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## The Uniform Commerical Code's Misplaced Emphasis on Possession

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# THE UNIFORM COMMERCIAL CODE'S MISPLACED EMPHASIS ON POSSESSION

*Robert A. Zadek\**

## I. THE PROBLEM

The idea for this Essay came to me about fifteen years ago, when I was a "Garmento"—an associate practicing law in the Garment Center of New York City. The credit manager of a large textile company client called seeking help. A buyer with weak credit asked him to approve a \$500,000 order. The buyer was willing to grant a security interest in its inventory—which would more than secure the \$500,000 credit exposure—provided my client did not file a financing statement. The buyer explained that once its trade creditors learned that its inventory was encumbered, its trade credit would disappear and it could not survive. What should my client do?

I suggested that my client set up a field warehouse on the buyer's premises. All inventory would be placed under the control of the warehouse and would not be released to the buyer until payment arrangements were made. The inconvenience to the buyer would be minimal, and my client would hold a perfected security interest *without having to file a financing statement*. Everyone would win except the trade creditors and other third parties who would have no easy way to learn of my client's lien. Is this any way to run the law of secured transactions? Why should the Uniform Commercial Code (UCC) permit this?

Let us take this a step further. I often lecture to loan officers. At a certain point in my lecture, I conduct the following dialogue with the audience:

Question: "Do your loan approvals require that you hold a first security interest in the inventory?"

Answer: "Yes."

Question: "Do you always verify that you have a first security interest before you fund the loan?"

Answer: "Yes."

Question: "How do you make sure?"

Universal Answer: "I do a postfiling search."

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"How silly. How naive," I think to myself. I explain to them that unless the lenders know, by actual physical inspection, that on the date they file their financing statement all of the inventory is *in the actual physical possession* of the borrower, it is impossible to confirm lien priority. The lenders are shocked and surprised. The utility, convenience, and certainty that the filing provisions of the UCC are supposed to provide are undermined by the word "goods" as included in section 9-305 of the UCC.<sup>1</sup>

## II. THE PROBLEM WORSENS

UCC section 9-305 compounds the problem by expanding the concept of possession to include goods held by a bailee and by providing that the secured party is deemed to have possession "from the time the bailee receives notification of the secured party's interest."<sup>2</sup>

The loan officer, graduate of my lecture, now knows to verify, at the exact moment of filing, that no other secured party has possession of the collateral. The officer arranges for an inspection of the collateral *at the moment of filing* and learns that some of the collateral is held in a public warehouse in the name of the debtor. The officer visits the warehouse and inquires whether the warehouse supervisor has received notification from any other purportedly secured party asserting a security interest in the collateral. The warehouse supervisor does not remember and just wants to be left alone. How can a secured party ascertain its priority?

Can this be called a "modernization" of commercial law where a statute requires that a secured creditor must actually visit each location of the debtor's business where inventory or equipment may be located to confirm priority? Is it realistic? Does anybody actually do it?

## III. MY THESIS

Perfection by possession of inventory or equipment is:

- (1) wholly unnecessary for commerce;
- (2) an anachronistic concept which has no place in a modern commercial statute; and
- (3) a mostly unknown trap for the secured lender.

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1. U.C.C. § 9-305 (1990). "A security interest in . . . *goods* . . . may be perfected by the secured party's taking possession of the collateral." *Id.* (emphasis added).

2. *Id.*

I urge that the ongoing revision of Article 9 remove possessory perfection of a security interest in goods. No one will miss it. The only real consequence will be the "non-consequence" that all such security interests will be perfected by filing, and this is the case now!

As more fully discussed below, the pledge was created at a time *when there was no other means* to publicize a security interest. Other means now exist, and the pledge has outlived—by about fifty years—its usefulness.

#### IV. THE HISTORY OF THE PLEDGE

As Gilmore points out, the pledge "dates from the beginning of legal history."<sup>3</sup> When the ancients had to do deals, they used what they had because they could not wait for paper, ink, and filing systems to be created. The concept developed that once a lien was granted to a secured party—or whatever a creditor was called 5000 years ago—the debtor's other creditors would be defrauded by the secured party allowing the debtor to remain in possession of the collateral. Thus, the only way to alert creditors of a lien was for the secured creditor to take possession.<sup>4</sup> Makes sense to me . . . then.

At common law the creditor perfected its security interest by taking physical possession of the collateral.<sup>5</sup> Gilmore states that "[t]he requirement that a secured party take possession of his collateral" has come to be known as "the pledge."<sup>6</sup> The fundamental policy behind the pledge is that the debtor should be precluded from representing to other third parties that the collateral is owned free and clear of the secured party's interest.<sup>7</sup> The secured party, by taking possession of the pledged collateral, indicates to potential creditors that it has a security interest in the collateral. As Professor Coogan points out,

[i]t was assumed that potential creditors and purchasers would rely on a debtor's apparent ownership of assets physically in his possession; this was part of the basic common law

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3. 1 GRANT GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* § 14.1 (1965).

4. *Id.* at 439.

5. "Until the early nineteenth century, the only way to create a valid security interest in personal property was by physical pledge . . ." Peter F. Coogan, *Article 9—An Agenda for the Next Decade*, 87 *YALE L.J.* 1012, 1014 (1978).

6. 1 GILMORE, *supra* note 3, § 14.1.

7. The editorial comment to *Twyne's Case* stated that a grant of a security interest without a transfer of possession was "always a badge of fraud." 76 Eng. Rep. 809, 811 n.(B) (Star Ch. 1601). The court explained that "by reason [of the pledgor's continued possession] he . . . trafficked with others, and defrauded and deceived them." *Id.* at 812-13 (footnote omitted).

doctrine of protecting creditors against undisclosed interests in property. In other words, it was a requirement that there be public notice of the creation of a security interest; physical pledge, presumably, gave that public notice.<sup>8</sup>

## V. THE LAW NOW

The drafters of the UCC borrowed from the common law of pledges when they imported the concept of possession into Article 9.<sup>9</sup> Significantly, as Gilmore writes, "The traditional differentiation between possessory (pledge) and nonpossessory interests was accepted without question."<sup>10</sup> In my view, once this major decision was made, without much thought, the die was cast with the problems discussed below as the unfortunate but inevitable consequence.

Article 9, which governs secured transactions, sets forth the steps that a secured party must take in order to perfect a security interest in the debtor's property taken as collateral.<sup>11</sup> Section 9-302(1) requires the filing of a financing statement to perfect all security interests except those listed in subsections 9-302(1)(a)-(g).<sup>12</sup> The first and most important exception for purposes of this Essay is subsection 9-302(1)(a) which states, "a security interest in collateral in possession of the secured party under Section 9-305."<sup>13</sup> Thus, under section 9-305 the secured party is given the option of perfecting a security interest through possession, as opposed to filing.<sup>14</sup>

8. Coogan, *supra* note 5, at 1014-15 (footnote omitted).

9. See official comments to UCC §§ 9-101, 9-205, 9-302, and 9-305 which make references to the common law. More notably, § 1-103 states that common-law rules were intended to supplement UCC provisions.

10. GILMORE, *supra* note 3, § 9.2.

11. UCC § 9-303(1) provides that

[a] security interest is perfected when it has attached and when all of the applicable steps required for perfection have been taken. Such steps are specified in Sections 9-302, 9-304, 9-305, and 9-306. If such steps are taken before the security interest attaches, it is perfected at the time it attaches.

12. U.C.C. § 9-302(1) (1990).

13. *Id.* § 9-302(1)(a).

14. UCC § 9-305 provides as follows:

A security interest in letters of credit and advices of credit (subsection (2)(a) of Section 5-116), goods, instruments (other than certificated securities), money, negotiable documents, or chattel paper may be perfected by the secured party's taking possession of the collateral. If such collateral other than goods covered by a negotiable document is held by a bailee, the secured party is deemed to have possession from the time the bailee receives notification of the secured party's interest. A security interest is perfected by possession from the time possession is taken without a relation back and continues only so long as possession is retained, unless otherwise specified in this Article. The security interest may be otherwise

## VI. WHAT IS POSSESSION?

One of the problems with perfection through possession is the uncertainty as to what constitutes "possession." Section 9-305 mentions the "secured party's taking possession of the collateral."<sup>15</sup> But what constitutes "taking possession?" Is it having physical custody or exclusive control? When does it begin and when does it end? The cases discussed later in this Essay reveal that these questions do not always have clear answers.

Interestingly, despite the importance of possession in Article 9, possession itself is not defined. Professor Clark suggests that "the drafters wisely left the matter to be decided by case law."<sup>16</sup> Unfortunately, the courts have not always shown the same wisdom as the drafters. Because the UCC does not define possession, the courts do not have a clear idea of what common-law concepts of possession should be used to decide cases where the issue of possession for purposes of perfection is in dispute.

Suppose that the debtor buys a computer from the secured party and makes a down payment. As security for the remainder, the secured party allows the debtor to take the computer, but does not provide the user access code until the debtor makes full payment. Does the secured party have sufficient possession for purposes of perfection? The answer is not obvious. If the focus is on physical possession, the secured party is not perfected. If the issue is control, by retaining the access code the secured party has retained control. Most likely, the computer is useless to the debtor without an access code—assuming that the debtor is not a computer hacker or that the debtor does not destroy the computer out of malice or caprice. By retaining the access code, the secured party, for all intents and purposes, remains in control of the collateral.

*In re Bialk*<sup>17</sup> presents an even stronger case for concluding that a secured party—not in actual physical possession of the collateral—has possession of collateral under Article 9 nevertheless. The debtor took out a loan from the secured party. As collateral, the debtor granted a

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perfected as provided in this Article before or after the period of possession by the secured party.

15. *Id.*

16. See BARKLEY CLARK, *THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* § 7.07(1) (rev. ed. 1993). The drafters may have failed to define possession not because of great wisdom, but because they were unable to come up with a satisfactory definition. The difficulty of drafting a workable definition should have given the drafters pause about providing for perfection by possession in the first place.

17. 16 U.C.C. Rep. Serv. (Callaghan) 519 (W.D. Mich. 1974).

security interest in a collection of medals and coins stored in a safe-deposit box.<sup>18</sup> The debtor gave the secured party the only keys to the safe-deposit box containing the coins and medals.<sup>19</sup> Yet, the court concluded that the secured party did not perfect a security interest in the medals and coins because "any depositor can gain access to a box without a key with little effort."<sup>20</sup> Moreover, the court reasoned that "[p]ossession of keys would not be so open and obvious as to come to the attention of an interested person."<sup>21</sup>

Unless going into a bank with a crowbar is a customary way of opening safe-deposit boxes, it is not obvious to me how the debtor can gain access to the contents of the safe-deposit box without having a key, assuming the bank was notified that the secured party has a security interest in the contents of the box and now holds the only key to it. If holding the only key—other than the bank's—to a safe-deposit box does not constitute complete dominion and control over the contents of the box, many wealthy widows have reason to be nervous about their jewelry.

The other reason the court concluded that there was no perfection—that "[p]ossession of the keys would not be so open and obvious as to come to the attention of an interested person"—is even more puzzling. Does the secured party have to hang the keys on a big sign which reads that the keys are to the debtor's safe-deposit box? The UCC does not require that one must advertise the fact in addition to taking possession. The court seems to be confusing the concept of possession with the historical implications of and the rationale behind the common-law pledge.

Despite the holding in *Bialk*, actual possession is not required because section 9-305 allows for constructive possession through a bailee.<sup>22</sup> But as the following case indicates, courts do not always recognize constructive possession when they see it. Consider a situation where a debtor purchases shares of stock from the secured party using a down payment.<sup>23</sup> The debtor secures the balance of the purchase price by agreeing to place the securities in escrow until the debtor

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18. *Id.* at 520.

19. *Id.*

20. *Id.* at 524-25.

21. *Id.* at 524.

22. UCC § 9-305 states in pertinent part, "If such collateral other than goods covered by a negotiable document is held by a bailee, the secured party is deemed to have possession from the time the bailee receives notification of the secured party's interest."

23. *In re Dolly Madison Industries, Inc.*, 351 F. Supp. 1038, 1040 (E.D. Pa. 1972), *aff'd sub nom.* Appeal of Groff, 480 F.2d 918 (3d Cir. 1973).

makes payment in full.<sup>24</sup> Before making the final installment, the debtor goes bankrupt.<sup>25</sup>

Does the secured party have possession for purposes of perfecting a security interest? The court in *In re Dolly Madison Industries, Inc.* did not think so. The court held that no pledge had been created because "the pledgee must have absolute dominion and control over the property."<sup>26</sup> Superficially, the court's conclusion makes sense. "Absolute dominion and control" remained with the escrow agent who was not an agent for either party.<sup>27</sup> But does the function of the escrow arrangement differ so fundamentally from the bailee arrangement—an accepted means of taking constructive possession?

Is not the intent of the parties, in both cases, to insure that the debtor does not obtain a benefit from the secured party without the secured party having a contingent right to acquire the collateral? Both the escrow agent and the bailee take the collateral from the debtor's control until the obligations of the debtor to the secured party are satisfied or until the debtor-creditor relationship is terminated.

On facts quite similar to those in *Dolly Madison*, the court in *In re Copeland*<sup>28</sup> took a more enlightened approach and concluded that if the escrow arrangement was interpreted as not giving the secured party a perfected security interest in the stock, the entire intent of the parties would be frustrated.<sup>29</sup> In dealing with the issue of whether the secured party took possession for purposes of section 9-305, the court noted that "[o]nly when the limitations of common law pledge are engrafted upon . . . [section] 9-305 does this conceptual difficulty appear."<sup>30</sup> In summary the court stated that if it held that an escrow arrangement can never protect creditors against "[third party lienholders or the powers of a bankruptcy trustee or debtor-in-posses-

24. *Id.*

25. *Id.*

26. *Id.* at 1042.

27. *Id.*

28. 391 F. Supp. 134 (D. Del. 1975), *aff'd in part and vacated without prejudice in part*, 531 F.2d 1195 (3d Cir. 1976).

29. *Id.* at 150.

30. *Id.* at 151 (citation omitted). The court went on to comment:

[U]nder the Code, a chief purpose of requiring possession of certain collateral is to provide notice to prospective third party creditors that the debtor no longer has unfettered use of the collateral. Where, as here, physical possession of the stock certificates was . . . placed with WTC [escrow holder] . . . the effective notice to other potential creditors was precisely the same as if Pension Benefit had taken possession of the . . . stock . . . i.e., Copeland was without the certificates.

*Id.* (footnote omitted).

sion],” the court would “elevate ‘technicality over substance and [negate] the reasonableness the Code hoped to impart to commercial practices.’”<sup>31</sup>

Thus, apart from the philosophical question of what it means to possess a thing, it is not always clear whether a secured party has possession—for purposes of perfection—particularly when the collateral is held by a bailee.

## VII. PROBLEMS WITH THE PLEDGE

What is it about the pledge that gives notice to third-party creditors that the debtor no longer owns the collateral free and clear of third-party claims? Is it that the debtor *does not* have possession of the collateral or that the secured party *does have* possession?

On first glance it may seem not to matter. In either case, potential future creditors should be on notice because the debtor no longer has physical possession of the collateral and therefore cannot use it to secure other loans. Conversely, the fact that another party—the secured creditor—has possession should also put other creditors on notice that the debtor no longer owns the collateral free and clear.

But if the main purpose of the pledge is to prevent the debtor from defrauding other creditors, why does the UCC emphasize possession by the secured party, rather than relinquishment of possession by the debtor? As long as the debtor no longer possesses the collateral, it would seem that it cannot defraud other creditors.

Requiring that the secured party take possession of the collateral puts the world on notice that the secured party has the security interest in the collateral. Under this reasoning, requiring possession of the collateral by the secured party for perfection of the security interest makes sense. It still appears, however, that the most important consequence for other creditors is the fact that the *debtor* no longer has possession.

The concept of perfection has nothing to do with the legal relationship between the secured party and the debtor. The secured party has rights with respect to the collateral whether or not the security interest is perfected, assuming it has attached.<sup>32</sup> Rather, perfection relates to the secured party’s rights vis-a-vis other creditors of the

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31. *Id.* (quoting Comment, *Attachment Under Section 9-204 and Perfection Under Section 9-305 of the Uniform Commercial Code of Pennsylvania: Explicit Language Delaying Attachment and Escrow As Satisfaction of Possession*, 5 RUT.-CAM. L.J. 336, 344 (1974)).

32. For the requirements of attachment, see UCC § 9-203.

debtor.<sup>33</sup> Given this, the only role of perfection—whether by filing or through possession—is to put the world on notice that a particular secured party has taken a security interest in certain collateral of a certain debtor.

Strangely, however, the text of the UCC does not state that the primary rationale behind perfection is to give notice to other potential creditors.<sup>34</sup> Professor Coogan explains that “[l]ogically, of course, this underlying rationale is obvious; otherwise, the sponsors might as well have required secured parties to stand on their heads or look toward Mecca or perform some other ritual in order to perfect their security interests.”<sup>35</sup>

### VIII. DOES POSSESSORY PERFECTION MAKE SENSE? Is It NEEDED?

The rationale behind perfection may be obvious, as Professor Coogan notes. What is less obvious, however, is whether perfection through possession serves that rationale. If the central purpose of perfection is providing notice to third parties, it would seem more sensible to require filing in all cases and not to allow possession as an alternative means of perfecting a security interest.

If possessory perfection were not permitted, and filing was the only means to perfect a security interest in goods, creditors would have certainty as to whether or not the debtor’s collateral was encumbered. There would be one place to search: the filing records of the pertinent jurisdiction. The potential creditor would not be required to make physical inspections in an effort to ascertain whether the debtor actually has possession of the collateral.

By permitting perfection by possession, the UCC fails to simplify and streamline the law of commercial secured transactions as much as it otherwise could. The strongest argument against perfection by possession is that it fails to fulfill its function: to provide notice to other third parties that the secured party has taken a security interest in the debtor’s property.

33. See U.C.C. § 9-301 and accompanying official comments.

34. The text of Article 9 does not, unfortunately, specifically articulate the “public notice” requirement. Professor Homer Kripke, in the early days of Article 9, once casually mentioned the desirability of a phrase such as “giving (or excusing) public notice,” but neither he nor I followed this up at a time when it could easily have been done. . . . In any event, the rationale is clear from the official comments.

Coogan, *supra* note 5, at 1032 n.75.

35. *Id.*

Years ago the pledge may have served that function well. The pledge, by a debtor to a creditor, of a wheelbarrow in the town marketplace may have put others on notice that the debtor no longer owned the wheelbarrow free and clear. In our modern society the pledge has outlived its usefulness.

In my opinion an important goal of the drafters of the UCC was to create a commercial world of certainty, where issues to be litigated are kept to a minimum, and factual inquiries minimized; a world where objective, easily provable facts will determine a party's rights.<sup>36</sup>

With possessory perfection, however, the UCC preserves for the courts the proof issue of when a secured creditor gained possession or—to use an irresistible double entendre—became possessed. This may be difficult to prove and requires resort to shipping records, bills of lading, and the like. These documents are often incomplete and, in my opinion and experience, rarely describe all the goods which they cover.

It is difficult to argue against the proposition that perfection by filing is cheaper and better suited for notice purposes than perfection by possession. It would be a matter of record who was first to perfect and there would be no litigation concerning what is and what is not possession. We must wean the UCC from the concept of perfection by possession. By so doing, we lend more certainty and effectiveness to the filing system, and decrease costs in all secured transactions.

I have raised this issue at the Article 9 drafting sessions, with the response from the drafters that “if it ain't broke, don't fix it.” I think it is “broke.” The pledge—insofar as it relates to goods—was apparently included in the UCC due to its more than 5000 year history—without much thought being given to its ramifications. I find this an insufficient basis to continue it. Since we now have paper, phones, computers, and UCC filing offices, it seems appropriate to retire this tired, somewhat useless anachronism.

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36. The avoidance of litigation is demonstrated by the elimination of the determination of a party's priority based on “what it knew and when did it know it?” This issue is difficult to prove. Indeed, I believe the only provision in the UCC where knowledge will affect priority is § 9-401(2). This section deals with the rights of a secured party who filed “in good faith in an improper place or not in all of the places required.” This section provides that the filing is nevertheless effective against “any person who has knowledge of the contents of such financing statement.” U.C.C. § 9-401(2) (1990).