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Case Comments, Secured Transactions: Old McDonald's Secret Lien

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SECURED TRANSACTIONS: OLD McDONALD'S SECRET LIEN

International Harvester Credit Corp. v. American National Bank of Jacksonville, 296 So. 2d 32 (Fla. 1974)

On April 10, 1969, respondent American National Bank perfected[1] a security interest[2] in all property, including after-acquired property,[3] of Machek Farms, Inc. as collateral for an installment note debt.[4] On April 25 of that year Machek purchased two pieces of farm equipment, priced at approximately $2,000 each, from petitioner Florida Truck and Tractor Company pursuant to a single installment sales contract. Machek also purchased seven additional items of farm equipment for an aggregate contract price of approximately $30,000 on August 8. Four of these items were priced below $2,500 each. This second contract was subsequently assigned to petitioner International Harvester Credit Corp. Neither petitioner timely filed a financing statement.[5] Machek subsequently defaulted on the loan payments to respondent and the installment sales payments to petitioners, and voluntarily relinquished possession of the financed farm equipment. Respondent bank then brought a replevin action against petitioners, alleging a superior right to possession of the equipment by virtue of its perfected interest in all property of Machek Farms acquired after April 10, 1969. The trial court certified to the First District Court of Appeal the question[6] whether the $2,500 value limitation on automatic perfection of a security interest in farm equipment[7] is determined by the price of each individual item or the aggregate price of all items

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1. "Perfection" is the term employed by the Uniform Commercial Code to designate the highest degree of creditor protection allowed in a secured transaction. O. SPIVACK, SECURED TRANSACTIONS 3 (1962). See note 23 *infra.*

2. The term "security interest" as used in the Code denotes any interest in chattel retained by a creditor as security for an obligation. FLA. STAT. §671.201(37) (1973).

3. The Uniform Commercial Code, as enacted in Florida, expressly approves liens on after-acquired property as security for a debt. Adoption of the Code ended doubts as to the legitimacy of common business practices such as floating liens on the use of a changing inventory as collateral despite the impossibility of describing that type of collateral exactly at the time of execution of the loan. *See* FLA. STAT. ANN. §679.204 (1971) (Official Comments).

4. 269 So. 2d 726, 727 (1st D.C.A. Fla. 1972).

5. International Harvester did file a financing statement for the installment sales contract assigned to it, but subsequent to expiration of the ten-day grace period allowed by FLA. STAT. §679.312(4) (1973). 269 So. 2d at 727.

6. Two questions were certified to the court under FLA. APP. R. §4.6(a), only one of which, the first, is discussed in this comment. The second question was: "Under Florida Statute §§679.312(4) and (5), does a party with a security interest in after acquired property take priority over a party with a purchase money security interest which was not perfected within ten days after the debtor took possession of the collateral?" The Florida supreme court answered this question in the affirmative, but held that the security protection to the prior creditor is limited to his equity in the secured goods. 296 So. 2d 32, 33 (1974).

7. FLA. STAT. §679.302(1)(c) (1973).

on one contract.[8] The district court held the contract value controlling,[9] and in turn certified the question to the Florida supreme court as a matter of great public interest.[10] The supreme court overruled the district court and HELD, the individual price of each piece of farm equipment rather than the total contract price determines the applicability of the farm equipment exemption from the general requirement that security interests be perfected by timely filing.[11]

Article 9 of the Uniform Commercial Code, as codified in Florida in 1967,[12] attempts to establish a simplified and rational structure within which secured transactions may take place without secrecy and with a high degree of certainty regarding the rights and responsibilities of all parties.[13] The confused tangle of pre-Code filing requirements, which varied with the particular form of encumbrance,[14] was replaced by a single filing system and hence a single source of public notice of chattel encumbrances.[15] This integrated filing system is outlined in section 9-302 of the Code,[16] which generally requires a financing statement to be filed to perfect any security interest.[17] This rule, however, is subject to certain exceptions, all but two of which owe their existence to adequate pre-Code filing and public notice systems.[18] The only security in tangible goods exempt from *any* filing requirement is a purchase money security interest in consumer goods[19] and farm equipment valued under $2,500.[20] These two exemptions are often viewed as similar and complementary, despite their different origins in public policy.[21]

The filing exemption accorded transactions in consumer goods is based on the premise that to require filing to perfect security interests in goods, such as refrigerators or stoves, would be futile and would merely congest the recording system.[22] The high volume of consumer goods sales and the relatively low sales prices justify this filing exemption. The advantages to be gained in reducing

8. 269 So. 2d at 727.
9. *Id.* at 729.
10. FLA. CONST. art. V, §3(b)(3).
11. FLA. STAT. §679.302(1) (1973).
12. FLA. STAT. §§671.101-679.506 (1973).
13. O. SPIVACK, *supra* note 1, at 3.
14. The complexity of pre-Code secured transactions resulted mainly from the existence of different modes of filing for each of the various types of encumbrances, such as chattel mortgages or conditional sale contracts. The Code focuses on the functional similarity of all such transactions creating one filing format and dispensing with differentiation based solely on the form of a particular security. *See generally* 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY (1965).
15. FLA. STAT. §§679.401-03 (1973).
16. FLA. STAT. §679.302 (1973).
17. FLA. STAT. §679.302(1)(d) (1973).
18. FLA. STAT. ANN. §679.302 (1971) (Official Comments).
19. FLA. STAT. §679.302(1)(d) (1973).
20. FLA. STAT. §679.302(1)(c) (1973) provides: "(1) A financing statement must be filed to perfect all security interests except the following: . . . (c) a purchase money security interest in farm equipment having a purchase price not in excess of $2500."
21. *See* W. DAVENFORT & R. HENSON, SECURED TRANSACTIONS 72 (1966).
22. 1 G. GILMORE, *supra* note 14, at 537.

administrative cost and inconvenience outweigh the disadvantage of loss of public notice of encumbrances and the additional risks assumed by creditors.[23]

In contrast to the consumer goods exemption the farm equipment exemption is not grounded in any pragmatic assessment of its convenience in commerce; rather, it is the result of the desire of the original drafters of the Uniform Commercial Code to give preferential treatment to the farmer in his business activities.[24] In part, this extraordinary concern for the farmer was based on a belief that farmers were somehow unsophisticated in the ways of commerce.[25] Additionally, the original Code sought to give more security to farm-related credit to induce financing institutions to facilitate credit acquisitions by farmers.[26] The farm equipment filing exemption was justified, in pursuit of this aim, as a means of maintaining the apparent integrity of equipment inventories as a source of collateral despite encumbrances on relatively minor items.[27]

The actual effect of the exemption, however, was contrary to the intentions of the drafters and the enacting states. Lending institutions, conscious of the potential for secret liens on farm equipment, became reluctant to accept such equipment as collateral.[28] The mere possibility of undisclosed encumbrances raised the risk of lending on such collateral and inevitably tightened the availability of credit secured by equipment inventories. Beyond credit considerations, the exemption failed to ease the administrative burdens of farm equipment retailers because it was subject to a relatively low price limitation[29] and added substantial risks that could be avoided by filing a financing statement.[30] Retailers allowed the exemption to fall into disuse. Thus, although little used by vendors of farm equipment the exemption affected farm credit merely by its potential for hiding chattel encumbrances.

The farm equipment exemption did not enjoy uniform acceptance among those jurisdictions that adopted the Code. Oklahoma, for example, omitted it entirely, finding the exemption contrary to state policy.[31] Wisconsin reduced the ceiling amount from $2,500 to $250 as a compromise between an aversion to secret liens and prevailing commercial custom.[32] In all, fifteen states either

23. The automatically perfected security interest is not as secure as an interest perfected by filing. A subsequent buyer of consumer goods takes the property free of encumbrances if he purchases without knowledge, for value, and for his personal use, and if no financing statement has been filed to establish public notice. *See* FLA. STAT. §679.307(2) (1973).

24. *See* Sorelle, *"Farm Products" Under the U.C.C.—Is a Special Classification Desirable?*, 47 TEXAS L. REV. 309 (1969).

25. Cook Grains, Inc. v. Fallis, 239 Ark. 962, 980, 395 S.W.2d 553, 561 (1965).

26. *See* Hawkland, *The Proposed Amendment to Article 9 of the U.C.C.—Part I Financing the Farmer*, 71 COM. L.J. 416 (1973).

27. *Id.* at 417.

28. *See* Coogan & Mays, *Crop Financing and Article 9: A Dialogue with Particular Emphasis on the Problems of Florida Citrus Crop Financing*, 22 U. MIAMI L. REV. 13, 19 (1967).

29. *See* 1 G. GILMORE, *supra* note 14, at 532.

30. See note 23 *supra*. *See also* 2 W. HAWKLAND, A TRANSACTIONAL GUIDE TO THE U.C.C. 785 (1964).

31. *See* OKLA. STAT. ANN. tit. 12, §9-302(1) (1973).

32. The Wisconsin compromise was based on the assumption that the frequency with which minor items of farm equipment or consumer goods are subject to purchase money

abolished the exemption or reduced the dollar ceiling,[33] thereby significantly reducing the number of potentially exempt transactions. Thus, not only was the exemption detrimental to farmer credit and unused by equipment sellers, but it had become as well a very nonuniform provision. It was "a foolish monument of a foolish privilege and a trap for the unwary."[34] Apparently recognizing the inherent weaknesses of the provision, the drafters of the 1972 version of the Code deleted it,[35] conceding that the effect of the exemption had been to restrict credit flow to the farm. The argument that the exemption represented merely a rural analogy to the consumer goods exemption was summarily dismissed as "inappropriate."[36]

The instant decision fits awkwardly into the progression of the farm equipment exemption from inclusion in the original Code to subsequent limitation by a number of enacting states and eventual repudiation by the 1972 Code. By holding that the individual item price controls the applicability of the exemption rather than the total contract price, the instant court broadened both the scope and impact of the provision, including a maximum number of farm equipment transactions within its purview. The majority did not address policy considerations or historical trends in reaching its decision. Rather, the court's rationale turned on interpretation of the term "purchase price" in the exemption.[37] The consistent use of the singular form was interpreted as evidence of a clear legislative intent to require filing only for "farm items substantial enough to cost $2,500," not for any number of small items on one contract the aggregate price of which might exceed $2,500.[38] The majority cited a Kentucky decision, *Mammoth Cave Production Credit Association v. York*,[39] as persuasive authority supporting the adoption of item over contract price. In *Mammoth Cave* the Court of Appeals of Kentucky refused to extend the farm equipment exemption to permit automatic perfection for an item with an initial purchase price in excess of $2,500 but an installment sale contract price reduced below that figure by a cash downpayment.[40] By analogy, the instant court read *Mammoth Cave* as affirming the superiority of purchase price over contract price in relation to the farm equipment filing exemption.

The instant court expressly rejected the holding of the district court that contract price should control the applicability of the filing exemption.[41] All items sold under one contract are subject to one security interest, the value of

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security interests acts as constructive notice to future creditors. The drastic reduction in the dollar limitations, however, testifies to that state legislature's reluctance to foster secret encumbrances. *See* WIS. STAT. ANN. §409.302(1)(c) (1974) (Official Comments).

33. *See, e.g.*, IOWA CODE ANN. §554.9302(1)(c) (1974) (reducing exemption ceiling to $1,000); MASS. GEN. LAWS ANN. ch. 106, §9-302(1)(c) (1973) (reducing ceiling to $500); TENN. CODE ANN. §47-9-302(1)(c) (1973) (reducing ceiling to $500).

34. Hawkland, *supra* note 26, at 417.

35. UNIFORM COMMERCIAL CODE §9-302 (Committee Comments on Changes in 1972 Draft).

36. *Id.*

37. FLA. STAT. §679.302(1)(c) (1973). See note 20 *supra*.

38. 296 So. 2d 32, 33-34 (1974).

39. 429 S.W.2d 26 (Ky. 1968).

40. *Id.* at 27.

41. 296 So. 2d at 33.

which is measured by the total value of the contract. Hence, the district court held that if that single security interest exceeds $2,500 filing is required.[42] Nonetheless, the supreme court reasoned that the seller of the equipment could always gain automatic perfection for the sale of items priced below $2,500, even when the total value of the transaction exceeded that amount, simply by executing different contracts for each item. Thus, using the contract price as the determinant would merely force the retailer into needless paperwork, an exercise in form over substance immaterial to the issue of whether the price of equipment is "substantial enough to cost $2,500."[43]

Justice Carlton in dissent focused squarely on the policy issues the majority did not reach. The Code expressly provides directions for its interpretation by calling for "liberal judicial construction to promote the underlying goals of the Code."[44] In this context the dissenting opion argued that the majority had grasped one original purpose of the exemption, administrative convenience to the farm equipment dealer, but had overlooked the general purposes of article 9.[45] The goals of public notice of encumbrance, avoidance of uncertainty among lenders, and the facilitation of credit acquisition by the farmer were ignored. Thus, the dissent found the narrow, syntactical analysis of the majority lacking in full appreciation of all competing interests involved.[46]

The differences between the majority and dissenting opinions result from a basic disagreement regarding the proper function of the court in statutory interpretation. The majority's strict observance of the exact language of the farm equipment exemption[47] contrasts sharply with the dissent's insistence on a judicial evaluation of the purposes and effects of the statute as a frame of reference for construing it.[48] The majority's limited scope of analysis and its steadfast refusal to look behind the words of the statute renders the principal decision an anomaly in two respects. First, whatever policy prompted the inclusion of the farm equipment exemption in the Code found no support in pre-Code Florida law. Prior to adoption of the Code no such exemption from filing and notice requirements existed in the state. In fact, state statutes expressly rejected the concept of encumbrances not made public either through filing[49] or physical possession of the collateral by a mortgagee.[50] The court in

42. 269 So. 2d at 727.

43. 296 So. 2d at 33-34.

44. FLA. STAT. §671.102 (1973).

45. 296 So. 2d at 35.

46. *Id.* at 38.

47. "There was a valid reason for the statute to set a ceiling on substantial items of equipment; apparently the Legislature fixed upon $2,500 as being a reasonable one. . . . The exception was *plainly* intended to cover farm items substantial enough to cost $2,500." *Id.* at 33 (emphasis added).

48. "No reason is given by our majority for reaching the interpretation it does—except that the term 'purchase price' is singular in the statute. In my view, this does not justify answering the question certified to us in a manner which simply makes no sense when measured against the purposes of the Code and this particular section of it." *Id.* at 39.

49. *See, e.g.,* FLA. COMP. GEN. LAWS §1742 (1927) (requiring filing and notice for *any* lien on personal property); FLA. STAT. §698.01 (1973) (requiring filing to secure *any* chattel mortgage).

50. Article 9 does not require public notice by filing of any encumbrances on tangible

the instant decision, therefore, expanded the scope of a provision that was contrary to state policy until enactment of the Code and that has since been repudiated by the body responsible for its transplantation into Florida law. By its refusal to consider the underlying policy issues as a factor in interpreting the statute the majority not only failed to fulfill the Code's dictates to interpret so as to promote its goals,[51] but also failed to support well-established state policy. To the extent that ambiguity exists in the term "purchase price" within the farm equipment exemption, state pre-Code attitudes should have offered a clearly defined direction for construing the statute.

A second anomaly flowing from the majority's narrow approach to interpretations of the statute is to be found in the misinterpretation of the Kentucky court's holding in *Mammoth Cave*. Technically, *Mammoth Cave* does rely on the purchase price of an item instead of the finance contract price as the standard for applicability of the farm equipment filing exemption. The facts in that case, however, bear no resemblance to those of the principal decision. The transaction involved one piece of equipment, priced in excess of $2,500, rather than a collection of several small items. The *Mammoth Cave* court refused to allow the scope of the exemption to be expanded to permit automatic perfection where a downpayment or a trade-in reduced the financed amount below the exemption price ceiling. Although *Mammoth Cave* held that the item's purchase price was the controlling figure, the court defined purchase price as "the price agreed upon by the parties as a consideration for which the property is sold and purchased."[52] That definition could easily encompass an aggregate contract price for a transaction involving more than one item. *Mammoth Cave* lacks the definitional clarity attributed to it by the majority in the instant case. It does, however, provide a meaningful policy guide. *Mammoth Cave* actually limited rather than expanded the farm equipment exemption by refusing to allow automatic perfection of a security interest valued above $2,500 and by refusing to maximize the number of transactions falling within the scope of the exemption. Thus, the instant decision, which allows the maximum number of transactions to fall within the purview of the exemption and permits the seller to take a security interest in excess of $2,500 so long as individual pieces each cost less than that amount, is actually in conflict with *Mammoth Cave*.

Viewed in the light of extant precedent,[53] the underlying policy of the Code,[54] and the realities of farm credit[55] the decision in the instant case appears clearly erroneous. As a result of the decision, farm credit will be hampered by still greater doubts concerning the security provided by farm

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goods when the creditor has physical possession of the collateral. Although seldom practical in a modern commercial setting, possession by a secured party satisfies the notice requirement because it reduces the opportunity for a subsequent creditor to rely on the chattel to secure a future credit transaction. O. SPIVACK, *supra* note 1, at 78.

51. FLA. STAT. §671.102 (1973).

52. Byrd v. Babin, 196 La. 902, 908, 200 So. 294, 300 (1941).

53. Mammoth Cave Prod. Credit Ass'n v. York, 429 S.W.2d 26 (Ky. 1968).

54. *See* O. SPIVACK, *supra* note 1, at 3.

55. See Hawkland, *supra* note 26.

equipment collateral. At least in theory, a farmer in Florida may now buy fifty items of farm equipment, each worth $2,000, under a single installment contract, and the retailer will gain an automatically perfected security interest in $100,000 worth of collateral without any notice to future creditors who may rely on that equipment as security for credit advanced to the farmer. This potential for secret liens may well result in constriction of available credit to farmers. Additionally, it is clear that the points of law involved in the instant case will be relitigated due to the number of problems the instant decision leaves unsolved. For example, it is unclear whether a set of six tractor attachments with a contract price of $3,000 would gain automatic perfection for the vendor's security interest because the items each sell individually for less than $2,500. Further, a large piece of farm machinery arguably may be described in the sales contract as component parts, valued below $2,500 each, giving the seller an automatically perfected security interest in a major piece of equipment without any public notice through filing. In addressing these and similar difficulties the court should avail itself of the opportunity to reconsider its holding in the instant case and to limit the scope of the farm equipment exemption.

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