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Gerald T. McLaughlin

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ARTICLE

“SEEK BUT YOU MAY NOT FIND”: NON-UCC RECORDED, UNRECORDED AND HIDDEN SECURITY INTERESTS UNDER ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

GERALD T. MCLAUGHLIN*

INTRODUCTION

SEEK and you shall find:¹ That is the message of the Scriptures. Unfortunately, the message of Article 9 of the Uniform Commercial Code (UCC or Code) is less comforting. The message of Article 9 might be more aptly phrased: Seek but you may not find.

Article 9 provides “a comprehensive scheme for the regulation of [consensual] security interests in personal property and fixtures.”² In order to notify a subsequent creditor of his security interest in collateral, Article 9 normally requires a secured party to file a financing statement.³ Thus, a later creditor can discover a record of a prior creditor’s security interest and will be able to act accordingly.⁴

What every creditor should realize, however, is that Article 9 tolerates “non-UCC recorded,” “unrecorded” and “hidden” security interests.⁵ As defined in this Article, a “non-UCC recorded” security interest is an attached security interest⁶ that is recorded somewhere other than in the Article 9 filing system.⁷ An “unrecorded” security interest, on the other hand, is an attached security interest that is not recorded in any filing

* Professor of Law, Fordham University School of Law; Visiting Professor of Law, Brooklyn Law School; LL.B., 1966, New York University.

1. Luke 11:9 (New Am. Standard Version) (“[S]eek and you shall find . . .”).

2. U.C.C. § 9-101 official comment (1977); *see id.* § 9-102(1)(a), (2). Unless otherwise noted, all citations are to the 1977 Official Text of the Uniform Commercial Code (U.C.C. or Code).

3. *See id.* §§ 9-302(1), 9-303.

4. In the normal case, the Code gives priority to the creditor who first files a financing statement. *See id.* § 9-312(5)(a). Thus, when a subsequent creditor discovers a prior security interest he will either refuse to make the loan or will make the loan with knowledge of his junior interest in the collateral.

5. *See generally* Baird & Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 Stan. L. Rev. 175, 176-77 (1983) (discussing Article 9’s “internal risks”); Ryan, *Legal Opinions to Third Parties, Representations, and Warranties Covering Security Interests in Personal Property*, in II ALI-ABA Resource Materials, Banking and Commercial Lending Law 121, 135-47 (1980) (discussing several examples of U.C.C. search problems).

6. *See* U.C.C. § 9-203 (1977) (discussing when a security interest attaches).

7. *See infra* Pt. I.

system.⁸ Finally, a "hidden" security interest is an attached security interest that is recorded in the Article 9 filing system but which may not be discovered by a reasonably diligent search of that filing system.⁹ When a creditor tries to assess whether he has first priority in collateral, he should consider the possibility that a prior non-UCC recorded, unrecorded or hidden security interest may exist. Failure to do so may leave him with an inaccurate impression of his priority rights in the collateral.

This Article will catalogue some common and some not-so-common forms of these "problem" security interests. Part I examines non-UCC recorded security interests. Unrecorded and hidden security interests are discussed in Parts II and III, respectively. In each discussion, the author will suggest ways to discover the existence of these security interests and, when that is impossible, ways to neutralize, or at least minimize, their impact on subsequent creditors.¹⁰

Before proceeding to Part I of the Article, however, several important disclaimers should be noted. First, this Article deals with consensual security interests in personal property, which arise primarily under Article 9 of the Code. It does not attempt to deal with the wide variety of non-consensual security interests¹¹ and personal property liens that arise by operation of law. Many of these security interests and liens, such as Article 2 security interests,¹² federal tax liens,¹³ liens under the Employer Retirement Income Security Act of 1974 (ERISA),¹⁴ liens of trustees in bankruptcy,¹⁵ or artisan's liens,¹⁶ must be taken into account in assessing one's priority in personal property collateral. Similarly, this Article does not deal with the rights of prior lessors, consignors and bailors, which

8. See *infra* Pt. II.

9. See *infra* Pt. III.

10. In this regard, detailed representations and warranties from the debtor and an opinion from the debtor's counsel that the lender will have first priority in the collateral can serve as protective devices. On these subjects, see Ryan, *supra* note 5.

11. The Code defines a "security interest" as "an interest in personal property or fixtures which secures payment or performance of an obligation." U.C.C. § 1-201(37) (1977). Thus, Code security interests can arise either by consent or by operation of law. Compare *id.* § 9-102 (security interests arise only out of transactions intended to create them) with *id.* § 2-711(3) (security interest created by operation of law in goods rightfully rejected by buyer or when acceptance is justifiably revoked by buyer, until seller returns payments and expenses; otherwise buyer has right to sell goods to recover payment and expenses). With respect to the interrelationship between security interests under Article 2 (sales) and the rules of Article 9 (secured transactions), see *id.* § 9-113.

12. See, e.g., *id.* §§ 2-505(1), 2-711(3). Nonconsensual security interests can arise not only under Article 2 of the Code but elsewhere in the Code as well. See, e.g., *id.* § 4-208(1).

13. See 26 U.S.C. § 6321 (1982).

14. See Pub. L. No. 93-406, § 4068, 88 Stat. 829, 1032 (codified at 29 U.S.C. § 1368 (1982)).

15. See 11 U.S.C. § 544(a) (1982).

16. See, e.g., N.Y. Lien Law § 180 (McKinney Supp. 1984-85); Va. Code § 43-33 (Cum. Supp. 1984). The Code, however, does give some guidance on resolving priority disputes between an Article 9 secured party and a party with an artisan's lien. See U.C.C. § 9-310 (1977).

could affect the priority rights of subsequent Article 9 creditors.¹⁷ The sheer number and variety of these non-Article 9 liens, security interests and other property interests makes adequate coverage in an Article of this length impossible.

Second, this Article will analyze the 1977 Official Text of Article 9. On occasion, however, the Article will consider significant state variations of the Official Text and significant judicial opinions construing the Official Text, although no attempt is made to provide a comprehensive survey of all relevant state variations or judicial decisions. Thus, the analysis presented here may have to be adjusted in light of local state law. Third, possible non-UCC recorded, unrecorded or hidden interests involving fixtures have not been included in the analysis. These issues are also better left for separate discussion.¹⁸

I. "NON-UCC RECORDED" SECURITY INTERESTS

As previously defined, non-UCC recorded security interests are those that are recorded somewhere other than in the Article 9 filing system.

A. *National or International Registration Pursuant to Federal Law*

Section 9-302(3)(a) of the Code does not require an Article 9 filing when a statute of the United States "provides for a national or international registration" with respect to property.¹⁹ According to section 9-302(4), compliance with such a statute "is equivalent to the filing of a financing statement under [Article 9] and a security interest in property subject to the statute . . . can be perfected only by compliance therewith"²⁰

To illustrate how subsections 9-302(3) and (4) operate, consider section 1403(a) of title 49 of the United States Code. This statute provides that "[t]he Secretary of Transportation shall establish and maintain a system for the recording of . . . (1) [a]ny conveyance which affects the title to, or any interest in, any civil aircraft of the United States; (2) [a]ny lease . . . or other instrument executed for security purposes, which . . . affects the title to, or any interest in" specifically designated aircraft parts.²¹ All such conveyances, leases and encumbrances must be re-

17. See Baird & Jackson, *supra* note 5, at 177. Although a consignor does not file a financing statement, he may still be able to take priority over a subsequent secured party. See U.C.C. § 2-326(3)(a), (b) (1977).

18. A good treatment of the relationship between fixtures and Article 9 is found in J. White & R. Summers, *Handbook of the Law Under the Uniform Commercial Code* §§ 25-7 to -11, at 1053-64 (2d ed. 1980).

19. U.C.C. § 9-302(3)(a) (1977). In addition to security interests in aircraft and copyrights, which are discussed in this Article, security interests in other types of property are subject to federal filing requirements. See, e.g., 35 U.S.C. § 261 (1982) (patents); 46 U.S.C. § 921(a) (1982) (vessels of the United States); 49 U.S.C. § 11303(a) (1982) (railroad rolling stock).

20. U.C.C. § 9-302(4) (1977); see *id.* § 9-104(a).

21. 49 U.S.C. app. § 1403(a) (1982).

corded with the Federal Aviation Administration Aircraft Registry Office in Oklahoma City.²²

EXAMPLE I: On June 1, A lends B \$100,000 secured by an interest in B's Lear Jet. On June 3, A records his security interest in the Lear Jet in the Aircraft Registry in Oklahoma City.²³ If on June 10, C, a subsequent secured creditor of B, searches the Article 9 filings, he will not discover any record of A's prior security interest in the Lear Jet. Nonetheless, A's security interest in the Lear Jet, properly recorded in the federal registry, will take priority over C's security interest.²⁴

Federal law also provides for the recordation of security interests in copyrights. Section 205(a) of title 17 of the United States Code states that "[a]ny transfer of copyright ownership or other document pertaining to a copyright may be recorded in the Copyright Office" in Washington, D.C.²⁵ In most instances, the recordation of the document in the Register of Copyrights gives all persons "constructive notice" of the facts stated in the recorded document.²⁶

EXAMPLE II: On June 1, A lends B \$100,000 secured by B's copyright in a best-selling novel previously registered. On June 3, A records his interest in the copyright with the Register of Copyrights in Washington, D.C. If, on June 10, C, a subsequent secured creditor of B, searches the Article 9 filings for any record of A's prior security interest, he will presumably find no such record.²⁷ Nonetheless, A's security interest in the copyright, properly recorded in the Register of Copyrights, will take priority over C's security interest.²⁸

22. 14 C.F.R. § 49.11 (1984).

23. In *In re La Manca Aire, Inc.*, 39 U.C.C. Rep Serv. (Callaghan) 675 (Bankr. S.D. Fla., July 26, 1984), the court held a filing under the UCC ineffectual for perfection of a security interest in an airplane, pursuant to U.C.C. § 9-302(3)(a). *See id.* at 675. To perfect such a security interest the secured party must file with the FAA in Oklahoma City. *See id.* at 675-76. *See infra* note 33.

24. In *Philko Aviation Inc. v. Shackel*, 462 U.S. 406 (1983), the Supreme Court recognized that priorities among secured creditors in aircraft were subject to state law. *See id.* at 413. Thus, the Code's "first to file" rule, *see* U.C.C. § 9-312(5)(a) (1977), would apply here.

25. 17 U.S.C. § 205(a) (1982).

26. *Id.* § 205(c). On the question of security interests in copyrights, see Handler & Lin, *How to Perfect Security Interests in Patents, Trademarks and Copyrights*, 11 U.C.C. L.J. 346 (1979); Note, *Transfers of Copyrights for Security Under the New Copyright Act*, 88 Yale L.J. 125 (1978).

27. In those states that have adopted the Code, "federal copyright recording procedures are sufficient to give constructive notice not only by reason of federal preemption, but also because state law so provides." 3 M. Nimmer, *Nimmer on Copyright* §10.05(a), at 10-44 n.12 (1984). Still, in an abundance of caution, certain creditors with security interests in copyrights may file a financing statement in the Article 9 system. *Id.* § 10.05(a), at 10-44.

28. "As between two conflicting transfers, the one executed first prevails if it is recorded, in the manner required to give constructive notice under subsection (c), within one month after its execution in the United States" 17 U.S.C. § 205(e) (1982). *See* 17 U.S.C. § 205(a) and (c) for certain technical requirements for recording in the Copyright Office.

B. *State Certificates of Title and Central Filing Statutes*

The Code also provides that an Article 9 filing is not required to perfect a security interest in property subject to state certificate of title statutes or state central filing statutes other than Article 9.²⁹ State certificate of title statutes have been enacted to cover automobiles and other types of mobile goods.³⁰ Where these statutes control, security interests are to be recorded on the certificate of title of the respective car or boat,³¹ not in the Article 9 filing system.

EXAMPLE III: On June 1, A lends B \$3,000 secured by an interest in B's automobile. The applicable law of the state requires that any security interest in the car be recorded on the car's certificate of title. On June 5, A has his security interest recorded on the certificate of title and takes possession of that certificate of title. If on June 10, C, a subsequent creditor of B, searches the Article 9 filings, he will find no record of A's prior security interest in the car. Nonetheless A's security interest in the car properly recorded on the certificate of title will take priority over C's security interest.³²

Generally speaking, the presence of non-UCC recorded security interests should not pose serious difficulties for a sophisticated lender. First of all, with respect to certain types of collateral, even when Article 9 requires a federal filing, a secured creditor may still make an additional filing in the Article 9 system.³³ Thus, a second creditor may occasionally discover the existence of a federally filed security interest through a search of the Article 9 filing system. Second, even when this does not happen, a lender should quickly discover any applicable non-Article 9 recording system by analyzing the type of collateral involved in the transaction and the ramifications of section 9-302(3).³⁴ Once he realizes that federal law requires a national filing (Examples I and II), the lender will be able to search in the correct filing system and discover any prior security interest. Similarly, once the lender is aware that a state certificate of title statute requires that security interests be recorded on the certificate of title of the car or boat (Example III), then the lack of an Article 9 filing will not mislead him.

29. See U.C.C. § 9-302(3)(b) (1977).

30. See R. Reiley, *Guidebook to Security Interests in Personal Property* § 11.2 (1981).

31. See, e.g., Fla. Stat. Ann. § 319.24 (West Supp. 1985) (motor vehicles); S.C. Code Ann. § 50-23-90 (Law. Co-op. 1977) (boats).

32. See U.C.C. § 9-302(3)(b), (4) (1977).

33. See 3 M. Nimmer, *supra* note 27, at §10.05(a), at 10-44 (1984). But this filing would seem to be unnecessary. *Id.* § 10.05(a), at 10-44 n.12. An additional filing in the Article 9 system may also be made by a lender with a security interest in aircraft.

34. For example, a reading of U.C.C. § 9-302 official comment 8 (1977) would alert a lender to the primary types of collateral requiring a federal filing.

II. "UNRECORDED" SECURITY INTERESTS

The Code also permits valid security interests to be perfected even though they are not recorded in any filing or certificate of title system—state or federal.³⁵ These unrecorded security interests can be better studied if they are subdivided into two categories: what might be termed "permanently unrecorded" and "temporarily unrecorded" security interests.

A. "Permanently Unrecorded" Security Interests

"Permanently unrecorded" security interests are of two types: (1) possessory security interests³⁶ and (2) automatically perfected security interests.³⁷

1. Possessory Security Interests

By far the most common of these "permanently unrecorded" security interests are possessory security interests. Possessory security interests can arise under Articles 8 or 9 of the Code, under the common law, or under non-Code statutory law.

a. Article 9 Possessory Security Interests

The Code states that "[a] financing statement must be filed to perfect all security interests except . . . (a) a security interest in collateral in possession of the secured party"³⁸

EXAMPLE IV: On June 1, A lends B \$100,000 secured by a valuable Renoir painting owned by B. Pursuant to a written security agreement, B gives A possession of the Renoir painting as collateral for the loan. If subsequent secured creditor C searches the Article 9 filings to see whether there are any prior security interests in the Renoir painting, he will discover no record of A's prior perfected security interest. Nonetheless, C takes subject to A's prior possessory security interest in the Renoir.

Although, in most instances, the secured party himself will keep possession of the collateral, Article 9 also permits an agent of the secured party to keep possession.³⁹ When the collateral is goods kept in a warehouse, possession may be by the bailee warehouseman. For example, section 9-304(3) of the Code provides that a security interest in goods held by a bailee (other than one who has issued a negotiable warehouse receipt or other negotiable document covering the goods) can be perfected by the

35. See *id.* § 9-302(1).

36. See *id.* § 9-302(1)(a).

37. See *id.* § 9-302(1)(c)-(e), (g).

38. *Id.* § 9-302(1)(a). The Code does not define the term "possession." Common law rules would have to be applied. See *id.* § 1-103, § 9-205 official comment 6.

39. See *id.* § 9-305 official comment 2.

bailee's receipt of notification of the secured party's interest.⁴⁰

b. *Article 8 Possessory Security Interests*

With respect to both creating and perfecting security interests in certificated securities, Article 9 refers to Article 8.⁴¹ Section 8-321(1) states that "[a] security interest in a security is enforceable and can attach only if it is transferred to the secured party or a person designated by him pursuant to a provision of Section 8-313(1)."⁴² Section 8-321(2) then adds that "[a] security interest so transferred pursuant to agreement by a transferor who has rights in the security to a transferee who has given value is a perfected security interest"⁴³ Thus, the key to creating a perfected security interest in certificated securities lies in the transfer provisions of section 8-313(1). Under this section, a transfer of a security interest occurs, *inter alia*, at the time the secured party "acquires possession of a certificated security."⁴⁴

EXAMPLE V: On June 1, A lends B \$100,000 secured by certificated securities owned by B. Pursuant to a written agreement, B gives A possession of the securities as collateral for the loan. If subsequent secured creditor C searches the Article 9 filings to discover any prior security interest in B's securities, he will not discover any record of A's interest. Nonetheless, A's possessory security interest in the certificated securities takes priority over C's.

c. *State Common Law or Statutory Possessory Security Interests*

Possessory security interests in certain types of collateral may be recognized under state common or statutory law. For example, Article 9 excludes from its scope the transfer of an interest in an insurance policy,⁴⁵ such as a life insurance policy. Under state law, a security interest in a life insurance policy can usually be enforced against third parties if the secured party takes physical possession of the policy.⁴⁶ A search of

40. *See id.* §§ 9-304(3), -305.

41. For example, § 9-203, which sets down rules for attaching Article 9 security interests, is subject to § 8-321. *See id.* § 9-203(1). Similarly, § 8-321, and not Article 9, governs certificated securities. *See id.* § 9-304 official comment 1.

42. *Id.* § 8-321(1).

43. *Id.* § 8-321(2).

44. *Id.* § 8-313(1)(a).

45. *See id.* § 9-104(g). This exclusion applies only "to a transfer of an interest in or claim in or under any policy of insurance," and not to a transfer of an interest relating to insurance policies. *Id.*; *see In re Roy A. Dart Ins. Agency, Inc.*, 30 U.C.C. Rep. Serv. (Callaghan) 1113, 1123-27 (Bankr. D. Mass. 1980). The insurance exclusion does not cover insurance monies that constitute "proceeds" of collateral. U.C.C. §§ 9-104(g), 9-306(1) (1977).

46. In *In re Maplewood Poultry Co.* the court stated:

Maine common law requires possession of the collateral as a prerequisite to the enforceability against third parties of a pledge of intangibles. . . . A pledge of insurance policies requires that the pledgee maintain physical possession of the policies. Here, the collateral is not the insurance policies themselves, but the

the Article 9 filings will obviously not uncover any record of a possessory security interest in a life insurance policy. Nonetheless such a security interest is valid under state law and will take priority over subsequent lenders.

Possessory security interests that arise under Article 9 (Example IV), Article 8 (Example V), or state common or statutory law should not present serious problems for the commercial lender. Possession by a third party has traditionally constituted a form of notice in lieu of filing;⁴⁷ possession of collateral by someone other than the debtor should alert a lender to the possibility that the party in possession may claim an interest in the collateral. Indeed, the pledge is the oldest form of enforceable security interest in personal property.⁴⁸ Thus, a potential creditor should always inquire why collateral is in the possession of a third party and should ask for representations from the debtor and the third party that the third party has no claim to or security interest in that collateral.

2. Automatically Perfected Security Interests

Automatically perfected security interests are security interests that are perfected from the time of attachment without either filing or possession. Two of these automatically perfected security interests will be analyzed here.⁴⁹

a. Section 9-302(1)(d)

Section 9-302(1)(d) of the Code permits automatic perfection of purchase money security interests⁵⁰ in most types of consumer goods.⁵¹

EXAMPLE VI: On June 1, A sells B a jade necklace for B's personal

unearned premiums, a general intangible. The perfection of a pledge of intangibles under the common law required possession by the pledgee of the evidence of the pledge itself. Since [the pledgee] retained possession of the premium finance agreement under which the security interest in unearned premiums was created, it would appear that sufficient compliance was had with the pledge perfection requirements of Maine common law.

28 U.C.C. Rep. Serv. (Callaghan) 186, 189 & n.5 (Bankr. D. Me. 1980); see Annot. 53 A.L.R. 2d 1396, 1404-06 (1957) (cases holding that a pledge of an interest in a life insurance policy can be created by manual delivery of the policy); see also 30 N.Y. Jur. § 889, at 146 (1963) ("The assignment by the insured of a life insurance policy upon his life as collateral security does not divest the insured of his general property in the policy but merely creates a lien in favor of the assignee to the extent of the debt owed.").

47. Article 9 recognizes "suitable alternative systems for giving public notice." U.C.C. § 9-302 official comment 1 (1977). "As at common law, there is no requirement of filing when the secured party has possession of the collateral . . ." *Id.* official comment 2.

48. I G. Gilmore, *Security Interests in Personal Property* § 14.1 (1965).

49. On automatically perfected security interests, see B. Clark, *The Law of Secured Transactions Under the Uniform Commercial Code* (1980) ¶ 12.2; J. White & R. Summers, *supra* note 18, §§ 23-7 to -9, at 920-33.

50. See U.C.C. § 9-302(1)(d) (1977). "Purchase money security interests" are defined in *id.* § 9-107.

51. See *id.* § 9-302(1)(d). "Consumer goods" are defined in *id.* § 9-109(1). "Goods" are defined in *id.* § 9-105(1)(h). The UCC does not, however, permit automatic perfection

use and A retains a security interest in the necklace to secure the unpaid portion of the purchase price. In most states A's purchase money security interest would be perfected without filing or possession.⁵² If on June 5, subsequent secured lender C searches the Article 9 filings, he would discover no record of A's prior security interest. Despite the unrecorded nature of A's security interest, C takes subject to A's automatically perfected purchase money security interest in the jade necklace.⁵³

The drafters of Article 9 believed that the pre-Code exemption of consumer credit transactions from filing requirements should be continued.⁵⁴ As Professors White and Summers put it, without the consumer purchase money exemption, "courthouses throughout the country would be bulging at the seams."⁵⁵

The drafters' decision to permit the automatic perfection of purchase money security interests in most types of consumer goods will not cause problems for all lenders. Several states either have not adopted⁵⁶ or have limited⁵⁷ the section 9-302(1)(d) consumer goods automatic perfection rule. But where the automatic perfection rule does apply, it can cause serious problems for subsequent lenders.⁵⁸

It is important to remember that the Code defines "consumer goods" in relation to how those goods are used by the debtor, not in relation to their intrinsic value.⁵⁹ Depending on how the debtor uses it, a Renoir painting or a jade necklace could constitute either "consumer goods," "equipment" or "inventory."⁶⁰ Thus, if a commercial lender collateral-

of purchase money security interests in motor vehicles required to be registered. *See id.* § 9-302(1)(d).

52. Most states have adopted § 9-302(1)(d). Only Kansas, *see* Kan. Stat. Ann. tit. 84 § 9-302(1) comment 1983 subsection (1) (1983), and Oklahoma, *see* Okla. Stat. Ann. tit. 12A, § 9-302(1) comment 1(c)(d) (West 1985), have omitted subsection (1)(d). Louisiana, of course, has not adopted the UCC as such, and only articles 1, 3, 4, 5, 7 and 8 have been adopted in substance. *See* U.C.C. Rep. Serv., State Correlation Tables 191 (Callaghan 1979). Some states, however, have adopted § 9-302(1)(d) in modified form. *See infra* note 57.

53. Under a recently enacted FTC regulation involving consumer credit transactions, taking a nonpossessory, nonpurchase money security interest in the jade necklace would not be an unfair credit practice by a lender. *See infra* notes 62-63 and accompanying text.

54. *See* U.C.C. § 9-302 official comment 4 (1977).

55. J. White & R. Summers, *supra* note 18, § 23-7 at 920.

56. *See supra* note 52.

57. The Maine version of § 9-302(1) reads: "A financing statement must be filed to perfect all security interests except the following: . . . (d) A purchase money security interest in consumer goods where the amount financed . . . is less than \$1,000 . . ." Me. Rev. Stat. Ann. tit. 11, § 9-302(1)(d) (Supp. 1984-1985); *see* Colo. Rev. Stat. § 4-9-302(1)(d) (Supp. 1984) (no filing required for goods with a purchase price of \$250 or less); Md. Com. Law Code Ann. § 9-302(1)(d) (1975) (no filing required for goods with a purchase price of \$500 or less); Wis. Stat. Ann. § 409.302(1)(d) (West Supp. 1984-1985) (same).

58. *See* J. White & R. Summers, *supra* note 18, at 924.

59. *See* U.C.C. § 9-109(1) (1977); B. Clark, *supra* note 49, at ¶ 9.1[1] ("The function of the collateral in the hands of the debtor is the key.").

60. *See* U.C.C. § 9-109 (1977). If the Renoir were hung in the debtor's living room, it would constitute "consumer goods"; if it were hung in the debtor's business office, it

ized his loan with such valuable consumer goods, knowledge of prior "unrecorded" purchase money security interests would be important.⁶¹ Although he may try to discover the existence of a prior purchase money security interest, a commercial lender will be hard pressed to devise a foolproof method of discovery. For example, a lender may demand that the debtor produce a bill of sale showing where the debtor purchased the collateral. If the debtor acts honestly and produces a real bill of sale, the lender will then be able to ask the named seller whether he has retained any security interest in the collateral. But what if the debtor produces a forged bill of sale listing a confederate as the seller? The confederate will simply lie and say that he retained no security interest in the collateral. But a real seller may exist who has retained a purchase money security interest in the collateral. This undiscovered security interest will, of course, take priority over the security interest of the subsequent creditor.

The Federal Trade Commission recently made it an unfair credit practice for a lender "in connection with the extension of credit to consumers," to take a nonpossessory, nonpurchase money security interest in "household goods."⁶² The definition of "household goods," however, excludes such items as antiques, jewelry and works of art.⁶³ Thus, in Example VI, C's nonpossessory, nonpurchase money security interest in the jade necklace would not constitute an unfair credit practice.

b. *Section 9-302(1)(e)*

Section 9-302(1)(e) contains yet another automatic perfection rule, although one of less significance than the automatic perfection rule governing purchase money security interests in consumer goods. If there is an assignment of an insignificant amount of an assignor's outstanding accounts,⁶⁴ the assignee-secured party need not file a financing statement to perfect his security interest in the assigned accounts.⁶⁵

EXAMPLE VII: On June 1, A lends B \$10,000 secured by \$10,000 worth of B's outstanding accounts receivable. Assuming that the \$10,000 worth of accounts constitutes an insignificant amount of B's outstanding accounts, A need not file to perfect his security interest in the accounts. If on June 5, subsequent secured creditor C searches the Article 9 filings, again he would discover no record of A's prior security interest. Nonetheless, A has first priority in these accounts.

would constitute "equipment"; and if it were hung in the debtor's gallery for sale, it would constitute "inventory." *See id.*

61. On this question, see generally J. White & R. Summers, *supra* note 18, at 924-25.

62. *See* 16 C.F.R. § 444.1(i), .2(a)(4) (1985). The new regulation took effect on March 1, 1985. *See id.* § 444, at 284.

63. *See id.* § 444.1(i), at 284-85.

64. The official comment states that "[t]he purpose of the subsection (1)(e) exemption is to save from *ex post facto* invalidation casual or isolated assignments . . ." U.C.C. § 9-302 official comment 5 (1977). Are casual or isolated assignments to be considered assignments of an insignificant amount of accounts?

65. *See id.* § 9-302(1)(e).

Like the automatic perfection rule for purchase money security interests in consumer goods discussed above, this automatic perfection rule for accounts will affect few commercial lenders.⁶⁶ The reason is simple. Section 9-302(1)(e) dispenses with filing only when there has been a transfer of an insignificant part of a debtor's outstanding accounts.⁶⁷ As the relevant case law shows, an "insignificant part of the [debtor's] outstanding accounts" is a slippery concept and one too uncertain to be relied on by prudent lenders.⁶⁸ Thus, prudent lenders against accounts will routinely file a financing statement no matter how insignificant the value of their accounts collateral.⁶⁹ Thus, the section 9-302(1)(e) automatic perfection rule will be encountered rarely—presumably only in situations in which a prior lender has failed to file and is trying to bootstrap himself into perfection.⁷⁰

B. "Temporarily Unrecorded" Security Interests

"Temporarily unrecorded" security interests are those that permit a grace period for filing. Generally speaking, a grace period gives an existing secured creditor time to learn of a change in the debtor's circumstances that may require the secured creditor to make a new filing. Although they protect existing secured creditors, grace periods harm subsequent creditors by creating enforceable but "temporarily unrecorded" security interests. For example, if a security interest is considered perfected from the time of attachment provided there is a filing within ten days of attachment, then a temporarily unrecorded security interest will exist for all or part of this ten-day period. Someone who searches the filings during this period would not discover a record of the prior security interest. In several instances, the Code sanctions grace periods for filing financing statements.⁷¹ For ease of analysis, these will be divided into ten-day, twenty-one-day and four-month grace periods.

1. Ten-Day Grace Periods

Section 9-306(3) states that a perfected security interest in original collateral remains a continuously perfected security interest in proceeds of

66. It should be remembered, however, that Article 9 does not apply to security interests in certain accounts, such as the transfer of a single account to an assignee in whole or partial satisfaction of a preexisting indebtedness. *See id.* § 9-104(f).

67. *See supra* note 64 and accompanying text.

68. *See, e.g., In re B. Hollis Knight Co.*, 605 F.2d 397, 400-02 (8th Cir. 1979); *Standard Lumber Co. v. Chambers Frames, Inc.*, 317 F. Supp. 837, 840 (E.D. Ark. 1970); *Abramson v. Printer's Bindery, Inc.*, 440 S.W.2d 326, 328 (Tex. Civ. App. 1969); *B. Clark, supra* note 49, at ¶ 2.7[6] & n.84.

69. *See B. Clark, supra* note 49, ¶ 2.7[6]. "The prudent course, therefore, is to file and avoid a 9-302(1)(e) type of perfection like the plague." T. Quinn, 14 *The Uniform Commercial Code Law Letter* No. 3, at 2 (Apr. 1980).

70. T. Quinn, *supra* note 69, at 2. Professor Henson states that "[i]t would be an oversight to rely on this provision." R. Henson, *Handbook on Secured Transactions Under the Uniform Commercial Code* 147 (2d ed. 1979).

71. *See infra* notes 72-114 and accompanying text.

that original collateral for at least ten days.⁷² Beyond this ten-day period, however, there may or may not have to be an additional filing to continue perfection in the proceeds. In situations in which the secured party will have to file to continue his perfection in the proceeds,⁷³ the ten-day grace period for filing might create problems for subsequent lenders. Consider the following two situations:

EXAMPLE VIII: On June 1, A sells B a Renoir painting and A retains a purchase money security interest in the painting to secure its price. Assuming B hangs the Renoir in his home, A would have an automatically perfected purchase money security interest in the painting, because the painting would constitute "consumer goods" under the Code.⁷⁴ On September 1, B sells the Renoir on open credit to Z without A's authorization, thereby creating proceeds collateral in the form of an account. A's perfected security interest in the Renoir automatically continues as a perfected security interest in the account for ten days after B's "receipt" of the proceeds—here the account receivable. If on September 3, B borrows money from C and gives C a security interest in the account owed him by Z, a search of the files by C would probably not discover any record of A's prior perfected security interest in the account. Yet if A files a financing statement on September 8, he will take priority over C as to the account.

EXAMPLE IX: Assume that the relevant state law requires a central filing for "equipment" and a local filing for "consumer goods." On June 1, A files in the state capital and perfects his security interest in B's type W computer, which B uses as equipment in his business. On June 4, B exchanges the Type W computer for a Super X computer, which B now decides to use in his home as a consumer good. A's security interest continues perfected in the Super X model (proceeds collateral) for 10 days after B receives the computer. If on June 8, C searches the files locally to see if there is any filing covering any of B's consumer goods, he would find no record of any filing. Yet if A files locally with respect to the Super X computer on June 10, A's security interest in the Super X computer—proceeds collateral—would take priority over C's security interest in the Super X computer.⁷⁵

The temporarily unrecorded security interests permitted by the section 9-306(3) rules regarding proceeds are not frequently encountered, but

72. U.C.C. § 9-306(3) (1977) ("The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a perfected security interest and becomes unperfected ten days after receipt of the proceeds by the debtor . . .").

73. See *id.* § 9-306(3). Unless § 9-306(3)(a) or (b) is applicable, a security interest in the proceeds would have to be perfected before the expiration of the ten-day period. See *id.* § 9-306(3)(c). This would normally (but not exclusively) be done by filing.

74. See *supra* notes 59-60, 62-63 and accompanying text.

75. The Super X computer is assumed not to be "household goods" within the meaning of the Federal Trade Commission's unfair credit practice regulation. See *supra* notes 62-63 and accompanying text.

when they do create concern, the Code provides a way to protect against them. Article 9 permits a secured party to prefile a financing statement before his security interest attaches.⁷⁶ By prefiling and then waiting to make the loan, any temporarily unrecorded security interest in proceeds will either have to be recorded or the grace period will lapse. If no prior security interest in proceeds is perfected within the ten-day period, the creditor has not hurt himself by delaying the loan. Under the Code, priority dates from the time of prefiling, not from the time the loan is made or the security interest attaches.⁷⁷ If, however, a prior security interest in proceeds is perfected within the ten-day period, the creditor will usually be able to cancel the loan without incurring any liability towards the borrower. Typically, the borrower will have made a previous representation that no prior security interest exists.⁷⁸ If one does exist, the borrower will have made a material misrepresentation, and principles of estoppel⁷⁹ should preclude the borrower from objecting to the loan cancellation.⁸⁰

Another ten-day grace period provision, section 9-312(4), provides that a "purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral . . . if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter."⁸¹ Although it is typically treated as a rule that gives a "second in time" purchase money creditor greater rights than a "first in time" non-purchase money creditor,⁸² section 9-312(4) can also work to create a temporarily unrecorded security interest between a "first in time" purchase money creditor and a "second in time" nonpurchase money creditor.

EXAMPLE X: On June 1, A finances the purchase of equipment by B. B receives the equipment on June 2. On June 5, B borrows money from C, giving C a nonpurchase money security interest in the equipment. If on June 5, C searches the Article 9 filings, he will not discover

76. See U.C.C. § 9-402(1) (1977) ("A financing statement may be filed before a security agreement is made or a security interest otherwise attaches.").

77. See *id.* § 9-312(5)(a) ("Conflicting security interests rank according to priority in time of filing or perfection."); *id.* § 9-312 official comment 4 ("rank will be based on the first filing or perfection"). A good example of how this system works is given at *id.* § 9-312 official comment 5 ex. 1.

78. See Ryan, *supra* note 5, at 194, 196 (illustrative representations and warranties to protect lender).

79. Section 1-103 states that principles of law and equity, including estoppel, can supplement the provisions of the Code unless a particular provision of the Code has displaced pre-Code legal or equitable rules. See U.C.C. § 1-103 (1977).

80. While prefiling and delayed lending will protect against "temporarily unrecorded" security interests, the length of time between prefiling and lending may have to be adjusted to meet local filing conditions. For example, if a particular jurisdiction is behind seven days in indexing filings, a lender should wait seventeen days between prefiling and making the loan. This will ensure that a filing on the tenth day of the grace period will be discovered prior to making the loan.

81. *Id.* § 9-312(4).

82. See *id.* § 9-312(4). See *infra* Example XXIX.

any record of A's purchase money security interest in the equipment. A files a financing statement on June 9. According to the language of section 9-312(4), A would have priority over C with respect to the equipment.

Like the unrecorded security interests discussed above in Examples VIII and IX, this ten-day temporarily unrecorded purchase money security interest will not pose a serious problem for the typical commercial lender. For a lender to be prejudiced by section 9-312(4), a prior creditor must first achieve purchase money status. This is sometimes easier said than done.⁸³ Even if the prior creditor does achieve purchase money status, a subsequent lender can protect himself from harm by adopting the same pre-filing strategy outlined above.⁸⁴ Thus, if a lender prefiles and then delays making the loan for more than ten days, either the ten-day grace period will lapse or the prior temporarily unrecorded security interest will appear in the filing system. If a prior security interest does appear, the loan can be safely cancelled, assuming of course that the debtor has made a previous representation that no such prior security interest existed.

Before concluding this discussion of section 9-312(4) purchase money security interests, one further point should be emphasized. According to the language of the section, the ten-day grace period begins to run at the time the debtor receives possession of the collateral.⁸⁵ According to some cases, this language must be read literally: The ten-day period runs from the time he takes possession of the collateral *as debtor*, not from the time he takes possession of the collateral in some other capacity.⁸⁶ This reading can create a particularly dangerous form of temporarily unrecorded security interest.

EXAMPLE XI: On June 1, A (the seller) and B (the buyer) enter into negotiations for the sale of certain equipment. On June 10, however, before the parties conclude all of the terms of the sale, A permits B to take possession of the equipment. On July 1, B approaches C and asks for a loan, offering the equipment still owned by A as collateral. Because B ostensibly owns the equipment, C agrees to the loan and searches the Article 9 filings to discover any record of a prior security interest in the equipment. Finding no record of A's interest, C lends B the money and perfects his security interest on July 2. On August 30, A and B finally conclude the terms of the credit sale and the purchase money security

83. For example, an "add on" clause may destroy purchase money status. See McLaughlin, "Add On" Clauses in Equipment Purchase Money Financing: Too Much of a Good Thing, 49 Fordham L. Rev. 661, 682-83 (1981).

84. See *supra* text accompanying notes 76-77.

85. See U.C.C. § 9-312(4) (1977). The Code defines the term "debtor" as "the person who owes payment or other performance of the obligation secured." *Id.* § 9-105(1)(d).

86. See *In re Ultra Precision Indus., Inc.*, 503 F.2d 414, 417 (9th Cir. 1974); *Brodie Hotel Supply, Inc. v. United States*, 431 F.2d 1316, 1319 (9th Cir. 1970). For a good summary of differing views on this issue, see *Bank One v. Farmers Prod. Credit*, 39 U.C.C. Rep. Serv. (Callaghan) 1511, 44 Bankr. Rep. 716 (Bankr. N.D. Ohio 1984).

agreement is signed. A files his financing statement on September 1. One might assume that C should prevail over A, but this may not be correct. A did file within 10 days after the debtor received possession of the equipment as debtor. After all, B could not be considered to be a debtor until he owed payment,⁸⁷ which did not occur until August 30. Thus A might prevail over C through this rather stretched version of a temporarily unrecorded security interest.⁸⁸

2. Twenty-One-Day Grace Periods

Under section 9-304(5), a security interest in a negotiable document may remain perfected for a period of twenty-one days without filing or possession when the secured party gives up possession of the negotiable document for the purpose of selling or preparing for sale the goods represented by the document.⁸⁹ This form of temporarily unrecorded security interest often occurs in a letter of credit transaction.⁹⁰

EXAMPLE XII: At buyer B's request, Bank A issues a commercial letter of credit in favor of seller X. The letter obligates Bank A to honor X's draft for \$500,000 when X presents to the Bank a negotiable bill of lading and other specified documents evidencing shipment of the required merchandise. Seller X presents the negotiable bill of lading and shipping documents and Bank A honors X's draft. When Bank A takes possession of the negotiable bill of lading it perfects its security interest in the negotiable document of title (and in the merchandise represented by the document of title) by possession.⁹¹ Buyer B, however, needs the goods to resell before he will be able to repay Bank A. On June 1, Bank A releases the negotiable bill of lading to B so that B can obtain possession of the merchandise for resale. If on June 10, C, a subsequent creditor of buyer B, searches the Article 9 filings preparatory to making a loan to B secured by the merchandise, C will find no record of Bank A's perfected security interest in the negotiable document or in the merchandise represented thereby. Nevertheless, Bank A's security interest in the merchandise will take priority over C's as long as Bank A either files as to the goods within twenty-one days after releasing the negotiable docu-

87. See *supra* note 85.

88. *But see In re Ultra Precision Indus., Inc.*, 503 F.2d 414, 418 (9th Cir. 1974) (possibility of estoppel); *Brodie Hotel Supply, Inc. v. United States*, 431 F.2d 1316, 1319 (9th Cir. 1970).

89. A security interest remains perfected for a period of 21 days without filing where a secured party having a perfected security interest in an instrument . . . a negotiable document or goods in possession of a bailee other than one who has issued a negotiable document therefor

(a) makes available to the debtor the goods or documents representing the goods for the purpose of ultimate sale or exchange or for the purpose of loading, unloading, storing, shipping, transshipping, manufacturing, processing or otherwise dealing with them in a manner preliminary to their sale or exchange

U.C.C. § 9-304(5) (1977).

90. See *id.* § 9-304 official comment 4.

91. See *id.* § 9-305.

ment to B or retakes possession of the negotiable document before the twenty-one-day period expires.⁹²

Section 9-304(4) also permits a temporarily unrecorded security interest to arise by reason of its twenty-one-day grace period for perfection.⁹³ This section provides that a security interest in an instrument or in a negotiable document is perfected "without filing or the taking of possession for a period of 21 days from the time [the security interest] attaches to the extent that it arises for new value given under a written security agreement."⁹⁴

EXAMPLE XIII: At the request of buyer B, Bank A issues a commercial letter of credit in favor of seller X. In the application for the letter of credit, buyer B grants Bank A a security interest in all negotiable documents of title involved in the transaction.⁹⁵ Because the application for the letter of credit constitutes a written security agreement and because the bank has given new value by unconditionally obligating itself to honor X's drafts upon the presentation of specified documents,⁹⁶ the bank's security interest will attach in the negotiable document as soon as the debtor has rights in the collateral. Pursuant to the letter of credit, on June 1, seller X ships the goods and procures from the carrier a negotiable bill of lading covering the goods. Because the buyer-debtor now has rights in the collateral, Bank A's security interest attaches to the negotiable document and, according to section 9-304(4), its security interest is perfected for twenty-one days from this time without filing or possession of the document.⁹⁷ This is sensible because it will take time before the negotiable document reaches the bank. If on June 10, C, a subsequent creditor of B, takes a security interest in the goods represented by the negotiable document, he will not discover Bank A's prior security interest in the negotiable document and the goods through an Article 9 file search. Nonetheless, Bank A's security interest in the goods has priority over C's security interest in the goods as long as Bank A either files or obtains possession of the negotiable document before the end of the twenty-one-day period.⁹⁸

92. See *id.* § 9-304(6) (perfection after the 21-day period depends on compliance with Article 9).

93. See *id.* § 9-304(4).

94. *Id.*

95. In an application for a letter of credit, the buyer (customer), see *id.* § 5-103(1)(g), routinely gives the bank (issuer), see *id.* § 5-103(1)(c), a security interest in the documents involved in the transaction. See H. Harfield, *Bank Credits and Acceptances* ¶ 8, at 313 app. B (5th ed. 1974).

96. For a definition of "value," see U.C.C. § 1-201(44) (1977). Subsection (a) states that, *inter alia*, "a binding commitment to extend credit" constitutes "value." *Id.* § 1-201(44)(a).

97. See *id.* § 9-304(4).

98. Professors White and Summers argue that § 9-304(4) does not permit a secured party's perfected security interest in a negotiable document to continue in the goods for the rest of the 21-day period once the debtor trades in the negotiable document and takes possession of the goods. See J. White & R. Summers, *supra* note 18, at 930-31. But in Example XIII the negotiable document representing the goods is still outstanding when

These twenty-one-day grace periods help to facilitate trade. Section 9-304(4) (Example XIII) recognizes that a negotiable document of title, such as a bill of lading, may take weeks before it reaches the secured party.⁹⁹ Thus, Article 9 tolerates a twenty-one-day temporarily unrecorded security interest *prior* to the secured party's taking possession of the document.

Similarly, as shown in Example XII, a twenty-one-day temporarily unrecorded security interest is recognized *after* the secured party gives up possession of the document. This latter type of "unrecorded" security interest has common law antecedents. Historically, a pledge of collateral could continue if the secured party relinquished possession and control of the collateral for a short period of time and for a reason that primarily benefited the secured party.¹⁰⁰ In this case, the secured party (the bank) does release the collateral (the bill of lading) for a short period of time (twenty-one days) and for its own benefit. By releasing the negotiable bill of lading, the debtor will be able to obtain possession of the goods, hopefully resell them, and then reimburse the bank with the proceeds of the sale.

Like the harm caused by ten-day temporarily unrecorded security interests, the danger of these twenty-one-day "temporarily unrecorded" security interests can be neutralized by prefiling and loan deferral.¹⁰¹ After twenty-one days, unless there has been a filing as to the negotiable bill of lading¹⁰² or the bill of lading has come into the bank's possession, the bank's security interest will lapse. Of course, as the filing grace periods become longer—twenty-one days or four months¹⁰³—it becomes progressively more difficult to rely on prefiling and loan deferral to protect against temporarily unrecorded security interests. Several other courses of action may be advised. First, if the debtor imports goods, there is a good chance that letter of credit financing is involved.¹⁰⁴ The potential creditor should request permission from the debtor to contact the debtor's bank to discover whether the bank has undertaken letter of credit financing for the debtor's account. Second, a creditor might be able to detect possible prior security interests without a bank inquiry. The possession of collateral by a third party—as in Example XIII—

the subsequent creditor takes a security interest in the goods. According to Article 9, when the goods are "in the possession of the issuer of a negotiable document therefor, a security interest in the goods is perfected by perfecting a security interest in the document, and any security interest in the goods otherwise perfected during such period is subject thereto." U.C.C. § 9-304(2) (1977) (emphasis added).

99. See U.C.C. § 9-304(4) (1977) (grace period of 21 days).

100. See I G. Gilmore, *supra* note 48, at 449-50.

101. See *supra* notes 76-77.

102. "A security interest in . . . negotiable documents may be perfected by filing." U.C.C. § 9-304(1) (1977). A bill of lading is a "document" for the purposes of Article 9. See *id.* §§ 9-105(1)(f), 1-201(15).

103. See *infra* notes 106-11 and accompanying text.

104. Commercial letters of credit are commonly used to pay for goods shipped in international trade. See H. Harfield, *supra* note 95, at 38.

should be a tip-off to the possibility of prior security interests.¹⁰⁵ Third, the creditor or his attorney can demand that the debtor make detailed representations in the security agreement that no prior security interests exist. Debtor's counsel will then be forced to make an appropriate investigation of the facts.

3. Four-Month Grace Periods

Simply stated, section 9-103(1)(d) provides that when most types of "goods" collateral are moved from one state to another, a security interest perfected by filing under the law of the first state remains perfected in the second state for four months after the goods are brought into the second state, or for a shorter period of time if the period of perfection in the first state expires before the end of the four months.¹⁰⁶ Thus, the drafters of Article 9 opted not to require a creditor to police his collateral closely and refile immediately when the collateral is taken to a second state. Section 9-103 requires the secured creditor to monitor his collateral only sporadically.¹⁰⁷ With respect to subsequent secured creditors, however, the section can result in a four-month temporarily unrecorded security interest in the state to which the collateral has been removed.

EXAMPLE XIV: On June 1, A files a financing statement in State X to perfect his security interest in B's computer equipment. On June 15, however, B moves the equipment to State Z. A's security interest will remain perfected in State Z for four months after June 15 based on his filing in State X. On June 23, C lends money to B secured by the computer equipment. A search by C of the State Z filing system will not reveal any record of A's perfected security interest in the equipment. Despite C's inability to detect A's prior security interest, C's interest is subject to A's perfected security interest, as long as A files a financing statement in State Z before the four-month period expires.¹⁰⁸

105. Third party possession of collateral may be a sign that there is an attached, *see* U.C.C. § 9-203(1) (1977), and perfected, *see id.* § 9-302(1)(a), security interest in collateral.

106. *See id.* § 9-103(1)(d). A financing statement is effective for five years from the date of filing. *Id.* § 9-403(2).

107. The drafters did not want to burden the secured party with excessive monitoring of the collateral and felt that

[t]he four-month period is long enough for a secured party to discover in most cases that the collateral has been removed and refile in this state; thereafter, if he has not done so, his interest, although originally perfected in the jurisdiction from which the collateral was removed, is subject to defeat here by purchasers of the collateral.

Id. § 9-103 official comment 7.

108. If A did not file or take possession of the collateral before the end of the four-month period, C would prevail over A. C, as a secured creditor, would be a "purchaser" for the purposes of § 9-103(1)(d). *See id.* § 1-201(32), (33). Under § 9-103(1)(d)(i), unless A takes possession or files, his security interest "is thereafter deemed to have been unperfected as against a person who became a purchaser after removal." Thus C, a perfected secured party, would prevail over A, an unperfected secured party. *See id.* §§ 9-301(1)(a), 9-312(5)(a).

An analogous "temporarily unrecorded" security interest problem can arise when goods are moved from one county to another county in a state that adopts alternative subsection (3) to section 9-401.

A filing which is made in the proper county continues effective for four months after a change to another county of the debtor's residence or place of business or the location of the collateral, whichever controlled the original filing. It becomes ineffective thereafter unless a copy of the financing statement . . . is filed in the new county within said period.¹⁰⁹

Thus both the interstate and intrastate movement of collateral or a change in the debtor's residence can create similar temporarily unrecorded security interest problems.

The four-month filing grace period caused by the interstate movement of debtor's goods collateral poses a serious problem in a fifty-state filing system. One obvious solution is to change from a fifty-state filing system to a national filing system. Although a national filing system may not have been totally feasible when Article 9 was first drafted, the technology for such a system now appears to exist.¹¹⁰ A national filing system would solve the interstate temporarily unrecorded security interest problem illustrated by Example XIV. Absent a national filing system, however, how can a prudent lender protect himself against these four-month temporarily unrecorded security interests? There is no easy answer. In the security agreement a lender might at least demand specific representations that no such prior security interests exist. In addition, the lender should request documentary data on the prior maintenance and repair history of "goods" collateral. Evidence showing maintenance or repair work done in a different state could lead to further inquiries and perhaps the discovery of a prior, valid security interest in that other state. The lack of prior maintenance or repair records may also be significant; it might make the lender justifiably suspicious.

How much detective work should be done will depend on, inter alia, the amount of the loan and the potential for harm. When appropriate, asking for a standby letter of credit¹¹¹ or some other type of third party guarantee to assure repayment of the loan could eliminate the harm caused by these temporarily unrecorded security interests. Of course, if it is feasible, the strategy of pre-filing and loan deferral could be used here as well.

109. *Id.* § 9-401(3) (alternative subsection).

110. On the subject of a national filing system, see C. Felsenfeld, Outline: National Filing Proposal (Draft July 29, 1983) (available in files of *Fordham Law Review*). This Outline grew out of a meeting of UCC experts held at Citicorp in New York City on May 13, 1983.

111. A standby letter of credit functions much like a guarantee. It substitutes the credit of the issuer for the credit of the debtor. Although state and national banks "generally lack the statutory power to guarantee the indebtedness of other parties," Note, *Recent Extensions in the Use of Commercial Letters of Credit*, 66 Yale L.J. 902, 911 (1957), banks normally have the statutory power to issue standby letters of credit, see *id.* at 911-13.

4. Administrative Delays

A rather novel form of temporarily unrecorded security interest can result from administrative delay in indexing a filing. According to section 9-403(1) of the Code, filing is effective upon presentation to the filing officer of an appropriate financing statement and the requisite filing fee.¹¹² The risk that the filing officer will delay indexing the filing is borne by the subsequent creditor.¹¹³

EXAMPLE XV: On June 1, A presents his financing statement and filing fee to the filing officer. The filing officer does not index the filing until June 6. If subsequent creditor C searches the filing index on June 5, he would not discover any record of A's filing. Yet C would take subject to A's security interest because the Code places the risk of administrative delay and error on the second creditor.

Administrative delays in indexing are the inevitable by-product of any filing system. Thus, temporarily unrecorded security interests caused by indexing delays will never be fully eliminated. The only consolation is that these administrative delays are usually short. Prefiling and loan deferral, even for a few days, should protect against harm in the vast majority of these cases. Occasionally, however, there is the exceptional situation in which the delay is longer. For example, in 1983 "hundreds of unfiled and unprocessed documents" were discovered in a county clerk's office in New York State.¹¹⁴ While the documents apparently related to real estate transactions,¹¹⁵ the incident demonstrates that long indexing delays can and do occur. It is difficult to devise a foolproof strategy to protect against this problem. Perhaps the most that can be obtained is an explicit and detailed representation in the security agreement that no prior security interest exists.

III. "HIDDEN" SECURITY INTERESTS

As mentioned, "hidden" security interests are security interests that are recorded in the Article 9 filing system but which may not be discovered by a reasonably diligent file search.¹¹⁶ They can be divided into six general categories:

- (a) "Different name" security interests
- (b) "Change-of-use" security interests
- (c) "Change-of-place" security interests
- (d) "Misindexed" security interests
- (e) "Semi-hidden" security interests
- (f) "Second in time, first in right" security interests.

112. The amount of the filing fee is left up to each state. U.C.C. § 9-403(5) (1977).

113. See *id.* § 9-407 official comment 1. Section 9-403(4) requires the filing officer to index the filing under the name of the debtor.

114. N.Y. Times, Oct. 9, 1983, at 47, col. 1.

115. *Id.*

116. See *supra* text accompanying note 9.

A. "Different Name" Security Interests

"Different name" security interests are security interests that are recorded under the name of debtor B but are effective with respect to the collateral of debtor Q. These "different name" security interests can arise in at least four ways: by name change, sale of the collateral, use of trade names, or use of collateral owned by someone other than the obligor of the debt.

1. Name Change

Section 9-402(7) of the Code provides that when an organization or individual changes its name so that a prior financing statement becomes seriously misleading, the secured party need *not* refile under the new name with respect to either collateral already owned by the debtor prior to the name change or collateral acquired within four months of the name change.¹¹⁷ There must be a new filing, however, with respect to collateral acquired more than four months after such name change.¹¹⁸

EXAMPLE XVI: On June 1, A files and perfects a security interest in specified equipment of MPX Corporation. On June 5, MPX Corporation changes its name to HIJ Corporation. If on June 10, subsequent secured creditor C searches the Article 9 filings under the name of HIJ Corporation, he presumably will not discover A's prior filing under the name of MPX corporation. Nonetheless, regardless of A's knowledge of the name change, A's security interest in the specified equipment takes priority over C's subsequent security interest.¹¹⁹

A name change may frequently cause a different name hidden security interest. At least in the case of a corporate name change, it should be relatively easy to discover a prior security interest recorded under an earlier corporate name. If the lender's attorney checks with the Secretary of State's office, he can usually discover prior names of a corporation.¹²⁰ Normally a corporation is obliged to amend its articles of incorporation whenever it changes its name.¹²¹ Once he obtains a prior corporate name,

117. See U.C.C. § 9-402(7) & official comment 7 (1977). An "organization" as defined in the Code includes, inter alia, a corporation, trust, estate or partnership. See *id.* § 1-201(28).

118. *Id.* § 9-402(7) & official comment 7. This new financing statement filed under the debtor's new name may be signed by the secured party rather than by the debtor. *Id.* § 9-402(2)(d).

119. See *id.* § 9-402(7).

120. Corporate names are generally filed with the Secretary of State. See, e.g., Colo. Rev. Stat. § 7-71-101(2) (Supp. 1984) (effective July 1, 1985); N.Y. Bus. Corp. Law § 303(c) (McKinney Supp. 1984).

121. See, e.g., Cal. Bus. & Prof. Code § 17,910 (West Supp. 1985); N.Y. Bus. Corp. Law § 801(b)(1) (McKinney 1978). A foreign corporation doing business in New York may amend its application for authority to do business in the state so as to change its corporate name "if such change has been effected under the laws of the jurisdiction of its incorporation." *Id.* § 1308(a)(1).

the lender's attorney can run an Article 9 file search under this name and discover whether any prior security interests exist.

Name changes by individuals, however, present more serious problems. There does not seem to be any foolproof method of discovering a prior name used by an individual. If this is true, why does the Code opt to make the second creditor bear the risk of a prior hidden security interest when there is little he can do to discover it? The simple answer may also be the correct answer: The Code gives priority to the first creditor because the first creditor is in no better position than the second creditor to discover a name change. How can the first creditor assure himself that his debtor is not using a different name to defraud some or all of his subsequent creditors? When neither creditor can reasonably discover the name change, it seems sensible at least to prefer the first creditor over the second creditor.¹²² As a result, if a lender plans to lend to an individual,¹²³ he should at least keep this name change problem in mind. Although there is no guarantee that it will uncover a prior identity, running a credit check is, of course, prudent. When there is real concern, additional precautionary measures can be taken. Questioning prior employers or credit references might be helpful in this regard.

2. Sale of the Collateral

Except in certain specified cases, "a security interest continues in collateral notwithstanding sale . . . unless the disposition was authorized by the secured party in the security agreement or otherwise . . ." ¹²⁴ If the security interest in the original collateral was perfected by filing at the time of the sale, the security interest should continue as a perfected security interest after the sale.¹²⁵ This can lead to a rather unusual form of

122. This is obvious from the generally accepted notion that first in time is first in right. See U.C.C. § 9-312(5) & official comments 4, 5 (1977).

123. A "purchase money" creditor who lends or extends credit to a debtor may not be severely prejudiced by prior security interests filed under different names of the debtor. A purchase money security interest in collateral normally means that the collateral has not been in the possession of the debtor prior to the time of its purchase. See *id.* § 9-107. Thus, it is unlikely that anyone has previously filed with respect to this purchase money collateral. Moreover, even if a prior creditor with an attached after-acquired property interest has filed a financing statement under a previous name of the debtor, this may not affect the priority of a subsequent purchase money creditor. Assuming the conditions of § 9-312(4) (purchase money security interest in collateral other than inventory) are satisfied, a subsequent purchase money lender will take first priority over the after-acquired property creditor. With respect to § 9-312(3) (purchase money security interests in inventory), however, the purchase money creditor's priority will depend on giving notice to the after-acquired property creditor. See *id.* § 9-312(3) & official comment 3. This will not be feasible unless the purchase money creditor knows the name of the after-acquired property creditor.

124. *Id.* § 9-306(2).

125. If a security interest in original collateral continues notwithstanding its sale by the debtor, then "[a] filed financing statement remains effective with respect to collateral transferred by the debtor even though the secured party knows of or consents to the transfer." *Id.* § 9-402(7). There is, however, a problem in reconciling this language with that of § 9-306(2), which states that "a security interest continues . . . unless the disposi-

"different name" security interest involving secured parties of two different debtors.

EXAMPLE XVII: Bank A has a perfected security interest in the equipment of debtor B, a candy manufacturer. It files a financing statement listing the debtor's name as B. If B now sells the equipment to C, Bank A's perfected security interest will continue in the equipment. Unless Bank A somehow authorized B's sale¹²⁶ or C could qualify as a buyer in ordinary course,¹²⁷ section 9-306(2) would seemingly require C to take the equipment subject to Bank A's perfected security interest.¹²⁸ If C now borrows money from D secured by the same equipment, D would search the Article 9 filings under the name of C and discover no record of A's filing under the name of B. Nonetheless, Bank A's security interest in the equipment would take priority over D's security interest.

Buyers of second-hand equipment should be particularly careful of this section 9-306(2) "different name" security interest. Suppose A has a perfected security interest in the equipment of B corporation. Without A's authorization, B corporation sells its used equipment to C corporation, a dealer in second-hand equipment. Under section 9-307(1) of the Code, C corporation is not a "buyer in ordinary course of business."¹²⁹ In order to attain this status, C corporation would, inter alia, have to buy from a seller who is "in the business of selling" used equipment.¹³⁰ B Corporation (seller) is not in the business of selling used equipment. Thus, C corporation does not take free of A's perfected security interest in the equipment. But now C corporation sells the used equipment to D. D is a "buyer in ordinary course" because C corporation is in the business of selling used equipment. Despite his status, however, D still takes the equipment subject to A's perfected security interest. Section 9-307(1) permits a buyer in ordinary course to take free of security interests "created by his seller," not by his seller's seller.¹³¹ Here D could take free of a security interest created by C but would not take free of A's security interest created by B. If E then lent money to D secured by this second-hand equipment, E would take subject to A's prior security interest.

These various forms of section 9-306(2) different name security interests will probably appear most often in transactions involving equipment

tion was authorized by the secured party" *Id.* § 9-306(2) (emphasis added). Could a secured party's consent to the transfer of collateral by the debtor be construed as an authorization to sell the collateral free of the secured party's security interest?

126. *See id.* § 9-306(2).

127. Section 9-307(1) requires a "buyer in ordinary course of business" to qualify under the definitional criteria of § 1-201(9). *See id.* § 9-307(1). C would not qualify as a buyer in ordinary course because B is not in the business of selling equipment.

128. *See supra* notes 124-25 and accompanying text.

129. *See supra* note 127.

130. *See* U.C.C. § 1-201(9) (1977).

131. On this point see *General Motors Acceptance Corp. v. Troville*, 6 U.C.C. Rep. Serv. (Callaghan) 409 (Mass. App. 1969). For a discussion of whether a buyer who cannot prevail under § 9-307(1) can rely on § 2-403 (good faith purchases), see J. White & R. Summers, *supra* note 18, § 25-15, at 1073-75.

collateral.¹³² One way to protect against harm from these security interests would be to trace the chain of title of the equipment. Once the names of prior owners of the collateral are known, it would be easy to run file searches under these names. Unfortunately, there is no easy way for a subsequent lender to trace the chain of title to personal property and uncover the names of prior owners. The law does not generally require that personal property transfers—as opposed to real estate transfers—be publicly recorded.¹³³ Thus, a lender can never be absolutely sure that he has discovered the names of all prior owners.

As a practical matter, however, creditors of subsequent owners (such as D in example XVII) will rarely be hurt by security interests created by prior owners of equipment collateral. When there is an unauthorized sale, the creditor of the prior owner (A in example XVII) has a security interest in both the original collateral and in the proceeds.¹³⁴ Thus, A can satisfy his security interest out of either the original or the proceeds collateral. Since the proceeds are in the hands of his immediate debtor (B in Example XVII), A may prefer initially to foreclose on the proceeds,¹³⁵ perhaps leaving subsequent creditor D a clear field with respect to the original collateral now in the hands of C.

3. The Use of Trade Names

Section 9-402(7) of the Code states that a “financing statement sufficiently shows the name of the debtor if it gives the individual, partnership or corporate name of the debtor, whether or not it adds other trade names or names of partners.”¹³⁶ Although the text of section 9-402(7) is not explicit on this point, it seems that a financing statement that listed only the trade name of the debtor would normally be insufficient.¹³⁷

132. This is because if the collateral were inventory in the hands of the first debtor (B corporation), there is a good chance that buyer C would be a “buyer in ordinary course” who would take free of A’s security interest. Similarly, if the collateral were inventory, secured creditor A might authorize B corporation to dispose of it in order to get cash to pay off the debt, thereby ending A’s security interest in the inventory. If the collateral were consumer goods in the hands of debtor B, buyer C may buy the goods free of A’s security interest in the goods under § 9-307(2) if C buys the goods for his consumer needs and if A has not filed a financing statement with respect to the goods.

133. See Ryan, *supra* note 5, at 33.

134. See *supra* notes 124-25 and accompanying text.

135. There are many practical and legal reasons why A may prefer to satisfy his security interest out of the proceeds in B’s hands. First of all, A chose to lend to B and no one else, and second, C, the buyer of the collateral, may not be amenable to suit in A’s jurisdiction.

136. U.C.C. § 9-402(7) (1977).

137. See *id.* § 9-402 official comment 7. Professors White and Summers point out that this subsection does not answer “the converse question whether a filing in the assumed name might be sufficient.” J. White & R. Summers, *supra* note 18, § 23-16, at 959. Recently, however, the Fifth Circuit held that a filing solely under a trade name may be sufficient under certain conditions. See *In re McBee*, 714 F.2d 1316, 1321 (5th Cir. 1983). It seems, however, that it was the intent of the drafters to require the use of the individual, corporate or partnership name. See U.C.C. § 9-402 official comment 7 (1977); B. Clark, *supra* note 49, ¶ 2.9(1), at 2-34 to -36.

Thus, a financing statement should state the debtor's individual or corporate name. As long as there is an indexing under the debtor's individual or corporate name, there can, of course, be an additional indexing under the debtor's trade name.¹³⁸ A different name security interest could therefore result if the first creditor properly used the debtor's individual name and did not add the debtor's trade name, but the second creditor searched under the debtor's trade name.

EXAMPLE XVIII: On June 1, A lends B \$10,000 secured by B's retail inventory. B operates her clothes store under the trade name "The Kettle of Chic." On June 3, A files a financing statement that lists the name of the debtor as B. A does not ask that the filing be indexed under the trade name. If on June 10, C, a subsequent secured creditor, searches the Article 9 filings under the name "The Kettle of Chic," he will not discover A's prior filing under the name of B. Nonetheless, A's prior security interest in the inventory takes priority over C's.

For the careful and diligent lender, this trade name problem should not be a serious concern. If a "hidden" security interest exists, it is caused solely by the carelessness of the file searcher or the inadequacy of the instructions given him. It is basic that the debtor's correct name must be ascertained before a file search is undertaken. Legislation in some states, like New York, can help a lender who knows the trade name of the debtor to discover the unknown individual or corporate name.¹³⁹

4. Collateral Owned by Someone Other than the Obligor of the Debt

Although there is case law authority against the proposition,¹⁴⁰ a "different name" security interest might occur when the obligor of the secured debt and the owner of the collateral are not the same person. Section 9-105(1)(d) provides that

[w]here the debtor and the owner of the collateral are not the same person, the term 'debtor' means the owner of the collateral in any provision of the Article dealing with the collateral, the obligor in any provision dealing with the obligation, and may include both where the context so requires.¹⁴¹

Under section 9-402(1), a financing statement must contain, *inter alia*, the name and signature of the debtor.¹⁴² When the obligor of the debt and the owner of the collateral are different, whose name and signature should the secured party have appear in the financing statement—the

138. See U.C.C. § 9-403(5) (1977). This Code option to index trade names separately should help "to protect third party searchers." B. Clark, *supra* note 49, ¶ 2.9[1], at 2-35 n.124.

139. See N.Y. Gen. Bus. Law §§ 130, 131 (McKinney Supp. 1984-1985) (businesses operating under assumed names must file names and addresses of persons conducting same).

140. See, e.g., *General Motors Acceptance Corp. v. Washington Trust Co.*, 120 R.I. 197, 200-02, 386 A.2d 1096, 1098-99 (1978).

141. U.C.C. § 9-105(1)(d) (1977).

142. See *id.* § 9-402(1).

obligor, the owner of the collateral or both? There is no clear answer to this question in the text or comments to section 9-402(1). According to section 9-105(1)(d), however, the secured party must determine whether section 9-402(1) is a provision dealing with the debt, in which case the obligor should sign and be listed in the financing statement; dealing with the collateral, in which case the owner should sign and be listed in the financing statement; or whether the "context" of the section deals with both the debt and the collateral, in which case both should sign and be listed in the financing statement. By its own terms, section 9-402(1) deals with the collateral because it requires that a financing statement describe the items of property constituting the collateral. The function of the financing statement is to publicize a secured creditor's interest in designated personal property collateral.¹⁴³ Indeed, section 9-402(1) does not even require that a financing statement mention the amount of the debt secured by the collateral. Thus, if section 9-402(1) were interpreted as dealing only with the collateral, a "different name" security interest could arise under the following conditions:

EXAMPLE XIX: On June 1, A lends B \$10,000 secured by collateral owned by Z. On June 3, A files a financing statement listing the name of the debtor as Z. On June 10, B, who now has physical possession of the collateral owned by Z, borrows money from C and "offers" C a security interest in Z's collateral. B does not tell C that the collateral is actually owned by Z. Thinking that the collateral is B's, C searches the files under B's name and does not discover a record of A's earlier filing under the name of Z. Sections 9-105(1)(d) and 9-402(1) could be read to suggest that A's security interest in the collateral will take priority over C's.

Although this "different obligor-different owner" dichotomy may theoretically result in a "hidden" security interest, it should not present a subsequent secured creditor with a serious problem. The limited case law on the question suggests that the "context" of section 9-402(1) requires that the names of both the obligor and the owner of the collateral be listed in the financing statement.¹⁴⁴ Thus, a prudent secured creditor will presumably list both names in the financing statement and have both the obligor and the owner sign the financing statement to assure proper filing.¹⁴⁵ The secured creditor should also take care that the filing is indexed under both names. Thus, a subsequent creditor who searches the files under either name should discover the earlier filing.

If a first creditor lists only the name of the owner of the collateral in the financing statement, however, there is at least a tenable argument

143. See *id.* § 9-402(1), (3).

144. See, e.g., *General Motors Acceptance Corp. v. Washington Trust Co.*, 120 R.I. 197, 201-02, 386 A.2d 1096, 1099 (1978).

145. See *Southwest Bank v. Moritz*, 203 Neb. 45, 53-54, 277 N.W.2d 430, 435 (1979) (owner of collateral did not sign financing statement, and filing of such an instrument was therefore considered insufficient to perfect a security interest).

that the filing is proper.¹⁴⁶ To guard against this outside possibility, the second creditor should demand a representation by the debtor that the debtor owns the collateral. This is, of course, common procedure in commercial financing.¹⁴⁷ In addition, the secured creditor should demand proof that the debtor owns the collateral. Absent fraud by the debtor, the name of the true owner should become apparent. Once the facts are clear, a search of the files under the true owner's name should uncover the prior security interest.

B. "Change of Use" Security Interests

According to section 9-401(3) of the Code, "[a] filing which is made in the proper place in this state continues effective even though . . . the location of the collateral or its use, whichever controlled the original filing, is thereafter changed."¹⁴⁸ Because section 9-401(3) never requires a refiling when the use of the collateral changes, it is easy to see how a "hidden" security interest may result. Based on the current use of collateral, a creditor will search the central state filing system and not discover a previous filing made in the local county—a filing necessitated by the previous use of the collateral.¹⁴⁹

EXAMPLE XX: Assume that the relevant state law requires an exclusive central filing for "equipment" and a local filing for "consumer goods." On June 1, A lends B \$100,000 secured by B's Renoir painting then hanging in B's home. Assuming the state requires a local filing for consumer goods, A will have to file his financing statement in the county of B's residence.¹⁵⁰ On June 5, B decides to take the Renoir into his office and puts it in the reception room of his business. Presumably B has now changed the classification of the collateral from consumer goods to equipment. If on June 10, C, a subsequent creditor of B, searches the Article 9 filings, he will probably not search in the county of B's residence but in the Secretary of State's office, because nonfarm equipment must be filed in the state capital.¹⁵¹ C will not discover A's prior local filing. Nonetheless, A's prior filing is good as against C, and thus A's security interest has first priority.

"Change-of-use" security interests are thus inherent in any filing system that requires some security interests to be filed exclusively in the

146. See *supra* notes 142-43 and accompanying text.

147. See Ryan, *supra* note 5, at 194.

148. U.C.C. § 9-401(3) (1977). Even if a state has adopted the alternative § 9-401(3), "[a] change in the use of the collateral does not impair the effectiveness of the original filing." *Id.* (alternative section).

149. See *id.* § 9-401(3). This section, however, "covers only changes between local filing units in the state." *Id.* § 9-401 official comment 6. Professor Gilmore, however, thinks that the official comment is wrong and that the section governs central/local filing changes as well. See I G. Gilmore, *supra* note 48, at 700.

150. U.C.C. § 9-401(1)(a) (1977) (second and third alternative subsections).

151. See U.C.C. § 9-401(1)(b) (first alternative section), (1)(c) (second and third alternative subsections) (1977).

state capital and others to be filed exclusively in the local county. Goods that begin as consumer goods may end up as equipment or vice versa.¹⁵² A change in use of the goods, however, will not be apparent to creditors. Thinking he is lending against equipment collateral, a creditor may search in the state capital and will not discover A's prior local filing as to consumer goods.

Although there may be exceptions, these "change of use" problems should not affect the average commercial lender. Most types of collateral require central filing and thus a change of use will not affect the place of filing. When such a problem does arise, however, it will almost invariably involve goods that were used either initially or subsequently as "consumer goods."¹⁵³ Two possibilities emerge. If the goods were initially used as equipment and then converted to consumer purposes, it is unlikely that a subsequent *commercial* lender would secure his loan with these goods.¹⁵⁴ Thus, he will not be prejudiced by any prior "hidden" security interests in these goods. On the other hand, if the goods were initially used as consumer goods and subsequently used as equipment, it is conceivable that a commercial lender might secure a loan with such equipment.¹⁵⁵ But even in that situation, it is unlikely that the commercial lender will be seriously prejudiced by an earlier security interest in the consumer goods. Except in rare cases, consumer goods converted to business equipment should not represent a significant part of the debtor's equipment collateral. Additionally, if there is any possibility that the goods in question could have been previously used as consumer goods, the creditor can research the requisite place of filing for consumer goods in order to avoid any possible loss of priority.

C. "Change of Place" Security Interests

Section 9-401(3) states that "[a] filing which is made in the proper place in this state continues effective even though the debtor's residence or place of business or the location of the collateral . . . whichever controlled the original filing, is thereafter changed."¹⁵⁶ Based on the current residence of the debtor, a creditor will search the files in county X and

152. Under the Code, the classification of "goods" collateral depends on the debtor's use of collateral. See *supra* notes 59-60.

153. See U.C.C. § 9-109 (1977) for classifications of goods. Consumer goods are goods "used or bought for use primarily for personal, family or household purposes." *Id.* Thus, if there is any possibility that a piece of equipment or inventory was ever used in the debtor's home, the creditor should check the place of filing required for consumer goods. The same problem could arise with respect to a change in the use of agricultural equipment, but this should be a remote possibility because agricultural equipment tends to be specialized and cannot be easily adapted to nonagricultural uses.

154. If the consumer goods constituted "household goods," a nonpossessory, non-purchase money security interest in these goods would constitute an unfair credit practice. See 16 C.F.R. §§ 444.1(i), .2(a)(4) (1985). See *supra* notes 59-61 and accompanying text.

155. See *supra* note 153.

156. U.C.C. § 9-401(3) (1977).

not discover a previous filing made in county Z—a filing necessitated by the prior residence of the debtor. These “hidden” security interests, however, will not occur in states that have adopted the alternative version of section 9-401(3).¹⁵⁷ Under this alternative, a filing made in the proper county will remain effective for four months after a change of residence of the debtor.¹⁵⁸ The filing lapses, however, unless a new filing is made in the second county within the four-month period.¹⁵⁹ In these states, a change of place of the debtor or of the collateral will create a “temporarily unrecorded” security interest—a subject that has already been discussed in Part II of this Article.¹⁶⁰

EXAMPLE XXI: On June 1, A lends B \$100,000 secured by B's Renoir painting which hangs in B's home. Assuming a state that requires local filing for consumer goods collateral, A will file his financing statement in the county of B's residence.¹⁶¹ On June 5, B moves to another county in the same state. If on June 10, C, a subsequent secured creditor, searches the filings in the second county, he will not discover A's prior filing in the first county. Nonetheless, A's prior security interest in the Renoir will take priority over C's.

A more complicated form of “change of place” security interest can result from the operation of section 9-103(1)(c) of the Code. This is a special rule governing situations in which goods are purchased in State X but are transported to State Z for use. The section provides that with respect to most goods the law of State Z governs “the effect of perfection or non-perfection of the security interest from the time it attaches until thirty days after the debtor receives possession of the goods and thereafter if the goods are taken to the other jurisdiction [State Z] before the end of the thirty-day period.”¹⁶² Properly understood, this thirty day provision creates a form of “hidden” security interest in State X.

EXAMPLE XXII: On June 1, A sells goods to B and retains a

157. Two states that have adopted the alternative subsection are Texas and Wyoming. See Tex. Bus. & Com. Code Ann. § 9.401(c) (Vernon Supp. 1985); Wyo. Stat. Ann. § 34-21-950(c) (1984). The great majority of states adopting the U.C.C. have adopted the original subsection 9-401(3). See S.C. Code Ann. § 36-9-401 reporter's comments (Law. Co-op. 1977) (24 out of 28 states).

158. See U.C.C. § 9-401(3) (1977) (alternative section).

159. *Id.*

160. See *supra* notes 106-11 and accompanying text.

161. Because the Renoir is a work of art, it is not covered by the FTC rule making it an unfair credit practice to take a nonpossessory, non-purchase money security interest in household goods. See 16 C.F.R. §§ 444.1(i), 2(a)(4) (1985).

162. U.C.C. § 9-103(1)(c) (1977). The full text reads:

If the parties to a transaction creating a purchase money security interest in goods in one jurisdiction understand at the time that the security interest attaches that the goods will be kept in another jurisdiction, then the law of the other jurisdiction governs the perfection and the effect of perfection or non-perfection of the security interest from the time it attaches until thirty days after the debtor receives possession of the goods and thereafter if the goods are taken to the other jurisdiction before the end of the thirty-day period.

purchase money security interest in the goods. At the time of the sale both A and B know that the goods now present in State X will be taken by B to State Z for use. On June 3, A files a financing statement in State Z pursuant to the rule of section 9-103(1)(c). This filing gives A perfection for thirty days after the date B receives possession of the goods (June 1). B, however, keeps the goods in State X, and on June 10, C lends B money secured by these goods. C searches the Article 9 filings in State X but discovers no record of A's security interest because A filed in State Z.¹⁶³ B then removes the goods to State Z on June 20. A's perfected security interest filed in State Z takes priority over C's perfected interest in the same collateral filed in State X.

A national filing system for all types of Article 9 collateral would be the simplest way to solve both the county-to-county and state-to-state change of place problems illustrated in Examples XXI and XXII. With a national filing system, the filing location would remain the same no matter where the debtor or the collateral goes.¹⁶⁴

In the absence of a national filing system, however, secured creditors can still take precautionary measures to protect against "change of place" security interests. Consider first the state-to-state problem in Example XXII. Prefiling and loan deferral offer the best protection for a secured creditor. If the creditor prefiles in State X and then waits thirty days before making the loan, either the prior filing in State Z will have lapsed by the end of the thirty-day period or the collateral will have been removed to State Z. To protect himself in the latter case, the creditor can condition the loan on nonremoval of the collateral from State X, and can therefore cancel the loan if the collateral is removed.

Absent prefiling and loan deferral, the secured creditor could request to see the bill of sale with respect to the collateral. Section 9-103(1)(c) is a special rule for purchase money security interests.¹⁶⁵ If the debtor is honest and gives the creditor the true bill of sale, the creditor will then be able to ascertain whether the seller of the collateral has retained a purchase money security interest in the collateral.¹⁶⁶

Finally, if it is a customary security agreement, the secured creditor will receive the debtor's representation that the collateral is free of prior

163. But see official comment 3 to § 9-103, which states that caution may dictate filing in both states X and Z.

164. See *supra* note 110 for a discussion of a national filing system.

165. See U.C.C. § 9-103(1)(c) & official comments 2-3 (1977).

166. In the typical case, the seller of the collateral will be the purchase money secured creditor. See *id.* § 9-107(a). If a third party financier is the purchase money secured creditor, a subsequent creditor should be able to discover this third party financier's interest by identifying the seller. To protect himself, the third party financier will probably make out his check to the order of either the seller or the seller and the debtor. See J. White & R. Summers, *supra* note 18, at 1045. This is necessary for a third party financier to ensure that his loan was in fact used to buy the collateral and thus that he is in fact a purchase money creditor. See U.C.C. § 9-107(b) (1977). Thus the identity of the third party financier will probably be known to the seller.

security interests.¹⁶⁷ Although the debtor may falsely make the representation, the due diligence of debtor's counsel will afford the secured creditor at least some measure of protection.

The county-to-county "change of place" problem illustrated in Example XXI will not pose a serious threat for most commercial lenders for two reasons. First, with respect to the most common forms of commercial collateral, such as inventory, chattel paper and nonagricultural accounts and equipment, there will be some statewide filing.¹⁶⁸ Thus, intrastate moves will not impair a creditor's ability to discover a prior security interest. Second, even in cases in which only local filing is required, intrastate moves will not always cause problems. In the case of minerals, growing timber or crops, for example, there must always be a filing in the county where the land is located.¹⁶⁹ Because these types of collateral are intimately connected with land, a creditor will presumably check the filings in the county in which the land is located. When the collateral is consumer goods or certain agricultural collateral, however, intrastate moves by the debtor may cause serious "change of place" security interest problems. In these cases, filing may be required only in the county of the debtor's residence.¹⁷⁰ This problem is more theoretical than real, however, because commercial lenders usually do not rely on these types of collateral as security for their loans.

D. *Misindexed Security Interests*

"Misindexed security interests" are those that will not be discovered by a reasonably diligent file search, due to misindexing caused either by error on the part of the filing officer or by a misspelling of the debtor's name in the financing statement.

1. Misindexing by the Filing Officer

According to Article 9, a filing is effective on presentation of a financing statement and the necessary filing fee.¹⁷¹ This rule puts the onus of administrative delay and error in indexing the filing on a subsequent creditor.¹⁷² Even though he will not be able to discover a record of the prior filing, the subsequent creditor will take subject to it. As compared to administrative delay in indexing a filing, misindexing by the filing officer presents a more serious problem. Delay in indexing causes a "temporarily unrecorded" security interest.¹⁷³ Misindexing, on the other

167. See McKinney's U.C.C. Forms 9:1125(3) (West 1965); Ryan, *supra* note 5, at 194.

168. Under all the alternative § 9-401(1) subsections, these types of collateral must be filed centrally. There may, however, have to be a second local filing. See U.C.C. § 9-401(1)(c) (1977) (third alternative subsection).

169. See *id.* §§ 9-401(1)(a) (first alternative subsection), (1)(b) (second and third alternative subsections).

170. See *id.* § 9-401(1)(a) (second and third alternative subsections).

171. See *id.* § 9-403(1).

172. See *id.* § 9-407 official comment 1.

173. See *supra* Example XV.

hand, causes a permanently "hidden" security interest.

EXAMPLE XXIII: On June 1, A presents a proper financing statement and the necessary filing fee to filing officer Z. The financing statement properly lists the name of the debtor as "McLaughlin." On June 2, the filing officer misreads the name of the debtor and indexes the filing under "Laughlin." On June 10, C searches the Article 9 filings under the name "McLaughlin" and discovers no record of any prior security interest. A's filing indexed under "Laughlin" is still good against creditor C even though C could not have reasonably discovered A's prior filing.

Although administrative mistakes in indexing filings are inevitable, they may be discovered and corrected by first creditors before they harm subsequent creditors. Some creditors may run a file search to make sure that their filings have been properly recorded and indexed.¹⁷⁴ Thus, within a short period of time after filing, many of these misindexings may be uncovered and the filings properly recorded. If the misindexing harms a later creditor, an action may lie against the state or county agency responsible for improperly indexing the filing.¹⁷⁵

Before concluding this discussion of filing officer misindexings, an analogous problem should also be mentioned. If a state official, in response to an inquiry, reports that there are no prior filings when in fact a prior filing does exist, the second creditor will obviously take subject to the unreported prior filing. But the second creditor may have an action against the appropriate state or county official for giving out incorrect information.¹⁷⁶

2. Misindexing Caused by Misspelling the Debtor's Name

The standard form of a Code financing statement, the UCC-1, lists the debtor's name in two places.¹⁷⁷ The debtor's name must be printed or typed in the text of the UCC-1, last name first, and the debtor must also sign the UCC-1. Because the financing statement is alphabetically indexed under the name of the debtor, it is important that the debtor's name be spelled correctly.

To index the filing, suppose the filing officer looks at the name of the

174. Pre-Code law in Pennsylvania, for example, required that the persons offering an instrument for recordation had the duty to see to it that it was properly recorded. *See In re Royal Electrotype Corp.*, 485 F.2d 394, 395 (3d Cir. 1973).

175. *See* Op. Att'y Gen. N.M. No. 62-1, 1 U.C.C. Rep. Serv. (Callaghan) 718, 727-28 (1963).

176. *See, e.g.,* *Hudleasco, Inc. v. State*, 90 Misc. 2d 1057, 1062, 396 N.Y.S.2d 1002, 1006, (Ct. Cl. 1977), *aff'd mem.*, 63 A.D.2d 1042, 405 N.Y.S.2d 784 (1978); *Scot Lad Foods, Inc. v. Secretary of State*, 66 Ohio St. 2d 1, 9, 418 N.E.2d 1368, 1373 (1981); Op. Att'y Gen. Ohio No. 3288, 1 U.C.C. Rep. Serv. (Callaghan) 768, 769 (1962).

177. *See* U.C.C. § 9-402(1), (3) (1977). Section 9-402(1) requires that UCC-1 contain the name and the signature of the debtor. *See id.* § 9-402(1). Because a signature includes "any symbol executed or adopted by a party," *id.* § 1-201(39), the debtor could sign a UCC-1 by signing his name or some other symbol. Thus, the UCC-1 may not always include the debtor's name in two places.

debtor in the body of the UCC-1 rather than at the debtor's signature.¹⁷⁸ A printed or typed name is usually easier to read than a handwritten signature. But what if the filing officer uses the printed or typed name of the debtor to index the filing and the name of the debtor is misspelled? Of course, a court may find that the financing statement is defective—that is, misleading—in such cases.¹⁷⁹ But a court may find that the error in the spelling of the debtor's name is minor and as such does not negate the effectiveness of the filing. This could cause a "hidden" security interest.¹⁸⁰

Section 9-402(8) states that "a financing statement substantially complying with the requirements of this section is effective even though it contains minor errors which are not seriously misleading."¹⁸¹ The implication of the section seems clear: Some errors in a financing statement may not be sufficiently misleading to negate the effectiveness of a filing. What these "minor errors" are, however, is not spelled out. Consider possible minor errors in the spelling of the debtor's name. If the name of the debtor is spelled "Padams" on the UCC-1 when his name is really "Adams," a subsequent creditor cannot be expected to discover any record of the filing. In such a case, the error in the spelling of the name should not be treated as minor; it is a seriously misleading error that should destroy the effectiveness of the filing.¹⁸² But are there situations in which the misspelling of the debtor's name should not be treated as seriously misleading?

EXAMPLE XXIV: On June 1, A lends McLaughlin \$10,000 secured by designated collateral. On June 3, A files a financing statement on which he has typed the debtor's name as "McLaughlyn." The financing

178. See *In re Kulesza*, 4 U.C.C. Rep. Serv. (Callaghan) 66 (W.D. Mich. 1967) (filing officer recorded the filing under the typed name "Kelesza" instead of the signed "Kulesza").

179. See *In re Raymond F. Sargent, Inc.*, 8 U.C.C. Rep. Serv. (Callaghan) 583, 593 (Bankr. D. Me. 1970); *Bank of N. America v. Bank of Nutley*, 94 N.J. Super. 220, 227 A.2d 535 (1967). But see *In re Vaughan*, 4 U.C.C. Rep. Serv. (Callaghan) 61 (W.D. Mich. 1967).

180. See U.C.C. § 9-402(8) (1977). For examples of cases in which courts have found that mistake of name in indexing was a minor error and did not invalidate a security interest, see *Sales Fin. Corp. v. McDermott Appliance Co.*, 340 Mass. 493, 494, 165 N.E.2d 119, 119-20 (1960); *Pavlick v. Reginald Oliver Co.*, 106 N.J.L. 292, 295, 148 A. 624, 626 (1930); *Beneficial Fin. Co. v. Kurland Cadillac-Oldsmobile, Inc.*, 57 Misc. 2d 806, 811, 293 N.Y.S.2d 647, 652 (Sup. Ct. 1968), *rev'd on other grounds*, 32 A.D.2d 643, 300 N.Y.S.2d 884 (1969). But see *John Deere Co. v. William C. Pahl Constr. Co.*, 34 A.D.2d 85, 89, 310 N.Y.S.2d 945, 949 (1970) (misspelling of debtor's name was misleading and amounted to no filing at all).

181. U.C.C. § 9-402(8) (1977).

182. Compare *John Deere Co. v. William C. Pahl Constr. Co.*, 59 Misc. 2d 872, 874-75, 300 N.Y.S.2d 701, 704 (Sup. Ct. 1969) (misspelling of debtor's name misleading when five other financing statements had correct name), *aff'd*, 34 A.D.2d 85, 310 N.Y.S.2d 945 (1970) with *Beneficial Fin. Co. v. Kurland Cadillac-Oldsmobile, Inc.*, 57 Misc. 2d 806, 811, 293 N.Y.S.2d 641, 652 (Sup. Ct. 1968), *rev'd on other grounds*, 32 A.D.2d 643, 300 N.Y.S.2d 884 (1969) (misspelling of debtor's first name considered minor and not misleading).

statement, however, correctly gives the debtor's first name and address and is properly signed by McLaughlin. The filing officer uses the typed name "McLaughlyn" as the basis for his alphabetical indexing. On June 10, C, a subsequent creditor, searches the files and discovers a record of the filing. He may realize that "McLaughlin" and "McLaughlyn" are the same person given that the first name and the address are the same. But if C does not make the connection, despite A's negligence in misspelling the name of the debtor, a court may find that a reasonably diligent file searcher should not have been misled by A's error.¹⁸³

E. *Semi-hidden Security Interests*

Certain types of security interests may be described as "semi-hidden." A "semi-hidden" security interest is one whose existence will be discovered by a file search, but either one of its significant terms will not be readily ascertainable, or its relevance will not be readily understood by a subsequent creditor.

1. Significant Terms of the Security Interests are "Semi-hidden"

As a preface to the discussion of these "semi-hidden" security interests, one must realize that significant terms of every security interest will not be discovered through a simple file search. For example, when a creditor discovers a record of a prior filing, the financing statement will not tell him the amount of the debt secured by the collateral.¹⁸⁴ The Code, however, provides a mechanism by which the creditor can discover the amount of the secured debt. According to section 9-208, the creditor may request the debtor to present a prior creditor with a statement indicating "what he [the debtor] believes to be the aggregate amount of unpaid indebtedness."¹⁸⁵ The prior creditor must then either approve the statement as submitted or correct it.¹⁸⁶ Once he either approves or corrects the statement, principles of estoppel will prevent the prior creditor from subsequently changing his position.¹⁸⁷ But as the following example indicates, the section 9-208 mechanism is not foolproof; it may result in a form of "semi-hidden" security interest when the security agreement permits a creditor to make future secured advances.¹⁸⁸

183. See J. White & R. Summers, *supra* note 18, at 958 ("A court should not fail to ask whether a diligent person, searching under the true name, would have been likely to have discovered the filing."). U.C.C. § 9-402(8) (1977) differentiates between "misleading" errors in a financing statement, which do not negate the effectiveness of a filing, and "seriously misleading" errors, which do.

184. See U.C.C. § 9-402(1) (1977). There is no statutory requirement that the financing statement contain any reference to the amount of the debt obligation secured by the collateral. See *id.* § 9-208 official comment 2.

185. *Id.* § 9-208(1).

186. See *id.*

187. Principles of estoppel can normally supplement Code provisions. *Id.* § 1-103.

188. Section 9-204(3) permits the secured party to include a future advance clause in the security agreement. See *id.* § 9-204(3).

EXAMPLE XXV: On June 1, A lends B \$100,000 secured by all of B's existing equipment. The security agreement, however, contains a future advance clause which permits but does not obligate A to loan B an additional \$500,000 secured by the equipment. On June 3, A files his financing statement. If it is a standard financing statement, it will mention neither the amount of the \$100,000 existing loan nor the possibility of \$500,000 in future loans. If on June 10, subsequent creditor C searches the filings and discovers A's prior filing, he may wish to discover his priority position in the equipment with respect to A. He asks B for information about the debt already secured by the equipment. To avoid scaring him off, B does not tell C about the possibility of A's future loans. The Code, however, will give A's future loans the same first priority as the existing \$100,000 loan.¹⁸⁹ If he is prudent, C will not rely simply on B's word but will request B to have A either approve or correct a statement of the debt secured by the collateral. Since section 9-208 requires A only to approve or correct a statement of "unpaid indebtedness,"¹⁹⁰ A does not mention the possibility of future loans. Based on this statement approved by A, C loans \$200,000. Lender A lends B the additional \$500,000. Arguably A has priority in the equipment for up to the full \$600,000 of his loans.

The above conclusion has been qualified by using the word "arguably" for reasons that should be apparent to any student of the Code. On the one hand, the text of section 9-208 does not specifically require a secured party to refer to possible future debt in the section 9-208 statement. On the other hand, the Code mandates that the secured party act in "good faith" in carrying out his obligation under section 9-208.¹⁹¹ Moreover, common law principles of estoppel presumably bind a secured party with respect to this statement.¹⁹² There is an obvious tension here between the text of section 9-208 and the Code's general fairness provisions. Professor Gilmore sums up the situation this way: "It is unclear under the Code . . . exactly what information about future advances a secured party may be required to disclose, in how much detail and to whom."¹⁹³

As a practical matter, however, a prior secured creditor will probably err on the side of prudence and report the possibility of future advances.¹⁹⁴ If he fails to report this information in approving any section 9-208 statement and this failure injures a later creditor, the prior creditor must realize that no matter what the literal language of section 9-208, there is a definite possibility of costly and protracted litigation over what "good faith" means in this context. Thus, there is an obvious incentive

189. *See id.* § 9-312(7).

190. *See id.* § 9-208(1).

191. *See id.* § 1-203 ("Every . . . duty within this Act imposes an obligation of good faith in its performance or enforcement.").

192. *See id.* § 1-103.

193. II G. Gilmore, *supra* note 48, at 933.

194. *See supra* notes 185-88 and accompanying text.

for the prior creditor to inform the subsequent creditor of the possibility of future advances.

A more serious type of "semi-hidden" security interest can develop if a prior creditor decides to make unanticipated future loans to the debtor after a subsequent creditor has made his loan. In Example XXV, the first creditor and the debtor contemplated the possibility of future loans by including a future advance clause in their security agreement. As previously demonstrated, a second creditor may be able to learn about these future contemplated loans through the section 9-208 mechanism. But the priority rules of Article 9 also permit future unanticipated loans to be given the same priority as the first loan.¹⁹⁵

EXAMPLE XXVI: On June 1, A lends B \$100,000 secured by all of B's existing and after-acquired equipment. The security agreement, however, contains no future advance clause. On June 3, A files a financing statement covering "equipment." The financing statement is good for five years.¹⁹⁶ If subsequent creditor C searches the filings on June 10, he will discover a record of A's prior filing. Through the section 9-208 mechanism, C learns that the outstanding debt on A's loan is \$100,000. On June 15, C decides to lend B \$150,000 secured by all of B's existing equipment. C files his financing statement on June 16. Two years later, A and B agree on a second loan of \$300,000. A and B sign a second security agreement giving A a security interest in all of B's equipment. Because A's filed financing statement covering B's equipment is still effective, A takes priority over C in the equipment for \$400,000—the combined amount of his first and second loans.¹⁹⁷

2. Relevance of Security Interest that is "Semi-hidden"

In this type of "semi-hidden" security interest, the prior filing is readily discoverable but its relevance to the subsequent creditor may not be apparent. Typically, "accessions"¹⁹⁸ or "commingled or processed

195. See U.C.C. § 9-312 official comment 7 (1977). For illustrative case law on this question, see *In re Rivet*, 299 F. Supp. 374, 377-80 (E.D. Mich. 1969). An earlier decision holding that future advances not contemplated by the initial security agreement did not receive the same priority as loans made under the security agreement, see *Coin-O-Matic Serv. Co. v. Rhode Island Hosp. Trust Co.*, 3 U.C.C. Rep. Serv. (Callaghan) 1112, 1120 (R.I. Super. 1966), was rejected by subsequent case law, see *In re Rivet*, 299 F. Supp. at 377, and by the drafters of the 1972 amendments to Article 9, see U.C.C. app. II, E-39 to -41, at 896-97 (1977).

196. U.C.C. § 9-403(2) (1977).

197. Section 9-316, of course, permits the subordination of priority rights by agreement. See *id.* § 9-316.

198. "Accessions" are goods that are installed or affixed to other goods, *id.* § 9-314(1), but that are not so commingled with these other goods so as to lose their identity, see *id.* § 9-314 official comment 3.

A security interest in goods which attaches before they are installed in or affixed to other goods takes priority as to the goods installed or affixed (called in this section "accessions") over the claims of all persons to the whole except as stated in subsection (3) and subject to Section 9-315(1).

goods"¹⁹⁹ may create such "semi-hidden" security interests.

EXAMPLE XXVII: B manufactures polyurethane chairs. The chairs consist of wooden frames, which are covered with polyurethane. On June 1, A lends B \$100,000 secured by B's inventory of lumber. On June 3, A files his financing statement listing "lumber" as the collateral. On August 15, C lends B \$200,000 secured by B's inventory of polyurethane and files a financing statement covering the polyurethane and any products of the polyurethane (the chairs). If C searches the filings, he will discover A's prior filing with respect to B's lumber. According to section 9-315 of the Code, A's prior security interest in the lumber which has now become part of the polyurethane chairs continues as a security interest in the chairs.²⁰⁰ Thus, A and C will both rank equally and share ratably in the chairs.²⁰¹ Unless C makes the connection between A's prior filing with respect to the lumber and his filing with respect to polyurethane, there will be a "semi-hidden" security interest. C will be aware of the prior filing but may not understand its relevance to him.

The Code's provisions covering the perfection of security interests in proceeds collateral can also create this form of semi-hidden security interest. A perfected security interest in original collateral automatically continues as a perfected security interest in proceeds collateral for at least ten days after the debtor receives the proceeds.²⁰² Beyond this ten-day period, a perfected security interest in proceeds may or may not continue automatically.²⁰³ If it is necessary to refile as to the proceeds before the expiration of the ten-day period, what has been called a "temporarily unrecorded" security interest would result.²⁰⁴ But in cases in which the perfected security interest in proceeds will automatically continue beyond the ten-day period, a semi-hidden security interest may result.

Section 9-306(3)(a) states that a perfected security interest in original collateral will continue as a perfected security interest in proceeds beyond ten days if "a filed financing statement covers the original collateral and the proceeds are collateral in which a security interest may be perfected by filing in the office or offices where the financing statement has been filed and, if the proceeds are acquired with cash proceeds, the description of collateral in the financing statement indicates the types of property constituting the proceeds."²⁰⁵ Thus, in some cases when one piece of Article 9 collateral is exchanged for another, a semi-hidden se-

Id. § 9-314(1). Unless a file searcher is careful, he may overlook a prior security interest in an "accession" to the collateral that is the subject of his search.

199. *Id.* § 9-315.

200. *See id.* § 9-315(1)(a).

201. *See id.* § 9-315(2).

202. *Id.* § 9-306(3).

203. For example, a perfected security interest automatically continues in proceeds beyond 10 days if "a filed financing statement covers the original collateral and the proceeds are identifiable cash proceeds." *Id.* § 9-306(3)(b). *See infra* Example XXVIII.

204. *See supra* notes 72-88 and accompanying text. *See supra* Examples VIII, IX.

205. U.C.C. § 9-306(3)(a) (1977).

curity interest can result unless, of course, the relevance of a prior filing is understood.

EXAMPLE XXVIII: On June 1, A lends B \$10,000 and takes a security interest in a Renoir watercolor that hangs in the waiting room of B's office. On June 3, A files a financing statement in the Secretary of State's office describing the equipment collateral as a "Renoir watercolor entitled 'The Opera.'" On June 15, B trades the Renoir watercolor for a Whistler etching which B also hangs in his waiting room. The Whistler is the proceeds collateral of the original collateral, the Renoir.²⁰⁶ If C, a subsequent secured creditor of B, searches the files on June 30 to see if the Whistler is already encumbered, he will discover A's prior filing as to the Renoir watercolor entitled "The Opera." Because the Whistler is also equipment and constitutes proceeds of the Renoir, the filing covering the Renoir is good as to the Whistler.²⁰⁷ Unless C makes this connection, he may lend to B and find that his security interest in the Whistler is subordinate to A's.

With respect to semi-hidden security interests such as those described in Examples XXVII and XXVIII, the problem will disappear if the file searcher makes the necessary connection between the prior filing and the present situation. It may, however, be easier to put the two pieces of the puzzle together in the case of commingled goods than in the case of proceeds collateral. Assuming he is careful and attentive, a file searcher should be able to connect a prior raw materials filing with a subsequent security interest in finished goods. In the case of proceeds, however, he may find it more difficult to solve the puzzle. As Example XXVIII shows, a Whistler etching may be the proceeds of a Renoir painting if the debtor trades the one for the other. If the prior filing lists the collateral as a Renoir painting, the connection between it and the Whistler will not be readily apparent. Normally, however, the average commercial lender should not encounter these "in kind" trades of collateral and thus should not be injured by these semi-hidden security interests in proceeds.

F. "Second in Time, First in Right" Security Interests

Logically, these security interests should not be included in an Article that analyzes "non-UCC recorded," "unrecorded" and "hidden" security interests. While the latter types of security interests will have attached²⁰⁸ before the aggrieved creditor makes his secured loan, "second in time" security interests will not attach until after the creditor makes his secured loan. Although they do not yet exist, these security interests will still be given first priority. Despite this definitional incongruence,

206. See *id.* § 9-306(1). The Whistler was "received upon the . . . exchange . . . of collateral." *Id.*

207. See *id.* § 9-306(3)(a) (as long as a filing as to original and proceeds collateral would be made in same filing office, filing as to original collateral is good with respect to proceeds collateral).

208. See U.C.C. § 9-203 (1977).

“second in time, first in right” security interests have been included in this Article because they create problems similar to those created by various “unrecorded” security interests. As with automatically perfected “unrecorded” security interests, a subsequent creditor will not be able to discover a “second in time” security interest by a file search. These interests will nonetheless take precedence over his security interest.

The Code sometimes permits “second in time” purchase money security interests to take priority over “first in time” nonpurchase money security interests.²⁰⁹ For an example of a “second in time, first in right” security interest, consider section 9-312(4) of the Code. If certain conditions are met, section 9-312(4) permits a purchase money creditor who finances the purchase of noninventory collateral to take priority over an earlier creditor with an after-acquired property interest in that same noninventory collateral.²¹⁰

EXAMPLE XXIX: On June 1, A makes a loan secured by B’s existing and after-acquired equipment. A searches the files and finds that no creditor has a prior interest in any of B’s equipment. A files on June 3. On June 10, C sells B a new piece of equipment and retains a purchase money security interest in the equipment. C files his financing statement on June 12, two days after B takes possession of the piece of equipment. As to the new piece of equipment and its proceeds, C will take priority over A even though A could not have discovered C’s “second in time” security interest at the time of his loan on June 1.

There is no way to prevent these “second in time” purchase money interests from taking priority. Thus, an after-acquired property creditor should take account of this possibility when he lends. His only line of defense after the sale is to challenge the “second in time” creditor’s purchase money status.²¹¹ But even if the “second in time” creditor can demonstrate that he is in fact a purchase money creditor, this should not deplete the existing collateral base of the “first in time” creditor. By definition, purchase money security interests represent security interests in collateral that presumably would not have been part of the collateral base of the “first in time” creditor but for the enabling purchase money loan of the “second in time” creditor.²¹² If anything, the “first in time” creditor is benefited because now he has a second interest in this new collateral.²¹³

One final cautionary note should be sounded. Although this Article

209. See *id.* §§ 9-312(3), (4), 9-313(4)(a). On the “second in time” rights of purchase money lenders, see J. White & R. Summers, *supra* note 18, at 1042-52.

210. See U.C.C. § 9-312(4) (1977). The Code permits a creditor to take a security interest in after-acquired property. See *id.* § 9-204(1). After-acquired property interests, however, are limited with respect to consumer goods. *Id.* § 9-204(2).

211. For example, so-called “add on” clauses may destroy purchase money status. See McLaughlin, *supra* note 83, at 662.

212. See U.C.C. § 9-107 (1977).

213. Since the first creditor has an after-acquired property clause in his security agreement, he will take a security interest in the new purchase money collateral but it will be a

represents a comprehensive study of "non-UCC recorded," "unrecorded" and "hidden" security interests, it does not claim to be an exhaustive study. The perfection and priority rules of Article 9 are complex, and new variations of the examples discussed in this Article frequently surface. Consider the following example, a rather unusual form of "hidden" security interest that is present in a priority dispute described by Professor Henson in a recent article.²¹⁴

EXAMPLE XXX: On June 1, A files a financing statement covering all of manufacturer B's inventory of widgets. C is a retailer who sells widgets. On June 10, B and C sign a contract whereby C agrees to buy 50,000 widgets from manufacturer B. On this same day (June 10), B crates 50,000 widgets and puts them in his warehouse for shipment to C on August 15. On June 20, C borrows \$100,000 from D and gives D a security interest in his inventory. D searches the Article 9 filings and discovers no prior filing as to C's inventory on June 20. D files his financing statement on June 20. Because the 50,000 widgets in B's warehouse were "identified" to the B-C contract on June 10, C acquired a "special property" in the widgets as of this date.²¹⁵ This "special property" meant that C had rights in the collateral and thus as of June 20, D's perfected security interest in C's inventory attached to the widgets still in B's warehouse. But on June 20, A's perfected security interest in B's inventory still covered the 50,000 widgets. According to Section 9-307(1) of the Code, C will buy free of A's perfected security interest when he qualifies as a "buyer in ordinary course."²¹⁶ But C cannot become a buyer in ordinary course until there has been a "sale" of the widgets. UCC section 9-105(3) incorporates the Article 2 definition of sale—"the passing of title from the seller to the buyer for a price"²¹⁷—for use in Article 9.²¹⁸ Thus, there cannot be a sale, and C cannot become a buyer in ordinary course, until title to the widgets passes to C.²¹⁹ In the absence of an agreement to the contrary, "title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods."²²⁰ Under the facts, this will not occur until August 15. Thus, between June 20 and August 15, both

second in time, nonpurchase money security interest. *See id.* § 9-312(3), (4). Still, it is clear that the first creditor has benefited.

214. *See Henson, Some Problems Involving Documents of Title*, 43 Ohio St. L.J. 585, 589-90 (1982).

215. *See U.C.C. §§ 2-401(1), 2-501(1)* (1977).

216. *See id.* § 9-307(1) (1977). There could be an alternate course of analysis. If A had authorized the sale of the widgets from B to C, C would take free of A's security interest under § 9-306(2), but only after the goods had been sold to C. Thus, the § 9-306(2) and § 9-307(1) analyses both hinge on when the B-C sale occurs.

217. *Id.* § 2-106.

218. *See id.* § 9-105(3).

219. *See Kinetics Technology Int'l Corp. v. Fourth Nat'l Bank*, 705 F.2d 396, 402, 36 U.C.C. Rep. Serv. (Callaghan) 292, 301-02 (10th Cir. 1983), as to when a "sale" takes place for the purposes of Article 9.

220. U.C.C. § 2-401(2) (1977).

A, as B's creditor, and D, as C's creditor, can both claim perfected security interests in the 50,000 widgets in B's warehouse. The Code does not contain any rule that states which of these two security interests should take precedence over the other.²²¹

CONCLUSION

Parts I, II and III of this Article discussed numerous examples of "non-UCC recorded," "unrecorded" and "hidden" security interests tolerated by the Article 9 filing system. In addition, the analysis focused on ways either to discover the existence of these "problem" security interests or, when that is impossible, to neutralize, or at least minimize, their effect on subsequent lenders. In this regard, pre-filing loan deferral and tightly drafted representations and warranties given by the debtor are important protective measures. As a further protective device, a lender may ask debtor's counsel to render an opinion as to the lender's first priority in the collateral.²²² If the opinion is given, debtor's counsel typically will include a list of exceptions to his opinion.²²³ Even though narrow, the opinion will give the sophisticated lender a true picture of the risks he is taking and will, in combination with the other measures mentioned throughout the Article, presumably give the lender the most complete protection available.

221. See Henson, *supra* note 214, at 590.

222. See Ryan, *supra* note 5, at 179-93.

223. For some suggested exceptions in an opinion of debtor's counsel, see *id.* at 181-83.

