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THE EFFECT OF ARTICLE NINE OF THE UNIFORM
COMMERCIAL CODE UPON CHATTEL MORTGAGES
IN KENTUCKY

Introduction

The Uniform Commercial Code¹ introduced by Senator F. H. Bassett, Jr. was passed unanimously by the 1958 General Assembly and signed by Governor Chandler to become effective July 1, 1960. The Code consists of nine articles and repeals Stock Transfer, Negotiable Instruments, Warehouse Receipts, Sales, Bank Collection, Bulk Sales and numerous other sections of the Kentucky Statutes. This note will be limited to a discussion of Article Nine of the Code and what effect it will have on the law concerning chattel mortgages in Kentucky. Before beginning a comparison of the present law in Kentucky with the Code, it seems appropriate to state the purpose of Article Nine of the Code.

The Security Interest

Article Nine combines all the various security devices into one category referred to as a security interest. A security interest is defined as "an interest in personal property or fixtures which secures payment or performance of an obligation."² The Code applies to "any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures, including goods, documents, instruments, general intangibles, chattel paper, accounts or contract rights; and also to any sale of accounts, contract rights or chattel paper."³ Among the various security devices included in the term "security interest" are the pledge, assignment, chattel mortgage, chattel trust, trust deed, factor's lien, equipment trust, conditional sale, trust receipt, other lien or title retention contracts, and lease or consignment intended as security.⁴ The broad purpose of the Code is to eliminate all of these security devices by substituting the new device called a security interest. In achieving this result the Code has adopted a terminology of its own. Instead of referring to the mortgagor, pledgor, or assignor, the term "debtor" is substituted.⁵ In place of the mortgagee, assignee, or pledgee, the Code uses the

¹ Hereafter to be referred to as the "Code."

² UCC sec. 1-201 (37).

³ UCC sec. 9-102 (1) (a) (b).

⁴ UCC sec. 9-102 (2).

⁵ A debtor is defined as "the person who owes payment or other performance of the obligation secured, . . ." UCC sec. 9-105 (1) (d).

term "secured party,"⁶ and for mortgage, pledge, or assignment, the Code has adopted the term "security agreement."⁷ Other new terms are "consumer goods," "equipment," "farm products" and "inventory."⁸ It is essential to understand the meaning of this terminology as defined under the Code, since many rights are based upon these classifications. For example, an automobile if used for personal, family, or household purposes would be classified as a consumer good; if being held or being prepared for sale it would be classified as inventory.⁹ Because filing requirements for a security interest in consumer goods differ from filing requirements for a security interest in inventory, improper classification could result in improper filing.¹⁰ However classification of the collateral may not be as important in Kentucky because, as will be shown, Kentucky retained their present system of recording instead of adopting either of the alternatives presented by the Code.

Rights of the Parties and Rights of Third Parties

By statute in Kentucky a deed of trust or any other instrument given to secure any present or future indebtedness, and which operates as a mortgage, pledge or lien upon personal property, is considered to be a chattel mortgage.¹¹ In accordance with this statute the court has said:

[W]hatever may be the name or form of a transaction, when it is designed to hold personal property as a mere security for a debt, it is regarded as a chattel mortgage.¹²

Furthermore, the court has held that trust receipts¹³ and conditional sales contracts¹⁴ should be treated as chattel mortgages. However,

⁶ A secured party is defined as "a lender, seller or other person in whose favor there is a security interest, . . ." UCC sec. 9-105(1) (i).

⁷ A security agreement is defined as "an agreement which creates or provides for a security interest," UCC sec. 9-105 (1) (h).

⁸ UCC sec. 9-109 (1) (2) (3) (4).

⁹ See the definitions of "consumer goods," UCC sec. 9-109(1) and "inventory," UCC sec. 9-109(4). For a discussion of the problems of classification under Article Nine of the Code see Funk, "Problems of Classification Under Article 9 of the Uniform Commercial Code," 102 U. Pa. L. Rev. 703.

¹⁰ For a criticism of the classification of goods in connection with the filing requirements, see Beutel, "The Proposed Uniform (?) Commercial Code Should Not Be Adopted In Ohio," 14 Ohio St. L. J. 3, 28-30.

¹¹ Ky. Rev. Stat. sec. 382.600(1) (b) (1956). (Hereafter referred to as K.R.S.).

¹² General Motors Acceptance Corp. v. Sharp Motor Sales Co., 233 Ky. 290, 293, 25 S.W. 2d 405, 406 (1930).

¹³ Commercial Investment Trust Corporation v. Wilson, 58 F.2d 910 (Ky. 1932).

¹⁴ Munz v. National Bond and Investment Co., 243 Ky. 293, 47 S.W. 2d 1055 (1932).

an assignment of a chose in action, such as an account receivable, is not treated as a chattel mortgage since a chose in action is not considered personal property.¹⁵ Kentucky, by treating all security transactions as chattel mortgages except those transactions concerning a chose in action, is in spirit much in accord with the Code treatment since, as pointed out previously, the broad purpose of the Code is to combine the various security devices into one category called a security interest.

Kentucky requires by statute that a chattel mortgage be acknowledged in order to be recorded.¹⁶ The purpose of the statutory requirement, in making sure the instrument lodged for record is in fact signed and acknowledged by the mortgagor, is to prevent fraud.¹⁷ The court has held that an unacknowledged mortgage is good as between the parties¹⁸ but, as to third persons it does not give constructive notice even though it is recorded.¹⁹ The decisions seem illogical for if an unacknowledged chattel mortgage is good as between the parties, it should give constructive notice when in fact recorded. The requirements of acknowledgment with its purpose of preventing fraud should have no bearing on notice in the absence of fraud. The Code would eliminate what the writer considers an unjust result, since the Code does not require that a security agreement be acknowledged. Under the Code, the only formal requirements necessary to create a security interest are that the security agreement be signed by the debtor, and contain a description of the collateral.²⁰

Like the Code, Kentucky requires that the chattel mortgage contain a description of the collateral—the test being whether the description is sufficiently definite and certain to enable the public in general to identify the property.²¹ However, this test does not apply where there is a dispute between the original parties to a chattel mortgage.²² The test contemplated by the Code provides that even though the

¹⁵ *Iowa Valve Co. v. Meckle Contracting Co.*, 258 Ky. 444, 80 S.W. 2d 557 (1935).

¹⁶ "No deed or deed of trust or mortgage conveying a legal or equitable title to real or personal property shall be valid against a purchaser for a valuable consideration, without notice thereof, or against creditors, until such deed or mortgage is acknowledged or proved according to law and lodged for record . . ." K.R.S. sec. 382.270.

¹⁷ *Starr Piano Company v. Petrey*, 168 Ky. 530, 532, 182 S.W. 624, 625 (1916).

¹⁸ *Shraeffler v. Rodman*, 146 Ky. 1, 141 S.W. 742 (1911).

¹⁹ See e. g. *Kerr v. Watkins*, 234 Ky. 104, 27 S.W. 2d 679 (1930).

²⁰ UCC sec. 9-203(1) (b).

²¹ E.g., *Hauseman Motor Co. v. Napierella*, 223 Ky. 433, 3 S.W. 2d 1084 (1928) (Property described in chattel mortgage as "one service truck, 3½ tons" and "one Paige truck, two tons" held not sufficient to give constructive notice).

²² *Hart County Deposit Bank v. Hatfield*, 236 Ky. 725, 33 S.W. 2d 660 (1930).

description is not specific, it is sufficient if it reasonably identifies what is described.²³ At first glance the test under the Code may appear more liberal than Kentucky's test, but the validity of that conclusion remains with the courts. Unlike the acknowledgment requirement under present Kentucky law, the description requirement under Kentucky law and the Code is reasonable, since the description of the collateral is an inherent part of giving notice. A third party must be able to identify the collateral described in either a chattel mortgage or a security agreement.

Kentucky requires by statute that a chattel mortgage must be recorded in order for the mortgagee to be protected against a purchaser for a valuable consideration or against creditors.²⁴ Under the Code there are two methods by which a secured party may perfect a security interest against third parties—by taking possession of the collateral²⁵ or by filing²⁶ except in certain stated instances where filing is not required.²⁷ While Kentucky law and the Code both recognize recording as a means of perfecting against third parties, the Code allows the secured party to perfect by taking possession of the collateral. No case has been found in Kentucky holding that it would recognize the taking of possession by the secured party as a *substitute for recording* a chattel mortgage. But in *Davis v. Allen* there is dictum to the effect that possession by a mortgagee of real property would be a substitute for recording.²⁸ Even if Kentucky applied this rule, it remains uncertain whether Kentucky would apply the rule to personal property. An argument for applying the rule that taking of possession should be a substitute for recording can be made on the basis of the language in KRS Sec. 378.040 which indicates that a transfer of possession will perfect against third parties in lieu of recording. Another argument may rest on the analogy to a pledge which Kentucky recognizes as a valid security transaction.²⁹

In the event the security interest under the Code is not perfected by filing, where filing is required, or by possession, a person who becomes a lien creditor without knowledge of the security interest will prevail.³⁰ An exception to this rule exists with respect to a secured

²³ UCC sec. 9-110.

²⁴ See note 16 supra.

²⁵ UCC sec. 9-305.

²⁶ UCC sec. 9-302 (1).

²⁷ See exceptions, UCC sec. 9-302.

²⁸ *Davis v. Allen*, 280 Ky. 798, 134 S.W. 2d 617 (1939) (Record owner and mortgagee both resided on premises, so facts did not present mortgagee in possession).

²⁹ *Mason v. Scruggs*, 207 Ky. 66, 268 S.W. 833 (1925).

³⁰ UCC sec. 9-301 (1) (b). For other classes of persons who take priority over an unperfected security interest see UCC sec. 9-301 (1) (a) (c) (d).

party who has an unperfected purchase money security interest in that he has a ten day grace period during which he can perfect against a transferee in bulk or a lien creditor.³¹

In the event a mortgage in Kentucky is not perfected by recording, the statute by its terms, protects purchasers for a valuable consideration and without notice of the unrecorded mortgage, and creditors.³² The statute is clear with respect to purchasers who are protected, whereas judicial interpretation was necessary in order to determine what creditors were protected.

In *Mason v. Scruggs*,³³ the court said:

In 1916 the legislature amended the foregoing Statute by adding thereto the following:

"The word 'creditors' as used herein shall include all creditors irrespective of whether or not they may have acquired a lien by legal or equitable proceedings or by voluntary conveyance."

The court then interpreted the statute:

[T]he expression "all creditors" therein means subsequent creditors, whether they be secured or unsecured, and such antecedent creditors who at some time prior to the recording of the mortgage or deed of trust have secured some equity in the property.

The court in interpreting the statute divided creditors into two classes, antecedent or those that became creditors before the chattel mortgage was executed, and subsequent or those that became creditors after the execution of the mortgage.³⁴ Furthermore, the court interpreted the statute as protecting subsequent creditors whether secured or unsecured, but provided that antecedent creditors must secure some equity in the property prior to the recording of the mortgage. Unlike Kentucky, the Code does not make a distinction between antecedent and subsequent creditors; instead, the Code treats all creditors alike by requiring a creditor without notice to obtain a lien before the security interest is perfected.³⁵ The big distinction between the Code and the Kentucky rule with respect to subsequent creditors is that under the Code the security interest can be perfected against a subsequent creditor if done before the subsequent creditor obtains a lien, whereas under the Kentucky rule an unrecorded chattel mortgage can never be perfected against a subsequent creditor.³⁶

³¹ UCC sec. 9-301 (2).

³² See note 16 supra.

³³ 207 Ky. 66, 68, 268 S.W. 833, 834 (1925).

³⁴ For a discussion of the definition of antecedent and subsequent creditor, see *Larimore v. Perkinson*, 208 Ky. 382, 271 S.W. 69 (1925).

³⁵ UCC sec. 9-302.

³⁶ UCC sec. 9-301 (1) (b).

Since the distinction is important, which rule should prevail? The theory behind Kentucky's reason for protecting subsequent creditors is that an unrecorded mortgage is fraudulent to them, since the truth does not appear on the record at the time the subsequent creditor extends credit.³⁷ The argument against this view is based on the assumption that creditors do not rely on the record, an argument which breaks down when creditors do rely on the record and find nothing. Certainly it does not seem just to allow a mortgagee to record a mortgage the day after a subsequent creditor extended credit and thus perfect it against the subsequent creditor. The writer agrees with the present Kentucky rule which protects subsequent creditors without notice of the unrecorded mortgage, but in adopting the Code, Kentucky abandoned the rule. Thus, when the Code takes effect in Kentucky, a creditor must obtain a lien before an unperfected security interest is perfected.

Place of Filing

With regard to the place of filing a chattel mortgage, the Kentucky statute provides:

(1) Chattel mortgage, in order to be recorded, shall be filed in the county where the mortgagor, if a resident of the state, resides at the time of the execution thereof. If the mortgagor is not a resident of the state, the mortgage shall be filed in the county where the mortgaged property is located at the time of the execution of the mortgage.³⁸

The Code presents alternative methods of filing, neither alternative being the same as the present method in Kentucky. The first alternative presented by the Code makes the place of filing—either with Secretary of State or County Clerk—depend on the subject matter of the collateral and its use. For instance, if the goods are used or bought for use primarily for personal, family or household purposes they are classified as consumer goods.³⁹ Where the collateral is consumer goods filing with the county clerk is required.⁴⁰ On the other hand, an illustration where local filing is not required is where the goods are inventory. Again the Code defines the collateral according to its use. If they are held by a person who holds them for sale or lease, or to be furnished under contracts of service or if he has so furnished them, or if they are raw materials, work in process, or

³⁷ *Wicks v. McConnell*, 102 Ky. 434, 20 Ky. Law Rep. 84, 43 S.W. 205 (1897).

³⁸ K.R.S. 382.670.

³⁹ UCC sec. 9-109 (1).

⁴⁰ UCC sec. 9-401 (1) Optional Paragraph (a).

materials used or consumed in a business they are classified as inventory.⁴¹ Where inventory is the subject matter of a security agreement filing with the Secretary of State is required.⁴² Many other illustrations could be shown where it must first be determined what the collateral is used for, then classify the collateral according to its use, and then file the financing statement either with the county clerk or with the Secretary of State. In states which want to continue local filing in all cases the Code provides optional language which if adopted allows duplicate filing.⁴³ Thus, as illustrated above, if the collateral is consumer goods filing with the county clerk is required and if the optional language were adopted filing with the Secretary of State would also be required.

The second alternative presented by the Code is to require filing with the Secretary of State in all cases, thus, under this alternative local filing would be abolished in all security transactions concerning personal property.

The justification given by the Code editors for requiring filing with the Secretary of State under either of the alternatives just discussed is that credit information services may thereby have easy access to information needed by creditors who have debtors in many counties, without being put to the great cost of digging out the required information in a multitude of local offices.⁴⁴

Kentucky in adopting the Code did not accept either of the Code's alternative methods of filing the financing statement. Instead Kentucky retained its present system by requiring filing with the county clerk in all cases and no filing with the Secretary of State in any case.⁴⁵ By retaining its present system Kentucky has avoided the necessity of classifying the collateral in order to determine the proper place of filing. In addition Kentucky avoided the problem of duplicate filing which would create additional expense or the problem of complete central filing which could create much added expense and inconvenience to those who desire to check the record. Whether Kentucky in retaining its present system of local filing defeated one of the main advancements of the Code remains to be seen. Certainly the Code intended for central filing in some cases to be required and Kentucky in adopting the Code did not accept this feature. One important word of warning should be given at this time. Filing is not required in all instances in order to perfect a security interest. For

⁴¹ UCC sec. 9-109 (4).

⁴² UCC sec. 9-401 (1) Optional Paragraph (c).

⁴³ *Ibid.*

⁴⁴ UCC sec. 9-401 (1952) Text and Comments Ed.).

⁴⁵ S.B. No. 169 (1958) (effective 1960).

example, filing is not required to perfect the security interest where the secured party has possession;⁴⁶ or a purchase money security interest in farm equipment having a purchase price not in excess of \$2,500.⁴⁷

After-Acquired Property and Future Advances

After-acquired property, as the subject matter of a mortgage, is property which at the time of execution of the mortgage is not owned by the mortgagor or property which is not yet in existence.⁴⁸ At common law a chattel mortgage can operate only on property actually in existence and belonging to the mortgagor, or potentially belonging to him as an incident of other property then in existence and belonging to him.⁴⁹ Kentucky by judicial decision and by statute has engrafted exceptions on the common law rule. By judicial decision Kentucky allows a corporation to execute a mortgage to include the increase of female animals since they are potentially in existence.⁵⁰ By statute Kentucky provides that a chattel mortgage given by any person may cover crops to be planted within one year; tools, machinery, or farming implements owned at the time of the execution of the mortgage or which may be thereafter acquired; and replacements of any of the property described in the mortgage.⁵¹ In addition the statute incorporates the exception to the common law rule by allowing a mortgage to cover the increase of female animals.⁵²

In any case not within the above exceptions to the common law rule a mortgage on after acquired property is not valid against third parties. But in equity as between the parties a chattel mortgage of after-acquired property operates to create an equitable interest in the mortgage under the maxim that equity considers that as done which ought to be done.⁵³ Also, a mortgage of after-acquired property which creates an equitable interest in the mortgage will be enforced against third parties with notice.⁵⁴ But when a mortgage of after-acquired property is tainted with fraud, it will not be enforced against

⁴⁶ UCC sec. 9-302 (1) (a).

⁴⁷ UCC sec. 9-302 (1) (c). (For other illustrations where filing is not required see UCC 9-302 (1) (b) (d) (e) (f), (2), (3) (a) (b), (4).)

⁴⁸ For a good discussion of mortgages on after-acquired property in Kentucky, see Note, 35 Ky. L.J. 320 (1947).

⁴⁹ *Sandy Valley Grocery v. Patrick*, 267 Ky. 768, 770, 103 S.W. 2d 307, 308 (1937).

⁵⁰ Note, 35 Ky. L.J. 320, 329.

⁵¹ K.R.S. sec. 382.610.

⁵² K.R.S. sec. 382.610 (a).

⁵³ *Sandy Valley Grocery Co. v. Patrick*, 267 Ky. 768, 711, 103 S.W. 2d 307, 308 (1937).

⁵⁴ *Scoggan v. Dillon*, 252 S.W. 2d 35 (Ky. 1952). (Trust Agreement covering after-acquired property created an equitable lien and was recorded).

a third party with notice. In *Sandy Valley Grocery Company v. Patrick* the chattel mortgage covered replacements of stock in trade. The court recognized that the mortgage created an equitable lien, but refused to enforce it against third parties stating that a mortgage is fraudulent and void if it permits the mortgagor to sell from stock from time to time, although he agrees to replace any stock with stock of equal value.⁵⁵ As indicated in the opinion the court was reluctant to reach this conclusion, but felt bound by stare decisis. If the mortgagee had allowed the mortgagor to dispose of the collateral without replacing it with stock of equal value, then this would have constituted fraud and the decision would have been justified.

The Code provides that a security interest will attach when there is an agreement that it attach, when value is given, and when the debtor has rights in the collateral.⁵⁶ It also provides that a security agreement may provide that collateral, whenever acquired, shall secure all obligations covered by the security agreement.⁵⁷ In permitting a security agreement to cover after-acquired property, the Code editors assert that they are merely recognizing an existing state of things by recognizing what has been variously called the floating charge, the free handed mortgage and the lien on shifting stock.⁵⁸ If the Code provision permitting the security agreement to cover after-acquired property were applied to the *Sandy Valley Grocery Company* case, the transaction would be upheld as a valid lien on shifting stock. In addition to this improvement of Kentucky law, the Code will eliminate the confusion which has resulted from the cases creating certain exceptions to the common law rule.

"Future advances" is the term applied to an agreement between the mortgagor and mortgagee wherein the mortgagee agrees to advance additional money under the mortgage at some future time. By statute Kentucky provides that a chattel mortgage may secure future advances, good against all persons, to be made by the mortgagee, at its option, within one year from the execution of the mortgage, but not to exceed in the aggregate an amount stated in the mortgage.⁵⁹ No cases have been found in which the court has been faced with the necessity of interpreting this statute. Like Kentucky, the Code provides that the security agreement may provide for future advances.⁶⁰ In the absence of cases interpreting the Kentucky statute,

⁵⁵ Supra, note 45.

⁵⁶ UCC sec. 9-204 (1).

⁵⁷ UCC sec. 9-204 (3).

⁵⁸ UCC sec. 9-204 (1952) Text and Comments Ed.).

⁵⁹ K.R.S. sec. 382.620 (For the statute permitting a mortgage on real property to secure future advances, see K.R.S. 382.520).

⁶⁰ UCC sec. 9-204 (5).

it is futile to attempt to make a comparison between the Kentucky law and the Code. It is believed that both Kentucky and the Code would require that the provision for making future advances be stated in the security instrument. The Code may be broader than the statute inasmuch as the Code does not contain the limitation that the advances must be made within one year.

Default

The essence of a security transaction is the rights pertaining to the parties in the event of default. In Kentucky the mortgagee upon default is entitled to possession of the mortgaged property if he can get possession without a breach of the peace.⁶¹ When a chattel mortgagee takes possession of the mortgaged property after default, the mortgagee must within a reasonable time, unless the property be redeemed by the mortgagor, sell the property at a fair sale and on adequate notice, returning to the mortgagor any surplus over the balance due.⁶² In the event the mortgagee cannot get possession, he may bring an action in equity to foreclose the mortgage.

Under the Code unless otherwise agreed, the secured party has upon default the right to take possession of the collateral and proceed without judicial process if this can be done without breach of the peace.⁶³ The secured party may sell, lease, or otherwise dispose of any or all of the collateral subject to the Article on Sales.⁶⁴ The secured party must account to the debtor for any surplus and, unless otherwise agreed, the debtor is liable for any deficiency.⁶⁵ The disposition may be by public or private proceedings, and the collateral may be sold as a unit or in parcels.⁶⁶ The main restrictions are that the secured party must give the debtor notice of the sale and the sale must be commercially reasonable.⁶⁷ The Code gives the debtor a right to redeem the collateral at any time before the secured party has disposed of it by tendering fulfillment of all obligations secured by the collateral plus reasonable expenses incurred by the secured party.⁶⁸ In the event the secured party cannot get possession, he may use the judicial procedures available in order to foreclose.⁶⁹ Because the Code provides in a detailed manner the rights of the parties

⁶¹ *Hawkins Furniture Co. v. Morris*, 143 Ky. 738, 137 S.W. 527 (1911).

⁶² *Commercial Credit Co. v. Cooper*, 246 Ky. 513, 55 S.W. 2d 381 (1933).

⁶³ UCC sec. 9-503.

⁶⁴ UCC sec. 9-504 (1).

⁶⁵ UCC sec. 9-504 (2).

⁶⁶ UCC sec. 9-504 (3).

⁶⁷ *Ibid.*

⁶⁸ UCC sec. 9-506.

⁶⁹ UCC sec. 9-501 (1).

upon default where the secured party gets possession, it would be an improvement over the present Kentucky law.

Conclusion

Many articles have appeared in various law reviews concerning an appraisal of Article Nine of the Code, and the trend favors adoption. The broad purpose of Article Nine is to eliminate all the various security devices by substituting one new device called a security interest. In achieving this result the Code has adopted new terminology of its own in order to eliminate any confusion with the various security devices that have been made obsolete. The Code provides a notice type description and abolishes the requirement of acknowledgment, thereby reducing the formal requirements in Kentucky. The Code changes the Kentucky rule which protects a subsequent creditor against an unrecorded mortgage by requiring the subsequent creditor to obtain a lien before the unrecorded mortgage is perfected. The Code presents alternative methods of filing, one of which contemplates local filing in certain instances with central filing in others. The other alternative provides central filing in all cases. Kentucky in adopting the Code rejected both of these alternatives and retained its present system of local filing in all cases. In retaining its present system of local filing Kentucky rejected one of the most important features presented by the Code. The Code broadens the rule in Kentucky in cases where after-acquired property is used as collateral. Because Kentucky's statute permitting future advances to be covered by a chattel mortgage has not been interpreted, it is not possible to determine whether or not the Code broadens the rule. The Code sets out well-defined provisions concerning the rights of the parties upon default. From this perusal of the Code and its effect upon chattel mortgages in Kentucky, the writer believes that the adoption of the Code in Kentucky was a progressive step, and will eliminate much confusion which has resulted in this area.

Richard D. Cooper

THE ORIGINAL CRIMINAL JURISDICTION OF COURTS IN KENTUCKY

As is indicated by the title, this note is limited to the original criminal jurisdiction of courts in Kentucky and does not include their appellate jurisdiction. Since the original jurisdiction of any one of these courts is subject to exceptions, the jurisdiction of each court is