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Commercial Law—Uniform Commercial Code—Security Interests in Livestock: Clovis Nat'l Bank v. Thomas, 77 N.M. 554, 425 P.2d 726 (1967).

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COMMERCIAL LAW—UNIFORM COMMERCIAL CODE—SECURITY INTERESTS IN LIVESTOCK*

Banks have traditionally loaned money to ranchers in return for a promissory note and a consensual lien in livestock held by the rancher. The problems involved in using livestock as collateral are numerous, but central among them is the problem of keeping account of the animals. A bank cannot keep livestock within its vault, as is the practice when stocks or bonds are used as collateral for a loan. Neither has any means been devised of marking or separating the livestock so it can be clearly determined that the animals are subject to a possessory interest held by the bank. Since the collateral cannot be held by the lender, the security agreement typically includes a promise by the borrower assuring that the livestock will not be sold or transferred without the written consent of the secured party. The security interest in the collateral is perfected by filing with the county clerk in the county of the debtor's residence. In this manner, constructive notice that the livestock is subject to a mortgage is given within the county.

In *Clovis National Bank v. Harold Thomas d/b/a Clovis Cattle Commission Company*[1], the bank loaned money to a rancher who in turn gave the bank a promissory note and a security interest in cattle. The security interest was perfected by proper recording in two New Mexico counties.[2] By the terms of the security agreement, the rancher promised not to sell or transfer the cattle without the permission of the bank. The rancher consigned these cattle to the defendant for sale at public auction, although the bank had no knowledge of the consignment and had not given express consent to the sales. The auctioneer sold the cattle and remitted the proceeds to the rancher, but the rancher failed to pay off the bank loan which the cattle had secured.

The bank brought this action against the auctioneer for conversion. The auctioneer alleged reliance on a prior course of dealing between the bank and the rancher as establishing the ineffectiveness of the rancher's agreement not to sell the cattle without the bank's consent. The rancher had previously sold cattle covered by a similar security agreement without obtaining the bank's permission

* Clovis National Bank v. Harold Thomas d/b/a Clovis Cattle Commission Co., 77 N.M. 554, 425 P.2d 726 (1967).

1. 77 N.M. 554, 425 P.2d 726 (1967).

2. *Id.* at 557, 425 P.2d at 728.

to do so. On that occasion he had voluntarily taken the proceeds of the sale to the bank as payment on a note which they secured. The tender had been under conditions such that the bank knew an unpermitted sale of the collateral had been made, but the bank received the payment without quarreling about the sale.[3]

The trial court held that the bank had consented to and acquiesced in the sales, and was estopped from recovery because of its conduct. On appeal, the New Mexico Supreme Court *held,* Affirmed; the bank, by prior conduct, waived its right to require its authorization for sale or other disposition of the cattle. The court based its decision, not on estoppel, but only on consent and waiver.[4] The court stated that although the provisions of the Uniform Commercial Code applied to this case, the pre-code law result still prevails.[5]

This Comment will demonstrate that application of the Uniform Commercial Code[6] should lead to a different result. The language of section 9-102 of the Code clearly provides that the Code is applicable to the transaction in the *Thomas* case.[7] The Code applies to any transaction which is intended to create a security interest in goods. Section 9-109 classifies farm products, including livestock, as goods.[8]

3. *Id.* at 559, 425 P.2d at 729. There was other testimony that the bank made a practice of allowing debtors to sell livestock collateral without obtaining prior permission.

4. *Id.* at 560, 425 P.2d at 730. It is difficult to reconcile the application of the doctrine of estoppel. There was no fault or fraud on the part of the bank. Its prior acquiescence to the sale of collateral was merely passive. Further, there was no relationship whatsoever between the bank and defendant. The defendant did not rely on the conduct of the bank. *See* Rank v. (Krug) United States, 142 F. Supp. 1 (S.D. Cal. 1956).

5. *See* note 1 *supra* at 562, 425 P.2d at 731.

6. The 1958 version of the Uniform Commercial Code was made law in New Mexico effective in 1961. The state legislature made a few changes from the official text. None of these changes creates substantial differences from the present official text with respect to this problem. The analysis of this comment is substantially the same under the New Mexico Commercial Code with its variations and under the present official text of the Code. New Mexico, in contrast to some states, has not enacted the comments to the official text as law. However, the draftsmen of the Code supplemented the text with comments to safeguard against misconstruing of the text and an examination of these comments seems appropriate to clarify the questions involved here.

7. N.M. Stat. Ann. § 50A-9-102 (1)(a) (Repl. 1962). 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. . . ."

8. N.M. Stat. Ann. § 50A-9-109 (Repl. 1962).

Under the provisions of the Code, a security interest is not enforceable against the debtor or third parties unless the debtor has signed a security agreement which contains a description of the collateral, or the collateral is in the possession of the secured party.[9] Section 9-110 indicates that a description of collateral is sufficient, whether or not it is specific, if it reasonably identifies what is described.[10] In *Thomas,* the security agreement signed by the rancher contained a description of the brand on the cattle and indicated the kind and number of the cattle covered by the agreement. The validity of the security agreement signed by the rancher was unquestioned.

Section 9-401 of the Code provides for proper filing in order to perfect a security interest.[11] New Mexico requires that a security interest, such as the one in *Thomas,* be filed in the office of the county clerk in the county of the debtor's residence. This requirement was met by the bank.[12] The security agreement gave two locations where the cattle would be kept, one of which was in the county of the debtor's residence. The agreement was filed in the county seat of both locations.

In *Thomas,* the security agreement prohibited transfers without the consent of the secured party. Did the bank consent to the sales? There was no express consent or waiver. If consent or waiver was implied, then it must have been implied from the course of dealing. Even if the course of dealing did *imply* consent or waiver, that course of dealing was inconsistent with the terms of the written agreement. The Code provides a solution when factors such as these conflict. Section 1-205 states:

> The express terms of an agreement and an applicable course of dealing or usage of trade shall be construed wherever reasonable as consistent with each other; but when such construction is unreasonable express terms control both course of dealing and usage of trade.[13]

This section seems to be in direct disagreement with the holding of the court in *Thomas.* It is not reasonable to construe the conduct of

9. N.M. Stat. Ann. § 50A-9-203 (Repl. 1962). The official comment to this section states: "The only requirements for the enforceability of non-possessory security interests in cases not involving land are (a) a writing; (b) the debtor's signature; and (c) a description of the collateral or kinds of collateral."

10. N.M. Stat. Ann. § 50A-9-110 (Repl. 1962).

11. N.M. Stat. Ann. § 50A-9-401 (Repl. 1962).

12. *See* note 1 *supra* at 557, 425 P.2d at 728.

13. N.M. Stat. Ann. § 50A-1-205 (4) (Repl. 1962).

the parties as being consistent with the written agreement. However, even if an inconsistent course of dealing did imply consent the court's result is not justified. The Code expressly provides that the terms of the written agreement are controlling.

Pre-Code case law on facts like these holds that express terms of a contract prevail over a course of dealing. In *Thomas,* the court found that a course of dealing was established by previous transactions in which the rancher sold cattle without obtaining the consent of the bank and the bank accepted the proceeds without complaint.[14] However, a California district court has stated that in order to be binding, a custom or usage must be definite, uniform and well known, established by clear and satisfactory evidence, shown to be long established, reasonable, and accepted by acquiescence.[15] It is doubtful that these requirements fit the relationship between the bank and the rancher in *Thomas.* In *Security State Bank v. Clovis Mill and Elevator Company*[16], The Supreme Court held that custom will not prevail over a statute or the terms of a contract in conflict with the custom. In another case the New Mexico Supreme Court held that proof of a custom is not allowable to vary the terms of a contract.[17] These cases, as well as the Code itself, seem to indicate that if there is a signed agreement between the parties and a course of dealing inconsistent with that agreement, the terms of the agreement prevail.

The protection to which the bank was entitled and which it should have expected is made evident by the Code. Section 9-201, dealing with the general validity of a security agreement, states: "Except as otherwise provided by this Act a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors."[18] The official comment to this section emphasizes that a security agreement is effective against third parties.[19] This section seems to point out that the defendant, having accepted the collateral as a consignee, cannot escape liability merely because he was not a party to the agreement. Section 9-303 emphasizes the rule that a security interest once perfected, remains perfected.[20] Comment 1 to this section points

14. *See* note 1 *supra* at 559, 425 P.2d at 729.
15. Rosenberg Brothers & Company v. United States Shipping Board, 7 F.2d 893 (D.C. Cal. 1925).
16. 41 N.M. 341, 345, 68 P.2d 918 (1937).
17. Romero v. Romero, 29 N.M. 667, 670, 226 P. 652 (1924).
18. N.M. Stat. Ann. § 50A-9-201 (Repl. 1962).
19. Uniform Commercial Code § 9-201, Comment.
20. N.M. Stat. Ann. § 50A-9-303(2) (Repl. 1962).

out that the secured party is protected against transferees of the debtor.[21] It seems clear that one purpose of the Code is to prevent a result such as occured in *Thomas*. There are strict requirements involved in establishing a security interest in collateral, but once these requirements have been met, the secured party should be protected against losing that interest through circumstances over which he has no control.

Section 1-107 of the Code provides for the waiver of any claim or right arising out of an alleged breach.[22] It requires that such a waiver be in writing. It is doubtful whether this section applies to the *Thomas* case because it appears that a waiver can be exercised only where a breach has already occurred. This is the only section that mentions waiver in regard to secured transactions. However, the Comment to this section states that the effectiveness of waiver and estoppel is recognized.[23]

Section 1-103 provides for the application of supplementary principles of law.[24] This section states that, unless they are displaced by the particular provisions of the Code, the principles of law and equity, such as estoppel and waiver, supplement the Code. It was by the authority of this Code section that the court found that the bank had waived its rights in the cattle. The bank should have been completely protected by the provisions of the Code, but even if supplementary principles of law are considered, it still must be established that the bank consented to the sale of the cattle and waived its right. The court in *Thomas* stated that waiver is the "intentional abandonment or relinquishment of a known right."[25] In the very case the court cites[26], (an insurance case dealing with agent-principal relationship), the court emphasized the importance of establishing the *intent* of the party to waive its right. In *Thomas,* there was no evidence to indicate that the bank intended to waive its right; there was merely little opportunity for it to exercise the right. Another case cited by the court[27] involved collection from an insurance company. There the holding was based on the interrelationship of the doctrines of waiver and estoppel.[28] It stated that estoppel

21. Uniform Commercial Code § 9-303, Comment 1.
22. N.M. Stat. Ann. § 50A-1-107 (Repl. 1962).
23. Uniform Commercial Code § 1-107, Comment.
24. N.M. Stat. Ann. § 50A-1-103 (Repl. 1962).
25. *See* note 1 *supra* at 560, 425 P.2d at 730.
26. Smith v. New York Life Insurance Co., 26 N.M. 408, 193 P. 67 (1920).
27. Miller v. Phoenix Assur. Co., 52 N.M. 68, 191 P.2d 993 (1948).
28. *See* note 4 *supra.*

precludes assertion of a right, which might otherwise have existed, because of acts or conduct relied and acted upon by another to his detriment and prejudice. The auctioneer in *Thomas* could not reasonably rely on the bank's conduct as constituting an intentional relinquishment of a known right.

A Pennsylvania district court case has stated that a waiver of a contractual right will not be presumed or implied contrary to the intention of the party whose rights would be injuriously affected thereby, unless by his conduct the opposite party has been misled, to his prejudice, into the honest belief that such waiver was intended or consented to.[29] The rancher in *Thomas* was clearly not misled to his prejudice. It is doubtful if there was a waiver of the bank's rights even outside the provisions of the Code.

Another Code section that should be examined in relation to the *Thomas* case is section 9-306.[30] It provides that a security interest in collateral continues in any identifiable proceeds after the sale or exchange of that collateral. This section is pointed directly at the factual situation in *Thomas*. The draftsmen of the Code stated in the Comment to this section that: ". . . since the transferee takes subject to the security interest, the secured party may repossess the collateral from him or in an appropriate case maintain an action for conversion."[31] Is *Thomas* an appropriate case for this type of action? It appears from the facts of the case and the language of the Code that it is. The section that outlines the purposes of the Code seems particularly applicable.[32] It provides that the code is to be "liberally construed and applied to promote its underlying purposes and policies." These purposes and policies are:

(a) to simplify, clarify and modernize the law governing commercial transactions;

(b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties;

(c) to make uniform the law among the various jurisdictions.[33]

It is essential that the courts recognize that security agreements in livestock transactions are as binding as other commercial transactions.[34] A purchaser of real estate is charged with notice of the

29. In re Zimmerman, 35 F. Supp. 13 (E.D.Pa. 1940).
30. N.M. Stat. Ann. § 50A-9-306 (Repl. 1962).
31. Uniform Commercial Code § 9-306, Comment 3.
32. N.M. Stat. Ann. § 50A-1-102 (Repl. 1962).
33. N.M. Stat. Ann. § 50A-1-102(2) (Repl. 1962).
34. *See* Bunn, *Financing Farmers,* 1954 Wis. L. Rev. 353, 360 (1954).

real property records. An auctioneer, as in *Thomas,* or a person buying livestock directly from the owner should be charged with the duty to search the records for the presence of a security agreement covering the livestock. A search of the records would put the auctioneer on notice to question the bank about the provisions of the security agreement. This would protect the secured party by eliminating the possibility of reliance on any course of performance between the bank and the debtor which is inconsistent with the terms of the security agreement. At the same time it does not seem that having to search the record on all cattle to be sold would place too great a burden on an auctioneer. The burden on potential buyers at the auction to search the record on all the cattle to be sold *is* unreasonable.

A liberal construction of the Code would bring about the application of these procedures to livestock transactions. The New Mexico Supreme Court in *Strevell-Paterson Finance Company v. May*[35] has emphasized that in the area of secured transactions the Code is to be construed liberally, and applied to promote its underlying purposes and policies. The code hints at the peculiar problems of secured transactions in livestock when it states in section 9-307 (1)[36] that:

> A buyer in ordinary course of business other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

One purpose of the Code is to permit the continued expansion of commercial practices.[37] The decision in the *Thomas* case is likely to restrict loans on livestock. The usefulness of providing livestock as collateral is now under question.

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35. 77 N.M. 331, 442 P.2d 366 (1967).
36. N.M. Stat. Ann § 50A-9-307 (Repl. 1962).
37. N.M. Stat. Ann. § 50A-1-102 (Repl. 1962).