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Sections 9-307(1) and 1-201(9) of the Uniform Commercial Code: The Requirement of Buying From a Person in the Business of Selling Goods of That Kind

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Sections 9-307(1) and 1-201(9) of the Uniform Commercial Code: The Requirement of Buying From a Person in the Business of Selling Goods of That Kind

When a debtor sells goods which have served as collateral, the security interest in those goods is usually terminated, either because the sale was authorized by the secured party or because the sale was to a "buyer in ordinary course of business" under section 9-307(1) of the Uniform Commercial Code. This section provides:

A buyer in ordinary course of business (subsection (9) of Section 1-201) other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

In order to qualify as a "buyer in ordinary course of business" one must fulfill the requirements of section 1-201(9), which provides:

"Buyer in ordinary course of business" means a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind but does not include a pawnbroker.

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1 Throughout this note the term "debtor" refers to a person who is both a debtor to a secured party and a seller to a third party.
2 The term "goods" is defined by U.C.C. § 9-109 (1962). "Goods" is used throughout this note rather than "inventory," which is a subset of "goods," id. at (4), because U.C.C. § 9-307(1) (1962) applies to all "goods" and not solely to "inventory."
4 When the debtor is authorized to sell, as is routinely the case with an inventory loan, H. REILEY, GUIDEBOOK TO SECURITY INTERESTS IN PERSONAL PROPERTY § 8.3 (1982) ("Normally, sales of inventory free of the security interest are expected and desired by the secured party . . .."); the creditor’s security interest is severed on the sale. Id.; T. QUINN, UNIFORM COMMERCIAL CODE COMMENTARY AND LAW DIGEST ¶ 9-307[A][2] (1978); see U.C.C. § 9-307 comment 2 (1962).
5 All citations to the Uniform Commercial Code are to the 1962 official text, unless otherwise indicated, which has been adopted in all states (Louisiana has adopted only articles 1, 3, 4, and 5) by Congress for the District of Columbia, and by the Virgin Islands. For a table of states that have adopted the Code, and the effective date of adoption, see 1 P. COGAN, W. HOGAN, D. VAGTS & J. MCDONNELL, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE vii (1982). The 1962 official text and the 1972 official text, which has been adopted in sixteen states, do not differ in regard to sections pertinent to this note.
6 U.C.C. § 9-307(1).
7 Id. § 1-201(9). The scope of this note is limited to an examination of the requirement in U.C.C. § 1-201(9) that the buyer purchase from a "person in the business of selling goods of that kind." It should be noted, however, that if any of the other requirements of the section are not fulfilled the buyer will not qualify as a buyer in ordinary course of business. See T. QUINN, supra note 4, at ¶ 9-307[A][7].
If a debtor sells goods which are collateral without the authority to sell them, then the requirement that the buyer purchase "in ordinary course from a person in the business of selling goods of that kind" is of chief importance. Whether this requirement has been satisfied will determine whether the secured party will be able to take the goods from the buyer to satisfy his loan to the debtor. If the buyer has bought from such a person, he will be able to withstand any attempt by the secured party to take the goods. If not, section 9-306(2) provides that the secured party's lien continues in the goods, and, in the event of the debtor's insolvency, the secured party will be able to take the goods to satisfy his loan.

Whether the section 9-307(1) requirement has been satisfied has not been a difficult determination for courts to make when the primary business of the debtor is selling "goods of that kind." However, if selling such goods is only an incidental or secondary part of the debtor's business, courts have been divided as to how the issue should be resolved.

When a secured party takes a security interest in the goods of a debtor,
but forbids the debtor to sell them, it is because the two parties anticipate no sale of these goods while they are in the hands of the debtor. Often the debtor is expected to use the goods in business, such as when raw materials are manufactured into finished products or consumed in the manufacturing process. In many cases the debtor is not authorized to sell because he is expected to rent the goods, as is the case when automobiles are rented by an automobile rental agency. This note contends that even if a debtor's primary business is not selling such goods he can still be a “person in the business of selling goods of that kind.” The following examples are illustrative.

Example one: Average Buyer decides to purchase a certain type of chain saw. The only place Average Buyer can find one is Bargain Rent-All, a renter of work tools. Bargain has financed its operation by putting up its rental equipment as collateral. Its security agreement forbids the sale of collateral. Bargain has never-sold any of its rental equipment. In addition, it is not customary in the work tool rental industry to sell used equipment. Tools are normally rented until they are unprofitable to repair and are then returned to the manufacturer for rebuilding. However, Average Buyer persuades Bargain to sell the chain saw.

Example two: Average Buyer decides to purchase a certain model automobile. The only place in town that has one is Auto Rentals, a com-

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15 A secured party will forbid his debtor to sell secured goods only if the remedy of repossession from the buyer is commercially reasonable. If a good has no resale value following repossession from the buyer, it would be a useless exercise to take it from the buyer in order to satisfy the debt. A half-used bottle of mouthwash, for example, is virtually unmarketable. Indeed, such goods are often completely consumed long before a secured party could recognize a need to take possession of the collateral. Even if the bottle of mouthwash had not been opened, the transaction costs of repossession exceed the probable resale value. Many other types of goods, food items being the most obvious example, have this same characteristic. Conversely, where the goods could have a resale value to the lender after repossession, the lender might forbid their sale by the debtor. Occasionally, the two parties do contemplate a sale of the goods in the hands of the debtor, but the secured party does not authorize the debtor to sell unless the debtor has secured the express permission of the secured party. In this way the secured party retains greater control over the disposition of the goods.

16 Statements concerning industry custom in the work tool industry are hypothetical.

17 Automobiles and other vehicles that are covered by a certificate of title pursuant to U.C.C. § 9-103(2) present issues which are beyond the scope of this note. Questions arise "when a secured party who has recorded his security interest on a certificate of title claims that certificate of title law governs his rights against a purchaser of the auto who claims that 9-307 governs." J. White & R. Summers, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 1075 (2d ed. 1980). Professors White and Summers conclude that they have found no case which squarely holds that the rights of a purchaser of a used car from a dealer are superior to those of a secured party who has recorded his security interest under a certificate of title act, [but] the trend favors the purchaser. In this situation the purchaser's position is supported by sound technical and policy arguments. In the first place the misconduct of the dealers in these cases is normally more susceptible to control by the secured party than by a purchaser who has neither the leverage nor the opportunity to exercise control over a dealer. Secondly, the purchaser in such cases falls squarely within the class of persons section 9-307(1) is designed
pany which rents automobiles. Auto, like Bargain, has financed its operation by putting up its rental equipment as collateral for a loan. Normally, Auto does not sell its collateral because its security agreement forbids it to do so, but it has done so sporadically in the past. It is common practice in the automobile rental industry to sell used automobiles when they are no longer profitable to maintain as rental units. Average Buyer purchases the automobile from Auto.

Although both examples describe debtors which are rental companies, the situations presented above have different consequences. This note argues that the debtor in example one, Bargain Rent-All, is not a person in the business of selling power tools, but that the debtor in example two, Auto Rentals, is a person in the business of selling automobiles for purposes of section 9-307(1). In the event of Bargain's insolvency, its secured lender will be able to take the chain saw from Average Buyer in order to satisfy its loan while Auto's secured lender will not be able to take the automobile from Average Buyer under any circumstances. The bases for these contentions are examined in the sections which follow. This note discusses the language and policy of sections 9-307(1) and 1-201(9) of the Code and analyzes the tests and factors used by the courts in determining who is a “person in the business of selling goods of that kind” in cases where the selling is incidental to the debtor's primary business. This note submits that in light of the policies behind section 9-307(1) the circumstances of each debtor must be examined in order to determine whether he is a “person in the business of selling goods of that kind.”

CONFLICTING POLICIES BEHIND THE BUYER IN ORDINARY COURSE OF BUSINESS RULE

The rule embodied in section 9-307(1) of the Code is an exception to

to protect. Moreover, section 9-302(3) does not render the whole of Article Nine inapplicable. It merely excludes some transactions from the Code's filing system.


The possibility of conflicts between secured parties who have noted their liens on certificates of title and purchasers who claim under § 9-307 is somewhat lessened because "not all states have enacted certificate of title laws, and of those that have, not all require notation of liens as the exclusive mode of perfection." J. White & R. Summers, supra, at 977. For a list of states in which perfection of a security interest in a good covered by a certificate of title can only be accomplished by notation of the security interest on the certificate, see Note, Interstate Movement of Motor Vehicles: Certificate of Title Acts and the Uniform Commercial Code, 9 CREIGHTON L. REV. 373, 376 n.26 (1975). For a list of those states which require some other act, in addition to or instead of notation on the certificate of title, see id. at 378 n.27.
the general rule that when a debtor sells goods which operate as collateral and which he has been forbidden to sell, the creditor's security interest in the goods continues notwithstanding sale. The drafters of the Code have provided that certain buyers take the goods for which they have paid free of any security interests.

The extent to which section 9-307(1) of the Code allows buyers to take free of security interests is determined by the equilibrium point between two conflicting policies. The policy behind the general rule is to protect the interests of the secured lender when a debtor sells his collateral without authorization. Allowing the security interest to continue in the goods is one way the secured party can be protected in the event that the debtor becomes insolvent. This also encourages lenders to finance businesses. The policy behind the section 9-307(1) exception is to allow buyers to feel confident that their ownership of the purchased goods will not be disputed. A buyer will be reluctant to buy goods if he perceives that a secured party will be able to take those goods from him in order to satisfy the seller's debt.

18 U.C.C. § 9-306(2).

19 Id. § 9-307(1).

20 The term “equilibrium point” as used in this note means the point at which the weight given to one of the two conflicting policies equals that given to the other.

21 Many commentators believe that the policy of protecting the innocent purchaser for value should be furthered in all cases unless there is a strong reason against it. See 2 N.Y. LAW REV COMM’N 1954 REPORT—STUDY OF THE UNIFORM COMMERCIAL CODE, at 1018, N.Y. Leg. Doc. No. 65 (1954); Comment, Section 9-307(1) of the U.C.C.: The Scope of the Protection Given a Buyer in Ordinary Course of Business, 9 B.C. IND. & COM. L. REV. 985, 992 (1968); Annot., supra note 14, at 341. But cf. T. QUINN, supra note 4, at 9-307[A][3] (narrows the policy to protect only the “run-of-the-mill off-the-shelf purchase”); Skilton, Buyer in Ordinary Course of Business Under Article 9 of the Uniform Commercial Code, 1974 Wis. L. REV. 1, 22 (narrows the scope of the policy).

This policy has been referred to as a policy of “utility,” Skilton, supra, at 3, which serves to promote the “free movement of goods,” 2 N.Y. LAW REV COMM’N 1954 REPORT, supra, at 1018. See B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 3.4 (1980); Dugan, Buyer-Secured Party Conflicts Under Section 9-307(1) of the Uniform Commercial Code, 46 U. COLO. L. REV. 333, 352 (1975); Kennedy, Secured Lending Under the Uniform Commercial Code, 83 BANKING L.J. 223, 225 (1966); Warren, Cutting Off Claims of Ownership Under the Uniform Commercial Code, 30 U. CHI. L. REV. 469, 493 (1963); Special Project—The Priority Rules of Article 9, 62 CORNELL L. REV. 834, 946 (1977); Comment, supra, at 990-91. Section 9-307(1) is certainly sound business practice. Skilton, supra, at 88. If a consumer were required to check security records every time he intended to buy a good it would seriously hinder business at the retail level. See infra note 39 and accompanying text. By protecting the good faith purchaser for value, the Code has allowed inventory financing to exist. 1A P. COOGAN, W. HOGAN, D. VAGTS & J. MCDONNELL, supra note 5, § 7.11A[2][q]; see W. HAWKLAND, A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE 702 (1984); Coogan, Article 9—An Agenda for the Next Decade, 87 YALE L.J. 1012, 1016 (1977). Without the buyer in ordinary course rule, inventory financing would be very unpopular with the secured party, the debtor, and the buyer. All three want to see goods sold quickly and easily with a minimum of dispute both before and after the sale.

Blackstone wrote: “[I]t is expedient, that the buyer, by taking proper precautions, may at all events be secure of his purchase, otherwise all commerce between man and man must soon be at an end.” 1 W. BLACKSTONE, COMMENTARIES 449. See Cohen, The Future Advance Interest Under the Uniform Commercial Code: Validity and Priority, 10 B.C. IND. & COM. L. REV. 1, 25 (1968); Skilton, supra note 21, at 88.
The equilibrium point between these policies is defined by the drafters of the Code as those cases where the buyer is purchasing “in ordinary course from a person in the business of selling goods of that kind.” Thus, buyers who fulfill this requirement will take free of security interests regardless of whether the seller was authorized to sell, and secured parties will retain their security interest in the goods only when the buyer does not fulfill the requirement.

Certain inferences can be drawn from the way in which the drafters have described the equilibrium point. First, the ordinary, run-of-the-mill purchase will come within the section 9-307(1) exception. Most purchases are made from those who clearly are persons in the business of selling such goods. For instance, groceries are bought in grocery stores, medicines in drug stores, and shoes in shoe stores. Second, a person who is clearly in the business of selling goods of that kind may also rent such goods, or rent and sell other goods, and the purchase will still be within the section 9-307(1) exception; there is no requirement that the debtor sell such goods to the exclusion of other goods and services. Third, the drafters of the Code focused on the seller of the goods rather than the buyer. Assuming that the buyer fulfills the requirements of section 1-201(9), his identity and other characteristics are irrelevant to the question of whether the purchase comes within the exception. Therefore, if a seller is a “person in the business of selling goods of that kind,” then all persons buying from him “in ordinary course” will take free of any security interest. Whether a purchase falls within the exception will be dependent on the characteristics and circumstances of the seller or the seller’s business.

The remainder of this note will be devoted to addressing two questions raised by these policies: first, on what basis are buyers who purchase from persons in the business of selling goods of that kind protected; and second, what factors determine whether a seller has the characteristics of a person in the business of selling goods of that kind?

ESTOPPEL AND THE BUYER IN ORDINARY COURSE OF BUSINESS RULE

The basic principle behind the rule embodied in sections 9-307(1) and 1-201(9) of the Code is equitable estoppel. This estoppel principle can

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5 U.C.C. § 9-307(1).
24 See T. Quinn, supra note 4, at ¶ 9-307(A)(3).
25 U.C.C. § 9-307(1).
26 See id.
27 U.C.C. § 9-307(1).
28 See id. §§ 1-201(9), 9-307(1); 3 J. Pomeroy, A TREATISE ON EQUITY JURISPRUDENCE §§ 801-821 (5th ed. S. Symons 1941). Originally the basis of the buyer in ordinary course of business rule was not only estoppel but fraud. See 2 G. Gilmore, SECURITY INTERESTS
apply to either the secured party or the buyer. When a secured party allows goods to be held by a debtor who is a "person in the business of selling goods of that kind" he will be estopped from later claiming a continuing security interest in them. When a buyer purchases goods from a seller who is not a "person in the business of selling goods of that kind" he will be estopped from later claiming that he relied on the seller's possession or other evidence of ownership. Thus, proper application of section 9-307(1) requires both some circumstances justifying the buyer in failing to make an inquiry and a basis for throwing the loss on the secured party.29

The secured party, by allowing the debtor to have possession, has placed him in a position of apparent authority to sell the goods.30 Limitations on the debtor's power to sell, either to certain persons or under certain circumstances, are not advertised to the general public. The filing of such limitations does not help prospective buyers who have no reason to check the filing records since they have not been given notice or any reason to believe that the sale is in violation of a security agreement.31 Those

29 In Personal Property § 26.2, at 679-80 (1965); see generally 2 J. Pomeroy, supra, § 660; Gilmore, Article 9: What it Does For the Past, 26 La. L. Rev. 285, 288-89 (1966). The power of the debtor to sell was regarded as inconsistent with the secured party's claim of a security interest. 2 G. Gilmore, supra, at 680. Gradually it came to be held that the secured party's power to sell "was not conclusive but merely presumptive evidence of fraud," unless the debtor 'had been allowed to keep the proceeds for his own benefit. Id. With the rise in acceptance of the floating lien, a lender's attack upon the buyer's title by virtue of the debtor's fraud could no longer be a consideration in inventory financing. Codifications of the buyer in ordinary course of business rule paved the way for acceptance of the floating lien. For example:

In 1941 the New York Legislature added to the Chattel Mortgage Act a section authorizing the financing of dealer inventories under chattel mortgages in much the same way that they could be financed under trust receipts; this section, consistently with all other modern inventory statutes, expressly provided that: "A buyer in ordinary course of trade, purchasing from a dealer any goods covered by any such mortgage, shall acquire such goods free and clear of the lien or encumbrance of said mortgage."

2 G. Gilmore, supra, at 684 (footnotes omitted). It became clear that the underlying principle of estoppel, and not fraud, was to be the basis for later modification of the rule. In 1956 the New York State Law Revision Commission recommended that § 9-307(1) be revised to "make it clear that 'entrusting' of the goods to the seller, by the person whose security interest is cut off, is the controlling factor." N.Y. Law Revn Commn 1956 Report—Study of the Uniform Commercial Code, at 475, N.Y. Leg. Doc. No. 65 (1956) (emphasis added).


31 3 J. Pomeroy, supra note 28, §§ 809-813; see 2 G. Gilmore, supra note 28, at 661; L. Vold, Handbook of the Law of Sales 368-72 (2d ed. 1959); see also Warren, supra note 21, at 470.

In Denno v. Standard Acceptance Corp., 277 Mass. 251, 255, 178 N.E. 513, 515 (1931), it was held that:

the implied notice arising from recording a mortgage is not enough as a matter of law to offset the inference of authority to sell arising from the circumstances here found. Nor is the general knowledge of automobile finance possessed by the plaintiff enough, as a matter of law, to destroy his good faith.

In European-American Bank & Trust Co. v. Sheriff of the County of Nassau, 97 Misc. 2d 549, 553, 411 N.Y.S.2d 851, 854 (1978), the court stated:
buyers who have actual knowledge of such a violation will be estopped from claiming reliance on the debtor's apparent authority to sell, but as to innocent buyers, unless some objective circumstances of the sale put them on notice to check the record, they will be able to rely on the debtor's apparent authority. Simply knowing that a security agreement between a secured party and a debtor exists will not serve to refute the buyer's good faith and lack of knowledge.

This estoppel analysis may be used to set out the circumstances in which the secured party will be estopped from asserting his security interest in the goods sold by his debtor, and to determine when a buyer from the debtor will be deemed to have been put on notice so as to estop him from claiming reliance on the debtor's apparent authority to sell the goods.

Three possible situations exist which demonstrate the problems a secured party faces in attempting to determine if he would be estopped from asserting his security interest against a buyer of the goods. In the first two it is readily apparent whether or not the debtor is a “person in the business of selling goods of that kind,” and the consequences for the secured party clearly follow. In the last situation the status of the debtor is not so apparent. This leads to a consideration of what circumstances should put the buyer on notice.

The Debtor Is Clearly a Person in the Business of Selling Goods of That Kind

The first situation is one in which the secured party allows the goods to stay in the possession of a debtor who is clearly a person who regularly sells goods of that kind, although the security agreement forbids the debtor to sell the goods. For example, a secured party may have a security interest in a rental automobile which is possessed by a debtor who both rents and sells used automobiles. The debtor represents to the lender that the automobile is to be used as a rental; hence, the security agreement does not contemplate or authorize its sale. However, the debtor is clearly in the business of selling such automobiles.

It was not incumbent upon petitioner to make a search for any possible security interests. As one court has stated: "Whatever the common-sense appeal of this argument, it would appear that [petitioner] is not to be charged with such bad faith as would deprive it of the protection afforded buyers in the ordinary course of business by Section 9-307 merely because it failed to search for liens." [Hempstead Bank v. Andy's Car Rental System, 35 A.D.2d 35, 38, 312 N.Y.S.2d 317, 320 (1970)].

See generally supra note 28.

3 J. POMEROY, supra note 28, §§ 809-813.

U.C.C. § 9-307 comment 2 provides that "the buyer takes free if he merely knows that there is a security interest which covers the goods but takes subject if he knows, in addition, that the sale is in violation of some term in the security agreement." Accord Comment, supra note 21, at 994-97. See also Knapp, Protecting the Buyer of Previously Encumbered Goods: Another Plea for Revision of UCC Section 9-307(1), 15 Ariz. L. Rev. 861, 877 (1973).
In this situation, the secured party runs the risk that prospective buyers will be led to believe that the debtor owns or has authority to sell the goods. If the secured party does nothing to inform buyers that it holds a security interest in the goods being purchased or that the debtor does not have authority to sell the goods, then the secured party is, by its silence, taking a known risk that the debtor will violate the security agreement by selling to a buyer in ordinary course of business. Once the goods are purchased from a debtor who is a "person in the business of selling goods of that kind," the security interest in the goods is destroyed, and the secured party must depend on the debtor to turn over the proceeds from the sales. The secured party knew or should have known that such a debtor could sell free of his lien to an innocent buyer for value, regardless of whether there were limitations on the debtor's ability to sell. Thus, the secured party will be estopped from claiming a continuing security interest in the collateral.

Since the debtor regularly sells goods of that kind, no notice, either

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25 The "known risk" taken by a secured party has been clearly documented. Professor Clark reasons:

B. CLARK, supra note 21, ¶ 3.4 [2], at 3-22 to -23 (emphasis added) (citations omitted). Professor Skilton states that

Skilton, supra note 21, at 4. See W. HAWKLAND, supra note 21, at 702 ("although the Code validates the 'floating lien,' a financier employing it may assume a number of business risks unless he takes appropriate action in supervising the collateral and policing the agreement.") The court in Rome Bank & Trust Co. v. Bradshaw, 143 Ga. App. 152, 157, 237 S.E.2d 612, 615 (1977) stated:

26 Professor Gilmore states that "for a secured party to be subordinated under § 9-307(1), he should know when he enters the financing transaction that he is financing goods of a type which the seller can sell to a 'buyer in ordinary course of business.' " 2 G. GILMORE, supra note 28, ¶ 26.8, at 700; see also Knapp, supra note 34, at 884 ("When a creditor under Article 9 lends against the security of goods held for sale, he knows (or should know) that the debtor will have the power . . . to convey to any [buyer in ordinary course] a good title to such merchandise, free of the secured party's claim.").

27 3 J. POMEROY, supra note 28, §§ 809-813.
actual or constructive,\textsuperscript{28} of the secured party's interest, or the fact that the sale would be violative of the security agreement, is given to a prospective buyer. Faced with a common situation, that of a person selling the same type of goods that he ordinarily and regularly sells, the buyer has no indication that buying the goods may violate a security agreement between the debtor and his secured lender. No warning is given to the buyer which would prompt him to check the record. Since there is nothing to make the buyer wary or suspicious of the transaction, the secured party is estopped from asserting its security interest. To require the buyer to always check the record, whether or not the transaction was suspect, would be commercially unreasonable and unworkable.\textsuperscript{29}

\textsuperscript{28} The terms "actual notice" and "constructive notice" are borrowed from 2 J. Pomeroy, A TREATISE ON EQUITY JURISPRUDENCE (5th ed. S. Symons 1941) in which a system of principles and terms is developed to deal with the different types of notice associated with real property recording acts. These terms are more accurate and useful than the simple "notice" definition in U.C.C. § 1-201(25).

Actual notice, according to Pomeroy, is information concerning a prior hostile claim that is directly or personally communicated to the buyer. It may or may not convey complete knowledge of the prior claim. If, from direct or circumstantial evidence, "the court or the jury is entitled to infer, as a conclusion of fact, and not by means of any legal presumptions, that the information was personally communicated to [the buyer.] the notice is actual." 2 J. Pomeroy, supra, § 595 (emphasis omitted). Actual notice is a conclusion of fact which can be established by all types of evidence. Id. If shown by indirect evidence, the inference of actual notice can be defeated by proper evidence. However, the inference is absolute in three situations: 1) if it is shown by direct evidence; 2) if the information, when prosecuted with reasonable diligence, would have certainly led to discovery of the conflicting claim; and 3) if, having received such information, the buyer purposefully fails to prosecute it in a reasonable manner so that he does not discover the conflicting claim. See id. § 597.

Constructive notice is information concerning a prior hostile claim which gives the buyer notice which is inferred through legal presumptions. It assumes that no actual notice is shown by the evidence. Such legal presumptions are of two types, conclusive and rebuttable. See id. § 604. The presumption is conclusive if "the circumstances are such that the inquiry, if made and followed up with reasonable care and diligence, would lead to a discovery of the truth" about the conflicting claim. Id. § 608 (emphasis omitted). This conclusive presumption is irrebuttable by any evidence. See id. The presumption is rebuttable if the buyer "has information or knowledge of certain extraneous facts, which are not of themselves actual [knowledge] but which are sufficient to put [the buyer] on inquiry concerning the existence of a conflicting interest." Id. § 606 (emphasis omitted). This "prima facie" presumption that the buyer in fact acquired the truth about the conflicting claim is rebuttable by proper evidence. See id.

For criticism of Pomeroy's system, and the introduction of a different system, see Philbrick, Limits of Record Search and Therefore of Notice, 93 U. Pa. L. Rev. 125, 259, 391 (1944).

\textsuperscript{29} In support of this conclusion, Professor Gilmore has cited Helms v. American Security Co., 216 Ind. 1, 22 N.E.2d 822 (1939), which held that the substitution of the "caveat emptor" rule for the "innocent purchaser" rule

would be manifestly unjust, inequitable, and oppressive since no one could safely buy anything whatever from a retail establishment without first making a search of the county recorder's office to make certain that it was not encumbered with a chattel mortgage, or by seeing that the purchase price was paid to the mortgagee.

2 G. Gilmore, supra note 28, § 26.2 at 685 (quoting 216 Ind. 1, 8-9, 22 N.E.2d 822, 825). The good faith buyer, Professor Gilmore states, "is protected not because of his praiseworthy character, but to the end that commercial transactions may be engaged in without elaborate investigation of property rights and in reliance on the possession of property by one who
The second situation is one in which the debtor clearly is not a dealer in such goods and therefore cannot sell free of the secured party's lien. An example is when a secured party has a security interest in the machinery used in a manufacturing process. The manufacturer is in the business of producing and selling goods produced by the machinery, not the machinery itself.

In this situation, prospective buyers are not allowed to rely on the debtor's apparent authority to sell because the sale is not in the ordinary course of business. The requirement that a buyer in ordinary course of business buy from a "person in the business of selling goods of that kind" is based on the presumption that since the debtor is not in the business of selling such goods, a prospective buyer would be put on constructive notice, and, consequently, would check the record for a security interest in the collateral. Upon finding the previously filed security interest, he would discover that the sale would be in violation of that security agreement. Such knowledge would prevent a prospective buyer from relying on the debtor's apparent authority to sell.

When put on constructive or actual notice, buyers are presumed to act with the reasonable diligence of a prudent man in an effort to investigate the existence of any adverse claims. To allow a lesser standard would

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The Debtor Is Clearly Not a Person in the Business of Selling Goods of That Kind

the existence of any adverse claims. To allow a lesser standard would
be to encourage buyers not to investigate suspicious circumstances because they might learn of conflicting claims. Such a buyer would not be acting in "good faith.""

The effect of constructive notice, therefore, is the same as that of actual notice. In both cases, the drafters have determined that the buyer will not be allowed to rely on the debtor's apparent authority to sell. When the debtor is clearly not a person in the business of selling such goods, a secured party who allows the debtor to have possession of such goods is not risking anything as against a buyer in the ordinary course of business. In actuality, the secured party has not given the debtor apparent authority at all because the very character of the debtor prevents a buyer from relying on that apparent authority. Hence, there is no basis for applying estoppel to a secured party in this situation.

**It Is Unclear if the Debtor Is a Person in the Business of Selling Goods of That Kind**

The final situation is one in which it is not clear whether the debtor is in the business of selling goods of that kind. An example is when a secured party has a security interest in the automobiles of a rental car company. The rental company occasionally sells one of its used rental automobiles, even though it is forbidden to do so by its lender. In such a case it would not be immediately clear whether or not the debtor was a "person in the business of selling goods of that kind."

Whether the buyer will be able to rely on the debtor's apparent authority should depend on whether the circumstances surrounding the debtor put a buyer on notice. If the buyer is put on notice, a conclusive presumption that the buyer investigated and acquired knowledge of all conflicting interests operates against the buyer. If the circumstances do not put

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44 See U.C.C. § 1-201(9).
45 J. Pomeroy, supra note 23, § 594.
46 The Code makes no distinction between the different kinds of notice. U.C.C. § 1-201(25) includes both actual and constructive notice as defined by Pomeroy. See supra note 38 and accompanying text. Subsection (a) of § 1-201(25) concerns "actual knowledge," which is contained within Pomeroy's definition of actual notice. Subsection (b) concerns receiving "notice or notification" of a fact, also covered by Pomeroy's definition of actual notice. Subsection (c) concerns "facts and circumstances" which give a person "reason to know" a fact exists, a situation covered by Pomeroy's definition of constructive notice. The Code provides that any of these situations constitutes notice. "Facts and circumstances" which give a person "reason to know" that a fact exists have the same effect as when a person has actual knowledge. Since U.C.C. § 1-201(9) states that knowledge that a sale is violative of the ownership rights of a third party will prevent a person from being a buyer in ordinary course of business, if the facts and circumstances give a buyer reason to know that a debtor is not a person in the business of selling goods of that kind, it will prevent that buyer from being a buyer in ordinary course of business.
47 "Under the Code, the protection afforded a security interest against sale by the debtor is determined by the nature of the debtor," Comment, supra note 21, at 992. See Kripke, Practice Commentary, N.Y. U.C.C. § 9-307 (McKinney 1964).
the buyer on notice, he will be able to rely on the debtor's apparent authority to sell and can take free of the secured party's lien. Further inquiry requires an examination of the kinds of circumstances that put a buyer on notice.48

CIRCUMSTANCES THAT PUT A BUYER ON NOTICE

Unfortunately, sections 9-307(1) and 1-201(9) provide little assistance in determining whether a debtor is a “person in the business of selling goods of that kind.” These sections provide no guidelines nor do they indicate which factors might properly play a part in such a determination. It therefore becomes necessary to return to the presumption adopted by the drafters which underlies these sections. The drafters presumed that a prospective buyer dealing with a debtor who was not in the business of selling goods would have constructive notice of that fact. Such a buyer could therefore not reasonably rely on the debtor's circumstantial authority to sell since such authority would not be apparent. Since this presumption is the basis of the “person in the business of selling goods of that kind” requirement, those factors which would put a prospective buyer on constructive notice are the factors that should be examined to determine if the debtor has met the requirement. It has been generally acknowledged that it is difficult, if not impossible, to lay down a general rule as to what facts would in every case be sufficient to put a buyer on notice.49 It is possible, however, to examine the factors that drafters of the Code and courts believe put buyers on notice.

Before examining the factors, it is necessary to form some general rules as to which types of factors should be considered. First, the only circumstances or factors which may properly be considered are those which a buyer would know or be able to observe before the completion of the sale.50 Those factors which a buyer would have no way of knowing or


49 See Philbrick, supra note 38, at 273.

50 From the secured lender's point of view, the only circumstances or factors that are proper to consider are those which a lender could reasonably anticipate would be observable by a prospective buyer. Thus, the lender and the buyer are put on notice by the same circumstances or factors.
observing without investigation cannot be considered because the buyer has no reason to investigate and should not be charged with knowledge of any fact which requires investigation. Second, the actual knowledge possessed by a prospective buyer, other than actual knowledge that the sale violates a security agreement, is irrelevant. The standard is an objective one, focusing on those factors which a prudent, reasonable buyer would know or observe. The secured party and the prospective buyer will consider the same factors in determining whether the debtor is a "person in the business of selling goods of that kind" with respect to certain goods.

By examining the requirements of section 1-201(9), one can determine some of the circumstances the drafters believed would or would not put prospective buyers on notice. It is clear that a buyer who has knowledge "that the sale to him is in violation of the ownership rights or security interest of a third party in the goods" has actual notice and cannot be a buyer in ordinary course of business. However, the comment to section 9-307(1) emphasizes that the buyer does take free "if he merely knows that there is a security interest which covers the goods." Thus, the fact that the buyer is aware of a security interest is not a factor giving rise to constructive notice that the seller is not in the business of selling goods of that kind. Since sections 1-201(9) and 9-307(1) provide no additional guidance as to which factors should be considered or the relative weight which should be attached to each factor, a nonstatutory test is needed to determine how cases in this area should be decided. Courts have created and administered tests to determine who is a "person in the business of selling goods of that kind."

When applying these tests, courts have considered two main factors which a prudent buyer should know or observe during his dealings with the debtor. Neither factor is conclusive and a proper determination considers both. In order of importance, these factors are: first, whether the sale was in accordance with the standard or custom of the debtor's industry; and second, whether the debtor has made it his own standard

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5 The only subjective requirements imposed by § 1-201(9) are that the buyer be "in good faith" and "without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods." See supra notes 32-34, 42-44 and accompanying text. Whether the debtor is a "person in the business of selling goods of that kind" is a question which is answered without reference to the buyer's subjective beliefs. See supra notes 26, 47-48 and accompanying text. Otherwise, the answer would be totally unpredictable because it would depend on the identity and beliefs of a given buyer. Since one of the main reasons for having such a rule is to be able to predict its outcomes, using a subjective standard would significantly diminish the usefulness of the rule.

5a U.C.C. § 1-201(9).

5b Id. § 9-307(1) comment 2.

or custom to sell such goods, as evidenced by the debtor's previous dealings.\textsuperscript{55} Both factors will usually be applicable.\textsuperscript{56} Other factors may be considered if it can be shown that a reasonable buyer would have known or observed them before the sale. For instance, some courts have taken into account the fact that the debtor advertised the goods for sale\textsuperscript{57} and the fact that the debtor sold the goods on a systematic basis.\textsuperscript{58} Whether one or more of the factors mentioned above applies in a given situation will depend on the circumstances of each debtor.

Many courts have mistakenly considered circumstances that a buyer could not have known or observed without investigation.\textsuperscript{59} Courts have inappropriately considered the purpose of a business as stated in its articles of incorporation,\textsuperscript{60} information contained on a business' financing statement,\textsuperscript{61} testimony given by a business' former employee,\textsuperscript{62} and the fact that the goods sold were part of the debtor's rental inventory when the buyer did not know the goods were not part of the debtor's sales inventory.\textsuperscript{63} None of these factors could have been considered by a prospective buyer. It is also improper for a court to consider a factor on which the buyer could not reasonably rely without investigation. One court took into account the fact that the transaction made "commercial sense."\textsuperscript{64}
It is doubtful that the buyer even considered this factor, much less knew it with sufficient certainty to depend on it.

The tests created and administered by courts to determine who is a "person in the business of selling goods of that kind" have produced varying results. The efficacy of these judicial tests will be examined in an attempt to determine which of them more nearly produces results that harmonize with the policies and principles of section 1-201(9) and 9-307(1).

**JUDICIAL TESTS**

To be able to take free of a secured party's lien, a buyer must fulfill the requirements of section 1-201(9). The requirement of buying "in ordinary course from a person in the business of selling goods of that kind" was intended to define professional sellers who regularly sell goods of that kind. It was meant to exclude sellers who do not make it their business to sell such goods. While it is easy to think of extreme examples, the distinction is less clear in the middle. To help bring this middle area into focus, courts have devised nonstatutory tests which are of varying degrees of usefulness.

**Reasonable Expectations Test**

The most recent test to emerge is the reasonable expectations test. The court in *Tanbro Fabrics Corp. v. Deering Milliken, Ind.* stated that "[a]ll subdivision (1) of section 9-307 requires is that the sale be of the variety reasonably to be expected in the regular course of an on-going business." By addressing the buyer's expectations, the test seeks to determine if circumstances exist which would either cause a buyer to be on

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65 Skilton, supra note 21, at 21:22.
66 Id.
67 Id. at 22.
69 Id. at 637, 350 N.E.2d at 593, 385 N.Y.S.2d at 262-63 (citations omitted). It should be noted that one aspect of the *Tanbro* court's holding, unrelated to the present inquiry, has been controversial. Much discussion has been directed to the Court's holding that a buyer of goods may be a buyer in ordinary course of business under section 9-307(1) even though he knows that the goods are not in his debtor's possession, and are held by a secured party (pledgee) under a form of contract which does not permit the buyer to order the goods out unless the secured party agrees. The holding has attracted wide attention in the textile industry.

notice and check the record or cause the secured party to expect that the security interest would continue.

The reasonable expectations test avoids oversimplification problems of earlier tests. It focuses on impressions created when all relevant circumstances of the debtor are considered. The language of the reasonable expectations tests allows for discretion in its application and therefore there is a danger that the test will be applied either too strictly or too loosely. If, however, the test is applied consistently with the general rules set forth previously and the relevant factors are given their proper weight, the reasonable expectations test achieves the purpose underlying the section 9-307(1) exception.

The application of this test can be demonstrated by using the two examples set out above. In example one, Average Buyer purchased a chainsaw from a rental company which was held as collateral under a security agreement forbidding sale. It was not customary in the industry to sell used rental tools and the rental company had never sold such tools before. Example one is thus a situation in which a sale cannot be reasonably expected in the regular course of the rental company's business. Example two, on the other hand, involved Average Buyer's purchase of an automobile from a rental company. Like the rental company in example one, the automobile rental company did not have authority to sell. In the automobile rental industry, however, it was customary to sell used rental automobiles and the rental company had occasionally done so in the past. In example two, the sale of the used rental automobile can be reasonably expected in the regular course of the rental company's business.

In both cases in which it has appeared, the reasonable expectations test has been applied correctly. In Tanbro it was correctly used to decide that a manufacturer who converted "greige goods" into finished goods was a person in the business of selling the greige goods. The court relied

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70 See infra notes 99-101, 121-27 and accompanying text.
71 See supra text accompanying notes 49-67.
72 See supra notes 54-64 and accompanying text.
73 See supra text accompanying notes 16-17.
74 See supra note 16.
75 Professor Clark has suggested this result.
   In Tanbro Fabrics Corp. v. Deering Milliken, Inc., the seller's primary business was converting unfinished textiles into finished goods. The court held, however, that a sale of unfinished textiles was "in ordinary course" under § 9-307 because such sales were the industry norm, though only a secondary business for the transferor. Using the Tanbro test—can such sales be expected as part of an industry norm?—recurring sales of worn-out rental cars might well trigger the protection of § 9-307(1).
B. CLARK, supra note 21, ¶ 3.4[1], at 3-19 (citations omitted).
76 The term "greige goods" means unfinished goods.
77 39 N.Y.2d at 637, 350 N.E.2d at 593, 385 N.Y.S.2d at 262; see 1A P. COOGAN, W. HOGAN, D. VAGTS & J. McDonnell, supra note 5, ¶ 7.11A[2][q], at 7AA-60.
heavily on the fact that it "was customary for [the debtor], and in the trade for converters, to sell off excess goods . . . ." The debtor had sold off excess greige goods in the past and neither the buyer nor the secured party had reason for suspicion. In Sindone v. Farber the reasonable expectations test was applied to a sale of "capital inventory" equipment used in a junkyard. In holding that the debtor was not "in the business of selling goods of that kind," the court noted that the goods were "the type of chattels which would normally alert a buyer 'to protect himself against a possible security interest.'"

**In the Business of Selling Goods of That Kind Test**

The in the business of selling goods of that kind test is little more than a restatement of the definition in section 1-201(9), but it has been expressed as a test, at least initially, by many courts. In Hempstead Bank v. Andy's Car Rental System the court stated the test as follows: "Did [the buyer] purchase 'in ordinary course from a person in the business of selling goods of that kind' . . . ?" There has been a distinct difference in how this test has been applied, depending on whether the court used other tests as well.

Courts which have used the test exclusively have applied it in its strictest sense. If the debtor's primary business was selling goods of that kind, these courts have held that this fulfills the requirement, but that anything less does not. Even if a debtor regularly sells a kind of good, but those sales are only incidental to his primary business, the debtor will not be deemed to be a "person in the business of selling goods of that kind."

**Hempstead** is the leading case which has applied the in the business of selling goods of that kind test. In that case, the bank had a perfected security interest in the automobiles of an automobile rental company. The debtor sold thirteen used automobiles to the buyer over a period of five months. It was undisputed that "all such companies periodically sell their used cars and replace them with used ones . . . ." The court

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78 39 N.Y.2d at 637, 350 N.E.2d at 593, 385 N.Y.S.2d at 262.
79 105 Misc. 2d 634, 432 N.Y.S.2d 778 (1980).
80 Id. at 639, 432 N.Y.S.2d at 782.
81 Id.
82 Some courts have stated this test but have not applied it. See infra note 101.
84 Id. at 38, 312 N.Y.S.2d at 320 (citations omitted).
85 See, e.g., id.
86 See supra note 10.
87 See supra note 12.
88 35 A.D.2d at 38, 312 N.Y.S.2d at 320.
89 Id. at 36, 312 N.Y.S.2d at 319.
90 Id. at 37, 312 N.Y.S.2d at 319.
91 Id. at 38, 312 N.Y.S.2d at 320-21.
stated that the "periodic sale of [the debtor's] used cars was merely incidental to its leasing or rental business."\footnote{Id. at 39, 312 N.Y.S.2d at 321.} In the court's opinion, section 9-307(1) had no application to "such incidental sales."\footnote{Id.} The holding, therefore, was that "as a matter of law, [the buyer] did not purchase from a person engaged in the business of selling cars . . . ."\footnote{Id.}

The court's analysis in Hempstead consisted almost entirely of a rejection of the test the defendant proposed, the debtor's inventory test.\footnote{Id.} While the Hempstead court may have been justified in criticizing and refusing to apply that test,\footnote{Id.} it employed an inadequate test itself. To say that the requirement of buying from a "person in the business of selling goods of that kind" is fulfilled only if selling goods of that kind is the debtor's primary business is to oversimplify the issue. Nowhere in the text or the official comments of sections 9-307(1) and 1-201(9) is mentioned a requirement concerning frequency of sales.\footnote{Id.} Nowhere is there a requirement that the sales be a certain proportion of that debtor's business. The greatest deficiency in the Hempstead court's interpretation, however, is that it fails to take into account any factor or circumstance other than volume of sales as compared to the rest of the debtor's business. The test should take into account factors which might put the buyer on notice of possible violations of a security agreement.\footnote{Id.}

The drawbacks of this test can be demonstrated by its application to the situation in example two.\footnote{Id.} In that example, the debtor's primary business was renting automobiles, not selling them. Even though the debtor occasionally sold rental automobiles and it was customary in the debtor's industry to do so, the in the business of selling goods of that kind test dictates that the debtor not be deemed a "person in the business of selling goods of that kind," an erroneous conclusion.\footnote{Id.}

The Hempstead court's oversimplification and lack of analysis demonstrate why the in the business of selling goods of that kind test is inadequate. The test is too broad to be of any use and it does not assist in bringing the middle ground into focus. As applied by those courts that use it exclusively, the test is so difficult to pass that it has taken away the middle ground altogether. Any ambiguous situations will be construed against a finding that the debtor fulfilled the requirement. While most courts that have considered this question have stated this test, roughly
half have supplemented it with more precise tests. In doing so, these
courts have actually relied on the more precise tests and have not ap-
plied the broader in the business of selling goods of that kind test. Possibly
these courts realized that the latter test does not provide accurate and
helpful guidelines.

Debtor's Inventory Test

Another test used to bring the middle ground into focus has been the
debtor's inventory test. The court in Sindone v. Farber stated that
"[u]nder the Code, whether a purchase was made from a person in the
business of selling goods of that kind turns primarily on whether that
person holds the goods for sale. In other words, are these goods or chattels
the seller's selling inventory." This test has been used by several
courts but specifically rejected by others. This test requires that the
item sold be part of the inventory of the debtor's primary business in
order for the debtor to qualify as a "person in the business of selling
goods of that kind."

The origins of the debtor's inventory test predate the 1962 version of
the Code. In the 1950 version of the Code, section 9-307(1) applied only
to inventory and a "buyer in ordinary course of business" was a per-
son who bought "goods" from a person in the business of selling "goods." In 1952, section 9-307(1) was expanded to apply to "inventory, and . . .
other goods as to which the secured party . . . claims a security interest
in proceeds."

101 Courts that stated this test but did not actually apply it include the courts in the
following cases: O'Neill v. Barnett Bank, 360 So. 2d 150 (Fla. Dist. Ct. App. 1978); McFadden
v. Mercantile-Safe Deposit & Trust Co., 260 Md. 601, 273 A.2d 198 (1971); Tanbro Fabrics

102 Id. at 638, 432 N.Y.S.2d at 781 (emphasis in original).

103 See McFadden v. Mercantile-Safe Deposit & Trust Co., 260 Md. 601, 623, 273 A.2d
198, 208 (1971); Tanbro Fabrics Corp. v. Deering Milliken, Inc., 39 N.Y.2d 632, 636, 350

104 See, e.g., Hempstead Bank v. Andy's Car Rental Sys., 35 A.D.2d 35, 39, 312 N.Y.S.2d
317, 321 (1970); see also McKenzie v. Oliver, 571 S.W.2d 102, 108 (Ky. Ct. App. 1978) (adopted
reasoning of Hempstead).

105 The 1950 Official Text of U.C.C. § 9-307(1) provided:
In the case of inventory, a buyer in ordinary course of business takes free
of a security interest even though perfected and even though the buyer knows
of the terms of the security agreement. A "buyer in ordinary course of business"
means a person who buys goods in ordinary course from a person in the business
of selling goods of that kind.

106 U.C.C. § 1-201(9) (1950).

107 The 1952 Official Text of U.C.C. § 9-307(1) provided:
In the case of inventory, and in the case of other goods as to which the
secured party files a financing statement in which he claims a security interest
in proceeds, a buyer in ordinary course of business takes free of a security
interest even though perfected and even though the buyer knows of the terms
of the security agreement.
"business" was changed to require a purchase from a person "in the business of selling goods of that kind." In the 1956 Recommended Text all reference to "inventory" in section 9-307(1) was removed, and the comment stated that the reason for doing so was "because the definition of 'buyer in the ordinary course of business' limits subsection (1) to inventory cases."

The modern version of the debtor's inventory test is derived from the text and official comments of sections 9-307(1), 1-201(9), and 9-109(4). Section 9-307(1) refers to section 1-201(9) for the definition of "buyer in ordinary course of business," which section 1-201(9) defines as one who purchases from a seller who is "in the business of selling goods of that kind." "Goods" are broken down into the four categories of "consumer goods," "equipment," "farm products," and "inventory." These categories are mutually exclusive. Whether a good is in a certain category depends on its use at the time the security agreement is created. Thus, changes in use after a security interest is created do not change a good's status under the Code.

The definition of inventory in section 9-109(4) is as follows:

Goods are . . . "inventory" if they are held by a person who holds them for sale or lease or to be furnished under contracts of service or if he has so furnished them, or if they are raw materials, work in process or materials used or consumed in a business. Inventory of a person is not to be classified as his equipment.

The official comment to section 9-307(1) states that "subsection [(1)] applies, in the terminology of this Article, primarily to inventory." Thus,

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108 The 1956 Recommended Text of U.C.C. § 9-307(1) provided:

In the case of inventory, and in the case of other goods as to which the secured party files a financing statement in which he claims a security interest in proceeds, a] A buyer in ordinary course of business (subsection (9) of Section 1-201) other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of [the terms] its existence [of the security agreement].

109 U.C.C. § 9-307, 1956 Recommended Text, comment. See 1956 RECOMMENDATIONS, supra note 109, at 284 (text in brackets was recommended for deletion; text in italics is new).


111 For commentary on the Code comments, see 2 N.Y. LAW REV 1954 REPORT, supra note 21, at 1317-18; B. CLARK, supra note 21, ¶ 1.1[a]; Gilmore, On the Difficulties of Codifying Commercial Law, 57 YALE L.J. 1341, 1355 (1948).

112 U.C.C. § 9-307(1).

113 Id. § 1-201(9).

114 Id. § 9-109.

115 Id. at comment 2.

116 See 1 H. BIRNBAUM, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 21.2 at 92-93 (1954); T. QUINN, supra note 4, ¶ 9-109[4].


118 Id. § 9-307(1) comment 2.
it seems as if the 1956 comment to section 9-307(1) is correct and section 9-307(1) does seem to apply to "inventory." To ask if the item sold was part of the debtor's inventory would, therefore, seem to be a valid test.

While the preceding argument demonstrates the origin and basis of the debtor's inventory test, the following analysis reveals that it is not an effective test. It is true that section 9-307(1) applies primarily to "inventory," but it is erroneous to simply equate the set of goods which falls under the "inventory" definition with the set of goods section 9-307(1) was intended to cover. Not all goods that are inventory are intended to be covered by section 9-307(1). "Goods to be furnished under a contract for the sale of goods are not inventory."

1. "Not all goods that are inventory are intended to be covered by section 9-307(1)."

2. Some commentators have created an issue from the fact that U.C.C. § 1-201(9) does not say "inventory" specifically. Instead it says "goods," which has been taken to mean that U.C.C. § 9-307(1) could apply to goods other than inventory.

We note that the term "inventory" is not used. The goods are described rather in terms of who is the seller—a person who sells goods of that kind. Ordinarily, such goods would be inventory (section 9-109); but it is perhaps a question of semantics as to whether the old truck sold by a trucking company is equipment no longer needed for use, or whether the truck was transformed from equipment to inventory when put up for sale.

1A P. COOGAN, W. HOGAN, D. VAGTS & J. MCDONNELL, supra note 5, § 7.11[2][b][ii], at 7AA-59; see Skilton, supra note 21, at 12-13. The fact that U.C.C. § 9-307 comment 2 states that the subsection applies "primarily," yet not exclusively, to inventory has been interpreted as supporting this conclusion. In 1956 the New York State Law Revision Commission described § 9-307(1) as "confusing" because it applied (at the time) only to inventory and goods as to which the secured party filed a financing statement claiming proceeds, while U.C.C. § 2-403(a) was broad enough to cut off a security interest in any goods. N.Y. LAW REV'N COMM'N 1956 REPORT, supra note 28, at 67. The Committee proposed to delete the clause limiting the subsection to inventory and goods "to which the secured party files a financing statement in which he claims proceeds." Id. at 474-75.

Professor Gilmore, however, has taken an opposing stance. He states that it is impossible for there to be a "buyer in ordinary course of business" of goods which are classified either as "consumer goods" or as "equipment." Under the definition the goods must be bought from "a person in the business of selling goods of that kind". Both "consumer goods" and "equipment" are defined (§ 9-109) as goods which have been bought "primarily" for use.

2 G. GILMORE, supra note 28, § 26.6, at 694 (footnote omitted). Other commentators concur with Professor Gilmore. See O. SPIVACK, SECURED TRANSACTIONS 53-54 (1963); Kripke, supra note 47. One exception exists on which both Professor Gilmore and Professor Skilton agree. If the secured party takes a security interest in goods purchased by the debtor as consumer goods or equipment, knowing the debtor to be in the business of selling goods of that kind, and the debtor then puts the goods in his inventory and sells them to a buyer in ordinary course of business, the buyer should take free of the security interest under § 9-307(1). See 2 G. GILMORE, supra note 28, § 26.8, at 699-700; Skilton, supra note 21, at 13 n.36.

Professor Murray has stated:

[Even though the cars in question were classifiable as inventory under Section 9-109(4), that section is not the true test of applying the buyer in ordinary course of business rule under Sections 9-307 and 1-201(9). The true test is whether the car leasing business was "in the business of selling goods of that kind."]

Murray, supra note 17, at 655 (emphasis in original) (footnote omitted); see 2 G. GILMORE, supra note 28, § 26.6, at 694-95.
tract of service,” “the fleet of cars owned by a car rental agency,” and “[m]aterials used or consumed in a business” are all examples of inventory according to the comment on section 9-109(4). However, it is not necessarily true that these types of goods were meant to be covered by section 9-307(1).

Thus, to require simply that the purchased goods be classified as inventory under section 9-109(4) reaches overbroadly because not all goods of that type will be sold “in ordinary course” by a debtor who is “in the business” of selling such goods. The commentators to the Code recognized this problem when they noted that “[g]oods to be furnished under a contract of service are inventory even though the arrangement under which they are furnished is not technically a sale.” In the same comment “materials used or consumed in a business” were described as a “class of goods . . . not held for disposition to a purchaser.” Conversely, if particular items of inventory are held for sale, lease, or furnishing under contracts of service, they are not necessarily “excluded from the buying in ordinary course rule of § 9-307(1). The determinative fact is whether the debtor, in addition to ‘leasing’ or ‘furnishing,’ also regularly sells goods of ‘that kind.’”

In recent years several courts have “corrected” the defect in the debtor’s inventory test by asking whether the item sold is part of the debtor’s selling inventory. This modification excludes those goods which are not held for sale, but it fails as well because it still does not line up adequately with the intent of the section 9-307(1) rule. While goods which are inventory and are held for sale will probably qualify under the section 9-307(1) rule, the modified inventory test does not take into account the fact that goods which are not held for sale may fit under the section 9-307(1) rule as well. Narrowing or widening the scope of the debtor’s inventory test will not improve the test because that is not where it fails. The section 9-307(1) exception should take into account an entire set of circumstances which will determine the set of goods it covers. Defining a type of good is not a feasible way to attack the problem because whether

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123 U.C.C. § 9-109 comment 3.
124 See 1A P. COOGAN, W. HOGAN, D. VAGTS, & J. MCDONNELL, supra note 5, § 6.02[2][e], at 475 n.40 ("[W]hile leased trucks are by definition ‘inventory’ of the lessor there is no intention that these trucks could be sold free of a security interest therein merely because they are classified as ‘inventory.’"); W. HAWKLAND, supra note 21, § 2.32, at 701 ("The definition of ‘inventory,’ however, encompasses more than goods held for immediate or ultimate sale."); Skilton, supra note 21, at 22 ("[O]nly certain kinds of inventory, as defined in section 9-109(4), would be included in the scope of section 9-307(1).")
125 U.C.C. § 9-109 comment 3.
126 Id.
127 2 G. GILMORE, supra note 28, § 26.6, at 695; see supra note 122.
a good falls under the section 9-307(1) rule depends on various circumstances surrounding the sale, and whether those circumstances put the buyer on notice.

Both the original and modified debtor's inventory tests are inadequate to assist in more clearly defining the section 9-307(1) rule. They are respectively too broad and too narrow, and as such are misleading. While they may in some cases render a correct result, there is an equal chance that they will be wrong.

**SHOULD THE CODE BE AMENDED?**

The concept of a buyer in the ordinary course of business taking free of a secured party's lien is not a new one in commercial law. Although the policies and principles behind provisions defining the abilities and limitations of such a buyer have remained virtually unchanged, the text of almost every successive Code version of this concept has been modified to some degree. These modifications have attempted to reflect changing business attitudes and to address new controversies.

Amendment, however, is a "costly, cumbersome, and unsatisfactory process." Often it is more desirable to examine the policies and principles behind a provision in order to solve new problems within an existing framework than to attempt to amend the provision. Sections

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130 See Skilton, supra note 21. For modifications of the buyer in ordinary course of business concept within the Code, see supra notes 106-11 and accompanying text.

131 U.C.C. § 1-102(1) provides that the Code "shall be liberally construed and applied to promote its underlying purposes and policies." The commentators state that the Code is drawn to provide flexibility so that, since it is intended to be a semi-permanent piece of legislation, it will provide its own machinery for expansion of commercial practices. It is intended to make it possible for the law embodied in this Act to be developed by the courts in the light of unforeseen and new circumstances and practices.

U.C.C. § 1-102(1) comment 1. Professor Gilmore has stated that "it is a matter of vital importance that the Code as a whole be kept in terms of such generality as to allow an easy and unstrained application of its provisions to new patterns of business behavior." Gilmore, supra note 112, at 1355.

132 Gilmore, supra note 112, at 1355.

133 U.C.C. § 1-102 comment 1 provides:

Courts ... have recognized the policies embodied in an act as applicable in reason to subject-matter which was not expressly included in the language of the act ... [and] have implemented a statutory policy with liberal and useful remedies not provided in the statutory text ....

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

Professor Gilmore explains why the Code provides room for interpretation:

There is always a choice between loose or open-ended drafting and a style that is tight, detailed and precise. The tighter you make your statute ...
9-307(1) and 1-201(9) provide a suitable framework for the development of a useful nonstatutory test. The reasonable expectations test utilizes the policies and principles of the drafters in order to bring about the result the drafters intended. The existence of the reasonable expectations test obviates the need to amend these sections of the Code.

CONCLUSION

Sections 9-307(1) and 1-201(9) of the Code represent an equilibrium point between the two competing policies of protecting the interests of the secured lender and promoting the confident purchase of goods by buyers. When the provisions of sections 9-307(1) and 1-201(9) are construed consistently with their policies and purposes, it is possible to form a nonstatutory test which determines precisely who is a "person in the business of selling goods of that kind" in a section 9-307(1) situation.

Application of section 9-307(1) to a given situation requires circumstances which justify the buyer in failing to check the record and provide a basis for throwing the loss on the secured party. Whether a debtor is a "person in the business of selling goods of that kind" pursuant to section 1-201(9) is a determination which must be based on those circumstances of each individual debtor that a reasonable, prudent buyer should know or observe before the sale is completed. Two main factors should always be considered. The first is whether the sale is in accordance with the standard or custom of the debtor's industry. The second is whether the debtor made it his own standard or custom to sell such goods, as evidenced by his previous dealings. Other factors should also be considered if it can be shown that a reasonable buyer would have known or observed them before the sale was completed and that such factors would have put a prospective buyer on constructive notice that the debtor might not be a "person in the business of selling goods of that kind."

The reasonable expectations test, when applied in conjunction with a consideration of applicable factors, yields a result in complete harmony with the principles and policies of sections 9-307(1) and 1-201(9). It focuses on the impressions created when all relevant circumstances are considered. Other nonstatutory tests have focused on only one aspect of the debtor and, consequently, do not produce results in accord with the purposes of the section 9-307(1) rule.

THOMAS W. WALDREP, JR.

Gilmore, Article 9: What It Does Not Do For the Future, 26 LA. L. Rev. 300 (1966). Professor Gilmore's choice is to "keep the Code . . . as general, as unspecific as possible. Let the strategic strong points be as widely spaced as they can be and still defend the essential territory." Gilmore, supra note 112, at 1358.