

PERFECTION AND PRIORITY OF SECURITY INTERESTS IN GOODS HELD BY THIRD-PARTY BAILEES

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Revised Article 9 of the Uniform Commercial Code has made several important changes to the laws governing security interests in goods held in bailment. This article summarizes and discusses these statutory changes.

Summary discussions of significant statutory revisions under Revised Article 9 of the Uniform Commercial Code often mention the shift from bailee notification of a security interest covering goods held in bailment to a consensual arrangement requiring the bailee's express consent to the secured party's interest. While this abandonment of bailee notification as a permissible method of perfection is a correct statement of the law in many circumstances, the short shrift given to this topic in numerous articles actually belies a fair amount of complexity under Revised Article 9 concerning the intersection of the laws of bailment and secured transactions. Consider, for example, and as will be discussed in detail below, that in many cases bailee notification, with or without bailee consent, remains a valid method of perfection under Revised Article 9. A specific review of the Uniform Commercial Code's treatment of security interests in bailments,

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with particular emphasis on changes under Revised Article 9, is therefore warranted.

FRAMEWORK FOR ANALYSIS

A debtor's assets may be held by third-party bailees for a whole host of business reasons, such as inventory or equipment processing, storing and warehousing. In addressing the rights of a secured party holding a lien on assets delivered to a third-party bailee (as distinguished from a consignee; the Uniform Commercial Code's treatment of consignment relationships is beyond the scope of the present article), the Uniform Commercial Code is generally disinterested in the specifics of the underlying business relationship between a debtor and its bailee. Instead, for analytic purposes the Uniform Commercial Code focuses on the nature of the documentation describing and evidencing the bailment itself. The legal character of such documentation, as discussed below, drives distinct sets of rules regarding the perfection of security interests in the underlying goods.

Analysis begins with a simple question: What evidences the bailment relationship? Debtors will rarely, if ever (one would hope), entrust their goods with a third party without some legal documentation describing the arrangement. A linchpin of analysis in this context is whether the bailment relationship is evidenced by a "document". Under the Uniform Commercial Code, "document" is defined, somewhat unhelpfully at first blush, as a "document of title" or, in more limited cases, as certain receipts issued where goods are stored under a statute requiring a bond against withdrawal.¹ Focusing on the more common case, a "document of title" is defined as any bill of lading, dock warrant, dock receipt, warehouse receipt or order for the delivery of goods, and also any document:

which in the regular course of business or financing is treated as adequately evidencing that the person in possession of it is entitled to receive, hold and dispose of the document and the goods it covers. To be a document of title a document must purport to be issued by or addressed to a bailee and purport to cover goods in the bailee's posses-

sion which are either identified or are fungible portions of an identified mass.²

Applying this definition is obviously a fact specific endeavor. Generally speaking, however, the Uniform Commercial Code's concern is that title to the goods on bailment is somehow wrapped up in the document entered into between debtor and bailee. So, for instance, a simple processing agreement setting forth the duties of an outside inventory processor and the associated costs to be charged would not qualify as "document of title" under Article 1 of the Uniform Commercial Code, and therefore also would fail as a "document" for purposes of Article 9. In contrast, an inventory storage receipt which makes the release of specifically identified stored goods dependent on the tendering of the receipt to the bailee readily appears to satisfy the statutory elements.

The Uniform Commercial Code makes one further analytic distinction relevant to the laws of secured transactions. Documents of title are either negotiable or non-negotiable. Documents are negotiable where, by their terms, "the goods are to be delivered to bearer or to the order of a named person" or where the document is "recognized in overseas trade, if it runs to a named person or assigns".³ All other documents of title are non-negotiable.⁴ Negotiable documents of title, accordingly, not only evidence the right to possession of the underlying goods, they are also a medium of trade in certain marketplaces. As is the case of negotiable instruments and securities, the holders of such documents enjoy special statutory rights designed to support commercial endeavors.⁵

BAILMENTS FOR WHICH NO DOCUMENT OF TITLE EXIST

As mentioned above, the categorization of bailment relationships between those evidenced by documents of title and those that are not, and the further distinction between documents of title which are negotiable and those that are not, all drive separate provisions of the Uniform Commercial Code as it pertains to the perfection of security interests in the underlying goods.

In situations where no document of title is involved, Revised Article 9 identifies two manners of perfection: filing of an appropriate financing statement as against the goods on bailment, and possession by the secured party of the goods themselves. From a statutory perspective, Revised Section 9-310 provides the general default rule requiring the filing of a financing statement as against goods, and the joint operation of Revised Section 9-310 and Revised Section 9-313 authorize a special form of possession of goods held on bailment, as discussed below.

Revised Section 9-301 (Law Governing Perfection and Priority of Security Interests), Revised Section 9-307 (Location of Debtor) and Part 5 of Revised Article 9 in conjunction determine where and how to file a financing statement covering goods. The salient point here is that, in the case of bailments for which no document of title exists, a single, properly filed financing statement covering the goods will be sufficient to perfect a security interest in the goods held by third-party bailees in each and every jurisdiction which has adopted Revised Article 9. For jurisdictions which have not adopted Revised Article 9, an appropriate UCC-1 financing statement complying with the requirements of Old Article 9 will need to be filed in the jurisdiction where the goods are located.⁶

Perfection by possession, in the case of bailments not evidenced by documents of title, is the subject of the significant policy shift between Old and Revised Article 9 mentioned in this article's introduction. Old Article 9 provides that a secured party is deemed to be in possession of the underlying goods "from the time the bailee receives notification of the secured party's interest".⁷ Under Old Article 9, notification alone is sufficient to perfect; the bailee is neither required to consent to or acknowledge the notification sent. In contrast, Revised Article 9 permits perfection by constructive possession only where the bailee "authenticates a record acknowledging that it holds possession of the collateral for the secured party's benefit", or accepts the collateral after having authenticated such a record.⁸ The stylized language of Revised Article 9 ("authenticate", "record", etc.) is designed, consistent with a major emphasis of the overall statutory overhaul, to accommodate new methods of contracting, such as electronic signatures. The critical aspect here is that express bailment consent is required to perfect by constructive possession under Revised Article 9.

General articles on Revised Article 9 often mention this changed method of perfection in the context of analyzing the one-year grace transition rule set forth at Revised Section 9-703. The general example, a form of which is presented at Example 2 to Official Comment 2 to Revised Section 9-703, runs as follows: if, under Old Article 9, a secured party perfected a security interest in goods held on bailment by direct notification, that secured party will have one year within which to obtain bailee consent sufficient under Revised Section 9-313(c) in order to avoid losing continuous perfection. The analysis is technically correct though, I suspect, highly misleading.

Misleading, because it will often be the case that a secured creditor will have perfected under Old Article 9 not just by bailee notification. It is common, conservative practice for secured creditors also to file financing statements covering the underlying collateral which, as discussed above, is an entirely sufficient method of perfection. Assuming that the secured creditor identified above has already perfected through the filing of an appropriate financing statement, no extra advantages from a perfection standpoint are gained by obtaining the bailee's written acknowledgment during the one-year grace period. The one-year grace period is, therefore, a matter of concern only where (i) bailee notification was the method of perfection and (ii) the secured creditor either failed to perfect by filing, or could not legally perfect by filing (the precise case, though not highlighted, in Example 2 to Official Comment 2 to Revised Section 9-703).

Conservative practice dictates that, in addition to perfecting by filing, secured creditors should obtain waiver letters signed by the bailees. These letters have several goals, such as to afford the secured creditor legal access to the goods upon debtor default and to cause the bailee to waive or subordinate its rights under Article 9 and under any "secret lien" statutory provisions. Such letters may or may not contain language to the effect that the bailee holds possession for the benefit of the secured party. Where such language does not exist, the letter will be insufficient under Revised Section 9-313 to perfect, giving rise to a one-year grace period to correct the letter pursuant to Revised Section 9-703. If the secured party has also, however, perfected by filing, no corrective action with respect to the bailee letter is required for purposes of continuing perfection. Moreover, whatever legal rights have been created by any such letters, such as collateral access rights,

will not be vitiated merely due to the fact that the bailee letter is insufficient, under Revised Article 9, to perfect a security interest.

BAILMENTS FOR WHICH NON-NEGOTIABLE DOCUMENTS OF TITLE EXIST

The rules for perfection in situations where goods held in bailment are covered by non-negotiable documents of title are unchanged as between Old and Revised Article 9. The statutory cites are Old Section 9-304(3) and Revised Section 9-312(d). Under both statutes there are three methods of perfection: (i) issuance of a document in the name of the secured party, (ii) receipt by the bailee of notification of the secured party's interest and (iii) filing as to the underlying goods. Note, with respect to the second option, that in contrast to the revised rules of perfection for goods not covered by documents, where consensual arrangements have supplanted direct notification, direct bailee notification, with or without bailee consent or acknowledgment, remains a valid option where goods are covered by non-negotiable documents. The Uniform Commercial Code therefore is more protective of the interests of third-party bailees which do not issue documents of title to evidence their relationships, as compared to those that issue non-negotiable documents of title. As a result, secured creditors which might otherwise believe themselves to have a one-year grace to switch from direct notification to consensual arrangement should also be sure to examine the underlying form of bailment. If the bailment is evidenced by a non-negotiable document, the grace period is inapplicable, as perfection is continuous.

BAILMENTS FOR WHICH NEGOTIABLE DOCUMENTS OF TITLE EXIST

Special rules apply where goods held in bailment are covered by negotiable documents of title. In such cases, the Uniform Commercial Code treats title to the underlying goods as being "locked up" in the document of title itself. By way of contrast, note that the Uniform Commercial Code does not provide for any method of perfection against non-negotiable doc-

uments. There are, as discussed above, methods for perfection as against the underlying goods, but the Uniform Commercial Code essentially treats a third-party claim against a non-negotiable document of title as of negligible value, and accordingly provides no specific method of perfection with respect thereto. The exact opposite is the case where negotiable documents are involved. Because legal ownership of a negotiable document equates with legal ownership of the underlying assets, the Uniform Commercial Code specially addresses perfection of security interests in such documents and related priority topics, discussed below, as between competing contestants against a negotiable document and its underlying assets.

Revised Article 9 continues in place the basic perfection methods established under Old Article 9 with respect to negotiable documents of title. Security interests in negotiable documents may be perfected either by possession⁹ or through the filing of a financing statement identifying the document as collateral.¹⁰ Also consistent with Old Article 9, Revised Article 9 provides that perfection of a security interest in a negotiable document also constitutes the perfection of a security interest in the underlying goods.¹¹

TEMPORARY PERFECTION EXTENSIONS

The Uniform Commercial Code contains two “temporary perfection” rules applicable to goods held in bailment, each of which is designed to promote commercial bailments without compromising the interests of secured creditors. The first rule is set forth in Old Section 9-304(4), carried forward into Revised Section 9-312(e). This rule provides that a security interest in negotiable documents is automatically perfected for a limited period of time (21 days in Old Article 9, reduced to 20 days under Revised Article 9), commencing with the date the applicable security interest attaches. This automatic perfection right is, however, limited to situations where the security interest arises for new value given under the security agreement. Note, also, that this rule does not apply to goods held under non-negotiable documents, or goods held by bailees for which no document of title is issued.

A second temporary perfection rule concerns the release of goods held in bailment as a prelude to ultimate sale or other disposition. In contrast to the first temporary perfection rule, this rule applies not only to negotiable

documents, but also to goods in possession of a bailee for which either no document of title or a non-negotiable document of title has been issued. Also, unlike the first temporary perfection rule, which creates a new, temporary perfection period under certain circumstances, this rule extends the reach of a pre-existing perfected security interest. This rule provides that where a properly perfected secured creditor in a bailment arrangement makes the document of title or the underlying goods available to the debtor for the purposes of ultimate sale or exchange, or for certain other statutorily enumerated purposes concerned with the commercial movement of such goods, the secured creditor will retain its perfected status for a limited period of time. Again, this period is 21 days under Old Article 9, and 20 days under Revised Article 9.¹²

An example will help illustrate the practical effect of this second temporary perfection rule. A bank that desires to finance the purchase of inventory by a debtor will often take possession of the negotiable bill of lading evidencing the right to the goods. By possessing this document, the bank will perfect its security interest in the document and the underlying goods. With this collateral in hand, the bank will advance funds to its debtor for purposes of purchasing the goods. In order to actually obtain the goods, however, the debtor will need to present the bill of lading to the seller. The Uniform Commercial Code gives the bank the ability to release the bill of lading without forfeiting its perfected security interest, at least for 21 (and now 20 under Revised Article 9) days. If the bank is not repaid in full during this temporary period, it will need to perfect directly against the underlying goods if it desires a continuous perfected status after the expiration of this temporary period.

PRIORITY RULES

Who wins in a priority dispute where two or more secured creditors claim a properly perfected security interest in the same goods held in bailment? The ground rules under Revised Article 9, set forth at Revised Section 9-322, are identical to the approach under Old Article 9: conflicting perfected security interests rank according to priority in time of filing or perfection. Unless countermanded by one of the exceptions set forth below, the

first secured creditor to properly perfect its interest, whether by filing or by possession, will have the priority position.

One such exception is presented at Revised Section 9-312(c)(2), a re-draft of an existing provision at Old Section 9-304(2). This section — applicable only in the case of goods held pursuant to negotiable documents — provides that during the time that goods are in possession of a bailee that has issued a negotiable document covering the goods, a valid security interest in the document will have priority over any security interest that becomes perfected in the goods by another method during that time. This rule initially puts the onus on a secured party perfecting against the document, as opposed to the underlying goods, as a secured creditor taking possession of a negotiable warehouse receipt, for example, takes subject to any record liens against the underlying goods which pre-date the bailee's possession of the goods. But assuming the absence of any such liens against the goods, the secured creditor may perfect against the warehouse receipt without concern that another party may have perfected against the goods while in the bailee's possession. So, for example, if goods are stored with a bailee on January 1, 2001, as evidenced by the issuance of a negotiable warehouse receipt, SP1 files against the goods of February 1, 2001 and SP2 takes possession of the negotiable warehouse receipt on February 15, 2001, SP2 will have a prior perfected security interest pursuant to Revised Section 9-312(c)(2). This special priority rule supports the policy position that while a negotiable document is in existence, title to the underlying goods is "locked up" in the document, and any effort to perfect against the goods identified to the receipt will be subordinated to a lien against the goods.

Another special circumstance exists where perfection is temporarily extended pursuant to Old Section 9-304(5) and Revised Section 9-312(f). As discussed above, compliance with these provisions permits a perfected secured creditor to release its hold on goods held in bailment without concurrent loss of perfection, at least for a temporary period. However, continuity of perfection, in this situation, does not equate with continuity of priority. For illustrative purposes, consider the case of a bank having a perfected security interest in goods held in bailment through possession of a negotiable document. Pursuant to the temporary perfection rules discussed above, the bank releases its possession of the document to facilitate the

debtor's acquisition of the goods from a seller. During the limited perfection period (21 days under Old Article 9; 20 days under Revised Article 9), the bank files a proper financing statement against the goods.

While the bank will remain continuously perfected against the goods, another secured creditor may nonetheless prime the bank's interest in the goods. Consider the position of a second creditor which has perfected a security interest directly against the debtor's goods through the filing of an appropriate UCC financing statement. Old Section 9-304(5)(a) provides that priority between conflicting security interests in goods, in situations where one secured creditor relies on the temporary perfection rule of Old Section 9-304(5), is subject to Old Section 9-312(3), which awards priority to inventory purchase money secured creditors only where (among other things) due notice is given to prior perfected creditors. In other words, and as amplified in Official Comment 4 to Old Section 9-304, a creditor which has filed a proper financing statement against the underlying goods will have priority over a secured creditor relying on temporary perfection upon release of goods from bailment, unless that creditor provides notice to existing lien creditors of record of its pre-existing interest.

Revised Article 9 carries this concept forward in two ways. First, as expressly stated in Official Comment 9 to Revised Section 9-312:

Subsections (f) and (g) [an analogous provision concerning certificated securities and instruments] deal only with perfection. Other sections of this Article govern the priority of a security interest in goods after surrender of the document covering them. In the case of a purchase-money security interest in inventory, priority may be conditioned upon giving notification to a prior inventory financier. *See* [Revised] Section 9-324.

Revised Section 9-324, which is concerned with the priority of purchase money security interests, has its origins in Old Section 9-312(3), thereby directly relating back to the exception first cited at Old Section 9-304(5)(a).

Note that the excerpt above mentions "other sections" of the code, indicating at least one additional provision on point. One of these "additional" provisions is Revised Section 9-322(d). Without antecedents in Old Article 9, Revised Section 9-322(d) provides a special priority rule where two cred-

itors both claim a perfected security interest in proceeds in what Revised Article 9 labels (under the Official Comments) “non-filing collateral”, defined as “collateral of a type for which perfection may be achieved by a method other than filing (possession or control, mainly) and for which secured parties who so perfect generally do not expect or need to conduct a filing search.”¹³ The section, for instance, addresses proceeds of chattel paper, deposit accounts, investments property and, central to the present topic, proceeds of negotiable documents. The section provides that where perfection of security interests in such collateral is perfected by a method other than filing, conflicting perfected security interests in proceeds of such collateral rank according to priority in time of filing, thereby subordinating possession to filing. The rule, therefore, provides an important exception to the general rule of first to file or otherwise perfect, carried forward at Revised Section 9-322(a)(1). One important limitation to this special priority rule, set forth at Revised Section 9-322(e), is that the proceeds at issue must not be “cash proceeds, chattel paper, negotiable documents, instruments, investment property, or letter-of-credit rights” — i.e. all collateral types for which the filing of a financing statement is either not a proper method of perfection or a customary method of perfection.

A simple example will help illustrate the application of these rules. Consider the case of a secured creditor (SP1) which has perfected a security interest in a debtor’s bank account by means of a control agreement.¹⁴ The debtor removes cash from the account and purchases inventory. The inventory is proceeds of the cash from the deposit account, giving SP1 continuous perfection in such proceeds, at least for 20 days, pursuant to Revised Section 9-315. If, however, another creditor of debtor (SP2) has perfected a security interest in debtor’s inventory by filing an appropriate financing statement, SP2 will have priority over SP1, regardless of the temporal ordering of SP1’s and SP2’s methods of perfection. Because the proceeds of this collateral (inventory) is generally perfected through filing, the Uniform Commercial Code awards priority to the party that has filed. SP1, knowing at deal inception that such proceeds are likely to arise, may of course protect itself by filing a financing statement covering the proceeds, thereby putting all competing parties (including SP2) on notice as to its interest.

Revised Section 9-322(d) expressly covers negotiable documents. In

contrast to the case of deposit accounts, application of Revised Section 9-322(d) to the case of negotiable documents seems at least initially unclear. As mentioned above, security interests in negotiable documents may be perfected by filing — thereby taking away the very predicate of Revised Section 9-322(d), which applies only where perfection is achieved by a method other than filing — or by possession. Where a negotiable document is under the possession by a secured creditor, how can proceeds of such collateral arise? Unlike the case of deposit accounts, where funds may go in and out of an account which is always subject to a control agreement in favor of a secured creditor, the very act of possessing a negotiable document “locks up” title to the underlying goods, thereby precluding the production of proceeds.

While the Official Comments to Revised Section 9-322(d) do not address application of this rule to negotiable documents, it would appear that Revised Section 9-322(d) must have applicability only where a secured creditor has temporarily released its possession of a negotiable document, and is relying on a temporary extension of its perfection pursuant to Revised Section 9-312(f). For example, if a bank releases a negotiable document of lading to permit the completion of a purchase of goods by its debtor, as discussed above the bank will have a limited period in which its security interest remains perfected. However, Revised Section 9-322(d) may be read to indicate that another party which has perfected against the underlying goods — the proceeds of the negotiable document — will prime the bank, just as it would in the case of inventory purchases from cash from a deposit account.

Revised Section 9-322(d) is conceptually more satisfying than the treatment under Old Section 9-304(5). As discussed above, Old Section 9-304(5) provides that priority between conflicting security interests in the underlying goods is subject to the inventory purchase money security interest rules set forth at Old Section 9-312(3). This is really an indirect way of stating the express rule Revised Section 9-322(d) — i.e. that a secured creditor that fails to avail itself of the inventory “PMSI” rules will lose its priority status to a secured creditor that has filed against the underlying goods. Moreover, compliance with the inventory “PMSI” rules is but one method of redressing the loss of priority, and not applicable in all cases. For instance, a security interest created by a lender which has perfected by possession of a

negotiable document may not always qualify as a “purchase money security interest”. Revised Article 9 avoids these problems by presenting a broader-speaking priority rule, then leaves it to the lender to determine another method of achieving continuous perfection and priority.

That said, Revised Section 9-322(d) still leaves some legal uncertainty concerning other forms of bailments. Recall, for instance, that the temporary perfection rule of Old Section 9-304(5) applies not only where negotiable documents are released, but also in situations where goods in possession of a bailee are released for which either no document or a non-negotiable document exists. In all these situations, Old Section 9-304(5) says, in essence, that a perfected secured creditor will lose its priority unless compliance with the inventory “PMSI” rules is made. By contrast, Revised Section 9-322(d) addresses only negotiable documents. As for perfection in situations where either no document of title or a non-negotiable document is issued, Revised Section 9-322(d) appears to be inapplicable. The default rule of first to file or otherwise perfect, set forth at Revised Section 9-322(a)(1) would therefore apply. This leaves the anomaly under Revised Article 9 that a secured creditor releasing its hold over a negotiable document may lose its priority position to any filer against the underlying inventory (under Revised Section 9-322(d)), whereas a secured creditor releasing goods held under non-negotiable documents or undocumented arrangements will apparently have continuous priority during the temporary extension period. Given that the central policy concern of Revised Section 9-322(d) is to conform to the reasonable expectations of filing parties, the structure of the underlying bailment does not seem to be a sensible basis for different results.

NOTES

- ¹ Revised Section 9-102(30), incorporating Section 7-201(2).
- ² Section 1-201(15)
- ³ Section 7-104(1).
- ⁴ Section 7-104(2).
- ⁵ *See, e.g.*, Section 7-502.
- ⁶ *See* Old Section 9-103, Old Section 9-304 and Old Section 9-401.

- ⁷ Old Section 9-305.
- ⁸ Revised Section 9-313(c).
- ⁹ Revised Section 9-313(a).
- ¹⁰ Revised Section 9-312(a).
- ¹¹ Revised Section 9-312(c).
- ¹² Old Section 9-304(5), Revised Section 9-312(f).
- ¹³ Official Comment 7 to Revised Section 9-322.
- ¹⁴ *See* Revised Section 9-314 and Revised Section 9-104.