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Conflicting Perfected Security Interests in Proceeds Under Article 9 of the Uniform Commercial Code

Prior to the enactment of the Uniform Commercial Code (Code)[1] a financer had difficulty establishing a continuing lien on a constantly changing collateral such as inventory. Courts would often vitiate the secured transaction if the debtor was in possession and control of the secured property[2] or would considerably weaken the security device by refusing to enforce after-acquired property clauses.[3] Field warehousing avoided most of the legal problems of inventory financing but was too cumbersome and costly for most financers.[4] The Uniform Trust Receipts Act[5] was the first legislative attempt to deal with inventory financing, but its provisions were complex and difficult to apply.[6]

Today, article 9 of the Code has facilitated inventory financing by enabling the debtor to carry on his business of selling goods while still protecting the secured party's interest in the inventory. Article 9 provides that the security interest can shift from the stock which the debtor sells to the new inventory that he acquires, thus allowing those who buy from the inventory to take free of the security interest.[7] Moreover, the debtor can maintain control over the secured property,[8] and can give present security in future acquisitions of new inventory[9] or the proceeds of the inventory.[10] Finally, the secured party can acquire a lien which "floats" from the original inventory to other after-acquired inventory.[11]

Section 9-306 gives the inventory financer a "continuously perfected" security interest in the proceeds of the inventory if the security interest in the original collateral was perfected. "Proceeds" is defined as including "whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of."[12]

1. The Code is hereinafter cited as U.C.C. Citations are to the 1962 Official Text.
2. *E.g.*, Benedict v. Ratner, 268 U.S. 353 (1925).
3. *E.g.*, Callahan v. Auburn Prod. Credit Ass'n, 240 Ala. 104, 197 S. 347 (1940).
4. *See, e.g., In re* United Wholesalers, Inc., 274 F.2d 316 (7th Cir. 1960); Ribaudu v. Citizens Nat'l Bank, 261 F.2d 929 (5th Cir. 1958).
5. 9c UNIFORM LAWS ANN. 231 (1957).
6. E. FARNSWORTH & J. HONNOLD, COMMERCIAL LAW 764 (1965).
7. U.C.C. § 9-307.
8. U.C.C. § 9-205.
9. U.C.C. §§ 9-204(3), -108 (stating that a security interest in certain after-acquired property is deemed to have been given for present consideration rather than for an antecedent debt).
10. It will be assumed, unless otherwise stated, that proceeds means identifiable proceeds. If proceeds is not identifiable, then under U.C.C. § 9-306(2), there can be no claim to it.
11. *See, e.g.*, Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien,"* 72 HARV. L. REV. 838, 839 (1959); Gordon, *The Security Interest in Inventory Under Article 9 of the Uniform Commercial Code and the Preference Problem*, 62 COLUM. L. REV. 49 (1962).
12. U.C.C. § 9-306(1).

Thus, the inventory financer may have a security interest in the proceeds of the original collateral or the proceeds of the proceeds. The security interest in the proceeds may be perfected[13] in either of two ways: (1) under section 9-306(3)(a) the security interest is perfected by filing a financing statement that expressly covers both the original collateral and the proceeds; (2) under section 9-306(3)(b) the security interest in proceeds is perfected by filing a new financing statement within ten days after the debtor has received the proceeds.

The ease of perfecting a security interest in proceeds, however, increases the possibility of conflicting security interests in collateral in a number of situations in which at least one of the secured parties claims the collateral as proceeds. For example, the inventory financer may have an interest in proceeds consisting of documents,[14] instruments,[15] or chattel paper[16] which conflicts with a claim by one who has purchased[17] the paper or documents. Second, there may be two inventory financers claiming the proceeds.[18] Third, the proceeds may be in the form of accounts,[19] in which case both an inventory financer and an accounts financer could have a claim. It is the purpose of this Comment to discuss the problems created by these conflicts, to evaluate the solutions offered by the Code, and to recommend appropriate alterations where the Code scheme is inadequate.

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13. U.C.C. § 9-303(1):

A security interest is perfected when it has attached [Section 9-204] and when all the applicable steps required for perfection have been taken. Such steps are specified in Sections 9-302, 9-304, 9-305 and 9-306. If such steps are taken before the security interest attaches, it is perfected at the time when it attaches.

14. Under U.C.C. § 9-105(1)(e) "document" means "document of title." U.C.C. § 1-201 (15) defines the latter term as follows:

"Document of title" includes bill of lading, dock warrant, dock receipt, warehouse receipt or order for the delivery of goods, and also any other document which in the regular course of business or financing is treated as adequately evidencing that the person in possession of it is entitled to receive, hold and dispose of the document and the goods it covers. To be a document of title a document must purport to be issued by or addressed to a bailee and purport to cover goods in the bailee's possession which are either identified or are fungible portions of an identified mass.

15. U.C.C. § 9-105(1)(g):

"Instrument" means a negotiable instrument (defined in Section 3-104), or a security (defined in Section 8-102) or any other writing which evidences a right to the payment of money and is not itself a security agreement or lease and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment.

16. Under U.C.C. § 9-105(1)(b):

"Chattel paper" means a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods. When a transaction is evidenced both by such a security agreement or a lease and by an instrument or a series of instruments, the group of writings taken together constitutes chattel paper.

17. *See* note 36 *infra* and accompanying text.

18. If the two inventory financers are financing different inventory, there will be no conflict, since the proceeds will arise from the disposition of particular inventory, and the financer of that particular inventory will prevail.

19. Under U.C.C. § 9-106 "account" means "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper."

I. The General Rules of Priority

Section 9-312(5) establishes a general framework to govern priorities among secured parties with perfected security interests in the same collateral. It provides first that when both secured parties have perfected by filing, the first to have filed prevails.[20] To illustrate, assume that an inventory financer, *A*, files a financing statement covering a debtor's inventory, but does not advance the debtor any money. A second inventory financer, *B*, later loans the same debtor a sum of money, takes as collateral an interest in the same inventory, and files a financing statement. If *A* subsequently advances the debtor money under their agreement, *A*'s security interest then becomes perfected.[21] Since *A* and *B* have perfected by filing, *A*, having filed first, would prevail, not withstanding his later perfection.

The second general rule of priority provides that when one of the secured parties has perfected otherwise than by filing, the first to have perfected prevails.[22] Using the hypothetical discussed above, assume that *B*, instead of filing a financing statement, had perfected by taking possession of the collateral.[23] *B* would then prevail because, although *A* had filed first, *A*'s interest did not become perfected until he advanced the money,[24] which was after *B* had perfected by taking possession.

The third rule, which is most relevant to the concept of a continuously perfected security interest, is contained in section 9-312(6):

> For the purpose of the priority rules of the immediately preceding subsection [containing the first and second rules], a continuously perfected security interest shall be treated at all times as if perfected by filing if it was originally so perfected and it shall be treated at all times as if perfected otherwise than by filing if it was originally perfected otherwise than by filing.

For example, assume that an inventory financer, *A*, files a financing statement covering a debtor's inventory, but does not advance the debtor any money. A second inventory financer, *B*, perfects by taking possession of warehouse receipts covering the inventory.[25] *A* then loans the debtor money under their agreement, and *B* returns the receipts to the debtor. Under section 9-304(5), *B*'s security interest remains perfected for twenty-one days after he surrenders possession of the receipts to the debtor. If *B* files a financing statement

20. U.C.C. § 9-312(5)(a).

21. Under U.C.C. § 9-204(1) a security interest cannot attach, and therefore cannot perfect, until value is given.

22. U.C.C. § 9-312(5)(b).

23. Perfection is possible by taking possession under U.C.C. § 9-305.

24. *See* note 21 *supra.*

25. Perfection of a security interest in warehouse receipts by taking possession is permissible under U.C.C. § 9-305.

within the twenty-one day period, he would prevail over *A*, since under section 9-312(6) *B* had perfected otherwise than by filing and before *A*, even though *A* had been the first to file.

II. THE CONCEPT OF A "CONTINUOUSLY PERFECTED" SECURITY INTEREST

Section 9-306(3) states that "[t]he security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected . . . ." When confronted with a priority problem, it is important to determine whether the perfection is an original perfection or a continuation of an already existing perfection. If an inventory financer has a perfected security interest in the inventory of the debtor but has not filed a financing statement covering the proceeds, section 9-306(3) allows him ten days after receipt of the proceeds to perfect his interest in the proceeds. However, a question arises as to the nature of the perfection in proceeds during the ten-day period[26]—that is, whether the interest should be considered as perfected by filing or perfected otherwise than by filing. In his *Practice Commentary to the New York Uniform Commercial Code,* Homer Kripke admits that there is such a thing as continuity of perfection, but argues that the priority of the secured party as to inventory does not continue as to the proceeds of the inventory when sold.[27] The premise of this argument seems to be that proceeds is "different collateral," and that since the perfection in proceeds is "automatic," it is therefore perfection otherwise than by filing.[28] In a contest between an inventory financer claiming proceeds perfected "automatically" within the ten-day period and another secured party who has perfected by filing, Kripke would argue that priority should be given to the first to perfect.[29] Kripke would argue further that even though the "automatically perfected" security interest in proceeds is subsequently perfected by filing, under section 9-312(6) the security interest in proceeds is always to be considered as having been perfected otherwise than by filing.[30] However, by emphasizing that the collateral has taken a different form when it becomes proceeds, Kripke's analysis ignores the principle underlying the concept of continuity of perfection: the automatic perfection that takes place when the inventory becomes proceeds is not an initiation of a perfection; rather, it is a continuation of an already existing perfection. Thus, as will be demonstrated, Kripke's analysis seems to be refuted by

26. U.C.C. § 9-306(3)(b) gives the secured party ten days to perfect his security interest in proceeds.

27. N.Y. U.C.C. § 9-312 (Practice Commentary 7) (McKinney 1964).

28. *Id.*

29. *Id.*

30. *Id.*

both the provisions of the Code and the underlying principles of a floating lien enunciated by the Code.

Section 9-302(2) explains that as long as there is no period when the security interest is unperfected, the interest "shall be deemed to be perfected continuously." Section 9-312(6), discussed above,[31] states that such a continuously perfected security interest shall be treated as having been perfected in the same manner as that in which perfection originally occurred. Therefore, since a security interest in proceeds is treated as a continuously perfected security interest,[32] it is the perfection of the original collateral which should be the determining factor in deciding what priority rule governs with respect to proceeds. Thus, if an inventory financer has originally perfected an interest in inventory by filing, the interest in proceeds perfected within the ten-day grace period should also be deemed perfected by filing. On the other hand, if the interest in the original collateral was perfected otherwise than by filing, the interest in proceeds should be treated as perfected otherwise than by filing.[33]

Section 9-402(2)(b) also suggests that a security interest in proceeds should be considered to be perfected in the same manner as the perfection of the security interest in the original collateral. This section allows the secured party to continue the perfection in proceeds beyond the ten-day grace period by filing a financing statement covering proceeds which is signed only by the secured party and describes only the original collateral. If the drafters of the Code considered the filing of such a statement to be an initiation of a new perfection, the financing statement would have to be signed by both the secured party *and* the debtor, and it would also have to describe the new collateral.[34]

Finally, the very concept of a floating lien suggests that the original lien continues, even though the collateral changes form. The process of holding an inventory of goods for sale involves a continuous transformation of inventory into proceeds and then proceeds back into inventory. Yet, even though the collateral changes in form, a filing statement covering *all* the inventory of a named debtor located at a specific address would describe the collateral sufficiently to maintain perfection and to put any subsequent financer on notice. The Code has tried to simplify and en-

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31. *See* text following note 24 *supra.*

32. U.C.C. § 9-306(3).

33. It is interesting to note that Kripke, while willing to apply U.C.C. § 9-312(6) to say that the automatic perfection as to proceeds is controlling even though subsequently filed, will not apply that section to say that the perfection of the interest in proceeds is controlled by the type of perfection of the original collateral. *See* N.Y. U.C.C. § 9-312 (Practice Commentary 7) (McKinney 1964); text accompanying note 30 *supra.*

34. *See* U.C.C. § 9-402(1).

courage inventory financing by allowing the secured party to follow the inventory as it changes into proceeds by giving the secured party a "continuously perfected security interest" in proceeds. If the secured party were required to file a new agreement every time the collateral changed form, the purpose of a floating lien would be defeated. Not only would new agreements have to be filed at frequent intervals, but the secured party would continually have to police the debtor to discover any possible changes in the collateral. Thus, to consider the perfection of the security interest in proceeds of the original collateral as a new perfection in different collateral is contrary to the underlying scheme which the Code intended to effectuate.

Once the concept of continuity of perfection is understood, it becomes clear why the Code looks to the perfection of the original collateral to determine priority, and why it does not require a financing statement which covers only proceeds either to be signed by the debtor or to describe the proceeds. Continued perfection of a security interest would be pointless if it did not bring with it continued priority, since a creditor only perfects in order to gain a priority; thus, for perfection to be continued, in any meaningful sense, it is obvious that the initial priority must also be continued.

Having reached this understanding of the concept of a "continuously perfected security interest," many of the complex priority problems will become easier to solve.

III. CONFLICTING SECURITY INTERESTS IN PROCEEDS

A. *Chattel Paper, Instruments, and Documents*

Frequently, the proceeds claimed by an inventory financer will take the form of chattel paper. Chattel paper is a general term signifying a writing evidencing both a monetary obligation and a security interest.[35] When the debtor receives chattel paper in return for a sale, a conflict may arise between the inventory financer of the debtor who will claim the chattel paper as proceeds and a subsequent purchaser of the chattel paper. The Code defines a purchaser as any one who takes by "sale, discount, negotiation, mortgage, pledge, lien, issue or re-issue, gift, or any other voluntary transaction creating an interest in property."[36] The purchaser may have perfected either by filing as to all the debtor's existing and after-acquired chattel paper[37] or by taking possession of the paper.[38]

35. *See* note 16 *supra.*

36. U.C.C. § 1-201(32), -201(33).

37. U.C.C. § 9-304(1) permits perfection of a security interest in chattel paper by filing.

38. U.C.C. § 9-305 permits perfection of a security interest in chattel paper by taking possession of the paper.

Section 9-308 of the Code attempts to resolve the possible conflict between an inventory financer and a purchaser who perfects by *taking possession* of the chattel paper.[39] This section is designed to cover two specific situations: (1) the conflict between a purchaser and an inventory financer who claims the chattel paper "merely as proceeds"; (2) the conflict between a purchaser and a secured party who has a direct interest in the chattel paper. The purchaser who takes possession of the chattel paper is always given a priority over the inventory financer claiming the chattel paper "merely as proceeds," even when he takes with knowledge of the inventory financer's security interest. Yet the inventory financer is not injured because the purchaser of the chattel paper must have given new value, thereby providing assets that the inventory financer can reach through section 9-306 as proceeds of proceeds. The inventory financer, however, may have difficulty identifying the proceeds realized from the disposition of the paper; thus, he would be advised to take possession either of the paper, which would prevent section 9-308 from applying altogether, or the proceeds of the paper in order to insure that funds will be available for payment of the debt.

The inventory financer's claim to the chattel paper appears to remain "merely as proceeds" until he refinances the debtor and takes a security interest directly in the chattel paper.[40] If the inventory financer has so refinanced, he retains priority over a subsequent purchaser of the chattel paper, unless that purchaser has met the added requirement of section 9-308—that he take "without knowledge that the specific paper . . . is subject to a security interest." Since knowledge as used in the Code means actual knowledge,[41] the purchaser would not be presumed to have discovered any possible conflicting security interest. Presumably, then, if the purchaser knows only that an inventory financer has a claim to the paper "merely as proceeds," and is unaware of a new and direct interest acquired by refinancing, he would meet the requirement of section 9-308 that he take without knowledge.[42]

A purchaser of chattel paper may perfect his security interest by filing rather than by taking possession, in which case he is not protected by the special priority rule in section 9-308 and must resort

39. U.C.C. § 9-308:
A purchaser of chattel paper or a non-negotiable instrument who gives new value and takes possession of it in the ordinary course of his business and without knowledge that the specific paper or instrument is subject to a security interest has priority over a security interest which is perfected under Section 9-304 (permissive filing and temporary perfection). A purchaser of chattel paper who gives new value and takes possession of it in the ordinary course of his business has priority over a security interest in chattel paper which is claimed merely as proceeds of inventory subject to a security interest (Section 9-306), even though he knows that the specific paper is subject to the security interest.

40. *See* 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 730-31 (1965).

41. U.C.C. § 1-201(25).

42. *See* 2 G. GILMORE, *supra* note 40, at 730-31.

to the general priority rules of section 9-312(5). Under this provision, if both the inventory financer and the purchaser of the chattel paper perfect by filing, the first to file takes priority; on the other hand, if the inventory financer perfects his security interest in the original collateral otherwise than by filing, the first to perfect prevails.

The proceeds claimed by the inventory financer may also consist of non-negotiable instruments;[43] for example, the debtor may sell goods in exchange for a ninety-day promissory note. As in the case of chattel paper, the Code evidences a policy of protecting one who *takes possession* of a non-negotiable instrument in order to facilitate its flow in commerce. Section 9-308, when dealing with the conflict between a purchaser and an inventory financer who claims the instrument "merely as proceeds," refers only to purchasers of chattel paper.[44] However, the language of the same section, when concerned with the conflict between a purchaser and a secured party who has a direct interest in the instrument, refers to purchasers of both chattel paper and non-negotiable instruments. Thus, apparently, a purchaser of a non-negotiable instrument who perfects by taking possession must meet the requirement of lack of knowledge in order to prevail over an inventory financer who claims the instrument as proceeds. This analysis assumes, of course, that if a purchaser without knowledge can take priority over an inventory financer with a direct interest in the instrument, then, a fortiori, he can prevail over an inventory financer claiming the non-negotiable instrument as proceeds.[45]

Although the inventory financer automatically has a perfected security interest in proceeds for ten days following the debtor's receipt of the proceeds, it has been argued that, when the proceeds consist of non-negotiable instruments, the inventory financer must take possession of the instruments in order to maintain the perfection of this security interest.[46] This argument is based on section 9-304(1), which provides that "[a] security interest in instruments (other than instruments which constitute part of chattel paper) can be perfected only by the secured party's taking possession, except as provided in subsections (4) and (5) [relating to a twenty-one-day grace period]." However, since proceeds in the form of a non-negotiable instrument does not represent new collateral but merely a change in form of the original collateral, the inventory financer does not take a new perfected interest in the instrument, but rather

43. The Code defines a non-negotiable instrument by elimination. Therefore, it is an instrument which does not meet the requirements of U.C.C. § 3-104. Under U.C.C. § 8-105 investment securities are negotiable instruments.

44. *See* § 9-308 quoted in note 39 *supra.*

45. *See* U.C.C. § 9-308, Comment 3.

46. N.Y. U.C.C. § 9-306 (Practice Commentary 6) (McKinney 1964). *See* Coogan, *supra* note 11, at 871.

maintains a "continuously" perfected security interest in the instrument as proceeds of the original collateral. Therefore, despite the language of section 9-304(1), it seems that the inventory financer can continue his perfected interest in the instruments claimed as proceeds simply by filing within the ten-day grace period. This argument applies with even greater force where the inventory financer filed originally as to both inventory and proceeds. As the inventory is sold in exchange for instruments, the interest of the inventory financer would remain perfected so long as his filing continues to be valid. If the interest in proceeds is to be truly continuous, it would be incongruous to require any further act on the part of the inventory financer who has originally filed as to proceeds.

The view that the inventory financer retains a perfected security interest in non-negotiable instruments in the form of proceeds without taking possession is further substantiated by the language of 9-309, which specifically refers to the filing of negotiable instruments and thus indicates that, despite the language of section 9-304(1), filing must have been contemplated as a method of perfection by the drafters of the Code.[47]

Much of the foregoing analysis also applies to proceeds in the form of negotiable instruments. Here, however, it is clear that if the purchaser can meet the requirements of being a holder in due course[48] he will be protected under section 9-309 from previous security interests even if such an interest was perfected by filing.[49] When proceeds are in the form of negotiable documents rather than instruments the problems are less complex.[50] Section 9-304(1)

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47. U.C.C. § 9-309 provides in pertinent part that: "Filing under this article does not constitute notice of the security interest to such holders or purchasers."

Such an interpretation of section 9-309 does not give unfair advantage to the inventory financer. In the case of a negotiable instrument, if a second party purchases the instrument and becomes a holder in due course [*see* text of § 3-302(1) quoted in note 48 *infra*], he will be protected from previous security interests even if the previous security interest was perfected by filing. U.C.C. § 9-309. It is also conceivable that in addition to an inventory financer another secured party, such as an accounts financer, may be claiming the instrument as proceeds. Since the accounts financer is not a holder [U.C.C. § 1-201(20) defines holder as "a person who is in possession of a document of title or an instrument or an investment security drawn, issued or indorsed to him or to his order or to bearer or in blank."], he would not have the protection of the special priority rule in section 9-309 for holders in due course, and his security interest would again be subject to the general priority rules in section 9-312(5).

48. U.C.C. § 3-302(1):

A holder in due course is a holder who takes the instrument
(a) for value; and
(b) in good faith; and
(c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person.

49. U.C.C. § 9-309: "Nothing in this Article limits the rights of a holder in due course of a negotiable instrument . . . ."

50. *See* note 14 *supra*. There would seem to be no problem presented if proceeds consists of non-negotiable documents, since under U.C.C. § 9-304(3) a filing as to the goods perfects the security interest in the document.

permits a security interest in a negotiable document to be perfected by filing. Consequently, the problem of the inventory financer losing his perfection by failing to take possession is eliminated. As in the case of negotiable instruments, if the negotiable document has been duly negotiated to the holder, section 9-309 gives him priority over an inventory financer.[51]

B. *Accounts*

If the debtor has sold some of his inventory, an inventory financer may be claiming the accounts thereby created as proceeds,[52] while at the same time an accounts financer is claiming the accounts as original collateral. Although it will be rare that both an accounts financer and an inventory financer are financing the same debtor, the situation does occasionally arise and the problems created appear to be handled adequately by the Code.

The filing of a financing statement is necessary for the perfection of a security interest in accounts,[53] but since a security interest in accounts cannot attach until the accounts come into existence,[54] the accounts financer cannot perfect until the goods are sold and the accounts actually arise.[55] However, since the perfection in proceeds is a continuous one, the inventory financer would be deemed to have perfected as to accounts at the time he perfected as to the original collateral.

With this background, assume first that both financers have filed as to the original collateral and that their interests are thereby perfected. If the inventory financer had filed originally as to both inventory and proceeds, then clearly section 9-312(5)(a) applies, and the first to file would prevail. However, even if the inventory financer had not filed originally as to proceeds, and the two lenders are claiming the accounts during the ten-day period after the debtor has received the accounts, the inventory financer retains his limited perfected status in the accounts as proceeds under section 9-306(3). Under Kripke's analysis, discussed above, it can be argued that since the proceeds are then automatically perfected, there has been a perfection otherwise than by filing, so that the first-to-file rule would be inapplicable.[56] Applying the alternative first-to-perfect rule, the

51. *See* U.C.C. § 7-501.

52. *See* note 19 *supra.*

53. U.C.C. § 9-302.

54. U.C.C. § 9-204.

55. U.C.C. § 9-303(1).

56. *See* text accompanying notes 27-30 *supra.* N.Y. U.C.C. § 9-312 (Practice Commentary 7) (McKinney 1964); Coogan & Gordon, *The Effect of the Uniform Commercial Code Upon Receivables Financing—Some Answers and Some Unresolved Problems,* 76 HARV. L. REV. 1529, 1544-45, 1559-62 (1963); Craig, *Accounts Receivable Financing: Transition From Variety to Uniform Commercial Code,* 42 B.U.L. REV. 187, 201-02 (1962).

inventory financer would prevail even if the accounts financer had been the first to file, because the inventory financer's perfection dates back to the perfection of the original collateral, while the accounts financer's perfection does not occur until the account comes into existence. As was noted above,[57] however, the fallacy of this analysis is that the perfection of the inventory financer's interest in proceeds is created otherwise than by filing.[58] When the proceeds comes into existence, there is no "new" perfection—the inventory has merely taken a different form, and in section 9-306(3) the Code makes it clear that the original perfection continues as to this new form. It follows, then, that if the inventory financer files as to proceeds within the ten-day grace period, priority should still be determined by the first-to-file rule. Thus, regardless of whether the inventory financer has filed within the ten-day grace period or the conflicting claim arises during that period, the first to file as to the original collateral would prevail, since in either case the inventory financer's perfection as to proceeds would be merely a continuation of the original perfection.

Suppose, however, that the inventory financer perfects his security interest in the original collateral otherwise than by filing, such as by taking possession of warehouse receipts,[59] a situation which might occur where the debtor has temporarily stored excess inventory in a warehouse. Under section 9-304(4) and (5) the inventory financer can relinquish the warehouse receipts to the debtor and still remain perfected for a period of twenty-one days. If the inventory financer files within that period, section 9-312(6) provides that for purposes of determining priority the security interest will be treated as perfected in the same manner as perfection originally occurred. Thus, regardless of whether the inventory financer has filed within the twenty-one day period or the inventory covered by the receipts is sold during that period, for purposes of determining priority he would be treated as if he had perfected by taking possession. Consequently, as between the inventory financer and the accounts financer, the first-to-perfect rule, rather than the first-to-file rule, would apply.[60] As a result, even though the accounts financer may have filed before the inventory financer perfected, the rights of the accounts financer would be inferior to those of the inventory financer because of the latter's prior perfection. Yet there is no apparent reason for preferring the inventory financer in this situa-

57. *See* text following note 30 *supra*.

58. U.C.C. § 9-312(6) states that for purposes of priority, a continuously perfected security interest is treated as perfected in the same way as the perfection originally occurred. Thus, if the security interest in the inventory was perfected by filing, then the security interest in proceeds during the ten-day period, being a continuously perfected one, should also be deemed to be perfected by filing.

59. *See* note 25 *supra*.

60. U.C.C. § 9-312(5)(b).

tion, while giving priority to the accounts financer when he files first in a situation where both perfect by filing. In both instances, the inventory financer would have notice of the accounts financer's prior interest. The accounts financer who had filed first, however, could not have notice of the inventory financer's later perfection. For this reason the accounts financer is protected from the inventory financer who later perfects by filing, and on the same basis he should be protected from the inventory financer who later perfects otherwise than by filing.

One way to protect the accounts financer from an intervening inventory financer who perfects otherwise than by filing would be to amend section 9-204 so that a security interest in accounts would attach at the time the secured party files.[61] If attachment, and therefore perfection, of the security interest in accounts could occur when the secured party files, the inventory financer could not prevail by perfecting otherwise than by filing after the accounts financer has filed. Consequently, if the accounts financer files before the inventory financer perfects (whether by filing or otherwise), the accounts financer will prevail and will thus have the protection to which he is entitled. Such a result would encourage financers to accept accounts as collateral, since they would not have to fear another financer coming in at a later date and getting priority.

The traditional notion that a security interest does not attach until the account comes into existence stems from the deceptively appealing logic that one cannot give rights in something he does not have. Clearly, this notion is meaningful with respect to tangible items. For example, assume a debtor borrows $5,000 to buy a particular boat and the lender attempts to take a security interest in the boat to be purchased. Assume further that the debtor does not use the money to buy the boat, but instead squanders it and goes bankrupt. If the security interest were to attach before the debtor acquired rights in the boat, the result would be absurd: the secured party would be able to satisfy the debt by taking the boat from its owner. Additional problems could arise if the debtor takes goods which are already subject to previous security interests. For example, suppose that after borrowing the $5,000, the debtor buys a $7,000 boat subject to an existing $6,000 perfected security interest. If the $5,000 security interest were to attach when filed, the holder of the $6,000 security interest would be deprived of his collateral if he were not the first to file. He is protected, however, by the doctrine that a security interest attaches only when the debtor acquires

61. U.C.C. § 9-204 presently provides in pertinent part:

(1) A security interest cannot attach until there is agreement (subsection (3) of Section 1—201) that it attach and value is given and the debtor has rights in the collateral. It attaches as soon as all the events in the preceding sentence have taken place unless explicit agreement postpones the time of attaching.

rights in the goods; under this rule, the holder of the $5,000 security interest can reach only the debtor's interest in the boat, which in this case would be $1,000. Finally, if this were not the rule, some goods might even come into existence subject to a prior interest. Unborn young of livestock might be subject to an interest claimed in the mother.[62] Crops not yet planted, oil, gas, minerals, or uncut timber might be claimed by the owner of the land, and fish not yet caught by the owner of the water.[63]

However, intangibles,[64] such as accounts and contract rights[65] are not subject to such vicissitudes. Since intangibles are incapable of possession and are defined in terms of the debtor,[66] all interests in them arise only through that debtor. Filing as to intangibles is accomplished according to the debtor and not according to the collateral,[67] so that the filing requirements would give sufficient notice to a subsequent financer. Conflicting security interests in intangibles could thus be resolved by the ordinary priority rules. Unlike the boat hypothetical, the only other possible security interest which could conflict with that of an accounts financer would be the interest of someone claiming the accounts as proceeds from other collateral owned by the debtor. This claimant would be adequately put on notice by the filing requirements. Therefore, the reasons for not permitting a security interest to attach to tangible goods are not applicable to intangibles.

In situations involving after-acquired accounts, an amendment to the Code providing for attachment coincident with filing would also avoid a potential conflict between the Code and the Bankruptcy Act. Section 60 of the Bankruptcy Act permits the trustee in bankruptcy to void a transfer by the bankrupt if such a transfer is "for or on account of an antecedent debt," and if a number of other conditions are satisfied.[68] According to section 60, a transfer occurs when the transferee obtains a security interest which has priority over the claim of a subsequent lien creditor;[69] under the Code, a security interest would have such priority only after it is perfected.[70] The Code provides further that a security interest is not perfected

62. *E.g.*, Dunning v. Croffutt, 81 Conn. 101, 70 A. 630 (1908); Kellogg v. Lovely, 46 Mich. 131, 8 N.W. 699 (1881).

63. *See, e.g.*, Fruth v. Charleston Board of Affairs, 75 W. Va. 456, 84 S.E. 105 (1915).

64. The term "intangibles" is used here in its common sense, and should not be confused with the category "general intangibles" as defined in U.C.C. § 9-106.

65. The Code's distinction between accounts and contract rights seems unnecessary. The only section which distinguishes between the two is U.C.C. § 9-318, and that distinction could be handled even if contract rights were included in the definition of accounts.

66. *See* U.C.C. § 9-106.

67. *See* U.C.C. § 9-401.

68. § 60a(1), 11 U.S.C. § 96(a)(1) (1964).

69. § 60a(2), 11 U.S.C. § 96(a)(2) (1964).

70. Under the U.C.C. a security interest prevails over a lien creditor only after it is perfected. U.C.C. § 9-301(1)(b).

until it attaches,[71] and it does not attach until the debtor acquires rights in the collateral.[72] In the case of an accounts financer, the debtor has no rights in the collateral until the account actually comes into existence, and thus a transfer occurs only at this point. Since there is no consideration given at this time, bankruptcy doctrine might deem it to be a transfer for an antecedent debt which the trustee in bankruptcy could void,[73] but the Code provides that this same transfer "shall be deemed to be taken for new value and not as security for an antecedent debt."[74] The courts have not yet resolved this apparent conflict.[75] The proposed amendment providing for attachment at the time of filing would effect a transfer simultaneous with the exchange of consideration, and, since such a transfer would not be "for or on account of an antecedent debt," it would not be considered a voidable preference in bankruptcy.

C. *Purchase Money Security Interests*

Whether a purchase money security interest[76] in inventory extends to proceeds in the form of chattel paper or accounts is unclear.[77] The pertinent language of section 9-312(3) reads: "A purchase money security interest in *inventory* collateral has priority over a conflicting security interest in the *same* collateral if . . . ."[78] At least one writer seems to feel that since accounts and chattel paper are not the "same collateral" as the inventory, the purchase money financer has no priority as to them.[79] While the Code is not explicit, it would seem logical to interpret the phrase "same col-

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71. U.C.C. § 9-303(1).

72. U.C.C. § 9-204(1).

73. This conclusion is somewhat uncertain because the Bankruptcy Act fails to define antecedent debt. Thus, a court could legitimately borrow such a definition from § 9-108 of the Code, which would resolve the apparent conflict. *But see* 3 W. COLLIER, BANKRUPTCY § 60.19 (Supp. 1966).

74. U.C.C. § 9-108.

75. *See* 2 GILMORE, *supra* note 40, at § 45.6. Many other distinguished commentators have found the same conflict to exist. *See, e.g.*, Gordon, *The Security Interest in Inventory Under Article 9 of the Uniform Commercial Code and the Preference Problem*, 62 COLUM. L. REV. 49 (1962); Krause, Kripke & Seligson, *The Code and the Bankruptcy Act: Three Views on Preferences and After-Acquired Property*, 42 N.Y.U.L. REV. 278 (1967); Kennedy, *The Trustee in Bankruptcy Under the Uniform Commercial Code: Some Problems Suggested by Articles 2 and 9*, 14 RUTGERS L. REV. 518 (1960); Riemer, *The After-Acquired Property Clause Revisited*, 70 COM. L.J. 334 (1965). *See also In re* Portland Newspaper Publishing Co., 271 F. Supp. 395 (D. Ore. 1967); Note, 65 MICH. L. REV. 1004 (1967); *cf.* Rosenberg v. Rudnick, 262 F. Supp. 635 (D. Mass. 1967).

76. For a discussion of purchase money security interests in inventory, *see* 2 G. GILMORE, *supra* note 40, at 784-91.

77. *See id.* at 791-97; Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien,"* 72 HARV. L. REV. 838, 861 n.87 863 (1959).

78. Emphasis added.

79. Coogan, *supra* note 77.

lateral" as including all proceeds of the inventory.[80] In the case of the non-purchase money financer, proceeds is considered to be the same collateral in a different form, and the proceeds of inventory subject to a purchase money security interest should be treated in the same way. The language of section 9-306, which provides for a continuing security interest in proceeds, certainly does not limit its application to the non-purchase money situation, nor does section 9-312(3) indicate that the two sections are mutually exclusive. Furthermore, the concept of a floating lien,[81] which seems equally applicable to purchase money financing, supports the notion that the purchase money interest in inventory should continue in proceeds.

As between a non-purchase money inventory financer and a purchase money inventory financer both claiming the same proceeds, the purchase money financer prevails, regardless of the order of perfection or filing, if he has satisfied the three requirements of section 9-312(3).[82] This result is not unreasonable, since one of the requirements of section 9-312(3) is that the non-purchase money financer be notified of the interest of the purchase money financer. Because of the notice requirement, the non-purchase money inventory financer cannot be misled into advancing money in reliance upon new inventory which is already subject to a purchase money security interest.

A serious problem arises, however, if the purchase money inventory financer is claiming accounts as proceeds, while an accounts financer, who filed before the purchase money financer became a secured party, is claiming them as accounts. Section 9-312(3)(b) requires the purchase money financer to notify "any secured party whose security interest is known to the holder of the purchase money security interest or who, prior to the date of the filing made by the holder of the purchase money security interest, had filed a financing statement covering the *same items or type of inventory* . . . ."[83] It is significant to note that this section does not speak

80. *See* Henson, *"Proceeds" Under the Uniform Commercial Code*, 65 COLUM. L. REV. 232, 240 (1965).

81. *See* note 11 *supra.*

82. The three requirements are:

(a) the purchase money security interest is perfected at the time the debtor receives possession of the collateral; and

(b) any secured party whose security interest is known to the holder of the purchase money security interest or who, prior to the date of the filing made by the holder of the purchase money security interest, had filed a financing statement covering the same items or type of inventory, has received notification of the purchase money security interest before the debtor receives possession of the collateral covered by the purchase money security interest; and

(c) such notification states that the person giving the notice has or expects to acquire a purchase money security interest in inventory of the debtor, describing such inventory by item or type.

83. Emphasis added. An interesting problem as to notice might arise if instead of inventory, the purchase money security interest is in farm products, since U.C.C. § 9-312(3) applies only to inventory collateral.

in terms of the "same collateral,"[84] but instead uses the phrase "same items or type of inventory." Thus, the accounts financer could not argue that he is entitled to notice because proceeds is the "same collateral in different form." As a result, although the purchase money financer would have to notify the holder of a previously filed non-purchase money security interest in the inventory, presumably he would not have to notify an accounts financer.[85] There is no apparent reason, however, for placing the non-purchase money inventory financer in a more advantageous position than the accounts financer vis-à-vis the purchase money inventory financer. Both the non-purchase money inventory financer and the accounts financer have a floating lien and would be advancing money as the debtor acquires new security. Yet the non-purchase money financer is entitled to a warning that the inventory he is about to accept as collateral for a new advancement is subject to a prior interest, while the accounts financer, evidently, does not have a right to the same warning.[86]

It appears that the priority problem created by the conflicting security interests of the purchase money inventory financer and the accounts financer could be solved by a simple change in section 9-312(3)(b). That section should be amended to give priority to the purchase money financer over *all* other previously filed secured parties who have been notified,[87] assuming, of course, that the other requirements of that section have been met. This change, in addition to protecting the previously filed accounts financer, would also establish that the purchase money inventory financer has a continuously perfected security interest in the proceeds. Since the purchase money inventory financer would have to search the records anyway for any non-purchase money inventory interest, the added burden to him would not be very great.

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84. See text accompanying note 80 *supra.*

85. *But see* 2 GILMORE, *supra* note 40, at 795, for the argument that the accounts financer must be notified.

86. *But see* Craig, *Accounts Receivable Financing: Transition From Variety to Uniform Commercial Code,* 42 B.U.L. REV. 187, 203-04 (1962), for the argument that an inventory financer's priority over an accounts financer who filed first is supportable as a matter of policy.

87. *See* Coogan & Gordon, *The Effect of the Uniform Commercial Code Upon Receivables Financing—Some Answers and Some Unresolved Problems,* 76 HARV. L. REV. 1529, 1568 (1963), for the suggestion that if purchase money interests are to be followed into proceeds, the accounts financer should be given notice.