle that earns the King
priority in certain circumstances and subordinates the King in
others. A skeptic might say that the priority rules in Articles 2
and 9 are no more than a set of ad hoc rules that portray the
power and interests of the parties that influenced the drafting of
Articles 2 and 9. Although there may be a kernel of truth to that
claim, I suspect that the complexities of and variation in the un-
derlying transactions call for varied rules and sometimes obscure

\textsuperscript{14} Id. § 9-301(4) ("A person who becomes a lien creditor while a security
interest is perfected takes subject to the security interest . . . . ").

\textsuperscript{15} Id. § 9-307(3) ("A buyer other than a buyer in ordinary course of busi-
ness . . . . takes free of a security interest . . . . ").

\textsuperscript{16} Id. § 9-308 (concerning purchase of chattel paper and instruments).

\textsuperscript{17} Id. § 9-309 (concerning protection of purchasers of instruments, docu-
ments, and securities).

\textsuperscript{18} Id. § 9-312(3) (purchase money security interest in inventory); id. § 9-
312(4) (purchase money security interest in collateral other than inventory).
the guiding principles. Even if there is a principle somewhere in this dung heap, the hodge podge of current rules on priority should not satisfy us.

B. **Revising Current Priority, Filers vs. Searchers under a Revised Filing System**

Treating first filer as King, let us now consider the arguments of each of the competitors who currently enjoys priority over the King. To do that, I propose to canvas the arguments that have traditionally been given for priority of these persons and also to speculate about the virtues and vices of making the King superior. In some cases efficiency may point one way and fairness another. Never mind that the firmest conclusions about fairness and efficiency will be erected, beam on pillar, on empirical sand.

1. Parties with Prior Claims

Under the current Code, filing is everything as to certain competitors whose claims arise prior to the filing; it is nothing as to others. In the former group are creditors who take security interests, but have failed to perfect those interests. The filing and priority rules of Article 9 are aimed directly at them; a principal consequence of being the first to file is priority over them. Under the pure race provisions of section 9-312, that priority is conferred even over unperfected creditors whose security claims are known to the King at the time of the King's filing.

A different rule applies when the prior party has possession of the goods, and so is perfected prior to the competitor's filing, or where the prior party has done an ineffective filing (for example, in the wrong place) that is discovered by the first to file. In these two cases, the first to file is subordinated. In the first case, the earlier party's possession subordinates the first to file.\(^19\) In the second case, the filer's knowledge of the contents of the financing statement subordinates the first to file under section 9-401(2).

"Title" claimants—those who claim title to the goods and who are not characterized as secured creditors by sections 2-401(1) or 1-201(37)—are untouched by another's filing. An example is a lessor of goods who has priority under section 2A-305. Another example is an owner whose goods were stolen and transferred to the debtor before granting the security interest to the first to file. That person would have priority over the King under

\(^{19}\) *Id.* § 9-312.
the provisions of and negative implications in sections 2-401 and 2-403. As to that group and as to others who sold goods to the debtor in fraudulent transactions, and so gave the debtor voidable title, the filing in Article 9 is irrelevant. Nothing in Article 2 or Article 9 purports to give the filer greater rights vis-à-vis a prior party whose goods have been stolen or a lessor of goods or similar person simply because the competitor has filed a financing statement under Article 9. In these cases the priority rules lurk in Article 2, and the King achieves priority only because he qualifies as a bona fide purchaser under section 2-403 or under section 2-702. Those sections of Article 2 govern only if no provision of that Article, such as section 2-401 or section 2-326, or of Article 1, such as section 1-201(37), turns the "title claimant" into a secured creditor.

In effect there are two universes; the King appears in both but his competitors appear in only one. On the one hand, the King fights as a bona fide purchaser under Articles 2 or 2A against lessors and other title claimants. Sections 2-403 and 2A-305 are properly considered non-Article 9 priority rules. On the other hand, it is under Article 9 that the King confronts others who are converted into secured creditors by section 2-401 or whose documentation acknowledges them to be secured creditors. In this case the King's priority depends almost entirely on its filing.

a. Prior "Title" Claimants

Should a first filing earn any rights against title claimants (such as lessors) whose rights predate the secured creditor's and who do not assert secured creditor status? The real estate recording statutes show that it is possible for a filing to earn one priority not only over a prior secured creditor, but also over prior title holders. When A transfers title of real estate to B, who fails to record, and A later transfers title to C, who records its interest, C will have priority over B if C recorded without notice of B's interest.

To attach similar rights to the first to file under Article 9 with respect to a personal property interest (i.e., to give that person priority over lessors and other owners who have not filed) might have the virtue of efficiency, but the filing system

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20. See supra note 6 (citing cases involving attempts to pass title of stolen goods).
21. See 4 AMERICAN LAW OF PROPERTY § 17.5 (A. James Casner et al. eds, 1952).
22. Id.
just does not accommodate it. It is now well recognized that one
derives and protects title to real estate partly by recording one's
deed. That is not true of personal property. With rare excep-
tions, such as automobiles, one expects to get good title to per-
sonal property by paying the price and taking a bill of sale from
the prior owner. Unless one takes or gives security, one need not
and does not expect to worry about the personal property filing
system—at least as to subsequent transferees of one's transferor.
There is no mechanism for filing, and no expectation that an
"owner" of personal property will file a public document showing
its interest. Thus, to say that a lessor or other innocent title
holder should be divested by a subsequent party's filing a financ-
ing statement is like subordinating the title holder or lessor be-
cause the holder is blue eyed; it has nothing to do with that
interest. Our law neither requires nor even offers a system for
recording title to personal property of the kind offered for real
estate.

There is, of course, a gray area between the two universes.
Here we find quasi secured creditors, those who "retain title"
thinking they are "owners" but who are thrown by section 2-401
into Article 9 and are characterized by section 2-401 as mere se-
cured creditors. There is a similar troublesome overlay in sec-
tions 2-702, 2-326, and 2-403. Presumably that is an inefficiency
with which we can live; it does not outweigh the unfairness that
would attend the subordination of unsuspecting owners under
Article 9.

b. Prior Secured Creditors

Of course, secured creditors who have failed to perfect are
subordinate to subsequent creditors who file financing state-
ments. Under the pure race rules of section 9-312, they are
subordinate even though the filer has knowledge of their inter-
est when it files. That is a central rule of Article 9 and one that
suggests the drafters favored efficiency over fairness as the long-
term interest of society when the two appear to clash. Pure race

23. In contrast, several Canadian provinces have enacted Personal Property
Security Acts, which "provide no exemption from registration for security inter-
est in consumer goods"; some provinces consider commercial leases with a term
over one year to be security agreements for purposes of perfection. Ronald C.C.
Cuming, Computerization of Personal Property Security Registries: What the Ca-

24. Subordinating a lessor for failure to file would reverse the decision made
in Article 2A to recognize the lessor's priority over creditors of the lessee even
though the lessor has never filed a financing statement.
is hard to defend on micro-fairness grounds, i.e., fairness to this person. It can be defended on macro-fairness grounds, i.e., fairness to all over the long term. But macro-fairness is probably no more than efficiency; the pure race rules facilitate transactions and minimize litigation, and therefore the grand effect is fair even at the cost of unfairness to a few whose interests are subordinated to later claimants who file with knowledge of those interests.

But what of unperfected secured creditors who have made an ineffective attempt to perfect—they have filed in the wrong place—and whose filing has been uncovered by the unusually diligent search of the King? They are protected by section 9-401(2).\textsuperscript{25} If the first to file discovers an earlier filing, that party is burdened by the knowledge of the data contained in that financing statement and, if it applies to the same collateral the party claims, it subordinates the first to file’s claim.

Why should those who file in the wrong place earn priority because of others’ diligence? Under section 9-312 the first filer could have full knowledge about the claims of a prior unperfected but secured creditor and yet be superior.\textsuperscript{26} If that knowledge derived directly from the debtor or from another secured creditor, the King’s filing would earn priority over that person, but if the King found the information in an earlier but ineffective filing, the King would be subordinate.\textsuperscript{27} I do not understand why the source of that knowledge commands different outcomes.

The argument for the abolition of section 9-401(2) gains strength if the filing proposal of Professor LoPucki\textsuperscript{28} is adopted. This will make it more difficult for a filer to file in the wrong place, and will make an incorrect filing a more culpable act than under the current system. When one files with respect to all col-

\begin{itemize}
  \item [25] According to this section:
  
  \begin{quotation}
  [a] filing which is made in good faith in an improper place or not in all of the places required by this section is nevertheless effective with regard to any collateral as to which the filing complied with the requirements of this Article and is also effective with regard to collateral covered by the financing statement against any person who has knowledge of the contents of such financing statement.
  \end{quotation}

  U.C.C. § 9-401(2).

  \item [26] "Whichever secured party first perfects his interest . . . takes priority and it makes no difference whether or not he knows of the other interest at the time he perfects his own." \textit{Id.} § 9-312(5) & cmt. 5, example 2.

  \item [27] Section 9-401(2) requires "knowledge of the contents of [the] financing statement." This is different from the "knowledge of the security interest" used in § 9-301(1)(c)-(d) and knowledge of "the filing" as stated in § 9-401(2) prior to the 1957 revisions.

  \item [28] LoPucki, \textit{supra} note 1, at 581, 591.
  
\end{itemize}
lateral at the place of incorporation of the debtor, it will be difficult to file in the wrong place. This possibility make it easier for the filer to do it right, but not necessarily easier for the searcher to find an incorrect filing. This proposal diminishes the need and justification for section 9-401(2).

If section 9-401(2) is carefully limited to cases in which the first to file actually lays eyes on the defectively filed financing statement, it is a trivial exception to the priority rules and can easily be tolerated. The risk to the efficiency of the system is that courts may ream larger the section 9-401(2) hole and thus allow a variety of parties to slip through, even when the first to file has not laid eyes on the defective financing statement. Cases sub-

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29. Some cases seem to require only that the searcher know that the misfiler has a security interest. See, e.g., In re Mistura, Inc., 705 F.2d 1496, 1498 (9th Cir. 1983) (noting that "knowledge of the facts contained in a financing statement, even though learned in ignorance of the improperly filed financing statement, satisfies the requisite knowledge requirement of the [UCCI]"); Security Fin. Group, Inc. v. United States, 706 F. Supp. 83, 85-86 (D.D.C. 1989) (creditor's misfiled financing statement was effective against IRS under the "actual knowledge/good faith" exception contained in § 9-401(2) where the debtor had told IRS agent that certain proceeds of a contract were committed to payment of creditor's claim); In re Davidoff, 351 F. Supp. 440, 442, 443 (S.D.N.Y. 1972) (bank's unperfected security interest in debtor's dental equipment prevailed over manufacturer's interest in same equipment where debtor informed principal of manufacturing company that equipment had been pledged to the bank); In re Nemko, Inc., 136 B.R. 334, 339-41 (Bankr. E.D.N.Y. 1992) (debtor moved from New Jersey to New York and New Jersey bank did not perfect as to accounts in New York, yet New Jersey bank prevailed over New York bank because New York bank had knowledge of prior unlaps New Jersey security interest of New Jersey bank); In re Johnson, 28 B.R. 292, 296-97 (Bankr. N.D. Ill. 1983) (bank's perfected security interest in debtor's farm equipment failed as against equipment manufacturers' unperfected interests where bank assisted debtor in preparing detailed cash flow statements and acquired knowledge of debtor's financial obligations); Franklin Nat'l Inv. Corp. v. American Swiss Parts Co., 201 N.W.2d 673, 674 (Mich. Ct. App. 1972) (where debtor informed creditor that equipment purchased was financed by seller, creditor had knowledge of the contents of the financing statement and thus failed to prevail over seller's misfiled interest); ITT Indus. Credit Co. v. Robinson, 350 So. 2d 48, 51 (Miss. 1977) (where equipment manufacturer sold equipment and then learned that equipment was in turn leased to a third party, equipment manufacturer had knowledge of the contents of the financing statement and thus could not take priority over lessor's misfiled security interest); First Nat'l Bank v. First Sec. Bank, 721 P.2d 1270, 1273-74 (Mont. 1986) (where cattle rancher informed second bank that first bank had a security interest in his cattle, second bank had knowledge of the contents of the financing statement and could not prevail over first bank's misfiled financing statement); In re Enark Indus., 383 N.Y.S.2d 796, 797-98 (App. Term 1976) (first creditor's misfiled security interest took priority over second party's perfected interest where second party was aware that debtor's collateral had previously been pledged).

For cases requiring more than knowledge of the interest, see, J.I. Case Co. v. Crestar Bank, No. 90-2659, 1991 U.S. App. LEXIS 1045, at *11-*12 (4th Cir.
ordinating creditors who only know of the prior interest but have not actually gleaned information from a financing statement undermine and could destroy the pure race rule in section 9-312.\(^{30}\)

I favor the abolition of section 9-401(2). As an alternative, one might add language to the Code or to the Comments to restrict section 9-401(2) to the case of the later searcher whose agent actually lays eyes on the errant financing statement.

c. Perfection by Possession

Efficiency might direct that a person who perfects an interest by possession be subordinate to a later filer—it might just be efficient to abolish possession as a way of achieving priority over those perfected by filing.\(^{31}\) Why? First, possession as an indication of ownership is surely in decline. Leasing is everywhere.\(^{32}\) By hypothesis, ownership and possession are divided in every lease. In modern commercial and mercantile society—where little business is done by individuals and much is done by corporations—possession is never by John of his cow, but rather by General Electric's or General Motors's agent on behalf of the corporation. The inferences that one could draw from a party's possession in feudal English society at the time of Twyne's Case\(^{33}\) cannot be and are not drawn today. At a minimum, one must ask


30. See supra note 29 (citing cases where knowledge is of security interest and not specifically of contents of financing statement).

31. Here I disregard the right of the trustee in bankruptcy. Surely the trustee in bankruptcy should be subordinated to a secured creditor who takes possession.

32. Some estimate that equipment leasing in the United States has been growing at a rate of approximately 30% per year. Amelia H. Boss, The History of Article 2A: A Lesson for Practitioner and Scholar Alike, 39 Ala. L. Rev. 575, 576 (1988). As of December 1987, equipment leasing accounted for over 20% of all annual capital investment in the United States, and over $310 billion in lease receivables was estimated to be outstanding. Gregory J. Naples, A Review and Analysis of the New Article 2A-Leases Amendment to the UCC and Its Impact on Secured Creditors, Equipment and Finance Lessors, 93 CoM. L.J. 342, 343 n.2 (1988).

33. 3 Coke Rep. 80b, 76 Eng. Rep. 809 (Star Chamber 1601).
whether a possessor is a lessee. In many cases it will be necessary to investigate the possessor's agency status to determine which fictitious entity is considered in law to be in possession of a particular good. In modern mercantile society, one might conclude possession does not tell enough to earn priority.34

A second reason why possession might receive a lesser status than formerly is that it now seems to be infrequently used as a mode of perfecting. Pledges were once common. Perfection by possession of stock certificates and possession by a field warehouseman's possession were widely used, but the latter has declined in use with the rise of filing, and the former is threatened with extinction by the new Article 8 and by the disappearance of certificates from debtors' possession.35

What efficiencies would be gained by allowing the first to file to have priority over a secured creditor who perfected by possession prior to the filing? The change would free the secured creditor of the need to confirm the debtor's possession of the collateral, and would eliminate lawsuits dependent on questionable claims of possession. The filing system would be elevated one more notch.

Still there are problems. First, what of the case in which goods are in the hands of a bailee? In certain trades apparently it is common for commercial warehousemen to hold goods that are subject to security interests. The practice in those cases is to perfect by giving notice to the bailee, not by filing. If one were to outlaw perfection and priority arising from possession, somehow

34. For an argument supporting perfection by possession and advocating that possession be found where a reasonable person would be put on notice of a third party's claim, see Steven O. Weise, Perfection by Possession: The Need for an Objective Test, 29 IDAHO L. REV. 705, 712-15 (1992); see also David A. Ebroom, Perfection by Possession in Article 9: Challenging the Arcane But Honored Rule, 69 IND. L.J. 1193 (1994) (discussing irrationality of rule that bailees cannot be controlled by the debtor and proposing that bailees may be controlled by either the debtor or the secured party).

35. See Uniform Commercial Code Revised Article 8, Discussion Draft, Reporter's Prefatory Note xvii-xxiii (April 9, 1993):

Virtually all publicly traded corporate and municipal securities are still issued in certificated form . . . . The certificates representing the largest portion of the shares, however, are not held by the beneficial owners, but by clearing corporations. Settlement of securities trading occurs not by delivery of certificates or by registration of transfer on the records of the issuers or their transfer agents, but by notation on the records of clearing corporations and securities intermediaries.

one would have to change the practices of the participants in those trades.

Even more troublesome is the case of the seller who retains possession of sold goods. Because section 2-401(1) makes the seller's retention of title a mere security interest, the competition with the King is under Article 9, not Article 2. Recall the outrage caused by *Tanbro Fabrics Corp. v. Deering Milliken, Inc.*,37 when the court subordinated the interest of the seller of goods despite the seller's unbroken possession of the goods. The secured seller did not lose to another creditor because of section 9-312, but to a buyer in the ordinary course under section 9-307. Even so, the case was thought to be unfair because it was inconsistent with the legitimate expectations of the seller in continuous possession. I suspect that the outrage *Tanbro Fabrics* caused arises from sellers' expectation that their rights are always protected by their possession of goods. I doubt they could be disabused of this notion by a change in the rules on priority under section 9-312. Despite the decline of possession as an indicium of ownership, current practice and expectation probably require us to recognize the rights of the possessor, even against the King, and to retain the rule in section 9-312(5) that subordinates the first to file to someone who has perfected by earlier possession.

Where does this leave the law when the first to file competes with prior interests? I would change only one rule: abolish sec-

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When the PEB Study Group finally addressed the issue in 1992, it recommended the following:

A. The definition of "buyer in ordinary course of business" in § 1-201(9) should be revised to provide that the earliest time that a buyer can achieve the status of a buyer of goods is the time that the buyer obtains the right to possession of the goods under Article 2.

B. Section 9-307(1) should be revised to provide that a buyer in ordinary course of business does not take goods free of a security interest if the secured party is in possession of the goods, rejecting the holding of *Tanbro Fabrics Corp. v. Deering Milliken, Inc.*, 350 N.E.2d 590 (N.Y. 1976).

tion 9-401(2). Section 9-401(2) presumes that it would be unfair to allow one with knowledge of the contents of an improperly filed financing statement to have priority. Given the decision, based presumably on efficiency concerns, that the party first to file is superior to a prior security interest that is known to it, I cannot distinguish the section 9-401(2) case, and I conclude that we should favor efficiency here. By hypothesis, the competitor has failed to comply with the law on filing. That creditor is only incrementally less culpable than the person who has done no filing at all. And the first to file competitor is not necessarily more culpable.

Of course, one could argue against a pure race statute. But having concluded that a pure race statute is appropriate, why allow one to achieve priority over a prior secured claim even with full knowledge of every detail of that claim, as long as the details are acquired directly from the secured creditor or from the debtor and not from an improperly filed financing statement? Section 9-401(2) should be repealed.

Most of the King's losses to prior parties can be justified by noting that only a small set of persons dealing with rights to personal property expects those rights to be recorded in and controlled by a public filing. In that respect, Article 9's filing system and its users' expectations are different from the real estate title recording system, with its users' expectations that recording is necessary against other claimants of all kinds. Because of those expectations, the rules in the Code are generally correct in refusing to recognize the first filing as a route to priority over earlier claimants who are not themselves secured creditors.

Secured creditors are different; it is fair to expect them to check the files and to file to perfect their own interests. When they do not do so effectively, it is fair to subordinate them. Driving all secured sheep into the filing pen will eventually produce efficiency at small cost to fairness, but it is too soon to reject possession as a mode of earning priority. Perhaps the drafters can subordinate possessors in the first revision of the twenty-first century when possession has even more diminished significance than it does today.

38. See David G. Carlson, Rationality, Accident, and Priority Under Article 9 of the Uniform Commercial Code, 71 Minn. L. Rev. 207, 209-11, 235-40 (1986) (race priority of Article 9 began as an accident, continues through public apathy, and advantages professional over amateur lender).
2. Later Claimants to the Same Collateral

The general rule of Article 9, embodied in sections 9-201, 9-301, and 9-312, is that the first to file has priority over all subsequent claimants whether those parties are perfected secured creditors, lien creditors, trustees in bankruptcy, or buyers. Even with the collateral to which a security interest of the first to file has attached, however, and disregarding the problems of after-acquired property and proceeds, Article 9 subordinates the first to file to a handful of creditors under section 9-103, to certain buyers of goods under sections 9-301 and 9-307, and to certain purchasers of paper under sections 9-308 and 9-309.

I readily concede priority to two of these subsequent claimants. First are holders in due course of negotiable instruments that are subject to prior security interests; these rights are recognized by section 9-309. In this provision worlds collide. To say that a secured creditor who files a financing statement should have priority over a holder in due course because of that filing contradicts the very idea of a holder in due course of a negotiable instrument. Except as to proceeds, a filing does not even perfect a security interest in negotiable instruments and that seems correct, both on fairness and efficiency grounds. Any other rule would not only conflict with the expectations of the parties, it would produce difficulties and inefficiency in markets where negotiable instruments are transferred from one party to another without reference to any external record of title.

The same is true of the claims of a buyer in the ordinary course in section 9-307(1). The classic buyer in the ordinary course purchases from inventory at retail. To check files is the farthest from the imagination of that person. In normal cases, the secured creditor does not expect to retain its security interest against the ordinary course purchaser and, in fact, hopes that its debtor will sell all of the inventory in the ordinary course. A rule that provides otherwise would violate fairness and efficiency principles.

39. According to this section:

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

U.C.C. § 9-309.
Now compare my four remaining examples of subsequent claimants to the same collateral. These are professional purchasers of paper under section 9-308, creditors under section 9-301(4), non ordinary course buyers under section 9-307(3), and creditors who take security interests in goods that have moved across state lines or intangibles owned by debtors who have moved across state lines. On both fairness and efficiency, the claims of all four of these are weak when compared to the claim of the first to file. I discuss each in detail.

a. **Purchasers of Paper under Sections 9-308, 3-302**

Under section 9-308, a purchaser of chattel paper or of negotiable instruments may take priority over a prior perfected security interest that is perfected by filing or is claimed "merely as proceeds" of inventory. The section reads in full as follows:

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

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

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

The section was amended in 1972. Before that time it was more limited. What if the drafters repealed section 9-308 and amended section 3-302(c) so that a secured creditor who purchased multiple notes in one transaction was not a holder in due course? If modifying section 3-302(c) would offend the gods, the drafters could limit themselves to repealing section 9-308.

40. Id. § 9-308.

41. The 1962 official draft of § 9-308 read in full:

A purchaser of chattel paper or a non-negotiable instrument who gives new value and takes possession of it in the ordinary course of his business and without knowledge that the specific paper or instrument is subject to a security interest has priority over a security interest which is perfected under Section 9-304 (permissive filing and temporary perfection). A purchaser of chattel paper who gives new value and takes possession of it in the ordinary course of his business has priority over a security interest in chattel paper which is claimed merely as proceeds of inventory subject to a security interest (Section 9-306), even though he knows that the specific paper is subject to the security interest.
To measure the efficiency and fairness of this rule, we should first ask who are the beneficiaries of the rule.\textsuperscript{42} They are professional buyers of chattel paper. They are in the business of buying paper and know more about the UCC filing system than most of us do. Presumably they check the files and find out who has security interests in chattel paper perfected by filing. If section 9-308 were repealed, they would have to go to the prior perfected secured creditor and seek subordination. Alternatively, they could buy out the senior creditors or raise their own interest rates to offset the risks of taking a subordinate position.

Because those protected by section 9-308 are by hypothesis sophisticated business buyers of paper, their claim for protection from the King is weaker than the claim of buyers in the ordinary course, for example.\textsuperscript{43} Clearly, these are knowing players in the secured credit market and there would be nothing unfair about subordinating them to a prior filed interest.

The argument for keeping section 9-308 must ride on efficiency grounds. But what are those—what makes it efficient for a person to purchase paper already subject to a prior public security interest? If the person is a holder in due course buying a single note, the answer is easy, but if the purchaser is one of those contemplated in section 9-308, who buys in bulk,\textsuperscript{44} it is not clear why it is efficient to grant that person victory over the King. Perhaps denial of priority would obstruct these transactions. Possibly the transaction would go forward, but at a higher cost because of the need for a subordination agreement between the junior and senior creditors. None of that is obvious. Starting with the hypothesis that the King should win unless there is an efficiency or fairness grounds on which to rule otherwise, I find none and conclude that section 9-308 ought to be repealed.


\textsuperscript{43} See supra note 13 and accompanying text (discussing buyer in ordinary course).

\textsuperscript{44} Note that except to the extent a transferor has rights as a holder in due course, a purchaser (transferee) of negotiable instruments as part of a bulk transaction does not acquire rights of a holder in due course. See U.C.C. § 3-302(3)(c).
The cloudy language of section 9-308(b) makes it a particularly inviting target for repeal. The "merely as proceeds" phrase in section 9-308 defies definition and has been the subject of a trickle of litigation.\(^{45}\) In fact, section 9-308 invites knowing but silent claimants to take a security interest and then hope for the best in litigation with the prior perfected secured creditor. Why not force the junior creditors to negotiate with the senior, to be sure that neither is misled by the other's presence? Repeal of section 9-308 would do that.

b. **Creditors under Sections 9-301(4) and 9-307(3)\(^{46}\)**

Both of these subsections were added in 1972.\(^{47}\) They are among the most obnoxious of the underbrush in Article 9 and should be among the first removed. It is so difficult for a lien creditor to fit under section 9-301(4) that it is unclear if one has ever nested there.\(^{48}\) Why degrade the prior perfected secured creditor's interest to take account of such an insignificant and unlikely claimant?\(^{49}\) Why not make the buyer in section 9-307(3)\(^{50}\) take subject to the prior security or force the buyer to negotiate with the secured creditor? By hypothesis, this person


\(^{46}\) Section 9-301(4) provides:

A person who becomes a lien creditor while a security interest is perfected takes subject to the security interest only to the extent that it secures advances made before he becomes a lien creditor or within 45 days thereafter or made without knowledge of the lien or pursuant to a commitment entered into without knowledge of the lien.

Section 9-307(3) provides:

A buyer other than a buyer in ordinary course of business (subsection (1) of this section) takes free of a security interest to the extent that it secures future advances made after the secured party acquires knowledge of the purchase, or more than 45 days after the purchase, whichever first occurs, unless made pursuant to a commitment entered into without knowledge of the purchase and before the expiration of the 45 day period.

\(^{47}\) See id. §§ 9-301, 307 (Official Statement of Reasons For 1972 Changes In Official Text).

\(^{48}\) Of course my argument can be turned on me: If it is so unlikely, what harm? I retreat to aesthetics; a statute should be sparse, not lush.

\(^{49}\) See UNI Imports, Inc. v. Aparacor, Inc., 978 F.2d 984, 987-91 (7th Cir. 1992) (interpreting UCC § 9-301(4)).

\(^{50}\) See Spector United Employee's Credit Union v. Smith, 263 S.E.2d 319, 321-22 (N.C. Ct. App. 1980) (addressing application of UCC § 9-307(3)).
is not a buyer in the ordinary course. This person either buys from someone not in the business of selling goods of the kind sold (i.e., buys equipment) or otherwise somehow fails to be a buyer in the ordinary course. In either case, why not force the buyer to deal with the person who has a prior interest? Neither the claimants under section 9-301(4) nor those under section 9-307(3) has a strong fairness claim. Lien creditors are not reliance creditors, of course, and the buyers section 9-307(3) covers are not buyers in the ordinary course.

I see no efficiency argument for these rules. Because they add complexity to a complex statute, they threaten the certainty and therefore the efficiency of other provisions. At best, they have no effect; at worst, they might obscure the workings of the more important provisions of Article 9 and lead an occasional judge to a wrong conclusion. Added in 1972, they should be removed.

c. Moving Goods and Debtors under Section 9-103(1)(d)

Section 9-103(1)(d) reads in part as follows:

When collateral is brought into and kept in this state while subject to a security interest perfected under the law of the jurisdiction from which the collateral was removed, the security interest remains perfected, but if action is required by Part 3 of this Article to perfect the security interest,

(i) if the action is not taken before the expiration of the period of perfection in the other jurisdiction or the end of four months after the collateral is brought into this state, whichever period first expires, the security interest becomes unperfected at the end of that period and is thereafter deemed to have been unperfected as against a person who became a purchaser after removal.[5]

Suppose section 9-103(1)(d) were changed to read as follows:

When collateral is brought into and kept in the state while subject to a security interest perfected under the law of another jurisdiction from which the collateral was removed, the security interest remains perfected for the same period it would have remained perfected in the other jurisdiction had the collateral not been brought to this state.

This change (and a similar change to section 9-103(3)) would continue perfection despite the movement of the goods or the change of the debtor’s location.

51. U.C.C. § 9-103(1)(d).
52. Id. § 9-103(3). This section provides:

(3) Accounts, general intangibles and mobile goods.

. . .

(e) A security interest perfected under the law of the jurisdiction of the location of the debtor is perfected until the expiration of four months after a change of the debtor’s location to another jurisdiction, or
What are the gains and losses from a repeal of the current rule? First, innocent creditors in other states could be misled. One cannot deny that possibility, but it is just possible that creditors already account for the chance that goods have come from another state. Moreover, with the adoption of multistate computer networks, it may soon be easy and inexpensive to check the files in a particular debtor's name in many states. When checking the files in an adjoining state consists of merely sitting at a computer terminal and adding a few key strokes, the cost of monitoring another state's filing system is trivial. Note, too, that this problem will be minimized if Professor LoPucki's proposal is adopted, for under that proposal the movement of the goods will not require a filing in a new state. His system will routinely involve examination of files in a state far removed from the debtor's and creditor's place of business, in all cases where the debtor is incorporated out of state.

I think it both fair and efficient to put the burden on the new lender in the new state to discover either that the goods have moved (and therefore to find a filing in another state under the current rules), or that the debtor's place of incorporation has changed (and so it must find a filing in the old place of incorporation). This is particularly true with computerization of filing and searching, and with the potential of changing filing to place of incorporation.

Here the potential gains seem large. Amendment of section 9-103 would leave searchers slightly worse off and filers far better off. Abolition would do away with litigation concerning time of movement, change in debtor's place of business, and the like.

53. As of January 1995, UCC information in some form was available on LEXIS from eight states, real estate tax information from 31 states, and real estate transfer information from 22 states.

54. LoPucki, supra note 1, at 591-94 (noting that because corporation cannot change its state of incorporation, moving goods will not require new filing).

55. Id. at 593-619 (advocating filing based on state of incorporation).

With or without Professor LoPucki's amendment, section 9-103(1)(d) and the comparable rules in section 9-103(3) should be changed to preserve the perfection of the King despite change of debtor's location or movement of the goods.

Purchasers, secured creditors, lien creditors, and other transferees who claim the same collateral that is already subject to a prior filed interest have a particularly difficult time justifying their superiority over the King. They do not necessarily add new value like the purchase money lender. Their claims do not precede secured creditors' interests like the lessor's claims. They do not even claim different collateral the way the proceeds and after-acquired claimants do. Even though they are later in time, even though some of them are professionals (those under section 9-308), and even though they claim the very same collateral, they have the audacity to claim priority over the prior filed secured creditor. Because of the prior filing as to exactly the same goods, and because advances in the filing system are on the horizon, these creditors' claim for priority do not appeal to my sense of fairness. To me it seems at least as fair to subordinate them as to raise them.

Their claim for efficiency is at best muddled. No one can show that the added search costs of out of state creditors (that I would impose) will exceed the reduction in monitoring costs of in-state creditors. With radically better filing and searching systems, the reverse seems probable. For all of these reasons I argue that sections 9-301(4) and 9-307(3), and parts of section 9-103 as well as section 9-308 ought to be repealed. The outcome opposite from the one now mandated by these sections is likely to be more fair and more efficient than the current outcome mandated.

3. Later Claimants to Derivative or After-Acquired Collateral

Where collateral is after-acquired or where collateral has changed into proceeds, the King's claim is weaker, because the notice given by the filing is marginally less effective, and the expectations both of the original filer and of subsequent claimants are perhaps different than if the collateral had never changed status. Three sections elevate various subsequent claimants to this derivative collateral over the first to file. First is section 9-

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57. LoPucki, supra note 1, at 593-619 (identifying benefits of filing based on state of incorporation).
402(7), which allows a subsequent secured creditor to take priority over the first to file as to collateral acquired more than four months after a reorganization or a name change that renders the original filing seriously misleading.\textsuperscript{58} A second section concerns certain claims to proceeds.\textsuperscript{59} In these cases, the debtor is an out-of-state debtor, requiring either perfection in a new state as goods become intangibles, or filing in a new office within the state because collateral changes from farm products to something else, or vice versa. The third section is the purchase money lender who enjoys priority under sections 9-312(3) or (4) when it finances the debtor’s acquisition of new collateral.\textsuperscript{60} I vote for change of section 9-402(7), and section 9-306, but not of sections 9-312(3) and (4).

\textbf{a. Name Changes under Section 9-402(7)}

Section 9-402(7) reads in part as follows:

Where the debtor so changes his name or in the case of an organization its name, identity or corporate structure that a filed financing statement becomes seriously misleading, the filing is not effective to perfect a security interest in collateral acquired by the debtor more than four

\textsuperscript{58} U.C.C. § 9-402(7).
\textsuperscript{59} Id. § 9-306.
\textsuperscript{60} Id. § 9-312(3)-(4). This section provides:

(3) A perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory and also has priority in identifiable cash proceeds received on or before the delivery of the inventory to a buyer if

(a) the purchase money security interest is perfected at the time the debtor receives possession of the inventory; and

(b) the purchase money secured party gives notification in writing to the holder of the conflicting security interest if the holder had filed a financing statement covering the same types of inventory (i) before the date of the filing made by the purchase money secured party, or (ii) before the beginning of the 21 day period where the purchase money security interest is temporarily perfected without filing or possession (subsection (5) of Section 9-304); and

(c) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and

(d) the notification states that the person giving the notice has or expects to acquire a purchase money security interest in inventory of the debtor, describing such inventory by item or type.

(4) A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral or its proceeds if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter.
Suppose the quoted sentence were changed to read as follows:

Where the debtor changes its name, identity or corporate structure, or engages in a merger, reorganization, or other change of business entity, a financing statement properly filed in the original name remains effective until it expires under section 9-403(2).

What would be the consequence of such change? First, it would end all litigation on the question whether a name change rendered a secured creditor unperfected. That the debtor formerly did business as Greentree Manufacturing, but now does business as General Electric Corporation, would not matter, and no amount of argument could unseat the secured creditor who had filed under Greentree Manufacturing. The clarity of the rule would discourage most potential plaintiffs, however disappointed, and would allow for summary judgment against the foolish plaintiff who might claim otherwise.

The modification would, of course, cause a second change. Under the current filing system it would require any searcher to know every name its debtor used in the last five years, whether it was the name of the debtor's current organization or whether it was the name of a predecessor organization. The searcher would thus have to cross examine potential debtors, possibly get warranties from them or their lawyers, and search under all of those names.

But there would be savings, too. The secured creditor who had originally filed in the proper name at the time of the filing would have no need to search the files thereafter, to monitor against changed names, mergers, or other acts that might render the filing "seriously misleading." If the reduction in monitoring costs of existing filers offsets the searching costs of existing and prospective filers, the reduction of litigation by eliminating this sentence in section 9-402(7) would create a pure efficiency surplus. Even if the new search costs outweigh the monitoring costs, there would be a gain to the extent some of the savings

61. Id. § 9-402(7).
from reduction in monitoring and reduction in litigation outweighed the new search costs.

If Professor LoPucki’s proposal is adopted, the Secretary of State (who would maintain the filings of corporate names and charters and the UCC files) could make an entry in the Article 9 filing index for every name change and corporate reorganization. Then a search under the debtor’s old or new name would produce all filings under either name. That should clinch the case for the abolition of section 9-402(7). Abolishing section 9-402(7) might save a lot and cost little. Adoption of Professor LoPucki’s proposal completely undermines its reason for being.

b. Proceeds under Section 9-306

Section 9-306(3) concerning perfection of proceeds reads as follows:

The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a perfected security interest and becomes unperfected ten days after receipt of the proceeds by the debtor unless

(a) a filed financing statement covers the original collateral and the proceeds are collateral in which a security interest may be perfected by filing in the office or offices where the financing statement has been filed and, if the proceeds are acquired with cash proceeds, the description of collateral in the financing statement indicates the types of property constituting the proceeds; or

(b) a filed financing statement covers the original collateral and the proceeds are identifiable cash proceeds; or

(c) the security interest in the proceeds is perfected before the expiration of the ten day period.

Except as provided in this section, a security interest in proceeds can be perfected only by the methods or under the circumstances permitted in this Article for original collateral of the same type.

One might change it to read as follows:

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63. LoPucki, supra note 1, at 581, 591 (proposing filing for all corporate debtors for all collateral at the place of incorporation).

. 64. Ignoring these changes for a moment, I have no idea how to compare the efficiency of a regime without § 9-402(7) with the efficiency of the current regime. It is not intuitively obvious that the monitoring costs saved by abolition would be less than the new costs of investigation required by abolition. I suspect that even now diligent creditors ask a debtor to disclose all of the names under which it has done business in the last five years and that these creditors search under all those names.

Of course, the debtor might lie and, if so, the current law would save the searcher in certain cases where the proposed law would not. I wonder how often a debtor lies at the outset of a transaction to its prospective creditor about the names and organizations under which it has done business for the past five years. Might the number be insignificant?
The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected.

This modification returns to the 1962 Code, where checking the block on the original UCC-1 perfected a security interest in proceeds wherever located, irrespective that an original filing to perfect as to the proceeds might have been far removed from the filing actually made as to the original collateral. As with the two suggestions above, this change would increase the searching burden and reduce the monitoring burden. It would mean that those who wished to lend against accounts receivable or other tangible and intangible assets would have to trace their ancestry (these accounts are from the sale of what inventory located where?) and would have to search at the location of the ancestral assets in the name of the debtor.

If Professor LoPucki's proposal is adopted, most of the problems with section 9-306 will disappear. The principal problem under current law is the requirement of a filing at the physical location of goods, combined with a requirement of a filing at the place of the debtor's location as to proceeds when those goods turn into intangible proceeds. Assume a debtor is incorporated in Illinois and has its principal place of business there, but has a plant in Ohio. A secured creditor takes a security interest in the goods in Ohio and files in Columbus. When those goods are sold and produce accounts receivable, the proper filing as to the accounts is at the Secretary of State's office in the state of the debtor's principal place of business, Springfield, Illinois. If the secured creditor fails to file there, it becomes unperfected. Under the LoPucki proposal, the original filing would be in Springfield, and no new filing would be required to continue perfection in intangible proceeds. In that regime, both section 9-306(3) and my suggestion for modification of section 9-306 are beside the point. Absent Professor LoPucki's proposal, the costs and benefits of modification would be similar to those described above with re-

65. UCC § 9-306(3) in the 1962 Code read:

The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a perfected security interest and becomes unperfected ten days after receipt of the proceeds by the debtor unless

(a) a filed financing statement covering the original collateral also covers proceeds; or

(b) the security interest in the proceeds is perfected before the expiration of the ten day period.

66. LoPucki, supra note 1, at 581, 591 (recommending filing for all assets at the place of incorporation of the debtor).
spect to sections 9-407(2) and 9-103. Here as elsewhere smarter programs and better computer access reduce the searcher's cost and favor repeal of the current rule.

c. **Purchase Money Security Interests in Sections 9-312(3) and (4)**

Exactly why a purchase money secured creditor who comes later in time and is on notice of prior perfected security interests deserves priority over that interest is not clear. Yet purchase money secured creditors are the most direct challengers of the King and enjoy most the best recognized priority of all those considered in this paper. Their rights are specifically set out in very same section that anoints the King and recognizes his pure race rights. What justifies this purchase money priority?

Perhaps fairness commands priority for purchase money lenders. It might be argued that a seller, less likely a financer, naturally expects to have priority as to the assets that it sells to a debtor. An intelligent business person who is ignorant of Article 9 might reflect: "I own this commodity. No one else has any claim to it; therefore, I must be able to control the rights in it. If I retain rights, such as a security interest, I must have priority over all others because that security interest is merely a lesser right than I hold now." Of course, if that expectation is the basis

67. For cases involving § 9-306(3), see, e.g., *In re* Reliance Equities, Inc., 966 F.2d 1338, 1342 (10th Cir. 1992) (holding because creditor did nothing to perfect its security interest during 10-day period of automatic perfected security interest after sale of promissory note, security interest was unperfected); *In re* Keneco Fin. Group, Inc., 131 B.R. 90 (Bankr. N.D. Ill. 1991) (holding creditor had perfected security interest in proceeds of debtor’s equipment leases as long as creditor had perfected security interest in leases themselves); *In re* Kirk, 71 B.R. 510 (C.D. Ill. 1987) (holding UCC § 9-306(3) permits security interest in proceeds of collateral sold to be automatically perfected for only 20 days unless the interest is perfected by filing a financial statement covering the original collateral within the 20 days).

68. Bob Summers and I have given the following feeble defense: [T]he debtor needs some protection from a creditor who has filed a financing statement with respect to his goods, but who is unwilling to advance additional funds. . . . Thus, the purchase money provisions give the debtor somewhat greater bargaining power and at least theoretically enlarge his ability to get credit.


for the purchase money priority rule, section 9-312(3),\textsuperscript{69} which requires notice to the prior filers, and section 9-312(4),\textsuperscript{70} which depends on prompt filing or retention of possession, are without justification because they already violate that expectation. Given those limitations on the rights of the purchase money lender, it is hard to justify them on the grounds that we are merely conforming to the expectation of the clear thinking business person.

A second justification for purchase money priority relates to efficiency. By giving the debtor the possibility of granting first priority to a subsequent purchase money lender, one may facilitate socially desirable transactions that would not otherwise occur. Conceivably, a secured creditor who has a perfected security interest in all of the debtor’s inventory, or inventory and equipment, including after-acquired property, might refuse to make a new loan for the purchase of new assets. Yet a seller or another financer of the debtor might make a different evaluation of the debtor’s creditworthiness and thus be willing to finance a new acquisition—at least if it could be assured of priority in the assets to be acquired. Assuming these transactions are socially desirable, they should be facilitated.

Although that efficiency often is asserted, I have never seen it proven. First, one must assume the original lender will not lend on the same terms as the purchase money lender. Second, one must assume that the second lender does not intend to buy out and thus replace the first lender, for that would be possible even without the purchase money rules. Third, one must assume the second lender is unwilling to lend unsecured, or that it would charge an additional interest fee that would exceed the costs (on others) of granting a prior perfected security interest. Fourth, one must assume the potential injury to the first filer, from suffering a purchase money lender with priority, is outweighed by the potential gain from the new transaction.

Finally, one must assume the transaction—which the new lender will finance, but the old lender will not—is more likely to increase the wealth of the parties than to decrease it. Conceivably the first lender has declined to lend, not out of vindictiveness, but because of its view that the debtor is already as deeply in debt as it should be. It is possible that an empirical examination of purchase money loans would show that the debtor’s optimism is unwarranted and that most purchase money loans that would

\textsuperscript{69} See supra note 60 (providing text of UCC § 9-312(3)).

\textsuperscript{70} See supra note 60 (providing text of UCC § 9-312(4)).
not have been made by the original debtor lead to bankruptcy, not to riches.

Note, too, that there are costs to the King in allowing purchase money priority. First is the possibility that the original lender and the purchase money lender's assets or proceeds will become commingled, causing a dispute between them. Second is the possibility that both the original lender and the subsequent lender will ultimately be partially unsecured, and thus the first lender will suffer injury by a reduction of the percentage it will be paid on its unsecured portion.\footnote{For an explanation how a later lender injures an earlier secured creditor when both are partially unsecured on debtor's insolvency, see Alan Schwartz, \textit{Taking the Analysis of Security Seriously}, 80 Va. L. Rev. 2073 (1994).}

Furthermore, the transaction could take place even in the absence of a particular priority rule that favors purchase money lenders. In the absence of sections 9-312(3) and (4), the second lender would have to negotiate for subordination of the first lender.

To me, the most persuasive claim for purchase money priority is the fairness argument—that reasonable business people expect to have priority when they sell goods from their own stock. Perhaps this idea is embedded so deeply in mercantile expectation that it must be recognized by the Code in order to meet the legitimate expectations of our honest but ill informed mercantile actor.

Even so, the question remains whether purchase money rights should be extended beyond the seller. Conceivably section 9-107 ought to be limited to sellers and should exclude financers. Presumably those financers would not be misled. They would know the need to get subordination agreements and the same fairness arguments could not be made on their behalf as would be made on behalf of the seller. Of course, modifying section 9-107 could produce silly behavior, such as the financer's purchasing the goods and then purporting to sell them to the debtor to fit within the purchase money rules. Note that we are now on uneasy ground where the intelligent but uninformed business person may be injured because of failure to give notice under section 9-312(3) or failure promptly to perfect under section 9-312(4).

I suspect that the status quo is too powerful to challenge here. Perhaps the widespread recognition of purchase money priority says that it is either fair or efficient or both. I still have my doubts. At least the drafters should appreciate that the case for priority of purchase money loans over earlier filed creditors
has always been uneasy. I would not shed a tear over the aboli-
tion of sections 9-312(3) and (4).

CONCLUSION

Most of my judgments about the proper priority of the first to
file are tentative. I raise them not because I imagine that every
change I might suggest is wise or politic, but because I think it
important for the drafters to consider alternative rules and to
question their assumptions. And the drafters need to be re-
mined of their ignorance. In response to almost every empirical
question that could be asked about current creditor behavior—
much less about behavior in response to new law—we have only
anecdotal evidence. When representatives of debtors and of se-
cured and unsecured creditors of every stripe appear at the draft-
ing committee meetings and make confident assertions, we hear
assertions, not proof. Recognizing their ignorance, the drafters
should ask what laws should be enacted in the face of that
ignorance.\footnote{Unable to prove the value of any other rules, perhaps they should con-
centrate on reduction of transaction costs.}

Next the drafters should ask what implications arise from a
cheaper, better, and more effective filing system. Given the pos-
sibility that one may soon be able sit at a computer and search
files with respect to the debtor’s name or ID number in every
state, do the rules in sections 9-306 or 9-103 make sense? Pre-
sumably the better and more accessible the file, the more reli-
ance we can put on it and the less reliance is necessary on rules
such as those in section 9-103. Arguably computerization and
ever smarter software make searching correspondingly easier
and the results more reliable. These technological advances may
justify some of the changes that I propose.

Finally, by encouraging them to focus on efficiency as well as
fairness—they are not necessarily inconsistent—I hope to get
the drafters to remove some of the ugly brush that has grown up
in Article 9 over time. I want them to understand how fairness
to a few often brings complexity to many. By detracting from the
clarity and certainty that should characterize commercial law,
complexity may ultimately bring unfairness too.