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LEGISLATIVE

INTERESTS OF REMOTE PARTIES IN GOODS UNDER THE UNIFORM COMMERCIAL CODE

By

REED T. PHALAN*

Suppose a purchaser, in good faith and for value, buys goods from a possessor or a creditor attaches goods in the hands of a possessor or a possessor becomes insolvent and a receiver or trustee in bankruptcy is appointed with all the rights of an attaching creditor. In all of these situations, because of some event previous to the purchase or attachment, a prior party may have or claim some interest in the goods.

The general rule is that a purchaser or lien creditor acquires only the rights of the possessor from whom he buys or against whom he brings attachment proceeding. Even if the purchase was in good faith and for value, the goods remain subject to the claim of a prior party with an interest superior to that of the possessor from whom the purchaser bought, unless such prior claimant is estopped or precluded by his conduct from asserting his title or interest.¹

Factors leading to such estoppel or preclusion include: conduct of the party-claimant which gives the possessor the appearance of having absolute ownership or authority to sell for the owner, and the social utility of the transaction or relationship between such prior party-claimant and possessor. In regard to the latter factor, as a matter of policy, should that type of transaction be altogether discouraged, made more risky, or encouraged, with or without imposing some burden by way of formalities to protect the interest of the prior party-claimant?

The relationship between possessor and prior party-claimant or the status of the possessor can be classified into the following fact situations. A brief explanation and discussion of each situation follows this list.

1. Where the possessor is a thief or is a buyer through a thief.
2. Where the possessor is a rightful possessor.
3. Where the rightful possessor has additional indication of ownership.
4. Where the rightful possessor is a merchant.
5. Where the rightful possessor still has goods which are already sold.
6. Where the possessor has voidable title.
7. Where the possessor is an agent with power to sell.
8. Where the possessor is a merchant selling in bulk.

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¹ Uniform Commercial Code §§ 2-403, 1-103.

9. Where property in the possessor's hands is subject to a security interest.

10. Where, in a somewhat similar situation to (4) and (5) above, a seller has ended his possession by shipping the goods to a buyer, but while the goods are still in transit, the seller has power to divert the shipment and have the goods returned or delivered to another person.

1. POSSESSOR IS A THIEF OR BUYER THROUGH A THIEF

The interest of the owner from whom the goods were stolen is superior to the interest of any good faith purchaser for value or lien creditor who takes or attaches the goods, regardless of how many prior innocent purchasers for value have bought and sold the goods since the original theft.

If the duration of possession of present and prior good faith purchasers for value exceeds the period of the statute of limitations for an action in replevin (for example, six years in Pennsylvania), but the owner was justifiably ignorant of the location of his goods, decisions conflict as to whether the statute would begin to run from the start of possession of the first purchaser or from the time the owner discovered the location of his goods.²

Negligence of the owner, making theft possible or easier, does not preclude the owner from successfully asserting his interest.

2. POSSESSOR IS A RIGHTFUL POSSESSOR

Possession is rightful when the owner voluntarily delivers the goods to the possessor. If there are no additional circumstances which might mislead third persons, the owner's interest is superior to that of any good faith purchaser for value or any attaching creditor.

3. RIGHTFUL POSSESSOR HAS ADDITIONAL INDICATION OF OWNERSHIP

If the rightful possessor, besides having possession of the goods, has, with the permission of the owner, some additional evidence of ownership in himself, then the owner may be estopped or precluded from asserting his interest against a good faith purchaser for value who relied on the additional evidence of ownership. An example is a case in which a buying agent purchased goods, took the bill of sale in his own name and then was permitted by his principal to retain both the goods and the bill of sale. The possessor's sale, although unauthorized and wrongful, was nevertheless binding on the owner.³

4. RIGHTFUL POSSESSOR IS A MERCHANT

If the rightful possessor is a merchant who deals in goods of that kind, although he has no actual authority to sell or encumber the goods in question, the owner is precluded from asserting his interest against a buyer to whom the merchant sells in the ordinary course of his business.⁴ Every good faith purchaser for value, of course, is not necessarily a "buyer in ordinary course of business".

² *Dixon Valve & Coupling Co. v. Shea*, 62 Montg. 337 (1946); 136 A.L.R. 658 (1942).

³ *Nixon v. Brown*, 57 N.H. 34 (1876).

⁴ Uniform Commercial Code § 2-403.

A merchant's possession might arise in one of two ways. The owner may have delivered possession to the merchant for some purpose other than sale, for example, for repair, or the owner may have purchased the goods from the merchant and left them in the merchant's possession. The latter is included in the following fact situation.

5. RIGHTFUL POSSESSOR STILL HAS GOODS WHICH ARE ALREADY SOLD

This situation generally has been treated by courts as a source of fraud and collusion, easy to perpetrate and difficult for innocent purchasers or creditors to prove. In regard to the rights of an innocent purchaser for value where the possessor is a merchant who deals in goods of that kind, the buyer who buys in the ordinary course of business is preferred.⁵ A buyer not in the ordinary course of a merchant's business would usually be a bulk buyer whose rights are determined by the article in the *Code* on bulk sales. In regard to the possessor who is not a merchant, under the *Uniform Sales Act*, the purchaser was preferred if he took possession in good faith for value and without notice of a prior sale.⁶ The *Sales Act* has been repealed and the *Code* states no rule applying expressly to this fact situation. On one side, it is strongly arguable that since the *Code* includes by reference the general rules of estoppel,⁷ and since the owner was estopped in this situation at common law, he is also estopped under the *Code*. The comment to Section 2-403 so implies, and the comments are expressly declared useable in construing the *Code*.⁸ But, on the other hand, it is arguable that when the *Code* repealed the rule of the *Sales Act* and substituted a rule expressly excluding the interest of the owner only as against a buyer in the ordinary course of a merchant's business, the legislature intended to repeal the common law rule of estoppel which the *Sales Act* had codified and intended to follow the general rule that the purchaser gets only the rights of the one from whom he buys. In regard to the rights of lien creditors,⁹ some states, including Pennsylvania, prefer the attaching creditor. Under the *Code*, rights are to be determined according to the policy of each state, except that the attaching creditor is not preferred if the possessor was a merchant and retention was in good faith and in the current course of trade and was for a commercially reasonable time.¹⁰

6. POSSESSOR HAS VOIDABLE TITLE

If the owner sells and delivers the goods to a buyer, intending to pass title, the buyer becomes the owner of the goods. If for some reason, the seller has a right to rescind or avoid the transaction, the buyer's title is considered as voidable. For example, it is fraud for a buyer to obtain goods with a check which he knows will not be honored. When the seller discovers the fraud, he can rescind the transaction and recover the goods. However, if before the seller rescinds, the buyer in posses-

⁵ See n. 4, supra.

⁶ Uniform Sales Act § 25.

⁷ Uniform Commercial Code § 1-103.

⁸ Uniform Commercial Code § 1-102.

⁹ Uniform Commercial Code § 2-402.

¹⁰ See n. 9 supra.

sion sells to a good faith purchaser for value, the latter takes good title, and it is not subject to being defeated by the original seller. The seller's right to avoid the transfer is cut off as against such a purchaser.¹¹

The *Code* says nothing as to knowledge of the purchaser. If a possessor acquired title through fraud, one who buys from him with knowledge of the fraud has not purchased in good faith. The purchaser's knowledge merely that possessor's title is voidable because his seller was a minor probably would not constitute bad faith.

When the possessor has voidable title, his attaching creditor obtains no better rights than the possessor had.

7. POSSESSOR IS AN AGENT WITH POWER TO SELL

The owner delivers goods to an agent to sell according to certain instructions. The owner is bound by any transaction the agent enters into if his sale or other transfer is within the agent's actual or apparent authority. If the transfer is not within the agent's actual or apparent authority, then two distinct possibilities must be considered. If the owner-principal is wholly or partially disclosed, that is, the person dealing with the possessor knows he is dealing with someone not actually the owner of the goods, then the owner is not bound by the transfer. If the owner-principal is undisclosed, that is, the person dealing with the possessor has no knowledge he is dealing with someone not the actual owner of the goods, such innocent person to whom the goods are shipped or otherwise transmitted, or with whom the goods are deposited or pledged, has a lien for any money or negotiable instrument given as present value and before he knows he is dealing with an agent.¹²

Generally, the agent's creditor who attaches the principal's goods while in the agent's possession will acquire against the principal no better rights than the agent had. As to such creditor and regardless of actual intent, however, the shipment to the agent is a sale vesting title to the goods in the agent, and the agent's creditor may effectively attach the goods if the following four elements are all present:

- (1) The agent is a dealer in goods of that kind;
- (2) The agent is not known to be primarily engaged in selling goods of others;
- (3) The principal charges the goods to the agent at a fixed price, which usually the agent is to pay upon selling the goods or to cancel by returning the goods; and
- (4) The principal does not file a financing statement as for a secured transaction.

If the above four elements are present, any express term that the goods are "on consignment" or "on memorandum", or other words reserving title in the principal, is not sufficient as against the agent's creditor to keep the transaction from being a "sale or return".¹³ The creditor's knowledge or lack of knowledge is ap-

¹¹ See n. 4, *supra*.

¹² Pennsylvania Factors' Act of 1834; similar statutes are in effect in some other states.

¹³ Uniform Commercial Code § 2-326.

parently not material. The attachment is effective even if the creditor knows the details of the agent-dealer's acquisition of the goods, that it, knows the principal expressly retains title.

8. POSSESSOR IS A MERCHANT SELLING IN BULK

A retail merchant has acquired a substantial part of his merchandise on credit. The creditors have sold to the merchant on "open" or "book" account, that is, they did not expressly reserve any ownership or security interest in the delivered goods. Deciding to withdraw from business, the merchant transfers his business and retail stock to someone who is to succeed him as owner and operator of the retail store. If the merchant's creditors are not paid, they, of course, have the right to sue and obtain judgments against him. If the merchant appears to have become insolvent or has disappeared, the creditors might desire the right to collect in some way from his transferee and successor in business. Of course an ordinary retail cash customer would have no liability to the merchant's creditors. In the absence of a special statute, the merchant's transferee and successor in business would not be liable unless upon purchasing the business, the transferee expressly assumed and agreed to pay the outstanding debts of the business, or the transfer was unfair and dishonest as to creditors, being usually called a "fraudulent conveyance", that is, the transferee did not pay the fair value for the property transferred to him, and the transfer left the transferor insolvent.

A person extending credit without security is taking certain risks. The risks change tremendously if, after extension of credit, the merchant-debtor deviates from his ordinary operations and disposes of a large quantity of his stock in one transaction. Many merchants have been tempted to go through the motions of disposing of their businesses, while secretly retaining interests which, they afterwards realize, most creditors give up trying to collect. It is so easy to fabricate the appearance of full payment that it is often practically impossible to prove the transfer was such a collusive arrangement, that is, a "fraudulent conveyance". Even if there were no collusion and if the transferee paid full value, the transferor's creditors still might be prejudiced by the transfer. The dishonest transferor can travel far and fast with a pocketful of money, leaving his creditors unpaid.

The considerable prejudice to creditors from such transfers convinced legislatures of the need for further protection for creditors. Bulk sales statutes have been adopted in all the states and there is a Bulk Sales Article in the *Uniform Commercial Code*. In general the remedy is to give creditors advance notice that the transfer is going to be made. Creditors then can more fully protect themselves by verifying in advance the bona fides of the intended transfer. In many states, including Pennsylvania, additional protection is afforded by providing, in effect, for creditors to be paid out of the money given for the transfer.

Transfers Regulated As Bulk Sales

Whether or not a particular transfer is subject to regulation as a bulk sale depends on how much, if at all, the transfer threatens to prejudice creditors. The

factors involved are (1) the type of the transferor's business, (2) the type and quantity of goods being transferred and (3) other circumstances.

(1) **Type of Business.** A business is subject to bulk sales regulation if its principal business is the sale of merchandise from stock. This includes an enterprise which manufactures what it sells, but does not include farming nor establishments like hotels and restaurants the principal business of which is supplying services rather than selling merchandise from stock.¹⁴

(2) **Goods.** Businesses of the type subject to bulk sales regulation have in their possession goods of two main classes, that is, inventory and equipment. Inventory consists of goods held for sale or being prepared for sale, and raw materials, work in process and materials used or consumed in the business over a relatively short period. If in the conduct of the business goods are used and reused over a relatively long period of time, they are classified as equipment.¹⁵

A bulk transfer is a transfer outside of the ordinary course of the transferor's business of a major part, that is more than half, of the goods or merchandise classified as inventory. A transfer of equipment is subject to bulk sale regulation only if it accompanies a bulk transfer of inventory.¹⁶

(3) **Other Circumstances.** Both the transferor and the transfer may be of the types ordinarily subject to bulk sales regulation, but in a particular situation, the transfer may not prejudice the transferor's creditors. In the absence of possible prejudice, there is no reason to impede the transfer with the onerous and sometimes expensive requirements of bulk sales regulation, and, therefore, such a transfer is exempt from the requirements. The principal exempt transfers include:¹⁷

(a) A transfer made to secure the transferor's promise to pay a debt, that is a transfer of a security interest only.

(b) A sheriff's sale on a judgment, or a receiver's or other insolvency sale.

(c) A transfer to a person who is solvent, who already has a known place of business in the state, who expressly assumes and agrees to pay debts of the transferor and who gives public notice that he has assumed the transferor's debts.

(d) A transfer merely to accomplish a change in the form of business organization, if the only consideration received by the transferor in exchange for the transfer is a share in the new business organization, and the new business assumes and agrees to pay the debts of the transferor and public notice is given of the transaction.

Bulk Sales Procedure

Except for auction sales discussed later, if a transfer is one subject to bulk sales regulation, the transferee must comply with a three-step procedure:

¹⁴ Uniform Commercial Code § 6-102.

¹⁵ Uniform Commercial Code § 9-109.

¹⁶ See n. 14, *supra*.

¹⁷ Uniform Commercial Code § 6-103.

- (1) He must obtain and keep available a list of the transferor's debts and an inventory or schedule of the transferred goods.
- (2) He must give advance notice to the transferor's creditors.
- (3) He must assure that any new consideration the transferee is paying is applied to the transferor's debts.

If the transferee fails to comply with the first two steps, the transfer will be ineffective against the transferor's creditors for a period of six months.¹⁸ For a typical case, suppose the transferee, himself one of transferor's creditors, accepts the transfer in satisfaction of the transferor's debt, without complying with steps one and two. Step three would not apply since the transferee would not be paying any new consideration for the transfer. Any time within the six-month period, a judgment creditor of the transferor may have the sheriff levy on any of the transferred goods, and a court-appointed representative of the transferor's creditors, that is, a receiver or trustee in bankruptcy, may reclaim the goods. If two or more creditors, acting independently, have levies made, apparently their claims on the goods will have priority in the order in which the levies are made. The goods remain subject to creditors' claims until, within the six months, they are acquired by a purchaser for value without knowledge or notice of the transferee's failure to comply with bulk sales procedure.¹⁹ The transferee may lose the goods but apparently he incurs no personal liability from failure to comply with steps one and two.

The third step applies when the transferee is to pay the transferor new consideration, usually money, for the transferred goods. If he fails to observe the third step, the transferee incurs a personal liability as to the transferor's debts. For six months after the transfer, the transferee may be held liable to the transferor's creditors, up to an amount equal to the new consideration for the transfer.²⁰ Thus, if without regard for step three, the transferee has made full payment of the consideration to the transferor, the transferee can be required to pay an equal amount to be used for the benefit of all transferor's creditors. A proceeding to enforce this liability would probably take precedence over any individual creditor's prior attachment on the transferred goods.

Substantially exact compliance with bulk sales procedure is required. An arrangement the parties think is "just as good" may not accomplish a transfer free from the claims of creditors.

For example suppose the transferor agreed to sell the inventory and equipment of his gas station to the transferee for \$1592.05. The transferor told the transferee he had only two creditors. The transferor prepared a sworn statement to the effect that he had no creditors. When the transferee paid the two creditors in full and paid the balance of the purchase price to the transferor, the latter gave the transferee the bill of sale, an inventory of the goods sold and the sworn statement. The transferee did not know that the transferor had additional creditors, including

¹⁸ Uniform Commercial Code §§ 6-104, 6-105, 6-111.

¹⁹ Uniform Commercial Code § 6-110.

²⁰ *Miller v. T.I.C. Consumer Discount Co.*, 69 Pa. D. & C. 585 (1949).

a consumer discount company. Within the statutory period, the company, having a judgment against the transferor, had the sheriff levy on the transferred goods owned by the transferee. Other creditors also asserted claims against the transferee. The court decided the transferee was liable in the amount of \$1592.05 for the benefit of all creditors. Since claims exceeded that amount, distribution was made to all claimants pro rata, after giving the transferee proportionate credit for the payments he previously made to the two creditors, since the transferee succeeded to the rights of those creditors. Transferee's payment to the two creditors was a part payment of the purchase price for the business. The procedure followed could be classified in either of two ways, neither of which complied with statute:

First, there was an oral, unsworn statement that the transferor had only the two named creditors. If it had been in writing and was sworn to as required by statute, and proper advance notice had been given to the two named creditors, the transferee would have been protected against the other creditors not disclosed by the transferor. Secondly, there was a part payment before delivery to the transferee of the sworn written statement. The statute required that the transferee receive the statement before making any payment.²¹

The transferee should take the initiative as to bulk sales procedure and be sure that his contract to buy in bulk expressly requires completion of the procedure before he is to make any payment to the transferor. If bulk sale procedure is not mentioned until after the transferee becomes a party to the agreement, he may be unable to compel the transferor's cooperation. Suppose for example on July 11, in exchange for a bill of sale for a business, with stock and fixtures, the transferee gave the transferor a check for \$2200, the full agreed price. The next day, being advised by his lawyer of bulk sales procedure, the transferee stopped payment on his check and requested the transferor to cooperate in bulk sales procedure. The transferor refused and sued the transferee on his check. The transferor recovered. There being no evidence of any actual fraud on the part of the transferor, the failure to observe bulk sales procedure did not give the transferee any right to rescind the transaction.

In the statement as to debts, the transferor should list all persons who have claims or allege to have claims against him, with addresses and the amounts claimed by each. If the transferor has no creditors, the statement should so state. The transferor or his agent should swear or affirm that the statement is accurate and complete. He can be punished criminally if he knows the statement is false. If the statement is inaccurate, it nevertheless sufficiently complies with the requirement and protects the transferee against the transferor's creditors, even those omitted, unless the transferee has knowledge of the inaccuracy prior to completion of the transfer.²²

²¹ *Kadair v. Serack*, 63 Pa. D. & C. 27 (1947).

²² Uniform Commercial Code § 6-104.

The written inventory of goods need not be a sworn statement. It can be prepared by either or both parties and must describe the goods specifically enough to enable them to be identified.²³

During the six months after the transfer, the transferee must have both the list of creditors and the inventory of goods available for inspection by the transferor's creditors. The transferee may either retain the statements in his own possession for the six months or file them in the office of the prothonotary of the county where the goods were located at the time of transfer.²⁴

Notice must be given to all persons named in the transferor's sworn list of creditors and to any other persons whom the transferee knows are asserting claims against the transferor.²⁵ Notice must be delivered personally or sent by registered mail²⁶ and must be given at least ten days before occurrence of any of the following with respect to the transferred goods: passing of title to transferee, moving of the goods pursuant to the transfer or taking of possession by the transferee.²⁷

Although not required to be written, it is wise, as with all important business communications, to put the notice in writing. If the transaction will result in complete payment of the transferor's debts as they come due, the transferee may use a short-form notice. Otherwise a long-form notice is required.²⁸ A short-form notice must state:

- (1) that a bulk transfer is intended,
- (2) the names and business addresses of the transferor and transferee, and business names and addresses of the transferor for the prior three years,
- (3) that as a result of the transaction the transferor's debts will be paid in full as they fall due,
- (4) the address to which the transferor's creditors should send their bills.

A long-form notice must state:

- (1) and (2) the same as for the short-form notice,
- (3) the location and a general description of the goods being transferred, and the address where the list of creditors and inventory of goods may be inspected,
- (4) the amount the transferee is paying for the transferred goods, the time and place for payment and the time and place for the transferor's creditors to file their claims; or that the transfer is being made as payment on one or more of the transferor's debts, that is, with no new consideration being paid by the transferee, the amount of the debts being so paid and to whom.

²³ See n. 22, *supra*.

²⁴ See n. 22, *supra*.

²⁵ Uniform Commercial Code § 6-107.

²⁶ See n. 25, *supra*.

²⁷ Uniform Commercial Code § 6-105.

²⁸ See n. 25, *supra*.

Application of Proceeds

The transferee must assure that the money being paid for the transfer is used to pay transferor's debts, both those shown on the sworn list of creditors and also any claim made within thirty days after mailing of notices to creditors. If the amount is not sufficient to pay all debts, the transferee must assure that pro rata payment is made.²⁹

The parties can accomplish this in any of several ways. For example, suppose the transferee is buying the transferor's business and is to pay the agreed price in a lump sum, the amount being \$3000 in excess of existing business debts. In making his payment, the transferee can draw a check to each of the creditors and the final check for \$3000 to the transferor. Or suppose, although making a transfer in bulk, the transferor is to continue in business and he intends to pay his debts as they mature, and expressly assures the transferee that he will do so. The transferee can rely on this assurance and pay the transferor the agreed price for the transfer. The transferee should realize he is trusting the honesty, solvency and business good faith of the transferor. The transferee can be held personally liable for the transferor's debts up to an amount equal to the consideration for the transfer. If the transferee is unwilling to take this risk, he can arrange with the transferor for withholding for a time a portion of the payment for the transferred goods. Other arrangements are also possible, varying with details of the transfer.

Auction Sales

If the bulk sale is by auction, the burden of complying with bulk sales procedure falls on the auctioneer rather than on the transferee purchasing at the auction sale. For failure to comply, the auctioneer, for six months following the sale, can be held liable for the transferor's debts, up to an amount equal to the net proceeds from the sale. The liability is to all creditors as a group rather than to any individual creditor.³⁰

9. PROPERTY IS SUBJECT TO A SECURITY INTEREST

Whether a third party acquiring an interest in goods has priority over the holder of a security interest depends on several factors, including the type of third party, the nature of the goods, the type of security interest, the filing of a financing statement and others. A discussion of these factors is beyond the scope of this article.³¹

10. SELLER HAS POWER TO DIVERT SHIPPED GOODS

When the seller ships goods conforming to the buyer's order, F.O.B. ship-

²⁹ Uniform Commercial Code § 6-106.

³⁰ Uniform Commercial Code § 6-108.

³¹ See Tanner, A Study of the Uniform Commercial Code on Secured Transactions, 58 Dick. L. Rev. 35 (1953).

ping point, title passes to the buyer at the time and place of shipment.³² If the shipment is by straight bill of lading, even if the buyer is named as consignee, the seller as consignor has power to divert the shipment by instructing the carrier to return the shipment or deliver to a person other than stated in the bill of lading.³³ If the seller wrongfully secures return of the goods, the buyer-consignee as owner can sue the seller to recover possession. However, if the seller wrongfully diverts and causes the goods to be delivered to another person who takes as a buyer in the ordinary course of the seller's trade, the title of the first buyer-consignee is cut off and good title passes to the second buyer.³⁴ The first buyer-consignee has no recourse against the carrier.

In a shipment by an order bill of lading, only the holder, that is the consignee or indorsee or bearer if so deliverable, has power to divert.³⁵ A buyer who pays on a straight bill of lading prior to receipt of the goods should realize he is trusting the business good faith of his seller.

The power of a consignor to divert is personal, and if he does not exercise it, his creditors have no additional rights, by virtue of this power, to reach shipped goods.

Federal law would apply to an interstate shipment. Under the *Federal Bills of Lading Act*, if title has passed to the buyer-consignee, the consignor has no power to wrongfully divert the shipment and defeat the consignee's title.

³² Uniform Commercial Code § 2-401.

³³ Uniform Commercial Code § 7-303.

³⁴ Uniform Commercial Code § 7-504.

³⁵ See n. 16 supra.