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# Commercial Law - Subrogation and Priority of Liens on Chattels under the Uniform Commercial Code

Robert Bromberg

*Electric* case did not involve coercion,[34] the *Union Oil* decision does not necessarily indicate a complete change of judicial thinking on consignment marketing. Further clarification of this area awaits future litigation, at which time it is hoped the Court will clearly enunciate a theory on resale price maintenance.[35]

*George Spindler*

[34] In *United States v. General Electric*, 82 F. Supp. 753 (1949), the Justice Department again challenged General Electric's distribution system of agents and consignment contracts but the Court again found the relationship of the parties to be consistent with true agencies. Of course, Union exerted far more pressure on its dealers than General Electric, since by cancelling service station leases Union could put them out of business. All General Electric could do was to quit supplying light bulbs, but since most of its agents were general merchants, this would injure only one line of products marketed by them, not their entire business.

[35] It is believed that the present case will eventually be disposed of by the application of the McGuire Act and the California Fair Trade Law in favor of Union Oil. The CAL. BUS. & P. CODE § 16902 (1964) provides that contracts for resale price maintenance are not illegal as long as the parties do not compete. Since Union Oil did not operate any retail outlets in the Fresno, California area, it should not be prevented from forming a valid fair-trade agreement with Simpson. Such an agreement, being legal in California, would not violate the Sherman Act because of the provision of the McGuire Act. Thus, if Union's "consignments" were really resale price agreements, as the Court thought, they would be legal. It is perplexing why the Court did not itself apply the Fair Trade statutes instead of ignoring them and finding the marketing practices of Union to be illegal, but apparently the Court was anxious to go on record as being opposed to retail prices which are established through consignment agreements enforced by the threat of possible loss of business franchise. The Court in remanding, provided that the Fair Trade Acts should be considered.

## COMMERCIAL LAW–SUBROGATION AND PRIORITY OF LIENS ON CHATTELS UNDER THE UNIFORM COMMERCIAL CODE

French Lumber Company, the purchaser, brought a bill in equity to determine the ownership of certain funds derived from the sale of a 1959 Cadillac automobile at public auction. The purchaser had financed its purchase of the vehicle through Ware Trust Company (the first lienor) in February of 1959, and entered into a Uniform Commercial Code security agreement as security for its note. This agreement was duly recorded. Five months later, the purchaser pledged its existing equity in the automobile, along with certain other security, to Commercial Realty & Finance Company (the second lienor). With knowledge that its rights were subordinated to those of the first lienor, Commercial duly filed its lien on the automobile. The automobile was subsequently repossessed by the first lienor when the purchaser defaulted in its payments on the note. The purchaser thereupon arranged with Associates Discount Corporation

(the third lienor) to refinance the automobile. The purchaser did not inform the third lienor of the second lienor's security interest in the automobile. Later the third lienor, without examining the public records to ascertain whether such an interest did exist, paid the first lienor the remaining balance of its note, and received the same marked "paid in full." The third lienor thereupon duly recorded what it believed to be the only lien on the chattel, and when the purchaser again became in arrears on the note, proceeded to repossess the automobile and sold same at public auction. From a decision awarding the proceeds of the sale to the third lienor, Commercial (the second lienor) appealed, and the decision was affirmed. *French Lumber Co., Inc. v. Commercial Realty & Finance Co., Inc.*, ___Mass.___, 195 N.E.2d 507 (1964).

The importance of this case lies in the fact that it is apparently the first time that the equitable doctrine of subrogation was held to have supplemented a section of the Uniform Commercial Code. This case can be analyzed in three parts: (1) an explanation of the applicable sections of the Code; (2) an analysis of the criteria of subrogation and how the third lienor was properly held to be subrogated to the rights of the first lienor; and (3) the reasons why the third lienor's negligence in not discovering the prior lien was not a bar to its recovery.

Commercial Realty, as the second lienor, contended that its rights in the proceeds were superior to those of Associates, the third lienor, because, under the explicit provisions of the Code,[1] the rights of those with conflicting security interests in the same collateral are determined: "in the *order* of filing if both are perfected by filing, *regardless* of which security interest attached first under § 9-204(1) and whether it attached before or after filing."[2] Under this provision, the order of priorities would be: Ware (first lienor), Commercial (second lienor) and Associates (third lienor).

Initially, it would appear that the Code provides that the second lienor should have prevailed in this action because it was the first claimant to perfect its security interest by filing.

The Supreme Judicial Court of Massachusetts, however, affirmed the ruling of the lower court, holding that the third lienor acquired priority through the equitable doctrine of subrogation.[3] The court also held that previous decisions on subrogation have not been superseded by the Code,

[1] MASS. GEN. LAWS ch. 106 (1957).

[2] MASS. GEN. LAWS ch. 106, § 9-312(5)(a). (Emphasis added.)

[3] The court quoted with approval the case of Home Owner's Loan Corp. v. Baker, 299 Mass. 158, 161–62, 12 N.E.2d 199, 201 (1937): "The plaintiff having paid the debts of the defendant out of its funds and taken its mortgage in the mistaken belief that it would have a first lien on the premises, was not officious. In such circumstances, equity has given relief by way of subrogation when the interest of intervening lienors were not prejudicially affected."

noting that section 1-103 of the Code provides in part, "Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant . . . or other validating or invalidating cause shall supplement its provisions."[4]

In reviewing the Code, it is significant that section 1-103 appears at the virtual beginning of the Code. This seems to indicate that the draftsmen intended that equitable principles should govern the Code. Such a concept is not new. There have been similar provisions in other uniform laws.[5] Courts have ruled that an existing equitable doctrine must be clearly repugnant to, or be specifically overruled by the statute itself in order to avoid the applicability of equitable principles.[6]

The core of the *French Lumber* decision is the applicability of the equitable doctrine of subrogation. The third lienor's rights were determined on the basis of the third lienor's being subrogated to the rights of the first lienor. The equitable doctrine of subrogation[7] is specifically included within the Code.[8] Thus, it appears clear that it was intended by the authors of the Code that the doctrine of subrogation should be made applicable to supplement section 9-312 (5)(a).

There are two types of subrogation, conventional and legal (including

[4] The court in the *French Lumber* case said: "No provision of the Code purports to affect the fundamental equitable doctrine of subrogation." 195 N.E.2d at 510.

[5] UNIFORM SALES ACT § 2; UNIFORM NEGOTIABLE INSTRUMENTS LAW § 196; UNIFORM BILLS OF LADING ACT § 51; UNIFORM WAREHOUSE RECEIPTS ACT § 56; UNIFORM STOCK TRANSFER ACT § 18.

[6] Syracuse Trust Co. v. Corey, 167 Misc. 506, 512, 4 N.Y.S. 2d 349, 355 (1938): "While the law of the State of New York has become largely statutory and there is a narrow field left for the development of common law through judicial decision, nevertheless, the general equity power of the court remains largely unimpaired, excepting where a law is so rigid as to inhibit the application of equitable doctrines."

[7] See generally, Pearlman v. Reliance Insurance Co., 371 U.S. 132 (1962); Jackson Co. v. Boylston Mutual Insurance Co., 139 Mass. 508, 2 N.E. 103 (1885); Detroit Steel Products Co. v. Hudes, 17 Ill. App.2d 514 151 N.E.2d 136 (1958).

[8] UNIFORM COMMERCIAL CODE § 9-504:

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

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

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

"(5) A person who is liable to a secured party under a guaranty indorsement, repurchase agreement or the like and who receives a transfer of collateral from the secured party or is *subrogated* to his rights has thereafter the rights and duties of the secured party. Such a transfer of collateral is not a sale or disposition of the collateral under this article." (Emphasis added.)

equitable). Conventional subrogation arises by virtue of an agreement between the interested parties.[9] Legal (or equitable) subrogation, on the other hand, arises by operation of law where certain sets of circumstances exist.[10] Under the circumstances of the instant case, the rights of the third lienor, by operation of law, were subrogated to the rights of the first lienor.[11] Legal (or equitable) subrogation initially requires the full payment of an existing debt.[12] In the *French Lumber* case, the purchaser owed a debt to the first lienor, which the third lienor paid in full. Secondly, it must be a debt for which another is primarily liable,[13] as was purchaser in the instant case. Thirdly, the party paying the debt must not be a mere volunteer, but must have some interest or right to be protected.[14] However, one who pays another's debt at that other's request is not considered to be a volunteer but will be entitled to be subrogated to the rights of the party whom he has paid.[15] The purchaser in the instant case had approached the third lienor and requested that the third lienor refinance the automobile. And finally, there must be either an actual or an implied understanding (as in the *French Lumber* case) that the party paying the debt shall acquire the rights of the party whom he has paid.[16] Third lienor,

[9] Meyer v. Florida Home Finders, 90 Fla. 128, 105 So. 267 (1925). A common use of conventional subrogation is found in an insurance contract.

[10] Dunlap v. Pierce, 336 Ill. 178, 168 N.E. 277 (1929).

[11] In the *French Lumber* case, the court said: "It is incredible that Associates [third lienor] would not have taken appropriate protective steps by way of an assignment from the bank [first lienor]." 195 N.E.2d at 509. But for all practical purposes, the third lienor did receive an assignment from the first lienor, even though it was not a formal assignment. *Cf.*, Home Owners' Loan Corp. v. Papara, 241 Wis. 112, 118, 3 N.W.2d 730, 732 (1942).

[12] American Surety Co. v. Westinghouse Electric Manufacturing Co., 296 U.S. 133 (1935); Prairie State National Bank v. United States, 164 U.S. 227 (1896).

[13] Employers Mutual Liability Insurance Co. v. Griffen Construction Co., 280 S.W.2d (Ky. 1955).

[14] American Surety Co. of New York v. Bethlehem National Bank, 314 U.S. 314 (1941); Wilkens, Neely & Jones v. Gibson, 113 Ga. 31, 38 S.E. 374 (1901).

[15] Home Savings Bank v. Bierstadt, 168 Ill. 618, 48 N.E. 161 (1897). See generally Note, 32 MINN. L. REV. 183 (1948).

[16] Peek v. Wachovia Bank and Trust Co., 242 N.C. 1, 15, 86 S.E.2d 745, 755 (1955). The court said: "That as a general rule, one who furnishes money for the purpose of paying off an encumbrance on real or personal property, at the instance either of the owner of the property, or the holder of the encumbrance, either upon an express understanding, or under circumstances from which an understanding would be implied, that the advance made is to be secured by a first lien on the property, will be subrogated to the rights of the prior lienholder as against the holder of an intervening lien, of which the lender was excusably ignorant." This case is very interesting in that it is on all fours with the instant case, with the exception that the U.C.C. had not been adopted in North Carolina at that time, nor has it been adopted at the time of this writing.

in the *French Lumber* case, paid the purchaser's indebtedness with the implied understanding that it would acquire the rights of the first lienor.[17]

The second lienor also contended that even if the rights of the third lienor were protected by the rules of legal subrogation, its negligence in not ascertaining the second lienor's prior lien should preclude it from asserting that right of subrogation. However, there is ample authority that under the circumstances of this case, the third lienor's alleged negligence would not be such a bar. The subrogee may have been negligent as to its own interests, but if that negligence does not adversely affect the interests of a prior lienor, it will not affect the subrogee's rights.[18] Even if a party seeking subrogation is negligent in not ascertaining the existence of a prior encumbrance, he will not be estopped from asserting his right to subrogation if the prior lien claimant has not changed his position by virtue of that act of omission.[19]

In the instant case the position of the second lienor was not adversely affected. When it secured its lien, it knew that its rights were subordinated to those of the first lienor. When the third lienor moved into the position of the first lienor, it merely caused the rights of the second lienor to be subordinated to those of a new party. Of course, if the prior lienor had been forced into a change of position as a result of the subrogee's negligence, then the subrogee would be estopped from asserting his rights to subrogation.[20]

This concept of excusable negligence not being a bar in cases of subrogation was commented upon graphically by the Supreme Court of Wisconsin in the case of *Iowa County Bank v. Pittz:*

[17] See generally Note, 24 MONT. L. REV. 161 (1962); Comment, 22 LA. L. REV. 225 (1961); Kessner, *Federal Court Interpretation of the Real Party in Interest Rule in Cases of Subrogation*, 39 Neb. L. Rev. 452 (1960).

[18] Wall v. Mason, 102 Mass. 313, 317 (1869): "He may have been negligent as to his own interest, but he has not been so as to either of them (grantor and creditor). They have nothing to complain of; and no wrong can possibly be done to either of them by transferring to him the securities which the creditors held."

[19] Worcester North Savings Institution v. Farwell, 292 Mass. 568, 574, 198 N.E. 897, 899 (1935): "[N]egligence of one which does not evidence a change of position of another is not a bar to recovery in cases of subrogation." In this case, a bank which had furnished money to pay off a mortgage was held to be entitled to subrogation, even though negligent in not discovering a third mortgage, since the third mortgagee had not changed his position because of the transaction.

[20] Webber v. Frye, 199 Iowa 448, 202 N.W. 1 (1925). The court held in this case that negligence should be a bar to subrogration under the facts presented in that the intervening lienor had been caused to change his position as a result of the intended subrogee's negligence. He had acquired a mechanic's lien on the property as a result of labor and material expended improving it. He continued to add new labor and material after the subrogee acquired an interest as a result of not discovering the prior mechanic's lien and was then unjustly enriched as a result of the new improvements. *Cf.*, Conner v. Welch, 51 Wis. 431, 8 N.W. 260 (1881).

From the very nature of this doctrine of subrogation, its mantle must many times, like the garment of charity, cover and wipe out a number of sins of omission or commission.[21]

The courts have been prone to interpret the provisions of the Code liberally rather than strictly.[22] The Code, it has been held, is designed to simplify rather than complicate commercial transactions.[23] Subrogation has long been considered a doctrine that readily lends itself to liberal, equitable, and broad application.[24]

In the case at bar, the court in its rationale did not specifically rule that the doctrine of subrogation supersedes section 9-312(5)(a). In effect, it ruled that it was merely stressing the intention of the drafters of the Code that the concept of subrogation was, and should be, an inherent part of the Code. This rationale is not inconsistent with the modern, liberal approach to law, which, is increasingly striking down narrow, technical interpretations of statutes which too often defeat rather than aid the realistic and orderly administration of justice.[25]

*Robert Bromberg*

[21] Iowa County Bank v. Pittz, 192 Wis. 83, 91, 211 N.W. 134, 137 (1927).

[22] See Note, 13 DE PAUL L. REV. 172 (1963).

[23] Arcuri v. Weiss, 198 Pa. Super. 506, 184 A.2d 24 (1962).

[24] Jackson Co. v. Bolyston Mutual Insurance Co., 139 Mass. 508, 2 N.E. 103 (1885).

[25] *Contra*, Hartford Accident and Indemnity Co. v. State Public School Building Authority, 76 Dauphin County (Pa.) Bar Ass'n, *Reporter*, 296 (1962). This was a trial court case which was not appealed. The court ruled that since the surety (party seeking subrogation) had constructive notice of bank's duly filed security interest, it should not be subrogated to the rights of that bank.

## COMMERCIAL LAW–WARANTIES–PRIVITY AND THE UNIFORM COMMERCIAL CODE

Plaintiff was employed as the manager of a hotel. In the course of his duties as manager he personally purchased four bottles of champagne for the hotel. The wine was produced and bottled by defendant. While plaintiff and other employees were preparing to serve the wine, a cap from one of the bottles suddenly ejected, flew through the air, and struck the plaintiff in the eye, causing serious injury. An action was brought based on breach of implied warranty. The trial court dismissed the complaint upon demurrer by the defendant. The Supreme Court of Pennsylvania reversed the lower court's decision. *Yentzer v. Taylor Wine Company*, 414 Pa. 272, 199 A.2d 463 (1964).

Two problems were faced by the court in its decision in favor of the