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Carl Felsenfeld
Fordham University School of Law, cfelsenfeld@law.fordham.edu

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KNOWLEDGE AS A FACTOR IN DETERMINING PRIORITIES UNDER THE UNIFORM COMMERCIAL CODE

CARL FELSENFELD*

Before the Uniform Commercial Code, a second secured party could not perfect his interest over a prior unperfected interest if he had knowledge of that prior interest. The Code, in contrast, promulgates a basic "first-to-file" priority rule in section 9-312(5). In this sharp departure from prior law, the knowledge factor is omitted. Other sections of Article 9, however, allude to certain aspects of the pre-Code knowledge requirements. Mr. Felsenfeld analyzes the difficulties and incongruities which may arise from this lack of explicitness with regard to knowledge of prior security interests. He concludes that the courts may and should reconcile such disparities in accordance with basic Code policy, and suggests logical and practical interpretations to fill the void.

I

INTRODUCTION

ALTHOUGH Article 9 of the Uniform Commercial Code may be presented as "a comprehensive scheme for the regulation of security interests," it does not, nor does it aspire to, answer all questions that may arise concerning chattel security. Despite use of the word "code," it is clear that the draftsmen had an "anticodification or antistatute predilection," and did not attempt to write down all the law in the historic civil-law sense. The regular use of such concepts as "reasonableness," "ordinary course of business," and the like in Article 9, as well as the broad conceptualizations throughout the Code, indicate a clear recognition that the Code could not possibly, without judicial assistance, resolve all the issues in the enormously complex areas it treats. In addition, no man or group of men can draft statutory provisions covering the law of sales, negotiable instruments, banking, securities, security interests, and the like without some lapses. Thus, it

* Carl Felsenfeld is a member of the New York Bar and Assistant to the General Counsel of the C.I.T. Financial Corporation.
1 Uniform Commercial Code § 9-101, comment.
3 See Hawkland, Article 9 Methodology, 9 Wayne L. Rev. 531, 532 (1963), where Dean Hawkland describes the "nightmare" Prussian attempt to draft a Code of 28,000 sections.
4 See, as one of numerous examples, the sweeping definition of "document of title" in § 1-201(15), designed to avoid the limitations of warehouse receipts and bills of lading imposed by the two uniform acts on those subjects.
was fully anticipated that statutory vacuums would be discovered as the Code went into effect.\(^5\)

Some of the vacuums are clearly the result of human errors, such as the failure to deal sufficiently with accounts receivable as proceeds of merchandise inventory.\(^6\) Other neglected problems, such as the issue of subordinations,\(^7\) probably were so deeply submerged in pre-Code thinking that they were not even identified as legitimate legal questions until the legal community began applying a hard intellectual test to old and habitually accepted practices.\(^8\)

This article is concerned with a more subtle type of void—where the draftsmen both identified and handled a basic problem, but where the results may not be entirely as intended. Article 9 of the Code, in its basic structure, removes knowledge of a prior lien (the term “lien” being used herein as shorthand for “security interest\(^9\)”) as a factor in determining the relative priority of a later lien.\(^9\) As a result, a second secured party with an interest in particular collateral generally may take priority over an earlier lien which has not been perfected or properly created under the Code, although he knows of its existence when he obtains his later lien. This effects a change in the basic pre-Code rule that failure to perfect a lien will not destroy it as against one with knowledge of its existence. While this change represents a conscious decision on the part of the draftsmen,\(^10\) there is reason to believe that it may not have been fully deliberated.\(^11\) Regardless of the reason,

\(^5\) It was undoubtedly the recognition of this that incited so much of the early opposition to the Code. Entrenched financial institutions with large investments, the value of which depended to a large degree upon the continued effectiveness of accepted commercial law doctrines, looked upon the Code with suspicion and delayed its passage.


\(^7\) See Coogan, Kripke & Weiss, The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements, 79 Harv. L. Rev. 229 (1965).

\(^8\) Some felt that the inventory-receivables problem was in this area. “Nothing in prior law even recognized the possibility of the existence of such a conflict, much less provided a solution.” Goodwin, Priorities in Secured Transactions—Article 9, Uniform Commercial Code, 20 Bus. Law. 877-78 (1965).

\(^9\) The Code does this in a backhanded fashion. The only explicit mention of the removal of knowledge from the basic priority rules is in a comment, Uniform Commercial Code § 9-312, comment (4), examples 1, 2, 3, and 4. Even there the reference, relating only to the time of perfection and not to the time an interest is obtained, is enigmatic. 2 Gilmore, Security Interests in Personal Property § 34.2, at 901 (1965) [hereinafter Gilmore].

\(^10\) But see 2 Gilmore § 34.2, at 901, questioning whether this was an intended, deliberate change in policy from pre-Code law.

\(^11\) Knowledge appeared as a significant factor in the 1952 Official Draft. See Uniform Commercial Code § 9-301(1)(b) (1952). The recollections of the
however, drafting deficiencies and internal inconsistencies have resulted from the Article 9 treatment of knowledge. The present article is designed to focus upon some of these deficiencies and inconsistencies, and to suggest that the courts can and should take appropriate steps to preserve the basic Code scheme of priorities in cases where the unintended and unforeseen effects of the draftsmanship would otherwise defeat that scheme.

II

THE BASIC SCHEME

A. The Omission of the Factor of Knowledge—

Sections 9-312(5), 9-301(1)(a)

The crucial section for this discussion of priorities is section 9-312, entitled "Priorities Among Conflicting Security Interests in the Same Collateral." Section 9-312(5) establishes the basic order of priority among competing interests as follows:

(a) in the order of filing if both are perfected by filing, regardless of which security interest attached first under Section 9-204(1) and whether it attached before or after filing;

(b) in the order of perfection unless both are perfected by filing, regardless of which security interest attached first under Section 9-204(1) and, in the case of a filed security interest, whether it attached before or after filing; and

(c) in the order of attachment under Section 9-204(1) so long as neither is perfected.

Most significant in this order of priorities, for present purposes, is that there is no mention of whether knowledge of a prior interest will prevent the later interest from achieving the priority granted under these sections. Thus, reading the section literally: where both interests are perfected by filing, the first to file has priority without regard to knowledge of the other interest; where one interest is perfected other than by filing, the first to perfect has priority, again without regard to knowledge of the other interest; and, the first of two unperfected interests to attach has priority, also without reference to knowledge.

It would be unnecessary to raise the possibility that knowledge could be a factor under section 9-312(5) were it not for the pre-Code law. Most pre-Code filing and recording statutes were designed to exhibit to the world the existence and good faith

draftsmen with whom the writer has talked are generally to the effect that they desired to make Code perfection, as the factor presenting the fewest evidentiary problems, the dominant test of lien priorities. Knowledge was, therefore, eliminated in the post-1952 efforts. Gilmore describes the metamorphosis of the 1952 draft to the present draft in 2 Gilmore § 34.2, at 898-900.
of the lien transaction.\textsuperscript{12} Since there was no evident change in ownership when a lien was created by contract alone, notice of the changed ownership was required to be provided by a filing in a prescribed public office. It was a natural development from these premises that a physical change of possession which demonstrated some change in ownership made filing unnecessary, as did actual notice of the lien. Filing statutes were usually drafted to provide that, for holders of subsequent interests in a chattel to take free of a prior lien, they must be without knowledge of the lien or in "good faith," which was generally held to mean the same thing.\textsuperscript{13} Even when a filing statute was worded so broadly as to free all third parties from the effect of an unfiled lien, it was often held, both in England and in the United States, that actual knowledge of the lien had, at least for the knowing party, the same legal effect as filing.\textsuperscript{14} Filing and knowledge came to be regarded as two forms of the same thing: one "constructive" notice, the other "actual" notice.\textsuperscript{15}

Despite the silence of the Code provisions on priorities in section 9–312(5) as to the effect of knowledge, it is apparent that the Code was intended to change the equation of knowledge with filing and to create a "pure" filing structure. One evidence of this intent is that the draftsmen were well aware of the significance of knowledge. Elsewhere, they specifically provided that a second interest could defeat a prior interest even if the holder had knowledge of it,\textsuperscript{16} and one such provision, dealing with farm crops, was written into another subsection of section 9–312.\textsuperscript{17} The draftsmen

\textsuperscript{13} 1 Gilmore § 21.2, at 584. See 1 Jones § 311, at 495.
\textsuperscript{15} United States v. Suring State Bank, 150 F. Supp. 60, 63 (E.D. Wis. 1957); Strahorn-Hutton-Evans Comm'n Co. v. Florer & Bannerman, 7 Okla. 499, 54 Pac. 710 (1898).

There are, of course, exceptions to this basic rule which will help pave the way for acceptance of the Code rules. Some states have filing or recording statutes under which failure to perfect will destroy the lien even as against a party with knowledge of the lien. See, e.g., Potter Mfg. Co. v. Arthur, 220 Fed. 843 (6th Cir. 1915). Professor Gilmore has suggested that under the accounts receivable recording acts knowledge will not replace filing. 2 Gilmore § 34.2, at 397. However, there are insufficient cases to create a doctrine here, and the statutes are equivocal. Other recording statutes are as clear as the Code that, in the event of conflict, the first to file has priority. E.g., N.C. Gen. Stat. § 44–80 (1965); Tex. Rev. Civ. Stat. Ann. art. 260–1 (1959). In addition, there are the protections for the retail purchaser and the purchasers from purchasers which are not defeated by knowledge of the prior lien.

\textsuperscript{16} Uniform Commercial Code § 9–307(1).
\textsuperscript{17} Uniform Commercial Code § 9–312(2).
also specifically provided that knowledge of a prior interest would, in some cases, prevent priority over it,\textsuperscript{18} again with one such provision being present in another subsection of section 9–312.\textsuperscript{19} Although the draftsmen were not explicit in section 9–312(5), their intent that knowledge be irrelevant is clear from the comments to that section.\textsuperscript{20} The examples of the operation of the basic priority rules explicitly state that knowledge is not a factor and that the first to file, perfect, or attach (depending upon the applicable provision) will prevail without regard to his knowledge of a prior interest.\textsuperscript{21}

Although it sets out the Code's basic priority provisions, section 9–312(5) is drafted as a residual section, applying only if the rules of the rest of section 9–312 do not apply, and section 9–312(1) defers to the priority rules set out in a number of specific provisions elsewhere in Article 9. Most of those sections which concern the effect of knowledge on priorities will be dealt with below. It is necessary at this point to observe the interrelation of section 9–301 and section 9–312. Section 9–301 deals with the legal effect of the unperfected security interest.\textsuperscript{22} In addition to subjecting unperfected security interests to certain lien creditors and transferees, section 9–301 provides that they are "subordinate to the rights of (a) persons entitled to priority under Section 9–312..." What this reference to section 9–312 means, since section 9–312 merely lists competing interests in order of their priority, is that unperfected security interests are subject to any interests given priority under section 9–312. There is no requirement, in this deference to section 9–312, that the interests given priority over an unperfected security interest be without knowledge of it; nor is there any basis in section 9–312 to require absence of knowledge to defeat a prior unperfected lien. Again, the

\textsuperscript{18} Uniform Commercial Code §§ 9–301(1)(b), 9–308.

\textsuperscript{19} Uniform Commercial Code § 9–312(3).

\textsuperscript{20} It should be noted that § 1–102 of the 1952 Code had provided: "The Comments... may be consulted in the construction and application of this Act..." This has been deleted from the present Code, primarily at the instance of the New York Law Revision Commission, which felt that an express statutory invitation to consult the comments "is unnecessary and could lead to unprecedented use of the Comments to expand and qualify the text." N.Y. Law Revision Comm'n, Study of the Uniform Commercial Code 17 (1956).

\textsuperscript{21} Uniform Commercial Code § 9–312, comment (4), examples 1 ("it makes no difference whether or not A knew of B's interest when he made his advance"), 2 ("it makes no difference whether or not he knows of the other interest at the time he perfects his own"), 3 ("whether or not he knows of B's interest when he files"), and 4 ("whether or not A knows of B's intervening advance when he makes his second advance").

\textsuperscript{22} To be precise, § 9–201 states that a security agreement is effective against purchasers and creditors. Section 9–301 then presents parties who may take free of an unperfected interest as exceptions to the basic rule.
draftsmen have made knowledge irrelevant only by their failure to state that it is a factor, and not by expressly stating that it is not a factor. And again, as in section 9–312(5), the specific reference to knowledge in other subsections of the same section serves to highlight its absence from the cross-reference to section 9–312.23

Thus the plain meaning of the statute is that a second secured party, even with full knowledge of a prior unperfected lien, may obtain priority over it by obtaining a lien and perfecting in accordance with Article 9. It is likewise true that if the later party elects not to perfect, he can still lose to the earlier lien if the former perfects first. The basic system established under section 9–312(5), whereby perfection is through filing, is sometimes referred to as “pure” filing. Relative priorities are determined by an objective and easily ascertainable standard—the state of the record—and the more ephemeral question of one’s knowledge may be ignored.

B. The Meaning of “Knowledge” Under the Code

Although the basic structure of Code priorities removes knowledge as a factor, there are a number of special sections under which knowledge of a prior security interest is important. Under the many pre-Code statutes requiring a party to be without notice or knowledge of a prior lien, or to be acting in good faith, to take free of that lien, the degree of information required to constitute notice, knowledge, or bad faith was left to the courts,24 with only rare exceptions.25 The general position, under the multitude of recording statutes, was that knowledge of circumstances that would lead an ordinarily prudent man to realize that a prior lien existed would support a showing of notice or its equivalent.26 An extremely limited group of cases held that to be bound by a prior lien, one must have specific information as to its details.27

23 See Uniform Commercial Code § 9–301(1).
24 Bogert, Commentaries on Conditional Sales, 2A U.L.A. § 58 (1924) [hereinafter Bogert]. In general, the courts have delegated this function to the juries.
25 See Uniform Trust Receipts Act § 9; Uniform Negotiable Instruments Law § 56.
26 Glisson v. Burkhalter, 31 Ga. App. 365, 120 S.E. 664 (1923); Werner, Mosiman & Co. v. Winzer, 109 Kan. 647, 202 Pac. 80 (1921); D. M. Osborne Co. v. Plano Mfg. Co., 51 Neb. 502, 70 N.W. 1124 (1897); Osco Motors Corp. v. Martin, 137 N.J. Eq. 433, 45 A.2d 454 (Ch. 1946); New Dells Lumber Co. v. Pfänner, 216 Wis. 638, 258 N.W. 375 (1935). As to prior rights in a negotiable instrument, Uniform Negotiable Instruments Law §§ 52 and 56 codified this rule in defining the prerequisites of a holder in due course, and the cases have applied it as stated.
The pre-Code law thus appears to have required "notice" only as that term is defined for Code purposes in section 1–201(25), which provides that one has "notice" of a fact when "from all the facts and circumstances known to him at the time in question he has reason to know that it exists." However, under the Code, where information (to use a neutral term) of a prior lien is significant, the Code consistently uses the term "knowledge." Section 1–201(25) defines knowledge as "actual knowledge." Therefore, even in those sections that retain the pre-Code law's subordination to a prior interest of which a party has "information," the Code has reduced the protection accorded to the prior interest by requiring "knowledge" rather than mere "notice."

A further problem, in those instances where knowledge is relevant, concerns the subject of the required knowledge. The few cases that considered this matter under the pre-Code law stand for the proposition that for a later holder to be subject to an unperfected lien of which he has knowledge, the lien must at least be valid between the parties to it.\textsuperscript{28} If the prior lien instrument were so defective that it could not even be enforced by a secured party against the debtor, knowledge of it would not adversely affect the rights of a future lienholder. It is logical that the same result will be reached under section 9–301, section 9–312, and any other sections which grant certain prior security interests priority over later interests whose holders have knowledge of the first security interest.\textsuperscript{29} How, after all, could one be subordinate to a security interest which itself was ineffective?

A question of somewhat more practical concern is whether knowledge of a "security interest" presupposes that the interest has attached. Section 9–204, which establishes the requirements for attachment (a prerequisite to perfection under the Code\textsuperscript{30}), refers to three necessary elements for a "security interest" to attach. A literal reading would imply that there can be a security interest before it has attached. But the comments to the section explain that it "states three basic prerequisites to the existence of a security interest: agreement, value, and collateral."\textsuperscript{31} Since there is no other definition of "security interest" which determines at what point one arises,\textsuperscript{32} and since there should

\textsuperscript{28} Arro Oil & Ref. Co. v. Montana & Dakota Grain Co., 87 Mont. 259, 286 Pac. 1115 (1930); Smith v. Allen, 78 Wash. 135, 138 Pac. 683 (1914).

\textsuperscript{29} This result should follow even though under the § 9–203 definitions a "security interest" may apparently exist which is nevertheless ineffective between the parties.

\textsuperscript{30} Uniform Commercial Code § 9–303.

\textsuperscript{31} Uniform Commercial Code § 9–204, comment (1). (Emphasis added.)

\textsuperscript{32} The definition of security interest in § 1–201(37) is of no assistance. It
be an actual interest before knowledge of it can defeat a later creditor's interest, then only when an interest has attached should knowledge of it be relevant. The Code permits pre-filing of a financing statement, but this is to allow an interest to be perfected when it arises, not to define when the interest arises. Nevertheless, pre-filing raises the question whether knowledge of a filed statement when the interest has not yet attached qualifies as "knowledge of a security interest." The Code scheme, properly interpreted, answers that question in the negative.

III

Knowledge and the Unperfected Lien

A. The Later Perfected Lien: Section 9-312(5)(c)

Under most of the pre-Code filing statutes, it was held that where two interests were unperfected, the later interest would prevail, unless it was obtained with knowledge of the former. The theory of these cases was essentially that, by failing to perfect, the earlier party may have misled the later and, therefore, should suffer the consequence of subordination, even if the second party also failed to file. It is apparent that the second party could not be misled by the first party's failure to file if he had actual knowledge of the former's interest. Consequently, the pre-Code law made knowledge the equivalent of filing. Later filing by either party would not alter the basic reliance rationale and, therefore, would not alter the lien priorities. However, a few statutes and interpretive cases required the later lien to be perfected first in order to retain its priority.

Under Code section 9-301(1)(a), an unperfected security interest is subordinate to the rights of persons entitled to priority under section 9-312. Under section 9-312(5)(c), where two interests are unperfected, the first to attach (which generally means the first to be obtained) will have priority. This first-to-attach rule is not inconsistent with the concept of "pure" filing (where the first to file prevails), but neither is the pre-Code majority rule that the later interest prevails. Each rule will en-

merely provides: "'Security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation . . . ."


36 Uniform Commercial Code § 9-204.
courge a secured party to file immediately in order to protect himself against both earlier and subsequent interests. The pre-
Code majority rule will prevent a late filing by the first secured party from defeating the second secured party, while the Code will permit that result (thus giving a more complete deference to filing). If, under the Code, Financer A elects not to perfect and Financer B takes an interest in reliance upon a clear record and does not himself perfect, there is some justice in permitting A to prevail since B could have protected himself by filing. In addition, there is a certain symmetry in letting the first-to-attach rule parallel the first-to-file rule. B, in this hypothetical, loses to A when without knowledge of A's lien; a fortiori, the same result follows when B does have knowledge. However, regardless of who was first to attach and presumably regardless of estoppel doctrines related to knowledge or lack thereof, the first to file will always prevail under the Code. For this reason, the comment to section 9-312(5)(c) is well taken—the first-to-attach rule "may be thought to be of merely theoretical interest, since it is hard to imagine a situation where the case would come into litigation without either A or B having perfected his interest."\textsuperscript{37} One may construct such situation—bankruptcy where neither interest had been perfected prior to the filing of the petition. As will be discussed later,\textsuperscript{38} the referee in bankruptcy will have to decide priority questions when distributing the property among the creditors, and state law (i.e., the Code) will govern the priorities. Since the bankruptcy court is a court of equity, it may well be questioned whether the rule of section 9-312(5)(c), that the first to attach wins without regard to knowledge of another's interest, will be respected.

There are, however, situations—those where both interests attach simultaneously\textsuperscript{39}—which the first-to-attach rule for unperfected competing interests will not cover. The Code contains no resolution for the simultaneous attachment situation. One possibility would be for each interest to be given a pro rata share in the collateral. Another possibility is that the pre-Code law will be employed, under which the second interest (defined, of course, other than by order of attachment) prevails over a prior unfiled interest, unless the second interest is taken with knowledge of the

\textsuperscript{37} Uniform Commercial Code § 9-312, comment (4), example 2.

\textsuperscript{38} See pp. 250-61 infra.

\textsuperscript{39} Simultaneous attachment could occur where an interest in accounts as proceeds from the sale of inventory was in conflict with an interest in the accounts themselves. Both interests would attach when the accounts arose. See Uniform Commercial Code § 9-204.
first. In other words, knowledge may well be relevant in cases where section 9–312(5)(c) does not in fact establish the priorities. 40

B. Lien Creditors: Section 9–301(1)(b)

Returning to section 9–301(1), the absence of knowledge from subdivision (a), relating to conflicting liens, is in contrast to its presence in subdivision (b).

Under subdivision (b), an unperfected security interest is subordinate to the interest of "a person who becomes a lien creditor without knowledge of the security interest and before it is perfected." 41 The Code thus requires that the unsecured creditor obtain a lien on the property by attachment, levy, or the like at a time when he is without knowledge of the prior unperfected lien if he is to obtain priority over it.

This result is as difficult to justify as the pre-Code law which it adopts. Are we to say that a person taking a mortgage who actually knows of a prior unperfected interest may become superior to it under section 9–312, but that a lien creditor (typically one levying on a judgment) who is enforcing rights acquired perhaps from a tortious act or a breach of an employment contract will obtain a lien superior to an unfiled security interest only if he does not know of it? If knowledge is eliminated from security interest priority tests, where reliance upon the debtor's apparent unencumbered ownership is a vital factor, surely there is even greater reason for eliminating it from the lien creditor area. Imagine a judgment creditor who is ready to levy. He examines the judgment debtor to discover where his property is located. The debtor says, "I have a valuable turret lathe in my basement." If he fails to mention unperfected liens on it, the lien creditor will prevail over them. If he does mention them, the lien creditor will be subordinate. Consider also a situation where the holder of a judgment, before levying execution, searches the local filing records to determine the status of his debtor's property. He chances to discover a lien of record which had been misfiled. By virtue of this discovery, he destroys any valuable right of execu–

40 The same possibility exists when § 9–312(5)(b) applies (first to perfect), and both interests, probably because of simultaneous attachment of the interests, become perfected simultaneously.

41 Uniform Commercial Code § 9–301(1)(b). Section 9–301(3) defines a "lien creditor" as "a creditor who has acquired a lien on the property involved by attachment, levy or the like and includes an assignee for benefit of creditors from the time of assignment, and a trustee in bankruptcy from the date of the filing of the petition or a receiver in equity from the time of appointment."
tion he might otherwise have had. Should knowledge be such a vital factor in the rights of a lien creditor?

The rationale of the statutes upon which the Code was based for making knowledge significant if acquired before the judgment creditor obtained his lien was that creditors "have in a certain sense become the purchasers of the goods." In other words, if he knew the property was encumbered, the creditor was not justified in levying on it. This reasoning was justly criticized on the ground that reliance upon the debtor's apparent ownership of property would not normally occur when a creditor levies, but rather, if at all, when he extends credit. Yet to make knowledge at this earlier time significant introduces difficult problems of proof. In addition, it fails to cover one large category of lien creditors—those who, like the successful plaintiff in a tort case, never did extend credit. If actual knowledge at the time of levy has any importance, it is only that the levying creditor would be more likely to move against property he knew to be unencumbered.

The analogy between a levying unsecured creditor and a party who would only extend credit on a secured basis in the first place was never convincing. If, under the Code, the latter may now extend credit free of a known lien, is there any policy for retaining the old test for the former, to whom its application had a weaker rationale in the first place?

C. Other Transferees: Sections 9-301(1)(c), (d)

Section 9-301(1), in subdivisions (c) and (d), gives priority over an unperfected interest to the rights of:

(c) in the case of goods, instruments, documents, and chattel paper, a person who is not a secured party and who is a transferee in bulk or other buyer not in ordinary course of business to the extent that he gives value and receives delivery of the collateral without knowledge of the security interest and before it is perfected;

(d) in the case of accounts, contract rights, and general intangibles, a person who is not a secured party and who is a transferee to the extent that he gives value without knowledge of the security interest and before it is perfected.

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42 Uniform Commercial Code § 9-401(2) has a similar effect even for a secured party who discovers a misstated statement. See pp. 272–73 infra.

43 It should be noted that a lien creditor cannot protect himself by filing under the Code.

44 Commissioners' Note to Uniform Conditional Sales Act § 5.

45 Bogert § 59.

46 The liens protected in §§ 9-301(c) and (d) will, of course, be defeated by a perfected security interest. Uniform Commercial Code § 9-301, comment (4).

47 These sections excluded the secured party because his priorities are determined in other sections.
Here, the existence of knowledge as a factor is clearly interjected, and it seems appropriate as a matter of principle: If the transferees knew of the lien before they acquired the assets, it is reasonable that they be subject to it. This principle would, of course, seem to be equally applicable to conflicting security interests, for which the Code in section 9-312 creates a different rule. As a result of sections 9-301(1)(c) and (d), however, the Code knowledge rule is not applied to buyers generally but only to conflicting security interests, which are primarily a concern of professionals. The change in the common law of knowledge implemented by sections 9-301(1)(a) and 9-312(5) may, therefore, be justified in some measure by the nature of the people who will be affected.

Although the purpose of sections 9-301(c) and (d) is clear, the draftsmanship is not, and certain problems are created by the awkward phrasing of these sections. The language of subsections (c) and (d) is apparently intended to cover residually transferees other than those secured parties and buyers whose priorities are determined elsewhere. But the draftmen selected an unnecessarily devious method of expressing this intent. The phrase "buyer not in ordinary course of business" (emphasis added) used in subsection (c) was probably intended to cover buyers other than buyers in the ordinary course, since the latter are covered (through sections 9-307 and 1-201) for goods and documents. Buyers in the ordinary course of business are defined in Article 1, and the comment to section 9-312(c) refers to the Article 1 definition of "buyer in ordinary course," to cover only buyers of goods and documents. Consequently, the phrase has no apparent meaning regarding purchasers of chattel paper and instruments. There is, however, another possible source explaining this strange phrase: section 9-308 defines the rights of a purchaser of chattel paper and nonnegotiable instruments who takes them "in the ordinary course of his business." Presumably, then, those parties not covered by this phrase in section 9-308 are intended to be covered in subsection (c). Unless subsection (c) is so read, the only transferees of chattel paper and instruments covered by that subsection's knowledge rule would be bulk purchasers. Section 9-301(1)(c) is more meaningfully read as a residual section and should be so interpreted.

The actual time that the acquisition of knowledge becomes significant in subsection (c) also deserves mention. For a transferee to take free of a preexisting unperfected lien, the subsection

48 Buyers in ordinary course are protected by § 9-307(1) from prior liens. See pp. 264-65 infra.
requires that he both give value and receive delivery of the collateral before he learns of the lien. The comment emphasizes that both of these were intended as the test and, indeed, the Uniform Trust Receipts Act, from which the test is derived, so provides.  

(There is no equivalent requirement in subsection (d) because that subsection covers assets not subject to physical delivery.) Consider, however, a buyer (not a secured party) of one of the items of collateral covered by subsection (c) who merely contracts to purchase. If the contract is binding, and whether or not he has paid any or all of the purchase price, he has clearly given "value" as defined by the Code. Between contract and possession, however, he learns of a previous, unperfected lien. Unless a warranty, express or implied in the purchase agreement, permits him not to conclude his acquisition, he must take subject to the lien. Here again, it appears that the draftsmen did not really analyze the problem thoroughly. Of course, transferees with knowledge of existing liens should generally take subject to them. But where the knowledge is acquired after they are already bound by their bargain, it seems curious that physical possession should be made a controlling test. Under other similar statutes, courts appear to have applied an equitable gloss to the twofold requirement so that the commitment alone, if without knowledge, is enough.

The significant factor about subsections (c) and (d) for our present inquiry is that, like subsection (b), they make actual knowledge a determining factor in establishing the relative priority of an unperfected lien as against most transferees. This is fundamentally an adoption of pre-Code law.

D. Bankruptcy

A discussion of general creditors would be incomplete without at least some mention of the interrelationship of knowledge, section 9-301, and the Bankruptcy Act. Sections 60, 70c, and 70e of the Bankruptcy Act give a trustee power to upset unperfected liens. Other provisions deal with fraudulent transfers, statutory liens, or other specialized elements beyond mere lack of perfection. It is state law, of course, that determines the perfeci-
tion of the lien and the types of persons who may upset it.\textsuperscript{54} Since section 9–301 of the Code gives no rights to a general creditor to upset an unperfected security interest, but requires that one have the status of a lien creditor to do so,\textsuperscript{55} section 70e, which deals only with rights of general creditors assumed by the trustee, is not relevant to the present discussion.

The Code requires that the lien creditor be without knowledge of an unperfected lien to upset it.\textsuperscript{56} Section 70c of the Bankruptcy Act gives the trustee the power of an ideal, even if hypothetical, lien creditor—who would, for bankruptcy purposes, presumably have no knowledge of anything he should not know.\textsuperscript{57} Section 9–301(3) extends "lien creditor" to include an assignee for the benefit of creditors and then provides that "unless all the creditors represented had knowledge of the security interest such a representative of creditors is a lien creditor without knowledge even though he personally has knowledge of the security interest." The negative pregnant of this provision is that when all the creditors \textit{do} have knowledge, then the representative of the creditors does also. Thus, if an assignee for the benefit of creditors is appointed when all the creditors have knowledge of a prior unperfected security interest, the assignee has knowledge also.

The interworkings of these sections are well illustrated by a recent bankruptcy case, \textit{Matter of Komfo Prods. Corp.}\textsuperscript{58} In \textit{Komfo}, there was first an assignment for the benefit of the creditors, all of whom may have had knowledge of the interest in question. If this were the case, under section 9–301(3) the assignee could not defeat the interest. A petition in bankruptcy was later filed, but perfection of the security interest in question intervened, so that at the date of bankruptcy the interest was perfected. Since it is settled that the trustee's lien creditor status under section 70c arises as of the date of bankruptcy,\textsuperscript{59} he could not use section 70c alone to defeat the secured interest. He imaginatively argued, however, that there was an actual lien creditor as of the date of bankruptcy to whose rights the trustee could succeed—the assignee for the benefit of creditors. Section 70c confers upon the trustee the status of an "ideal" lien creditor.

\textsuperscript{54} See \textit{In re Kravitz}, 278 F.2d 820 (3d Cir. 1960); 3 Collier \textsuperscript{\textregistered} 60.39 (14th ed. 1964).


\textsuperscript{56} Uniform Commercial Code \S\ 9–301(1)(b).

\textsuperscript{57} 4 Collier, \textit{Bankruptcy} \S\S\ 70.49, 70.53 (14th ed. 1964). As these sections illustrate, the application of this doctrine in the courts has not been as precise as stated herein. See also \textit{In re Babcock Box Co.}, 200 F. Supp. 80 (D. Mass. 1961).


who does not know anything he should not know. The trustee in *Komfo* tried to "piggy-back" this ideal condition to the assignee as of the time of the assignment, thereby expunging any adverse knowledge from the assignee (so that the assignee would not be defeated by section 9-301(3)), and then inherit the assignee's state-created rights in the bankruptcy proceedings. The trustee was unsuccessful. The "ideal" has been whittled away in some areas. For instance, the trustee cannot choose the time when his section 70c interest was acquired; instead it is deemed to have been at the time of bankruptcy. In addition, there must be an actual creditor who could have obtained a lien at the date of bankruptcy (not, however, one that *did* obtain the lien, just one that *could* have). In the absence of such a creditor, then, the trustee may be without the power to defeat the security interest. In the *Komfo* type of situation, the Bankruptcy Act should override the Code in not imputing to the trustee artificial powers that might be used to destroy an otherwise valid security interest.

With respect to the relative rights of a secured party and the bankrupt (or his trustee), the determinative priority tests should normally be based upon the factual question of Code perfection. If perfection occurred before bankruptcy, the trustee would have no rights under sections 70c or 70e since, under the Code, a lien creditor could not prevail after perfection. Similarly, under section 60a, the transfer represented by the security interests would be deemed to occur at the time of Code perfection, and, while there might be problems of antecedent consideration if perfection followed attachment, actual knowledge of an unperfected lien by the general creditors or the trustee could not alone save the lien.

There is another connection in which Code knowledge rules will come into the bankruptcy court. The most difficult questions relating to knowledge of liens that will face a bankruptcy court will probably relate not to issues of priority between secured creditors and the bankrupt, but to such issues between conflicting

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60 4 Collier, Bankruptcy §§ 70.49, 70.53 (14th ed. 1964).
62 Pacifi Fin., Corp. v. Edwards, 304 F.2d 224, 229 (9th Cir. 1962) (relying upon language in Lewis v. Manufacturers Nat'l Bank, supra note 61).
63 Uniform Commercial Code § 9-301(1)(b).
65 Issues of knowledge may become significant under § 60b to establish the presence of a voidable preference if the perfection occurred within four months of bankruptcy, but this is not the type of knowledge question we are dealing with since it concerns only the debtor's solvency.
secured creditors who fall within one of the situations discussed in this article. In releasing property or paying claims, it is one of the functions of the bankruptcy court to determine the proper recipient party. Since this court sits as a court of equity, the considerations of this article may well become highly significant in the context of a reclamation or similar proceeding.

IV

SPECIAL KNOWLEDGE RULES

As has been pointed out, the basic Code rule in section 9–312(5) is stated as a residual rule: "In all cases not governed by other rules stated in this section . . . ." There are two groups of special rules—those that are contained in other parts of section 9–312, and those listed in section 9–312(1), which provides that "the rules of priority stated in the following sections shall govern where applicable . . . ." In turning to these special rules, we shall be most interested in their internal consistency and in their relationship both to each other and to the Code scheme in general. As will appear, there are some troubling questions in the concept of knowledge in these sections.

A. Purchase Money Liens: Sections 9–312(3), (4)

The special priority accorded by section 9–312 to the purchase money financer developed from "venerable roots" in pre-Code law. Because of his vital economic function in enabling the debtor to acquire new goods, the purchase money financer obtains priority over those whose liens may "float" to the goods by virtue of either a previously filed financing statement and a security agreement with an "after-acquired-property" clause, or a later security agreement covered by a prior filed financing statement. The Code, however, distinguishes inventory financing from other financing for this purpose.

For goods other than inventory, the Code gives priority over competing liens to the purchase money financer if his interest is perfected within ten days after the debtor receives possession of the collateral. There is no mention of knowledge here, and the purchase money financer's lawyer can arrange a search of the records, find a financing statement on the same "type" of goods.

66 See Bank of America Nat'l Trust & Sav. Ass'n v. Erickson, 117 F.2d 796 (9th Cir. 1941); In re George P. Shinzel & Son, 16 F.2d 289 (S.D.N.Y. 1926).

67 2 Gilmore § 28.1, at 745.

68 Uniform Commercial Code § 9–312(4). Section 9–301(2) accords a similar priority to purchase money liens over transferees in bulk and lien creditors.

and still confidently advise his client to enter into purchase money financing without fear of a prior lien.70 This idea is not as difficult as the "pure" filing concept applied in other areas, possibly because the special purchase money treatment was traditionally acceptable,71 and also because the underlying lien is deemed capable of attaching only to the debtor's equity subject to the purchase money lien. And, of course, the purchase money financer obtains his interest in new collateral, upon which reliance by the prior secured party in the usual case (remembering that here goods other than inventory are involved) will be negligible, if at all, because the borrower did not have it.72

Knowledge of prior liens does become a factor, however, when purchase money financing of inventory is involved.73 Here a financer planning to "floor plan" a stock of goods, in order to obtain a special purchase money priority over prior liens, must give the prescribed notice to those who had filed a financing statement on the same items or types of inventory and also to any prior secured party, filed or not, whose "security interest" is known to the inventory financer. If the notice is not given to a known, prior, but unperfected secured party, the subsequent party will not have satisfied the requisites of section 9–312(3), and relative rights will be determined without the benefits of that section. Section 9–312(5) specifically states that it settles priorities when a purchase money interest fails to qualify under the special provisions of section 9–312. Consequently, if the notice requirement is not met, a filed purchase money security interest in inventory will lose to a previously filed interest and to a previously perfected interest, if obtained other than by filing. It thus becomes relevant to consider whether the notice requirement is clearly and sensibly drafted. Take the case of two prior interests, one perfected, the other not. By giving notice to both, the inventory financer will defeat both; by giving no notice he will lose to the perfected interest only. Suppose, however, that notice was given only to the perfected interest, and that the other interest

70 "There is no requirement that the purchase money secured party be without notice or knowledge of the other interest; he takes priority although he knows of it or it has been filed." Uniform Commercial Code § 9–312, comment (3).
72 Note that § 9–312(4) requires the purchase money financer to file. This is in contrast to an analogous situation regarding fixtures where no filing by the second interest is required. See Uniform Commercial Code § 9–313.
73 Uniform Commercial Code § 9–312(3).
was known. If the notice requirement were held not to have been met, then section 9-312(5) would give the perfected interest priority even though its holder had notice of the subsequent financings and the person who did not receive notice had no superior rights (because not perfected) against anyone at issue.\textsuperscript{74} This result can be avoided by reading the requirement that "any" interest be given notification to mean that the priorities between those interests given notice shall be determined by section 9-312(3) (i.e., the purchase money interest prevails), whereas those not given notice determine their priorities under section 9-312(5). This reading will serve the basic purpose of the knowledge provision; it will protect the prior secured parties by preserving their normal priority unless they are notified of a later secured interest, in which case they are on notice to cease their advances to the debtor against his inventory.

Why inventory alone for this special knowledge test? The comment to section 9-312(3) gives an excellent justification for the general requirement of notice to prior secured parties when inventory is involved, but fails to explain why notice must be given to those who are known, even if they have not perfected. Transactions in other forms of collateral can be just as important, and one wonders why a known but unperfected lien is accorded such significance when inventory is involved. Perhaps the answer is that the rule was an unintended product of the effort in section 9-312(3) to establish a novel inventory financing structure, with notice to the prior interests now required. It may also be that, in requiring notice to be given to known interests, whether or not filed, the draftsmen were really concerned with liens on inventory that might be acquired by using the popular field warehouse device, where no filing is required. The requirement, if this is the case, might have been notice to all perfected liens. But this would present some inequitable results. Given the desire to foster purchase money financing, and the fact that security interests can be perfected by the common device of field warehousing, which gives no notification to others by way of filing, it would place a substantial burden on purchase money financiers to ascertain whether or not there was a prior perfected interest. Consequently, requiring notice to those known liens appears to have been an unsatisfying compromise.

\textsuperscript{74} Compare Flushing Nat'l Bank v. Abrams, 270 App. Div. 911, 61 N.Y.S.2d 609 (1st Dep't 1946), aff'd, 296 N.Y. 1609, 73 N.E.2d 582 (1947) where, under the Bulk Sales Law, all known creditors were provided for but not notified as required by the statute, and the sale was voided by a creditor who became known at a later date.
B. The Ordinary Buyer: Section 9–307

One of the sections to which section 9–312(1) defers for a special priority rule is section 9–307, which protects ordinary retail buyers from wholesalers' liens, even though perfected. Under pre-Code law, severe limitations were placed upon the protection of one who secured himself with an interest in goods which were held for sale. Under some statutory and case law doctrines, an ordinary buyer from one regularly engaged in the sale of goods would usually be found to have acquired those goods free of any security interest (chattel mortgage, conditional sale contract, or other) placed upon the goods by the seller in favor of a third party. The retail protections, however, were spotty, and depended in large measure upon the technical device selected by the inventory financer.

Section 9–307(1) frees the "buyer in ordinary course of business" from a lien created by his seller, "even though the buyer knows of its existence.\(^{75}\) It is only by reference to the section 1–201(9) definition of "buyer in ordinary course of business" that the meaning of the section 9–307 protection becomes clear. "Buyer in ordinary course of business" requires an ordinary buyer in the lay sense, not a "purchaser" which would include secured parties under the Code.\(^{76}\) It also means that the seller be a "person in the business of selling goods of that kind." As a result, the protection will primarily cover purchases from inventory.\(^{77}\) Finally, two more tests are provided which raise the question of the role of knowledge. The first requires that the buyer be in "good faith,"\(^{78}\) which the Code defines as honesty in fact.\(^{79}\) The Code thus adopts the "subjective" test that has been incorporated into most of the other uniform laws, rather than the "objective" test of knowledge of peculiar circumstances surrounding the transaction that might put a prudent man on notice of the prior lien. The second test requires that the buyer be "without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods . . . ."\(^{80}\) It would be difficult for the buyer to be acting with both honesty in fact and knowledge that the sale to him was in violation of the

\(^{75}\) There is one exception: "a person buying farm products from a person engaged in farming operations. . . ." Uniform Commercial Code § 9–307(1).

\(^{76}\) See Uniform Commercial Code §§ 1–201(32), (33).

\(^{77}\) Inventory is defined to cover, inter alia, those goods which are held for sale. Uniform Commercial Code § 9–109(4).

\(^{78}\) Uniform Commercial Code § 1–201(9).

\(^{79}\) Uniform Commercial Code § 1–201(19).

\(^{80}\) Uniform Commercial Code § 1–201(9).
interest of another. Therefore the second test in section 1–201(9) seems to be at least implicit in the good faith requirement.

When section 1–201(9) is read together with section 9–307, which, it will be remembered, provided protection "even though the buyer knows of . . . [the lien's] existence," the intent is apparent. The buyer may know that the lien exists, but if he has, in addition, actual knowledge of some impediment to the sale of the goods, then he is no longer protected from the prior lien.\(^\text{81}\) This result accords with the rule under the Uniform Trust Receipts Act which, without any reference to a rule of good faith, provided that general knowledge of a wholesale lien was not enough to cause the buyer to take subject to it unless there was also specific knowledge that the sale was in violation of the rights of another.\(^\text{82}\) The reason for the distinction between knowledge of the lien itself and knowledge that the sale is in violation of the lienee's rights emerges when it is recognized that section 9–307(1) deals with buyers in the ordinary course of business, which means buyers from sellers "in the business of selling goods of that kind." This language would apply to the sale of inventory, and most liens on inventory are accompanied by some form of freedom, express or implied, to sell the goods. The buyer might well, should he ever think of the question, take it for granted that a seller of goods which he knows are being financed has this freedom to sell. Section 9–307 permits him to make this assumption without the risk of taking subject to a security interest, unless he has more specific knowledge.

C. Purchase and Possession of Chattel Paper: Section 9–308

Another significant exception to the basic first-to-file rule appears in the highly specialized section 9–308. Here, the Code made substantial changes in existing law and simultaneously recognized knowledge as an important factor in governing lien priorities. Prior to the Code, it was accepted that secured obligations (conditional sales contracts, chattel mortgages, or the like) were something in the nature of a "specialty,"\(^\text{83}\) certain rights in which were legally recognized by possession of the controlling documents. However, the precise qualities of this specialty had never been formalized in the pre-Code statutes. Consequently, by establishing a set of definite rules for priorities in "chattel paper"

\(^{81}\) Uniform Commercial Code § 9–307, comment (2).
\(^{82}\) See Uniform Trust Receipts Act § 1; General Motors Acceptance Corp. v. Anacone, 160 Me. 53, 197 A.2d 506 (1964).
\(^{83}\) See 2 Gilmore § 25.5, at 669. For some of the difficulties here, see also J. H. Gerlach Co. v. Noyes, 251 Mass. 558, 147 N.E. 24 (1925).
(the Code term for a secured obligation), section 9–308 represents somewhat of an innovation.

Elsewhere the Code confirms the premise of the prior law that knowledge is a significant factor in establishing relative rights when negotiable instruments are transferred. Similarly, in according secured obligations special status, and in creating special rules that supersede the basic section 9–312 pattern, section 9–308 imposes a knowledge requirement. It provides first that a purchaser (which under the Code includes a secured party) of chattel paper who gives new value and takes possession in the ordinary course of his (the purchaser's) business without knowledge that the "specific paper" is subject to a security interest, has priority over an interest which is perfected under section 9–304, the section governing methods to perfect interests in chattel paper. Section 9–308 explicitly states that the purchaser must take without knowledge of the other perfected lien in order to take free of it.

Section 9–308 specifically gives the purchaser freedom only from certain liens itemized therein. In other words, section 9–308 is not an example of an adoption by the Code of the general principle that knowledge is sufficient to invalidate a lien. It would appear that if the prior interest had not been perfected under one of the methods of section 9–304, and the other tests of section 9–308 were met, the purchaser would take free of even a known lien. The priority would, however, be under section 9–312 and not under section 9–308, since the latter section concerns priority only as to prior interests perfected under Article 9.

An earlier draft of the Code was criticized for establishing different rules for a negotiable secured note ("chattel paper") when the security interest and the obligation to pay (the note) were in one instrument as opposed to when they were in separate pieces of paper. The objections have been eliminated to a considerable degree by making negotiable notes subject to both Articles 3 and 9, while providing that the former must defer to the latter in case of conflict. We shall have the opportunity later to explore some of the ramifications of security interests in notes

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84 Section 9–308 also covers nonnegotiable instruments. Since traffic in such instruments is not of great commercial importance, it shall be ignored.
85 Uniform Commercial Code § 3–302.
86 Drafted principally by those well acquainted with traffic in secured paper, § 9–308 was designed to stimulate this flow in the established business channels.
87 Those acquired by permissive filing or temporary perfection under § 9–304.
89 Uniform Commercial Code § 3–103(2).
alone. In summary, if the purchaser of chattel paper knows of a prior lien that has been perfected as the Code allows, he takes subject to it; if he knows of an unperfected lien, it does not affect him and he wins under section 9–312. Thus, under the first sentence of section 9–308: (a) knowledge is important in establishing Code priorities; (b) the draftsmen have been explicit in defining the effect of knowledge; but (c) the knowledge must be of a defined act that the Code itself recognizes as perfection. Whatever undesirable vagueness existed in the pre-Code equitable rules of knowledge has been reduced to a minimum in this manner.

The second sentence of section 9–308 demonstrates again the predominance in drafting the Code of those intimate with dealings in security paper. When inventory is financed, the secured party will almost always bolster his claim with a string on “proceeds” received when the inventory is sold. The sale of much hard goods inventory results in the acquisition of chattel paper by the seller (it is sold on a time basis with security for the buyer’s obligation). However, the seller may well finance himself by transferring the paper to a financer who is different from the one who financed the inventory. Conflict may develop, therefore, between an inventory financer claiming proceeds and the direct transferee of the chattel paper. The Uniform Trust Receipts Act, which was the only statute that made even a pretense of covering this problem, was insufficient. Although the cases under the act were in some conflict, they generally tended to favor the direct transferee of the paper. While the reasoning of these cases varied, they seemed to accord the protection that the act explicitly gave a retail purchaser to that purchaser’s obligations to his financer. The Code also adopts this policy.

Under the second sentence of section 9–308, a purchaser of chattel paper who gives new value and takes possession in the ordinary course of his business gets a clear priority over one claiming “merely as proceeds,” although the former “knows that the specific paper or instrument is subject to the security interest.” In this section, knowledge is eliminated as a factor altogether, and the draftsmen chose to do so with specificity. If they had not made the specific reference to knowledge, however, the meaning of the second sentence of section 9–308 would seem to be the same: knowledge is irrelevant. The concept, however, is quite alien to pre-Code law (where protected purchasers are tradition-

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60 See pp. 268–72 infra.
61 Compare General Credit Corp. v. First Nat’l Bank, 74 Wyo. 1, 283 P.2d 1009 (1955) (protecting the retail assignee), with Universal Credit Co. v. Citizens State Bank, 224 Ind. 1, 64 N.E.2d 28 (1945) (protecting the wholesale financer).
ally those without notice), and it stands in contrast to the first sentence of section 9–308 where knowledge is relevant. It is justifiable, if not necessary, to be specific when ruling out knowledge as a factor. It is perhaps regrettable that the same approach was not taken in sections 9–301 and 9–312, where knowledge also occasionally appears as a factor, and where the draftsmen, in generally eliminating knowledge as a factor, were making a more fundamental change in the common law than in section 9–308. The variation in drafting approach should not, however, alter the meaning of sections 9–301 and 9–312 and lead to the injection of a knowledge factor where none was intended.

D. Negotiable Interests: Section 9–309

The place of knowledge in the structure of Article 9 becomes unclear when we compare the specialized sections referred to in section 9–312(1) to the basic priority rules (which are generally silent on knowledge). These sections not only may increase the "normal" order of priority but also, in some cases, may appear to decrease that order. One such example is the specialized treatment of negotiable instruments, documents, and securities for which section 9–312(1) refers to section 9–309. Section 9–309 gives certain interests "priority over an earlier security interest even though perfected." The specially protected interests are those of a "holder in due course of a negotiable instrument," a "holder to whom a negotiable document of title has been duly negotiated," and a "bona fide purchaser of a security." Each of these protected interests is available only to one who has possession of the item in question. In addition, the only method for perfection of a security interest in a negotiable instrument or security is by taking possession under section 9–304(1), or by falling under the twenty-one-day rule of perfection without filing in sections 9–304(4) and (5). For negotiable documents, possession is an alternative method of perfection, with filing and the twenty-one-day rule also available. It would seem, therefore, that a secured party in possession of a negotiable instrument, security, or negotiable document (after twenty-one days and subject to a filing question as to the negotiable document), must, under Article 9, have priority, since any possible conflicting party would have lost his lien through lack of possession.

Therefore, it is unclear why section 9–309 provides that "nothing in this Article [9] limits the rights" accorded by the three other articles. It must mean that greater rights are given elsewhere, but, at least for a negotiable instrument or security, what higher order of security interest may be attained than that
already granted by section 9-309 itself? The comment to section 9-309 suggests, however, that more than some illusory added protection may be intended:

Under this Article as at common law and under prior statutes the rights of purchasers of negotiable paper, including negotiable documents of title and investment securities, are determined by the rules of holding in due course and the like which are applicable to the type of paper concerned. (Articles 3, 7, and 8.)\(^9\)\(^2\)

Only when the interests referred to are present does section 9-309 provide a priority rule. Yet the holders of these interests must all be without actual knowledge of an earlier security interest in the collateral involved.\(^9\)\(^3\)

If the special rules of section 9-309 were intended to provide a rule overriding the section 9-304 twenty-one-day perfection period for negotiable instruments and securities, or if, for documents, these rules were intended not only as an exception to the twenty-one-day rule, but also as a section 9-308 type of possession-is-better-than-filing approach, they could have been more neatly drafted. Section 9-309 brings a blunderbuss approach to these matters.

Surprisingly, if the comment to section 9-309 is taken at face value, the total effect may be to weaken the protection that the specialized transferees would receive in the absence of section 9-309. Under section 9-312, the party in possession of a negotiable instrument or a security would, after twenty-one days, almost automatically have priority since he would be the only party perfected, possession being the only form of perfection and knowledge presumably being irrelevant. Under Articles 3 and 8, however, he must be without knowledge of an adverse lien to achieve the special status accorded protection by section 9-309. For “holder in due course” status (and the equivalent “bona fide purchaser” of a security), that is, of course, classic law. It would be surprising if the holders of these paper items, which have been tailored to flow in commerce with maximum fluidity, must prove absence of knowledge to take free of a prior security interest, while section 9-312, in the case of conflicting security interests in other types of collateral, accords priority to the first to perfect, regardless of actual knowledge. Are holders of negotiable paper given a lower order of priority than holders of ordinary security interests?

\(^9\)\(^2\) Uniform Commercial Code § 9-309, comment (1). (Emphasis added.)

\(^9\)\(^3\) Holder in due course of a negotiable instrument under § 3-302, holder to whom a negotiable document of title has been duly negotiated under § 7-501, and a bona fide purchaser of a security under § 8-301.
Neither section 9–309 nor section 9–312 is clear about what happens when the transferees of the three items do have knowledge of a prior lien and thus do not rise to the level of the specified interests. This may result in interesting litigation where negotiable instruments, documents, or securities are involved. The later transferee with knowledge of the interest of the earlier will claim that he is not within section 9–309 since (1) that section only relates to named interests that he cannot hold because of his knowledge, and (2) it only provides for greater rights when granted by the specialized articles ("nothing in this article limits ....."; yet with knowledge of an adverse lien, he could lose only under one of the other articles. Left to section 9–312, he has priority, despite knowledge, by perfection through possession. The prior party (whose interest is known) will argue that this result, although formally correct, drains all the meaning from section 9–309. It would give a major element of holder in due course status to one who was elsewhere specifically barred from it—the later transferee should take subject to prior claims as indicated by Articles 3, 7, or 8. The prior interested party will also point to the comment to section 9–309 as indicating that all the rights of the purchasers of the named items should be governed by Articles 3, 7, or 8. The later transferee will insist, however, that the basic priority system of the Code is one which makes knowledge irrelevant, and that the court should not be influenced to the contrary by "equitable" arguments.

The prior party might also argue that Articles 3, 7, and 8 are not entirely silent themselves on the subject of conflicting liens. Article 3, the most outspoken, provides that one not a holder in due course (i.e., one with knowledge) takes an instrument subject to all valid claims against it. The comment to the relevant section is clear that "claims" includes "all liens." Article 3, however, is specifically made "subject to the provisions of the Article on ... Secured Transactions (Article 9)." Inserted to resolve a conflict in the treatment of chattel paper, this deference to Article 9 may have wider effects. Similarly, Article 7 provides in section 7–504(1) that a transferee to whom a negotiable document has not been "duly negotiated" (e.g., the transferee may have had knowledge) acquires only the rights of his transferor. Article 8 is relatively circumspect in its treatment of conflicting liens. While in section 8–301(2) it provides that a "bona fide pur-

94 Uniform Commercial Code § 3–306.
95 Uniform Commercial Code § 3–306, comment (2).
96 Uniform Commercial Code § 3–103(2).
97 See pp. 265–68 supra.
"chaser" takes a security free of any adverse claims, it is nowhere specific on what a purchaser of lesser rank takes. Presumably the intent is that the purchaser with knowledge takes subject to what he knows, but this is not explicit. Neither Article 7 nor Article 8 contains any help on conflicts with Article 9.

Of interest here is the arbitrator's opinion in *Philadelphia Nat'l Bank v. Irving R. Boody & Co.* A holder of a nonnegotiable document of title claimed section 9–309 protection from a prior interest in the goods (for which the document was issued) that had been perfected by filing. Since section 9–309 relates only to *negotiable* documents, Arbitrator Funk held that it did not cover this matter and referred the parties back to section 9–312 to determine priority. The document holder also claimed that, since Articles 7 and 9 gave him inconsistent rights, and since Article 7 specifically covered documents, Article 7 should control. The arbitrator, however, showed that the articles were consistent and held that, when section 9–309 is not applicable, section 9–312 is.

Thus, whether section 9–312 applies or recourse is needed to the special rules of section 9–309 can depend in part on whether the holder has knowledge of a prior interest. If he had no knowledge, he could attain holder in due course status; if he had knowledge and, under *Boody*, section 9–312 would apply, he could achieve the same priority through exclusive possession.

Section 9–309 is not designed, and should not be used, to reduce the protection that section 9–312 would otherwise give to the physical holder of an instrument, document, or security. The concept of holder in due course and the related concepts of Articles 7 and 8 do, after all, accord protection in addition to freedom from prior liens. The suggestion in the comments to Article 3 that a holder of lesser rank may be subject to prior security interests must be deemed only an inadvertent remark without conscious regard to the priority rules of Article 9. No useful purpose would be served by giving the holder of a negotiable obligation a lower order of protection under Article 9 than other parties in analogous positions. Additional support for this result can be found from reading the Article 9 scheme as a whole. Section 9–308 deals with interests in chattel paper and *nonnegotiable* instruments, and under that section a later interest will defeat an earlier one which claims the paper "merely as proceeds" without regard to knowledge. If section 9–309 were read to give *lesser* rights than section 9–312 in the case where the taker has knowledge of the prior interest, a party would be safer taking a nonnegotiable instrument

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*8 CCH Instalment Credit Guide ¶ 99147 (1963).*
or chattel paper than he would be taking a negotiable instrument, at least vis-à-vis the prior interest as proceeds. Clearly, this result would be anomalous.

E. The Equitable Rule of Section 9-401(2)

Although the basic Article 9 priority system eliminates knowledge as a significant factor in testing lien priorities, section 9-401(2), in the pre-Code equitable spirit, imposes a rule of decency relating to knowledge. While under pre-Code law improper filing was no filing,99 knowledge of the improper filing would generally be sufficient to validate it against the secured party with knowledge. This is, of course, simply a corollary of the rule that knowledge is the equivalent of filing. Section 9-401(2) retains this part of the pre-Code knowledge rule, although in a somewhat limited form, by providing that where a filing is made "in good faith in an improper place or not in all of the places required... [it is] effective with regard to collateral covered by the financing statement against any person who has knowledge of the contents of such financing statement."

When a secured party chooses not to file at all, he is expected to know that under the Code he will lose to a later perfected interest, regardless of knowledge. But if he actually does file "in good faith," he can prevail, even though his filing is improper, when the later party has knowledge. "Good faith" under the Code means "honesty in fact."100 Presumably, in a filing context, this means that someone actually thought he was filing in the proper place or places. Given the Code's subjective definition of "good faith," circumstances suggesting that the secured party ought to have known better, ought to have studied the Code more closely, or ought to have consulted counsel appear to be irrelevant. There is, in other words, nothing in the language of this section to suggest that the improper filing must have been due to a difficult question of interpretation or other excusable mistake.

There is justice in the departure of section 9-401(2) from the "pure" filing concept. With a financing statement in some public record, a competing party is not misled when he has knowledge of its contents. Of course, if the competing party knew of the misfiling and "honestly," but mistakenly, thought that he could rely on the basic Code filing rules under which knowledge is irrelevant so long as the record is clear, then he would be "misled" by the improper filing—not misled, however, concerning the absence of an interest, but merely about its validity against his

99 Uniform Conditional Sales Act §§ 6, 7.
100 Uniform Commercial Code § 1-201(19).
proposed interest. He would be misled only by his incorrect interpretation of the Code rather than by anything that the competing party had done.

Section 9-401(2) ties into the "pure" filing concept of the Code not only because an actual filing is required, but also because mere knowledge of a preexisting or competing lien is not sufficient, as it was under prior law, to cause subordination. There must be "knowledge of the contents of such financing statement." This requirement clearly implies that the second party has actually seen the filed statement or obtained knowledge of the fact of filing. It would be unfortunate were the Code interpreted to require less. Since the necessary information in a financing statement is rather sparse—the signatures and addresses of the parties and the types or items of collateral—knowledge of this information could hardly qualify as knowledge of the "contents" without seriously undermining the pure filing scheme and introducing unintended opportunities for delay, if not fraud, on the part of prior creditors. It is apparent that section 9-401(2) will not protect every secured party who has filed in good faith, but only one who has had the good fortune to have the conflicting secured party know of his improperly filed statement.

In addition to an actual filing and knowledge of the contents of the financing statement, it would appear that a "financing statement" meeting the formalities of section 9-402 is required. Although section 9-402 is not written as a definition of "financing statement," it does prescribe the necessary formalities for one to be "effective." Statements that would not be effective even if filed in the correct office should not be protected under section 9-401(2), which is designed to protect only those who in good faith file in the wrong place.¹⁰³

V

Conclusion

It is evident that Article 9 of the Code establishes a system of priorities under which knowledge is irrelevant except where the Code provides otherwise, and that this represents a change in the common-law doctrine. It is also evident, however, that sufficient attention was not given to this change to produce a cohesive and internally consistent pattern. The new system is likely to

¹⁰¹ Uniform Commercial Code § 9-401(2).
¹⁰² Uniform Commercial Code § 9-402.
¹⁰³ It might be wondered why protection is not accorded a party who in good faith filed a deficient financing statement. The probable answer lies in the skeletal requirements of § 9-402 for the financing statement. It would be difficult to file even less than those requirements in good faith.
produce unintended results, at least if applied strictly. Room remains, therefore, in extreme cases, for applying the old doctrine and for employing the basic concepts of fair play that are written into the Code in order to avoid results that are unjust and inequitable.

In general, the courts have interpreted the Code substantially as anticipated by the draftsmen. The decisions clearly show, however, that the judiciary has not, merely because of the adoption of the Code, lost its ability to adapt the law to the needs of the litigants. The hand extended by the draftsmen for "the law embodied in this Act to be developed by the courts in the light of unforeseen and new circumstances and practices" has occasionally been grasped up to the elbow.

The outstanding example, in the area of lien priorities, of deviation from the result called for by a strict reading of the statute is French Lumber Co. v. Commercial Realty & Fin. Co. French Lumber Company obtained a loan from Ware Trust Company secured by a vehicle. A financing statement was filed under the Code. French then obtained a loan from Commercial Realty & Finance Company and gave Commercial a second lien. Commercial also filed. French defaulted to Ware, and, after some negotiations, Associates Discount Corporation refinanced the Ware debt. Instead of taking an assignment of Ware's interests, Associates merely paid Ware off, terminated Ware's filing, and itself filed under the Code — after Commercial. Thus, when a general default ensued, Commercial appeared on the record first despite Associates' refinancing of a lien originally preceding that of Commercial. The result under section 9–312(5) was clear: Commercial, as the first to file, had priority. The court, while recognizing this rule, gave priority instead to Associates under the equitable doctrine of subrogation, insisting that the Code had not deprived it of this latitude. The court would not penalize Associates for its error in its handling of the transaction. The following language of the lower court, which the Massachusetts Supreme Judicial Court adopted, indicates an emphasis on the underlying nature of the transaction rather than a strict application of the Code language: "There has been no change of position by Commercial. . . . It is left exactly in the position it originally was in. . . . If Associates had taken an assignment from . . . [Ware], Commercial would have no cause for complaint."}

105 Uniform Commercial Code § 1–102, comment (1).
107 Id. at 718, 195 N.E.2d at 509.
There are a number of principles upon which the courts may rely in tempering the effects of the strict Code language. For one, the general equitable principles which were the basis for the French Lumber Co. decision are available. The Code draftsmen were explicit in their invitation to refer to such principles when they included in the comment to section 1–102 the following language:

They [courts] have implemented a statutory policy with liberal and useful remedies not provided in the statutory text. They have disregarded a statutory limitation of remedy where the reason of the limitation did not apply.... Nothing in this Act stands in the way of the continuance of such action by the courts.  

In one case, nullifying a lien as to certain purchasers where the statute was clear to the contrary, the court expressed its duty to construe statutes "in the most beneficial way the language will permit to prevent absurdity, hardship or injustice and to favor public convenience and oppose all prejudice of public interest." There are also the supplementary principles of law to which the Code makes specific reference in sections 1–102, 1–103, and 1–203 as applying in general to Code transactions. It has been suggested that the principles of good faith in section 1–203 present an avenue of relief from the strict knowledge rules of Article 9. It also may be that section 1–103 supplementary principles, especially estoppel and the law merchant, will provide a source for exceptions and methods to temper otherwise harsh Code results. And the reference in section 1–102 to custom and usage will provide a source of new rules, especially in the area of security interests, which has experienced more than its share of growth and as to which the Code makes some dramatic changes. Another possible source of grounds for decisions contrary to the strict meaning of the Code is the policy of section 2–302. That section, dealing with the unenforceability of an unconscionable contract for the sale of goods, has been applied, by analogy, to Article 9 problems where it was held that the court need not enforce a lien secured pursuant to an unconscionable contract with the debtor. Clearly, this policy could not be relied upon to find the pure filing result itself unconscionable, but it would be available to a court wishing to avoid the strict Code result where the parties had used an un-
conscionable contract in order to qualify under one of its provisions.

Although it is safe to predict that some of the sections discussed in this article will have an equitable gloss placed upon them by the courts in some situations, it is nearly impossible to predict with any assurance the results of cases that by necessity will turn on their particular facts. Some of the factors that will probably influence the decisions can, however, be briefly discussed. The Code policy is unquestionably the strongest single factor in interpreting the Code's language.\(^{112}\) The establishment of a "pure" filing system has behind it a policy—the ability to rely on the record—that should be honored. It is only when that policy is used as an instrument of inequity or deceit that equitable principles should be superimposed. And the burden of proving inequity should be no less upon the party attempting to circumvent the statutory language than upon any other party attempting to assert an affirmative case. It may also be relevant that the variation of the plain statutory meaning serves to honor the reasonable expectations of the parties. In the French Lumber Co. case,\(^{113}\) the fact that a rigid application of the statute would apparently surprise all parties was one reason not to apply it. There may be reason for less sympathy to one who erred under the simplified Code than would be extended under the maze of pre-Code security laws. As with other areas where the common law has been derogated, the longer the Code is in operation, the more its principles will have been established and the less external equitable doctrines will be necessary to do justice. On the other hand, section 9-401(2) (on knowledge of misfilings) suggests a Code attitude that one should not knowingly profit from another's innocent mistake. In addition, in dealing with devices such as subordinations and participations, where it is not clear even to the experts whether Code perfection is required, actual knowledge by a competing party may be a reason to sustain a lien where the prior secured party acted in good faith and perhaps under legal guidance.

The streams of pre-Code security law run very deep; they may not have been entirely replaced by the sub silentio reversal effected by the Code. If a subsequent secured party wants to obtain a first lien position on goods which he has enabled the debtor

\(^{112}\) Uniform Commercial Code § 1-102, comment (I):

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

\(^{113}\) See text accompanying note 106 supra.
to purchase, there is no doubt that he may do so by perfecting his purchase money security interest even if he has actual knowledge of a prior unperfected lien on all present and future property of the debtor. Yet if he wants to extend a non-purchase money loan and still acquire a first lien, the Code answer is equally clear that he can. But traditions give one pause. It is the writer's thesis that the pause is appropriate.