U.C.C. Section 9-504 Sales by Junior Secured Parties: Is a Senior Party Entitled to Notice and Proceeds

Cynthia Lee Starnes
Michigan State University College of Law, starnesc@law.msu.edu

Follow this and additional works at: http://digitalcommons.law.msu.edu/facpubs

Part of the Commercial Law Commons

Recommended Citation

This Article is brought to you for free and open access by Digital Commons at Michigan State University College of Law. It has been accepted for inclusion in Faculty Publications by an authorized administrator of Digital Commons at Michigan State University College of Law. For more information, please contact domannbr@law.msu.edu.
U.C.C. SECTION 9-504 SALES BY JUNIOR SECURED PARTIES: IS A SENIOR PARTY ENTITLED TO NOTICE AND PROCEEDS?

Cynthia Starnes*

The Uniform Commercial Code1 is in a state of tremendous upheaval. The recent revision of Articles 3 and 4, the promulgation of Articles 2A and 4A, and the slating of Articles 2 and 9 for revision, evidence a broad commitment to rethinking the law of commercial transactions. It is a time to break stride and to assess the effects of advancing technology, changing commercial practice, and encroaching federal legislation. It is also a time to address nagging problems that have surfaced under old law.

One such nagging problem has arisen under the current Article 9 rules on default sales. Section 9-504, the cornerstone of the Code rules on default, produces curious results when applied to sales by junior secured parties. In some circumstances, section 9-504(3) permits a junior secured party to repossess collateral from a defaulting debtor and sell it without informing the senior secured party. This possibility seems to be the product of drafting oversight rather than design.2 Moreover, section 9-504(1) authorizes a foreclosing junior party to retain the proceeds of sale without accounting to a senior party, even if the senior party was unaware of the sale. Courts,3 commentators,4 and practitioners5 ad-

* Associate Professor of Law, Detroit College of Law. J.D. 1983, Indiana University—Indianapolis; LL.M. 1989, Columbia University. I want to thank my former professor, Donald Rapson, whose enthusiasm inspired my initial interest in this topic. He kindly read an earlier draft of this article, as did Ron Cuming, E. Allan Farnsworth and William Hawkland. This Article is much the better for all their comments. Homer Kripke also read an earlier draft and responded with an abundance of very helpful suggestions, for which I am most grateful. I am also indebted to my colleague, Kathy Payne, for her insightful answers to my many queries. My thanks also go to Mark Wright for his research assistance par excellence.

1. Unless otherwise indicated, all references and citations are to the 1978 official text of the Uniform Commercial Code [hereinafter the Code].
2. See infra note 44.
3. See infra notes 73-140 and accompanying text.
4. Over the last year, this problem has been the topic of numerous letters exchanged among William Hawkland, Homer Kripke, and Donald Rapson. It was also the topic of a memorandum from Homer Kripke to the Permanent Editorial Board of the Uniform Commercial Code. These letters and the memorandum are on file in the library of the Detroit College of Law.
dressing this issue have been hard-pressed to find satisfactory Code direction in either text or policy. Recently, the situation has been brought to the attention of the Article 9 Study Committee.

This Article will briefly explain the context in which the problem arises, detail the operation of section 9-504, explore relevant Code goals and policies, appraise possible solutions, and, finally, propose an amendment to section 9-504. This effort is made in the modest hope of eliminating one old and nagging problem, and of contributing to the successful revision of Article 9.

I. THE PROBLEM

A. Options of the Secured Party on Default of the Debtor

The starting point for any examination of default rules should be a definition of "default." The term, however, has no uniform meaning. The Code does not define it, leaving this task to the parties or to "any scraps of common law lying around." Essentially, "default is whatever the parties say it is." Typically, a security agreement will provide that, in addition to nonpayment, the following actions of the debtor constitute default:

1. a material misrepresentation made for the purpose of obtaining the loan;
2. a failure to properly insure the collateral;
3. a failure to properly maintain the collateral;
or
4. any voluntary or involuntary transfer of the collateral.

Once a debtor's default has been established, a secured party has several options. First, it may employ any remedies provided by the
security agreement to the extent that these remedies do not conflict
with Code provisions.18 Second, the secured party may use any non-
Code judicial procedures provided by state law.14 State procedures vary
but commonly provide for levy and execution or foreclosure on the col­
lateral, which may be followed by judicial sale.16 Third, the secured
party may choose the Code's own remedies. Section 9-503 authorizes a
secured party to take possession of the collateral without judicial pro­
cess if it can do so without breaching the peace.10 If the secured party
cannot seize the collateral quietly, it must seek judicial authority as, for
example, in an action for replevin.17

If the secured party repossesses the collateral, either through self-
help or judicial process, it has two further options. Section 9-505 gener-

actions, Sales of Accounts, Contract Rights and Chattel Paper, 30 A.L.R.3d § 22.9, at 131
(Supp. 1988) (collection of cases dealing with the remedies of a secured party after debtor's
default).

13. U.C.C. § 9-501(1) provides in part: “When a debtor is in default under a security
agreement, a secured party has the rights and remedies provided in this part and except as limited
by subsection (3) those provided in the security agreement.” U.C.C. § 9-501(1) (1978).
See also U.C.C. § 9-504(3) which precludes a secured party from waiving or varying rights of
the debtor or duties of the secured party except as allowed in Part 5. U.C.C. § 9-504(3) (1978).
For a criticism of these restrictions, see 2 STATE OF NEW YORK LAW REVISION COMMISSION
REPORT, HEARINGS ON THE UNIFORM COMMERCIAL CODE 113 (1954) (comment of Louis A.
Russo) (complaining that “the rigidity of this section would destroy, almost completely, freedom
of contract as to remedies on default”); but cf. observation of Professor Gilmore: “Despite the
considerable amount of wordage, however, Part 5, rejecting the [Uniform Conditional Sales Act]
approach of detailed statutory regulation, opts for a loosely organized, informal, anything-goes
 type of foreclosure pattern, subject to ultimate judicial supervision and control which is explicitly
provided for.” G. GILMORE, supra note 10, § 43.1, at 1183.

14. U.C.C. § 9-501(1) authorizes a secured party to “reduce his claim to judgment, fore­
close or otherwise enforce the security interest by any available judicial procedure.” U.C.C. § 9-

15. Riegert, supra note 11, at 128. Judicial process sometimes has the advantage of al­
lowing the secured party to levy on other assets of the debtor in addition to the collateral, an
important consequence when the collateral is insufficient to satisfy the obligation. For a discussion
of a secured party's in personam action on the debt, see B. CLARK, supra note 11, ¶ 4.03[2].

16. U.C.C. § 9-503 provides:
Unless otherwise agreed a secured party has on default the right to take possession of the
   collateral. In taking possession a secured party may proceed without judicial process if this
   can be done without breach of the peace or may proceed by action. If the security agree­
   ment so provides the secured party may require the debtor to assemble the collateral and
   make it available to the secured party at a place to be designated by the secured party
   which is reasonably convenient to both parties. Without removal a secured party may
   render equipment unusable, and may dispose of collateral on the debtor's premises under
   § 9-504.

17. For a discussion of the options of a secured party seeking to repossess by judicial action,
see J. WHITE & R. SUMMERS, supra note 9, § 25-7.
ally empowers the secured party to retain the collateral in satisfaction of the outstanding balance due on the debt.\textsuperscript{18} Alternatively, section 9-504 allows the secured party to sell the collateral and apply the proceeds of sale to the balance due on the obligation. This latter option is the most popular choice of secured parties.\textsuperscript{19}

**B. The Section 9-504 Sale**

Section 9-504 grants the secured creditor great latitude in fashioning the circumstances of a default sale. Subsection (1) broadly authorizes a secured party to “sell, lease or otherwise dispose of any or all of the collateral in its then condition or following any commercially reasonable preparation or processing.”\textsuperscript{20} Subsection (3) of 9-504\textsuperscript{21} imposes only two restrictions on the foreclosing party: (1) every aspect of the sale must be commercially reasonable; and (2) the secured party must notify the debtor\textsuperscript{22} and any other secured party from whom it has received written notice of an interest in the collateral.\textsuperscript{23}

Proceeds of sale are to be distributed according to the following

\begin{itemize}
  \item [18] The secured party may retain the collateral only if the debtor fails to object in writing to the secured party’s intention to retain it or, in certain cases involving consumer goods, only if the debtor after default signs a written statement waiving or modifying its rights under Part 5 of Article 9. U.C.C. § 9-505 (1978).
  \item [19] B. CLARK, supra note 11, ¶ 4.06. See also comment of Professor Gilmore: “Sale of the collateral is, always has been and always will be the normal default procedure.” G. GILMORE, supra note 10, § 44.6, at 1238.
  \item [21] U.C.C. § 9-504(3) provides:
    Disposition of the collateral may be by public or private proceedings and may be made by way of one or more contracts. Sale or other disposition may be as a unit or in parcels and at any time and place and on any terms but every aspect of the disposition including the method, manner, time, place and terms must be commercially reasonable. Unless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, reasonable notification of the time and place of any public sale or reasonable notification of the time after which any private sale or other intended disposition is to be made shall be sent by the secured party to the debtor if he has not signed after default a statement renouncing or modifying his right to notification of sale. In the case of consumer goods no other notification need be sent. In other cases notification shall be sent to any other secured party from whom the secured party has received (before sending his notification to the debtor or before the debtor’s renunciation of his rights) written notice of a claim of an interest in the collateral. The secured party may buy at any public sale and if the collateral is of a type customarily sold in a recognized market or is of a type which is the subject of widely distributed standard price quotations he may buy at private sale. U.C.C. § 9-504(3) (1978).
  \item [22] Such notice need not be given to a debtor who, after default, signed a statement renouncing or modifying its right to notice. U.C.C. § 9-504(3) (1978).
  \item [23] If the collateral is consumer goods, notice to other secured parties is not required. Id.
\end{itemize}
order of priority: (1) reasonable expenses of sale;\(^24\) (2) satisfaction of the indebtedness of the foreclosing party;\(^25\) and (3) satisfaction of any subordinate security interest.\(^26\) The default sale discharges the security interest of the foreclosing party and any subordinate security interest.\(^27\)

Operating in tandem, the notice and proceeds provisions of section 9-504 produce curious results when a junior party forecloses on collateral.

1. **Notice to Other Secured Parties**

   The notice provision of section 9-504(3) has an interesting history. The 1952 official text of this section required notice to any other secured party “who has filed a financing statement.”\(^28\) Early on, this simple requirement was challenged as unduly burdening foreclosing parties.\(^29\) Arguably, a secured party could satisfy this notice requirement.

---

24. U.C.C. § 9-504(1)(a) states that proceeds shall be applied to “the reasonable expenses of retaking, holding, preparing for sale or lease, selling, leasing and the like and, to the extent provided for in the agreement and not prohibited by law, the reasonable attorneys’ fees and legal expenses incurred by the secured party.” U.C.C. § 9-504(1)(a) (1978).

25. U.C.C. § 9-504(1)(b) states that proceeds shall be applied to “the satisfaction of indebtedness secured by the security interest under which the disposition is made.” U.C.C. § 9-504(1)(b) (1978).

26. U.C.C. § 9-504(1)(c) provides that proceeds shall be applied to the satisfaction of indebtedness secured by any subordinate security interest in the collateral if written notification of demand therefor is received before distribution of the proceeds is completed. If requested by the secured party, the holder of a subordinate security interest must seasonably furnish reasonable proof of his interest, and unless he does so, the secured party need not comply with his demand.

27. U.C.C. § 9-504(4) provides:

   When collateral is disposed of by a secured party after default, the disposition transfers to a purchaser for value all of the debtor’s rights therein, discharges the security interest under which it is made and any security interest or lien subordinate thereto. The purchaser takes free of all such rights and interests even though the secured party fails to comply with the requirements of this Part or of any judicial proceedings.

   (a) in the case of a public sale, if the purchaser has no knowledge of any defects in the sale and if he does not buy in collusion with the secured party, other bidders or the person conducting the sale; or

   (b) in any other case, if the purchaser acts in good faith.


29. During the 1954 hearings before the New York Law Review Commission, a bank representative objected that this notice requirement imposed an "entirely unwarranted burden" on foreclosing secured parties. See 2 STATE OF NEW YORK LAW REVISION COMMISSION REPORT. HEARINGS ON THE UNIFORM COMMERCIAL CODE 1116 (1954).
only by “searching in every filing place in every state where a financing statement might be filed relating to the collateral.”30 In response to this concern, Professor Gilmore suggested “restricting the Code provision on who gets notice to security interests on file in this state, avoiding thus the possible nightmare of a cross-country check of the files.”31 The 1958 and 1962 official texts of section 9-504(3) apparently adopted Professor Gilmore’s suggestion, requiring notice to secured parties who have filed a financing statement “in this state.”32 Ambiguity remained, however, as to what type of search requirement this new language imposed since it was unclear which state was meant by “this” state.33

The 1972 amendment to section 9-504(3) abandoned the notion that a foreclosing party must search out other secured parties with interests in the collateral. Under the 1972 text, a foreclosing party's only obligation is to notify “any other secured party from whom the secured party has received written notice of a claim of an interest in the collat-

30. Id.
31. Id. at 1174-75 (emphasis added).
32. See U.C.C. § 9-504(3) (1958 Official Text) and U.C.C. § 9-504(3) (Official Text 1962). The 1962 text provided:
(3) Disposition of the collateral may be by public or private proceedings and may be made by way of one or more contracts. Sale or other disposition may be as a unit or in parcels and at any time and place and on any terms but every aspect of the disposition including the method, manner, time, place and terms must be commercially reasonable. Unless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, reasonable notification of the time and place of any public sale or reasonable notification of the time after which any private sale or other intended disposition is to be made shall be sent by the secured party to the debtor, and except in the case of consumer goods to any other person who has a security interest in the collateral and who has duly filed a financing statement indexed in the name of the debtor in this state or who is known by the secured party to have a security interest in the collateral. The secured party may buy at any public sale and if the collateral is of a type customarily sold in a recognized market or is of a type which is the subject of widely distributed standard price quotations he may buy at private sale.
The 1952, 1958 and 1962 texts of § 9-504(3) also required the foreclosing party to notify any other secured party “who is known by the secured party to have a security interest in the collateral.” Such a requirement tends to encourage litigation over the particular facts which might or might not establish that a secured party is “known.” For this reason, it was wisely deleted from the 1972 draft.
The 1962 text also created a new exception to the notice requirement in the case of consumer goods. This exemption was proposed by the Permanent Editorial Board in its 1956 recommendations to the National Conference of Commissioners on Uniform State Laws. The Board explained, “the changes also eliminate notification to any other secured party when consumer goods are sold because there normally is no such other secured party.” U.C.C. § 9-504 (3) (1956 Recommendations of the Permanent Editorial Board of the Uniform Commercial Code).
33. See infra notes 143-44 and accompanying text.
In effect, the 1972 text reverses the parties’ roles. Foreclosing parties need not search out and notify other secured parties; rather, other secured parties must search out and notify potential foreclosing parties.

a. Notice to Junior Parties

When applied to foreclosures by senior parties, the 1972 amendment seems reasonable. From a practical perspective, requiring a senior party to go through the motions of searching for subordinate parties often was a meaningless gesture, because the likelihood was slim that such subordinate parties would receive any proceeds from the senior sale. Secured parties are often undercollateralized. Satisfaction of the senior interest therefore often depletes the sale proceeds, leaving nothing for the junior party. In the words of the drafters, “there would seldom be a junior secured party who really had an interest needing protection.” Consequently, any burden on the senior party, including a search requirement, seemed unreasonable.

The search requirement of the 1962 rule seemed especially objectionable to senior parties with purchase money security interests in equipment. These parties complained that while the Code granted them special priority without requiring a search of the records at the inception of the transaction, section 9-504(3) lumped them together with all other secured parties in imposing a search requirement at the time of foreclosure. As one 1972 drafter explained, “there were strong complaints by holders of purchase money security interests with priority on equipment. . . . We eliminated the notice requirement because these purchase money security interests on equipment are probably the most numerous single category of Article 9 transactions.”

---

37. U.C.C. § 9-107 provides:
A security interest is a “purchase money security interest” to the extent that it is (a) taken or retained by the seller of the collateral to secure all or part of its price; or (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.
38. Memorandum from Homer Kripke to Members of the Permanent Editorial Board for
b. Notice to Senior Parties

The 1972 notice rule seems reasonable when applied to sales by senior secured parties, it produces troublesome results when applied to sales by junior secured parties. In application, the 1972 rule means that a secured party will receive notice of a sale only if that party was previously aware of the interest of the foreclosing party. Senior parties, however, may often be unaware of junior interests in the collateral because their priority does not depend on the identification of such interests. 39 Senior parties thus may not have sent notice of their interest to junior parties, and therefore will not receive notice of a junior foreclosure. Senior parties with either ordinary security interests or purchase money security interests in equipment are the most likely to be unaware of junior interests. The Code priority rules account for their ignorance.

Generally, the Code gives priority to the first to file or perfect a security interest. 40 In the case of an ordinary perfected security interest in inventory or equipment, the senior party’s priority stems from its first filing. This party has no reason to search the records subsequent to filing, since its priority does not depend on identification of subsequently filed security interests. Thus, parties whose priority stems from a first filing may be unaware of junior interests in the same collateral.

The Code also gives priority to a purchase money security interest in equipment (or other non-inventory collateral). 41 Such a security interest outranks a conflicting ordinary security interest with an after-acquired property clause. The Code imposes no notice requirement on the purchase money secured party, i.e., the secured party’s priority is

---

39. The senior party may receive notice, however, pursuant to the terms of the security agreement. For example, the senior security agreement may require the debtor to notify the senior party immediately upon receipt of any notice of foreclosure against the collateral. If a debtor failed to meet this duty, a senior party might have a claim against the debtor for resulting damages. The value of such a claim, however, is questionable given the debtor’s precarious financial condition which probably prompted its default. Similarly, a senior party may have insisted upon a clause in the security agreement which forces any junior secured party to obtain the senior’s consent before foreclosing. The validity of such agreements is recognized by the broad language of U.C.C. § 9-201 (1978).

40. See U.C.C. § 9-312(5)(a) (1978). The first-to-file rule means simply that the first secured party to file a financing statement or perfect the security interest has priority over other secured parties. The primary exception to the first-to-file rule is the purchase money security interest, which is given special priority under §§ 9-312(3) and 9-312(4). U.C.C. §§ 9-312(3)-(4) (1978). For a more detailed explanation of the first-to-file rule, see B. CLARK, supra note 11.

41. See U.C.C. § 9-312(4) (1978). This priority depends on perfection of the purchase money security interest at the time the debtor receives possession or within ten days thereafter.
not contingent on its notice to any secured parties it subordinates. Consequently, a purchase money secured party might reasonably rely on its purchase money priority without checking the records for any ordinary security interest necessarily junior to its own. These secured parties may therefore be unaware of the existence of junior interests in the same collateral.\textsuperscript{42}

Interestingly, the 1972 drafters seem to have overlooked the possibility that a senior secured party might not receive notice of a junior party’s sale. The drafters’ explanation for the 1972 amendment to section 9-504(3) focuses exclusively on the value of notice to a junior secured party, suggesting a failure to consider sales by a junior party.\textsuperscript{43} In fact, this oversight has recently been frankly acknowledged.\textsuperscript{44}

Despite the drafters’ lack of intent to do so, the practical effect of the 1972 Code revision is to impose new and onerous burdens on senior parties when a junior party forecloses. In order to ensure notice of a junior party’s foreclosure, senior parties must check the records—not once, but habitually—in search of new subordinate security interests. Such a duty of constant policing defeats one goal of the filing system, which is to eliminate the need for subsequent checking once a security interest is recorded. Unless the senior party meets its burden of constant diligence, it might not be informed of an impending sale and might thus be deprived of an opportunity to intervene.\textsuperscript{45} The problem of the uninformed senior secured party is exacerbated by the provisions of section 9-504(1) directing distribution of the proceeds of sale.

\textsuperscript{42} The same problem does not occur in cases of a general inventory security interest and one or more conflicting inventory purchase money security interests. In these cases, each secured party should be aware of the other because the Code hinges purchase money priority on notice to conflicting interest holders. The priority rules thus ensure that a senior secured party will be aware of a junior interest. See U.C.C. § 9-312(3) (1978).

\textsuperscript{43} The drafters explained the change as follows: “These burdens of searching the record and of checking the secured party’s files were greater than the circumstances called for because as a practical matter there would seldom be a junior secured party who really had an interest needing protection in the case of a foreclosure sale.” U.C.C. § 9-504 app. (1972) (Official Statement for Reasons for 1972 Changes in Official Text).

\textsuperscript{44} “[W]e did not deliberately, by knocking out the requirement of notice to parties of record, intend to delete a notice from a junior party to a senior secured party that the junior was foreclosing. To be frank about it, we never thought about this problem of juniors foreclosing.” Memorandum of Homer Kripke, supra note 38. In fairness to the 1972 drafters, there were few, if any, significant pre-1972 cases involving junior foreclosures.

\textsuperscript{45} See infra notes 136-38 and accompanying text for a discussion of the ways in which an informed senior secured party could intervene to protect its interests.
2. Distribution of Proceeds of Sale

The earliest drafts of the Code directed that default sale proceeds should be applied to reasonable expenses of sale, and then to "the indebtedness." The debtor was entitled to any surplus and was liable for any deficiency. The September 1950 revisions replaced this simple rule with the following explicit order of distribution: (1) reasonable expenses of sale; (2) satisfaction of any senior security interest or lien; (3) satisfaction of the foreclosing party's security interest; and (4) satisfaction of any subordinate security interest. As in earlier drafts, the debtor was entitled to any surplus and liable for any deficiency.

Interestingly, the final draft proposed in the Spring of 1951 mysteriously deleted the senior secured party from the list of those entitled to share in sale proceeds. The 1951 draft stated the following order of distribution: (1) reasonable expenses of sale; (2) satisfaction of fore-

46. See U.C.C. § 8-604(1) (Sept. 1949 Draft) which stated:
A secured lender may realize on his collateral by selling any or all of it (as is or following preparation) and after application of the proceeds of sale to the reasonable expenses of retaking, holding, preparing for sale and selling and to the satisfaction of the indebtedness, he has a right to any deficiency but must account to the borrower for any surplus.

See also U.C.C. § 9-504(1) (Spring 1950 Proposed Final Draft) which provided:
A secured lender may realize on his collateral by selling any or all of it in its then condition or following any commercially reasonable preparation or processing. After application of the proceeds of sale to reasonable expenses of retaking, holding, preparing for sale and selling and to satisfaction of the indebtedness, he has a right to any deficiency but must account to the debtor for any surplus.

47. See supra note 46.

48. U.C.C. § 9-504(1)(a) (Sept. 1950 Revision) provided that proceeds should be applied to "the reasonable expenses of retaking, holding, preparing for sale, selling and the like to the extent the recovery thereof is not prohibited by law or agreement."

49. U.C.C. § 9-504(1)(b) (Sept. 1950 revision) stated that proceeds should be applied to the satisfaction of indebtedness secured by any security interest or lien having priority over the security interest under which the disposition is made unless with the consent of the owner of such prior interest or lien the disposition is made specifically subject thereto or unless such owner refuses to accept such proceeds.

50. U.C.C. § 9-504(1)(c) (Sept. 1950 Revision) provided that proceeds should be applied to "the satisfaction of indebtedness secured by the security interest under which the disposition is made."

51. U.C.C. § 9-504(1)(d) (Sept. 1950 Revision) provided that proceeds should be applied to "the satisfaction of indebtedness secured by any subordinate security interest in the collateral if written notification of demand therefor is received before distribution of the proceeds is completed."

52. The last sentence of U.C.C. § 9-504(1) (Sept. 1950 Revision) provided: "The secured lender must account to the debtor for any surplus, and, unless otherwise agreed, the debtor is liable for any deficiency."
closing party's security interest; and (3) satisfaction of any subordinate security interest.\(^{58}\)

The 1952 official draft of section 9-504(1) also made no provision for a senior secured party to recover sale proceeds.\(^{64}\) The failure of the 1952 draft to protect the interest of a senior secured party did not go unnoticed. During the 1954 hearings of the New York Law Revision Commission, a bank objected that "[a] further source of controversy and difficulty may be noted in that the provisions regarding application of excess proceeds speak only of subordinate security interests, not of equal or prior security interests."\(^{68}\) In their 1955 report, the Commission responded that "[a]pparently, disposal by a subordinate secured party will be subject to the senior secured party."\(^{68}\) The Commission's reasoning seemed to be that, unlike a subordinate interest which is discharged by sale, a senior interest survives sale and thus gives a senior party a post-sale interest in the collateral. Arguably, a senior party therefore is adequately protected after sale, and should not be forced to take an early pay-out on what may be a satisfactory investment.\(^{67}\) In contrast, because a junior security interest is discharged by the sale, that party's recovery against the collateral depends on its ability to claim sale proceeds. Indeed, the drafters explained the subordinate secured party's right to proceeds by citing the discharge of that party's interest.\(^{88}\)

The section 9-504 proceeds distribution rules of the 1958, 1962...
and 1972 official texts closely approximate the 1952 scheme. None of these texts requires or authorizes a selling junior party to turn over sale proceeds to a senior party. The earliest drafts of section 9-504 make clear that the failure to include any provision entitling a senior secured party to sale proceeds was intentional.

In addition to the history of section 9-504, the text itself suggests that the drafters intended to preclude senior secured parties from taking sale proceeds. Section 9-504(1) clearly specifies that only "subordinate security interests" are entitled to proceeds. Use of the word "subordinate" in section 9-504(1) suggests an effort to distinguish interests that are non-subordinate, i.e., senior interests. In fact, the specificity of the order of distribution suggests not only that a junior party has no obligation to turn over foreclosure proceeds to a senior party, but that the junior is affirmatively prohibited from doing so.

No other Code provision explicitly requires or permits a junior party to share or to pay over foreclosure proceeds to a senior party. The senior secured party, however, is not left totally without recourse; its remedy, as the New York Commission suggested, lies against the collateral in possession of the foreclosure sale purchaser.

C. Section 9-504 Postmortem—Remedy for a Disappointed Senior Secured Party

The harsh effects of section 9-504 on uninformed senior secured parties are somewhat ameliorated by section 9-306. Subsection (2) of that section generally recognizes a secured party's post-sale interest in

59. Each of these texts improves upon the 1952 provision by (1) specifying that reasonable attorneys' fees and legal expenses may be reasonable expenses of sale (9-504(1)(a)); and (2) authorizing a foreclosing party to demand reasonable proof of a subordinate security interest (9-504(1)(c)).

60. This conclusion draws upon the rule of statutory construction: "expressio unius est exclusio alterius"—the mention of one thing implies the exclusion of the other.

61. See Letter from William D. Hawkland to Homer Kripke (June 20, 1989) (the Detroit College of Law Library) ("9-504 mandates an order of distribution that does not require (or even permit) a junior secured party to account to a senior secured party with respect to foreclosure proceeds . . . .") At least one court has held that a foreclosing secured party may not voluntarily share proceeds with a senior secured party, as to do so would injure guarantors of the debt being foreclosed. First Union Nat'l Bank v. Tectamar, Inc., 33 N.C. App. 604, 235 S.E.2d 894 (1977). But cf. Consolidated Equip. Sales v. First Bank & Trust, 627 P.2d 432 (Okla. 1981) (holding that a junior party is liable for conversion if it fails to share proceeds with a senior party). On this latter point, see infra notes 98-100 and accompanying text.

62. See infra notes 108-20 and accompanying text for an argument that other Code sections, especially § 9-306(2), require a junior secured party to account to the senior party.
both the collateral and the identifiable proceeds of sale. Section 9-306(2) states:

Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the agreement or otherwise and continues in any identifiable proceeds including collections received by a debtor.

1: A Right to the Collateral

Section 9-306(2) clearly indicates that unless the senior party authorizes the sale, its interest follows the collateral into the hands of the foreclosure sale purchaser. Thus, the senior has a post-sale claim to the collateral. If the purchaser were unable or unwilling to surrender the collateral, it would be liable to the senior party for conversion.

Nothing in section 9-504 suggests an intent to alter the collateral rule of 9-306(2). Subsection (4) of 9-504 states that disposal of collateral by a secured party after default "transfers to a purchaser for value all of the debtor's rights therein, discharges the security interest under which it is made and any security interest or lien subordinate thereto." This section explicitly discharges only two types of security interests: (1) the interest of the party conducting the sale, and (2) any subordinate security interests. The specificity of the drafters demonstrates an intent to leave intact non-subordinate, i.e., senior security interests. Thus, these security interests would continue in the collateral as contemplated by 9-306(2).

Section 9-306(2) also could be interpreted to give a senior secured party an interest in sale proceeds collected by a junior secured party.

63. U.C.C. § 9-306(2) (1978). The words "other disposition" seem to include an involuntary transfer, such as a foreclosure. For a discussion of § 9-306(2) and other Code provisions supporting the view that a security interest continues in the collateral after an involuntary transfer, see Sortor, Involuntary Transfers Under U.C.C. Section 9-311, 39 Sw. L.J. 709, 730-33 (1985).

64. See U.C.C. § 9-306 comment 3 (1978): ("Since the transferee takes subject to the security interest, the secured party may repossess the collateral from him or in an appropriate case maintain an action for conversion."). See also R. Hillman, J. McDonnell & S. Nickels, Common Law and Equity Under the Uniform Commercial Code § 25.02[4][c] (1985).

The secured party, however, cannot sue the purchaser on the debt, since the purchaser does not incur the debtor's obligation to repay the debt. See R. Hillman, J. McDonnell & S. Nickels, supra note 64, at ¶ 25.01[a][b].


66. This inference finds support in the rule of statutory construction: "expressio unius est exclusio alterius" — the mention of one thing implies the exclusion of the other.
This possibility is discussed in Part III.B. of this Article. It is worth noting at this point, however, that such a reading of section 9-306(2) would conflict with the specific order of distribution in section 9-504(1), which omits a senior party from its list of those entitled to sale proceeds. Given the specificity of section 9-504(1), this section would seem to trump the more general rule of 9-306(2).67 In addition, the text of section 9-306(2) speaks only to proceeds “received by a debtor,” not to those received by a junior secured party.

2. A Hypothetical

A simple example illustrates the curious and precarious position in which the Code leaves a senior secured party after an undisclosed foreclosure by a junior party. Suppose that Bank loans debtor $50,000 and takes an ordinary security interest in debtor’s equipment, which is worth $100,000. Sometime thereafter, Finance Co. loans debtor $20,000 and takes an ordinary security interest in debtor’s $50,000 equity in the same collateral. Bank does not know of the security interest of Finance Co., as its priority did not depend on identification of any subsequent security interests. Debtor subsequently defaults on its obligation to Finance Co., which swiftly repossesses debtor’s equipment and sells it to X for $40,000 at a sale that is conducted in a commercially reasonable manner. With the proceeds, Finance Co. pays the sale costs (including fees to its attorney), applies $20,000 to satisfaction of its security interest, and, as there are no security interests subordinate to its own, returns the remaining funds to debtor. Soon thereafter, Bank contacts debtor who has also failed to make scheduled payments to Bank. Bank then learns that the collateral has been sold and the proceeds distributed without its knowledge.

Bank will probably be surprised to learn of the sale, and will be even more surprised to learn that the conduct of the junior secured party does not violate the Code. For the senior secured party crying “foul,” courts have suggested at least three possible answers: (1) preclude the junior party from selling the collateral; (2) give the senior party first priority in sale proceeds; or (3) leave the senior party to its remedy against the collateral. The efficacy of each answer should be examined in light of the Code’s goals and policies.

67. This conclusion follows from the rule of statutory construction “generalia specialibus non derogant”—general words do not derogate from the special.
II. GOALS AND POLICY CONCERNS

The Code's underlying purposes and policies are "(a) to simplify, clarify and modernize the law governing commercial transactions; (b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties; (c) to make uniform the law among the various jurisdictions." The specific goal of Article 9 is to provide a simple and unified structure for secured transactions which maximizes efficiency and certainty. Article 9 promotes these goals in part by authorizing and facilitating access to information by those who have a legitimate need for it. Certainty and efficiency also are promoted by the Code's simple first-to-file rule, which rewards the diligent and clarifies the rights of concerned parties. Article 9 further reflects a policy favoring the free alienability of property rights.

The policies of the Code, and of Article 9 in particular, suggest five concerns which should direct an analysis of junior party foreclosures. First, a simple and clear rule should be adopted that will provide the certainty and uniformity lacking under current law. Such a rule should enable a secured party to ascertain its rights readily in reference to other secured parties. Second, the expansion of commercial practices should be encouraged by avoiding any rule that would be inimical to secondary financing. Third, the general Code preference for the first to file should be honored. Fourth, economic efficiency should be encouraged by adopting procedures likely to maximize the price on resale of collateral and minimize the parties' transaction costs. Fifth, the free alienability of property should be respected by precluding any party from unilaterally vetoing transfer of the collateral. The resolutions of-

68. U.C.C. § 1-102 (1978). Comment 1 to this section suggests that "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." U.C.C. § 1-102 comment 1 (1978).

69. The official comment to U.C.C. § 9-101 provides in part: "The aim of this Article is to provide a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward with less cost and with greater certainty." U.C.C. § 9-101 Official Comment (1978).

70. See Sortor, supra note 63, at 719, citing U.C.C. § 9-208 (1978) (allowing debtor to obtain information from secured party regarding the amount of the debt and collateral) and U.C.C. § 9-402 (1978) (requiring financing statement to contain specified information).

71. See supra note 40 for a brief discussion of the first-to-file rule.

72. See Sortor, supra note 63, at 719. E.g., U.C.C. § 9-311 (1978) (authorizing debtors to transfer their rights in collateral notwithstanding provision in security agreement prohibiting such transfer).
ferred by various courts, together with those proposed by legal commentators, will be analyzed with a view to their tendency to further or inhibit these goals.

III. Possible Solutions

Courts have responded to junior foreclosures in an uncertain and unsatisfactory fashion. Judges tend to deal with the problem in one of three ways: (1) by prohibiting junior party foreclosures; (2) by distributing junior sale proceeds to senior parties; or (3) by leaving senior parties to their remedy against the collateral.

A. Prohibiting Junior Party Foreclosures

One way to deal with the problem of junior party foreclosures is simply to prohibit them. This approach may take one of two forms: (1) the sale itself may be proscribed, via pre-sale judicial disapproval or post-sale sanction against a selling junior party; or (2) the sale itself may be authorized, but a junior party's position as seller may effectively be preempted by a senior party who begins foreclosure of its own interest.

1. Prohibition of Sale (The No-Sale Option)

A few courts have taken the rather drastic position that a junior party lacks authority to sell the collateral upon a debtor's default. In *Roemer & Zeller v. Ace Transmission Center*73 ("Roemer-1"), a junior secured party sought judicial authority to replevy collateral that was in the possession of a defaulting debtor. A senior creditor intervened in opposition, arguing that replevin by the junior creditor would prejudice its rights and interests. Finding no statutory authorization for sales by junior parties, the court denied the junior party's request. In explanation, the court observed that the order of distribution in section 9-504 "does not even contemplate the situation where a party with a..."
subordinate security interest can dispose of the collateral over the objections of a creditor with a prior security interest.\textsuperscript{74}

The reasoning of the court in \textit{Roemer-1} is troublesome. In its haste to consult the proceeds distribution scheme of section 9-504(1), the court overlooked the basic tenet of that section authorizing a secured party to sell collateral upon a debtor’s default.\textsuperscript{75} Section 9-504(1) does not condition a secured party’s right to sell on a showing of superior priority. Neither is a secured party’s right to repossess the collateral under section 9-503\textsuperscript{76} conditioned on its superior priority.\textsuperscript{77} Unfortunately, the court failed to explain the impact of these crucial provisions. Soon after \textit{Roemer-1} was decided, it was, in effect, abandoned by the same court, which came down with a different though equally troublesome theory in \textit{Roemer-2}.\textsuperscript{78}

As a solution to the problem, the prohibition of junior party foreclosures suffers from an initial practical limitation—it requires that some form of affirmative action be taken to stop the sale. Unless the junior party seeks judicial authority to act, as in \textit{Roemer-1}, the sale could be avoided only by intervention of the senior party. Yet the senior party may be unaware of the proposed sale.\textsuperscript{79} This roadblock, of course, could be circumvented simply by ensuring that a junior party notify a senior party prior to sale.\textsuperscript{80} Alternatively, a junior secured party could be penalized after the fact of sale. For example, a few courts have taken the dubious view that a foreclosing junior party is guilty of converting the collateral.

Such was the approach taken by the court in \textit{Chadron Energy Corp. v. First Nat’l Bank.}\textsuperscript{81} In \textit{Chadron}, a bank holding company formed by borrowers to acquire bank stock sued the secured lender who had sold the stock. After finding that the lender held only a junior interest due to a novation, the court reached the startling conclusion that

\textsuperscript{74} \textit{Roemer-1}, 451 N.Y.S.2d at 603.
\textsuperscript{75} The first sentence of § 9-504(1) states: “A secured party after default may sell, lease or otherwise dispose of any or all of the collateral in its then condition or following any commercially reasonable preparation or processing.” \textit{U.C.C. § 9-504(1) (1978).}
\textsuperscript{76} For the text of \textit{U.C.C. § 9-503} see \textit{supra} note 16.
\textsuperscript{77} This is not necessarily to say that § 9-503 authorizes a junior party to retain possession if a senior party seeks to repossess and sell the collateral itself. \textit{See infra notes} 87-97 and accompanying text.
\textsuperscript{78} \textit{See infra} notes 101-04 and accompanying text.
\textsuperscript{79} \textit{See supra} notes 39-45 and accompanying text.
\textsuperscript{80} \textit{See infra} notes 141-64 and accompanying text.
the lender’s sale of the stock constituted a conversion. As in Roemer-1, the court failed to explain the impact of sections 9-503 and 9-504(1), which generally give a secured party authority to repossess and sell the collateral upon a debtor’s default.

Courts would be required to undertake a major reconstruction of the law before they could legitimately hold that a party who has a valid security interest cannot enforce it and would be guilty of conversion if it did so. Even if the junior creditor somehow acted improperly in disposing of the collateral, its liability for conversion should depend on some demonstrated harm to the senior secured party. Arguably, the act of sale does not in itself establish such harm, as the senior party’s interest continues in the collateral after sale, thus giving the senior party a right to repossess the collateral from the purchaser.

The prohibition of junior party foreclosures, by either pre-sale disapproval or post-sale sanction, clearly contravenes sections 9-503 and 9-504. In addition, this approach raises serious policy concerns. Giving the senior party a unilateral right to prevent transfer of the collateral would disrupt the general Code scheme of free alienability of property and would contravene the directive of section 9-311 that the debtor’s rights in collateral may be voluntarily or involuntarily transferred. Conferring a virtual veto power on the senior party would do much to protect its interests, but would completely ignore the interests of the junior party. This myopic approach would disadvantage a junior party so severely that the future of secondary financing might be jeopardized.

82. The court thought this conclusion was “clear, beyond reason.” In support, the court reasoned: “Where property is subject to a security interest, an exercise of dominion or control over the property which is inconsistent with the rights of the secured party, constitutes, as to him, a conversion of the property; and there may be conversion by [a] secured party where his acts are in defiance of the rights of others in the property.” 379 N.W.2d at 750 (quoting Trust Co. v. Associated Grocers Co-op, 152 Ga. App. 701, 702, 263 S.E.2d 676, 677 (1979)).

83. See R. Hillman, J. McDonnell & S. Nickels, supra note 64, ¶ 25.02[5][a].

84. For a discussion of the senior party’s post-sale rights in the collateral see infra notes 124-40 and accompanying text.

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

86. Speaking to the somewhat less drastic option of requiring a junior party to turn over sale proceeds to a senior party, Homer Kripke observed, “If SP2 had to turn his sale proceeds over to SPI he would have so little control of his investment that as a practical matter there would never be an SP2 who took junior security on a commercial basis instead of just grabbing what he could in a salvage situation. Who among us has the wisdom to decide that it is in the public
2. Preemption of Junior Party (The Senior Sale Option)

At least one court has applied a variation of the prohibition approach which honors the Code policy of free alienability of property while recognizing the interests of both secured parties. In *American Heritage & Trust Co. v. O&E, Inc.*, a Colorado court approved a senior party's repossession of collateral from a junior party who had taken it from a defaulting debtor. The court further directed the senior party to sell the collateral and to give the junior party any proceeds remaining after payment of the costs of sale and satisfaction of the senior interest. This approach, in effect, allows the senior party to preempt the junior party.

A preemption alternative raises one foundational concern. Unless the debtor is in default on the senior loan as in *American Heritage*, the Code does not seem to authorize foreclosure by the senior party. Sections 9-503 and 9-504(1) both premise a secured party's right to repossession and sell the collateral on the debtor's default. To interpret these sections to authorize a secured party to foreclose its interest when the debtor has defaulted on an unrelated obligation would twist the plain meaning of the text.

The necessity of establishing a default as to the senior interest may actually be little more than a theoretical concern. The likelihood that a debtor will default on one debt but continue to make payments on another seems remote. In addition, security agreements very often provide that the creation or foreclosure of a junior interest constitutes an event of default as to the senior interest.

Interest to discourage secondary financing for the vast investment in new types of assets in our great new world—fleets of airplanes, ships, specialized railroad cars, and automobiles; nuclear fuel; computer hardware and software; cat scan machines and other medical and biological wizardry; instruments for sending long and short radio, TV, and energy waves, etc.?" Letter from Homer Kripke to William Hawkland (Apr. 3, 1989) (on file at Detroit College of Law Library). See also infra notes 98-123 and accompanying text.


88. In *American Heritage*, the junior and senior parties both held security interests in a debtor's inventory, stock in trade, furniture, fixtures and equipment of a wine shop. When the debtors defaulted on both loans, the junior secured party took over the debtor's assets and began operating the business. Sometime thereafter, the senior secured party replevied the collateral pursuant to writ 576 P.2d at 567. It is troublesome to note the absence of any indication in the opinion that the senior party sought to sell the collateral.

89. In the extraordinary case in which a debtor has not defaulted on the senior interest, a court could authorize a senior party to step in and conduct the junior sale on behalf of the junior party. This stand-in option seems unsatisfactory since a senior party who would not share in sale proceeds would have little incentive to minimize sale costs and maximize purchase price. Code goals of economic efficiency would thus be compromised. The better approach would be to limit
An additional concern is the absence of any explicit Code provision empowering a senior party effectively to halt a junior party foreclosure.\textsuperscript{90} The ability of the court in \textit{American Heritage} to supplant the junior party stemmed from that party's violation of the default rules of Part 5 of Article 9.\textsuperscript{91} The junior party's violation triggered section 9-507(1), which provides that if a "secured party is not proceeding in accordance with the provisions of this Part, disposition may be ordered or restrained on appropriate terms and conditions."\textsuperscript{92} Apparently, it was this violation that enabled the court to take the "appropriate" action, under section 9-507(1) of authorizing the senior party to sell the collateral. Absent a junior party's violation of the default rules, a senior party's right to preempt a junior party depends on implicit rather than explicit Code authorization.

The priority rules of section 9-312 do not explicitly establish a senior party's right to repossess collateral from a junior party. These rules speak only to the question of whether a party has priority, leaving open issues of the privileges of priority.

At least one other Code section has been suggested as support for a senior party's right to foreclose its own interest after a junior party has repossessed the collateral.\textsuperscript{93} Section 9-201 states: "Except as otherwise provided by this Act, a security agreement is effective according to its terms . . . ."\textsuperscript{94} The comment to section 9-201 recognizes an exception to this broad rule in cases where Article 9 subordinates a party's security interest to that of another secured party. Arguably, "the terms of a junior secured party's security agreement, including his right to possession of the collateral on the debtor's default, are ineffectice against another secured party whose interest is given priority under Article 9."\textsuperscript{95} Thus, if the debtor has defaulted on the senior interest, a senior party could foreclose its interest by repossessing the collateral.

\textsuperscript{90} The absence of clear Code direction is noted in J. \textsc{White} & R. \textsc{Summers}, \textit{supra} note 9, § 25-9, where the authors observe: "It would appear (though the text is not wholly clear) that any such secured party senior to the foreclosing secured party is at least entitled to take over and control the conduct of the foreclosure proceedings."

\textsuperscript{91} In \textit{American Heritage}, the junior secured party failed to notify the senior party of its plan to operate a wine shop. 576 P.2d at 568. The failure violated the 1962 version of § 9-505(2) which required a secured party to provide written notice to other secured parties of its intent to retain the collateral.

\textsuperscript{92} U.C.C. § 9-507(1) (1978).

\textsuperscript{93} See R. \textsc{Hillman}, J. \textsc{McDonnell} & S. \textsc{Nickels}, \textit{supra} note 64, ¶ 25.02[2][c].

\textsuperscript{94} U.C.C. § 9-201 (1978).

\textsuperscript{95} R. \textsc{Hillman}, J. \textsc{McDonnell} & S. \textsc{Nickels}, \textit{supra} note 64, ¶ 25.02[2][c], at 25-56.
from the junior party and conducting its own sale. A junior party who refuses to surrender the collateral would be liable for conversion if its conduct seriously injured the senior party.96

Although explicit Code authorization for senior preemption is lacking, policy considerations support this alternative. Armchair equity suggests that if priority means anything, it means a paramount right to take the collateral from a defaulting debtor. If a senior party believes it would be in its best interest to foreclose, that party should not be prevented from doing so simply because a junior party rather than the debtor has the collateral.

In a well-ordered world, senior preemption should not compromise the junior party's ability to recover its interest. As long as bidders at a default sale are aware of both junior and senior interests, one would expect a junior sale to yield a smaller sale price than a senior sale, because the junior sale does not discharge the senior interest. Similarly, a senior sale should yield a higher purchase price because that sale discharges all subordinate security interests. Consequently, in practice, a junior party may have a similar chance of recovering its investment whether or not it conducts the sale.

The only real unfairness in allowing a senior party to preempt a junior party stems from the possibility that a senior party will delay in enforcing its rights. If at any time up until the instant of sale a word from the senior party could transform the junior sale into a senior sale, the junior party would be placed in a tenuous position. An eleventh hour ambush by the senior party could oust the junior party even after it had gone to the trouble of making all the sale arrangements. Thus, if a senior party is allowed to preempt the junior party, it should be required to do so within a reasonable time after receiving notice of a junior party's plan to sell the collateral.97 Timely notice to the senior party clearly would be an essential part of such a rule.

B. Distributing Proceeds to Senior Parties

Other courts facing the problem of junior foreclosures have held that although the Code does not preclude the junior party from selling the collateral, the junior party must account to the senior party for sale

---

96. See id. ¶ 25.02[5]a (citing RESTATEMENT (SECOND) OF TORTS § 229 (1965)).
97. See Byrne, Murphy & Vukovich, supra note 6, at 1927 (suggesting that a senior party should have 14 days to act, either to cure the debtor's default, to negotiate with the junior party, or to conduct the sale itself).
proceeds. Indeed, a junior party who fails to do so may be guilty of conversion.

In *Consolidated Equip. Sales v. First Bank & Trust,*\(^98\) for example, a junior secured party had repossessed and sold a wheel loader after the debtor defaulted on the junior loan. A bank with a senior security interest in the same wheel loader subsequently sued the junior party for conversion. The court correctly noted that section 9-503 gave the junior party a right to repossess the wheel loader since first priority status is not a prerequisite to repossession. However, the court further reasoned that upon sale of the collateral, the junior party was required to relinquish the proceeds to the senior party; the junior party’s failure to do so constituted a conversion.\(^99\) Unfortunately, the court failed to address the priority distribution scheme of section 9-504(1), which neither requires nor permits a foreclosing junior party to share proceeds with a senior party.\(^100\)

Similarly, in *Roemer & Zeller v. Ace Transmission Center*\(^101\) (hereinafter referred to as *Roemer-2*), a New York court concluded that a senior party had no power under the Code to prevent the junior party’s sale of the collateral.\(^102\) The court casually observed, however, that “[o]f course the senior secured party’s lien would still have priority over that of the junior secured party with regard to the proceeds of any

---

98. 627 P.2d 432 (Okla. 1981). In this case, McBride purchased a wheel loader from Consolidated in November 1973 for $50,619.00. Consolidated took a security interest in the wheel loader but did not qualify for purchase money priority because of failure to timely file a financing statement. Earlier that year, Bank had taken a security interest in all of McBride’s equipment “now owned [or] hereinafter acquired.” Id. at 434. Shortly after McBride declared bankruptcy in 1975, Consolidated took the wheel loader, leased it for six months, and timely sold it for $28,400.00. Meanwhile, Bank sued McBride on defaulted notes and won an $84,000.00 judgment against him. Shortly thereafter, McBride personally guaranteed payment to Bank and assigned to Bank his interest in the wheel loader. Id.

99. Id. at 438. The court did not detail the junior party’s sale. The opinion does not indicate whether the purchaser at foreclosure knew the collateral was subject to a senior security interest which would continue after sale. It is not clear whether sale proceeds were appropriate in amount for a sale subject to a senior interest.

100. As authority for its finding of conversion, the court cited, without discussion, the priority rule of § 9-312(5)(a), and the proceeds rule of § 9-306(2). *Id.* See infra notes 108-15 and accompanying text. As authority for its award of conversion damages against Consolidated, the court cited “failure to comply with the default procedures of § 9-501 *et seq.*, which brings into play § 9-507(1).” 627 P.2d at 438.


102. The court explained that it found “no indication that any particular creditor may unilaterally prevent seizure of a debtor’s assets solely as an incident of the status of the preferred party.” 454 N.Y.S.2d at 378.
The court gave no explanation and cited no authority for this assertion. Other courts have reached the same ultimate conclusion on equally dubious grounds.

The shared proceeds approach has some intuitive appeal. Requiring a junior party to account to a senior party would honor the Code rules on free alienability of property, the junior party's right to dispose of the collateral, and the senior party's first priority. Closer examination, however, reveals serious shortcomings in this option.

Initially, it lacks Code authority. Giving a senior party first priority in default sale proceeds conflicts with the specific order of distribution detailed in section 9-504(1). That section does not include a senior secured party among those entitled to share in default sale proceeds. The clear direction of section 9-504(1), however, does not pose an obstacle to courts determined to require an accounting. For example, in Stotts v. Johnson, an Arkansas court recently confronted a case involving a junior party's repossession and sale of a trailer. The court candidly conceded that Article 9 does not give a senior party a right to sale proceeds, but reasoned that "the plain meaning and logical implications of sections such as 9-306 and 9-504 may be preempted by a pervasive spirit of priority that supports giving a senior secured party a claim to the proceeds ..." While the court's identification of relevant Code sections is an improvement over decisions by other courts, its...

---

103. Id.
104. See, e.g., Bank of Danville v. Farmers Nat'l Bank, 602 S.W.2d 160 (Ky. 1980) (because security interest was inferior to that of Danville, Farmers not entitled to participate in proceeds of tobacco crop until Danville has been fully satisfied); American Fin. Corp. v. Computer Sciences Corp., 558 F. Supp. 182 (D. Del. 1983) (junior secured party can levy over objection of senior secured party, but proceeds of sale must be distributed according to priority rules).

Not all courts have required a junior secured party to account to a senior party for sale proceeds. See United States v. Coohan, 55,154 (E.D.N.C. February 9, 1990). In Coohan, a bank which held a junior security interest repossessed and sold a bulldozer from a defaulting farmer. The Farmers Home Administration, which held a senior security interest, claimed proceeds of sale. The court denied the FHA's claim, explaining that the proceeds rule of § 9-306(2) applies only where proceeds are received by a debtor and observing that the FHA had recourse against the collateral. See also Continental Bank v. Krebs, 184 III. App. 3d 693, 540 N.E.2d 1023 (1989). In Krebs, a junior creditor repossessed and sold an automobile upon the debtor's default. Plaintiff, claiming to be a senior secured party, then sought a share of sale proceeds. The court specifically rejected the argument that § 9-503 authorizes only senior secured parties to repossess collateral, and further determined that a senior secured party has no right to proceeds from a junior sale.

105. See supra notes 46-61 and accompanying text.
107. 791 S.W.2d at 351.
willingness to disregard those sections in favor of a “spirit” of priority is troubling.

No other Code section requires or authorizes a junior party to account to a senior party for sale proceeds. The Code’s general priority rules do not require such an accounting. Those rules speak only to the issue of who has priority and not to the separate issue of the privileges of priority.

At first blush, the proceeds rule of section 9-306(2) seems implicitly to require a junior party to account to a senior party. That section essentially provides that a security interest “continues in any identifiable proceeds, including collections received by a debtor.”\(^{108}\) The text seems to condition continuation of the security interest on the debtor’s receipt of proceeds.\(^{109}\) The dispositive question, of course, is whether “received by the debtor” modifies “proceeds” or only “collections.” If a senior party’s interest continues only in proceeds received by a debtor, section 9-306(2) will not aid a senior party hoping to collect proceeds received by a junior party.\(^{110}\)

The history of section 9-306 suggests an intent to address only the issue of proceeds that are received by a debtor. The 1952 official text of section 9-306 specified that “the security interest continues on any identifiable proceeds received by the debtor ....”\(^{111}\) The words “including collections” first appeared in the 1957 text,\(^{112}\) upon the recommendation of the Permanent Editorial Board.\(^{113}\) The purpose of the 1957 revision was not to alter existing law, but merely to “clarify” it.\(^{114}\) Thus, section 9-306 seems inapplicable to default sales, where a secured party rather than a debtor receives the proceeds. Not all courts, however, have adopted this restrictive interpretation of section 9-306(2).\(^{115}\)

108. U.C.C. § 9-306(2) (1978) provides: “Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange, or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.”

109. For a helpful discussion of this issue, see R. Hillman, J. McDonnell & S. Nickels, supra note 64, ¶ 25.02[4][b].

110. Any surplus proceeds paid to a debtor could be reached under this interpretation of § 9-306(2).


114. Id.

115. For a comprehensive discussion of recent cases addressing this issue, see E. Reiley.
To eliminate the tension between sections 9-504(1) and 9-306(2), William Hawkland recently drafted two amendments to the official Uniform Commercial Code in Louisiana. First, “receipts” was substituted for “proceeds” in the last line of section 9-504(1).116 Second, section 9-306(1) was amended by adding the following sentence: “‘Proceeds’ includes whatever is received upon the sale, exchange, collection, or other disposition of collateral or proceeds but does not include receipts that are derived from the disposition of collateral by a secured party by way of public or private sale under R.S. 10:9-504 or by judicial sale pursuant to applicable law.”117 These two simple alterations should make it clear that the proceeds rule of section 9-306 does not entitle a senior party to receipts of a junior party’s default sale.

At least two other Code sections might be interpreted to support a senior party’s claim to proceeds of a junior sale. Either interpretation, however, is very tenuous. Section 9-507(1) makes a foreclosing party liable to other secured parties for any loss caused by failure to comply with the rules of Part 5 of Article 9.118 This section does not exclude senior parties, and thus implies that a senior party, like other secured parties, has a stake in the outcome of the sale, i.e., a claim to sale proceeds. This conclusion, however, does not mean that the senior party has a prior claim to sale proceeds. The senior party’s claim to any surplus received by the debtor would be sufficient to give it a stake in the outcome of the sale.

Similarly, sections 9-312(3) and (4) could be interpreted to support a senior party’s claim to sale proceeds.119 Subsection (3) essentially provides that a purchase money security interest in inventory also has priority in identifiable cash proceeds under certain circumstances. Subsection (4) gives a purchase money security interest in collateral other than inventory priority in proceeds if the interest is perfected at the time the debtor takes possession of the collateral or within ten days.

---

118. This argument is presented and wisely rejected in R. Hillman, J. McDonnell & S. Nickels, supra note 64, ¶ 25.02[4][a] n.265. U.C.C. § 9-507(1) (1978) provides in pertinent part: “If the disposition has occurred the debtor or any person entitled to notification or whose security interest has been made known to the secured party prior to the disposition has a right to recover from the secured party any loss caused by a failure to comply with the provisions of this Part.”
119. This view is explained and rejected with appropriate speed in R. Hillman, J. McDonnell & S. Nickels, supra note 64.
thereafter. It is not clear, however, that the "proceeds" mentioned in section 9-312 include receipts from a section 9-504 sale.\textsuperscript{120} Indeed, interpreting section 9-312 to apply to default sales would produce a clear conflict between its provisions and the explicit provisions of section 9-504. This potential conflict suggests that the scope of section 9-312 does not extend to default sales.

In addition to the problem of the lack of Code authority, the shared proceeds approach raises serious policy concerns. Most importantly, it is inimical to secondary financing. If a junior party had to turn over sale proceeds to a senior party, the junior would have little control of its investment. Since parties are often undercollateralized, payment of proceeds to the senior party would likely deplete available funds. Yet, after sale the junior party would have no claim to the collateral because a default sale discharges all subordinate security interests.\textsuperscript{121} The junior party's inability to control its investment might well spell the demise of secondary financing. This consequence would have far-reaching implications.\textsuperscript{122}

Finally, as a practical matter, requiring a junior party to account for sale proceeds may not satisfy the senior party who might have preferred to foreclose on the collateral itself and control the conditions of sale in an effort to maximize sale price.\textsuperscript{123} The unfairness to the senior party is exacerbated if that party is uninformed of the sale.

\section*{C. Leaving Senior Parties to Their Remedies Against the Collateral}

Another way to deal with the issue of junior foreclosures is simply to leave the parties alone. Arguably, intervention is unnecessary because the 1972 Code adequately protects even an uninformed senior party. To the extent the debtor was personally liable on the senior interest prior to sale, the debtor is still liable. More importantly, the senior interest in the collateral continues after sale.\textsuperscript{124} This continuing in-

\begin{itemize}
\item \textsuperscript{120} See supra notes 108-15 and accompanying text for a discussion of whether "proceeds" as used in § 9-306 includes receipts of a foreclosure sale.
\item \textsuperscript{121} \textit{U.C.C.} § 9-504(4) (1978).
\item \textsuperscript{122} See supra note 86.
\item \textsuperscript{123} See Wechsler, \textit{Rights and Remedies of the Secured Party After an Unauthorized Transfer of Collateral: A Proposal for Balancing Competing Claims in Repossession, Resale, Proceeds, and Conversion Cases}, 32 \textit{Buffalo L. Rev.} 373, 390 (1983) ("Controlling the time, place and manner of the sale is a valuable attribute of the secured party's senior position."). The ability of the senior party to sell the collateral probably would depend on the debtor being in default as to the senior party. See supra notes 87-97 and accompanying text.
\item \textsuperscript{124} See \textit{U.C.C.} § 9-306(2) (1978).
\end{itemize}
Interest gives a senior party authority to repossess the collateral from the purchaser at the foreclosure sale, or if the purchaser is unwilling or unable to remit the collateral, to sue the purchaser for conversion. As a practical matter, the purchaser may agree to pay the senior debt in exchange for the senior party’s agreement to forebear from repossessing the collateral. The notion that the transfer of rights in collateral does not injure secured parties implicitly underscores the Code policy favoring free alienability of property rights. This view has been endorsed by some courts and commentators.

In some cases, however, the prospect of a junior foreclosure may distress a senior party. Generally, secured parties view repossession and sale as a “last resort, a desperate remedy to be avoided whenever possible.” A junior party foreclosure forces this last resort. The junior foreclosure may especially distress the senior party who is satisfied with the status quo. That senior party may have been receiving payments from a debtor either who had not defaulted on the senior loan, or with whom the senior party had chosen to negotiate a workout. The junior party’s foreclosure may force the senior party to take an early pay-out on what it considers to be a satisfactory investment.

Moreover, repossession of the collateral may diminish the debtor’s incentive to continue to pay the senior party, or may jeopardize the debtor’s ability to repay the senior loan. For a debtor in financial straits, repossession of inventory or equipment may be the final straw that causes collapse of the debtor’s business. In a worst-case scenario, loss of the collateral may force a commercial debtor into bankruptcy.

125. U.C.C. § 9-306, comment 3 (1978). In such cases, the senior party may also have an action for conversion against the junior creditor who “in essence, guarantees that the senior secured party’s priority over him will be vindicated.” R. Hillman, J. McDonnell & S. Nickels, supra note 64, ¶ 25.02[d], at 25-78.

126. See U.C.C. § 9-311 (1978), providing that the debtor’s rights in collateral may be voluntarily or involuntarily transferred. See also supra note 72.


128. See, e.g., J. White & R. Summers, supra note 9, ¶ 25-9. if the junior secured party conducts the sale, the interest of the senior secured party is protected since its security interest continues to attach to the collateral in possession of the purchaser).

129. G. Gilmore, supra note 10, ¶ 44.1, at 1214.

130. If the debtor has other personal assets, and especially if the senior party has interests in any other assets of the debtor, it is of course more likely that the debtor will continue to pay the senior party.
thus triggering an automatic stay, which would temporarily freeze enforcement of the senior security interest.\textsuperscript{131}

In addition to losing some of its leverage against the original debtor, the senior party may find itself undercollateralized if the collateral has reduced in value in the hands of the purchaser. The collateral, for example, may have limited value except when being used by the debtor in an ongoing business. The junior party's sale may also generate transaction costs for the senior party, including delay, inconvenience and expense in locating and retaking the collateral from a purchaser.\textsuperscript{132}

An analogy to real property is sometimes suggested in answer to these complaints.\textsuperscript{133} Real property law permits a junior mortgagee to sell its interests without affecting the interests of a senior mortgagee.\textsuperscript{134} Differences in real property and personal property, however, make this analogy unpersuasive. Unlike real property, personal property can be easily moved. This mobility, together with the speedy foreclosure process of the Code (as compared with the cumbersome procedures for sale of real property), may mean that by the time the senior party learns of the sale, the purchaser has moved the property to a new location or even a new jurisdiction. The senior party's costs will be even greater if there are several purchasers of multiple items. Moreover, in a worst case scenario, the senior party may encounter difficulty in locating the collateral, especially in states that do not require recording of a purchaser's identity.\textsuperscript{135} Given these important differences, rules adequate to protect a first mortgagee of real estate are likely to be inadequate in cases of personal property.

Most of the hardship inflicted upon a senior party by a junior fore-

\textsuperscript{131} See Bankruptcy Code § 362 (Bender, 1990). For a discussion of the automatic stay as it applies to security interests, see B. Clark, supra note 11, ¶ 6.08.

\textsuperscript{132} See Justice, Secured Parties and Judgment Creditors—The Courts and Section 9-311 of the Uniform Commercial Code, 30 Bus. Law. 433, 434 (1975).

\textsuperscript{133} For a persuasive criticism of the analogy of real property law to § 9-311, see Byrne, Murphy & Vukovich, supra note 6, at 1908-14.

\textit{See also Roemer-I} where the court rejected the junior party's argument that repossession and sale of personal property resembles a mortgage foreclosure proceeding in which a second mortgage may be foreclosed without regard to whether the first mortgage is in default. The court reasoned that the action of the second mortgage holder is specifically authorized by statute, unlike similar actions against personal property. 451 N.Y.S.2d 603 (1982) (citing N.Y. (Real Prop. Acts) § 1315 (West Consol. 1979)).


\textsuperscript{135} See Wechsler, supra note 123, at 396, \textit{citing} N.Y. CIV. PRAC. LAW § 5233(a) which does not require record keeping in sales by public auction.
closure could be avoided if a senior party were given notice of a junior party's plan to foreclose. A senior party aware of an impending sale has several options: it can avoid sale by curing the debtor’s default or by orchestrating a business workout; it can foreclose its own interest if the debtor has defaulted on the senior debt; or it can purchase the collateral itself at the junior sale. An informed senior party might decline to exercise these options for any number of reasons, including the possibility that it views a junior foreclosure not as the worst-case scenario described above, but as closer to a best-case scenario. The senior party may, for example, welcome substitution of a more financially sound purchaser for the original debtor who has defaulted on the junior interest. Such a senior party will be satisfied with its post-sale interest in the collateral.

There is one case, however, in which a continuing interest in the collateral cannot protect the senior party. If the junior party forecloses by collecting accounts, chattel paper, or instruments, the collateral is reduced to zero-value and the senior party thus has lost its security. In such situations, the senior party should be given a superior right to sale proceeds. Without this right, it would be left without a remedy. The inequity of this result prompted William Hawkland to redraft the Louisiana version of section 9-502 to provide that, notwithstanding section 9-504, where a secured party forecloses by collecting accounts or instruments, receipts are to be applied to security interests in their order of priority.

V. Proposal

If there is any unfairness in junior foreclosures, it exists because the Code authorizes a worst-case scenario—a case in which an uninformed senior party discovers postmortem that a junior party has sold

---

136. For a discussion of the business workout, see B. Clark, supra note 11, ¶ 4.03.
137. See supra notes 87-97 and accompanying text.
138. U.C.C. § 9-504(3) (1978) recognizes a secured party's right to purchase the collateral. That section provides in pertinent part: "The secured party may buy at any public sale and if the collateral is of a type customarily sold in a recognized market or is of a type which is the subject of widely distributed standard price quotations he may buy at private sale." This right was long recognized at common law. See G. Gilmore, supra note 10, § 44.6, at 1241.
139. This point was made by William Hawkland in a letter to Homer Kripke. See Letter from William Hawkland, supra note 61.
140. La. Rev. Stat. Ann. § 10:9-502 (West 1989). That section states: "notwithstanding the provisions of R.S. 10:9-504, where the secured party collects from an account debtor or obligor on an instrument the receipt of such collection shall be applied to security interests in the order of their priority."
its collateral and retained sale proceeds. This scenario rings two equitable alarms: (1) the senior party’s collateral was sold without its knowledge; and (2) the junior party’s interest was satisfied first, notwithstanding the senior party’s priority.

A. The Notice Problem

The problem of uninformed senior parties could easily be resolved by reinstating a modified version of the 1962 rule requiring a foreclosing party to notify all secured parties of record prior to sale. This rule would ensure that a senior party, including those with ordinary security interests or purchase money security interests in equipment, would receive notice of a section 9-504 sale. An informed senior party could then take whatever action it deemed appropriate to protect its interests.

The simple 1962 requirement that a foreclosing party notify “all other secured parties who have duly filed a financing statement ... in this state” should be clarified. It is unclear whether this language requires a foreclosing party to search the records of every state, since “this” state is not defined. One could reasonably suppose that “this” state means the state in which some aspect of the default process is being litigated. If this is the case, then as a practical matter, foreclosing parties would need to search the files in every state in which an action could be brought against them.

At least one other reading is possible. Commenting upon the almost identical notice requirement in the 1962 version of section 9-505(2), Professor Gilmore observed: “Which state is meant by ‘this’ state in this context may be somewhat ambiguous. Presumably it means the state in which the secured party who makes the proposal [to retain the collateral] is required to file or otherwise perfect his security interest.”

141. The additional provision in the 1962 rule requiring a foreclosing party to notify any person “who is known by the secured party to have a security interest in the collateral” should not be reinstated because of its tendency to provoke litigation over the foreclosing party’s actual knowledge. See supra note 32.
142. See supra notes 136-38 and accompanying text.
143. U.C.C. § 9-505(2) (1962) provided in pertinent part:
“Written notice shall be sent ... to any other secured party who has a security interest in the collateral and who has duly filed a financing statement indexed in the name of the debtor in this state or is known by the secured party in possession to have a security interest in it.
144. G. GILMORE, supra note 10, at 1223 n.3.
Whether or not Professor Gilmore's presumption is the most plausible interpretation, his statement suggests a reasonable rule. A foreclosing party could be required to search the records in the state in which that party would be required to file if it were filing on the date of repossession. This search should usually disclose all valid security interests of record, except in limited instances where the collateral or the debtor was recently moved. The strength of this approach is its reliance on the perfection rules of sections 9-401 and 9-103. If those rules would require a foreclosing party to file in a particular location, they also would ultimately require other secured parties with conflicting interests in the same collateral to file in the same location. Thus, a foreclosing party could usually discover all other valid security interests of record simply by searching the records of the state in which it would be required to file on the date of repossession.

145. The Code, of course, does not require a party to perfect its interest. If a party chooses to perfect, in some cases the Code allows perfection without filing. See U.C.C. § 9-302(1) (1978). If a party elects to perfect by filing, it must comply with the Article 9 rules governing that process, including rules specifying the proper place to file. Section 9-401 governs the location of a filing within a given state. That section offers states three alternatives, the most widely adopted of which requires central filing in most cases and local filing where the collateral is fixtures, consumer goods, or farm-related collateral. U.C.C. § 9-401 (1978). See J. White & R. Summers, supra note 9, § 22-14.

Section 9-103 governs perfection in multiple state transactions. If the collateral is documents, instruments, or ordinary (non-mobile) goods, § 9-103(1) generally requires that a financing statement be filed in the state where the goods are located. Subsection (1)(c) details a 30-day rule applicable to purchase money security interest created in one state but covering collateral to be kept in another state. When collateral is moved to another state, subsection (1)(d) generally requires a secured party either to take possession of the collateral or to refile in the new state within four months. U.C.C. § 9-103 (1978). See also J. White & R. Summers, supra note 9, § 22-21.

If the collateral is accounts, general intangibles or certain mobile goods, § 9-103(3)(b) generally requires filing in the debtor's "location." See U.C.C. § 9-103(3)(a) (1978) (describing accounts, general intangibles, and certain mobile goods); U.C.C. § 9-103(3)(d) (1978) (defining location). When a debtor changes location from one state to another, subsection (3)(e) requires a secured party to reperfect within four months. U.C.C. § 9-103(3)(e) (1978). See J. White & R. Summers, supra note 9, § 22-23.

If a secured party fails to reperfect within the four-month grace period of either U.C.C. § 9-103(1)(d) or (3)(e), the security interest becomes unperfected and "is deemed to have been unperfected as against a person who became a purchaser" thereafter. U.C.C. § 9-103(3)(e) (1978). A purchaser apparently includes a secured party. See U.C.C. § 1-201(32) (1978) (defining purchase).

If the collateral is chattel paper and perfection is by filing, the rules of § 9-103(3) on general intangibles govern. U.C.C. § 9-103(4) (1978). If the collateral is minerals in which the debtor has an interest before extraction and which attaches as extracted, filing must be in the jurisdiction in which the wellhead or minehead is located. U.C.C. § 9-103(5) (1978). See J. White & R. Summers, supra note 9, §§ 22-24, 22-25.

146. See infra notes 147-62 and accompanying text.

147. This search, of course, will not disclose security interests perfected by means other
Under this rule, a party who, for example, repossesses ordinary (non-mobile) goods located in Michigan, need not search the files of states other than Michigan. Because a financing statement covering non-mobile goods must initially be filed in the state in which the collateral is located (Michigan), a search of Michigan files, in the ordinary case, should disclose all valid security interests of record.\[^{148}\]

This approach contains one important caveat. A search limited to the state in which a financing statement would initially be filed on the date of repossession may not disclose security interests enjoying the four-month grace period granted by sections 9-103(1)(d) and (3)(e).\[^{149}\]

Consider, for example, the following scenario: Bank has filed a financing statement in state X to perfect its security interest in ordinary goods located in that state. Sometime thereafter, the debtor moves the goods to state Y. One month later, Finance Co. takes a security interest in the goods and files a financing statement in state Y. Shortly thereafter, the debtor defaults on the interest of Finance Co., which quickly forecloses. If less than four months has elapsed since relocation of the collateral to state Y, Bank's interest may properly be recorded only in state X. A search limited to the files of state Y will not disclose the interest of Bank, which consequently may not receive notice of Finance Co.'s sale.\[^{150}\]

Both practical and policy considerations support holding Finance Co. accountable for failure to discover and notify Bank in such circumstances. As a practical matter, Finance Co. should easily be able to discover Bank. At least in the ordinary case in which the junior party's subordinate position stems from its second filing, the junior party should already be aware of any parties enjoying the four-month grace period. A careful junior party will have asked the debtor as part of the pre-loan screening process whether, at the time the junior party took its interest, the debtor's collateral (or the debtor's location)\[^{151}\] had recently than filing. Requiring notice only to parties on file, however, is consistent with the 1962 notice rule of § 9-504(3), and seems a reasonable limitation on the search requirement of a foreclosing party. See U.C.C. § 9-504(3) (1962).

\[^{148}\] See supra note 145.

\[^{149}\] See J. White & R. Summers, supra note 9, §§ 22-21, 22-23.

\[^{150}\] A similar scenario could occur if the collateral is accounts, general intangibles, or certain mobile goods. In these cases, the "location" of the debtor determines the place of filing. See U.C.C. § 9-103(3)(b) (1978) and supra note 145. If the debtor had relocated within four months of the date of repossession, a search of the state in which the debtor is located might not disclose parties enjoying the four-month grace period. See U.C.C. § 9-103(3)(e) (1978).

\[^{151}\] See supra note 145.
been moved. Such an inquiry, on a loan application, for example, is necessary to an informed decision on whether to extend credit, because it may disclose recently created, conflicting security interests on file in another state. It therefore seems reasonable to require a second-in-time junior party to notify any other secured parties enjoying the four-month grace period.\(^{152}\)

Cases in which a junior party's subordinate position stems from a recently created purchase money security interest pose somewhat more troublesome notice issues.\(^{153}\) In these cases, the junior party cannot identify senior interests through an inquiry on the debtor's loan application because the senior interest may not have been created at the time the junior party took its interest. If the collateral is inventory, however, the junior party should be aware of a recently created purchase money security interest because section 9-312(3)(b) conditions purchase money priority in inventory on notice to the holder of a recorded, conflicting security interest.\(^{154}\) Thus, a junior party who forecloses against inventory should have previously received written notice of a recently-created, conflicting purchase money security interest. It would seem reasonable to require such a junior party to notify these senior parties.\(^{155}\)

152. A first-in-time senior party who forecloses should easily be able to discover a junior party enjoying the four-month grace period. For example, the collateral may have been in state X at the time the senior and junior parties took their interests, and later moved to state Y, where it was located at the time of the senior party's repossession. If the four-month reperfection period has not yet passed, a search of the files of state Y may not disclose the junior interest. Nevertheless, the senior party should be on the alert to check the files of state X since the senior interest is recorded in that state.

153. U.C.C. § 9-103(1)(c) (1978) may reduce the risk of undisclosed purchase money interests. That section removes the four-month grace period if the purchase money lender knows (at the time its interest attaches) that the goods will be kept in another state. Id. In such cases, the purchase money lender must file initially in the state in which the goods will be kept. Id. If the senior party were foreclosing its purchase money security interest against recently-moved inventory, it would seem equally reasonable to require notice to junior parties who have not yet reperfected in the new state. A senior party should be aware of the junior party

---

\[^{152}\] A first-in-time senior party who forecloses should easily be able to discover a junior party enjoying the four-month grace period. For example, the collateral may have been in state X at the time the senior and junior parties took their interests, and later moved to state Y, where it was located at the time of the senior party's repossession. If the four-month reperfection period has not yet passed, a search of the files of state Y may not disclose the junior interest. Nevertheless, the senior party should be on the alert to check the files of state X since the senior interest is recorded in that state.

\[^{153}\] U.C.C. § 9-103(1)(c) (1978) may reduce the risk of undisclosed purchase money interests. That section removes the four-month grace period if the purchase money lender knows (at the time its interest attaches) that the goods will be kept in another state. Id. In such cases, the purchase money lender must file initially in the state in which the goods will be kept. Id.

\[^{154}\] U.C.C. § 9-312(3)(b) (1978) provides:

A perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory and also has priority in identifiable cash proceeds received on or before the delivery of the inventory to a buyer if . . .

(b) the purchase money secured party gives notification in writing to the holder of the conflicting security interest if the holder had filed a financing statement covering the same types of inventory

(i) before the date of the filing made by the purchase money secured party, or

(ii) before the beginning of the 21 day period where the purchase money security interest is temporarily perfected without filing or possession (subsection (5) of Section 9-304).]

\[^{155}\] If the senior party were foreclosing its purchase money security interest against recently-moved inventory, it would seem equally reasonable to require notice to junior parties who have not yet reperfected in the new state. A senior party should be aware of the junior party
If the collateral is equipment, the problem of the four-month grace period is not so easily addressed, because purchase money priority in equipment does not depend on notice to holders of conflicting security interests.\(^\text{156}\) For example, suppose Finance Co. takes a security interest in the debtor's equipment, including after-acquired equipment, which it properly records in state X. Bank then finances a new piece of equipment for the debtor and takes a purchase money security interest in that equipment, which it properly records in state X. Sometime thereafter, the debtor moves its business, with all its equipment, to state Y. Bank has not yet filed in state Y, as it is enjoying the four-month grace period.\(^\text{157}\) If Finance Co. forecloses against the equipment, located in state Y, a search of the files of state Y would not disclose the interest of Bank.\(^\text{158}\) Even in this scenario, it seems reasonable to require Finance Co. to discover and identify Bank which is enjoying the four-month grace period because Finance Co. should be on the alert for security interests on file in state X, where its own interest was recently recorded. If Finance Co. took its interest after the collateral was moved to state Y, its interest would be second in time and Finance Co. should be able to discover Bank's interest by appropriate inquiry of the debtor during pre-loan screening. Thus, it seems reasonable to require a foreclosing junior party to notify even parties with purchase money security interests who are enjoying the four-month grace period.\(^\text{159}\)

Much of this reasoning is subject to the practical objection that the debtor may decline to disclose recent movement of the collateral (or the debtor's location) in the hope of obtaining financing which might otherwise be denied. The risk of debtor dishonesty, however, is one that most secured parties assume to some extent. Code rules should not be

\(^{156}\) See U.C.C. § 9-312(4) (1978) which provides: "A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral or its proceeds if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter."

\(^{157}\) See supra note 145.

\(^{158}\) Of course, if Bank took its interest after collateral was moved to state Y, a search of the files of state Y should reveal Bank's interest.

\(^{159}\) If a senior party forecloses its purchase money interest in equipment, it also seems reasonable to require it to notify junior parties enjoying the four-month grace period. If the junior and senior interests were both initially recorded in state X, then a senior party who forecloses on collateral moved to state Y should be on the alert to check the files of state X. If the senior party took its interest after the collateral was moved to state Y, and therefore never filed in state X, the senior party would be second in time and so could have discovered the recent movement of the debtor's equipment through appropriate pre-loan inquiry of its debtor.
framed to protect secured parties against their own unfortunate choice of a debtor. A foreclosing party who suspects that its debtor may have been motivated to compromise its integrity during loan negotiations could inquire again at the time of repossession in the hope that some incentive for dishonesty had been removed. A party with serious doubts regarding the honesty of its debtor could check the files in every state in which it had reason to suspect either the collateral or the debtor had recently been located. As a last resort, a foreclosing party could simply delay four months before selling the collateral.

Policy considerations also support requiring a foreclosing party to discover and notify secured parties enjoying the four-month grace period. Such a rule honors the Code decision temporarily to protect a secured party whose collateral has moved or whose debtor has relocated. To condition a secured party's right to notice on swift reperfection would be inconsistent with both the spirit and the letter of section 9-103, which allows reperfection within four months—a period that is not necessarily swift. On balance, it seems reasonable to require a foreclosing junior party to notify even those secured parties who have filed financing statements in states from which the debtor or the collateral recently moved.

Even a modified version of the 1962 notice rule, requiring something less than a search in all states, may burden foreclosing parties. As a practical matter, the costs of searching the record in even a single state may be significant. Arranging an expeditious search in another state by either public officials or private parties may be especially problematic. Difficulties are aggravated by the Code's provision for notice filing, which invites broadly worded financing statements, thus sometimes making the collateral difficult to identify.

Because a search requirement would apply to all foreclosing parties, parties with purchase money security interests in equipment could be expected to complain again about the unfairness of requiring them to search records at the time of foreclosure when they were not required to do so at the inception of the transaction. To exempt these

160. One may suspect, however, that the debtor may be disinclined to cooperate with the repossessor who has recently taken its property.
161. This difficulty is largely a product of the primitive state of the filing system in this country. Much can be learned from our Canadian neighbors who have established a central registry. See Cuming, Computerization of Personal Property Security Registries: What the Canadian Experience Presages for the United States, 23 U.C.C. L.J. 331 (1991).
163. See supra note 38 and accompanying text.
parties from the notice requirement, however, would complicate the Code's simple foreclosure rules, would invite uncertainty, and would generate disputes over the nature of a security interest, the classification of collateral, and other issues once irrelevant to the duties of a foreclosing party. This seems a costly price for relieving some foreclosing parties of a duty to access the Code's filing system.

On balance, the benefits of providing notice to all parties in the smoothest and most efficient way outweigh the cost of requiring every foreclosing party to search the records prior to sale.

The notice requirement outlined above could be enforced through Code rules already in place. A junior party's improper failure to inform a senior party would trigger section 9-507(1). That section gives an unnotified party the right to recover any loss caused by a violation of the default rules. In appropriate cases, the senior party could be given a first priority in proceeds of the junior sale. While ensuring notice is an essential step, it does not resolve the issue of entitlement to sale proceeds.

B. The Proceeds Problem

Notice to a senior party of a junior foreclosure sale is the linchpin of any default sale scheme. As long as all secured parties are notified of a junior sale, a predictable and equitable proceeds rule is not difficult to fashion.

As an initial matter, if a debtor has defaulted on the senior interest, the senior party should have a right to intervene by repossessing the collateral from a junior party and conducting its own sale. Preemption seems a logical extension of the senior party's priority and would allow a senior party to avoid any sale it deemed inimical to its interests. Because the junior party has only a subordinate interest in the collateral, it seems reasonable to relegate to it a subordinate right to repossess the collateral. If the senior party preempts the junior party and conducts its own sale, the junior party should have a subordinate right to proceeds of the senior sale.

---

164. U.C.C. § 9-507(1) (1978) provides in pertinent part:
If it is established that the secured party is not proceeding in accordance with the provisions of this Part, disposition may be ordered or restrained on appropriate terms and conditions. If the disposition has occurred the debtor or any person entitled to notification or whose security interest has been made known to the secured party prior to the disposition has a right to recover from the secured party any loss caused by a failure to comply with the provisions of this Part.
In fairness to the junior party, however, the senior party should be required to exercise its right to repossess within a reasonable time, e.g., thirty days after receiving notice of the planned junior sale. Such a limitation would protect the junior party against an eleventh-hour surprise after it has made foreclosure arrangements.

A senior party who declined to exercise its right to repossess the collateral would have several options. It could attempt to avoid the necessity of a sale by curing the debtor's default on the junior loan; it could buy the collateral at the junior sale; or it could await its remedy against the collateral after sale. A senior party given these options could hardly complain that it has been unfairly prejudiced by a junior sale.

If a junior party conducts the sale, it should have a first claim to sale proceeds (after payment of reasonable expenses of sale) without being required to account to the senior party. The junior interest would be discharged by the sale, but the senior interest would continue in the collateral after sale. This proceeds distribution scheme, however, should not apply to cases in which a junior party forecloses by collecting accounts, chattel paper, or instruments. In these cases, proceeds should be applied in the order of priority.165

One alternative approach deserves mention. Steps could be taken to ensure that a purchaser at a junior foreclosure receives pre-sale notice of the senior interest in the collateral. This end could most easily be achieved by requiring the junior party, who should be aware of the senior interest, to notify prospective purchasers.

A purchaser at a junior sale with notice of a senior interest in the collateral would presumably adjust its bid to take account of the senior interest. At least in a well-ordered world, the purchase price reflects the extent of the right purchased, i.e., whether the collateral is subject to any interests not discharged by the sale. A purchaser who was aware of a senior interest could hardly complain after sale that it has been prejudiced by continuation of the senior interest in the collateral.

However, a purchaser for value whom the junior party failed to notify of the senior interest prior to sale, and who otherwise lacked that knowledge, could be allowed to take the collateral free of the senior interest.166 The senior party could, of course, protect against this even-

165. See supra notes 139-40 and accompanying text.
166. See Byrne, Murphy & Vukowich, supra note 6, at 1926-31 (generally advocating discharge of the interests of senior creditors, whether or not notified, upon a junior sale as a method of encouraging senior creditor involvement and eliminating the risks of uncertain title).
tuality by ensuring that prospective purchasers receive notice of the senior interest.\textsuperscript{167} Such a rule would further the general Code theme of protection for innocent purchasers.\textsuperscript{168} Instead of an action against the collateral held by an innocent purchaser, the senior party would be required to proceed against the more culpable junior party, who likely obtained a higher purchase price because of failure to disclose the senior interest. A senior interest would have priority in the proceeds of the junior sale,\textsuperscript{169} and to the extent such proceeds are insufficient or unavailable, against the junior party personally.\textsuperscript{170}

The problem with this approach is that it strips the senior party of an important proprietary right and compromises the senior party’s ability to recover its interest. A right to proceeds or a personal cause of action against an unscrupulous junior party is hardly an adequate substitute for a security interest in collateral. Especially in cases where a junior party improperly fails to notify a senior party, this result would be untenable. A more appropriate remedy for a disappointed purchaser would be either an action to rescind the sale or an action to recover damages against the foreclosing junior party.

VI. CONCLUSION

Section 9-504, the core of the Code rules on default sales, has been a source of confusion and concern. This section allows a junior secured party to repossess and sell collateral without notifying a senior secured party and further allows a junior party to retain sale proceeds without accounting to a senior party. Various courts and commentators have struggled either to justify this scenario or to alter it by relying on the Code’s conflicting general priority sections. The best solution would be to amend section 9-504 to require a foreclosing party to notify all secured parties whose interests are on file in the state in which the foreclosing party would be required to file a financing statement on the date of repossession, or who are on file in another state and are en-

\textsuperscript{167} This option assumes that the senior party itself has notice of the junior sale.


\textsuperscript{169} The senior party would have a right against the debtor for any deficiency. U.C.C. § 9-504(2) (1978).

\textsuperscript{170} See Byrne, Murphy & Vukovich, supra note 6, at 1929.
joying the four-month grace period for reperfection under section 9-103(1)(d) or (3)(e). This change should eliminate the problem of the uninformed senior party.

Additionally, section 9-504 should be amended to clearly authorize a senior party whose interest is in default to repossess collateral from a junior party and to conduct the sale itself. A senior party should be required to act within a reasonable time after receiving notice of a junior foreclosure sale. If a senior party chose not to intervene, the junior party should be allowed to sell the collateral and retain sale proceeds without accounting to the senior party.

In order to clarify the junior party's first right to proceeds of its sale, sections 9-504(1) and 9-306(2) should be amended to remove any implication that the proceeds rule of section 9-306(2) applies to default sales. After a junior foreclosure, the senior security interest would follow the collateral into the hands of the purchaser. If, however, the junior party forecloses by collecting accounts, chattel paper, or instruments, the senior party should take a first right to proceeds of the junior foreclosure.