Notice Problems in the Double-Pledge Situation: Can a Junior Pledgee Give Notice of a Security Interest to a Pledgee-Bailee Under Section 9-305 of the Uniform Commercial Code?

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NOTICE PROBLEMS IN THE DOUBLE-PLEDGE SITUATION: CAN A JUNIOR PLEDGEE GIVE NOTICE OF A SECURITY INTEREST TO A PLEDGEE-BAILEE UNDER SECTION 9-305 OF THE UNIFORM COMMERCIAL CODE?

INTRODUCTION

Section 9-305 of the Uniform Commercial Code (U.C.C. or the Code) provides that a secured party may perfect his security interest in collateral by taking possession of the collateral.\(^1\) When the debtor's property is already in the hands of a third person, however, a security interest in the property also may be perfected through notice to the third party in possession.\(^2\)

Section 9-305 of the U.C.C. is silent as to which party, the debtor or the secured party, must give notice to a third party bailee.\(^3\) The Restatement of Security,\(^4\) U.C.C. commentators, and earlier cases clearly indicate that notice may come from either the debtor or the secured party.\(^5\) A new trend has developed in the law, however, with respect to the identity of the notice-giver, particularly in situations where the third party bailee is also a secured party holding for himself. This new view requires notice from the debtor as the only means of perfecting a junior security interest.\(^6\)

The reasons presented for concluding that notice must come from the pledgor in a double-pledge situation\(^7\) are three-fold: to modify the origi-
nal bailment/pledge agreement between the pledgor and senior pledgee; to release control over the pledgor's equity interest in collateral enabling the junior pledgee to acquire common law "possession;" and to protect the pledgor from interference by fraudulent claimants.\(^8\)

Notwithstanding that the arguments presented by some courts and recent commentators are persuasive and logically appealing, the position that notice must come from the pledgor is unwise and impractical. The better position is that notice to a pledgee-bailee may come from either the pledgor or the junior pledgee.

Part I of this Note introduces the concept of possessory security interests and its underlying principles. Part II presents the split of authority with respect to the identity of the notice-giver, discusses the arguments for requiring notice from the pledgor in the context of a key case, *In re Kontaratos*,\(^9\) and of newly revised Article 8 of the U.C.C., and suggests reasons why requiring notice from the pledgor is an unwise and impractical position, and perhaps also analytically unsound. Finally, this Note concludes that allowing either the pledgor or the junior pledgee to notify the pledgee-bailee is a more sensible position, both analytically and in terms of commercial practicality.

I. INTRODUCTION TO POSSESSORY SECURITY INTERESTS

The U.C.C. defines a "security interest" as any "interest in personal property or fixtures which secures payment or performance of an obligation."\(^10\) Article 9, which governs secured transactions, distinguishes between "perfected" and "unperfected" security interests.\(^11\) According to the U.C.C., a security interest is "perfected" when the secured party has taken whatever steps are required by the Code to give him such an interest.\(^12\)

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*See infra* notes 71-79 and accompanying text; *infra* notes 93-111 and accompanying text; and *infra* notes 126-28 and accompanying text.


10. U.C.C. § 1-201(37) (1978). Generally, there are three requirements for creating an enforceable security interest: a security agreement containing a description of the collateral signed by the debtor, the existence of the debtor's rights in the collateral, and the giving of value by the secured party. *See id.* § 9-203. A transfer of physical possession (i.e. the pledge), however, can substitute for the first requirement. *See id.*


The U.C.C. does not actually define the term "perfection." The decision not to define the term, however, was a conscious choice on the part of the drafters of Article 9. At the time of the 1972 revision of Article 9, the review committee stated that "[i]t would be
The term "perfected" describes a security interest in personal property that cannot be defeated in insolvency proceedings or by general creditors. Thus, an unperfected security interest is subordinate to the rights of anyone with a perfected interest, or anyone who becomes a lien creditor before the security interest becomes perfected.

The key effect of subordination of an unperfected security interest to lien creditors is that the interest is not good as against the pledgor's trustee in bankruptcy. Thus, in any loan transaction, the perfection of the creditor's security interest is essential to ensure that the creditor receives the collateral in the event the pledgor defaults or files for bankruptcy.

Article 9 of the U.C.C. provides for basically two methods of perfecting a security interest: by filing a financing statement or by taking possession of collateral. This Note deals exclusively with the possessory method of perfection.

unwise to attempt a formal definition of perfection, because of the subtlety of the problems involved in rights against many groups of third persons." U.C.C. Appendix II, General Comment on the Approach of the Review Committee for Article 9, E-16 at 889 (1978).


14. A "lien creditor" under the U.C.C. is "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 . . . and a trustee in bankruptcy from the date of the filing of the petition or a receiver in equity from the time of appointment." U.C.C. § 9-301(3) (1978).

15. See U.C.C. § 9-301(1)(a), (b) (1978).

16. This is because the definition of lien creditor in U.C.C. § 9-301(3) (1978) includes a trustee in bankruptcy. See 1 G. Gilmore, Security Interests in Personal Property § 14.2, at 435 (1965); U.C.C. § 9-303 official comment 1 ("[I]n general after perfection the secured party is protected against creditors and transferees of the debtor and in particular against any representative of creditors in insolvency proceedings instituted by or against the debtor.").

17. See U.C.C. § 9-503 (1978), which provides that upon default, a secured party has the right to take possession of collateral, if he is not already in possession as a pledgee, "without judicial process if this can be done without breach of the peace." This is the standard Code remedy in cases of default, where the debtor seeks to regain the collateral. See U.C.C. 9-503 & and official comment; T. Quinn, Uniform Commercial Code Commentary and Law Digest ¶ 9-501[A][3], at 9-304 (1978) (discussing Code remedies in general); id. ¶ 9-503[A][1]-[8], at 9-311 to -319 (discussing problems that have arisen out of this self-help repossession provision). U.C.C. § 9-504 further provides that after default a secured party in possession of collateral may then sell, lease or otherwise dispose of it in satisfaction of the indebtedness secured by the security interest. The only restriction placed on the secured party is that the method of disposition must be "commercially reasonable." See U.C.C. § 9-504 official comment 1 (1978). This is a powerful remedy for any creditor with a perfected interest.


19. U.C.C. § 9-304 official comment 1 (1978) ("For most types of property, filing and taking possession are alternative methods of perfection."). It should be noted that the U.C.C. does provide for a third method of perfection, which is used often and is also extremely important in commercial finance. U.C.C. § 9-304(4)-(5) allows for temporary perfection of security interests in instruments and negotiable documents although there has been no filing and the debtor is in possession of the collateral, see U.C.C. § 9-304(4)-(5) (1978), and U.C.C. § 9-302 allows for full, automatic perfection, without filing or possession, in six specific instances. See U.C.C. § 9-302(b)-(g) (1978).
The Code provides that a security interest may be perfected by the secured party's taking possession of the collateral. The drafters of the U.C.C., however, essentially intended sections of Article 9 relating to perfection through possession to be a codification of the common law theory of pledges.

At common law, a creditor normally took physical possession of collateral in order to perfect his interest. The delivery of the collateral to the secured party or his agent by the debtor was called a "pledge." The basic concern underlying the pledge is that the pledgor must not


21. As the court in In re Copeland, 391 F. Supp. 134, 147 n.20 (D. Del. 1975), aff'd in part and vacated in part, 531 F.2d 1195 (3d Cir. 1976), stated: "The perfection-by-possession sections of Article 9 share a common heritage in the prior law of pledge." See also I P. Coogan, Secured Transactions Under the Uniform Commercial Code § 3.14[3], at 3B-8 to -9 (1986) [hereinafter 1 Secured Transactions] ("Despite the fact that its draftsmen set out to abandon much of the existing chattel security law, almost every important concept, rule, or mechanism of Article 9 finds its origin in at least one of those separate bodies of chattel security law."). Hence, it is appropriate to refer to common law principles as well as Code principles in any analysis or discussion of § 9-305 possessory security interests. See 1 G. Gilmore, supra note 16, § 14.1, at 439; U.C.C. § 9-205 official comment 6 (1978) ("The common law rules on the degree and extent of possession which are necessary to perfect a pledge interest ... are not relaxed by this or any other section of this Article."); U.C.C. § 9-302 official comment 2 (1978) ("As at common law, there is no requirement of filing when the secured party has possession of the collateral in a pledge transaction . . ., Section 9-305 should be consulted on what collateral may be pledged and on the requirements of possession."); U.C.C. § 9-304 official comment 1 (1978) ("[W]here the collateral consists of instruments, it is universal practice for the secured party to take possession of them in pledge."); U.C.C. § 9-305 official comment 1 (1978) ("[As under the common law of pledge, no filing is required by this Article to perfect a security interest where the secured party has possession of the collateral."). U.C.C. § 9-101 official comment (1978) states that "[p]re-Code law recognized a wide variety of security devices, which came into use at various times to make possible different types of secured financing." Under Article 9, however, the traditional "distinctions based on form (except as between pledge and non-possessory interests) are no longer controlling." Id. (emphasis added). Finally, § 9-102(3) provides that Article 9 does not abolish existing security devices, U.C.C. § 9-102(3) (1978), and § 1-103 provide that common law rules were intended to supplement Code provisions. U.C.C. § 1-103 (1978).

22. See Coogan, Article 9-An Agenda for the Next Decade, 87 Yale L.J. 1012, 1014 (1978) [hereinafter Article 9-Agenda] ("Until the early nineteenth century, the only way to create a valid security interest in personal property was by physical pledge ... ."); 1 G. Gilmore, supra note 16, § 2.1, at 24 ("Until early in the nineteenth century the only security devices which were known in our legal system were the mortgage of real property and the pledge of chattels. . . . A transfer of an interest in personal property without delivery of possession was looked on as being in essence a fraudulent conveyance, invalid against creditors and purchasers."). The requirement that a creditor take possession dated from 1601, when the court in Twyne's Case concluded that grants of security interests without a corresponding transfer of possession were "always a badge of fraud." Twyne's Case, 3 Co. Rep. 80 b, 76 Eng. Rep. 809, 811 n.(B) (Star Chamber 1601); see also Casey v. Cavaroc, 96 U.S. 467, 477 (1877) (possession is the essence of the pledge); Pierce v. National Bank of Commerce, 268 F. 487, 492 (8th Cir. 1920) (pledge without delivery is ineffectual, though possession may also be by a third person).

23. "The requirement that a secured party take possession of his collateral" exists in Anglo-American law "under the name of pledge." 1 G. Gilmore, supra note 16, § 14.1, at 438. See generally supra note 22 (collecting cases and commentators that discuss requirements of common law pledge).
be able to pass off goods as his own. By taking possession of the collateral, the secured party demonstrates the ostensible ownership that indicates the perfected security interest to other potential creditors. The pledgor's lack of possession, together with actual possession by the pledgee or his agent, effectively provides notice to prospective third party creditors that the pledgor no longer has unfettered use of his property.

The U.C.C. does not define "possession" in Article 9. Since the Code does not define possession, pre-Code law provides a workable definition. Pre-Code security law construed possession to mean physical control. Given the public notice function underlying the pledge, the

References:

24. See Twyne's Case, 3 Co. Rep. 80 b, 76 Eng. Rep. 809 (Star Chamber 1601). In Twyne's Case, the court stated that "a secret transfer is always a badge of fraud," id. at 80 b, 76 Eng. Rep. at 811 n.(B), and that "by reason of [the pledgor's continued possession] . . . he traded and trafficked with others, and defrauded and deceived them." Id. at 81 a, 76 Eng. Rep. at 812-13. See also Gits v. Mauser Plumbing Supply Co., 148 F.2d 974, 977 (2d Cir. 1945) ("delivery should be all that the situation permits of at the time to remove the property from the ostensible ownership of the pledgor"); Pierce v. National Bank of Commerce, 268 F. 487, 492 (8th Cir. 1920) (possession of collateral by pledgee necessary so as not to give the pledgor a "false credit"); 1 G. Gilmore, supra note 16, § 14.2, at 440.


27. See Finance Co. of Am. v. Hans Mueller Corp. (In re Automated Bookbinding Servs.), 471 F.2d 546, 551-52 (4th Cir. 1972) ("'Possession' is one of the few terms employed by the Code for which it provides no definition."); In re Kontaratos, 10 Bankr. 956, 969 (Bankr. D. Me. 1981) ("'Possession is not a defined term under the Uniform Commercial Code'.").

28. Where the U.C.C. is silent on a point of law, common law principles are used to supplement the Code. See U.C.C. § 1-103 (1978).


30. See supra notes 25-26 and accompanying text; see also Article 9-Agenda, supra note 22, at 1030-33. In his article on Article 9, Professor Coogan describes "public notice" as the touchstone of possessory security interests under the Code, but nevertheless wryly notes:

The text of Article 9 does not, unfortunately, specifically articulate the 'public notice' requirement. Professor Homer Kripke, in the early days of Article 9, once casually mentioned the desirability of a phrase such as 'giving (or excusing) public notice,' but neither he nor I followed this up at a time when it could easily have been done. Logically, of course, this underlying rationale is obvious;
reason for equating possession with control is clear. The indicia of ownership that go along with possession are demonstrated through simple physical control. One who controls collateral possesses it, and leads others to believe it is his. Hence, a pledgee must exercise complete control over the collateral to have a perfected possessory security interest.

When collateral is already in the hands of a third person, however, both the common law and the U.C.C. validate possession by the third person as a means of perfecting a secured party's interest. Section 8 of the Restatement of Security states that when collateral is in the possession of a third person, a pledge may be created upon assent of the pledgor and notification of the third person by either the pledgor or pledgee of the new security interest. Section 9-305 of the U.C.C. similarly provides that "[i]f ... collateral ... is held by a bailee, the secured party is deemed to have possession from the time the bailee receives notification of the secured party's interest."

Taken at face value, sections 8 of the Restatement and 9-305 of the U.C.C. seem to suggest that possession by almost any third person will suffice to give the public notice of the security interest. The official comment to section 9-305, however, contains an important qualification with respect to who can be a section 9-305 bailee. Although possession may be by an agent acting on the secured party's behalf, the debtor or a person controlled by him cannot qualify as the agent for the secured party. Thus, equating possession with control is equally applicable in the context of perfection through third party possession.

otherwise, the sponsors might as well have required secured parties to stand on their heads or look toward Mecca or perform some other ritual in order to perfect their security interests.

Id. at 1032 n.75. The goal of protecting potential creditors from attempts by a debtor to portray property as unencumbered is hereinafter referred to as the "public notice function" of the U.C.C.


32. See supra notes 24-26 & 29-31 and accompanying text; cf. infra note 39 and accompanying text.


34. See Restatement of Security § 8 (1941).


37. Id.

38. U.C.C. § 9-305 official comment 2 (1978); see Restatement of Security § 11 comment b (1941).

39. The reason for equating possession with control in the context of perfecting a security interest through third party possession is clear. "Where the debtor controls the bailee, he controls the collateral notwithstanding its physical possession by the bailee,"

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In the situation where a pledgor already has transferred property to a bailee, any logical inconsistencies between providing for perfection by notice to the pledgor’s bailee and the strict common law requirement that the pledgee be in absolute control of pledged property were resolved at common law by means of a legal fiction—upon receipt of notice the bailee became the pledgee’s agent. 40

Thus, a secured party may acquire a perfected possessory interest upon notice to a third party bailee in actual possession, provided the bailee is independent of and not controlled by the pledgor. Perfection of the security interest occurs when the bailee receives notification of the interest. 41

hence the bailment does not satisfy the public notice requirement of U.C.C. § 9-305 (1978). In re Kontaratos, 10 Bankr. 956, 969 (Bankr. D. Me. 1981). Therefore, although possession by the pledgee may be accomplished through the use of an agent, the pledgee must have absolute dominion and control over the property. See Qualley v. Snoqualmie Valley Bank, 136 Wash. 42, 48, 238 P. 915, 917 (1925); see, e.g., Motobecane Am., Ltd. v. Patrick Petroleum Co., 791 F.2d 1248, 1252 (6th Cir. 1986) (general partner in partnership owed fiduciary duty to other partners, and, therefore, could not act as bailee for creditor of limited partner); Heinicke Instruments Co. v. Republic Corp., 543 F.2d 700, 702 (9th Cir. 1976) (corporation could not be bailee of its own stock on behalf of creditor where debtor was its former president and corporation continued to follow his directions); McDonald v. National Bank of Stigler (In re Hill), 7 Bankr. 433, 436 (Bankr. W.D. Okla. 1980) (father of debtor could not be deemed agent for creditor). As Professor Gilmore stated: “[I]t has been frozen law for fifty years that the possession which perfects a pledge is that of the pledgee himself or of some third party who is independent of the pledgor.” 1 G. Gilmore, supra note 16, § 14.2, at 440 (footnote omitted) (emphasis added).


To facilitate credit transactions involving third party bailees further, the common law even denied the pledgor’s bailee any right to accept or reject the imposition of such an agency relationship:

While ordinarily an agency cannot be created without consent of the agent (Restatement of Agency, § 15) it is not considered desirable to require the consent of the third person as a condition precedent to the creation of the pledge. The third person’s duties are not altered in any material respect by the pledge. To make the third person’s consent a test of the creation of the pledge would invest him with an arbitrary power of affecting the interests of the other parties. Restatement of Security § 8 comment a, at 24 (1941).

41. See supra notes 34-35 and accompanying text. Terminology is defined very precisely in the Code, particularly with respect to notice provisions. The U.C.C. distinguishes between the terms “notifies” and receives notification. See U.C.C. § 1-201 official comment 26 (1978). “Notifies” is used “when the essential fact is the proper dispatch of the notice, not its receipt.” Id. However, “[w]hen the essential fact is the other party’s receipt of the notice, that is stated.” Id. (emphasis added). Thus, use of the phrase “receives notification,” in § 9-305 is significant. See U.C.C. § 9-305 (1978).
II. THE TREND TOWARD REQUIRING NOTICE FROM THE PLEDGOR

Section 9-305 of the U.C.C. states that a security interest in collateral may be perfected through notice to a third party in possession of the collateral. Section 9-305, however, is silent as to which party must give notice to the third party bailee.

The commentators, the Restatement of Security, and earlier cases clearly indicate that notice may come from either the pledgor or the secured party. Indeed, the law was so clear that later commentators simply assumed that notice from a junior pledgee was sufficient to perfect an interest.

43. See id.; Aronstein, Security Interests in Securities: How Code Revision Reflects Modern Security-Holding Practices, 10 U.C.C. L.J. 289, 294 (1978) [hereinafter Modern Security-Holding Practices] ("statute provides no guidance as to the form the notification must take or, indeed, who must originate the notice"). In the early stages of drafting the Code, many sections underwent major revisions, and the drafters carefully documented the reasons for the changes. See Foreward to 1972 Official Text and Comments, U.C.C. at XXXVII (1978) ("In Part II the sections of the prior Official Draft that have been revised are set forth in a form that shows the original text and the changes now approved and recommended for uniform enactment, together with a statement of the reasons for change."); Coogan, Security Interests in Investment Securities Under Revised Article 8 of the Uniform Commercial Code, 92 Harv. L. Rev. 1013, 1016 n.9 (1979) [hereinafter Investment Securities] ("Willingness of the U.C.C. sponsors to consider changes has been an element of strength with the Code."). Section 9-305, however, has remained essentially intact throughout the drafting process. See U.C.C. § 9-305 in Appendices I & II, U.C.C. 1978 Official Text. The drafters simply never viewed the ambiguity with respect to the identity of the notice-giver as a problem.

44. For example, Professor Grant Gilmore, the principal architect of Article 9, see Article 9-An Agenda, supra note 22, at 1012 n.1, was clear on the point: "[P]erfection occurs when the third person receives notification, from either pledgor or pledgee, of the pledgee's interest. . . ." 1 G. Gilmore, supra note 16, § 14.2, at 440 (emphasis added). Also, the Restatement of Security states:

Where the chattel is in the possession of a third person a pledge may be created by assent of the pledgor and notification by either pledgor or pledgee, to the third person, that the chattel has been pledged to the pledgee.

See Restatement of Security § 8 (1941) (emphasis added); see e.g., Gins v. Mauser Plumbing Supply Co., 148 F.2d 974, 978 (2d Cir. 1945) (citing the Rest. of Security § 8 (1941)); Schram v. Sage, 46 F. Supp. 381, 383 (E.D. Mich. 1942) (same); see also Investment Securities, supra note 43, at 1027 ("person could formerly perfect a security interest in [collateral] by giving notice to the pledgee in possession under section 9-305"); cf. In re Hinds, 10 Cal. App. 3d 1021, 1024, 89 Cal. Rptr. 341, 343 (1970) ("Since there is no requirement that the secured party personally give notice, only that the bailee receive it, appellant's security interest was perfected on or about [the date] when [the bailee] presumably received the letter [notifying him of security interest].") (citations omitted).

45. Professor Barkley Clark, for example, in his treatise on the law of secured transactions, gave a hypothetical to explain the section 9-305 "bailee with notice" concept in which a junior lender perfected its security interest by sending a letter to a senior lender in possession of collateral. He stated:

Bank B [junior lender] could send a letter to Bank A [senior lender] indicating its security interest and requesting that the stock certificates be delivered to Bank B immediately upon repayment of the loan from Bank A. . . . Based on the language of § 9-305, a court should treat Bank A as a 'bailee with notice' holding the stock not only for itself, but as agent for the subordinated secured party.
Recently, however, the district court in *In re Kontaratos* held that to perfect a junior security interest, when the bailee in possession is actually a pledghee himself, notice of the security interest *must* come from the pledgor. Three other courts to date have adopted the reasoning of the court in *Kontaratos*, as part of what seems to be a trend toward requiring notice from the pledgor.

In holding that notice must come from the pledgor, Judge Cyr, who wrote the *Kontaratos* opinion, drew on the law of bailments and the common law "control" concept embodied in the pre-Code definition of possession. According to Judge Cyr, notice must come from the pledgor in order to accomplish two things: first, it effects a modification of the original bailment contract between the pledgor and the senior pledgee in possession, and second, it is a mechanism whereby the debtor relinquishes control over the part of the collateral in which the junior pledgee is trying to perfect an interest. In developing his analysis, Judge Cyr interwove the two arguments to present a unique challenge to existing law.

For reasons other than those presented by Judge Cyr in *Kontaratos*,

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B. Clark, The Law of Secured Transactions Under the Uniform Commercial Code ¶ 7.7[2], at 7-16 to -17 (1980).

Similarly, in his article on security interests under revised Article 8, Professor Coogan gives a hypothetical in which he simply assumes that notice from a junior pledgee would perfect a security interest. Coogan was concerned instead with the difficulty of proving receipt of notice by a recalcitrant and uncooperative pledgee-bailee. *See Investment Securities, supra* note 43, at 1029-30.


In the 1986 supplement to his book on the law of secured transactions, Professor Barclay Clark mentions the decision in *Kontaratos* as an "interesting application of the 'double pledge' situation," but does not voice an opinion as to the validity of the arguments presented in favor of requiring notice from the debtor. Instead, Clark simply notes that "if [the pledgor] does not notify the senior creditor of the junior security interest, the junior creditor can never be sure of its perfected status." B. Clark, The Law of Secured Transactions Under the Uniform Commercial Code ¶ 7.7[2], at S7-6 (1986 Supp. No. 3) (emphasis added).

47. *Id.* at 970.

48. *See Landmark Land Co. v. Sprague*, 529 F. Supp. 971, 980 (S.D.N.Y. 1981) (instructions from pledgor to senior creditor regarding the junior security interest deemed sufficient to perfect junior interest), rev'd on other grounds, 701 F.2d 1065 (2d Cir. 1983); *In re Baquet*, 61 Bankr. 495, 501 (Bankr. D. Mont. 1986) (court accepting *Kontaratos*, and in this case since there was no notification by the pledgor there was no perfection); *In re Coral Petroleum*, 50 Bankr. 830, 839 (Bankr. S.D. Tex. 1985) (citing *Kontaratos*). One unpublished district court opinion even seems to have foreshadowed *Kontaratos*. *See Winnett v. Inverness Counsel, Inc.*, No. 76 Civ. 3810 (S.D.N.Y. Aug. 14, 1979) (available on LEXIS, Genfed library, Dist file) (court held that notice from junior pledgee to pledgee-bailee was insufficient to create perfected security interest), aff'd without opinion, 614 F.2d 1293 (2d Cir. 1979); *see also In re Milam*, 4 Bankr. 621, 622 (Bankr. M.D. Ga. 1980) (issue of whether oral notice to bailee by creditor was sufficient to perfect interest, court held that "minimal step reasonably required would have been some form of written notice by the plaintiff [creditor] and debtor [bailor]" to the bailee) (emphasis added).

49. Judge Conrad Cyr is very well-respected in the field of bankruptcy law. At present he is a contributing editor to Collier on Bankruptcy, and from 1970 to 1981 he was Editor-in-Chief of the American Bankruptcy Law Journal. *See W. Dornett & R. Cross, Federal Judiciary Almanac 497 (1984).*
newly revised Article 8 of the U.C.C. also appears to be in accord with the Kontaratos result. Hence, this trend toward requiring notice to come exclusively from the pledgor is an important new development that must be fully addressed.

A. The Kontaratos Rationales

1. Modification of the Bailment

The first reason set forth for requiring notice from the debtor is based on a technical application of the law of bailments. A pledge of personal property is defined as a bailment for the purpose of securing payment or performance of an obligation. Thus, a secured party who takes possession of collateral for the purpose of perfecting his own interest is a bailee. Moreover, pledgees in possession, as bailees, also can hold collateral for the purpose of perfecting secondary security interests within the meaning of section 9-305. Because Article 9 of the U.C.C. does not

50. In 1977, sections of Article 8 of the U.C.C. were revised and one of the changes concerns what constitutes delivery of certificated securities for purposes of perfecting security interests therein. U.C.C. § 8-313(1)(h)(ii) (1978) provides that transfer of a security interest in certificated securities occurs when “a written notification, which . . . is signed by the debtor (which may be a copy of the security agreement) . . . is received by a third person . . . in possession of the security . . . .” Section 8-313 does not state specifically that the debtor must be the one who actually sends the signed, written notification. Several commentators, however, have interpreted the section to mean precisely that. See, e.g., Aronstein, U.C.C. Survey: Investment Securities, 38 Bus. Law. 1179, 1183 (1983) [hereinafter UCC Survey] (“Under new sections 8-313(1)(h) and 8-321(2), a security interest is perfected by the owner giving written notice to the bank.”); C. Israels & E. Guttman, Modern Securities Transfers § 4.02, at S.4-49 (Supp. 1985) (relying on Kontaratos to conclude that notice from debtor required); see also UCC Survey, supra at 1184-85. But see Investment Securities, supra note 43, at 1027-28 (only additional requirement is existence of security agreement signed by debtor and receipt of notice of the security interest by bailee). Nevertheless, the Code is ambiguous on the point, and there is no clear analytical reason for requiring the debtor to actually send the written notice himself. The purpose behind requiring written notification signed by the debtor is equally well served by a junior creditor’s delivery of a copy of the original security agreement between himself and the debtor to the third person. See infra notes 130-31 and accompanying text.

51. Restatement of Security § 1 (1941); see Brown on Personal Property § 128 (3rd ed. 1975); J. Lawson, Law on Bailments § 50, at 92 (1895) (“pledge or pawn is the bailment of a chattel as security for some debt or engagement”) (footnote omitted).

52. If a pledge is a bailment at law, then the pledgor and pledgee respectively stand in the relationship of bailor and bailee. According to the Restatement of Security, for example, “[t]he pledgor in possession is a bailee and the rule stated in [section 17] is the rule as to a bailee’s liability for lack of reasonable care.” Restatement of Security § 17 comment b (1941) (footnotes omitted) (discussing pledgee’s duty of reasonable care).

53. In the Kontaratos decision, Judge Cyr initially argues that the double-pledge situation is unique, stating: “Highly respected authority states that a pledgee in possession may be a bailee for UCC § 9-305 purposes, though no reported decision has ever done so.” In re Kontaratos, 10 Bankr. 956, 964-65 (D. Me. 1981) (footnote omitted). Judge Cyr was not exactly correct, however, regarding the uniqueness of the pledgee-bailee situation, and subsequent case law has confirmed that pledgees in possession may act as § 9-305 bailees.

At the time of the Kontaratos decision, there was significant authority for the proposi-
define "bailee," however, courts must look to the common law for controlling principles of law.⁵⁴

Under common law principles, a bailment is the delivery of personal property to a person in trust for a specific purpose, coupled with a contract, express or implied, that the trust shall be executed faithfully, and the property returned when the special purpose is accomplished.⁵⁵ A pledge is the delivery of collateral for purposes of securing payment or performance by a pledgor.⁵⁶

As in any bailment, however, the special purpose for which a pledgee-bailee is entrusted by a pledgor with possession of collateral depends on the terms of their security agreement.⁵⁷ The relationship between any

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⁵⁴ See In re Chapman, 5 U.C.C. Rep. Serv. 649, 652 (W.D. Mich. 1968) ([U]nless we hold that one secured party can hold for all we would be severely and unnecessarily restricting opportunities to finance by security agreements . . . ."). In an article on newly revised Article 8 of the U.C.C., the authors discussed conclusions reached by the Permanent Editorial Board for the UCC (PEB) as to the applicability of the perfection by notice provision of § 9-305 in the double-pledge situation, when the Board contemplated revisions in Article 8, stating: "In light of the common understanding that a pledge is a bailment to secure an obligation, it was undisputed that a senior pledgee in possession of the security was the 'bailee' to be notified, and that section 9-305 controlled." Aronstein, Haydock, & Scott, Article 8 is Ready, 93 Harv. L. Rev. 889, 902-03 (1980) [hereinafter Article 8] (footnote omitted). In his discussion of perfecting a security interest through notice, Professor Gilmore discussed possible situations where a creditor would not be able to take actual possession, and notice would be the only alternative method of perfection, and stated: "the collateral may be in the possession of a third person who holds merely as a bailee or who may himself claim a pledge or other interest." 1 G. Gilmore, supra note 16, § 14.2, at 440 (emphasis added). See also B. Clark, supra note 45, ¶ 7.7[2], at 7-17 (1980) (posing hypothetical in which pledgee-bailee holds for a junior pledgor).

Finally, although it was true that no "reported decision" had actually ever discussed § 9-305 in the context of a double-pledge situation at the time Judge Cyr wrote Kontaratos, it is clear from subsequent case law that a pledgee-bailee can act as a § 9-305 bailee for purposes of perfecting a junior security interest. See Furness Withy (Chartering), Inc. v. World Energy Sys. Assoc., 642 F. Supp. 50, 55 (W.D. Tenn. 1985) ("The fact that [the bailee] had an interest in the proceeds of the letter of credit does not disqualify it from acting as an agent on behalf of the other [creditors]."); Landmark Land Co. v. Sprague, 529 F. Supp 971, 979 (S.D.N.Y. 1981) (pledgee of collateral may possess pledged collateral on behalf of junior pledgor), rev'd on other grounds, 701 F.2d 1065 (2d Cir. 1983); In re Gemini at Dadeland, Ltd., 24 Bankr. 57, 58-59 (Bankr. S.D. Fla. 1982) (bank asserting security interest in the account in its possession may also possess the account on behalf of another bank claiming security interest therein).

⁵⁵ See supra note 51 and accompanying text.

⁵⁶ In re Kontaratos, 10 Bankr. 956, 968 (Bankr. D. Me. 1981) (emphasis in origin-
bailor and bailee is a contractual one. Thus, some courts conclude that because holding property for the purpose of perfecting a secondary security interest was not one of the special objects or purposes of the original pledge-bailment, a senior pledgee could not act as a section 9-305 bailee, absent modification of the original agreement.

This technical analysis of the section 9-305 bailment was laid out in detail by the court in Kontaratos. Courts that subsequently have addressed the issue have cited Kontaratos for the proposition that mere notification by the junior pledgee is insufficient to create a bailment that conforms with section 9-305, but their reasons for so holding are not as clearly stated.

In Kontaratos, the pledgors purchased all of the stock of a corporation using money borrowed from the plaintiff, Hale, and the Depositors Trust Company of Southern Maine (DTC). To secure the loans from both Hale and DTC, the pledgors granted each party a security interest in the stock. DTC, however, did not know of Hale's interest when DTC took physical possession of the stock. Although DTC's loan was closed subsequent to the closing of the Hale loan, the pledgors warranted to DTC that they were the sole owners of the stock and that no encumbrances would be created without DTC's prior approval.

The pledgors subsequently defaulted on both loans, and two months later Hale notified DTC of the stock pledge and related agreements between Hale and the pledgors, and demanded the right to redeem the stock. DTC refused. The pledgors filed for bankruptcy and Hale instituted adversary proceedings seeking relief from an automatic stay.

The issue before the court was whether Hale had a perfected security n al). See Restatement of Security §§ 14, 37 (1941) (dealing with underlying contractual nature of pledge).

58. See J. Lawson, supra note 51, § 5, at 9 ("certain contract relation exists between the parties, and this relation is called a bailment"); id. § 9, at 23 ("bailment being a contract relation, the parties thereto must be capable of contracting"); see also id. §§ 10, 11, 13, 18, 21.


62. Id.

63. Id.

64. Id. The part of the pledge agreement which prohibits the creation of competing pledges hereinafter is referred to as a negative pledge clause.

65. Id. at 959.

66. Id.

67. Id.
interest in the stock. Hale argued that upon giving notice to DTC, his security interest became perfected under section 9-305. The court disagreed.

Writing the Kontaratos opinion, Judge Cyr held that following performance by, and without the approval of, the pledgor, a pledgee in possession could not be compelled to hold or surrender possession of the collateral in contravention of the terms of their pledge agreement upon notification by a mere junior pledgee. After briefly reviewing the law of bailments, Judge Cyr stated that since "the special object or purpose for which a bailee is entrusted by a pledgor with possession of collateral depends upon the terms of their pledge agreement," a "pledgee in possession cannot be cast in the role of U.C.C. § 9-305 bailee absent a conforming adjustment of [that] agreement."

Judge Cyr basically conceded that the purpose behind requiring adjustment of the agreement by the pledgor is not to provide the pledgee-bailee with the opportunity to accept changes in the original contract. Under the Code, a pledgee-bailee need not acknowledge formally that he holds on a junior pledgee's behalf. More important, however, he has no right even to refuse the section 9-305 bailment. Allowing the senior pledgee to refuse to hold collateral as a section 9-305 bailee effectively would be to allow him to veto the creation of a junior pledge. Judge Cyr nevertheless held that modification of the terms of the original bailment was still necessary because the contract had to reflect that the senior pledgee in possession was now also holding the collateral for a junior pledgee. In other words, Judge Cyr construed the term "bailee" in section 9-305 literally to mean a party whose bailment contract explicitly describes them as "a § 9-305 bailee." Thus Judge Cyr concluded, and

68. Id. at 959, 963.
69. Id. at 963.
70. Id.
72. Kontaratos, 10 Bankr. at 968 (emphasis in original).
73. Id. at 967 n.59(2).
74. See infra notes 75-76.
75. Kontaratos, 10 Bankr. at 967 n.59(2) (citing U.C.C. § 9-305 official comment 2 (1978) which states: "[T]his rule rejects the common law doctrine that it is necessary for the bailee to attorn to the secured party or acknowledge that he now holds on his behalf.").

76. Kontaratos, 10 Bankr. at 966. Judge Cyr stated that the drafters of the Restatement were well within their rights to deny a bailee veto power. Id. See infra note 94.
77. See supra note 73 and accompanying text. Judge Cyr believed modification was especially necessary when there was a negative pledge clause in the original pledge agreement. Kontaratos, 10 Bankr. at 968 ("Where the agreement between the pledgor and the pledgee-bailee expressly prohibits the creation of other encumbrances there is no evidence of a conformable UCC § 9-305 bailment and it would be unreasonable to imply one.") (emphasis added).
78. Kontaratos, 10 Bankr. at 968 ("secured party depending for the perfection of its security interest upon the possession of a UCC § 9-305 bailee must establish the existence of a bailment consistent therewith").
other courts agree,\textsuperscript{79} that notification of the bailee under section 9-305

\textsuperscript{79} In another case, Landmark Land Co. v. Sprague, 529 F. Supp. 971, 980 (S.D.N.Y. 1981), \textit{rev'd on other grounds}, 701 F.2d 1065 (2d Cir. 1983), the court similarly framed the issue as whether the senior creditor possessed the collateral in question as "the agent or bailee of [the junior creditor] within the meaning of § 9305 [sic]." Citing Kontaratos, the court held that instructions from the pledgor to the senior pledgee to deliver the collateral to the junior pledgee upon satisfaction of the debt by the pledgor created a section 9-305 bailment. See id. Similarly in \textit{In re Coral Petroleum}, 50 Bankr. 830, 839 (Bankr. S.D. Tex. 1985), the court held that the junior pledgee failed to establish a section 9-305 bailment relationship upon mere notification of the senior pledgee.

In Coral Petroleum, the court also made a second argument for rejecting the junior creditor's claims. The court stated that senior secured creditors can never be § 9-305 bailees because they have an "interest in the instrument in [their] possession," and consequently there is a danger of the bailee "trying to pass the instrument off as his own." Id. The court cites only one case for the proposition that bailees must be disinterested, \textit{In re National Buy-Rite, Inc.}, 11 Bankr. 196, 198 (Bankr. N.D. Ga. 1981), and then sidesteps more persuasive and relevant authority to the contrary, by distinguishing a case on the basis of irrelevant facts. See Coral Petroleum, 50 Bankr. at 839-40 (citing \textit{In re Chapman}, 5 U.C.C. Rep. Serv. (Callaghan) 649 (W.D. Mich. 1968)). The Chapman case, however, plainly stands for the proposition that one secured party can hold for another. \textit{In re Chapman}, 5 U.C.C. Rep. Serv. (Callaghan) 649 (W.D. Mich. 1968). But the most telling evidence of how illogical the Coral Petroleum court's conclusion is comes from the court itself, when it indicates that the junior creditor could have claimed a perfected security interest, had all the parties executed a formal agency agreement establishing a § 9-305 bailment. See Coral Petroleum, 50 Bankr. at 840. Such an agreement clearly would not have changed the bailee's status as an "interested stakeholder." Id. See also B. Clark, \textit{supra} note 45, \textit{\S} 7.7[2], at 7-7 (1986 Supp. No. 3). Although Professor Clark acknowledges that Coral Petroleum "underscores the importance of obtaining a three-way agency agreement in the double pledge situation," he concludes that "a good argument may be made that the decision is wrong." Id. Professor Clark goes on to state that U.C.C. § 9-305 does not require a three-way agreement, "and no line is drawn between 'disinterested' bailees and those who are competing secured parties." Id. See also infra note 94 (collecting cases which approve the double-pledge situation).

A third, unreported decision, Winnett v. Inverness Counsel, Inc., No. 76 Civ. 3810 (S.D.N.Y. Aug. 14, 1979) (available on LEXIS, Genfed library, Dist file), \textit{aff'd without opinion}, 614 F.2d 1293 (2d Cir. 1979), seems to have foreshadowed Kontaratos. In Winnett, the court held that a junior security interest was not perfected when the senior pledgee in possession refused to turn over or hold collateral for a junior pledgee absent instructions from the pledgor. Id. The court made it clear, however, that had the pledgor notified the senior pledgee, the junior pledgee would have had a perfected security interest:

\begin{quote}
Under P5 of [their] Agreement, [the pledgor] could have been compelled to assist [the junior pledgee] in perfecting his security interest in the . . . stock. [The junior] chose not to seek [the pledgor's] assistance, and the steps that [the junior] took on his own behalf to perfect his interest were ineffective.
\end{quote}

\textit{Id}. Hence, notice from the junior pledgee was insufficient to affect any modification of the original agreement between the pledgor and the bank holding the stock which was necessary to give rise to a § 9-305 bailment.

\textit{Winnett} is the case most cited for the proposition that junior creditors cannot perfect through notification because a pledgee in possession cannot be conscripted into service as an involuntary § 9-305 bailee. See, e.g., \textit{In re Kontaratos}, 10 Bankr. 956, 965 n.47 (Bankr. D. Me. 1981); Coral Petroleum, 50 Bankr. at 840; see also 1B Secured Transactions, \textit{supra} note 21, \S 14.02[2], at 23 (Supp. 1986) (noting involuntary bailment argument in Winnett). Nonetheless, as the court in Winnett makes clear, notice from the pledgor would have served to perfect the junior pledgee's interest. Thus, a first pledgee of stock or goods can be compelled effectively to serve as a 9-305 bailee against its will by any debtor, hence the fatal flaw in the argument.
could only mean notification by the pledgor, as contracting party to the original agreement.

Though persuasive, Judge Cyr's bailment modification argument fails on three grounds. First, the argument that notice has to come from the pledgor in order to modify the original bailment contract is unsupported by established pre-Code and U.C.C. precedent. Prior to Kontaratos, cases discussing notice to both pure bailees and pledgee-bailees consistently stated that notice could come from either the pledgor or the secured party.80

Even though the court in Kontaratos limited its holding to double-pledge situations, there is no difference between a pure bailee and a pledgee-bailee regarding the contractual nature of their relationship to the pledgor, however different the terms of their individual agreements with the pledgor may be.81 An ordinary bailee who has no security interest in the property in his possession has an established contractual relationship with the pledgor and is as guided by the terms of his contract as is a pledgee-bailee.82 Nevertheless, it is well established that notice can come from either the pledgor or the pledgee in a pure bailee situation.83 Courts have never referred to a need for modifying the original bailment contracts.84 In the double-pledge situation, courts consistently have held

80. See infra notes 83-85 and accompanying text.
81. See supra notes 51-53 and accompanying text. Compare Restatement of Security § 1 (1941) (pledge defined) and id. § 14 (modification of normal incidents of pledge) and id. § 17 (pledgee's duty of reasonable care) and id. § 37 (duty to return asset upon performance by pledgor) with J. Lawson, Law of Bailments § 5 (1895) (bailment defined) and id. § 13 (modification of agreement) and id. § 11 (care and diligence required of bailees) and id. § 22(d) (duty to re-deliver bailed goods).
82. See supra notes 55-58 & 81 and accompanying text.
83. See supra note 44; see also Rogers v. United States, 511 F. Supp. 82, 86 (D. Minn. 1980) (secured party notified bailee and thereby perfected his interest under Minn. Stat. § 336.9-305); Johnson v. Conrail-Amtrak Fed. Credit Union, 37 U.C.C. Rep. Serv. (Callaghan) 933, 940 (D.C. Super. Ct. 1983) (bailee had notice of secured party's rights in collateral, and secured party herself was the one who gave that notice). Even Judge Cyr in Kontaratos seems to concede the point that notice can come from either the pledgor or the pledgee in a pure bailment situation. In re Kontaratos, 10 Bankr. 956, 966 n.52 (D. Me. 1981). He then goes on to state, however, that in the double-pledge situation, "the identity of the 'notice' giver may be pivotal." Id. Judge Cyr argues that in the pure bailee situation, the person in possession is not under the control of the debtor. In the double-pledge situation, however, control over the crucial part of the collateral "rests entirely with the debtor," according to Judge Cyr. See id. at 969. Nevertheless, it is clear that once Judge Cyr's control argument is negated, there is no longer any basis for distinguishing between pure bailees and pledgee-bailees. Although he makes two other arguments for requiring notice from the debtor, neither is persuasive. See infra note 94 (discussion of involuntary conscription argument and negative pledge clause argument).
84. See In re Estate of Hinds, 10 Cal. App. 3d 1021, 1024, 89 Cal. Rptr. 341, 343 & n.6 (1970) (court found notice alone rendered bailee an agent of secured party and identity of notice-giver was irrelevant). The Hinds court apparently did not consider the identity of the notice-giver under section 9-305 relevant. In fact, the only issue before the court was whether the secured party himself had to notify the bailee of the stock, not whether the secured party could send the notice. Id. The court focused on the importance of the receipt of notice, stating: "Since there is no requirement that the secured party personally give notice, only that the bailee receive it, appellant's security interest
that secured creditors acquire possession upon the notification of a pledgee-bailee, without reference to adjustments in the contractual relationships between the parties.85

Second, contract modification typically requires the consent of both parties to the original agreement because the purpose of modification is to ensure that both parties agree to and accept changes in the contract.86 Modification essentially recreates the earlier offer and acceptance stage of the contract. It is clear, however, that under the U.C.C. the third party bailee’s acceptance or refusal of notice is irrelevant to the perfection of a security interest.87 The bailee has no right to refuse or accept the imposition of the agency relationship between himself and the secured party created upon notice to the bailee of that party’s security interest.88

was perfected . . . .” Id. at 343. See also In re Miller, 545 F.2d 916, 919 (5th Cir.) (although debtor sent notice in this case, entire focus of court’s opinion was on whether the documents evidenced an intent on the part of the parties to create a security interest, and whether the letter sent to the bailee “adequately served to notify the [bailee] of [the creditor’s] rights in the collateral” so as to perfectly latter’s interest), cert. denied, 430 U.S. 987 (1977); Barney v. Rigby Loan & Inv. Co., 344 F. Supp. 694, 696 (D. Idaho 1972) (“bailee-trustee . . . received notification of the secured party’s interest well before the four-month period and the [secured party’s] possession became effective simultaneously therewith”).

85. For example, in Schram v. Sage, 46 F. Supp. 381 (E.D. Mich. 1942), the court cited the Restatement of Security § 8 and held that where stock certificates were in the possession of a bank, as senior pledgee, a subsequent pledge agreement between the pledgor and a junior pledgee, of which the bank had notice, created a pledge junior to the bank’s pledge. Id. at 383. In Gins v. Mauser Plumbing Supply Co., 148 F.2d 974, 978 (2d Cir. 1945), the court similarly held that “the owner of personal property subject to a prior pledge, perfected by delivery of possession, may make a valid pledge of his remaining interest to a second pledgee, by simple execution of a contract to that effect. The only additional requirement suggested is that the first pledgee be given notice of such contract.” (citations omitted) (emphasis added). Finally, in Pierce v. National Bank of Commerce, 268 F. 487, 495 (8th Cir. 1920), the court held that a pledgor may lawfully repledge his interest in collateral “by a contract or conveyance to that effect and notice thereof to the first pledgee, who will then be deemed to hold the property in trust for both pledgees as their interests exist.” (emphasis added). Note that in Pierce, the court does not speak of a separate modification of the original pledge agreement, but instead merely states that a senior pledgee will be “deemed” to have possession for both pledgees upon receiving notice. Id.

86. See U.C.C. § 2-209 official comment 3 (1978) (modification reflects changes mutually consented to by parties); J. Calamari & J. Perillo, Contracts § 5-14, at 192 (2d ed. 1977) (under pre-existing duty rule, agreement to modify requires consideration on both sides), id. § 5-15, at 195 (reason for requiring consideration under pre-existing duty rule is to prevent “coerced modification of contracts”); id. § 4-1, at 134-35 (essence of consideration is legal detriment “that has been bargained for and exchanged for” promise to perform).

87. According to U.C.C. § 9-305 official comment 2 (1978), a secured party is deemed to have possession from the time that the bailee receives notification of the security interest, and there is no need “for the bailee to attorn to the secured party or acknowledge that he now holds on his behalf.” According to Professor Gilmore, the “bailee with notice” provision was inspired by cases which followed the Restatement of Security § 8 (1941), and mere notice was sufficient to perfect an interest. 1 G. Gilmore, supra note 16, § 14.2, at 440. See 1A Secured Transactions, supra note 21, § 6C.08[1], at 6C-126 to -127.

88. See supra note 40. Professor Coogan, commenting on the Restatement’s position that the notified bailee has no right to refuse or accept the agency relationship created
Hence, Judge Cyr's use of the bailment "contract" as a basis for requiring modification seems rather fragile in the context of perfecting a junior pledgee's interest. The pledgee-bailee is informed of the change regardless of which party notifies him. The purpose behind contract modification is not served by requiring one-way notice from the pledgor.\footnote{89}

Third, assuming that Judge Cyr is correct in requiring that the bailment-pledge agreement reflect that the pledgee-bailee holds for a junior pledgee, modification of the contract still may not be necessary. The security agreement between the pledgor and senior pledgee includes far more than a promise to pay coupled with the grant of an interest in collateral.\footnote{90} Indeed, it is probable that the parties contemplated the grant-

upon notification, stated that apparently "[t]he drafters of the Restatement did not find the imposition of these duties on a bailee . . . to be onerous at all." 1A Secured Transactions, supra note 21, § 6C.08[1][b], at 6C-127. After citing Comment a to section 8, Coogan observed: "Here we have a development which parallels the recognition that contract rights are freely assignable, and the contract obligor cannot generally object to having to perform for a stranger." \textit{Id}. Moreover, concluded Professor Coogan, it was not "necessary to apologize" for section 9-305's obligating a bailee to perform for another, because "[k]eeping track of who is to get the collateral is no more abnormal than keeping track of who is to be paid for services rendered or goods delivered." \textit{Id}. Cf. U.C.C. § 9-318(2) official comment 2 (1978):

Prior law was in confusion as to whether modification of an executory contract by account debtor and assignor without the assignee's consent was possible after notification of an assignment. Subsection (2) makes good faith modifications by assignor and account debtor without the assignee's consent effective against the assignee even after notification. This rule may do some violence to accepted doctrines of contract law. Nevertheless it is a sound and indeed a necessary rule in view of the realities of large scale procurement.

\footnote{89} Some courts have also hinted at a fairness argument in holding that notice from a junior creditor was insufficient to perfect his interest; i.e., how can a third person in possession of collateral be obligated to perform for a junior creditor against his will? See \textit{In re Coral Petroleum, Inc.}, 50 Bankr. 830, 840 (Bankr. S.D. Tex. 1985) (discussing the senior creditor in possession's unwillingness to hold for the junior); \textit{In re Kontaratos}, 10 Bankr. 956, 966-67 (Bankr. D. Me. 1981) (discussing the "onerousness" of an involuntary bailment); see also \textit{Winnett v. Inverness Counsel, Inc.}, No. 76 Civ. 3810 (S.D.N.Y. August 14, 1979) (available on LEXIS, Genfed library, Dist file) (pledgee-bailee cannot be forced to hold collateral for junior pledgee against its will), \textit{aff'd without opinion}, 614 F.2d 1293 (2d Cir. 1979). The issue has been discussed in the context of the possible duties and liabilities of a notified bailee. See Article 8, supra note 53, at 905-07. Notice from the pledgor, however, is equally as onerous as notice from the pledgee, given that the baillee still has no right of acceptance or refusal.

\footnote{90} Under U.C.C. § 9-203, a valid security agreement is one that is signed by the debtor and contains a description of the collateral. Once the debtor signs such a writing, and assuming that he has acquired rights in the collateral and value has been given, the security agreement becomes enforceable and is said to have "attached." See U.C.C. § 9-203 (1978). It is clear, however, that other provisions of Article 9 give rise to more rights and obligations than those stated in the actual security agreement. See, e.g., U.C.C. § 9-207 (1978) (setting forth the rights and duties of a secured party in possession of collateral); id. § 9-208 (upon debtor's request, secured party must provide statement of account or list of collateral); id. § 9-311 (alienability of debtor's rights in collateral); id. § 9-318(2)-(3) (modification of contract after receiving notice of assignment, and ineffectiveness of any contract term prohibiting assignment); id. § 9-405 (allowing secured party to assign security interest); id. § 9-503 (giving a secured party the right to take possession of collateral after default); id. § 9-504 (giving a secured party the right to dispose of collat-
ning of secondary security interests at the time they entered into the
original agreement.

For example, section 9-207 provides that the pledgee-bailee himself
“may repledge the collateral upon terms which do not impair the
[pledgor’s] right to redeem it,” without informing the pledgor. 91 More-
over, section 9-311 makes clear that the debtor always retains the right
to transfer an interest in collateral despite the existence of a negative pledge
clause in the original security agreement. 92 Hence, a modification of
the original agreement is not necessary because the security agreement
impliedly provides for secondary security interests and for the repledge of
collateral by the pledgee-bailee.

2. Relinquishment of Control

The second rationale in Kontaratos for holding that notification of the
bailee means notification by the pledgor focused on the issues of control
and public notice. 93

Judge Cyr began his analysis by stating that the situation in which a
third party bailee is also a pledgee is different from an ordinary bail-
ment. 94 Essentially, the analysis turned on the concept that control of

91. U.C.C. § 9-207(c) (1978). Drafters of the Code expressly intended the rule stated
in § 9-207 to follow established common law precedents. See id. official comment 2; see
generally Restatement of Security §§ 23 Comment b, 29 (1941) (discussing general rules
with respect to the repledge of collateral).

92. See U.C.C. § 9-311 (1978):
The debtor’s rights in collateral may be voluntarily or involuntarily transferred
(by way of sale, creation of a security interest, attachment, levy, garnishment or
other judicial process) notwithstanding a provision in the security agreement
prohibiting any transfer or making the transfer constitute a default.

93. A security interest in personal property may be perfected by the secured party’s
taking possession of the collateral, and such possession may be either by the secured party
himself or by an agent acting on his behalf. See U.C.C. § 9-305 & official comment 2
(1978). For purposes of perfecting a security interest, pre-Code law defined possession as
meaning control. See supra notes 29-32 and accompanying text. When goods are in the
possession of a third person, that person, upon receiving notice of the new interest, is
deemed an “agent” of the secured party for purposes of perfecting the secured party’s
interest. See supra note 40 and accompanying text. Possession by the secured party or an
agent acting on his behalf satisfies the public notice requirement underlying § 9-305 and
the common law of pledges, because it removes ostensible ownership from the debtor.
See supra notes 30-31, 38-39 and accompanying text. For the same reason, however, the
debtor or any person controlled by him cannot qualify as such an agent for the secured
party. See U.C.C. § 9-305 official comment 2 (1978); 1B Secured Transactions, supra
note 21, § 14.02[2], at 23 (Supp. 1986).

94. Judge Cyr asserted that earlier decisions which stated that either party could give
the notice could not have been reached with the double-pledge situation in mind. In re
Kontaratos, 10 Bankr. 956, 966 (Bankr. D. Me. 1981). It is clear, however, that earlier
cases and distinguished commentators did consider the double-pledge situation. See
supra notes 44-45 and accompanying text.

Judge Cyr focused on Professor Gilmore’s treatise in particular, and posited that Gil-
more must have been “prompted” by the Restatement of Security § 8 in stating that
notice could come from either party. See Kontaratos, 10 Bankr. at 966 n.32. Judge Cyr
property in a pledgee-bailee situation is bifurcated. According to Judge
then went on to observe that the Restatement itself "did not contemplate a secondary
pledge of investment securities," as if to discredit Gilmore's conclusions. Id.
Judge Cyr based his conclusions with respect to the Restatement of Security on the
observation in comment a to section 8 that a third party bailee may surrender the posses-
sion if he does not wish to be under any duty to the pledgee. If the third party was
actually a pledgee-bailee, however, he could not surrender possession without losing his
perfected security interest. See id. at 966. See U.C.C. § 9-305 (1978) (perfection con-
tinues only so long as secured party retains possession). Hence, Judge Cyr concluded that
the Restatement was not intended to cover the double-pledge situation, see Kontaratos, 10
Bankr. at 966 & n.52, although he does not deal with the cases and commentators that
have expressly stated that notice from either party is sufficient to perfect an interest. Id.
at 966 n.52.
According to Judge Cyr, notice from the junior pledgee in a double-pledge situation is
a problem because it effectively conscripts the pledgee-bailee into serving as the junior
pledgee's agent against the bailee's will. See id. at 966-67. The pledgee-bailee does not
have the same freedom of choice that the ordinary bailee has by virtue of the fact that he
does not have a security interest in the goods in his possession. Compare Restatement of
Security § 8 comment a, at 23-24 (1941) (pure bailee has option of relinquishing control if
he does not want to hold for the pledgee) with U.C.C. § 9-305 (1978) (if pledgee-bailee
gives up possession he loses his perfected security interest). Judge Cyr, however, did not
go so far as to require that the pledgee-bailee have the option of either accepting or re-
jecting the agency relationship. See Kontaratos, 10 Bankr. at 966 ("The drafters of the
Restatement were well within their rights in refusing to permit a third person in posses-
sion of collateral to veto the creation of a secondary pledge.") (emphasis in original). Instead,
he used the involuntary conscription argument to hold that a better form of
notice is required, than "mere notification by a secured party." See id. Presumably the
pledgee-bailee will rest easier if the debtor notifies him, in that he thereby is assured of the
validity of the second pledge. This reasoning is implicit in Judge Cyr's comments. See id.
at 966-67 ("What is more, if a pledgee may be conscripted into service as a UCC § 9-305
bailee on mere notification by another pledgee, he may be drawn at great risk and expense
into litigation to defend, against the pledgor and any number of pledgees, his own pledge
as well as any surrender of possession to the pledgor or to another pledgee.").
In acknowledging that the pledgee-bailee does not have to attorn to the secured party
and the pledgee-bailee does not have the right to veto the creation of secondary security
interests, however, Judge Cyr exposed the fundamental flaw in his involuntary conscrip-
tion argument. Unless the pledgee-bailee is given the option of vetoing the creation of a
second pledge, in effect, there is no real distinction between the pledgee-bailee and the
pure bailee. Even if notice comes from the debtor in the double-pledge situation, the
bailee is equally as onerous because it is equally as involuntary. The sole distinction
Judge Cyr seems to be advocating, then, is that in one situation the bearer of the bad news
should be the pledgor and in another it should be, or rather, can be the pledgee. See supra
note 79 (discussion of Winnett case wherein court applied involuntary conscription
argument, but then observed that notice from the pledgor would have been sufficient to
obligate the pledgee-bailee to hold for the junior creditor).
It is at this point that Judge Cyr exposed one of the key reasons for his decision not to
allow the junior pledgee to perfect through notice to an unwilling senior pledgee—his
hesitancy to enforce the second pledge in the face of a negative pledge clause in the origin-
al agreement between the pledgor and the senior pledgee. Judge Cyr stated: "[T]he
commercial mischief flowing from a policy which would impose upon a pledgee in posses-
sion the obligation to perform for the holder of a secondary pledge expressly prohibited
under the first pledge agreement would greatly inhibit the utility of the primary pledge as
a security device." Kontaratos, 10 Bankr. at 967 n.58. Then Judge Cyr concluded that
"no UCC § 9-305 bailment [can exist] where the agreement between the pledgor and the
pledgee in possession prohibits other encumbrances." Id. at 967 n.59.
Judge Cyr fails to consider, however, the countervailing Code policy of protecting the
alienability of the debtor's rights in collateral, notwithstanding the existence of negative
Cyr, control of the property rested with the pledgee in possession only with respect to his own perfected security interest, while the "timing and direction of the post-performance disposition of the collateral remain[ed] within the control of the [pledgor] throughout." Judge Cyr then reasoned that because the junior interest could only attach to that part of the collateral in which the senior pledgee did not have an interest—specifically the theoretical "remainder" left over after the senior pledgee has been satisfied—the junior pledgee could not perfect his own interest through mere notice because the pledgor still technically controlled this "remainder" interest.

Finally, acknowledging that the junior pledgee has a perfected security interest despite the existence of a negative pledge clause in no way hurts the senior pledgee in possession. The senior pledgee, who already has a perfected security interest, can always maintain an action for breach of contract against the pledgor for creating the second pledge and accelerate payments on the loan obligation. See, e.g., Brummund v. First Nat'l Bank, 99 N.M. 221, 223-24, 656 P.2d 884, 886-87 (1983) (U.C.C. § 9-311 does not invalidate contract provision making a transfer of collateral a default, but simply allows two parties to define conditions of default while preserving interest of transferee); Sturdevant v. First Sec. Bank, 186 Mont. 91, 96-97, 606 P.2d 525, 528 (1980) (same); J. White and R. Summers, Handbook of the Law Under the Uniform Commercial Code § 26-7, at 1104 (2d ed. 1980). The actual security interest of the junior pledgee, however, remains valid and enforceable pursuant to U.C.C. § 9-311. See Brummund, 99 N.M. at 223, 656 P.2d at 886 (Section 9-311 preserves interest of transferee); Marine Midland Bank-Eastern Nat'l Ass'n v. Conerty Pontiac-Buick, Inc., 77 Misc. 2d 311, 318, 352 N.Y.S.2d 953, 961-62 (1974) (debtor can create junior liens notwithstanding negative pledge clause, and junior interest is merely subordinated to senior interest).

The interests of both pledgees, then, are protected under the Code. Since the senior pledgee always retains the right to dispose of the collateral and apply the proceeds to the debt in the event of the pledgor's default, he can always recoup his investment if the pledgor cannot pay upon acceleration of the debt. See U.C.C. §§ 9-503, 9-504 (1978) (self-help repossession and right to dispose provisions). At that point in time, any surplus could be turned over either to the junior pledgee to satisfy the junior lien, or to the courts for proper disposition if the senior pledgee was unsure about the validity of the junior interest. See, e.g., Fed. R. Civ. P. 67 (a party may deposit personal property with court for determination of various claimants' rights to the property, regardless of whether he has an interest in the property.).


As Judge Cyr framed his point:
Hale [the junior creditor] points out appropriately enough that DTC [the pledgee in possession] is not under the control of the debtors as concerns the retention of these securities as collateral for the DTC loan, since DTC may reasonably be expected to safeguard its own interests by retaining the collateral until its debt is satisfied. The appropriate test is not the adequacy of DTC's possession as a means of perfecting its own security interest, however, but that of Hale. The timing and direction of the post-performance disposition of the collateral remains with the control of the debtors throughout. Therefore, the equity cushion to which the Hale security interest attaches remains under the control of the debtors in these circumstances.
Judge Cyr based his conclusions on two points of law. First, two secured parties cannot have control over the same part of collateral when that collateral secures both of their respective security interests.97 A senior pledgee cannot relinquish control over the part of the collateral that secures his interest because he would lose his perfected interest in doing so. Therefore, a junior pledgee's interest can attach only to the remaining "equity cushion," namely, the value of the collateral over and above the senior's interest.98 Second, the pledgor always controls this equity cushion, irrespective of the pledgee-bailee's possession of the collateral, until the time when the pledgor actually releases control. The pledgor's control over the equity cushion, prior to such a release, is clear. First, he always retains the right to encumber an asset further, even after granting a first security interest in it, when the value of the asset will support a second pledge.99 Second, the pledgee in possession is legally obligated to return the collateral to the pledgor upon performance or satisfaction of the debt obligation owed to the senior pledgee.100

Essentially then, Judge Cyr argued in Kontaratos that, absent notification by the pledgor, the collateral in the bailee's possession to which the junior interest might have attached was still under the pledgor's "control" by virtue of the terms of the original agreement between the pledgor and the bailee.101 Because the pledgor had not notified the pledgee in

Id. (emphasis added).

97. See infra note 98.

98. According to U.C.C. § 9-305 (1978), "[a] security interest is perfected by possession from the time possession is taken . . . and continues only so long as possession is retained." Since possession is defined as "control," see supra note 29 and accompanying text, then any loss of "control" by a pledgee-bailee results in the loss of possession. The premise of Judge Cyr's argument is that two individuals cannot be simultaneously in "control" of the same equity interest in collateral. See supra note 96. Thus, although both are deemed to be in "possession," the two secured parties are actually in possession of different "pieces" of the collateral. In effect, then, the junior pledgee's constructive "possession" is limited to that part of the collateral that the pledgee-bailee does not need to "control" for purposes of perfecting his own interest.


100. See Jenkins v. National Village Bank, 58 Me. 275, 277-78 (1870) (bailee obligated to return pledged securities upon performance); Restatement of Security § 22 comment b (1941) (pledgee liable for conversion for refusing to surrender a chattel on demand) (quoting Restatement of Torts § 223); see also Restatement of Torts § 223(g) (1934) (a conversion is committed by refusing to surrender a chattel on demand). Essentially then, [t]he pledge as a security device ceases to exist when the reason for its creation is executed. . . . Indeed, once the obligation is discharged, the pledgee has a duty to return possession of the property to his pledgor. . . . The pledgee who fails to return the collateral upon satisfaction of the original obligation conducts himself in such a manner as to create an action in conversion for such conduct. Squillante, The Pledge as a Security Device, Part IV, 88 Commercial L. J. 159, 163 (1983) (footnote omitted).

101. According to Judge Cyr, the debtor's control of the equity cushion is manifested through the terms of the original pledge agreement, in which the pledgee-bailee promised to return the collateral once his interest was satisfied. In re Kontaratos, 10 Bankr. 956, 969 n.77 (D. Me. 1981). See supra note 100 (agreement gives rise to the pledgee-bailee's
possession, he technically had not relinquished control over the post-performance disposition of the collateral. If a pledgor retains control over property in which a purported pledgee has an interest, there can be no perfected security interest under section 9-305. Hence, Judge Cyr argued that the pledgor had to affirmatively give up his right of control through the notification process and, furthermore, that this could have been the only intended result under the “bailee with notice” provision of section 9-305, where secondary security interests are involved.

It was at this point that Judge Cyr linked the control and bailment modification arguments to strengthen his conclusion that notification of the bailee in section 9-305 means notification by the pledgor. Judge Cyr first argued that the pledgor had to give notice to the pledgee-bailee to amend the original pledge agreement so that its terms were consistent with a section 9-305 bailment. He then concluded that in so doing, the pledgor also simultaneously relinquished the right of “control” he technically had retained over the collateral by virtue of the original bailment contract between himself and the pledgee-bailee.

The key to Judge Cyr’s argument lies in the conceptual purpose of “notification.” Section 9-305 of the U.C.C. and section 8 of the Restatement of Security both make the receipt of notification the critical event that triggers an ipso facto possession in the secured party. The whole purpose of possession, however, is to provide the public with notice of the new security interest. Hence, Judge Cyr reasoned that because notification of a pledgee-bailee by itself affords no notice of the junior pledgee’s interest to creditors of the pledgor, the Code must have intended something more to happen to trigger the critical event of “possession.” For Judge Cyr, the only logical solution was to require notification by the pledgor—an event that simultaneously represents a duty to return the collateral to the pledgor upon satisfaction of the debt obligation). More accurately, however, the duty to return merely reflects that control over the equity cushion never actually left the debtor. See Kontaratos, 10 Bankr. at 969 n.77.

102. Kontaratos, 10 Bankr. at 966 & 969 n.77.
103. See supra notes 29-32 and accompanying text.
104. See Kontaratos, 10 Bankr. at 970. Judge Cyr arrives at this conclusion by reasoning that “if mere lack of possession in the debtor obviates the deceptive appearance of dominion on the part of the debtor, why does UCC § 9-305 specifically refer to a ‘bailee’ or, for that matter, require ‘notification’?” Id. at 969.
105. See supra notes 72-79 and accompanying text.
106. See Kontaratos, 10 Bankr. at 970.
107. Id. at 969 (notification substitutes for possession in that it strips control of equity cushion from pledgor).
108. Id. See supra notes 34-35 and accompanying text. Notice is essential to possession and perfection cannot occur prior to the secured party’s acquisition of possession. See Restatement of Security § 8, at 22 (1941). In other words, the execution of a security agreement alone does not create a pledge. See id. § 10(2), at 28.
109. See supra notes 24-26 and accompanying text.
110. Kontaratos, 10 Bankr. at 969 (“UCC § 9-305 makes the receipt of ‘notification’ of the secured party’s interest by a ‘bailee’ the critical event that triggers an ipso facto possession in the secured party.”) (footnotes omitted).
pledgor's abdication of "control" and the acquisition of "possession" by a junior pledgee. Once the junior pledgee has acquired true possession through this transfer of control, future creditors presumably are protected from any attempts by the pledgor to portray the collateral as free from encumbrances.

Although Judge Cyr's premise that notice from the pledgor serves to relinquish the pledgor's control over collateral may be analytically correct, for all practical purposes the debtor's technical control over an "equity cushion" is irrelevant.

Although Judge Cyr asserted that the pledgor always retains control of his equity interest in the collateral, even during the period in which the senior pledgee is holding for himself, this theoretical retention of control is not dispositive of whether the junior pledgee's "possession" is sufficient to give him a perfected interest. Although it is true that pre-Code se-

111. Judge Cyr stated:
Why then does UCC § 9-305 require 'notification' of the bailee? It can only have been because notification has long been viewed as essential to the validity of the nonpossessory pledge, a substitute for the actual possession which is infeasible in the circumstances. 'Notification' to the 'bailee' of the secured party's interest under these circumstances means notification by the pledgor to the bailee, because relinquishment by the pledgor of control over the disposition of the collateral following performance is indispensable to the creation of a bailment conformable with the requirements of UCC § 9-305 for the perfection of the secondary pledge.

Id. at 970 (footnotes omitted) (emphasis in original).

112. See infra notes 117-19 and accompanying text.

113. See infra notes 117-20 and accompanying text.

To the extent that Judge Cyr ignores the practical effect of notice from either the pledgor or pledgee in favor of a conservative, perhaps more technically correct construction of § 9-305, his opinion is analogous to a minority of courts' narrow interpretation of escrow in deciding that possession by an escrow agent generally is insufficient to perfect a security interest. See, e.g., Stein v. Rand Constr. Co., 400 F. Supp. 944, 948 (S.D.N.Y. 1975); In re Dolly Madison Indus., 351 F. Supp. 1038 (E.D. Pa. 1972), aff'd, 480 F.2d 917 (3d Cir. 1973).

Although technically "the simultaneous existence of an escrow and a pledge is a legal impossibility" because a creditor cannot have absolute control over an escrow agent, Dolly Madison, 351 F. Supp. at 1042, the majority of courts have held in favor of creditors. A secured party cannot technically have common law "possession" when collateral is held by an escrow agent because legally the agent is "controlled" only by the terms of the escrow agreement, hence a secured party cannot have the "absolute dominion and control" over the agent which is technically necessary to acquire a perfected possessory security interest at common law. See id. (during the time when the escrow agent is in possession of collateral, "the escrow agent is not empowered to act for either party . . . [and] his powers are solely limited to those stipulated in the escrow agreement"). Instead of adopting the narrow common law concepts of control and possession, however, the majority of courts that have addressed the issue focus on the debtor's lack of control, rather than the secured party's perfect acquisition of it. As one court noted in the escrow cases, to hold in favor of such a narrow construction would "elevate 'technicality over substance and [negate] the reasonableness the Code hoped to impart to commercial practices.'" In re Copeland, 391 F. Supp. 134, 151 (D. Del. 1973) (footnote omitted), aff'd in part and vacated in part, 531 F.2d 1195 (3d Cir. 1976). This observation rings true with respect to the notice problems in the double-pledge situation as well. Instead of focusing on whether the debtor himself technically releases control over collateral in the posses-
security law defined "possession" as control, the purpose behind the control requirement was to give the public notice of a secured party's interest.\footnote{114}

Section 1-102 of the U.C.C. states that the Code should be "liberally construed and applied to promote its underlying purposes and policies."
\footnote{115} Those purposes and policies include not only public notice, but also simplifying and modernizing the law governing commercial transactions, and permitting the "continued expansion of commercial practices through custom, usage and agreement of the parties."\footnote{116}

Given that the primary purpose of Article 9 is its public notice function,\footnote{117} the analysis should not turn on whether the pledgor technically retains a right of control over collateral by virtue of the fact that he has not amended the terms of the original bailment contract. Rather, the analysis should focus on the risk of misleading third party creditors with respect to the status of the pledgor's equity interest in the collateral.\footnote{118} It is the pledgee's dissemination of the vital fact that a second pledge has been created that really effectuates public notice, and that, by itself, has nothing to do with the identity of the notice-giver.\footnote{119} From a practical standpoint, then, whether notice comes from the pledgor or the junior pledgee is irrelevant because once a potential creditor discovers the existence of a first pledge he can always question the pledgee in possession about the existence of other liens.\footnote{120}

A second point can be made with respect to Judge Cyr's control analysis of a pledgee-bailee, courts should see to what extent notice from a junior pledgee serves the policies and purposes of the Code. \textit{See id.} at 150-51.
\footnote{114. See supra notes 24-26 and accompanying text.}
\footnote{115. U.C.C. § 1-102 (1978).}
\footnote{116. See id.}
\footnote{117. See supra note 30 and accompanying text.}

\textit{The analysis should not turn upon the . . . [identity of the] person who sends notification to the bailee-pledgee. The analysis should instead focus upon the risk of third parties being misled with respect to the status of the debtor's equity in the stock . . . . Since an inquiring creditor would have to communicate with the bailee-pledgee and since the bailee's possession prevents third parties from assuming the absence of encumbrances, it would seem that the Code's purposes are served.}
\footnote{119. See supra note 118.}
\footnote{120. See \textit{In re Chapman}, 5 U.C.C. Rep. Serv. (Callaghan) 649, 652 (W.D. Mich. 1968) ("If one inquired of [the pledgee in possession], he would not only obtain information of [his] secured interest but also that of [the junior creditors]. Thus, possession in one secured party should give notice to all secured interests known to the party having possession.").}

An important assumption underlying Judge Cyr's analysis in Kontaratos is that a pledgee-bailee simply will ignore notice from a junior pledgee, and hence only informa-
sis. If his premise that the junior interest can attach only to the pledgor's equity interest is correct, then arguably the junior pledgee cannot perfect his interest through any form of possession. An equity interest conceivably can be classified as an intangible, and under section 9-302 of the

tion transmitted directly by the debtor satisfies the public notice function. See In re Kontaratos, 10 Bankr. 956, 967 (D. Me. 1981).

The assumption that reliance upon the junior pledgee's notice threatens the public notice function of section 9-305 is consistent with Judge Cyr's control argument. See supra notes 101-03 and accompanying text. If the premise that only the debtor can relinquish control over the collateral is accepted, then since control equals possession, and possession alone satisfies the public notice function, see supra notes 23-26 and accompanying text, only the debtor's notice can serve the Code's public notice function. Contrary to Judge Cyr's assumptions, however, relying on the junior pledgee's notice to serve the public notice function is sound for a number of reasons.

First, in stating that notice from either the pledgor or the pledgee was sufficient to perfect an interest, it is clear that courts and commentators were never concerned about the equally real possibility of an ordinary bailee ignoring notice from a pledgee in the pure bailment situation. See supra notes 44-45 & 83 and accompanying text (notice alone sufficient to trigger possession). Second, to assume that a pledgee-bailee will simply ignore notice of a junior security interest or, worse, lie about its existence is to ignore the general good faith requirement embodied in every provision of the Code. See U.C.C. § 1-102(3) (1978). Under U.C.C. § 1-201(19), "good faith" is defined as "honesty in fact in the conduct or transaction concerned." Judge Cyr briefly acknowledges the good faith requirement, but states only that "[i]t would not seem dishonest for an alleged bailee in the present circumstances, after performance by the pledgor, to return the securities to the pledgor as agreed." Kontaratos, 10 Bankr. at 967 n.61. Once again, however, this concern never motivated courts and commentators with respect to pure bailies, and it is clear that notice can come from a pledgee in the pure bailment situation. Moreover, it is clear that an ordinary bailee is liable in damages for the wrongful delivery of collateral. See Smith v. Dean Vincent, Inc., 47 Or. App. 887, 895, 615 P.2d 1097, 1102 (1980); Restatement of Torts (Second) §§ 223, 224 (1965); cf. Restatement of Security, §§ 22-24 (1941) (discussing pledgee liability); U.C.C. § 8-318 (1978) (bailees not liable for innocent conversion or participation in breach of fiduciary duty, but concept of good faith includes the objective element of observing "reasonable commercial standards"). Finally, one commentator has suggested that even in the double-pledge situation, a properly notified pledgee-bailee would be under a "duty to respect the junior lender's rights and would be liable in conversion if he failed to do so." See Article 8, supra note 53, at 906. But see Investment Securities, supra note 43, at 1030-31. Thus, the junior pledgee's notice satisfies the public notice function equally as well as notice from the debtor, whether the bailee being notified is a pledgee-bailee or a pure bailee.

121. U.C.C. § 9-106 (1978) defines "general intangibles" as "any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and money." Arguably the "equity cushion" that Judge Cyr describes, Kontaratos, 10 Bankr. 956, 969 n.77 (Bankr. D. Me. 1981), is an intangible because it represents a right in the collateral, and not the actual asset itself. In fact, the pledgor may never have possession of the actual asset again, should he default and the pledgee-bailee sell the asset. In such case, the pledgor would have an interest not in the disposed asset, but in the surplus remaining after the proceeds of the sale had been applied to the pledgee's interest. See U.C.C. § 9-504(2) (1978); In re Barnes Freight Line, Inc., 29 Bankr. 664, 668 (N.D. Ga. 1983) (holding that language in the financing statement: "all other . . . obligations . . . in whatever form owing to Debtor from any person" sufficiently described an "account" under U.C.C. § 9-106, thereby enabling the secured party to have a perfected security interest in proceeds of an auction sale of debtor's property by senior creditor); cf. Heinicke Instruments Co. v. Republic Corp., 543 F.2d 700, 702 (9th Cir. 1976) (holding that rights in stock were general intangibles until certificates were actually issued).
Code intangibles can only be perfected through filing. Thus, when Judge Cyr's argument is taken apart and its components analyzed, it fails to support the new construction of section 9-305 that he proposes. Therefore, in arguing for a new construction of section 9-305, Judge Cyr lays the analytical groundwork for the undoing of his own argument.

B. Protection of the Debtor from Interference by Fraudulent Claimants

A final argument that may be raised for requiring notice to come from the debtor is that the 1977 amendments to Article 8 of the U.C.C. compel such a conclusion.

Article 8 of the U.C.C. governs the relationships, rights and duties of issuers of both certificated and uncertificated investment securities and the parties that deal with such securities. In 1977 existing sections of Article 8 were revised and new ones were drafted to govern the creation, perfection and termination of security interests in all securities, certificated and uncertificated.

New section 8-313(1)(h) applies where a security interest is perfected by notice to a third party holding the securities, and is intended as the Article 8 counterpart to section 9-305. Unlike section 9-305, however, which requires only notification, section 8-313(1)(h) further requires that


Section 8-321 governs the enforceability, attachment, perfection and termination of security interests in both types of investment securities, see U.C.C. § 8-321 & official comment 1 (1978), and section 8-313 lists the various ways of transferring such securities for the purpose of perfecting security interests therein. See U.C.C. § 8-313(1)(a)-(j).

125. See Modern Security-Holding Practices, supra note 43, at 296 ("In a broad sense, Section 8-313(1) is Article 8's analogue to Section 9-305, which deals with what might be termed constructive possession."); U.C.C. § 8-313 official comment 3 (1978) ("Paragraph (h) is analogous to Section 9-305 . . . .").
the notification be signed by the debtor transferring the security interest. According to the revisors, the purpose behind requiring notification to be signed by the debtor is to reduce the possibility of interference by fraudulent claimants.

The prevention of fraud is a valid and compelling reason for requiring that notification be both in writing and signed by the debtor, and several commentators implicitly have treated Article 8 as another signpost along the way towards requiring that notice come from the pledgor himself.

The requirement of a signed writing, however, does not necessarily preclude notice from a junior pledgee in any analytical sense. Although some commentators have interpreted section 8-313(1)(h) to mean that notice must actually be sent by the debtor, subsection (h) provides that the notification also may consist of a copy of the security agreement between the debtor and the secured party.

To the extent that the presentation of a signed security agreement to a bailee by anyone satisfies the purposes of section 8-313, subsection (h) does not necessarily compel a

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127. See Appendix I, Reasons for 1977 Change, § 8-313, at 831-32 (1978). See Article 8, supra note 53, at 905 ("In order to prevent interference with the debtor's rights without his consent, paragraph (h) requires a 'written notification...signed by the debtor.'") (quoting U.C.C. § 8-313(1)(h) (1978)).

128. See, e.g., U.C.C. Survey, supra note 50, at 1185, wherein Professor Martin Aronstein, one of the principal architects of the new Article 8, asserts: "As observed earlier in this article, the 1977 Amendments should have the effect of eliminating the uncertainty generated by [Kontaratos]. The general concept of notification to a bailee embodied in section 9-305 is replaced by an explicit statement in new section 8-313(1)(h) . . . ." Hence Aronstein concludes:

How can the owner effectively pledge his security as collateral for a loan? Under section 9-305, he can apparently give his lender a perfected security interest by notifying the bailee of his security . . . . Under new sections 8-313(1)(h) and 8-321(2), a security interest is perfected by the owner giving written notice to the bank.

Id. at 1183. See also C. Israels & E. Guttman, Modern Securities Transfers § 4.02, at S.4-49 (Supp. 1985) (discussing U.C.C. § 9-305 interwoven with discussion of Article 8 deliveries of securities wherein authors state that where security is held by bailee, "notice of a pledge of the security must be given in writing by the pledgor").

129. See supra note 128.

130. U.C.C. § 8-313(1)(h)(ii) provides:

Transfer of a security or a limited interest (including a security interest) therein to a purchaser occurs only: (h) with respect to the transfer of a security interest where the debtor has signed a security agreement containing a description of the security, at the time a written notification, which, in the case of the creation of the security interest, is signed by the debtor (which may be a copy of the security agreement) . . . . is received by . . . . (ii) a third person, not a financial intermediary, in possession of the security . . . .

U.C.C. § 8-313(1)(h)(ii) (1978) (emphasis added). See also Haydock, When is a Broker a Bailee or Is an Interest in Securities a General Intangible?, 35 Ark. L. Rev. 10, 22 (1981) (discussing requirements of U.C.C. § 8-313). It should be noted that as in U.C.C. § 9-305, the focus of this section is on the third party's receipt of notice. The section was written in the passive voice, and it is by no means clear that the debtor himself must physically send the written notification, just as § 9-305 is unclear on the origin of notice.
finding that notice actually must be sent by the debtor. 131

A final argument against requiring notice to come only from the pledgor is that such a requirement ultimately violates a basic precept of the Uniform Commercial Code. The U.C.C. generally charges a secured party with the task of doing all that is necessary to perfect his own security interest. 132 It is the secured party who files and who takes possession. 133 It is somewhat of an anomaly, then, to turn over the responsibility of perfecting a security interest to the pledgor in cases in which a junior interest has been created.

More important, however, is the reason behind placing the task of perfection in the hands of the secured party. The pledgor simply does not have the same interest in taking the necessary steps to perfect a secured party’s interest as does the secured party. It is not the pledgor but the pledgee who risks losing his interest in the collateral in a priority dispute if that interest is not perfected. 134 Thus, it is hardly in the pledgor’s interest to perfect with urgency and precision. 135 In fact, when there is a negative pledge clause in the original security agreement, it would be contrary to the pledgor’s interests to send notice of a junior security interest to the pledgee-bailee. 136

In light of these arguments, it seems extremely unwise and contrary to the U.C.C. to require notice from the pledgor in a double-pledge situation as the only effective means of perfecting a junior security interest. Therefore, for purposes of perfecting a junior security interest in collat-

131. See Investment Securities, supra note 43, at 1028 (discussing new U.C.C. § 8-313, author states only that “unlike section 9-305, there must be a security agreement signed by the debtor, and notification of the security interest must be received by the person who might be said to be in control of the security”) (emphasis added).

132. See U.C.C. § 9-301 official comment 1 (1978) (“A security interest is ‘perfected’ when the secured party has taken whatever steps are necessary to give him such an interest.”) (emphasis added). See supra note 12.

133. See U.C.C. § 9-303 official comment 2 (1978) (example shows secured party taking all necessary steps to perfect their security interest); U.C.C. § 9-304(1) (interest in money or instruments perfected only by “the secured party’s taking possession”) (emphasis added); id. § 9-403(2)-(3) (secured party responsible for filing continuation statements to keep his perfected interest).

134. See supra notes 13-17 and accompanying text. The priority race goes to the swiftest, thus each secured party wants to be in charge of perfecting his own security interest. See U.C.C. § 9-312(5)(a)-(b); U.C.C. § 9-312 official comment 5 (Example 2) (1978) (the result that first to perfect takes priority “may be regarded as an adoption . . . of the idea, deeply rooted at common law, of a race of diligence among creditors”). Moreover, if the secured party’s interest remains unperfected, it is subordinated to the debtor’s trustee in bankruptcy. See supra note 16 and accompanying text. Thus, to the extent a pledgor is in financial straits at the time he grants a security interest, there is a clear disincentive for him to take the necessary steps to perfect that interest.

135. See supra notes 133-34 and accompanying text.

136. Since the grant of a second security interest by the pledgor would be a condition of default under those circumstances, see In re Kontaratos, 10 Bankr. 956, 958 (D. Me. 1981), clearly no pledgor would want to send notice of the junior pledgee’s security interest. See also supra note 94 (discussing consequences of grant of second security interest when there is a negative pledge clause in the original pledge agreement).
eral under section 9-305, notification still should be allowed to come from either the pledgor or the junior pledgee.

CONCLUSION

Although the arguments presented for holding that notice must come from the pledgor are persuasive and logically appealing, requiring notice of a junior interest to come exclusively from the pledgor is an unsound approach for a number of compelling legal and practical reasons. The better position is that notice to a pledgee-bailee may be given by either the pledgor or the junior pledgee.

Furthermore, although requiring notice from the pledgor may satisfy concerns about fraudulent claimants, such concerns do not automatically preclude notice from the junior pledgee. For example, the practice actually followed in Kontaratos should have laid to rest any worries of the pledgee-bailee about the validity of the junior interest. In Kontaratos, the junior pledgee not only notified the pledgee-bailee of his interest but also included full documentation of all the original loan papers signed by himself and the pledgor.137

Perhaps requiring the presentation of written loan documentation is the wave of the future, with respect to perfecting junior interests. It provides the pledgee-bailee with some assurance of the validity of the second security interest, and thereby limits interference by fraudulent claimants.138 As section 8-313(1)(h) implicitly makes clear, however, the junior pledgee is as capable of sending copies of loan documentation as the pledgor. Thus, until Article 9 follows Article 8 with respect to requiring written notification signed by the debtor or copies of loan documentation,139 section 9-305 should not be read as requiring notice from the pledgor as the only effective means of perfecting a junior interest. To do so would both open up a trap for the unwary creditor and ignore the underlying purposes and policies of the Code itself.140

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137. Kontaratos, 10 Bankr. at 964.
138. See supra notes 127-28 and accompanying text.
140. Clearly the drafters of section 9-305 would have been more careful in drafting the notice to bailee provision if they had intended such a result. Furthermore, when the Permanent Editorial Board met to revise Article 8 in the late 1970's, they also considered revising comparable sections of Article 9 but chose against such revisions. See Article 8, supra note 53, at 903.