Dancing on the Edge of Article 9

James J. White

University of Michigan Law School, jjwhite@umich.edu

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DANCING ON THE EDGE OF ARTICLE 9

JAMES J. WHITE*

I. INTRODUCTION

Despite the fact that Article 9 is a much more comprehensive personal property security statute than was ever found in American law prior to its enactment, cases continue to present issues on the scope of the Article. Gone are the cases in which a court was called upon to determine whether a "conditional sales contract" could be dealt with under the "factor's lien" law; it is now clear that all such personal property security devices are governed by Article 9. Yet many problems remain for the unwary lawyer. I will identify several and deal in detail with three of these coverage problems.

The easiest scope cases are those in which the Congress has overridden Article 9. Examples of such overriding federal law are the Bankruptcy Code,¹ the rules on perfection of security interest in aircraft and ships,² and provisions about Federal Tax Liens.³ In one way or another those, among other federal statutes, modify the rights of the Article 9 secured creditor. For example, a security interest that would take its priority from the time of filing and would relate back to that time as to after-acquired property and future advances, has only a limited relation-back power against a federal tax lien.⁴ A UCC filing to perfect a security interest in an aircraft is wholly worthless and in many ways the secured creditor will find his rights more limited once the debtor has gone into bankruptcy than would otherwise be the case. To mention one bankruptcy limitation, con-

*The author is Robert A. Sullivan Professor of Law at the University of Michigan School of Law in Ann Arbor. He received his B.A. in 1956 from Amherst College and his J.D. in 1962 from the University of Michigan, where he was on the Michigan Law Review.

sider the automatic stay,\textsuperscript{5} which in effect cancels out the secured creditor's rights under Part 5 of Article 9 for the period during which the stay is in effect.

A second recurring scope issue, one clearly anticipated by the drafters and one the courts have dealt with from the moment of the enactment of the Code, is the confusing distinction between "leases" and "security agreements."\textsuperscript{6} For a variety of reasons that have changed over the years, lenders have often found it in their interest to identify as "leases" certain documents that bear some of the attributes of security agreements. Sometimes this activity is motivated by accounting rules, at other times by the tax treatment, or by limitations in other loan documents. There are scores of other reasons that might apply in particular cases. Recently the lease-security agreement debate has taken on new meaning because true leases are governed by Section 365 of the Bankruptcy Code (a section that requires the debtor who wishes to keep the leased asset to pay the full value of his original contract). Security interests, on the other hand, are governed by the cramdown provisions in Chapters 13 and 11 (under which the debtor can often keep the asset by paying only the present value of the collateral, not the larger amount due under the contract).\textsuperscript{7}

In any event there are endless and tiring cases that deal with the question: is this a security agreement or is it a lease. One can find long lists of attributes, some of which make sense and some of which do not. The basic section, 1-201(37),\textsuperscript{8} will now be supplemented by a new provision in the leasing law that may be added to Article 2

\textsuperscript{5} 11 U.S.C. Sec. 362 (1982).


\textsuperscript{7} See In re Witkowski, 38 UCC Rep. Serv. 320 (Bkrtcy D. N.D. 1984); In re Pin Oaks Apartments, 7 B.R. 364 (Bkrtcy. S.D. Tex. 1980).

\textsuperscript{8} "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer (Section 2-401) is limited in effect to a reservation of a "security interest." The term also includes any interest of a buyer of accounts or chattel paper which is subject to Article 9. The special property interest of a buyer of goods on identification of such goods to a contract for sale under Section 2-401 is not a "security interest", but a buyer may also acquire a "security interest" by complying with Article 9. Unless a lease or consignment is intended as security, reservation of title thereunder is not a "security interest" but a consignment is in any event subject to the provisions on consignment sales (Section 2-326).

Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.
as Article 2A. The issues here are now well understood. It is certainly possible to write something that is unambiguously a lease or alternatively unambiguously a security agreement. Those who wish to enjoy the treatment of one together with some of the attributes of

9. "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer (Section 2-401) is limited in effect to a reservation of a "security interest." The term also includes any interest of a buyer of accounts or chattel paper which is subject to Article 9. The special property interest of a buyer of goods on identification of those goods to a contract for sale under Section 2-401 is not a "security interest," but a buyer may also acquire a "security interest" by complying with Article 9. Unless a consignment is intended as security, reservation of title thereunder is not a "security interest," but a consignment in any event is subject to the provisions on consignment sales (Section 2-326).

Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and (a) the original term of the lease is equal to or greater than the remaining economic life of the goods; (b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods; (c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement; or (d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

A transaction does not create a security interest merely because it provides that (a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into; (b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods; (c) the lessee has an option to renew the lease or to become the owner of the goods; (d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed; or (e) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

For purposes of this subsection (37): (x) Additional consideration is not nominal if (i) when the option to renew the lease is granted to the lessee the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed; or (ii) when the option to become the owner of the goods is granted to the lessee the price is stated to be the fair market value of the goods determined at the time the option is to be performed. Additional consideration is nominal if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised; (y) "Reasonably predictable" and "remaining economic life of the goods" are to be determined with reference to the facts and circumstances at the time the transaction is entered into; and (z) "Present value" means the amount as of a date certain of one or more sums payable in the future, discounted to the date certain. The discount is determined by the interest rate specified by the parties if the rate is not manifestly unreasonable at the time the transaction is entered into; otherwise, the discount is
the other must continue to read the dismal cases and make uncertain predictions about the treatment that their particular documents will receive in bankruptcy. We will leave that to them; there is not room here to discuss those matters.

Another area of recent conflict between Article 9 and the common law has been in the treatment of setoff. In a number of recent cases, secured creditors have argued that bank accounts constitute proceeds of their security interests and that when the bank sets off the account it has appropriated their security.\(^{10}\) I, at least, had assumed that outside of bankruptcy, a commingled bank account was not a "identifiable proceed"\(^ {11}\) and therefore that the proceeds claim would not attach (unless, of course, the bank account were segregated and contained only proceeds). The courts have not agreed with that conclusion. As a consequence we have had a conflict between the right of the bank, claiming setoff at common law, and the right of the secured creditor, claiming the asset as proceeds. At least one court has held the entire argument is outside of Article 9 because of Section 9-104, but most have held that Section 9-306 governs and in effect grants priority to the secured creditor.

How the common law is integrated with the Code arises also in the setting in which a bank issuing a certificate of deposit asserts a right of setoff, and a second creditor who has taken possession of the certificate of deposit claims a perfected security interest in it. Here the second secured creditor with possession will invoke not just Article 9 and his possessory security interest in an instrument but also his status in the case of a negotiable certificate as a holder in due course. Moreover, the one with possession of the instrument may also invoke the common law doctrine of mutuality and may argue that the original bank may not set off because there is no longer mutuality.\(^ {12}\)

Below I will deal at length with three important and separate scope issues. The first is the treatment of the United States government as a lender. When the United States grants credit either to a farmer (as the Farmers Home Administration) or in one of a number of other transactions, its rights are governed by federal statutory and

determined by a commercially reasonable rate that takes into account the facts and circumstances of each case at the time the transaction was entered into.


11. UCC Section 9-306(2). Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

12. See, e.g., Citicorp (USA) Inc. v. Davidson Lumber, 718 F.2d 1030 (11th Cir. 1983); Citizens National Bank of Orlando v. Bornstein, 374 So.2d 6 (Fla. 1979).
common law. To what extent should that common law be derived from state law, namely Article 9?

Second, I deal with "quasi consignments." These are transactions in which an owner of goods puts those goods in the hands of another party for processing or other work of some sort. These arrangements are as varied as the imagination of the parties undertaking them. Some look indistinguishable from bailments, others look very much like consignments. In each case there is the question should we treat the original owner merely as an owner who has bailed his or her goods to another party or should we treat him or her as an unpaid seller or an unsecured creditor?

Finally, I will deal with Article 9 as it applies to transactions somehow involving real estate. The most familiar case is that in which a secured creditor lends money against a mortgagee's interest in a mortgage and mortgage note. Less well articulated, but nearly as important, are the secured creditor's rights when he or she is lending to the vendor on a land-sale contract, to the lessee on a lease or even to the lessor.

In all of the cases described above one party is likely to argue that Article 9 of the Uniform Commercial Code has no application at all and that instead the case should be analyzed under the real estate law, under the federal statutory law, or federal common law without regard to the UCC.

II. THE BASIC ARTICLE 9 SCOPE PROVISIONS

The starting point for all scope analysis under Article 9 is Section 9-102.13 Section 9-102(1) and (2) are as broad as possible. They indicate that Article 9 deals with "any transaction (regardless of its form) which is intended to create a security interest in personal property." Section 9-102(2) lists a series of pre-Code synonyms for security agreement, e.g., chattel mortgage, chattel trust, to make it

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13. UCC Section 9-102. Policy and Subject Matter of Article

(1) Except as otherwise provided in Section 9-104 on excluded transactions, this Article applies
(a) to any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts; and also
(b) to any sale of accounts or chattel paper.

(2) This Article applies to security interests created by contract including pledge, assignment, chattel mortgage, chattel trust, trust deed, factor’s lien, equipment trust, conditional sale, trust receipt, other lien or title retention contract and lease or consignment intended as security. This Article does not apply to statutory liens except as provided in Section 9-310.

(3) The application of this Article to a security interest in a secured obligation is not affected by the fact that the obligation is itself secured by a transaction or interest to which this Article does not apply.
clear that Article 9 is comprehensive. Finally, Section 9-102(3) deals
directly with the real estate transaction by stating that Article 9's
application is not "affected by the fact that the obligation itself is
secured by a transaction or interest to which this article does not
apply." In most cases Section 9-102 should be the starting point for
the argument that a transaction is within Article 9.

Next one should normally turn to Section 9-104 on excluded
transactions. The sections that are there relevant to the issues dis-
cussed here are Section 9-104(a), which excludes Article 9 coverage
"to the extent that [a statute of the United States] governs the rights
of the parties . . . ". Under (e) the article also does not apply "to a
transfer by a government or governmental subdivision or agency," nor under (i) to "any right of setoff," or under (1) to "any interest
in a deposit account . . . ".

The apparently clear direction in Section 9-102(3) is clouded by
Section 9-104(j)'s statement that Article 9 does not apply to "the
creation of a transfer of an interest in or lien on real estate, including
a lease or rents thereunder . . . ". Comment 4 to Section 9-102 also
deals with the application of Article 9 to a real estate case by giving
an example in which a mortgages borrows and gives his mortgage
and note as security. The Comment states that Article 9 applies to
the security interest created in the note, but it contains a confusing
sentence: "This article leaves to other law the question of the effect
of rights under the mortgage, delivery or non-delivery of the mort-
gage or of a recording or non-recording of an assignment of the mort-
gagee's interest."

A final Code scope section that should not be overlooked is Sec-
tion 1-201(37), the definition of "security interest." That subsection
specifically refers to leasing and consignment and gives some guid-
ance about when a particular document labeled a "lease" should be
regarded as a security agreement. Specifically it tells us that the
inclusion of an option to purchase in the "lease" does not of itself
make the lease intended as security, but that if the option is for a
nominal consideration or less, the option's presence does turn a
lease into a security agreement.

Studying these sections in the Uniform Commercial Code is but
the beginning of wisdom, but the lawyer should resist the temptation
to jump over the specific language of the Code lest he or she fall
abruptly into the pit of the cases. In some settings the language of
the Code itself will be determinative; in all cases it will be important.

III. THREE SITUATIONS THAT RAISE SCOPE
QUESTIONS

A. The Government as a Lender

The king, of course, is entitled to have his own law and to ignore
the law that governs his subjects. From time to time that has been
precisely the position the agents of our king, the federal government, have taken. In the Clearfield Trust doctrine\(^\text{14}\) the Supreme Court has generally supported that view; however, in a 1979 case, United States v. Kimbell Foods, Inc.,\(^\text{15}\) the Court substantially undercut the effect of the doctrine. In the Texas wing of that case, the Small Business Administration had guaranteed a $300,000 loan from Republic National Bank of Dallas to the debtor. Upon debtor's default, the SBA paid on its guaranty and took the position of Republic National Bank. Since Republic had filed a financing statement subsequent to Kimbell's, it would have been subordinate to Kimbell under the conventional Article 9 rules in Section 9-312. The SBA argued that its priority was to be determined according to federal law, and that even if Republic, its subrogee, would have been subordinate, it, as an arm of the federal government, should not be. It argued that the infamous choateness doctrine found in the federal tax lien law should be introduced in this case to subordinate Kimbell Food on the ground that Kimbell's claim was not "choate."\(^\text{16}\) It was not choate at the time the SBA took its interest because the total amount of the loan fluctuated, and in fact increased after that time.

The Court of Appeals for the Fifth Circuit\(^\text{17}\) and ultimately the Supreme Court rejected the SBA argument. The Supreme Court's rejection contained a sweeping adoption of Article 9 as the common law which is to govern the federal government as a personal property secured lender. The Court did not abandon the Clearfield Trust doctrine, rather it held that the federal law which governs the federal government as lender, except in unusual cases, should be Article 9 of the Uniform Commercial Code and other generally applicable state law. The Court recognized that there might be cases in which federal law, different from the state law, ought to be applied to favor the federal government. Such might be the case, for example, because a program must be "uniform in character throughout the nation,"\(^\text{18}\) or because state law might frustrate specific objects of a federal program. In the cases before it, however, the Court concluded "the state commercial codes 'furnish convenient solutions in no way

\(^\text{14}\) Clearfield Trust Co. v. United States, 318 U.S. 363 (1943).
\(^\text{16}\) In Plumb, Federal Tax Liens, (3d ed. 1972), Mr. Plumb defines that doctrine as follows at page 101: "...before the 1966 amendments [to the Federal Tax Lien Law] the courts had held that a mortgage, assignment, or other security interest was 'inchoate' as far as it secured after-arising obligations and was not a recognizable prior charge on property 'belonging to' the taxpayer, even as against liens for taxes assessed after the interest was perfected under state law."

At pages 149-150: "Beginning in 1950 ... the Supreme Court in a series of cases laid down the rule that no state-created lien could prevail over the federal tax lien unless the former had become 'choate' before the federal lien arose (by assessment). To be 'choate,' the competing lien had to meet the three tests of certainty of the lienor, of the property subject to the lien, and of the amount of the lien."

\(^\text{17}\) Kimbell Foods, Inc. v. Republic National Bank, 557 F.2d 491 (5th Cir. 1977).
inconsistent with adequate protection of the federal interest[s]' and
declined to override intricate state laws of general applicability upon
which private creditors base their daily commercial transactions."

One might have thought that Kimbell Foods put to rest the entire
question. After reading that case, one might conclude that the federal
government as a lender, particularly as a secured lender, would be
held to the same requirements of filing, perfection, and priority, as
a bank or any other private secured lender.

Although many cases have followed Kimbell Foods and have held
that the federal government as lender is subject to the same rules as
would apply to a private lender, that has not been the uniform out-
come. More troublesome, it has not always been obvious why the
federal government was subject to Article 9 in some cases, but not
in others.

Consider a case from the Court of Appeals for the Seventh Circuit
where the court in a two-to-one decision determined that the federal
government, acting through the Department of Defense, was not sub-
ject to the kind of limitations that would have applied to a private
lender. In In re American Pouch Foods, Inc., the debtor was in the
business of making combat rations held in food pouches for use in
the armed services. The federal government was obliged to make
progress payments equal to ninety percent of Pouch’s costs incurred
to the date of payment. A clause in the contract, common in such
contracts, provided that title to the parts and materials vested in the
government immediately upon payment.

After it had paid approximately $13 million, the government ter-
minated the contract and Pouch went into bankruptcy. Thereupon
the government claimed the goods in Pouch’s hands under its title-
vesting clause. The debtor-in-possession complained that the gov-
ernment’s right was inferior to the DIP’s claim as a judgment lienor
under Section 544(a). The DIP maintained that the federal govern-
ment at most was an unperfected secured creditor, that it was pos-
sibly no more than an unsecured creditor. Almost certainly (as the
court appears to acknowledge) a private party relying merely on a
prepayment and a vesting clause would have been treated as an
unperfected secured creditor under the Illinois law.

The court examined a long history of governmental statutes au-

19. Id. at 729.
20. See e.g., United States v. Kennedy, 738 F.2d 584 (3d Cir. 1984); Johnson v.
United States Department of Agriculture, 734 F.2d 774 (11th Cir. 1984); United States
v. Ellis, 714 F.2d 953 (9th Cir. 1983); United States v. Med-o-Farm, 701 F.2d 88 (9th
Cir. 1983); United States v. Public Auction Yard, Billings, Montana, 637 F.2d 613
(9th Cir. 1980); United States v. Iby, 618 F.2d 352 (5th Cir. 1980); United States v.
Dismuth, 616 F.2d 755 (5th Cir. 1980); United States v. Bailey Feed Mill, Inc., 592
F.Supp. 844 (E.D. N.C. 1984). See also Greig and Althoff, Kimbell Decision, 86 COM.
L.J. 447 (1981); Formulating a Federal Rule of Decision in Commercial Transactions
21. 769 F.2d 1190 (7th Cir. 1985).
uthorizing prepayment and considered the practice under those statutes. Notwithstanding Kimbell, it concluded that the federal government achieved priority by virtue of its title-vesting clause. The basis for the court’s deviation from Kimbell is not clear from the opinion, but it appears to be a finding that Congress intended such a rule of law to apply in these specific circumstances by virtue of the progress payment statute. The dissent by Judge Swygert contains a more extensive, and in my view, a more persuasive, analysis of Kimbell. Judge Swygert would have applied the Uniform Commercial Code and presumably would have subordinated the federal government to the debtor-in-possession.

After Kimbell Foods the general rule is: the UCC constitutes the federal common law and that law in turn governs the rights of the federal government as a lender. Under Kimbell Foods the courts can deviate from such a rule under a loose array of conditions. First, and most important, is the case in which Congress has specified a rule. This seems to be the basis for the American Pouch decision. Second, the federal common law might be different from the state law if the federal program in question called for a uniform rule, or the application of state law would frustrate a specific objective of the program. Finally there is a bias toward the use of the state rule in cases in which a federal rule would disrupt commercial relations based upon the state law. Routinely, lawyers for federal agencies will argue that there is a federal law embodied in a statute or in a regulation under a statute, or that there is a need for a uniform federal rule.

Except in unusual cases both arguments should be rejected. Where the “uniform federal rule” argument is merely that government employees were too lazy or ill-informed to comply with local filing rules or do the other things that are routinely expected of private creditors, the argument should be rejected out of hand. Equally unpersuasive is the argument that government as an explicit lender, e.g., the SBA or Farm Credit Administration, might be expected to know Article 9 but that the government as a purchaser of tanks and aircraft cannot be expected to understand and thus should be freed from state law compliance. When the government makes progress payments, it is a lender, should think of itself as such, and should comply with the laws that apply to others.

None of these cases present the cataclysmic situation in which a jealous debtor-in-possession is holding weapons that should be put on an airplane and carried to a foreign place to kill an enemy. Had the government lost in American Pouch, one suspects that soldiers, not welfare mothers, would ultimately have eaten the food held by the debtor-in-possession. The only question is whether the costs should come out of the hide of the private creditors of Pouch or from

the federal government and the other creditors. In short, it seems unpersuasive to me to distinguish Kimbell Food on the ground that it dealt with professional governmental lenders, not with semi-professional governmental lenders.

The Court of Claims' position in Marine Midland Bank v. United States,\(^\text{23}\) cited with approval in American Pouch, is no more persuasive. There the court held that the government had merely a lien, but that the lien enjoyed priority despite the fact that the government had not done things under state law that entitled it to such priority.

The solicitude for the federal government's position as a lender in the face of the rather strong statement by the Supreme Court in Kimbell Foods is surprising. Why the courts persist in protecting the interests of the country's largest and nastiest creditor in the face of apparently contrary instructions of the Supreme Court is beyond me. In my view Judge Swygert reads Kimbell correctly and if it were up to me, I would treat the federal government as a state-law lender except in the most extraordinary cases.

B. Bailments, Consignments and Quasi-Consignments

As I indicated above, the question whether a given document titled a lease should be treated as a security agreement has festered on the surface of the Code for thirty years. As the years pass the boil takes on different hues, but nothing that I nor any other can say will cure it.

An analogous case is that of the true consignment. A true consignment, in which an owner of goods puts them in the hands of a second party for their sale to a third party, or, failing a sale, to be returned to the original owner, is in some sense the functional equivalent of an inventory loan. It allows that second party (retailer) to sell goods and realize profit without investing capital in inventory. Of course, it is not identical to an inventory loan arrangement, for the retailer takes no risk that the commodity will depreciate in value or will prove unsalable. That risk is borne by the consignor, the owner.

The Code drafters realized that true consignment had some aspects of an inventory loan, and that third parties needed notice of the existence of a consignment. Because of that they originally enacted Section 2-326, and as part of the 1972 amendments added Section 9-114. Each of those sections takes substantial steps toward treating the consignor as a secured inventory lender. In general they force the consignor to file a financing statement, or to run the risk that he or she will lose his or her assets held by the retailer if the retailer goes into bankruptcy. While issues remain about the interpretation of Sections 2-326 and 9-114, I ignore those as well. For the

\(^{23}\) 687 F.2d 395, 231 Ct. Cl. 496 (1982).
most part the rules here are quite well set out; most understand their consequences.

Instead consider a hybrid transaction that I call a quasi-consignment. This is the case in which the owner of goods puts them in the hands of a second party, not specifically for sale, but for some form of processing. At the end of the processing the goods may be part of a larger whole, in some changed form. The contract between the processor and the original owner may have a variety of conclusions. In some cases the owner has a right to return of the goods or to receive payment for the goods from the processor. In others, the processor is to ship them to third parties at the owner's direction. Because the transactions vary greatly (depending, for example, upon whether one is considering the canning of beans, leaching of silver out of film, or the construction of a machine) there are many possibilities for disposal of the goods after the transaction is concluded.

Invariably the fundamental issue presented by the cases is to define the rights of the original owner. Without exception the owner will take the position he is just that—an owner who happens to have bailed his goods to another. Under the normal rules of bailment, neither trustee in bankruptcy nor any other creditor will enjoy greater rights than the bailee had, and once the bailment is concluded or breached, will be obliged to return the goods to the bailor.

The processor's trustee can characterize the transaction in several ways. First, he or she can claim that the owner is really a consignor and that the transaction basically is a “sale or return” subject to the rules of Section 2-326. Since the owner will seldom have filed a financing statement, this will usually lead to the conclusion that the trustee gets greater rights than the owner in the original assets. Second, he or she can argue that the owner should be regarded merely as a secured but unperfected creditor. Here he or she may maintain that the owner merely retains title, thus under Sections 9-102 and 2-401(1) obtained a security interest. Since the owner filed no financing statement he or she, of course, will be subordinate to the trustee's rights under Sections 544(a) and 9-301. Finally, he or she might argue that the owner is nothing more than an unsecured creditor who has sold goods to the processor and is awaiting payment.

To consider the difficulties involved in these cases, think about the two decisions by the same court and from the same year by the Court of Appeals for the Fifth Circuit, In re Sitkin Smelting and Refining.24 Each arose out of the bankruptcy of Sitkin, who was in the business of refining the silver out of defective photographic film. Each was decided by the Fifth Circuit in 1981 and both of the opinions are written by Judge Roney. In the first case the court held that Eastman Kodak as a bailor of waste film was entitled to its return.

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24. In re Sitkin Smelting & Refining, 639 F.2d 1213 (5th Cir. 1981); In re Sitkin Smelting & Refining, 648 F.2d 252 (5th Cir. 1981).
in preference to the claim of a secured creditor of the bailee. In the second case the court held that GTE Products Corporation was merely an unpaid seller of waste film, not entitled to return in competition with the trustee in bankruptcy.

In rejecting GTE's claim that it was merely a bailor, the court points out that Kodak, in the first case, had incorporated three specific terms in its agreement that made it the bailor. First, Kodak had the right to demand the return of the scrap material, not just the right to return of the refined metals. Second, Sitkin had an option to cancel the contract and to return the goods to Kodak unless Kodak asked that it be processed; Sitkin had not incurred an unconditional obligation to pay. Third, Kodak's agreement gave it "title" until the material had been processed. Kodak wished to insure that the processor did not resell the film that was of inferior quality. Also it was important to Kodak that the film not fall into the hands of Polaroid, with whom Kodak was litigating.

The two cases illustrate the potential complexity of underlying transactions in such cases. Despite the talk of title in the Kodak case, the parties apparently never contemplated the return of the refined silver to Kodak. Rather they planned a payment by the processor calculated by multiplying the ounces of silver obtained by a published price quote. It would have been easy for one to have found Kodak engaged merely in a sale of the goods to Sitkin. That case produced a dissent from Judge Clark which emphasized the purchase aspect of the operation. The court undertakes a minute analysis of the contracts in each case to ferret out provisions that make one appear as a bailment and the other as a purchase.

Surely the contract terms are important, but I would argue they should not be determinative. First, we are not concerned in any of these cases with the rights between the owner and processors/buyers. Rather we are concerned with the rights of third parties. Although rights of third parties should be influenced by private agreements not available to them, they should not be completely controlled by such terms. It is ancient law that the buyer in the ordinary course or other third parties will often be granted the right a reasonable person in his shoes thought he was getting based upon the ostensible ownership of his seller, not upon the actual ownership.²⁵ In my view, that too should be the guiding rule in these cases. Although courts should be concerned with the terms of the agreement, they should be principally concerned with the reasonable expectations of third parties, parties who are not privy to the underlying agreement, parties who might be misled by appearance.

In this setting it is easy to put the burden on the owner. Presumably he can solve any problem by the simple filing of UCC-1. I would

²⁵. See UCC Sections 2-402, 2-403(1), 2-502.
argue that even the most slovenly drafted bailment or sale and return agreement is entitled to protection under Section 9-203 as a security agreement. This right of return or of payment is an obligation that can be secured by the underlying asset. That security agreement in turn would be perfected by the filing of a financing statement in the name of the processor. Given the ease with which the owner could protect himself and the mischief the Sitkin's of the world can cause, why not resolve doubts in favor of the buyers and against the owner/sellers?

Note well, I am not suggesting that every owner of a good who puts it in the possession of a third party runs the risk of losing it to a buyer or a trustee in bankruptcy unless he files a financing statement. Courts should be concerned with the circumstances of ostensible ownership. The circumstances of the specific case at issue or of the trade in which the possessor is involved will often put a reasonably prudent third party on notice. For example, no one would seriously argue that a buyer who purchases a car from an auto body repair shop should take that car free of the true owner's title. Even a fool knows that the cars at the typical automotive repair shop do not belong to the shop, but belong to the patrons and are there on short-term bailment for repair. I would argue the same for most industrial equipment in a society where equipment leases are so commonplace that one should not put much store by possession of equipment. That is not true, however, for cases involving inventory and things like inventory, such as the silver in the waste film. Here there is little to put the bank or other third parties on notice. Even after one has seen the private document, there may not be agreement on the status of the title. Surely, without reference to the documents, one might well have said Sitkin owned the goods and had the power to sell them. Thus in Sitkin I would vote with Judge Clark in Kodak and Judge Roney in GTE to deprive both GTE and Kodak of their interests.

As these cases and others like them well demonstrate, there will continue to be difficult problems in the never, never land between perfected secured loans, bailments and loans for processing. Courts ought to look carefully at circumstances in the particular case and at the expectations of those in the trade.

The lesson of my rule for the owner/processor should also be clear. If I were advising the owner, I would suggest that he or she draft

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the document that would qualify as a security agreement in his or her own goods and file a financing statement in the name of the processor that would cover those goods.

C. Real Estate Problems

Real estate scope problems associated with Article 9 take many forms. Typically they involve one of four settings. The first is that in which the mortgagee borrows against his mortgage. A second and closely analogous case is one in which the vendor on a landsale contract borrows. Finally are the cases in which alternatively the lessor or the lessee attempts to borrow against his interest in the lease or the leased premises. One should first examine the Code sections and comments described above—Section 9-102(3), Comment 4 to Section 9-102, and Section 9-104(j). Section 9-102 makes clear that Article 9 governs some part of some of these transactions, but the sections and comment ultimately leave it unclear exactly which are covered and how, and exactly the extent to which real property security devices are preempted by Article 9.

The application of Article 9 to these transactions has been quite troublesome to courts. Part of that trouble derives from the fact that the drafters of the Code did not see the problems clearly, or, if they did, did not articulate the solutions with any clarity. The issues are particularly critical in the so-called secondary mortgage market in which lenders "warehouse" mortgages, that is, make loans of varying length against pools of mortgagees' interests. In such cases the lenders do not wish to go to the trouble and expense of making a real estate filing with respect to each of many mortgages. To require them to do so would not materially enhance the knowledge of other creditors and might impose a cost so high as to damage the secondary mortgage market.

By far the best analysis of the law, at least in the setting in which the debtor offers a mortgage and a note, is contained in Krasnowiecki, Kennedy Mortgage Company Bankruptcy Case: New Light Shed on the Position of Mortgage Warehousing Bank. There Professor Krasnowiecki argues that the world should be divided into two parts, the mortgagees' world and the mortgagors' world. He then argues that those dealing with the mortgagee, purchasing the mortgage or lending against it, are essentially dealing with personal property that happens to be secured by a real estate mortgage. For the most part the rights of such lenders should be governed by Article 9. Posses-

27. See, e.g., In re Kennedy Mortgage Co., 17 B.R. 957 (Bkrtcy D. N.J. 1982).
31. 56 AM. BANK. L.J. (1982).
sion of the note would be enough to perfect their interest even though they take no action with respect to the mortgage.

He argues on the other hand that the mortgagor's interest, the possessory interest, is a real estate interest, and that those dealing with the mortgagor, purchasers, lenders, and such, should be entitled to rely upon the real estate records and should be expected to record their interests there. Although his general thesis does not answer every question, it provides a working hypothesis from which to reason to a conclusion in specific cases.

In my view nearly the same analysis should be applied in the land-sale contract and the lease cases. In both of those cases the possessory interests, that of the vendee and the leasee respectively, should be regarded as real estate interests. One wishing to take a security interest in the appreciated value of the lease or in the vendee's equity in the land, should be expected to use a mortgage or some other form of real estate security device and should be expected to record in the real estate records in order to perfect. Conversely, the vendor's interest should not be treated as a real estate interest; it should be dealt with under Article 9. The lessor's interest should be treated as personal property (but, if one is to follow Bristol Associates discussed below, personal property to be dealt with outside of Article 9).

Even in the area of mortgages and notes, Professor Krasnowiecki's thesis has not been fully accepted by the courts. One can find a variety of cases that conflict with it. However, it is consistent with the best cases such as Kennedy Mortgage, and it deserves to be followed everywhere. In a sense Professor Krasnowiecki does the same analysis as the drafters did in establishing fixture filings and non-fixture filings in Section 9-313. The idea of non-fixture filings as a mode of perfecting a security interest in a fixture was that certain personal property claimants are not expected to and do not examine the real estate records. One ought to be treated as perfected against those if he or she has done nothing more than made a proper UCC-1 filing in the personal property records. Thus, one perfecting a security interest by filing a UCC-1 on a fixture has rights superior to the rights of the trustee in bankruptcy even though he or she might lose to a subsequent purchaser of the real estate. By the same token, one taking a security interest in a mortgagee's interest, the vendor's interest, or in a lessor's interest, should have priority over subse-

32. See, e.g., Maryville Savings and Loan Corp. 743 F.2d 413 (6th Cir. 1984); In the Matter of Isbell. 27 B.R. 926 (Bkrtcy W.D. Wis. 1983).
34. Compare UCC Section 9-313(4)(b) with (4)(d). A subsequent purchaser of the real estate would not be required to check the personal property files and would not have notice of a fixture filing there; whereas the personal property filing would subordinate the trustee.
quent claimants of those interests whether they be trustees in bankruptcy or creditors of the mortgagee, vendor and lessor.

Note that the assignee who has chosen not to make a real estate recording does not necessarily have priority over one who purchases from the mortgagor, the vendee or the lessee. In some cases such a purchaser will have notice of the assignee's right from extraneous factors, but Professor Krasnowiecki is not suggesting personal property filing against the mortgagee, vendor, etc., can by itself protect against a purchaser who is in the mortgagor's or vendee's world. In those, one could expect a real estate recording. That is consistent with the rules under Section 9-313 where we ask the secured creditor to do a "fixture" filing (a real property filing) if he or she wishes to have protection against those subsequent purchasers and others who could be expected to rely upon the real estate records.

This analysis tells us first that one who lends against a mortgage and a note should be regarded as having engaged in an Article 9 transaction. He or she perfects as to the note by taking possession.35 Moreover, we should conclude as Professor Krasnowiecki and the Kennedy court do, that it is unnecessary for the secured creditor to take any act, whether possession, filing, or any other, with respect to the mortgage. The Kennedy court held the mortgage follows the note. Any subsequent party dealing with the mortgagee is on notice of the first party's interest by the debtor's inability to produce the note which is in the possession of the first secured creditor.

What then of the land-sale contract? The principles are identical, but the mode of perfection is different. The courts are in agreement that the vendor's interest in a land-sale contract is not an instrument but a general intangible.36 For that reason possession by the secured creditor is not a permissible method of perfection; perfection must be by filing.37 Conversely, the purchaser of the vendee's interest should be entitled to rely upon the real estate records and one who wishes to protect his or her interest in such purchase should record in the real estate records. If, as in the usual case, the secured creditor is concerned merely about bankruptcy of the vendor, filing in the UCC records with respect to general intangibles should entitle such creditor to take free of the vendor's trustee's interest. That is the outcome, directly or by implication, from a series of recent cases such as In re Maltese,38 S.O.A.W.,39 and Southworth.40

Finally there is the lease. Here the analysis is similar, but not identical. Courts have generally held the lessor's interest is a non-

35. UCC Sections 9-105, 9-302, 9-305.
37. UCC Section 9-302.
38. Maltese, supra, note 36.
possessory personal property interest and that one takes a security interest in that interest by complying with personal property law. Moreover, the leading case, *In re Bristol Associates*,41 concluded that that security interest was entirely outside of Article 9. Section 9-104(j) explicitly refers to leases stating that a "lease or rents thereunder" are not subject to Article 9. Relying upon that language and some of the statutory history, the Court of Appeals for the Third Circuit held that Girard Bank got a perfected security interest in lessor's rights without complying with Article 9 (and, apparently, without complying with any real property recording either).

In the face of the explicit statement in Section 9-104(j), the court's decision seems correct. To that extent, however, rules in Article 9 with respect to leases are inconsistent with those dealing with a mortgagee's and a vendor's interest. Why should one have to file in order to perfect a security interest in a vendor's interest in a land-sale contract yet not have to do so in the case of a lease? Apart from the language in Section 9-104, I see no reason. Perhaps that language should be modified to require that one taking an assignment of rents file a financing statement to put others on notice. Until that is done, presumably Bristol remains the most persuasive case except in places such as Florida where the courts have gone off on their own.

What then of the lessee's interest in an appreciated leasehold? Following the Krasnowiecki analysis one would say this is a possessory—a true real estate—interest and one wishing to take security interest in it should use a mortgage and comply with the real estate recording laws. That is the holding in the recent bankruptcy case *In re LeSueur's*42 which seems to me to be a correct analysis. Again there are cases elsewhere in conflict, but these should be rejected.43

By adopting Professor Krasnowiecki's analysis and applying it to the lease and land-sale contract case, I do not mean to suggest that the courts have done so or that the law is as simple and well settled as one would like it to be. In fact the law is in disarray. In closing, let me analyze two or three of the worst cases so that one can understand the damage that might be done by these.

Perhaps the least satisfactory case is *In re Maryville Savings and Loan Corp.*44 In that case People's Bank of Polk County, Tennessee loaned $75,000 to the Maryville Savings and Loan Corporation, the debtor. Debtor assigned rights to People's in certain promissory notes and deeds of trust on which the debtor was the mortgagee and the bank recorded the assignment with the register of deeds in the real estate records. The bank did not take possession of the notes or

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44. 743 F.2d 413 (6th Cir. 1984).
deeds of trust. Because of this lack of possession, the bankruptcy
court held the bank had not perfected its security interest and that
its interest in the notes and deeds of trust was subordinate to the
rights of Maryville's trustee in bankruptcy. Finding that the real
estate recording was adequate for Tennessee law, the District Court
reversed. The Court of Appeals for the Sixth Circuit affirmed in part
and reversed in part. The concluding paragraph of the opinion reads
as follows:

In this case, then, we conclude that Article 9 applies to the plaintiff's
security interest, but only in the promissory notes themselves. Since
plaintiff did not take possession of the notes, plaintiff's security interest
in the notes was not perfected . . . On the other hand we conclude that
Article 9 does not apply to plaintiff's security interest in the deeds of
trust . . . [P]laintiff's security interest in the deeds of trust is therefore
demed to be perfected interest.

The court remanded the case for further proceedings in accordance
with its opinion. If you were the judge to which it was remanded
with that opinion, what would you do? The bankruptcy court had
said the trustee in bankruptcy gets the payments on the notes. Dis-
trict Court had said that the bank gets the payments on the notes.
The Court of Appeals says that neither of those decisions is correct.
What is the third possibility?

One possibility is that the trustee, holding the highest interest in
the notes, has a personal claim against the individual assets of the
underlying mortgagors and that the bank holds a non-recourse mort-
gage against the mortgaged premises of these mortgagors. That so-
lution, of course, is wacky. That would mean that the mortgagors—
who were presumably living on their property in Tennessee and
paying regularly—must now pay twice for their property. They must
pay off the non-recourse mortgage in order to get clear title and pay
the holder of their notes or suffer a judgment and the loss of their
other assets. Yet of all the people in this comedy, the mortgagors are
the only ones who have done nothing wrong. How then can we make
them pay twice? Surely the Court of Appeals could not have in-
tended that.

The proper outcome was that reached by the bankruptcy court.
Here we are dealing in the mortgagor's world, the world of personal
property, and there should have been a perfection according to Ar-
ticle 9. The only available mode of perfection would have been pos-
session of the underlying notes by the bank and since the bank failed
to take possession it should be subordinated to the trustee's claims.
On rehearing in 1985 the Court of Appeals made a somewhat grudg-
ing retreat and held for the trustee, at least in this case.45

A second case containing troublesome dictum is In re Freeborn.46

46. 617 P.2d 424, 94 Wash.2d 336 (Wash. 1980).
There the court holds that the assignee of various vendor interests in land-sale contracts are subordinate to the rights of the trustee in bankruptcy because of failure to perfect. The troublesome part of the case is the dictum that an assignment by the original vendor to the lender not merely of the right to the real estate contract payments but by a document titled "Deed and Seller's Assignment of Real Estate Contract" (conveyance of the underlying title) requires a filing both under Article 9 and in the real estate records. I would argue that the case is wrong to the extent it demands a real estate recording. Moreover it is unwise to say that one should have one result based on one form document and a different result based on the use of a different form when the underlying transaction is really the same in both cases. Taking a deed that is not recorded should probably subordinate the assignee to claims of subsequent purchasers from the vendee who are misled by the status of the real estate recording, but it should not diminish the rights of the assignee versus the vendor's trustee's claims.

Finally, there is a line of cases in Florida that would make a lessee's "contract right" subject to Article 9.\textsuperscript{47} Contract rights have now disappeared from Article 9. What were formerly contract rights are now mostly "accounts" as defined in Section 9-106. Accounts, like contract rights before them, are rights to payment for "goods sold or leased or for services." They do not include the right to payment of money for the use of real estate; nor do they include the right to possess the real estate. Thus, on a technical basis, the Florida court, followed by the bankruptcy court in Florida, misreads Article 9.

On a more fundamental basis the cases violate the Krasnowiecki division between the possessory and the non-possessory worlds. Presumably, one holding under a long-term lease will record it or a memorandum in the real estate records. Those dealing with a lessee by buying or selling a leasehold interest or borrowing against the appreciated value of his or her leasehold can also be expected to look at the real estate records. That being so, it seems to me that LeSueur is correct and the Florida cases wrong.

IV. CONCLUSION

We see that even the broad and sophisticated language of UCC Sections 9-102 and 9-104 do not anticipate all of the serious scope problems. No matter how well the courts and lawyers do their job we can expect to see persistent eruptions along the borders between Article 9 and real estate, Article 9 and Article 2, and in other areas. In dealing with these, the courts should not mechanically apply or reject Article 9. Rather they should pay some attention to those who have thought about these questions, such as Professor Krasnowiecki,

\textsuperscript{47} See cases in footnote 43.
and should give some thought to the probable impact on future lending transactions of a decision in any particular case. Even with the most careful consideration, dancing on the edge of Article 9 will remain one of the most exciting and interesting adventures that one can undertake in personal property law.