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# Uniform Commercial Code - Secured Transactions - Implied Consent to Sell

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It [majority decision] imposes a legal duty on an architect not only to prepare plans and specifications but to inspect the methods employed by the contractor leading up to the completion under the general inspection clause of his contract. I cannot read into a contract a duty which is not imposed by it. The architect's contract used here is a more or less standard form generally used by architects and engineers. It provides for detailed plans and specifications, obtaining approval of various governmental agencies, issuing certificates of payment and general administration. Supervision is limited. Since there is no contractual obligation, liability is fixed by an expansion of the common law.<sup>34</sup>

The right to inspect which was conferred upon the architect-defendant by the contract between the contractor and the school district must have been intended only to facilitate the performance of the architect's duty to the school district. The majority opinion translates this right into a tort duty owed to third persons. Such a result is neither consistent with general usage in the architectural profession nor contemplated by the contracting parties. The court should have confined its discussion to the terms of the contract between the owner and architect. It is unfortunate that it relied upon a contract to which the architect was not a party. It is the hope of this writer and undoubtedly that of architects that such a view is not adopted by other courts.

*James Bradley*

<sup>34</sup> *Miller v. DeWitt*, 37 Ill. 2d at 294, 226 N.E.2d at 642-43.

#### UNIFORM COMMERCIAL CODE—SECURED TRANSACTIONS— IMPLIED CONSENT TO SELL

The plaintiff bank made two loans to W. D. Bunch which were secured by livestock. Bunch, through the defendant auctioneer, sold some of the cattle covered by the security agreements. The bank had knowledge of these sales and accepted the proceeds as payment on the loans. Subsequently, the bank granted Bunch a new loan, secured by a new note and security agreement.<sup>1</sup> Thereafter, the cattle covered by the subsequent agreement were consigned to the auctioneer and sold by him. The proceeds were remitted to Bunch and he applied no part of them to his debt. The bank had no actual knowledge of the latter sales nor had it given Bunch any authority to sell. The bank brought suit against the auctioneer for conversion and the trial court held that the plaintiff bank had permitted, consented to, and acquiesced in

<sup>1</sup> The security agreement provided in part: "Debtor further represents and warrants, and agrees that . . . Without the prior written consent of Secured Party, Debtor will not sell . . . or otherwise dispose of the Collateral."

these sales, and therefore by its conduct waived its rights in the cattle.<sup>2</sup> In affirming the decision, the Supreme Court of New Mexico held that the bank had permitted the debtor to sell the property without first requiring written consent and therefore lost its security interest in the cattle, precluding recovery from the auctioneer. *Clovis National Bank v. Thomas*, 77 N.M. 554, 425 P.2d 726 (1967).

This case note will investigate the problem which a secured party faces in maintaining his lien in the collateral and in determining the course of action he must follow so as not to waive his security interest. It will concern itself with law prior to enactment of the Uniform Commercial Code, but more specifically with what the Code seems to say on the subject and in what manner this case contributes to the interpretation of the sections of the Code involved.<sup>3</sup>

On the state level, it has been consistently held that an auctioneer who sells mortgaged property at an auction at the request of the mortgagor who has no authority to sell converts the property and is liable to the mortgagee for damages.<sup>4</sup> The fact that the auctioneer has no knowledge of the mortgagee's interest and innocently turns the proceeds of the sale over to the mortgagor in no way exonerates him from liability.<sup>5</sup> The liability of an auctioneer on the federal level is also well settled and the only conflict which arises in the federal courts is whether or not to apply state law.<sup>6</sup> One of the most recent cases which is illustrative of the views of the federal courts is *United States v. Carson*.<sup>7</sup> In this case, the court, in finding that the enunciation of a uniform federal rule was necessary to assure that the security interests created by farm legislation would not be defeated, stated:

[T]hat an auctioneer is liable for conversion to the holder of a security interest in property which he has sold even if unaware of the existence of the security interest—has been applied as the federal law by two courts of appeals which have decided that the instant situation is to be governed by a uniform federal rule. We

<sup>2</sup> There was testimony that the bank had followed the practice of allowing its debtors to sell the collateral without first obtaining its consent and relied upon the debtors' honesty to bring in the proceeds.

<sup>3</sup> Since all of the particular sections of the Uniform Commercial Code on which the court has based its decision are exactly the same as the 1962 Official Text, all references to the Code in this note will be to the 1962 Official Text.

<sup>4</sup> *Pasley v. Ropp*, 334 S.W.2d 254 (Mo. Ct. App. 1960); *State Sec. Co. v. Svoboda*, 172 Neb. 526, 110 N.W.2d 109 (1961).

<sup>5</sup> *Eureka Spring Sales Co. v. Ward*, 226 Ark. 424, 290 S.W.2d 434 (1956); *Wisdom v. Kethley*, 237 Mo. App. 76, 167 S.W.2d 450 (1943); *Morin v. Hood*, 96 N.H. 485, 79 A.2d 4 (1951).

<sup>6</sup> This note is not intended to cover the various situations in which this conflict might arise.

<sup>7</sup> 372 F.2d 429 (6th Cir. 1967).

join with them and apply it here. We also take note of the fact that this rule is followed in nearly all the states.<sup>8</sup>

Clearly then, the liability of auctioneers for conversion of chattels in which some third party had a security interest has been well settled under pre-Code law.<sup>9</sup>

Since the collateral involved in the *Clovis* case is livestock, it falls within U.C.C. section 9-109(3), which governs security interests in "farm products."<sup>10</sup> There is no particular section of the Code which specifically determines the rights and liabilities of auctioneers or selling agents, but there are sections which imply that an auctioneer would be on notice and take subject to the terms of the security agreement and therefore be liable for conversion.<sup>11</sup> As far as farm products are concerned, section 9-307(1) also implies that an auctioneer, even though he may in some particular circumstances be considered a "buyer in the ordinary course of business,"<sup>12</sup> would not take free of the security interest created by the debtor.<sup>13</sup> Therefore, there being no specific section relating to this subject in the Code, by supplementing it with pre-Code law an auctioneer may be held liable for conversion.<sup>14</sup> However, the court in the principal case, addressing itself to the liability of the auctioneer, relied only on section 9-307(1) by way of analogy: "It would only seem logical and consistent that if a buyer from one engaged in farming operations takes subject to the security interest, then the selling agent is subject to the rights of the secured party in the collateral."<sup>15</sup>

Another case involving the liability of an auctioneer under the Uniform Commercial Code was *Warfel v. Lebanon Valley Livestock, Inc.*<sup>16</sup> The

<sup>8</sup> *Id.* at 434-35. The two cases referred to by the court are: *United States v. Somerville*, 324 F.2d 712 (3d Cir. 1963); *United States v. Matthews*, 244 F.2d 626 (9th Cir. 1957). *But see* *United States v. Union Livestock Sales Co.*, 298 F.2d 755 (4th Cir. 1962); *United States v. Kramel*, 234 F.2d 577 (8th Cir. 1956); both recognizing the liability of auctioneers but applying state law.

<sup>9</sup> *See generally* Annot., 96 A.L.R.2d 208 (1964).

<sup>10</sup> U.C.C. § 9-109 provides that: "Goods are . . . (3) 'farm products' if they are crops or livestock or supplies used or produced in farming operations . . . if they are in the possession of a debtor engaged in raising . . . or other farming operations."

<sup>11</sup> U.C.C. § 9-201 provides that: "Except as otherwise provided by this Act a security agreement is effective according to its terms between the parties, against purchasers of the collateral . . ." *See also* U.C.C. § 9-306, comment 3.

<sup>12</sup> U.C.C. § 1-201(9).

<sup>13</sup> U.C.C. § 9-307(1) provides that: "A buyer in the ordinary course of business other than a person buying farm products from a person engaged in farming operations takes free of the security interest created by his seller . . ."

<sup>14</sup> U.C.C. § 1-103. *See* *The Nat'l Shawmut Bank of Boston v. Vera*, 223 N.E.2d 515 (Mass. 1967) noted in 17 DEPAUL L. REV. 242 (1967). *See also, supra* notes 4, 8.

<sup>15</sup> *Clovis Nat'l Bank v. Thomas*, 77 N.M. 554, 562, 425 P.2d 726, 731 (1967).

<sup>16</sup> 9 Lebanon 300 (Pa. 1962).

plaintiff was granted a security interest in certain cows, but contrary to the terms of the agreement, the debtor delivered the cattle to the defendant auctioneer and they were subsequently sold by him. The plaintiff brought suit in conversion and the court found that the security agreement was notice to the world of the secured party's interest in the security and that the defendant, as auctioneer and agent for the converting debtor, was guilty of conversion. The court, relying on pre-Code law to supplement the Code, stated that: "There is little question that both Federal and State courts held that an agent is liable to the owner of property if he has taken part in a wrongful conversion, even though he has no knowledge that a wrongful conversion has taken place."<sup>17</sup>

Recognizing this liability, the court in the *Clovis* case held that a secured party may consent to a sale and thereby waive his security interest in the collateral.<sup>18</sup> Waiver is usually defined as an intentional or voluntary abandonment of a known right.<sup>19</sup> Therefore, to constitute a waiver there must be an existing right and an actual intention to relinquish it or such conduct which would warrant an inference of the waiver.<sup>20</sup> In *Clovis* it was found that the bank had no actual knowledge that the cattle were being sold. The bank contended that since the security agreement provided for its written consent before the debtor could properly dispose of the collateral and that since it had no knowledge of the sales, it could not have waived its rights.<sup>21</sup> However, the court held that the bank, because of its practice of allowing all its debtors to sell the collateral and relying upon their honesty to bring in the proceeds, had waived its rights by impliedly acquiescing to the sales in question and that therefore it was precluded from recovering against the auctioneer for conversion.<sup>22</sup> This being the case, want of knowledge on the part of the bank of a specific sale was immaterial, provided, however, that the secured party had made it a practice of allowing debtors to sell the collateral.<sup>23</sup> On the other hand, the party charged with conversion need not have had any knowledge that the secured party had given his consent to the sale.<sup>24</sup>

<sup>17</sup> *Id.* at 302.

<sup>18</sup> *Supra* note 15, at 563, 425 P.2d at 730.

<sup>19</sup> *Johnson v. Zerbst*, 304 U.S. 458 (1938).

<sup>20</sup> *Chase v. National Indem. Co.*, 129 Cal. App. 2d 853, 278 P.2d 68 (1954); *Food Fair Stores, Inc. v. Blumberg*, 234 Md. 521, 200 A.2d 166 (1964); *Alsleben v. Oliver Corp.*, 254 Minn. 197, 94 N.W.2d 354 (1959); *Ford v. Culbertson*, 158 Tex. 124, 308 S.W.2d 855 (1958).

<sup>21</sup> *Supra* note 1.

<sup>22</sup> *Supra* note 15, at 563, 425 P.2d at 732. *Accord, supra* note 20.

<sup>23</sup> *Pratt v. Maynard*, 116 Mass. 388 (1874).

<sup>24</sup> *Livingston v. Stephens*, 122 Iowa 62, 94 N.W. 925 (1903); *Stafford v. Whitcomb*, 90 Mass. 518 (1864); *Martin v. Duncan Auto. Co.*, 50 Nev. 91, 352 P. 322 (1927).

Whether or not the secured party has consented to a sale and thereby waived his rights in the collateral is a question of fact. Therefore, a discussion of a few cases which have had the occasion to deal with this subject of waiver would be beneficial at this point. In *United States v. Cassidy Commission Co.*,<sup>25</sup> the court held that even though the defendant auctioneer had made eight previous sales of stock covered by the plaintiff's mortgage without prior consent of the plaintiff being acquired by the mortgagor, but with after-sale approval and release of security being granted by the mortgagee, this course of conduct was not sufficient under the law to constitute an implied consent to the mortgagor to sell the stock in question and therefore the plaintiff did not waive its mortgage lien. In *Turnage Co. v. Morton*,<sup>26</sup> the plaintiff mortgagee allowed the mortgagors to remain in complete possession of the mortgaged tobacco at all times and also allowed the mortgagors to sell the tobacco although there was no agreement to do so. The defendant auctioneer had made one prior sale for the mortgagors before the sale in question, of which the plaintiff had knowledge. Plaintiff then brought suit against the auctioneer and the defendant contended that the mortgagee had waived his lien. The court, in affirming the decision for the mortgagee, and basing its decision on custom and usage, held that under an agricultural lien it was the customary procedure for the mortgagor to retain possession of the crops and to sell the tobacco at various markets. Therefore the plaintiff could not know where or when the tobacco would be sold. The court held that by custom and usage there was no waiver. In the *Clovis* case the court used custom and usage as being determinative of waiver. This contrary view is in accordance with *Birkett L. Williams Co. v. Smith*,<sup>27</sup> where the plaintiffs, Ohio corporations, brought a suit in conversion against the defendant automobile auctioneers. For a period of about three years the plaintiffs sold their autos to Hill Motors knowing that these autos were transported to and sold in Georgia. They took no steps to secure their interests under Georgia law. The court viewed the problem as a determination of the liability of an auctioneer for conversion when he auctioned property on behalf of a principal who had no title thereto but who had been set free over a period of years by the plaintiffs, who were the actual owners, to make just such sales as are now complained of. The court, recognizing the liability of auctioneers and the fact that a mortgagee by his conduct may waive his lien, held that the plaintiffs gave to Hill Motors such evidence of such a right to dispose of the autos. This was according to the custom of the trade and the common understanding of the market that usually accompanies the authority to sell.<sup>28</sup> Therefore, the auctioneers

<sup>25</sup> 263 F. Supp. 1019 (W.D. Okla. 1967).

<sup>26</sup> 240 N.C. 94, 81 S.E.2d 135 (1954).

<sup>27</sup> 353 F.2d 60 (5th Cir. 1965).

<sup>28</sup> *Accord*, *Cook Motor Co. of Panama City, Inc. v. Richardson*, 103 Ga. App. 129, 118 S.E.2d 502 (1961).

must stand in the same position as a bona fide purchaser for value without notice. In the *Clovis* case, although the debtor was not set free to sell for a period of years but only on two prior occasions, the court still found a waiver based on the bank's operations as a whole and not on its specific dealings with the debtor.<sup>29</sup>

In *Clovis*, the principal case, the security agreement stated that the debtor could not sell without the written permission of the secured party.<sup>30</sup> The plaintiff strongly relied on this provision in its suit, but the court found that it had waived this right. In *Texas National Bank of Houston v. Aufderheide*,<sup>31</sup> the bank brought an action to foreclose a chattel mortgage on an airplane. The defendant purchaser contended that the plaintiff had waived its lien. The court agreed with this contention and stated that, "[A] provision in a chattel mortgage prohibiting the sale of the mortgaged chattel without the mortgagee's consent is waived if the mortgagee knowingly permits the violation of such provision."<sup>32</sup> In *Producers Livestock Marketing Ass'n v. John Morrell & Co.*,<sup>33</sup> a case similar to the principal case, the plaintiff, assignee of a chattel mortgage on one hundred and eighty-three head of cattle, brought a suit for conversion against a purchaser of eighty-three of the steers covered by the mortgage. Prior to this sale in question, the mortgagor sold one hundred steers through its broker. The mortgagee, plaintiff's assignor, had accepted the broker's check endorsed over to it by the mortgagor as part payment on his mortgage. The sale in issue was conducted in the same manner but the check was returned unpaid. The court stated that receipt by the mortgagee of the check in payment of the one hundred steers without any objection tended to show "consent and ratification" of the sale. The mortgagee had also accepted the check for the second sale of the eighty-three head. The court held that, "It is the settled rule of law that, where the evidence shows without dispute that a mortgagee, through his agent and representative, consents to the sale of mortgaged property, notwithstanding the terms of the mortgage, then its acts in so doing would constitute a waiver of the mortgage lien."<sup>34</sup> These two cases can be distinguished from the principal case in that the bank did not have actual knowledge of the sales in question and therefore contended that it could not have knowingly permitted a violation of the provision calling for written permission to sell.

<sup>29</sup> *Supra* note 2.

<sup>30</sup> *Supra* note 1.

<sup>31</sup> 235 F. Supp. 599 (E.D. Ark. 1964).

<sup>32</sup> *Id.* at 603. See also, *supra* note 23.

<sup>33</sup> 220 Iowa 948, 263 N.W. 242 (1935).

<sup>34</sup> *Id.* at 951, 263 N.W. at 244. *Accord*, *United States v. Hanson*, 311 F.2d 477 (8th Cir. 1963).

The court, citing *Farmers' National Bank v. Missouri Livestock Commission Co.*,<sup>35</sup> found that the bank had impliedly consented to the sales by its course of conduct. Therefore custom and usage, more accurately, course of dealing,<sup>36</sup> can determine the rights and liabilities of the parties.<sup>37</sup>

The remainder of this note will concern itself with the Uniform Commercial Code and its application to the principal case and the law of waiver. Section 1-205(4) of the U.C.C. states that the terms of a contract and an applicable course of dealing or usage of trade should be construed as consistent with each other unless such construction is unreasonable. Under the authorities previously stated, a waiver by course of dealing would not be considered as an unreasonable construction.<sup>38</sup> The Clovis National Bank, in the principal case, had set forth a pattern with regard to its course of dealings with its customers, and it was not only the two isolated transactions with the debtor which prompted the court's decision.<sup>39</sup> Naturally, if a course of dealing is completely contrary to the terms of the contract, the court can only render a decision based upon the express assent of the parties.<sup>40</sup> Therefore, in the *Clovis* case the court found that by common practice, usage and procedure the bank had waived its lien.

It appears that the Code makes a provision for waiver by the use of the word "otherwise" in section 9-306(2).<sup>41</sup> The most classic example of implied authorization of a sale or other disposition of collateral is a claim to proceeds in the filed financing statement.<sup>42</sup> If a debtor engaged in selling goods makes an unauthorized disposition of the collateral and if there was no claim to proceeds in the original financing statement, the secured party could, unless otherwise provided,<sup>43</sup> follow the collateral into the hands of the purchaser or other transferee.<sup>44</sup> If proceeds were checked in this situation the secured party would have been considered as impliedly authorizing the sale.<sup>45</sup> The

<sup>35</sup> 53 F.2d 991 (8th Cir. 1931). *Accord, supra* note 20.

<sup>36</sup> U.C.C. § 1-205(1), (3) & (4).

<sup>37</sup> *Supra* notes 26, 27.

<sup>38</sup> *Supra* notes 27, 33.

<sup>39</sup> *Supra* note 2.

<sup>40</sup> *Higgins v. Cauhape*, 33 N.M. 11, 261 P. 813 (1927). *See also, supra* note 36.

<sup>41</sup> U.C.C. § 9-306(2) provides that: "Except where this article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof by the debtor unless his action was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds . . . ."

<sup>42</sup> U.C.C. § 9-306, comment 3.

<sup>43</sup> *E.g.*, U.C.C. §§ 9-301, 9-307, 9-308, 9-309.

<sup>44</sup> SPIVAK, SECURED TRANSACTIONS (3rd ed. 1963).

<sup>45</sup> *Supra* note 42.

reasoning seems to be: why would the secured party have checked proceeds if he did not expect the debtor to sell or otherwise dispose of the property? Whether or not the word "otherwise" was intended to include such a waiver as we have in the principal case seems to be clearly stated by Professor Gilmore:

The usual common law rules of waiver and estoppel may of course be invoked against such a secured party, and the debtor's authority to sell the collateral may derive either from an express provision in the security agreement or from the secured party's actions or conduct.<sup>46</sup>

It must be noted again, though, that the Code does not specifically provide for waiver of a security interest. Therefore, as in the case of the auctioneer's liability, one must go back to pre-Code law to supplement the terms of the Code.<sup>47</sup>

The decision in *Clovis* would not have any material effect on other areas of financing. In secured transactions other than farm products, a buyer in the ordinary course of business takes free of a security interest created by his seller.<sup>48</sup> Therefore, whether or not the debtor was authorized to sell would not affect the buyer's title. In situations where a transferee was not protected under the Code, the law of waiver and the decision in the principal case might be applicable. There being no section of the Code which "otherwise" provides with respect to farm products, section 9-306(2) gives the secured party the right to follow the collateral into the hands of a good faith purchaser for value and to have whatever remedy state law might provide.<sup>49</sup> Yet, with respect to other areas of secured transactions, the word "otherwise" is provided for, and the court's interpretation of the word would be limited.<sup>50</sup>

Therefore it is incumbent upon the secured party alone to maintain his security interest in the "farm product" collateral. Sound business practices and the decision in the principal case require a secured party to demand that all its debtors comply with the terms of the security agreement. Another safeguard would be to supply the local commission houses with a list of its debtors and make it known to the brokers that written permission for the debtor to sell must first be obtained from the secured party. In the principal case the bank knew that its debtors, in general, were selling the collateral contrary to the terms of the agreement but did nothing to prevent this.<sup>51</sup>

<sup>46</sup> 2 GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 26:11 (1965).

<sup>47</sup> *Supra* note 14.

<sup>48</sup> *Supra* notes 12, 13.

<sup>49</sup> *Supra* notes 42, 46.

<sup>50</sup> *Supra* note 43.

<sup>51</sup> *Supra* note 2.

This is clearly a waiver of its security interest in the collateral and the court rightly held so.

*Clovis National Bank v. Thomas* is relevant so far as it is applicable to the area of farm products and the Uniform Commercial Code. Beyond that, its importance diminishes. Since the Code does not specifically provide for waiver in a manner which can be uniformly decided by the adopting states, courts which have held that waiver is not determined by custom and usage will probably still decide along these same lines. This case still leaves the interpretation of what constitutes waiver to local courts; and the criteria to be applied will be local law. Therefore whether or not the states will split along their present lines still remains to be seen.

*John Goryl*

#### VENUE—PROPER FEDERAL FORUM FOR UNINCORPORATED ASSOCIATIONS

The Denver and Rio Grande Western Railroad Company sued the Brotherhood of Railroad Trainmen for breach of duty under the Railway Labor Act with respect to a strike. The United States District Court for the District of Colorado overruled the union's motion to dismiss the action for improper venue and awarded the railroad damages. The union appealed to the United States Court of Appeals for the Tenth Circuit where the decision was reversed, holding that the union could be sued only in the venue of its residence, and that its residence was not in Colorado. Certiorari was granted to the United States Supreme Court where it was ruled that the Court of Appeals improperly applied section 1391(b) of the United States Code,<sup>1</sup> thereby changing the venue requirements and abandoning the doctrine that an unincorporated association is not recognized as a citizen for venue and diversity purposes. *Denver and Rio Grande Railroad Co. v. Brotherhood of Railroad Trainmen*, 387 U.S. 485 (1967).

Section 1391(b) is the general venue statute governing transitory causes of action in the federal courts where jurisdiction does not depend solely on diversity of citizenship. Following its amendment in 1966, the section permits suit either in the district where all of the defendants reside or in the district where the cause of action arose. At the time this suit was brought, however, venue lay only at the defendant's residence, as had been the case since 1887. Thus, for almost eighty years, proper venue in federal question cases was

<sup>1</sup> 28 U.S.C. § 1391(b) reads as follows: "A civil action wherein jurisdiction is not founded solely on diversity of citizenship may be brought only in the judicial district where all defendants reside, except as otherwise provided by law."