**Power to Transfer Rights and Entrustment Under** § **2-403**

Welcome to this podcast on Power to Transfer Rights and Entrustment Under § 2-403brought to you by CALI. I am Professor Jennifer S. Martin. This podcast focuses on two Article 9 issues: (i) when does a person have sufficient rights to grant an Article 9 security interest even though they have voidable title and (ii) when does the debtor have sufficient rights to grant an Article 9 security interest under the entrustment doctrine.

You may recall that under § 9-203, a security interest becomes enforceable only if three elements are present: (i) *value* has been given (most of the time this is the same as consideration—the money or goods given or promised by the creditor); (ii) the *debtor has rights* in the collateral or power to transfer rights in the collateral to a secured party (meaning some form of property right to the personal property); and (iii) there is some proof that the debtor has entered into a security agreement. When the last of these three things occur, the security interest attaches and becomes enforceable, and the creditor can foreclose on the collateral if there is a default. In this podcast we will focus on special issues related to rights to the collateral that are requisite to § 9-203 that arise when a person has only voidable title and when the entrustment doctrine operates to provide a party with title. Broader issues related to Value and Rights to the Collateral and Security Agreements are the subject of separate podcasts.

Let’s look at an example where there’s no issue about a person having rights to collateral for purposes of § 9-203.

Example 1. Martin wanted to buy a clarinet for her son Marshall. Music City agreed to sell her the clarinet on credit with Music City using the clarinet as collateral to secure payment of the price over three years. Martin signed a promissory note promising to pay Music City over time for the clarinet and signed a security agreement that granted a security interest in the clarinet to Music City. The security interest attached to the clarinet because: (i) Music City gave *value* by providing Martin with the clarinet; (ii) the debtor (Martin) has *rights to the collateral* after Music City sold her the clarinet (she now owns it); and (iii) Martin *signed a written security agreement* that granted Music City a security interest and that identified the collateral as the clarinet.

Let’s focus first on how a person having void or voidable title might affect whether a party has rights to collateral sufficient to create an Article 9 security interest. Before beginning this discussion two important definitions are implicated. First, while it might seem against traditional understandings of who is a purchaser, under the UCC, a “*purchaser*” is a person who takes by sale, but also includes a person with a security interest. See §§ 1-201(b) (29) & (30). Second, under the UCC, a “buyer in the ordinary course” includes a person who buys from the seller’s inventory and takes possession of goods, but does not include a person with a security interest. See § 1-201(b)(9). Make sure that when reading the Code you watch for specific language used, as a secured party is a purchaser, but not a buyer in the ordinary course.

Section 2-403(1) permits a person with *voidable title* to transfer goods to a “good faith *purchaser* for value” in four limited circumstances. As a result, a person with voidable title can be a debtor for purposes of Article 9. Moreover, because a secured party is a “*purchaser*” for purposes of Article 9, a person with even voidable title has rights to collateral that can be transferred by way of a security interest to a secured party. However, this rule only applies even where: (i) the transferor was deceived about the identity of the purchaser; (ii) the delivery was for a check that was later dishonored; (iii) it was agreed that the transaction was a “cash sale;” and (iv) the delivery was procured through fraud punishable as larceny under criminal law.

Let’s look at some examples of where the operation of § 2-403(1) recognizes sufficient rights in collateral to permit attachment of the security interest.

Example 2. Dale, who runs a tool sale and repair business, borrowed $50,000 from Second Bank in order to pay operating expenses and granted a security interest in its existing and after-acquired inventory. Dale purchased $10,000 of tools for resale from Supplier and paid Supplier by check, which was later dishonored for insufficient funds. As a result of the bad check, Dale might be found to have *voidable title* to the goods (although this might also be viewed as a simple breach of contract, depending on the case). Dale has sufficient rights to grant a security interest to a purchaser due to the operation of § 2-403(1), even though the check was dishonored. Second Bank, a secured party, is a good faith purchaser for value. Accordingly, Second Bank’s security interest attached to the inventory because Dale has sufficient rights as recognized by § 2-403(1).

Example 3. Same loan as in Example 2. Dale purchased $10,000 of tools for resale from Supplier as part of a cash sale. Supplier loads the tools onto Dale’s truck, but Dale tried to pay with a check. Supplier stated it wanted cash and not a check but agreed to let Dale leave with the tools with the understanding that Dale would return with cash and Supplier would provide a bill of sale after the cash payment. Dale, who never intended to pay, failed to pay Supplier the cash. Dale has *voidable title* to the goods even though there was a failure to pay the cash (and Dale might later be convicted of larceny). Nevertheless, Second Bank, a secured party in inventory, is a good faith purchaser for value. Second Bank’s security interest attached to the tools because Dale had sufficient rights to the tools as recognized by § 2-403(1).

Example 4. Dale borrowed $5000 from First Bank to purchase tools, granting First Bank a security interest in Dale’s existing and after-acquired equipment. Dale purchased tools for use in the repair business from Toolco on credit without intending to pay Toolco. Dale would have *voidable title* and despite the possibility that Dale might be prosecuted for larceny under local law, Dale had rights to the collateral and the security interest of First Bank attached to the tools acquired from Toolco as recognized by § 2-403(1).

Example 5. Thief steals tools from Toolco. Thief does not have title and cannot transfer any rights to a good faith purchaser by virtue of § 2-403(1).

Let’s look at the “entrustment” rule under § 2-403(2) and how that might affect attachment of a security interest. The entrustment rule provides that any entrusting of possession of goods to a merchant who deals in goods of the kind has rights to transfer title to a buyer in the ordinary course of business. Let’s look at an example.

Example 6. Same loan as in Example 2 involving the secured loan of $50,000 from Second Bank to Dale. Customer brings a hydraulic wrench to Dale for repair. Dale is a merchant who deals in goods of the kind (tools), but Second Bank is not a buyer in the ordinary course under the UCC. As such, the security interest of Second Bank does not attach to Customer’s hydraulic wrench.

Example 7. Customer brings a hydraulic wrench to Dale for repair. Dale, who runs a tool sale and repair business, is a merchant who deals in goods of the kind (the sale of tools). Customer has entrusted the hydraulic wrench to Dale. Dale inadvertently sells the hydraulic wrench to Sam for cash who takes delivery and does not know of the entrustment by Customer. Sam is a buyer in ordinary course under the UCC. As such, Sam would have title to the hydraulic wrench entrusted by Customer to Dale. As such, Sam would have rights to the hydraulic wrench and be able to use the wrench as collateral for a loan with Third Bank.

Example 8. Same as Example 7, except rather than paying cash for the hydraulic wrench, Sam finances the purchase with Friendly Finance, which works with Dale’s customers and which takes a security interest in the wrench. Even though the sale to Sam is on a secured basis, Sam is a buyer in ordinary course under the UCC. As such, Sam would have title to the hydraulic wrench entrusted by Customer to Dale and has rights to the collateral such that the security interest of Friendly Finance will attach to the wrench.

At this point, you should be able to describe and apply how § 2-403 recognizes rights to collateral sufficient for the creation of a security interest. You should be able to identify when § 2-403(1) permits a party with voidable title to transfer rights to a good faith purchaser for value (including a secured party). You should also be able to explain how the entrustment rule of § 2-403(2) sometimes permits a merchant dealing in goods of the kind to transfer good title to goods entrusted to them to a buyer in ordinary course of business.

I hope you’ve enjoyed this podcast on Power to Transfer Rights and Entrustment under § 2-403.

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