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Uniform Commercial Code: Secret Lien Theory Yields To Race Of Diligence In Conditional Sales

*Piedmont Land and Development Co. v. Carney*¹

Debtor owed money to the plaintiff on a note dated February 5, 1962 and suffered judgment by confession thereon on March 20, 1962. On March 26, 1962 the debtor purchased an automobile subject to a conditional sales contract which was assigned to the Universal C.I.T. Credit Corporation. On April 2, 1962 the Department of Motor Vehicles issued title on the car and listed a lien thereon in favor of C.I.T. On April 10, 1962 the plaintiff placed a *fi. fa.* on its judgment in the hands of the sheriff who levied upon the automobile. Although C.I.T. did not record its conditional sales contract until April 18, 1962, it contended it was entitled to the proceeds of the sheriff's sale for the reason that the information in the DMV files constituted constructive notice to the plaintiff. The Maryland Court of Appeals stated that the DMV is not a "record office" and that information filed there could not serve as a basis for constructive notice. Since no evidence of actual notice was apparent on the record, the court's decision rested upon an interpretation of the Conditional Sales Act.² Section 66 read in part:

"Every * * * contract for the sale of goods and chattels * * * wherein the title thereto * * * is reserved until the same be paid in whole or in part, or the transfer of title is made to depend upon any condition therein expressed and possession is to be delivered to the vendee, shall in respect to such reservation and condition, be void as to *subsequent purchasers, mortgagees, incumbrancers, landlords with liens, pledges [pledgees], receivers, and creditors who acquired without notice a lien by judicial proceedings on such goods and chattels, * * ** until such note, sale or contract be in writing, signed by the vendee and be recorded, as provided in this section. . . ."

As the plaintiff was a creditor "who acquired without notice a lien by judicial proceedings", C.I.T. could prevail

¹ 232 Md. 21, 192 A. 2d 67 (1963).

² Laws of Md. 1951, ch. 577, § 71; 1941, ch. 875 (emphasis added), repealed by 8 Md. CODE (Cum. Supp. 1963) Art. 95B. For discussions of various problems arising under the Act, see Arnold, *Conditional Sales of Chattels in Maryland*, 1 Md. L. Rev. 187 (1937); Notes, 4 Md. L. Rev. 82 (1939); 13 Md. L. Rev. 154 (1953); 19 Md. L. Rev. 78 (1959); 19 Md. L. Rev. 157 (1959); and 21 Md. L. Rev. 160 (1961).

under this statute only if the word "subsequent" before "purchasers" also modifies "creditors who acquired without notice a lien by judicial proceedings". Under this interpretation C.I.T.'s conditional sales contract would not be void as to plaintiff because plaintiff was a prior creditor, having lent debtor money prior to March 26. The court, with Judge Henderson dissenting, found in favor of C.I.T.

Under conventional rules of construction, "subsequent" modifies the word immediately following it — "purchasers".³ Under the pertinent portion of the Conditional Sales Act the Maryland Court of Appeals has held that "subsequent" also modifies the following two named classes — "mortgagees"⁴ and "incumbrancers".⁵ After analyzing the original act passed in 1916 and the various amendments and cases decided under it, the court concluded that the underlying intent of the statute was to prevent secret liens and protect those who may have dealt with the debtor relying on false or misleading appearances of ownership based upon possession of chattels. Accordingly, only those who dealt with the debtor subsequent to the time indicia of ownership arose could claim protected status as a consequence of vendor's failure to record, and "subsequent" is to be construed as modifying "creditors".

In dissenting, Judge Henderson stated that if "subsequent" is to modify the first three classes listed in the statute (purchasers, mortgagees and incumbrancers) and also, as the majority finds, the last class (creditors), then "subsequent" logically must also modify the intervening three classes — landlords with liens, pledgees and receivers. "Landlords", he contended, cannot fairly be limited only to landlords after delivery of the chattel because completion of the lien by distraint evidently is required. Also, "pledgees" obtain a lien only by delivery of the particular chattel, so to speak of a 'subsequent' pledgee is meaningless." Furthermore, "a 'receiver' represents all creditors, whether prior or subsequent to the delivery of the chattel in question."⁶

The basic disagreement between the majority and dissent, however, stems from what each considered to be the underlying policy of the recording statute. Judge Henderson believed that protection to third parties dealing with the debtor should not be limited to situations where false

³ 20 M.L.E. *Statutes* § 90 (1961).

⁴ *Mohr v. Sands*, 213 Md. 206, 131 A. 2d 732 (1957).

⁵ *Automobile Accept. Corp. v. Universal CIT Credit Corp.*, 216 Md. 344, 139 A. 2d 683 (1958), noted in 19 Md. L. Rev. 157 (1959); *Rupp v. Johnston Co.*, 226 Md. 181, 172 A. 2d 875 (1961).

⁶ 232 Md., at 33.

appearances of assets are facilitated by secret liens, but rather that a "race of diligence" concept should control, whereby the first to secure his interest prevails — whether the creditor be prior or subsequent.

Since the Maryland General Assembly in its 1963 session repealed the Conditional Sales Act as of the same date that the Uniform Commercial Code⁷ came into effect, the specific question of statutory construction presented in the instant case is unlikely to arise again. At some future time, however, the Maryland courts may have to decide whether the "secret lien" or the "race of diligence" concept is to be applied when deciding appropriate cases under the UCC.

An analysis of Subtitle 9 of the UCC, dealing with secured transactions, indicates that the "race of diligence" concept prevails and the result in the instant case would be changed. Judge Henderson recognized this fact,⁸ as do certain of the official comments to the UCC text.⁹

A convenient procedure for determining the effect of Subtitle 9¹⁰ under the facts of the instant case is first to identify the parties and the transactions involved under the new language of the UCC. Section 9-301 defines "lien creditor" in subsection (3) as ". . . a creditor who has acquired a lien on the property involved by attachment, levy or the like. . . ." Section 9-107 provides in part that a "security interest"¹¹ includes "a 'purchase money security interest' to the extent that it is . . . taken or retained by the seller of the collateral to secure all or part of its price. . . ."¹² Thus, under the UCC the plaintiff would be

⁷ 8 MD. CODE (Cum. Supp. 1963) Art. 95B, § 10-101.

⁸ 232 Md., at 32.

⁹ Uniform Commercial Code § 9-312, Example 2, at 684, in which non-purchase money advances were made against the same collateral, it is stated that the result of giving priority to the first party to perfect his interest "may be regarded as an adoption . . . of the idea, deeply rooted at common law, of a race of diligence among creditors."

¹⁰ For a general discussion of secured transactions under Article 9, see Spivack, *Secured Transactions* (1963); Summers, *Secured Transactions Under the Uniform Commercial Code*, 42 ORE. L. REV. 1 (1962); Lee, *Perfection and Priorities Under the Uniform Commercial Code*, 17 WYO. L.J. 1 (1962); Gilmore, *The Purchase Money Priority*, 76 HARV. L. REV. 1333 (1963); 1 COOGAN, HOGAN and VAGTS, *SECURED TRANSACTIONS AND THE UNIFORM COMMERCIAL CODE* (1963); Uniform Commercial Code Annotations, 4 BOST. COLL. IND. & COMM. L. REV. (1963).

¹¹ 8 MD. CODE (Cum. Supp. 1963) Art. 95B, § 1-201 (37).

"'Security interest,' means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer (§ 2-401) is limited in effect to a reservation of a 'security interest.' The term also includes any interest of a buyer of accounts, chattel paper, or contract rights which is subject to subtitle 9."

¹² 8 MD. CODE (Cum. Supp. 1963) Art. 95B, § 9-107 (a).

a lien creditor and C.I.T. would hold a purchase money security interest. Furthermore, what was formerly known as a conditional sales contract is one of the types of transactions now subsumed under the general classification of "security agreement"¹³ and is usually perfected by the filing of a "financing statement".¹⁴

Under section 9-302(1)(d) a financing statement must be filed to perfect a security interest in any motor vehicle that is required to be licensed.¹⁵ If the motor vehicle is in the possession of a debtor and no statement is filed, it remains an unperfected security interest; section 9-301(1)(b) provides that an unperfected security interest is subordinate to the rights of a "person who becomes a lien creditor without knowledge of the security interest and before it is perfected."¹⁶ Section 9-301(2) states:

¹³ § MD. CODE (Cum. Supp. 1963) Art. 95B, §§ 9-201, 9-203(1)(b), 9-208. The Code does not in terms abolish existing forms of security transactions. See § 9-102, Comment 2. It does, however, recognize that all of the frequently used security devices have substantially the same purpose; to create security in personal property as assurance of payment of an obligation. The Code also recognizes that this singleness of purpose demands a single lien concept with precise specifications of rights and obligations. Therefore, the Code avoids the limitations and restrictions of the older concepts by applying the single term "security agreement" to all transactions in which the parties *intend* to create a security interest. See §§ 9-101, 9-102 and the definition of security interest in § 1-201(37). The Code concept of a security agreement, based on intent, is broad enough to include all existing forms of security transactions, transactions such as a consignment or memorandum sale, not previously considered to be secured transactions, and new forms of transactions growing out of expanding commercial concepts. At the same time, for a variety of policy reasons, certain transactions which could be included in the term "security agreement" are excluded from the scope of Article 9 by § 9-104.

¹⁴ § MD. CODE (Cum. Supp. 1963) Art. 95B, § 9-302. Section 9-402 describes the financing statement in detail and sets out its formal requirements. Sections 9-302(c) and (d) specify limited situations where a purchase money security interest is perfected without filing, not applicable to the instant problem. Perfection is not absolute, see note 20 *infra*.

¹⁵ The procedural aspects of filing are dealt with in detail in § 9-401 through § 9-406. The proper place to file a financing statement is with the clerk of the circuit court of the county where the debtor resides, except in Baltimore City where the Superior Court of Baltimore City should be used. § 9-401(1)(b). The statement is effective for a maximum of five years from the date of filing and will lapse at that time or 60 days after the stated maturity date, whichever occurs first, unless a continuation statement is filed prior to the lapse. § 9-403(2). Upon termination of the financing arrangement a "termination statement" is presented to the filing officer, and the original financing statement may be returned to the vendee. § 9-404. Also, a "secured party may assign of record all or a part of his rights under a financing statement by filing a separate written statement. . . ." § 9-405(2). See also, Opinions of Attorney General of Maryland, Daily Record, March 3, 1964 and March 24, 1964.

¹⁶ See *United v. Potts & Callahan*, 231 Md. 552, 191 A. 2d 570 (1963), in which the court applied Pennsylvania law which embodies the UCC and held that an unrecorded lease purchase (security) agreement was not valid as to a subsequent creditor with a judicial lien. See also *Girard Trust Bank v. Lepley Ford*, 12 Pa. D. & C. 2d 351 (1957).

"If the secured party files with respect to a purchase-money security interest before or within ten days after the collateral comes into possession of the debtor, he takes priority over the rights of a . . . lien creditor which arise between the time the security interest attaches and the time of filing."¹⁷

If the vendor (secured party) does not file within the ten day grace period, he must file prior to the perfection of a subsequent security interest or lien in order to have priority over it.¹⁸ The knowledge which will subordinate a lien creditor under section 9-301(1)(b) is actual knowledge, and mere suspicion of an outstanding unperfected security interest is not sufficient to make the security interest superior.¹⁹

Thus, if the instant case had arisen under the UCC, since the plaintiff was without actual knowledge of C.I.T.'s unperfected security interest on April 10, when he became a lien creditor by delivering the *fi. fa.* to the sheriff, he should prevail over C.I.T., which did not perfect its security interest under section 9-302(1)(d) until filing on April 18 and could not claim the benefit of the ten day grace period which commenced March 26.

Under the motor vehicle statute, liens may continue to be shown on certificates of title to automobiles, and this should often lead to actual knowledge of the security interest. In the absence of actual knowledge, the instant case and Maryland's departure from the uniform draft in section 9-302(3)(b) make it clear that the listing of a lien on the title certificate and in the DMV files does not afford constructive notice. Perfection can be achieved only by filing with one of the clerks of the specified courts.²⁰

¹⁷ See § 9-204 as to the time when a security interest attaches. See in the Matter of Luckenbill, 156 F. Supp. 129 (E.D. Pa. 1957), a bankruptcy trustee, who had the rights of a hypothetical lien creditor as of the date of bankruptcy under Bankruptcy Act § 70(c), 11 U.S.C.A. § 110(c), prevailed over an installment seller who had not formally complied with filing requirements. Partial filing prior to bankruptcy made "in good faith" was not sufficient to constitute knowledge to the trustee under § 9-401(2). To the same effect in the Matter of Lux's Superette, Inc., 206 F. Supp. 368 (E.D. Pa. 1962).

¹⁸ Spivack, *op. cit. supra* note 10, at 97. As to a subsequent conflicting security interest, see § 9-312(4).

¹⁹ § 1-201(25)(c): "A person 'knows' or has 'knowledge' of a fact when he has actual knowledge of it."

²⁰ See discussion in note 15 *supra* as to filing. Perfection by filing will not always protect against subsequent purchaser. A recent amendment to the Int. Rev. Code of 1954, § 6323, Pub. L. No. 272, 88th Cong., 2d Sess. (Feb. 26, 1964) follows this approach favoring subsequent purchaser by creating an exemption from federal tax liens in the case of motor vehicles if the purchaser is without actual notice or knowledge of the existence of such lien, or if before the purchaser obtains notice or knowledge, he acquired

Under the UCC, as under the prior law as to subsequent creditors, the creditor is protected only if he is ignorant of prior unperfected interest in the chattel;²¹ knowledge on his part prevents him from gaining priority regardless of whether he is "diligent in attaching". On the other hand, the rights of the holder of a purchase money security interest remain unaffected by any knowledge he may have concerning the existence of other creditors, and his rights are determined solely by the timeliness of his filing. This result encourages a free flow of credit sales by protecting a "secured party" vendor merely if he is diligent in filing. If there is no timely filing of a purchase money security interest, a general creditor may, by attachment, obtain a prior lien on the goods sold to the debtor, unless he knows of the conditional sale and consequently could not have been misled by any ostensible ownership of the debtor.

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possession of the vehicle and has not thereafter relinquished possession of the vehicle. Previously, tax liens on motor vehicles were valid if notice thereof was filed in an office designated by state law or with the clerk of the United States District Court in the judicial district in which the property was situated.

²¹ Lack of knowledge was also required of the judgment creditor under the old act. Laws of Md. 1951, ch. 577, § 71.