Conflicting Security Interests in Inventory and Proceeds under the Revised Article 9 of the Uniform Commercial Code

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CONFLICTING SECURITY INTERESTS IN INVENTORY AND PROCEEDS UNDER THE REVISED ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

Philip Lacy*

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I. Introduction

In 1988 South Carolina substantially amended its enactment of Article 9 of the Uniform Commercial Code by adopting, with minor
variations, the 1972 Official Text of the Code. Although the adoption of the 1972 Official Text effects many changes in the law of secured transactions in South Carolina, the 1972 Official Text does not represent a radical restructuring of the 1962 Official Text, which South Carolina enacted in 1966. In large part, the revisions to Article 9 effected in the 1972 Official Text were designed to clarify issues not resolved under the 1962 Official Text. One of the most significant sets of clarifying amendments involves the priority rules applicable to conflicts between competing security interests in inventory and proceeds. This article surveys the resolution of these priority conflicts under the revised Article 9. From this survey the article draws conclusions concerning the appropriate relationship between the various forms of Arti-


Throughout this article the author compares South Carolina’s former version of Article 9 of the Uniform Commercial Code (i.e., the 1962 Official Text adopted by the General Assembly in 1966 as modified) with the newly enacted version (i.e., the 1972 Official Text, as amended by the drafters in 1977, adopted by the General Assembly in 1988 as modified). Parallel citations to the Official Text and the South Carolina Code are given in almost every instance in which a U.C.C. section is cited. When the former version of the Official Text of Article 9 is cited, the year 1962 will be indicated parenthetically, as will the year 1977 to indicate that Article 9 as a whole was last substantially amended in that year (e.g., U.C.C. § 9-XXX(X) (1962) (amended 1977)). Likewise, when the former South Carolina version is cited, the year of the South Carolina Code, 1976, will be indicated parenthetically, as will the year of amendment, 1988, showing that the former state version of Article 9 was substantially amended in that year (e.g., S.C. Code Ann. § 36-9-XXX(X) (Law. Co-op. 1976) (amended 1988)). When the current version of the Official Text of Article 9 is cited, the year 1972 will be indicated parenthetically. Again, an additional parenthetical will be provided showing that the Official Text of Article 9 as a whole was last substantially amended in 1977 (e.g., U.C.C. § 9-XXX(X) (1972) (amended 1977)). In the rare case in which the Article 9 section cited was actually created in 1977, that year alone will be indicated parenthetically (e.g., U.C.C. § 9-XXX(X) (1977)). Citations to the new South Carolina version of Article 9 will be cited to the 1989 supplement to the South Carolina Code (e.g., S.C. Code Ann. § 36-9-XXX(X) (Law. Co-op. Supp. 1989)).

When a quotation is identical in both the Official Text of Article 9 and the South Carolina Code, parallel citations are given. When the South Carolina Code varies in any way from the Official Text of a quoted section, the South Carolina version is quoted and thus the citation is only to the South Carolina Code.


4. See Final Report, supra note 2, app., at 195-96.

5. See id. paras. E-29 to -38, at 221-26; see also Coogan, supra note 2, at 516-17 (the resolution of this conflict will greatly affect the debtor’s ability to obtain working capital).

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Article 9 financing available to debtors in the business of selling inventory.

This article envisions a debtor who sells inventory to buyers in the ordinary course of business under either secured or unsecured credit terms. The debtor contemplated requires financing both to acquire the inventory it holds for sale, and to provide working capital. This article further assumes that the debtor's inventory and the receivables generated by sales of inventory constitute the principal collateral that the debtor can provide to secure the necessary financing.

The priority rules of Article 9 suggest that several forms of secured financing may be available to this debtor. The debtor can finance its inventory acquisition by granting either its supplier or an inventory "floor planner" a purchase money security interest in items of inventory that they finance to secure the debtor's obligation to pay the purchase price or the enabling loan. The debtor also can grant a lender a floating lien upon its current and after-acquired receivables. Additionally, the Code contemplates financing through the sale of the debtor's accounts and chattel paper for new value. Perhaps the most basic form of Article 9 financing available to the debtor, however, is to secure all advances a lender makes by granting the lender a floating lien on current and after-acquired inventory and proceeds.

Article 9 does much to facilitate financing through a floating lien on inventory. The Code expressly validates both after-acquired property and future advance clauses. The Code system of notice filing also permits a secured party to perfect a security interest in the debtor's current and after-acquired inventory through a single filing. Moreover, under the revised Article 9, the filing with respect to the inventory generally will continue the perfected status of the security


8. See generally B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 10.01, at 10-2 (2d ed. 1988) (since loan is ongoing line of credit, security interest must "float"); Coogan, Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien," 72 HARV. L. REV. 838 (1959) (discussing the controversial floating lien permitted by Article 9).


interest in the proceeds realized on the sale of the inventory. 12 Most significantly, the priority rules of revised Article 9 afford substantial, but far from complete, protection to floating lienors if they are the first to file a financing statement covering the debtor's inventory. 13

The significance of the floating lien can be appreciated only in the context of the Article 9 priority rules governing conflicting security interests in inventory and proceeds. An analysis of these priority rules, however, must commence with a consideration of the essential dilemma confronting an inventory financer. Under section 9-307(1) 14 a buyer in ordinary course who purchases collateral from a debtor takes free of a security interest created by the debtor, even if the security interest is perfected and the buyer knows of its existence. The effect of section 9-307(1) upon an inventory financer is pronounced. The normal operation of the debtor's business results in the erosion of the inventory financer's original collateral. Accordingly, the inventory financer must adopt a strategy to protect its secured position.

The most straightforward method of protection is to insist that the debtor repay the secured debt as the items of collateral are sold. This strategy is particularly effective if the inventory financer is a supplier or floor planner to whom the debtor must turn for additional financing. If the inventory financer holds a floating lien that secures an advance of working capital, however, the repayment strategy may not be practical. The floating lienor must then seek protection through its security interest in the proceeds realized on the sale of the collateral and the dealer's after-acquired inventory. As a result, the floating lienor's priority in both after-acquired property and proceeds is critical to maintaining its secured position.

Under the revised Article 9, however, the floating lienor is not assured of priority with respect to either after-acquired property or proceeds. Much of this article is devoted to analyzing the situations in which a conflicting claim can prime the security interest asserted by a floating lienor who was the first to file a financing statement covering the debtor's inventory. For example, a subsequent purchase money fi-

   A buyer in ordinary course of business (subsection (9) of Section 36-1-201) 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.
nancer can prime the floating lienor with respect to after-acquired inventory.\textsuperscript{15} Moreover, a variety of secured parties who claim the proceeds of the inventory as original collateral can prime the floating lienor's proceeds claim.\textsuperscript{16}

The vulnerability of the floating lienor's security interest in after-acquired property and proceeds does not negate the utility of the floating lien on inventory. Rather, the priority rules of revised Article 9 effectively control the relationship between floating lien financing, purchase money financing, and receivables financing. Through an analysis of these priority rules, this article will define the respective roles of the various forms of financing available to a debtor in the business of selling inventory.\textsuperscript{17} Ultimately, the article will venture some conclusions concerning the relationship between these forms of financing.\textsuperscript{18}

II. CONFLICTING SECURITY INTERESTS IN INVENTORY

In most priority disputes involving conflicting security interests in inventory, at least one of the secured parties holds a floating lien on the debtor's current and after-acquired inventory. For the most part, this article surveys the range of priority disputes over inventory from the perspective of a floating lienor who perfected its security interest by filing. The article typically assumes that the floating lienor was the first secured party to file with respect to the debtor's inventory. The initial focus will be on the floating lienor's priority against conflicting security interests in inventory under the basic priority rule of revised section 9-312(5)(a).\textsuperscript{19} The focus will then turn to the extent to which a subsequent purchase money inventory financer can prime an earlier-filed floating lienor under the "super priority" rules of revised section 9-312(3).\textsuperscript{20}


\textsuperscript{16} A secured party who filed with respect to a debtor's accounts before the inventory financer filed with respect to the inventory is entitled to priority over the inventory financer with respect to the accounts as proceeds. U.C.C. § 9-312(5)(a), (6) (1972) (amended 1977); S.C. Code Ann. § 36-9-312(5)(a), (6) (Law. Co-op. Supp. 1989); see infra text accompanying notes 908, 934-44. Moreover, a subsequent purchaser of chattel paper who gives new value and takes possession in the ordinary course of business is entitled to priority over a financer who claims the chattel paper merely as proceeds of inventory. U.C.C. § 9-308(b) (1972) (amended 1977); S.C. Code Ann. § 36-9-308(b) (Law. Co-op. Supp. 1989); see infra text accompanying notes 710-43.

\textsuperscript{17} See infra text accompanying notes 1029-36.

\textsuperscript{18} See id.


A. *The Floating Lienor Versus Prior Secured Parties Who Perfect Automatically*

Revised section 9-312(5)(a)\(^21\) sets forth the basic priority rule governing conflicts between secured parties asserting perfected security interests in the same collateral. Under this provision the first secured party to file or perfect with respect to the collateral is entitled to priority. Moreover, for purposes of determining priority under this rule, a secured party can rely on the date of its filing or perfection, whichever is earlier. While revised section 9-312(5)(a) states a residual priority rule applicable only when no special priority rule governs the conflict,\(^22\)

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In all cases not governed by other rules stated in this section (including cases of purchase money security interests which do not qualify for the special priorities set forth in subsections (3) and (4) of this section), priority between conflicting security interests in the same collateral must be determined according to the following rules:

(a) Conflicting security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither filing nor perfection.


the provision will control many priority disputes over a debtor's inventory.

Since revised section 9-312(5)(a) awards priority to the first secured party to file or perfect, a lender contemplating a loan secured by a debtor's existing inventory must determine whether another party has filed against or perfected a security interest in that inventory. In South Carolina the lender usually can determine whether a financing statement has been filed against a debtor's inventory located in the state by searching the records in the office of the Secretary of State. Nevertheless, since security interests in inventory can be perfected by taking possession, either through a pledge or, more commonly, through a field warehouse arrangement, the prospective lender must


In such cases security interests are perfected by filing in the jurisdiction in which the debtor is located. U.C.C. § 9-103(3)(b) (1972) (amended 1977); S.C. Code Ann. § 36-9-103(3)(b) (Law. Co-op. Supp. 1989). "A debtor is considered located at his place of business if he has one, at his chief executive office if he has more than one place of business, otherwise at his residence." S.C. Code Ann. § 36-9-103(3)(d) (Law. Co-op. Supp. 1989). Therefore, if the goods at issue are inventory because they are held for lease, are mobile, and are of a type normally used in more than one jurisdiction, the potential lender must search the filings in the Secretary of State's office in the jurisdiction in which the debtor is located.


26. See infra notes 51-60 and accompanying text.
also determine whether the debtor has possession of the inventory. A critical issue arises when the lender's inquiry establishes that no financing statements have been filed against the existing inventory and the debtor has possession of the inventory. The question presented is whether the lender is assured of priority with respect to the debtor's existing inventory when filing the first financing statement covering that inventory. The answer to this question is no.

A secured party who files first with respect to inventory in a debtor's possession is not assured of priority because in certain situations Article 9 provides for the automatic perfection of security interests in inventory. To illustrate this problem, consider the following:

**ILLUSTRATION 1—**On June 1 Buyer, a farm equipment dealer located in Barnwell, South Carolina, entered into a contract with Seller, located in Seattle, Washington, to purchase ten tractors, which Buyer intended to hold as inventory. The contract provided for a documentary sale. On June 5 Seller delivered the tractors to a rail carrier in Seattle and procured a negotiable bill of lading covering the tractors. Also on June 5, Seller drew a sight draft on Buyer, which Seller attached to the negotiable bill of lading. Finally on June 5, Seller forwarded the sight draft and negotiable bill to Barnwell through banking channels.

On June 6 Buyer and Bank entered into a written security agreement under which Bank extended new value to Buyer to enable him to honor the sight draft. The security agreement granted Bank a security interest in the negotiable document and the underlying goods. On June 10 Buyer, using the funds provided by Bank, honored the sight draft and obtained possession of the negotiable bill of lading. Buyer, however, immediately surrendered the bill of lading to Bank. On June 20 the tractors arrived in Barnwell and Bank released the negotiable bill of lading to Buyer to enable Buyer to accept delivery of the tractors. Also on June 20, Buyer surrendered the negotiable bill of lading to the rail carrier and took possession of the tractors.

On July 1 Buyer and Finance Company entered into a written security agreement that granted Finance Company a security interest in Buyer's current and after-acquired inventory to secure a contemporaneous loan and any future advances. Also on July 1, Finance Company filed a properly executed financing statement in the Secretary of State's office that identified the collateral as Buyer's inventory of tractors.

On July 5 Bank filed a financing statement in the Secretary of State's office that described the collateral as the ten tractors.

Both Bank and Finance Company have perfected security interests in the ten tractors. Although Finance Company filed first, Bank is entitled to priority under revised section 9-312(5)(a), since Bank perfected its security interest before Finance Company filed. Section 9-304(2)\(^{28}\) provides that while goods are in the possession of the issuer of a negotiable document, a security interest in the goods is perfected by perfecting as to the document. Under section 9-304(4)\(^{29}\) a security interest in negotiable documents is perfected for twenty-one days without filing or possession if the security interest arises for new value given under a written security agreement. Therefore, Bank's security interest in the tractors was perfected on June 6 when it made the loan under its security agreement.

Moreover, Bank's security interest remained continuously perfected. On June 10 Bank perfected its security interest in the negotiable bill of lading and the underlying goods by taking possession of the document.\(^{30}\) Additionally, under revised section 9-304(5)(a),\(^{31}\) Bank's security interest remained automatically perfected for twenty-one days after June 20 when Bank made the negotiable bill of lading available to Buyer for acceptance of delivery of the tractors. Finally, Bank's filing on July 5, prior to the expiration of the twenty-one day period of automatic perfection under revised section 9-304(5)(a), was effective to continue the perfected status of its security interest.\(^{32}\) Therefore, Bank can rely upon June 6, the date of its initial perfection, for purposes of determining priority under revised section 9-312(5)(a). Since Bank perfected before Finance Company filed or perfected, Bank is entitled to


A security interest remains perfected for a period of twenty-one days without filing where a secured party having a perfected security interest in an instrument, a negotiable document, or goods in possession of a bailee other than one who has issued a negotiable document for the goods:

(a) makes available to the debtor the goods or documents representing the goods for the purpose of ultimate sale or exchange or for the purpose of loading, unloading, storing, shipping, transshipping, manufacturing, processing, or otherwise dealing with them in a manner preliminary to their sale or exchange, but priority between conflicting security interest in the goods is subject to subsection (3) of Section 36-9-312 . . . .


priority.

The lesson to be drawn from Illustration 1 is clear. Even if no prior financing statements covering a debtor’s inventory have been filed, a prospective lender cannot rely on existing inventory in the debtor’s possession as collateral. Before a lender makes a loan secured by inventory in the debtor’s possession, the lender must do more than determine that it is the first to file a financing statement covering the inventory. The lender also must verify that the existing inventory is not subject to a prior automatically perfected security interest. As a practical matter, the secured party can protect itself from an automatically perfected security interest in existing inventory by refusing to lend against that inventory for twenty-one days after filing, and then making the loan only if no conflicting financing statements have been filed within that twenty-one day period.\textsuperscript{33} Even if the inventory was subject to an automatically perfected security interest when the lender filed, the failure of the secured party holding that security interest to file within the twenty-one day period would break the continuity of the secured party’s perfection. Therefore, that secured party could not rely upon the date of that party’s original perfection for the purpose of determining priority under revised section 9-312(5)(a).

\textit{B. The Floating Lienor Versus Subsequent Nonpurchase Money Security Interests}

\textit{1. Basic Application of Revised Section 9-312(5)(a)}

In adopting the 1972 Official Text, the South Carolina General Assembly increased the protection afforded to secured parties who file first against subsequently perfected nonpurchase money security interests. Under revised section 9-312(5)(a), a secured party who files with respect to a debtor’s inventory before the holder of a conflicting nonpurchase money security interest files or perfects is assured of priority over the conflicting security interest. Under the 1962 Official Text, a secured party who filed first was not assured of priority over a subsequent nonpurchase money security interest that was originally perfected in a manner other than by filing a financing statement.\textsuperscript{34} To understand this aspect of the revised statute, the residual priority pro-

\begin{footnotesize}
\begin{itemize}
\item[33.] See generally McLaughlin, \textit{"Seek But You May Not Find": Non-UCC Recorded, Unrecorded and Hidden Security Interests Under Article 9 of the Uniform Commercial Code}, 53 FORDHAM L. REV. 953 (1985) (discussing various types of unrecorded security interests and ways to minimize their impact on subsequent creditors).
\end{itemize}
\end{footnotesize}
visions of the 1962 Official Text must be considered.

The "first to file or perfect" rule of revised section 9-312(5)(a) replaces the two residual priority rules of the 1962 Official Text.\textsuperscript{35} Under the prior law, if all conflicting security interests were originally perfected by filing, former section 9-312(5)(a) applied and determined priority by the order of filing.\textsuperscript{36} In contrast, if one or more of the conflicting security interests were originally perfected in a manner other than filing, former section 9-312(5)(b) applied and determined priority by the order of perfection.\textsuperscript{37} The substitution of the first to file or perfect rule for the two residual priority rules under the 1962 Official Text will change the outcome in only a few situations. The amendment, however, does change the resolution of some priority conflicts in which the subsequent party perfects by possession or automatically. Moreover, the amendment evidences the increased importance of notice filing in the resolution of priority disputes between secured parties under the revised Code.

To illustrate the effect of the amendments to section 9-312(5), consider the following:

ILLUSTRATION 2—On June 1 Bank entered into negotiations with Debtor which envisioned a loan secured by Debtor's current and after-acquired inventory. Also on June 1, Bank filed a financing statement that identified the collateral as Debtor's inventory. On July 1 Debtor entered into a security agreement with Finance Company, which granted Finance Company a possessory security interest in Debtor's inventory to secure a contemporaneous loan. On August 1 Bank and Debtor concluded their negotiations and executed a security agreement, which granted Bank a nonpossessory security interest in Debtor's inventory to secure a contemporaneous loan. Subsequently, Debtor defaulted on both loans and a priority dispute arose over the inventory in which Finance Company held a possessory security interest.

Since Finance Company perfected its security interest by taking possession of the collateral, the first to perfect rule of former section 9-312(5)(b) controls the resolution of this dispute under the 1962 Official Text. Application of former section 9-312(5)(b) required a determination of when both Bank and Finance Company perfected. Section 9-303(1) provides that a security interest is perfected when it has at-


tached and all applicable steps for perfection have been taken.38 Under former section 9-204(1), a security interest could not attach until there was an agreement that it would attach, the secured party had given value, and the debtor had obtained rights in the collateral.39 Applying these standards to Illustration 2, Finance Company perfected on July 1 and Bank did not perfect until August 1. Although Bank took the steps necessary to perfect its security interest on June 1, its security interest did not attach until August 1, since Bank did not give value or obtain an agreement that its security attach until August 1. Thus, under the 1962 Official Text, Finance Company is entitled to priority despite Bank's earlier filing.

The resolution of Illustration 2 under the 1962 Official Text raises serious policy issues. By filing on June 1 Bank gave public notice of its claim to Debtor's inventory. The Code's basic concept of notice filing rests upon the premise that the date of filing normally fixes a secured party's priority against conflicting security interests that arise after the filing. Although Article 9 provides exceptions to this general rule when strong policy reasons exist to prefer the subsequently secured party,40 there is no apparent reason to award Finance Company priority because it perfected by possession. Significantly, had Finance Company perfected by filing on July 1, Bank would have primed Finance Company under the first to file rule of former section 9-312(5)(a).

The application of former section 9-312(5)(b) to resolve the dispute depicted in Illustration 2 also affects the costs incurred by a prospective lender in investigating the proposed collateral. When a prospective debtor approaches a lender seeking a loan secured by existing inventory, the lender should immediately file a financing statement covering the proposed collateral.41 Before agreeing to make the loan, the lender also should investigate both the credit worthiness of the debtor and the status of the collateral. With respect to the collateral, the lender should determine whether any conflicting financing statements were filed against the inventory before it filed, whether the debtor has possession of the inventory, and whether the inventory in the debtor's possession is subject to an automatically perfected security interest.

Illustration 2, however, establishes that these inquiries were not sufficient under the 1962 Official Text. Under former section 9-312(5)(b), Bank, who filed first and did so when Debtor had possession of the unencumbered inventory, was primed by Finance Company, a subsequent-secured party who took a possessory security interest in the inventory after Bank filed but before Bank executed a security agreement and made a loan. Therefore, to be assured of priority over subsequent security interests, the lender had to reinvestigate the collateral immediately prior to making a loan in order to ascertain whether the debtor had retained possession.

The first to file or perfect rule of revised section 9-312(5)(a) reverses the outcome in Illustration 2. Under the revised statute, a secured party's "[p]riority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier . . . ." Therefore, under revised section 9-312(5)(a), Bank can base its claim upon its date of filing, even though Finance Company originally perfected through possession. Because Bank filed before Finance Company perfected, Bank prevails under the revised statute. Moreover, since the date of filing fixes the Bank's priority under revised section 9-312(5)(a), Bank would not need to determine whether the debtor retained possession of the inventory when it made the loan to be assured of priority over subsequent secured parties.

Even under the revised statute, however, such an investigation is prudent. A secured party's priority over judicial lien creditors depends on the secured party's perfecting its security interest before the creditor acquires its lien. Therefore, if a judgment creditor levies on collateral in the interval between filing and attachment, the secured party's security interest will be subordinate to the claim of the lien creditor.

44. The distinction between revised section 9-312(5)(a), under which filing without perfection affords priority over a subsequent-secured party, and revised section 9-301(1)(b), under which a filing without perfection does not afford priority over a subsequent lien creditor, appears to turn on the fact that a "judicial lien creditor" is not directly part of the Code system of priorities. Final Report, supra note 2, app., para. E-44, at 227-28. The drafters appear to have concluded that a secured party and a debtor should not be able to "squeeze out" a judgment creditor who has successfully levied on the debtor's equity by entering into a security agreement covered by an earlier financing statement after the judgment creditor has levied. Id.
In any event, if, prior to the consummation of the loan, the debtor has disposed of the collateral for whatever reason, business concerns would suggest that the loan transaction is ill advised.

The adoption of the first to file or perfect rule also changes the outcome of some priority disputes in which a secured party claims an automatically perfected security interest in inventory. To illustrate this aspect of revised section 9-312(5)(a), vary the facts of Illustration 1 by assuming that Finance Company filed on May 1 rather than July 1. Under the 1962 Official Text the resolution of this dispute appears to be controlled by the first to perfect rule of former section 9-312(5)(b), since Bank originally perfected automatically under section 9-304(4). Bank's date of perfection was June 6, when its security interest attached. Finance Company, despite its May 1 filing, was not perfected until July 1, when it entered into a security agreement and gave value. Therefore, under the 1962 Official Text, Bank would have been entitled to priority. In contrast, under the first to file or perfect rule of revised section 9-312(5)(a), Finance Company can base its claim for priority upon its May 1 filing. Therefore, under the residual priority rule of the 1972 Official Text, Finance Company primes Bank. Note, however, that since Bank had a purchase money security interest in the ten tractors under our variation of Illustration 1, Bank could have primed Finance Company under revised section 9-312(3) if Bank had met the notification requirements under that provision.46

2. The Application of Revised Section 9-312(5)(a) to After-Acquired Property

The most significant component of a floating lien upon inventory is an after-acquired property clause. Such clauses are validated by revised section 9-204(1).46 A valid after-acquired property clause, however, is of little value to the floating lienor unless the lienor can establish priority in the after-acquired inventory. Therefore, it is significant that the provisions of revised section 9-312(5)(a) apply to after-acquired property and enable the floating lienor to base its claim for priority in after-acquired inventory on the date of the lienor's original filing. As a result, the floating lienor has substantial protection against subsequent security interests in after-acquired inventory. This protection, however, is less than complete because a subsequent purchase money financer of new inventory can prime a floating lienor with re-

45. See infra notes 126-28, 168-87 and accompanying text.
spect to the new inventory.47
The effect of the first to file or perfect rule on after-acquired property can be illustrated as follows:

ILLUSTRATION 3—On June 1 Bank entered into a written security agreement with Debtor covering Debtor's existing and after-acquired inventory. Also on June 1, Bank properly filed a financing statement identifying the type of collateral as inventory. On July 1 Finance Company entered into a written security agreement with Debtor covering the same existing and after-acquired inventory. Also on July 1, Finance Company properly filed a financing statement covering inventory. On August 1 Debtor acquired a new item of inventory. This new inventory was not acquired with funds advanced by either Bank or Finance Company.

Although the security interests of Bank and Finance Company attached to the new item of inventory simultaneously when Debtor acquired rights in the collateral,48 and hence became perfected at the same time,49 Bank is entitled to priority based on its earlier filing.50
That revised section 9-312(5)(a) controls priorities with respect to after-acquired property has a pronounced impact on the traditional use of field warehousing in inventory financing.51 In a variety of contexts, but especially in financing the inventory of grain dealers, secured parties have relied on possessor security interests effected through field warehousing arrangements.52 Reliance on a field warehousing arrangement to establish and perfect a security interest in a debtor's inventory presents a number of legal problems.53 The most critical problem, how-

53. For example, if the debtor has control over the warehouseman and free access to the inventory after delivery to the warehouse, the transfer of the goods will not constitute a valid bailment. As a result, the warehouse's purported possession of the inventory will not be sufficient to establish a security agreement under revised section 9-203(1)(a) or to perfect a security interest under revised sections 9-304(3) and 9-305. See, e.g., In re Colonial Distrib. Co., 293 F. Supp. 1235 (D.S.C. 1968), appeal dismissed sub nom. Har-
ever, is the risk of losing priority in after-acquired property to a subse-
quently floating lienor who perfects by filing. The risk was present under
the first to perfect rule of former section 9-312(5)(b); it continues
under the first to file or perfect rule of revised section 9-312(5)(a).

In a traditional field warehousing arrangement the secured party
acquires a possessory security interest in a debtor's inventory. The
debtor is required to set aside a portion of the debtor's business pre-
misses as a field warehouse and grant an independent bailee control over
the field warehouse. The debtor then delivers inventory to the field
warehouse. In exchange for the inventory, the bailee issues nonnegot-
iable warehouse receipts in the name of the secured party and delivers
these receipts to the secured party. The secured party then makes
advances to the debtor against the inventory covered by the warehouse
receipts. Under section 9-304(3) these advances are secured by a per-
fected security interest on the inventory in the field warehouse.

To illustrate the potential problems in a field warehousing ar-
angement under revised section 312(5)(a), consider the following:

ILLUSTRATION 4—On June 1 Bank and Debtor entered into a writ-
ten security agreement that provided for inventory financing under a
field warehouse arrangement. On July 1 Finance Company entered
into a written security agreement with Debtor, which granted Finance
Company a security interest in Debtor's current and after-acquired
inventory to secure a contemporaneous loan and any future advances.
Also on July 1, Finance Company filed a financing statement that

relson v. Lewis, 418 F.2d 246 (4th Cir. 1969).
56. See generally B. CLARK, supra note 8, ¶ 7.13, at 7-44 to -45 (discussing field
warehousing as a form of inventory financing); 1 G. GILMORE, SECURITY INTERESTS IN
PERSONAL PROPERTY § 14.3, at 441-42 (1965) (overview of perfection and field warehous-
ing under Article 9).
57. The practice of field warehousing agricultural products in South Carolina devi-
ates from the traditional pattern in that a state warehouse issues receipts which, accord-
ing to the bankruptcy court, are negotiable. These warehouse receipts are issued to the
debtor. The debtor then endorses the receipts and delivers them to a secured party to
secure a loan. See, e.g., South Carolina Nat'l Bank v. Republic Nat'l Bank (In re R.V.
Segars Co.), 54 Bankr. 170 (Bankr. D.S.C. 1985); Hodges v. Anderson (In re George B.
696 F.2d 990 (4th Cir. 1982); see also infra note 62 (parenthetically discussing the "state
warehouse system"). The use of negotiable warehouse receipts in a field warehousing
operation gives rise to priority issues in addition to those arising under revised section 9-
312(5)(a). See infra notes 61-84 and accompanying text for an analysis of these issues.
identified Debtor's inventory as the collateral. On August 1 Debtor transferred the inventory it manufactured in July to the field warehouse in exchange for which the field warehouseman issued a nonnegotiable warehouse receipt in the name of the Bank. The field warehouseman then delivered the receipt to Bank and Bank made an advance to Debtor. On September 1 Debtor defaulted on its obligations to both Bank and Finance Company. A priority dispute subsequently arose over the inventory manufactured in July, which was in the possession of the field warehouse.

Both Bank and Finance Company have perfected security interests in the July 1 inventory. Bank perfected its security interest under section 9-304(3) through the issuance of the nonnegotiable warehouse receipt. Finance Company perfected its security interest by filing a financing statement. Since Bank did not file a financing statement covering Debtor's inventory, under revised section 9-312(5)(a), Bank's date for priority in the July inventory is the date on which its security interest became perfected. Under section 9-303(1)59 Bank's security interest became perfected on August 1, when the warehouse as bailee obtained possession of the inventory and issued the nonnegotiable receipt in Bank's name. On the other hand, since Finance Company filed with respect to Debtor's inventory, Finance Company's date for priority with respect to the July inventory is July 1, the date on which it filed. Therefore, under the first to file or perfect rule of revised section 9-312(5)(a), Finance Company is entitled to priority over Bank with respect to the August 1 inventory.60

A more complex situation arises if a field warehouseman issues negotiable warehouse receipts covering goods placed in its possession. Because warehouse receipts issued by state warehouses61 covering agri-

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60. Finance Company also would have prevailed over Bank under the first to perfect rule of former section 9-312(5)(b). Bank's security interest was perfected when the warehouse issued the nonnegotiable receipt in Bank's name. Therefore, the critical issue under former section 9-312(5)(b) was determining when Finance Company perfected. Under former section 9-303(1), Finance Company's security interest became perfected when it attached and when all applicable steps for perfection had been taken. Finance Company took the steps necessary for perfection on July 1. Moreover, two of the three requirements for attachment under former section 9-204(1) occurred on July 1. Finance Company obtained a security agreement providing for its security interest and it gave value on July 1. Therefore, the critical focus in determining the time of attachment and perfection is on when Debtor acquired rights in the collateral. This question does not have to be resolved with precision, since it is certain that Debtor had rights in the July inventory before it delivered the inventory to the warehouse on August 1. Thus, Finance Company's security interest in the July inventory was perfected prior to August 1. As a result, Finance Company primes Bank under former section 9-312(5)(b).

61. See S.C. CODE ANN. § 39-21-10 to -360 (Law. Co-op. 1976) (establishing and
tural products have been held to be negotiable, the issues raised by the use of such documents merit discussion. To analyze these issues, consider the following illustration inspired by the facts of South Carolina National Bank v. Republic National Bank (In re R.V. Segars, Co):

mandating a state warehouse system for storage of nonperishable agricultural products).

62. "A warehouse receipt, bill of lading or other document of title is negotiable . . . if by its terms the goods are to be delivered to bearer or to the order of a named person . . . ." U.C.C. § 7-104(1)(a) (1972); S.C. Code Ann. § 36-7-104(1)(a) (Law. Co-op. 1976).

Many of the warehouse receipts issued by the South Carolina Department of Agriculture do not include "bearer" or "order" language. See Hodges v. Anderson (In re George B. Kerr, Inc.), 25 Bankr. 2, 26-27 (Bankr. D.S.C. 1981), aff'd sub nom. Hodges v. First Nat'l Bank, 696 F.2d 990 (4th Cir. 1982); see also South Carolina Nat'l Bank v. Republic Nat'l Bank (In re R.V. Segars Co.) 54 Bankr. 170, 173 n.1 (Bankr. D.S.C. 1981) (dealing with same type warehouse receipts as in Kerr, which do not include "bearer" or "order" language). These receipts, however, do bear a legend stating: "Under the statute laws of South Carolina, this receipt carries absolute title to the products herein described which will be delivered only upon presentation of this receipt and payment of all warehouse charges and expenses." Id. (quoting the precise language of the warehouse receipts).

In Kerr the bankruptcy court held that these receipts were negotiable, despite the absence of bearer or order language. See Kerr, 25 Bankr. at 7. The court found "no support" in the Code or case law for the assertion that warehouse receipts were nonnegotiable unless they contained bearer or order language. Id. Moreover, the court reasoned that because the "absolute title" language on the receipts required that the goods be delivered only upon presentation and surrender of the receipts, the state warehouse receipts had the essential attribute of negotiable documents of title. Id. Finally, the court found that the usage of trade was to treat the receipts as negotiable documents of title. Id. at 6. In Segars the bankruptcy court reaffirmed its determination that such warehouse receipts are negotiable. Segars, 54 Bankrr. at 173.

The conclusion of the bankruptcy court that the warehouse receipts in Kerr and Segars were negotiable can be challenged on several grounds. First, consideration of trade usage to establish negotiability appears proper only in cases of documents used in overseas trade. See U.C.C. § 7-104(1)(b) (1972); S.C. Code Ann. § 36-7-104(1)(b) (Law. Co-op. 1976). Therefore, the court's apparent reliance on trade usage to establish negotiability appears improper. Second, and more significantly, the Code expressly provides that a domestic warehouse receipt that contains neither bearer nor order language is nonnegotiable. See U.C.C. § 7-104(2) (1972); S.C. Code Ann. § 36-7-104(2) (Law. Co-op. 1976). Finally, the comment to section 7-104 substantially undercuts the court's reliance on the "absolute title" legend to support its conclusion that the receipts were negotiable. The comment states:

A document of title is negotiable only if it satisfies this section. "Deliverable on proper indorsement and surrender of this receipt" will not render a document negotiable. Bailees often include such provisions as a means of insuring return of nonnegotiable receipts for record purposes. Such language may be regarded as insistence by the bailee upon a particular kind of receipt in connection with delivery of the goods.


63. 54 Bankr. 170 (Bankr. D.S.C. 1985). Segars, however, involved a nonpossessory security interest in farm products rather than inventory. For a decision involving a priority dispute over inventory covered by warehouse receipts issued by the South Carolina
ILLUSTRATION 5—On June 1 Bank entered into a written security agreement with Dealer, which granted Bank a security interest in Dealer's current and after-acquired inventory of peanuts to secure a contemporaneous loan and any future advances. Also on June 1, Bank filed a financing statement covering Dealer's inventory of peanuts in the Secretary of State's office. When Bank entered into the security agreement it knew that Dealer, as an ongoing practice, stored some of its inventory of peanuts in state warehouses and that negotiable warehouse receipts were being issued to the Dealer for those peanuts. During the month of June Dealer took possession of ten tons of peanuts it had purchased from farmers on unsecured credit. On July 1 Dealer placed the ten tons of peanuts in a state warehouse and the South Carolina Department of Agriculture issued a negotiable warehouse receipt to Dealer covering the peanuts. On August 1 Dealer endorsed the negotiable warehouse receipt and delivered it to Finance Company as security for a contemporaneous loan. On September 1 Dealer defaulted on both loans from Bank and Finance Company. A priority dispute subsequently arose over the ten tons of peanuts, which remained in the possession of the state warehouse.

Both Bank and Finance Company hold perfected security interests in the ten tons of peanuts. Bank's security interest was perfected by the June 1 filing; Finance Company's security interest was perfected when it took possession of the negotiable warehouse receipt on August 1. Therefore, unless a special priority rule controls the conflict, Bank will prime Finance Company under the first to file or perfect rule of revised section 9-312(5)(a). Finance Company, however, can argue that a special priority rule applies. Finance Company can assert not only that it holds a perfected security interest in the peanuts, but also that it qualifies as a good faith holder to whom a negotiable document of title has been duly negotiated.

Department of Agriculture, see Kerr, 25 Bankr. 2.


This section provides:

A negotiable document of title is "duly negotiated" when it is negotiated in the manner stated in this section to a holder who purchases it in good faith without notice of any defense against or claim to it on the part of any person and for value, unless it is established that the negotiation is not in the regular course of business or financing or involves receiving the document in settlement or payment of a money obligation.


Subsection (1) of section 7-501 provides that "[a] negotiable document of title running to the order of a named person is negotiated by his indorsement and delivery." U.C.C. § 7-501(1) (1972); S.C. CODE ANN. § 36-7-501(1) (Law. Co-op. 1976). Subsection (2)(a) of section 7-501 provides that "[a] negotiable document of title is also negotiated
Two Code provisions afford protection to persons who acquire negotiable documents by due negotiation. First, under revised section 9-309 such holders "take priority over an earlier security interest even though perfected."66 Although this provision is somewhat ambiguous, when properly interpreted it applies to earlier perfected security interests in a negotiable document and not to security interests in the underlying goods perfected before the document was issued.67 Therefore, revised section 9-309 does not assist Finance Company in its dispute with Bank. Finance Company, however, may be able to invoke its status as a holder to whom a negotiable document has been duly negotiated to claim priority under section 7-503(1)(b).68

The foundation for Finance Company's argument under section 7-503(1)(b) is intricate. Section 7-503(1)(b) is an exception to an exception. The general rule is stated in section 7-502(1)(b), which provides that subject to section 7-503, "a holder to whom a negotiable document of title has been duly negotiated acquires . . . title to the goods [covered by the document] . . . ."69 The exception to this general rule is set forth in section 7-503(1), which provides that "[a] document of title confers no right in goods against a person who before issuance of the document had . . . a perfected security interest in them . . . ."70 Paragraph (b) of section 7-503(1) then provides the exception to the exception. Under paragraph (b), if a secured party who perfected a security interest in the goods before the document of title was issued acquired in the debtor's procurement of that document, the secured party is precluded from arguing that the document does not confer title to the goods.71

Since section 7-503(1)(b) is an exception to an exception to the

67. See Dolan, Good Faith Purchase and Warehouse Receipts: Thoughts on the Interplay of Articles 2, 7, and 9 of the UCC, 30 Hastings L.J. 1, 17-21 (1978). Cf. Searles, 54 Bankr. 170 (applying both section 9-309 and section 7-503(1)(b) to a conflict involving a security interest in goods which was perfected before issuance of a negotiable document).
68. See U.C.C. § 7-503(1)(b) (1972); S.C. Code Ann. § 36-7-503(1)(b) (Law. Co-op. 1976). This section provides that "[a] document of title confers no right in goods against a person who before issuance of the document had a legal interest or a perfected security interest in them and who [has not] . . . acquiesced in the procurement by the bailor or his nominee of and document of title." U.C.C. § 7-503(1)(b) (1972); S.C. Code Ann. § 36-7-503(1)(b) (Law. Co-op. 1976).
71. See Dolan, supra note 67, at 7-8.
rule that a holder to whom a negotiable document has been duly negotiated acquires title to the goods, to claim priority under this section Finance Company apparently must establish both that the warehouse receipt was negotiable and that it acquired the receipt by due negotiation. Under the facts of Illustration 5, Finance Company should qualify as a holder of a negotiable document who took by due negotiation, unless Bank's filing constituted notice to Finance Company of an adverse claim to the document. Although not directly applicable to the dispute in Illustration 5, revised section 9-309 strongly suggests that Bank's filing does not constitute notice of the security interest. Therefore, Finance Company apparently qualifies as a holder to whom a negotiable document was duly negotiated.

Assuming that Finance Company does qualify as a holder to whom a negotiable document was duly negotiated, in order to prevail under section 7-503(1)(b), Finance Company also must establish that Bank "acquiesced" in Dealer's procurement of the warehouse receipt. Although the Code does not define acquiescence, the comments provide that acquiescence "does not require active consent . . . [but instead,] knowledge of the likelihood of storage or shipment with no objection or effort to control it is sufficient . . . ." Moreover, in analyzing facts comparable to those in Illustration 5, the court in in re R.V. Segars Co. relied on this comment to hold that the secured party had acquiesced for purposes of section 7-503(1)(b). Therefore, under the reasoning in Segars, Finance Company in Illustration 5 apparently is entitled to priority over Bank.

The only issue remaining in Illustration 5 is whether Finance Company can rely upon the special priority rule in section 7-503(1)(b), even though that provision was omitted from the list of special priority rules in revised section 9-312(1). Some case authority precludes a secured party in the position of Finance Company from relying on 7-

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72. See supra note 62.
73. See supra note 65. Whether a holder who fails to qualify as a holder to whom a negotiable document has been duly negotiated can assert priority over a perfected security interest under section 7-503(1)(b) is debatable. Compare Dolan, supra note 67, at 6-9 (no) with B. Clark, supra note 8, § 7.12, at 7-42 to -44 (yes). For the reasons outlined in the text, the author agrees with Dolan's conclusion.
75. U.C.C. § 7-503 comment 1 (1972); S.C. CODE ANN. § 36-7-503 comment 1 (Law. Co-op. 1976).
503(1)(b) on the grounds that Article 9 provides the exclusive rules governing priority disputes between two secured parties. Nevertheless, since section 7-503(1)(b) expressly addresses the conflict presented, that provision should apply. Moreover, the court in Segars relied on 7-503(1)(b) in awarding priority to a secured party in the position of Finance Company.

The lesson to be drawn from Illustrations 5 and 6 is clear. A lender entering into a long-term inventory financing transaction should not rely on possessory perfection under a traditional field warehousing arrangement for priority over subsequently secured parties with respect to after-acquired property. Under revised section 9-312(5)(a), a subsequently secured party who perfects by filing may claim priority with respect to after-acquired inventory unless the lender can establish all of the elements necessary under section 7-503(1)(b). This possible loss of priority does not mean, however, that field warehousing arrangements should be abandoned. Field warehousing is an effective, though often expensive, device to police collateral. Once inventory has been placed in a field warehouse, the debtor cannot gain access to it without the consent of the secured party.

By controlling a debtor's access to the collateral, the secured party reduces the possibility of debtor misconduct. Moreover, if the warehouse releases the collateral to the debtor without authorization, the secured party can hold the warehouseman liable for the ensuing loss. Therefore, in some transactions an inventory financer may be well advised to establish a field warehousing arrangement to police its collateral. In such cases, however, the secured party should not rely on the possession of the collateral by the warehouseman to evidence and perfect its security interest. To protect its security interest in after-acquired property, an inventory financer utilizing a field warehousing arrangement should insist on the execution of a written security agreement that includes an after-acquired property clause. Moreover, to perfect its security interest, the inventory financer should, at the outset of the transaction, promptly file a financing statement that cov-

79. See Segars, 54 Bankr. at 173-74; see also B. Clark, supra note 8, ¶ 7.12, at 7-43 (courts should not fail to consider impact of section 7-503).
80. See McGuire, supra note 51, at 280.
82. See McGuire, supra note 51, at 282.
ers the debtor’s current and after-acquired inventory.\textsuperscript{84}

In summary, the application of the first to file or perfect rule to after-acquired property facilitates long-term inventory financing. To the extent that revised section 9-312(5)(a) applies to resolve disputes over after-acquired property, a floating lienor who files the first financing statement covering a debtor’s inventory can rely on all inventory subsequently acquired by the debtor as collateral for the loan. The Code, however, provides a significant exception to the first to file or perfect rule. Although a floating lienor is the first to file with respect to a debtor’s inventory, its security interest in after-acquired inventory can be primed by a subsequent-secured party holding a purchase money security interest in that inventory if the purchase money financier meets the requirements of revised section 9-312(3).\textsuperscript{85} The Code recognizes the purchase money exception to the first to file or perfect rule in order to preclude the floating lienor from acquiring a situational monopoly over the extension of secured credit to the debtor.\textsuperscript{86} Such a monopoly could enable the floating lienor to thwart the expansion of the debtor’s business.\textsuperscript{87} As discussed below, however, revised section 9-312(3) attempts to balance the floating lienor’s need to rely on after-acquired property with the debtor’s need for access to additional inventory financing.\textsuperscript{88}

3. The Application of Revised Section 9-312(5)(a) to Future Advances

Many long-term inventory financing arrangements contemplate that the floating lienor will make future advances secured by the debtor’s after-acquired inventory.\textsuperscript{88} To facilitate such financing the floating lienor’s priority necessarily must extend to future advances. More precisely, the floating lienor needs assurance that it will prime a conflicting security interest with respect to secured advances it makes to the debtor after the conflicting secured party files or perfects. Although the 1962 Official Text generally afforded an earlier-filed float-

\begin{itemize}
  \item 84. See McGuire, supra note 51, at 280.
  \item 85. See infra notes 114-291 and accompanying text.
  \item 86. See Jackson & Kronman, Secured Financing and Priorities Among Creditors, 88 YALE L.J. 1143, 1167 (1979).
  \item 87. See J. White & R. Summers, UNIFORM COMMERCIAL CODES § 24-5, at 1138 (3d ed. 1988) [hereinafter WHITE & SUMMERS].
  \item 88. See infra notes 114-291 and accompanying text.
\end{itemize}
ing lienor priority with respect to subsequent secured advances,90 two situations gave rise to uncertainty under former section 9-312(5).

The first troublesome situation arose when the security agreement between the debtor and the first secured party to file did not include a future advance clause. Because a secured party with a floating lien on inventory typically will include a future advance clause in the security agreement, this problem rarely will arise in the context of inventory financing. Nevertheless, to illustrate the problem, consider the following:

ILLUSTRATION 6—On June 1 Bank and Debtor executed a written security agreement that granted Bank a security interest in Debtor’s current and after-acquired inventory to secure a contemporaneous loan. This security agreement did not include a future advance clause. Also on June 1, Bank filed a financing statement that identified its collateral as Debtor’s inventory. On July 1 Debtor repaid the loan obtained from Bank. Debtor did not, however, request Bank to provide a termination statement and no termination statement was filed. On August 1 Finance Company and Debtor executed a written security agreement which granted Finance Company a security interest in the same inventory claimed by Bank to secure a contemporaneous loan by Finance Company. Also on August 1, Finance Company filed a financing statement covering Debtor’s inventory. On September 1, to secure an additional loan to Debtor, Bank and Debtor entered into a second security agreement, which granted Bank a security interest in the inventory described in Bank’s June 1 financing statement.

The issue presented is whether Bank is entitled to priority over Finance Company with respect to the September 1 loan. Former section 9-312(5)(a) appears to award priority to Bank because it was the first party to file. On comparable facts, however, the court in Coin-O-Matic Service Co. v. Rhode Island Hospital Trust Co.91 reached the opposite result.92 The holding in Coin-O-Matic, however, is a minority interpretation of the 1962 Official Text.93 Although the drafters of the 1972 Official Text expressed concern over and specifically disapproved

90. If both secured parties originally perfected by filing, the first to file rule of former section 9-312(5)(a) governed priorities. Moreover, under this rule the priority given to the first secured party to file extended to future advances. See Final Report, supra note 2, app., para. E-42, at 227; 2 G. Gilmore, supra note 56, § 35.7, at 939-40.
92. Id. at 1120.
93. White & Summers, supra note 87, § 24-4, at 1133-35; see, e.g., In re Rivet, 299 F. Supp. 374 (E.D. Mich. 1969); Household Fin. Corp. v. Bank Comm’r, 248 Md. 233, 235 A.2d 732 (1967); see also Allis-Chalmers Credit Corp. v. Cheney Inv., Inc., 227 Kan. 4, 605 P.2d 525 (1980) (if security agreement is executed, value is given, and financing statement describing collateral is filed, later advances made pursuant to subsequent security agreements are perfected as of date of original filing).
of the holding in Coin-O-Matic, the drafters concluded that a statutory amendment was not necessary to overrule the decision. Rather, the drafters included an illustration in the Official Comments to revised section 9-312 rejecting the result in Coin-O-Matic. Therefore, although the resolution of Illustration 6 may have been unclear under prior law, under revised section 9-312(5)(a), Bank should prime Finance Company as to the September 1 loan.

The resolution of Illustration 6 under the revised Code graphically illustrates the Code's policy of notice filing and provides a warning to potential lenders in the position of Finance Company. Even though there may have been equity in Debtor's collateral on July 1, and even though Bank's June 1 security agreement did not provide for future advances, based on its earlier filing Bank can establish a prior claim to the equity on which Finance Company relied in making its secured loan. The lesson is clear: if a secured party has filed a financing statement covering collateral of a debtor, a subsequent lender should not lend against that collateral unless the debtor obtains and files a termination statement, or the lender enters into a subordination agreement with the secured party.

The second troubling situation under the 1962 Official Text arose when a secured party who perfected by filing made a future advance pursuant to a future advance clause in a security agreement after a subsequent-secured party had perfected by possession. To illustrate this problem, consider the following:

ILLUSTRATION 7—On June 1 Bank and Debtor executed a security agreement that granted Bank a security interest in all of Debtor's current and after-acquired inventory to secure a contemporaneous loan and any future advances. Also on June 1, Bank filed a financing statement covering Debtor's inventory. On July 1 Finance Company and Debtor entered into a security agreement that granted Finance Company a security interest in Debtor's current inventory. Also on July 1, in order to perfect the security interest, Finance Company had Debtor transfer possession of the inventory to an independent bailee with notice of Finance Company's security interest. On August 1 Bank

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made a future advance to Debtor under the terms of the June 1 security agreement.

The issue presented is whether Bank has a prior claim to the inventory in the bailee's possession so that the inventory effectively secures the August 1 advance.

Under the 1962 Official Text, former section 9-312(5)(b) governed the resolution of this issue because Finance Company originally perfected in a manner other than by filing.\(^{101}\) Therefore, one had to determine which of the two claimants was the first to perfect. Recall that a security interest is not perfected until it attaches\(^ {102}\) and that a security interest does not attach until the secured party gives value.\(^ {103}\) With respect to the future advance, Bank arguably did not give value until August 1.\(^ {104}\) If this argument is accepted, Bank did not perfect with respect to the future advance until August 1. Since Finance Company perfected on July 1, the 1962 Official Text could be interpreted to subordinate Bank's security interest to that of Finance Company to the extent that Bank's security interest secured the August 1 advance.\(^ {105}\) Bank could have protected itself by determining whether Debtor had granted a possessory security interest before Bank made the August 1 advance. Imposing such a burden on Bank, however, appears inconsistent with the Code's concept of notice filing.

The 1972 Official Text clarifies the resolution of priority disputes between secured parties with respect to future advances.\(^ {106}\) Under revised section 9-312(7), if a secured party makes a future advance while its security interest is perfected by filing or possession, for purposes of

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101. See supra text accompanying note 37.
104. See Coogan, supra note 8, at 866-68. But see 2 G. Gilmore, supra note 56, § 35.7, at 941-42 (discussing priority of holder of security interest in future advances over an intervening security interest).
105. See Coogan, supra note 8, at 866-68.
106. See U.C.C. § 9-312(7) (1972) (amended 1977). This section provides:
If future advances are made while a security interest is perfected by filing, [or] the taking of possession, . . . the security interest has the same priority for the purposes of subsection (5) with respect to the future advances as it does with respect to the first advance. If a commitment is made before or while the security interest is so perfected, the security interest has the same priority with respect to advances made pursuant thereto. In other cases a perfected security interest has priority from the date the advance is made.

Id.

revised section 9-312(5)(a), its security interest has the same priority with respect to the future advance as it has with respect to the first advance.\textsuperscript{107} In contrast, if the secured party has perfected automatically, its security interest has priority only from the date the advance is made.\textsuperscript{108}

If the dispute in Illustration 7 arose under the revised statute, Bank would prime Finance Company with respect to the August 1 advance. Since Bank perfected by filing when it made the advance on August 1, under revised section 312(5)(a), Bank has the same priority with respect to that advance that it had with respect to the initial loan on June 1. Under revised section 312(5)(a) Bank would prime Finance Company with respect to the June 1 loan, since Bank filed on June 1 before Finance Company perfected on July 1. Thus, Bank would prevail as to the August 1 advance.

Revised section 9-312(7) is an improvement over prior law. First, the revised section provides a certain answer while the resolution of the dispute under the 1962 Official Text was uncertain.\textsuperscript{109} Second, awarding priority with respect to future advances to the secured party who was the first to file or take possession is consistent with the policy of notice filing. A secured party who files a financing statement describing the collateral or who takes possession of the collateral effectively gives notice to third parties that it claims the collateral as security for current and future loans made to the debtor. If the secured party is the first creditor to give such notice, the concept of notice filing dictates that it should be awarded priority with respect to all advances.

Since most inventory financers perfect either by filing or taking possession, they will be entitled to the benefit of revised section 9-312(7). Nevertheless, a security interest in inventory can be perfected automatically. If an inventory financer perfects automatically, however, its priority with respect to the future advance will not relate back to the date of the initial loan. To illustrate such a case, consider the following:

**ILLUSTRATION 8**—On June 1, to secure a contemporaneous loan and any future advances, Bank entered into a written security agreement that granted Bank a security interest in certain negotiable warehouse receipts covering Debtor's inventory of cotton then stored in a


\textsuperscript{109} See supra notes 101-05 and accompanying text.
state warehouse. Also on June 1, Bank took possession of the warehouse receipts. On June 30 Bank made the warehouse receipts available to Debtor to enable Debtor to obtain possession of the cotton. Also on June 30, Debtor surrendered the receipts to the warehouse and in exchange obtained possession of the cotton. On July 1 Debtor entered into a written security agreement with Finance Company that granted Finance Company a security interest in the cotton to secure a contemporaneous loan. Also on July 1, Finance Company filed a financing statement to perfect its security interest. On July 10 Bank made an advance to Debtor under the future advance clause of the June 1 security agreement. On July 20 Bank filed a financing statement covering the cotton.

On June 1 Bank perfected its security interest in the negotiable warehouse receipts by taking possession.\textsuperscript{110} Bank’s perfection in the negotiable documents thus gave it a perfected security interest in the cotton.\textsuperscript{111} Moreover, Bank’s security interest in the warehouse receipts and the underlying cotton remained automatically perfected for 21 days after Bank made the negotiable documents available to Debtor.\textsuperscript{112} On July 20 Bank filed with respect to the cotton and thus preserved the continuity of its perfection.\textsuperscript{113} Therefore, Bank had a continuously perfected security interest which was first perfected on June 1.

Finance Company’s date for priority under revised section 9-312(5)(a) was July 1 when it filed the financing statement covering the cotton. Therefore, had Bank made the future advance while it was perfected by filing or possession, under revised section 9-312(7), Bank’s priority with respect to the advance for purposes of revised section 9-312(5)(a) would be June 1 and Bank would have primed Finance Company. In Illustration 8, however, Bank made the advance on July 10, when it was automatically perfected under revised section 9-304(5)(a). Therefore, under revised section 9-312(7), Bank’s priority date for the future advance is July 10, and Bank loses to Finance Company under revised section 9-312(5)(a).

\subsection*{C. The Purchase Money Priority in Inventory}

The validation of after-acquired property and future advance


clauses combined with the residual priority rule of revised section 9-312(5)(a) operates to afford a floating lienor who is the first to file substantial protection against subsequent conflicting security interests in a debtor’s inventory. The Code does not, however, afford a floating lienor absolute priority over the claims of all subsequent-secured parties. Under revised section 9-312(3) a subsequent-secured party who extends new value to enable the debtor to acquire new inventory can prime an earlier-filed floating lienor who claims the new inventory under an after-acquired property clause. The purchase money “super-priority” in inventory afforded by revised section 9-312(3) reflects a basic Code policy of favoring creditors who advance new value to enable debtors to acquire collateral. As will be discussed more fully below, however, the conditions that a purchase money financer must meet to establish priority under revised section 9-312(3) operate to protect the interests of an earlier-filed floating lienor.

The Code policy of preferring purchase money financers has


A perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory and also has priority in identifiable cash proceeds received on or before the delivery of the inventory to a buyer if:

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

(b) the purchase money secured party gives notification in writing to the holder of the conflicting security interest if the holder had filed a financing statement covering the same types of inventory (i) before the date of the filing made by the purchase money secured party, or (ii) before the beginning of the twenty-one day period where the purchase money security interest is temporarily perfected without filing or possession (subsection (5) of Section 36-9-304);

(c) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and

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


116. For definition of purchase money security interest, see infra note 126.
been justified by arguments of fairness and economics. The fairness argument stresses that the purchase money financer has given new value so that the debtor can acquire the new collateral, while the secured party who claims the collateral under an after-acquired property clause has not. Moreover, the argument runs that conferring priority on the purchase money financer does not impair the position of the floating lienor because the floating lienor retains priority in collateral other than that financed by the purchase money lender. In contrast, if the law awarded priority to the floating lienor, the floating lienor arguably would be unjustly enriched at the expense of the purchase money financer.

The economic arguments in support of the purchase money priority are made on two levels. First, commentators argue that the purchase money priority is necessary to prevent an uncooperative floating lienor from frustrating a debtor's ability to expand the debtor's business. For example, if a floating lienor afforded absolute priority over a debtor's after-acquired inventory refuses to finance a

117. See Nickles, supra note 115, at 1171.
118. See, e.g., Skilton, Security Interests in After-Acquired Property Under the Uniform Commercial Code, 1974 Wis. L. Rev. 925, 945, 948.
119. See, e.g., Jackson & Kronman, supra note 86, at 1145. The authors state:
Viewed uncritically, the purchase money priority may appear to strike a sensible balance between the interests of prior lenders, who retain their property with respect to their original collateral, and the interests of the new lender, who obtains a special priority in the particular item or items of property the acquisition of which the new lender financed.

Id.; see also Kripke, Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact, 133 U. Pa. L. Rev. 929, 936 (1985) (arguing that giving priority to the holders of purchase money security interests takes nothing away from unsecured creditors); Nickles, supra note 115, at 1172-74 (not allowing purchase money financers to have priority over floating liens would give the floating lienor a monopoly over extensions of credit to the debtor).

120. See Nickles, supra note 115, at 1172 (creditors who must rely on after-acquired collateral they did not finance are almost always to blame for the predicament and, therefore, allowing creditors to claim such collateral amounts to unjust enrichment).
121. See White & Summers, supra note 87, § 24-5, at 1138. The authors contend:
Finally, and most pervasive, is the argument that the debtor needs some protection from a creditor who has filed a financing statement with respect to his goods, but who is unwilling to advance additional funds. If such a debtor can find a lender willing to finance a new line of merchandise, the purchase money provisions enable him to give that new lender a first claim on the new merchandise notwithstanding a prior filing by another creditor. Thus, the purchase money provisions give the debtor somewhat greater bargaining power and at least theoretically enlarge his ability to get credit.

Id.; see also, Gilmore, supra note 115, at 1387 (when bonds have been issued to finance old equipment, it would be impossible to procure the bond holders' consent to subordinate their interests to the interests of a financer who gives new value for expansion of business).
new line of inventory, the debtor may be unable to obtain financing for the new inventory.\textsuperscript{122} By permitting the debtor to grant a purchase money financer priority in the new inventory, the Code fosters the expansion of the debtor’s business.\textsuperscript{123} Second, and on a more sophisticated level, commentators argue that the purchase money priority fosters competition among financers and prevents the floating lienor from maintaining a situational monopoly over extension of credit to the debtor.\textsuperscript{124} The competition among lenders tends to reduce the debtor’s cost of credit.\textsuperscript{125}

In order to establish priority under revised section 9-312(3), an inventory financer must hold a purchase money security interest in the inventory at issue.\textsuperscript{126} Moreover, the purchase money financer must

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  \item \textsuperscript{122} If a debtor were unable to grant priority to a purchase money financer of new inventory, the purchase money financer would extend credit only if it could obtain a subordination agreement from the earlier-filed floating lienor, or it could rationally extend credit on an unsecured basis. Significantly, the purchase money financer could not rely on the equity created by the new inventory because the earlier-filed floating lienor could appropriate this equity by making a subsequent advance secured by the inventory. Under the Code’s residual priority rules, the floating lienor’s priority would extend to this advance. See \textit{supra} notes 89-98 and accompanying text. Furthermore, even if the purchase money financer were willing to extend credit because it obtained a subordination agreement or the extension of credit could be justified on an unsecured basis, the cost to the debtor of obtaining this credit would be higher than if the purchase money financer had priority.

  \item First, in the case of a subordination agreement the debtor and purchase money financer would incur transaction costs in negotiating the subordination agreement. Moreover, the floating lienor could be expected to demand compensation in exchange for subordinating its claim to the new collateral. Second, if the purchase money financer were to extend credit in the absence of a subordination agreement, the purchase money financer would charge a higher interest rate to compensate for the increased risk of financing the new collateral without a right to priority. Furthermore, these increased costs of obtaining new credit probably would exceed any savings to the debtor which would flow from affording the floating lienor priority. See generally Jackson & Kronman, \textit{supra} note 86, at 1167-74 (Article 9 policy of giving priority to purchase money security interests is economically advantageous to both floating lienor and to debtor).

  \item \textsuperscript{123} See Scott, \textit{A Relational Theory of Secured Financing}, 86 COLUM. L. REV. 901, 962 (1986).

  \item \textsuperscript{124} See Jackson & Kronman, \textit{supra} note 86, at 1167; Special Project, \textit{The Priority Rules of Article 9}, 62 CORNELL L. REV. 834, 870-71 (1977).

  \item \textsuperscript{125} See Jackson & Kronman, \textit{supra} note 86, at 1171-72.

  \item \textsuperscript{126} U.C.C. § 9-107 (1972) (amended 1977); S.C. CODE ANN. § 36-9-107 (Law. Co-op. Supp. 1989). This section provides:

    A security interest is a “purchase money security interest” to the extent that it is:

    (a) taken or retained by the seller of the collateral to secure all or part of its price; or

    (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

\end{itemize}
meet two additional requirements. First, the purchase money security interest must be perfected at the time the debtor receives possession of the inventory.\textsuperscript{127} Second, the purchase money financer must notify certain holders of conflicting security interests who perfected by filing that it has or expects to acquire a purchase money security interest in the debtor’s inventory.\textsuperscript{128} Finally, revised section 9-312(3) severely limits the extent to which the purchase money priority in inventory extends to proceeds realized by the debtor on the sale of inventory.\textsuperscript{129} Both the conditions imposed on the purchase money priority and the limitations on the extension of the priority to proceeds operate to protect secured parties holding conflicting security interests. This section will analyze the operation and effect of the perfection and notification conditions on the purchase money priority in inventory. The effect of the proceeds limitations will be analyzed in Part III.\textsuperscript{130}

Revised section 9-312(3) does not represent a radical departure from prior law. Rather, the 1972 amendments clarify uncertainties that arose under former section 9-312(3).\textsuperscript{131} Most significantly, the 1972

\begin{quote}

The case law illustrates two problems an inventory financer may encounter in establishing that it holds a purchase money security interest. First, if a purchase money financer responds to a debtor’s default by refinancing the transaction, most courts hold that the security interest retained in the refinancing agreement is a nonpurchase money security interest. \textit{See, e.g.,} Dominion Bank v. Nucholls, 780 F.2d 408 (4th Cir. 1985); Matthews v. Transamerica Fin. Servs. (\textit{In re Matthews}), 724 F.2d 798 (9th Cir. 1984); Rosen v. Associates Fin. Servs. Co., 17 Bankr. 436 (D.S.C. 1982). \textit{But see} Billings v. Avco Colo. Indus. Bank (\textit{In re Billings}), 838 F.2d 405 (10th Cir. 1988). The courts that hold that a refinancing transforms a purchase money security interest into a nonpurchase money security interest reason that the refinancing involves a repayment of the original loan and an extension of a new loan. Accordingly, they hold that the security interest retained upon refinancing does not secure an advance made to enable the debtor to acquire the collateral. \textit{See Matthews}, 724 F.2d at 800.

The second and more significant problem arises when an inventory financer extends credit to enable a debtor to acquire specific inventory pursuant to a security agreement that includes an after-acquired property clause and a future advance clause. In Southtrust Bank v. Borg-Warner Acceptance Corp., 760 F.2d 1240 (11th Cir. 1985), the court held a secured party that financed a debtor’s acquisition of inventory could not claim a purchase money security interest when it exercised a future advance clause and an after-acquired property clause in its security agreement. \textit{Id.} at 1243.


128. U.C.C. § 9-312(3)(b) to (d) (1972) (amended 1977); S.C. Code Ann. 36-9-312(3)(b) to (d) (Law. Co-op. Supp. 1989); \textit{see infra} notes 162-291 and accompanying text.

129. \textit{See infra} notes 636-50, 930-58 and accompanying text.

130. \textit{See infra} notes 651-54, 961-1000 and accompanying text.

131. Section 9-312(3) of the 1962 Official Text provided:

A purchase money security interest in inventory collateral has priority over a conflicting security interest in the same collateral if
amendments resolve the question of whether the purchase money priority extends to proceeds. Although the 1972 Amendments do not vary the perfection condition upon the purchase money priority, they do alter the requirements of the notification condition.\textsuperscript{132} The amendments to the notification provisions not only clarify the process of giving notice,\textsuperscript{133} but also raise a new set of interpretive issues involving the notification condition.\textsuperscript{134}

1. The Perfection Condition

To claim priority in inventory under revised section 9-312(3), a purchase money financer's security interest must be perfected at the time the debtor receives possession of the inventory.\textsuperscript{135} This requirement is significant because two potential classes of nonpurchase money financers may assert conflicting security interests in the inventory subject to the purchase money security interest. First, a conflicting claim may be asserted by a floating lienor who filed covering a debtor's inventory before the debtor acquired the purchase money collateral. The floating lienor may claim a security interest in the new inventory under an after-acquired property clause. Recognition of a purchase money priority would impair the floating lienor's position if the lienor relied on the new inventory as collateral for a future advance. Although the perfection requirement of revised section 9-312(3)(a) provides the floating lienor some notice of most purchase money security interests,\textsuperscript{136} the notification requirements of subsections (b) through (d)

\begin{itemize}
\item[(a)] the purchase money security interest is perfected at the time the debtor receives possession of the collateral; and
\item[(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
\item[(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.
\end{itemize}


132. See id.

133. See infra notes 168-78, 195-202 and accompanying text; see also Final Report, supra note 2, app., paras. E-29 to E-31, at 221-23 (explaining the necessity of clarifying certain notice provisions of the 1962 Official Text).

134. See infra notes 203-91 and accompanying text.


provide the principal protections to earlier-filed floating lienors. 137

The second potential class of secured parties holding conflicting nonpurchase money security interests consists of those creditors who perfect nonpurchase money security interests after the debtor has received possession of the new inventory. When a purchase money financier of new inventory originally perfects by filing, the requirement of revised section 9-312(3)(a) operates to protect subsequent lenders contemplating a loan to a debtor secured by existing inventory. If a purchase money financier files before the debtor receives possession of the collateral, a subsequent lender will have notice of the purchase money security interest before relying on the new inventory by extending credit secured by that inventory.

Although the operation of revised section 9-312(3)(a) is fairly straightforward when applied to subsequent secured parties holding conflicting nonpurchase money security interests, several aspects of the provision merit further discussion. First, the perfection requirement of revised section 9-312(3)(a) does not afford the purchase money financier a grace period for perfection. The absence of a grace period distinguishes revised section 9-312(3) from the purchase money provisions in revised section 9-301(2), 138 revised section 9-312(4), 138 and re-

money security interest in inventory can be automatically perfected when the debtor obtains possession of the collateral. In such a case the perfection requirement affords no notice to an earlier-filed floating lienor. Id.; see generally supra notes 28-33, 45 and accompanying text (analysis of automatically perfected purchase money security interests in inventory).

137. See U.C.C. § 9-312(3)(b) to (d) (1972) (amended 1977); S.C. Code ANN. § 36-9-312(3)(b) to (d) (Law. Co-op. Supp. 1989); see generally infra notes 162-291 and accompanying text (analysis of notification requirements under revised section 9-312(3)(b) to (d)).


If the secured party files with respect to a purchase security interest before or within ten days after the debtor receives possession of the collateral, he takes priority over the rights of a transferee in bulk or of a lien creditor which arise between the time the security interest attaches and the time of filing.


The adoption of the 1988 Amendments reduced the grace period in South Carolina Code section 36-9-301(2) from twenty days to ten days. In 1979 South Carolina adopted a provision inconsistent with section 9-301(2) of the 1962 Official Text. This amendment increased the grace period from ten to twenty days. See S.C. Code ANN. § 36-9-312(4) (Law. Co-op. Supp. 1980) (repealed 1988). This inconsistent amendment was ill-advised because purchase money financiers who relied upon the twenty day grace lost the ability to claim the purchase money exception to the trustee's power to avoid preferences in bankruptcy. See 11 U.S.C. § 547(6)(3) (1988).

vised section 9-313(4)(a), all of which afford a purchase money financer a ten-day grace period for perfection. These grace periods accommodate the "transaction filing" systems developed under pre-Code law. Prior to adoption of the Code, conditional sellers and purchase money chattel mortgagees filed executed conditional sales contracts and chattel mortgages to perfect their liens. The drafters adopted the grace periods to conform the Code to these practices. Moreover, the grace periods expedite purchase money financing transactions. A supplier retaining a purchase money security interest need not delay delivery until filing if the supplier can obtain priority by filing within a subsequent grace period. In order to evaluate the perfection rule of revised section 9-312(3)(a), one must first compare it to the purchase money priority rule of revised section 9-312(4) and then to the priority rules governing fixtures in revised section 9-313(4)(a) and (b).

Revised section 9-312(4) sets forth the super priority rules governing purchase money security interests in collateral other than inventory. Under this provision, a purchase money financer is entitled to priority over a secured party holding a conflicting nonpurchase money security interest in the same collateral if the purchase money financer perfects within ten days after the debtor receives possession of the collateral. The difference between revised sections 9-312(3)(a) and 9-312(4) is illustrated by the following:

ILLUSTRATION 9—On June 1 Seller entered into a written contract to sell bulldozers to Debtor on credit. The contract granted Seller a purchase money security interest in the bulldozers to secure Debtor's

interest in collateral other than inventory has priority over a conflicting security interest in the same collateral or its proceeds if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter."


A perfected security interest in fixtures has priority over the conflicting interest of an encumbrancer or owner of the real estate where:

(a) the security interest is a purchase money security interest, the interest of the encumbrancer or owner arises before the goods become fixtures, the security interest is perfected by a fixture filing before the goods become fixtures or within ten days thereafter, and the debtor has an interest in record in the real estate or is in possession of the real estate . . . .

141. See 1 G. Gilmore, supra note 56, § 15.2, at 466.
142. See White & Summers, supra note 87, § 24-5, at 1148-59.
143. See 1 G. Gilmore, supra note 56, § 16.2, at 498.
obligation to pay the purchase price. On June 5 Debtor received possession of the bulldozers. On June 10 Debtor and Bank entered into a written security agreement that granted Bank a security interest in the bulldozers and after-acquired property of the same character to secure a contemporaneous loan. Also on June 10, Bank filed a financing statement in the Secretary of State’s office, which described the collateral so as to include the bulldozers. On June 15 Seller filed a financing statement in the Secretary of State’s office, which described the collateral as the bulldozers.

If the bulldozers in the possession of the Debtor constituted inventory under section 9-109(4), Seller’s filing on June 15, after Debtor received possession of the collateral, was too late to enable Seller to claim priority under revised section 9-312(3). Therefore, revised section 9-312(5)(a) would apply to resolve the priority dispute. Under that provision, Bank would prevail because it was the first party to file or perfect. In contrast, if the bulldozers in Debtor’s possession were equipment under section 9-109(2), Seller’s June 15 filing was within ten days after Debtor received possession of the collateral and thus preserved Seller’s purchase money priority under revised section 9-312(4).

In principle, the requirement of revised section 9-312(3)(a), that a security interest be perfected when the debtor receives possession of the collateral, is preferable to the grace period afforded under revised section 9-312(4). By conditioning a purchase money financer’s priority on perfection at the time the debtor receives possession of the collateral, revised section 9-312(3)(a) limits the situations in which a subsequent inventory financer can be misled by a debtor’s apparent unen-


Goods are . . . “inventory” if they are held by a person who holds them for sale or lease or to be furnished under contracts of service or he has so furnished them, or if they are raw materials, work in process, or materials used or consumed in a business. Inventory of a person is not to be classified as his equipment.


Goods are . . . “equipment” if they are used or brought for use primarily in business (including farming or a profession) or by a debtor who is a non-profit organization or a governmental subdivision or agency or if the goods are not included in the definitions of inventory, farm products, or consumer goods . . .

cumbered ownership of the collateral.\textsuperscript{148} Moreover, the policy of protecting secured parties against secret liens appears to outweigh the need to expedite purchase money financing under Article 9. Article 9 envisions notice filing by which a secured party can perfect its security interest by filing a financing statement prior to the execution of a security agreement.\textsuperscript{149} Given the availability of notice filing, in most cases there is little reason for a priority rule that provides a grace period for perfection against subsequent-secured parties.

Although the rule of revised section 9-312(3)(a) appears preferable to the grace period of revised section 9-312(4), the General Assembly could have protected subsequent-secured parties without depriving the purchase money financer of noninventory collateral of a grace period with respect to prior secured parties. For example, the purchase money priority with respect to fixtures under revised section 9-313(4)(a) provides for a ten-day grace period, but this grace period applies only to conflicting real estate interests that arose before the goods become fixtures.\textsuperscript{150} With respect to real estate interests that arise after the goods become fixtures, the "first in time, first in right" rule of revised section 9-313(4)(b)\textsuperscript{151} controls.\textsuperscript{152} For purposes of comparison, consider the following illustration of the operation of the revised fixture provision:

ILLUSTRATION 10—On January 10 First Bank loaned Debtor funds to purchase an office building and recorded a real estate mortgage, which encumbered the office building and any after-acquired fixtures and improvements. On June 1 Debtor purchased a new furnace for the office building from Seller under a conditional sales contract, which granted Seller a purchase money security interest in the furnace to secure Debtor's obligation to pay the purchase price. The furnace was

\textsuperscript{148} Note, however, that if the purchase money security interest is automatically perfected under revised section 9-304(5)(a), the perfection affords no notice to a subsequent-secured party. See \textit{supra} text accompanying notes 28-33, 45.


A perfected security interest in fixtures has priority over the conflicting interest of an encumbrancer or owner of the real estate where . . . the security interest is perfected by a fixture filing before the interest of the encumbrancer or owner is of record, the security interest has priority over any conflicting interest of a predecessor in title of the encumbrancer or owner, and the debtor has an interest of record in the real estate or is in possession of the real estate

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installed on June 5 and upon installation became a fixture. On June 10, Debtor obtained a loan from Second Bank secured by a mortgage upon the office building. Also on June 10 Second Bank recorded its mortgage. On June 15 Seller made a proper fixture filing covering the furnace.

Under revised section 9-313(4)(a) Seller's fixture filing on June 15 was effective to afford Seller priority over First Bank. The protection of revised section 9-313(4)(a), however, does not extend to afford Seller priority over Second Bank.153 By its terms, revised section 9-313(4)(a) applies only to real estate interests that arise before the goods become fixtures. Since Second Bank acquired its mortgage lien on June 10, after the goods were installed, the priority dispute between Seller and Second Bank is resolved under the residual rule of revised section 9-313(7),154 which awards priority to Second Bank as the holder of an interest in the real estate. Seller could have avoided the effect of revised section 9-313(7) and established priority over Second Bank by meeting the requirements of revised section 9-313(4)(b). Under section 9-313(4)(b) Seller would have primed Second Bank if the Seller had made a fixture filing before Bank recorded.155

In summary, the Code provides three distinct perfection rules for purchase money priority. Revised section 9-312(3)(a) affords no grace period for perfection with respect to either prior or subsequent non-purchase money security interests. Revised section 9-312(4) provides a grace period of ten days applicable to both prior and subsequent conflicting security interests. Revised section 9-313(4)(a) allows a purchase money financer a ten-day grace period only with respect to prior conflicting interests. From the perspective of a subsequent creditor, the rules of either revised section 9-312(3)(a) or revised section 9-313(4)(a) are preferable to the grace period permitted under revised section 9-312(4). By providing a ten-day grace period for perfection that applies to subsequent-secured parties, the Code creates a problem of apparent ownership. Because of the perfection rule of revised section 9-312(4), a lender can rely on a debtor's existing, apparently unencumbered property other than inventory only if the lender can establish that the debtor has been in possession of the collateral for more than ten days.

A remaining question is whether a provision allowing a grace period against prior secured parties is preferable to the no grace period

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The provision of revised section 9-312(3)(a). To resolve this question, the position of a prior secured creditor who might make an advance against the purchase money collateral must be analyzed. Ironically, in the abstract, a grace period applicable against prior secured parties appears more appropriate in the context of revised section 9-312(3) than it does under revised sections 9-312(4) and 9-313(4)(a). Under revised section 9-312(3) a prior secured party claiming a floating lien on a debtor's inventory cannot be primed by a subsequent purchase money financer unless the floating lienor receives written notice of the purchase money security interest before the debtor receives possession of the new inventory. Therefore, the purchase money financer's filing before the debtor receives possession of the collateral is not essential to protect the floating lienor from making advances in reliance upon the new inventory.

In contrast, under revised sections 9-312(4) and 9-313(4)(a) the purchase money priority is not conditioned on notice to prior secured parties holding conflicting security interests. Under these provisions, the purchase money financer's filing is the only notice to a prior secured party that warns the secured party not to rely on the after-acquired collateral in making an advance. The absence of a notification requirement, combined with the ten-day grace period for perfection under revised section 9-312(4), precludes a prior secured party from relying on after-acquired collateral in making a future advance unless the collateral has been in the debtor's possession for ten days.

The comments defend the absence of a notification requirement under revised section 9-312(4), and by implication the ten-day grace period for perfection, on the grounds that "an arrangement for periodic advances against incoming property is unusual outside the inventory field." The purchase money priority rule of revised section 9-313(4)(a) similarly precludes a prior mortgagee from relying on after-acquired fixtures in making advances unless the goods have been fixtures for more than ten days. Significantly, however, revised section 9-313(6) precludes a fixture financer from claiming priority under revised section 9-313(6).

166. U.C.C. § 9-312(3)(b) to (d) (1972) (amended 1977); S.C. CODE ANN. § 36-9-312(b) to (d) (Law. Co-op. Supp. 1989); see infra notes 195-99 and accompanying text.

157. See McLaughlin, supra note 33, at 966.


Notwithstanding paragraph (a) of subsection (4) but otherwise subject to subsections (4) and (5), a security interest in fixtures is subordinate to a construction mortgage recorded before the goods become fixtures if the goods become fixtures before the completion of the construction. To the extent that it
vised section 9-313(4)(a) when the prior mortgage is a construction mortgage. 160 Construction mortgagees typically make a series of advances to the mortgagor while the building is in construction. The preclusion from asserting the purchase money priority against a prior construction mortgagee affords the mortgagee substantially greater protection when making advances in reliance on after-acquired fixtures than a notification requirement would provide.

The final aspect of the perfection requirement of revised section 9-312(3)(a) that merits mention is that the requirement does not eliminate for subsequent secured parties the problem of apparent ownership. A purchase money security interest in inventory in the possession of the debtor can be perfected without filing under section 9-304(5)(a). 161 As Illustration 1 demonstrates, because of this possibility a lender cannot rely on a debtor's existing inventory simply because no financing statements have been filed against that inventory when the debtor received possession of the inventory or when the lender makes the loan.

2. The Notification Condition

Revised section 9-312(3) retains the basic requirement of the former statute: to obtain the super priority, a purchase money financer of new inventory must give notification of its purchase money security interest to certain prior secured parties claiming conflicting security interests in the new inventory. 162 The notification requirement is intended to protect earlier-filed floating lienors. 163 In the absence of such notification, a floating lienor who filed first with respect to a debtor's inventory might assume it had a prior claim to the new inventory as after-acquired property and thus make a future advance against the

is given to refinance a construction mortgage, a mortgage has this priority to the same extent as the construction mortgage.


163. U.C.C. § 9-312 comment 3 (1972) (amended 1977); S.C. Code Ann. § 36-9-312 comment 3 (Law. Co-op. Supp. 1989); see Final Report, supra note 2, app., para. E-31, at 222 ("[T]he obvious purpose of Section 9-312(3) is to permit a first-filed inventory financer to rely on his priority in making advances unless he receives notice of a competing purchase money security interest before the debtor receives the inventory.").

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new collateral.\textsuperscript{164} The manner in which the revised section imposes the notification requirement, however, differs in several aspects from the former law.

The notification requirements of revised section 9-312(3) are set forth in subsections (b) through (d). Each of these subsections appears to address a distinct aspect of the notification process. Although subsection (b) specifies that the notification must be written, its principal function is to define the secured parties that the purchase money financer must notify in order claim the super priority.\textsuperscript{165} Subsection (c) addresses the timing of the notification.\textsuperscript{166} Finally, subsection (d) defines the content of the notification.\textsuperscript{167}

Subsection (b) of revised section 9-312(3) requires a purchase money financer to give written notice to holders of conflicting security interests who have filed their financing statements before the purchase money financer files or before the beginning of the twenty-one day period during which the purchase money financer claims automatic perfection under section 9-304(5).\textsuperscript{168} Revised subsection (b) makes several changes in the prior law. First, former section 9-312(3)(b) did not clearly state whether the purchase money notification had to be in writing.\textsuperscript{169} Second, the former statute required a purchase money financer to give notification not only to holders of conflicting security interests who had filed before the purchase money financers filed, but also to any secured party whose security interest was known to the purchase money financer.\textsuperscript{170} Under revised subsection (b), the purchase money financer is not required to notify secured parties holding conflicting security interests unless those parties filed a financing statement before the purchase money financer files or before the period of automatic perfection under section 9-304(5) begins.\textsuperscript{171}

The most interesting change made by the 1988 amendments to


\textsuperscript{171} See Final Report, supra note 2, app., para. E-30, at 222.
section 9-312(3)(b) is the enactment of subparagraph (ii) relating to purchase money security interests automatically perfected under section 9-304(5). Subparagraph (ii) applies when a lender finances the debtor’s acquisition of new inventory through a documentary sale and initially perfects its purchase money security interest in the new inventory by perfecting a security interest in a negotiable bill of lading covering the goods. The purchase money financer may initially perfect its security interest either automatically under revised section 9-304(4) or by taking possession of the document. Subsequently, the purchase money financer may release the negotiable bill of lading to the debtor to enable the debtor to obtain possession of the new inventory from the carrier. Under revised section 9-304(5)(a), the purchase money security interest in the negotiable bill of lading and the underlying goods continues to be perfected automatically for twenty-one days following the release of the document to the debtor. If the purchase money financer has not been paid prior to the expiration of the twenty-one day period, it can continue the perfected status of its security interest by filing before the end of that period. In such a transaction, subparagraph (b)(ii) apparently conditions the purchase money financer’s super-priority on giving notice to any conflicting secured party who filed before the twenty-one day period of automatic perfection under revised section 9-304(5) begins.

To illustrate a straightforward application of revised section 9-312(3)(b)(ii), consider the following:

ILLUSTRATION 11—On June 1 Bank entered into a written security agreement with Dealer, under which Bank retained a security interest in Dealer’s current and after-acquired inventory to secure a contem-

172. See supra note 27 and accompanying text.
178. But see infra text accompanying notes 240-56 (revised section 9-312(3)(b)(ii) can be read to require the purchase money financer to give notification before the commencement of the twenty-one day period of automatic perfection).
poraneous loan and any future advances. Also on June 1, Bank properly filed a financing statement covering Dealer's inventory.

On July 1 Dealer entered into a written contract to purchase new inventory from Seller. This contract provided for a documentary sale. On July 5 Seller delivered the new inventory to a rail carrier, which issued a negotiable bill of lading to Seller covering the new inventory. Also on July 5, Seller drew a sight draft on Dealer for the purchase price of the new inventory, and forwarded the sight draft and negotiable bill of lading to a bank in Dealer's city.

On July 6 Dealer entered into a written security agreement with Finance Company, under which Finance Company advanced Dealer the funds necessary to honor the sight draft. This security agreement granted Finance Company a security interest in the negotiable bill of lading and the underlying new inventory. On July 9 Dealer paid the sight draft using the funds advanced by Finance Company and obtained possession of the negotiable bill of lading. Dealer, however, immediately delivered the negotiable bill of lading to Finance Company.

On August 1 the new inventory arrived in Dealer's city. On August 2 Finance Company released the negotiable bill of lading to Dealer to enable him to take delivery of the new inventory. On August 5 Dealer surrendered the negotiable bill of lading to the rail carrier and obtained possession of the new inventory. On August 20 Finance Company filed a financing statement covering the new inventory. On September 1 Dealer defaulted on both obligations to both Bank and Finance Company, and a priority dispute arose over the new inventory which remained in Dealer's possession.

Both Bank and Finance Company have perfected security interests in the new inventory. Bank's security interest arose under the after-acquired property clause in its security agreement and was perfected by its June 1 filing. Finance Company obtained a security interest in the negotiable bill of lading and the new inventory under its July 1 security agreement. Finance Company's security interest in the negotiable bill of lading was originally perfected automatically under section 9-304(4) on July 1. Moreover, Finance Company's perfection in the negotiable document perfected its security interest in the new inventory. Finance Company's security interest continued perfected through possession of the negotiable bill of lading from July 6 to August 1. Following Finance Company's release of the negotiable bill of lading on August 2, Bank's security interest in the new inventory remained perfected.

lading to Dealer on August 1, its security interest remained automatically perfected for twenty-one days.\textsuperscript{182} Finally, Finance Company continued the perfected status of its security interest by filing on August 20.\textsuperscript{183}

If revised section 9-312(5)(a) controls the resolution of this dispute, Bank will prevail over Finance Company because Bank filed on June 1 and Finance Company did not perfect until July 1. Finance Company, however, holds a purchase money security interest in the new inventory because it advanced value to enable Dealer to acquire the new inventory and the value was in fact so used.\textsuperscript{184} Therefore, Finance Company will be entitled to priority under revised section 9-312(3) if it met the conditions of that provision. Under the facts stated in Illustration 11, however, Finance Company failed to meet the conditions for the purchase money priority. Because Bank had filed on June 1 and before the beginning of the period of automatic perfection, which, under revised section 9-304(5)(a), was on August 2, revised section 9-312(3)(b)(ii) required Finance Company to give Bank written notice of its purchase money security interest.\textsuperscript{185} Since Finance Company failed to give such notification, Finance Company cannot claim priority under revised section 9-312(3). As a result, revised section 9-312(5)(a) applies to resolve the conflict\textsuperscript{186} and awards priority to Bank.\textsuperscript{187}

The curiosity in revised section 9-312(3)(b)(ii) becomes apparent if we vary the facts of Illustration 11 by assuming that Bank filed on July 10 rather than June 1. Since Bank's July 10 filing was before the commencement of Finance Company's period of automatic perfection under revised section 9-304(5)(a), revised section 9-312(3)(b)(ii) condi-


\textsuperscript{184} See U.C.C. § 9-107(b) (1972) (amended 1977); S.C. Code Ann. 36-9-107(b) (Law. Co-op. Supp. 1989); see also supra note 126 (analysis of requirements for a purchase money security interest).


\textsuperscript{187} See supra note 21.
tions Finance Company's purchase money priority on giving Bank written notification. Since Finance Company did not give the written notification, Finance Company cannot claim priority under revised section 9-312(3). Denying Finance Company priority under revised section 9-312(3) is consistent with the purpose of the notification requirement because Bank had no notice of Finance Company's claim to the new inventory and might have relied upon the new inventory in making an advance.\(^\text{188}\) That Finance Company is precluded from establishing priority under revised section 9-312(3), however, is not fatal to Finance Company's position. The effect of failing to qualify for the purchase money priority is simply to relegate Finance Company to the priority rules of revised section 9-312(5)(a).\(^\text{189}\) Moreover, under the residual priority rule, Finance Company will prevail because it initially perfected its security interest on July 1, before Bank filed on July 10.\(^\text{190}\)

The result in the variation of Illustration 11 is not the product of a flaw in revised section 9-312(3)(b)(ii). Rather, it is a manifestation of the problems that flow from the automatic perfection of security interests in inventory.\(^\text{191}\) Nevertheless, Illustration 11 and its variation indicate that revised section 9-312(3)(b)(ii) was not artfully drafted. From the perspective of a purchase money financer financing a debtor's acquisition of new inventory through a documentary sale, revised section 9-312(3) is significant only with respect to holders of conflicting security interests who filed before the purchase money financer initially perfected.\(^\text{192}\) Accordingly, if the function of revised section 9-312(3)(b)(ii) is to define the class of secured parties such a purchase money financer must notify to establish a super priority, the provision should require the purchase money financer to notify any secured party who filed before the purchase money financer initially perfected in the negotiable document.

This analysis at least suggests that revised section 9-312(3)(b)(ii) serves a function other than defining the class of conflicting secured parties that a purchase money financer must notify to obtain a purchase money priority. Specifically, this analysis suggests that subparagraph (ii) defines when the purchase money financer must give notice rather than whom it must notify.\(^\text{193}\) If this suggested interpretation is correct, subparagraph (ii) contributes to a significant ambiguity in

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188. See supra notes 163-64 and accompanying text.
189. See supra note 166.
190. See supra note 27-33 and accompanying text.
191. See supra notes 21-33 and accompanying text.
192. A purchase money financer who perfects before the holder of a conflicting security interest files will prevail under revised section 9-312(5)(a) and need not rely upon revised section 9-312(3) for priority. See supra text accompanying notes 27-33.
193. See infra notes 240-42 and accompanying text.
the notification requirements of the revised statute.\(^\text{194}\)

Subsection (c) of revised section 9-312(3) addresses the timing of the purchase money notification. Subsection (c) conditions the purchase money priority on "the holder of the conflicting security interest receiv[ing] the notification within five years before the debtor receives possession of the [new] inventory."\(^\text{195}\) Subsection (c) clarifies prior law to the extent that it defines how frequently the purchase money financer must notify holders of conflicting security interests.\(^\text{196}\) The provision continues prior law to the extent that it provides that the notification is effective if the holder of a conflicting security interest receives the notification before the debtor takes possession of the new inventory,\(^\text{197}\) possession being defined as physical possession.\(^\text{198}\)

\(^{194}\) See infra notes 204-06 and accompanying text.


\(^{196}\) See Final Report, supra note 2, app., para. E-29, at 221.


\(^{198}\) See 2 G. Gilmore, supra note 56, § 29.3, at 787 ("'Receives possession' [in former section 9-312(3)(b)] is evidently meant to refer to the moment when the goods are physically delivered at the debtor's place of business . . . .".). Physical possession, however, may not be sufficient unless the recipient qualifies as a debtor at the time of taking physical possession. See U.C.C. § 9-105(1)(d) (1972) (amended 1977); S.C. Code Ann. § 36-9-105(1)(d) (Law. Co-op. Supp. 1989) (providing that "'[d]ebtor' means the person who owes payment . . . .".). Therefore, the notification is arguably timely under revised section 9-312(3)(c) if it is received after the debtor receives possession of the new inventory but before the debtor incurs an obligation to pay for that inventory. Cf. National Acceptance Co. v. Community Bank (In re Ultra Precision Indus. Inc.), 503 F.2d 414 (9th Cir. 1974) (for purposes of section 9-312(4), a debtor receives possession of goods sold on approval when it decides to buy the goods); Brodie Hotel Supply, Inc. v. United States, 431 F.2d 1316, 1319 (9th Cir. 1970) (when debtor purchased goods that he had held under lease, debtor received possession for purposes of section 9-312(4) when it incurred obligation to pay the purchase price).

Significantly, however, courts have found that a debtor receives possession of goods purchased under a pure sales contract when taking physical possession even if installation is not completed, see Finance Co. of Am. v. Hans Mueller Corp. (In re Automated Bookbinding Servs., Inc.), 471 F.2d 546, 553 (4th Cir. 1972), or not accepting the goods. See Ever Ready Machinists, Inc. v. Relpak Corp. (In re Relpak Corp.), 25 Bankr. 148, 152 (Bankr. E.D.N.Y. 1982). But see James Talcott, Inc. v. Associates Capital Co., 491 F.2d 879 (6th Cir. 1974) (secured party may not retroactively bind debtor as of delivery date and still obtain perfected security interest by filing within ten days of agreement).

In the case of inventory, a purchase money financer should effect notification before the debtor's physical receipt of the collateral. The most common situation in which a person obtains physical possession of new inventory without incurring an obligation to pay for the goods is a true consignment. The Code, however, treats most true consignments as "sale or return" transactions. See U.C.C. § 2-326(3) (1972); S.C. Code Ann. § 36-2-326(3) (Law. Co-op. 1976). Furthermore, in most true consignment transactions, re-
This requirement appears reasonable. The holder of the conflicting security interest is typically a floating lienor who claims the new inventory under an after-acquired property clause. In most contexts, such a lender would not rely on the new inventory by making a future advance before the debtor took possession of the goods.199

Subsection (d) of revised section 9-312(3) defines the content of the notification. Subsection (d) requires that, to be effective, the notification state "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."200 This language is a verbatim adoption of the requirement set forth in former section 9-312(3)(c).201 The most significant aspect of subsection (d) is that when read in conjunction with subsection (c) it permits the notification to be effective for future purchase money security interests.202

Although a variety of issues have arisen in cases applying the notification provisions of revised section 9-312(3)(b) through (d),203 the very language of the statute gives rise to a significant issue of statutory construction. This issue arises in determining the time at which the notification must be given and involves an ambiguity in the requirements of section 9-312(3)(b). Specifically, the question raised is whether the "before" provisions of subparagraphs (i) and (ii) should be read as modifying the language "the purchase money secured party gives notification" or the language "the holder [of a conflicting security interest] had filed a financing statement."204 If the first interpretation

vised section 9-114(1)(b) to (c) conditions a consignor's priority over an earlier-filed inventory financer of the consignee upon the inventory financer's receiving written notice of the consignor's interest before the consignee receives possession of the goods. U.C.C. § 9-114(1)(b) to (c) (1972) (amended 1977); S.C. Code Ann. § 36-9-114(1)(b) to (c) (Law. Co-op. Supp. 1989); see infra notes 361-65 and accompanying text.

199. A lender might, however, rely upon a negotiable document of title covering the new inventory while the inventory is in the possession of the issuer of the document. See infra note 240 and accompanying text.


204. S.C. Code Ann. § 36-9-312(3) (Law. Co-op. Supp. 1989); see B. Clark, supra
is correct, subsection (3)(b) defines when the purchase money notification must be given.\textsuperscript{205} In contrast, if the latter interpretation is correct, subsection (3)(b) merely defines the persons whom the purchase money financier must notify.\textsuperscript{206}

The ambiguity in revised section 9-312(3)(b) is further complicated by the possibility that subparagraphs (i) and (ii) can be interpreted differently. Therefore, this section of the article will first consider the problem potentially arising under subparagraph (i) if the purchase money financier has perfected by filing when the debtor obtains possession of the new inventory. Then, the discussion will focus on the problem potentially arising under subparagraph (ii) if the purchase money security interest is automatically perfected under revised section 9-304(5)(a).\textsuperscript{207}

The ambiguity issue under revised section 9-312(3)(b)(i), when the purchase money financier perfected by filing, is illustrated by the following:

**ILLUSTRATION 12—**On June 1 Bank and Dealer entered into a written security agreement under which Bank retained a security interest in Dealer's current and after-acquired inventory. Also on June 1, Bank filed in the Secretary of State's office a financing statement covering Dealer's inventory. On July 1 Dealer and Seller began negotiating a contract under which Seller would sell new inventory to Dealer on secured credit terms. Also on July 1, Seller filed in the Secretary of State's office a financing statement that described the new inventory. On July 10 Dealer and Seller concluded their negotiations and executed a written agreement under which Seller contracted to sell new inventory to Dealer on credit secured by a security interest in the goods sold. On July 15 Seller gave Bank sufficient written notification describing the new inventory in which it held a purchase money security interest. Bank received the notification on July 20. On August 1 Seller delivered the new inventory to Dealer. On September 1 Dealer defaulted on its obligations to both Bank and Seller. A priority dispute arose concerning the new inventory which remained in Dealer's possession.

Seller clearly meets several of the requirements for a purchase

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\textsuperscript{205} See Baker, supra note 204, at 9.

\textsuperscript{206} See id. at 8-15. A third interpretation is possible under which the "before" language of subparagraphs (i) and (ii) modify both the "purchase money secured party gives notification" clause and the "the holder had filed a financing statement" clause. Id. at 15-21. Under this interpretation, revised section 9-312(3)(b) would determine both to whom and when written notification must be given. Id.

\textsuperscript{207} See infra text following note 229 and text accompanying notes 230-91.
money priority. Seller has a purchase money security interest,\(^208\) which was perfected when the debtor received possession of the new inventory.\(^209\) Moreover, Seller gave Bank sufficient written notification describing the inventory in which it claimed a purchase money security interest,\(^210\) and Bank received this notification before Dealer took possession of the new inventory.\(^211\) The critical question is whether the written notification was timely. Although Bank received the notification before Dealer received possession of the new inventory, Seller did not give the notification before the date on which the Seller filed its financing statement. Therefore, if the court interprets revised section 9-312(3)(b)(i) to confer the purchase money priority only if “the purchase money secured party gives notification . . . before the date of the filing made by the purchase money secured party,”\(^212\) Seller failed to meet the conditions for the purchase money priority. As a result, Bank would prime Seller with respect to the new inventory under revised section 9-312(5)(a).\(^213\)

The commentators who have specifically addressed this ambiguity have rejected the argument that revised section 9-312(3)(b)(i) conditions the purchase money priority upon the purchase money financer giving notification before it files.\(^214\) Furthermore, most courts that have considered the issue have agreed with the commentators.\(^215\) Under these authorities, subparagraph (i) of revised section 9-312(5)(b) modifies the phrase, “if the holder [of the conflicting security interest] ha[s] filed a financing statement covering the same types of inventory.”\(^216\) In


\(^{214}\text{See B. Clark, supra note 8, ¶ 3.09[3][a], at 3-102 to -103; Baker, supra note 204, at 21-22.}\)


essence, these authorities interpret revised section 9-312(3)(b) as defining which secured parties are entitled to written notification, not when the written notification must be given.\footnote{217} Under this interpretation, revised section 9-312(3)(b)(i) simply requires a purchase money inventory financer to give written notification to those secured parties who filed before the purchase money financer filed.

Several arguments support the apparent majority view that revised section 9-312(3)(b) defines whom the purchase money financer must notify rather than when the financer must give the notification. First, the timing of the purchase money notification is expressly addressed in revised section 9-312(3)(c). This section conditions the purchase money financer’s priority on the conflicting secured party’s receiving the written notification “within five years before the debtor receives possession of the inventory.”\footnote{218} Although the drafters of revised section 9-312(3)(c) were concerned primarily with how frequently the purchase money financer must give notice,\footnote{219} the provision clearly states that the notices must be received before the debtor receives possession of the purchase money collateral.\footnote{220} Therefore, interpreting revised section 9-312(3)(b)(i) to condition the purchase money priority on the purchase money financer’s giving notice before filing appears inconsistent with the express requirements of revised section 9-312(3)(c).\footnote{221}

The second argument against reading revised section 9-312(3)(b)(i) to require a purchase money inventory financer to give notice before it files is that such a requirement is not necessary to effect the policy underlying the notification provision. Revised section 9-312(3) conditions the purchase money priority on notification to the holder of a conflicting security interest to protect an earlier-filed secured party claiming a floating lien from relying on the new inventory by making a future advance.\footnote{222} The risk of the floating lienor relying on the new inventory, however, would rarely arise before the debtor obtained pos-

\footnote{217} See King’s Appliance & Elecs. Inc., 157 Ga. App. at 859-60, 278 S.E.2d at 736; Baker, supra note 204, at 10.
\footnote{219} See Final Report, supra note 2, app., para. E-29, at 221.
\footnote{220} See Baker, supra note 204, at 9-10.
\footnote{221} It is possible to argue that revised section 9-312(3)(b)(i) requires the purchase money financer to give notice before filing, and that revised section 9-312(3)(c) requires the secured party holding the conflicting security interest to receive the notification before the debtor receives possession of the new inventory. There seems, however, no reason for imposing such a dual requirement. Id. at 19-20.
session of the new inventory. Therefore, the notification is effective to accomplish its function if it is received by the conflicting secured party before the debtor obtains possession of the purchase money collateral.

The third argument against interpreting revised section 9-312(3)(b)(i) to require a purchase money financer to give written notification before filing involves the policy of prompt filing implemented under revised section 9-402(1). Under revised section 9-402(1), a secured party can file before a security agreement is made or a security interest attaches. Moreover, sound practice dictates that a secured party file at the start of negotiations concerning the creation of a security interest. Therefore, a purchase money financer would be expected to file at the commencement of negotiations looking toward a sale of inventory or an enabling loan.

If revised section 9-312(3)(b)(i) requires the purchase money financer to give written notice before filing, two potential problems arise. First, a purchase money financer must delay filing until it has given notice, a requirement which appears inconsistent with the practice fostered under section 9-402(1). Second, potential purchase money financers would give notification in cases in which the negotiations failed and no purchase money security interest was created. In such cases the notification might disrupt the debtor's financing arrangements with a floating lienor, even though no purchase money financing ever takes place.

The final argument against interpreting revised section 9-312(3)(b)(i) to require notification prior to filing is that such an interpretation is inconsistent with the 1962 Official Text and the drafters did not express an intention to change the rule. Under former section 9-312(3) a notification was timely if a conflicting secured party received the notification before the debtor received possession of the new inventory. Thus, under prior law, a purchase money financer was not precluded from claiming the super priority if the financer filed

223. But see infra note 240 and accompanying text.


225. See B. Clark, supra note 8, ¶ 2.13[1], at 2-136 to -138.

226. Under the 1962 Official Text the clear rule of section 9-312(3) was that the notice must be received before the debtor receives possession of the collateral, and not that the notice must be given before the purchase money financer filed. See Baker, supra note 204, at 10.

227. Id.

before giving notice. Had the drafters intended to change this rule, presumably they would have done so clearly and would have documented the change in the Final Report and revised Official Comments. The Final Report gives no indication that a change was intended. Moreover, the revised Official Comments indicate that the date the debtor receives possession of the new inventory is the reference point for determining whether a notification is timely. 229

Revised section 9-312(3)(b)(i) thus should not be interpreted to condition a purchase money financer's super priority on giving written notice before filing, but to provide that notification is timely if received before the debtor obtains possession of the new inventory. The remaining issue is whether revised section 9-312(3)(b)(ii) should be interpreted to require written notice before the beginning of the period of automatic perfection under revised section 9-304(5)(a). This issue arises when the purchase money financer initially perfects either through possession of a negotiable document or automatically under section 9-304(4), and subsequently releases the negotiable document to the debtor to enable the debtor to take delivery of the goods. A notion of consistency suggests that if revised section 9-312(3)(b)(i) does not require notification prior to filing, revised section 9-312(3)(b)(ii) should not be interpreted to require notification before the period of automatic perfection begins under revised section 9-304(5)(a). Nevertheless, the policy of protecting floating lienors underlying the notification requirements of revised section 9-312(3) arguably supports such an interpretation.

To illustrate the problem in interpreting revised section 9-312(3)(b)(ii), consider the following:

ILLUSTRATION 13—On June 1 Bank and Dealer entered into a written security agreement that granted Bank a security interest in Dealer's current and after-acquired inventory to secure a contemporaneous loan and future advances. Also on June 1, Bank filed a financing statement in the Secretary of State's office covering Dealer's inventory.

On July 1 Dealer entered into a written contract with Seller under which Dealer purchased new inventory from Seller. This contract provided for a documentary sale. Seller identified the new inventory to this contract on July 1.

On July 2 Seller delivered the new inventory to a rail carrier and, in exchange for the goods, received a negotiable bill of lading. Also on July 2, Seller drew a sight draft on Dealer for the purchase price of the new inventory. Seller then forwarded the negotiable bill of lading and the sight draft to a bank in Dealer's city.

On July 3 Dealer and Finance Company entered into a written security agreement under which Finance Company advanced funds to the Dealer to enable him to pay the sight draft. This security agreement granted Finance Company a security interest in the negotiable bill of lading and the underlying new inventory to secure the advance.

On July 5 Dealer paid the sight draft using the funds advanced by Finance Company and obtained possession of the negotiable bill of lading. Dealer immediately transferred possession of the bill of lading to Finance Company.

On July 10 the new inventory arrived in Dealer’s city and Finance Company released the negotiable bill of lading to Dealer to enable him to take possession of the new inventory.

On July 12 Finance Company sent written notification of its purchase money security interest to Bank. Bank received the notice on July 13.

On July 14 Dealer surrendered the negotiable bill of lading to the rail carrier and obtained possession of the new inventory.

On July 31 Finance Company filed a financing statement in the Secretary of State’s office covering the new inventory.

Subsequently, Dealer defaulted under the terms of the security agreements with Bank and Finance Company. A priority dispute arose over the new inventory that remained in Dealer’s possession.

Ultimately, the issue presented in Illustration 13 is whether the written notification sent by Finance Company on July 12 and received by Bank on July 13 was timely under revised section 9-312(3). To resolve this issue the other requirements for the super priority must first be addressed. First, since Finance Company advanced funds to Dealer to enable Dealer to acquire the new inventory and the funds were in fact so used, Finance Company has a purchase money security interest. Second, Finance Company’s security interest was perfected when Dealer received possession of the new inventory on July 14. Finance Company’s security interest in the negotiable bill of lading was automatically perfected on July 3 for a period of twenty-one days. As a result, Finance Company’s security interest in the new inventory covered by the negotiable bill of lading was also perfected on July 3. The perfected status of Finance Company’s security interest

continued when it took possession of the negotiable bill of lading.\textsuperscript{234} Moreover, under revised section 9-304(5)(a) Finance Company's security interest remained perfected for twenty-one days after it surrendered the negotiable bill of lading to Dealer on July 10.\textsuperscript{235} Finally, Finance Company gave Bank written notification, including a sufficient description of the new inventory, and Bank received the notification before Dealer obtained possession of the collateral.\textsuperscript{236} Therefore, unless revised section 9-312(3)(b)(ii) is interpreted to require a purchase money financer to give notification before the beginning of the twenty-one-day period of automatic perfection, Finance Company has met the conditions for the purchase money priority.

Arguably, Finance Company's notification was timely. First, unless a clear indication to the contrary exists, it is fair to assume that subparagraph (ii) serves the same purpose as subparagraph (i). Since the authorities agree that subparagraph (i) defines the conflicting secured parties who must be notified rather than when the notification must be given,\textsuperscript{237} subparagraph (ii) arguably does not require a purchase money financer to give notification before the period of automatic perfection under revised section 9-304(5)(a) begins. Therefore, Finance Company's notification would seem timely under revised section 9-312(3)(c) because Bank received the notification before Dealer obtained possession of the new inventory. Moreover, the Official Comments expressly support this conclusion. Describing the operation of revised section 9-312(3), the Official Comments state:

Where the purchase money inventory financing began by possession of a negotiable document of title by the secured party, he must in order to retain priority give the notice required by subsection (3) at or before the usual time, i.e., when the debtor gets possession of the inventory, even though his security interest remains perfected for twenty-one days under Section 9-304(5).\textsuperscript{238}

Additionally, commenting on revised sections 9-312(3)(b)(ii) and 9-304(5)(a), the Review Committee for Article 9 asserted that "the Committee's proposed revision of Sections 9-304(5) and 9-312(3) requires the notice to be given before the debtor receives the inventory,


\textsuperscript{237} See sources cited supra notes 214-15.

and if this is done, the purchase money security interest obtains a priority and retains it so long as the interest remains perfected."²³⁹

In response to this argument, Bank can assert that the purchase money notification cannot serve its function unless the notification occurs before Dealer obtains possession of the negotiable bill of lading. Even though Dealer did not have possession of the new inventory on July 10, it did have possession of the negotiable document which entitled him to possession of the goods.²⁴⁰ Therefore, absent notification of Finance Company's purchase money security interest, Bank might have relied on the new inventory covered by the bill of lading. To avoid this risk, Bank can assert that revised section 9-312(3)(b)(ii) should be interpreted to condition the purchase money priority on Finance Company's giving notice before the period of temporary perfection begins. Thus Bank would conclude that Finance Company's notification given on July 12 was too late to satisfy the conditions for the purchase money priority.

In the only decision to date interpreting revised section 9-312(3)(b)(ii), the court in Scallop Petroleum Co. v. Banque Trad-Credit Lyonnais S.A.²⁴¹ concluded that the provision requires a purchase money financer to give notification before the period of temporary perfection under revised section 9-304(5) begins.²⁴² The court, however, did not support its conclusion with the argument suggested above. Moreover, the court appeared to be unaware that its conclusion was inconsistent with the accepted interpretation of revised section 9-312(3)(b)(i). Therefore, the authoritative effect of this aspect of the Scallop Petroleum decision is debatable.

Although the interpretation of revised section 9-312(3)(b)(ii) in Scallop Petroleum appears to protect a floating lienor who may rely on new inventory covered by a negotiable bill of lading, two arguments can be advanced in opposition to that interpretation. First, reading subparagraph (ii) to require notification prior to the commencement of the period of temporary perfection under revised section 9-304(5) is not necessary to protect the interests of a floating lienor. If Bank in Illustration 13 made an advance on July 11 in reliance on the new inventory covered by the negotiable bill of lading, Bank could have enhanced its position by taking possession of the document. If Bank took a possessory security interest in the negotiable bill of lading, Bank apparently could qualify as a holder to whom a negotiable document of

²⁴⁰ See U.C.C. § 7-403(1), (3) (1972); S.C. Code Ann. § 36-7-403(1), (3) (Law. Co-op. 1976).
²⁴² Id. at 191-92.
title has been duly negotiated.\textsuperscript{243} If so, Bank would prime Finance Company under revised section 9-309 even if Finance Company's notification was sufficient under revised section 9-312(3).\textsuperscript{244} Therefore, the Scallop Petroleum interpretation of subparagraph (ii) seems necessary to protect only those floating liens who fail to protect their own interests by not taking possession of the negotiable bill of lading through due negotiation. A court cannot be faulted for refusing to adopt a strained interpretation of revised section 9-312(3)(b)(ii) to protect a party who failed to protect itself.\textsuperscript{245}

Second, the Scallop Petroleum interpretation of subparagraph (ii) arguably should not be adopted because it does not fully protect a floating liener. If Finance Company had mailed written notice of its purchase money security interest to Bank on July 9, this notification apparently would be timely under the Scallop Petroleum interpretation of subparagraph (ii). If Bank did not receive the notification until July 12, however, the notification would not provide Bank meaningful notice of Finance Company's purchase money claim. For example, if Bank made an advance to Dealer on July 11 in reliance on the new inventory, even under Scallop Petroleum Finance Company would prime Bank under revised section 9-312(3).

Even if a court refuses to interpret subparagraph (ii) to condition the purchase money priority on giving written notice prior to the beginning of the period of automatic perfection under revised section 9-304(5), the court is not precluded from holding that Finance Company in Illustration 13 failed to meet the requirements of revised section 9-312(3). A court determined to hold in favor of Bank could find that the


Nothing in this chapter limits the rights of a holder in due course of a negotiable instrument (Section 36-3-302) or a holder to whom a negotiable document of title has been duly negotiated (Section 36-7-501) or a bona fide purchaser of a security (Section 36-8-301), and the holders or purchasers take priority over an earlier security interest even though perfected. Filing under this chapter does not constitute notice of the security interest to the holders or purchasers.


Revised section 9-309 rather than section 7-503(1)(b) would control this issue because Finance Company would be asserting an automatically perfected security interest in the negotiable bill of lading and Bank would be asserting its status as a holder to whom a negotiable document of title had been duly negotiated. See Dolan, supra note 67, at 17-21.

\textsuperscript{245} See James Baird Co. v. Gimbel Bros., Inc., 64 F.2d 344, 346 (2d Cir. 1933) (Hand, J.) ("[I]n commercial transactions it does not in the end promote justice to seek strained interpretations in aid of those who do not protect themselves.").
written notification was untimely under revised section 9-312(3)(c). Although Dealer did not receive physical possession of the inventory until July 14, Dealer did receive the negotiable bill of lading on July 10. The negotiable bill of lading entitled Dealer to possession of the new inventory. Moreover, pursuant to section 9-304(2), possession of a negotiable document of title is the equivalent of possession of the goods covered by the document. Therefore, a court could find that Dealer received possession of the inventory on July 10, before Bank's receipt of the purchase money notification on July 13.

On this basis the court could conclude that Finance Company failed to meet the condition imposed by revised section 9-312(3)(c). Such a conclusion is consistent with the intended function of the notification requirement. A purchase money financer should be entitled to priority over an earlier-filed floating lienor only if the floating lienor receives notice of the purchase money security interest before it can rely upon the new inventory. In most cases a floating lienor would not rely on new inventory until the debtor received possession of that inventory. Nevertheless, when the inventory is in the possession of a bailee who has issued a negotiable document and the debtor has possession of the document, the floating lienor may rely on the new inventory before the debtor surrenders the document and takes physical possession of the goods.

Although the court in Scallop Petroleum did not adopt the suggested interpretation of "receives possession" under revised section 9-312(3)(c), it reached a result not inconsistent with that interpretation. The debtor in Scallop Petroleum was in the business of trading oil. The debtor had granted security interests in the after-acquired inventory of oil to two related banks. Subsequently, the debtor entered into a contract to purchase 312,000 barrels of oil located in Italy for shipment to New Jersey. The purchase money financer of this oil ini-

246. See supra note 131.
Subsection (2), following prior law and consistently with the provisions of Article 7, takes the position that, so long as a negotiable document covering goods is outstanding, title to the goods is, so to say, locked up in the document and the proper way of dealing with such goods is through the document.
tially perfected by taking possession of a negotiable bill of lading that covered the oil, which was issued by the company transporting the oil. When the oil reached New Jersey, the purchase money financer apparently released the bill of lading to the debtor, who in turn surrendered it to the carrier.251

The debtor in *Scallop Petroleum*, however, instructed the captain of the vessel that had transported the oil to deliver a portion of the oil to a third party, Belcher Oil Company. Belcher Oil in turn issued a non-negotiable warehouse receipt to the purchase money financer covering this oil. Although the purchase money financer never gave written notification to the banks holding the floating liens, the purchase money financer asserted that it was entitled to priority under revised section 9-312(3). The purchase money financer argued that since the debtor never received possession of the oil, it was not required to give notice.252 The court rejected this argument, asserting that the requirement of giving written notice was not excused by the debtor’s failure to take physical possession of the inventory.253

The *Scallop Petroleum* court, however, did not base its decision on the conclusion that a debtor has “received possession of the inventory” for purposes of revised section 9-312(3)(c) when it has received possession of a negotiable document covering the goods. Rather, the court held that revised section 9-312(3)(b)(ii) requires a purchase money financer to give written notification before the period of automatic perfection under revised section 9-304(5) commences, even in cases in which the debtor never takes possession of the inventory.254

In conclusion, whether Finance Company primes Bank under revised section 9-312(3) in Illustration 13 is uncertain. The critical issue is whether Finance Company’s notification was timely under subsections (b) and (c) of revised section 9-312(3). Although most authorities conclude that subsection (b) defines the persons who must be notified rather than when notice must be given,255 the court in *Scallop Petroleum* asserted that subparagraph (ii) conditions the purchase money priority on notification before the twenty-one-day period of automatic perfection under revised section 9-304(5) begins. Since Finance Company in Illustration 13 did not give written notification to Bank until after Finance Company had surrendered the negotiable bill of lading to Dealer and triggered the commencement of the period of temporary perfection, Bank can argue that Finance Company’s notification was

251. *Id.*
252. *Id.* at 192.
253. *Id.*
254. *Id.* at 191-92.
255. See *supra* notes 214-15.
untimely under revised section 9-312(3)(b)(ii).

Even if a court rejects the Scallop Petroleum interpretation of subparagraph (ii), Bank can argue that for purposes of subsection (c) Dealer received possession of the new inventory when it obtained possession of the negotiable bill of lading. Therefore, Bank can claim that since it did not receive Finance Company's written notification before Dealer took possession of the bill of lading, the notification was un-
timely under revised section 9-312(3)(c). If either of Bank's arguments is accepted, Finance Company cannot establish a purchase money priority in the new inventory. Therefore, Bank would argue that it is entitled to priority under the residual first to file or perfect rule of revised section 9-312(5)(a).258

Finance Company has one final argument which rests upon the provisions of Article 7 rather than Article 9. Finance Company can assert that under section 7-503(1)(b)257 it took free of Bank's perfected security interest in the new inventory.258 To succeed with this argument, Finance Company must prevail on three basic issues. First, Fi-
nance Company must establish that it is a holder to whom the negotia-
table bill of lading covering the new inventory has been duly negotiated.259 Second, Finance Company must establish that Bank ac-
quiesced in the procurement of the negotiable bill of lading.260 Finally, Finance Company must establish that section 7-503(1)(b) supercedes the priority rules of Article 9.

Section 7-503(1) is a limitation on the rights acquired by the holder of a negotiable document who takes by due negotiation.261 Under section 7-502(1)(b) a holder who takes a negotiable document by due negotiation acquires title to the underlying goods.262 The holder's rights under section 7-502(1), however, are expressly subject to

256. See U.C.C. § 9-312(5)(a) (1972) (amended 1977); S.C. CODE ANN. § 36-9-
257. U.C.C. § 7-503(1)(b) (1972); S.C. CODE ANN. § 36-7-503(1)(b) (Law. Co-op.
1976); see supra note 68.
258. Under this argument section 7-503(1)(b), rather than revised section 9-309, would control the conflict at issue because Bank in Illustration 13 held a perfected se-
curity interest in the new inventory before the negotiable bill of lading was issued. See supra note 67, 243 and accompanying text; see also Dolan, supra note 67, at 8 (section 7-
503(1) applies to qualified holders of negotiable documents).
259. See U.C.C. 7-501(4) (1972); S.C. CODE ANN. § 36-7-501(4) (Law. Co-op. 1976);
see also supra notes 69-74 and accompanying text.
260. See U.C.C. § 7-503(1)(b) (1972); S.C. CODE ANN. § 36-7-503(1)(b) (Law. Co-op.
1976); see also supra notes 75-76.
262. U.C.C. § 7-502(1)(b) (1972); S.C. CODE ANN. § 36-7-502(1)(b) (Law. Co-op.
1976).
section 7-503(1).\textsuperscript{263} As a general rule, section 7-503(1) provides that a document of title confers no right in the goods covered by the document against a secured party who perfected a security interest in the goods before the negotiable document was issued. Subsection 7-503(1)(b), however, provides an exception to this general rule if the secured party acquiesced in the procurement of the document of title. Since section 7-503(1) limits the rights acquired by a holder of a negotiable document who took by due negotiation, the exception to the limitation should be available only to such holders.\textsuperscript{264} Therefore, to prevail under the section 7-503(1)(b) argument, Finance Company must initially establish that it acquired the negotiable bill of lading covering the new inventory by due negotiation.\textsuperscript{265}

To be duly negotiated, a negotiable document must be negotiated according to the terms of section 7-501.\textsuperscript{266} A negotiable document running to the order of a named person is negotiated by that person's endorsement and delivery.\textsuperscript{267} A negotiable document, however, may be negotiated only by delivery when, by its original terms, it runs to the bearer.\textsuperscript{268} Assuming that the negotiable bill of lading in Illustration 13 was properly negotiated to Finance Company, Finance Company must establish several additional facts to establish that it took by due negotiation. Section 7-501(4) requires Finance Company to establish that it purchased the negotiable bill of lading in good faith and for value and without notice of any defense against a claim to it.\textsuperscript{269} Additionally, Finance Company must establish that the negotiation was in the regular course of business or financing.\textsuperscript{270}

By extending credit to Dealer secured by the negotiable bill of lading, Finance Company purchased the document for value.\textsuperscript{271} Furthermore, Finance Company appears to have purchased the document in good faith and in the ordinary course of business. Therefore, the critical issue is whether Finance Company purchased the document without notice of an adverse claim. Whether Bank had an adverse claim to the document appears doubtful. Bank had a perfected security interest

\textsuperscript{264} See Dolan, supra note 67, at 17-21.
\textsuperscript{271} See U.C.C. § 1-201(44) (1972); S.C. Code Ann. § 36-1-201(44) (Law. Co-op. 1976).
in the new inventory, but it did not claim a security interest directly in
the bill of lading. Moreover, even if Bank had a claim to the bill of
lading, Bank’s financing statement should not constitute notice of its
security interest.272 Therefore, unless Finance Company had notice
other than the filing of Bank’s security interest, Finance Company
should qualify as a holder who took by due negotiation.

Under section 7-503(1), Finance Company’s status as a holder of a
negotiable document who took by due negotiation does not alone en-
able it to claim title to the goods free of Bank’s perfected security in-
terest. Finance Company must also establish that Bank acquiesced in
the procurement of the bill of lading.273 To establish that Bank acqui-
esced in the procurement of the negotiable bill of lading, Finance Com-
pany need not prove that Bank affirmatively consented to the docu-
men
tary sale of the new inventory and the procurement of the bill of
lading.274 Rather, Finance Company can establish acquiescence if it
proves that Bank had “knowledge of the likelihood of . . . shipment
with no objection or effort to control it.”275 Therefore, if Bank had
knowledge that Dealer regularly financed its purchases of new inven-
tory by negotiating bills of lading to financers and Bank made no effort
to control the practice, Finance Company has a reasonable claim that
Bank acquiesced within the meaning of section 7-503(1)(b).276

The final and most critical issue raised by Finance Company’s Ar-
ticle 7 argument is whether the provisions of section 7-503(1)(b)
supercede the priority rules of Article 9. The court addressed this issue
in Scallop Petroleum Co. v. Banque Trad-Credit Lyonnais S.A.277 and
concluded that Article 9, rather than section 7-503(1)(b), controlled a
priority conflict comparable to that presented in Illustration 13.278 The
court in Scallop Petroleum provided little analysis or authority to sup-
port its conclusion. The only decision the court cited to support its
position was Douglas-Guardian Warehouse Corp. v. Esslair Endsley
Co.279 Although the Douglas-Guardian court refused to apply section

273. See U.C.C. § 7-503(1)(b) (1972); S.C. CODE ANN. § 36-7-503(1)(b) (Law. Co-op.
1976); see generally supra notes 75-76 (discussing requirements of acquiescence).
274. See U.C.C. § 7-503 comment 1 (1972); S.C. CODE ANN. § 36-7-503 comment 1
275. U.C.C. § 7-503 comment 1 (1972); S.C. CODE ANN. § 36-7-503 comment 1 (Law.
Co-op. 1976).
276. See, e.g., United States v. Hexx, 444 F.2d 804, 814 n.34 (5th Cir. 1971); South
278. Id. at 190.
7-503(1)(b) to allow a subsequent-secured party who perfected through a document of title to prime an earlier-filed party, the decision is distinguishable.

In Douglas-Guardian the subsequent-secured party perfected through a non-negotiable warehouse receipt.\(^{280}\) The court held that section 7-503(1)(b) can be asserted only by holders of negotiable documents who take by due negotiation.\(^{281}\) Therefore, the court held that the subsequent-secured party was not entitled to assert section 7-503(1)(b).\(^{282}\) As a result, Douglas-Guardian does not support the conclusion in Scallop Petroleum that section 7-503(1)(b) is inapplicable to vary a determination of priority under Article 9 when the subsequent-secured party is a purchaser who took by due negotiation. Moreover, both commentators\(^{283}\) and other courts\(^{284}\) have asserted that section 7-503(1)(b) enables a qualified holder to reverse the priorities dictated by revised section 9-312(5)(a).

Although the Scallop Petroleum court's analysis of section 7-503(1)(b) is less than satisfying, the court indirectly supported its conclusion in its analysis of section 9-309.\(^{285}\) Section 9-309 provides a special priority rule to resolve certain conflicts over negotiable documents.\(^{286}\) The provision applies when an initial secured party perfects a nonpossessionary security interest in a negotiable document either by filing or automatically under revised section 9-304(4) or (5)(a) and a subsequent-secured party perfects a possessionary security interest in the document. Under section 9-309, the subsequent-secured party will pre-

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280. Id. at 180-81.
281. Id. at 190.
282. Id.
283. See Dolan, supra note 67, at 17-21; see also B. CLARK, supra note 8, ¶ 7.12, at 7-43. Professor Clark's analysis differs from that asserted above to the extent he considers section 7-503(1)(b) to be available to holders of nonnegotiable documents. See supra notes 257-58 and accompanying text. Nevertheless, Professor Clark advocates the following two-step analysis under which Finance Company could invoke section 7-503(1)(b) to overcome Bank's priority under Article 9:

(1) Does A [Bank] have priority over B [Finance Company] under the first-to-file-or-perfect rule of § 9-312(5)?

(2) If so, is this priority taken away because A [Bank] gave the debtor [Dealer] authority to store the goods or acquiesced in the issuance of the nonnegotiable warehouse receipt? The same analysis should apply when the battle is between a prior filed financing statement and the pledgee of a negotiable document issued after the filing.

B. CLARK, supra note 8, ¶ 7.12, at 7-43.

vail if the party qualifies as a holder to whom a negotiable document had been duly negotiated. Although technically inapplicable to the dispute in Scallop Petroleum,287 the court considered the purchase money financer’s rights under the provision. In essence, the court found that while the purchase money financer had possession of the negotiable bill of lading, the purchase money financer could assert priority under section 9-309.288 The court, however, apparently accepted the floating lienor’s argument that the purchaser money financer lost its status as a holder who took by due negotiations when it released the negotiable bill of lading to the debtor.289 Therefore, after it released the negotiable document, the purchase money financer could not rely upon section 9-309.

The analysis of section 9-309 in Scallop Petroleum can be applied to section 7-503(1)(b). In terms of Illustration 13, Finance Company arguably qualified as a holder of a negotiable bill of lading only while it retained possession of the document.290 Consequently, when Finance Company released the bill of lading to Dealer, it lost its status as a holder to whom a negotiable document of title had been duly negotiated. As a result, on release of the document Finance Company lost its ability to prime Bank under section 7-503(1)(b). After the release, Finance Company’s priority turned on compliance with the requirements of revised section 9-312(3).

Ultimately, this analysis represents the best accommodations of the conflicting policies of section 7-503(1)(b) and revised section 9-312(3). The policy of encouraging commercial reliance on negotiable documents of title supports a decision to subordinate the security interest of a floating lienor who acquiesces in the procurement of a negotiable document to the claim of a subsequent holder to whom the document has been duly negotiated. When the holder releases the negotiable document to the debtor without giving the floating lienor notification of the holder’s purchase money security interest, the policies of section 9-312(3) support a decision to subordinate the holder’s security interest in the goods. By releasing the negotiable document to the debtor without notification to the floating lienor, the purchase money financer has given the debtor the appearance of unencumbered ownership of the underlying goods. Hence, the debtor’s possession of

287. See supra note 67 and accompanying text.
289. Id.
290. See U.C.C. 1-201(20) (1972) (amended 1977); S.C. CODE ANN. § 36-1-201(20) (Law. Co-op. 1976). This section provides that “‘holder’ means 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.” S.C. CODE ANN. § 36-1-201(20) (Law. Co-op. 1976) (emphasis added).
the negotiable document has the potential to induce reliance on the part of the floating lienor. 291

3. Conflicting Purchase Money Security Interests

A final priority issue under revised section 9-312(3) arises when both secured parties hold purchase money security interests in the same item of inventory. If only one of the purchase money financers satisfies the conditions of revised section 9-312(3), that party should be entitled to priority. Moreover, the residual priority rule of revised section 9-312(5)(a) will apply if both of the purchase money financers fail to meet the conditions of revised section 9-312(3). 292 The interesting issue arises when both purchase money financers have met the conditions for priority under revised section 9-312(3). To illustrate this conflict consider the following:

ILLUSTRATION 14—On June 1 Finance Company and Boat Dealer entered into a security agreement under which Finance Company agreed to advance Dealer $40,000 to enable Dealer to purchase a sailboat from Manufacturer. The security agreement granted Finance Company a security interest in the sailboat to secure this loan. On June 1 Finance Company filed a financing statement covering the sailboat. Also on June 1, Finance Company drew a check for $40,000 payable jointly to Boat Dealer and Manufacturer.

On June 5 Manufacturer and Boat Dealer entered into a written contract under which Boat Dealer purchased the sailboat for $50,000. On June 5 Boat Dealer endorsed the $40,000 check over to Manufacturer as a down payment. On June 5 Boat Dealer and Manufacturer also executed a security agreement under which Manufacturer retained a security interest in the sailboat to secure the remaining $10,000 of the purchase price. Finally, on June 5 Manufacturer gave written notice of its security interest to Finance Company. On June 6 Manufacturer filed a financing statement covering the sailboat.

On June 7 Finance Company received the written notice of Manufacturer's security interest. On June 10 Boat Dealer received possession of the sailboat.

Both Finance Company and Manufacturer hold purchase money security interests in the sailboat. Finance Company's security interest arose under section 9-107(b), 293 and Manufacturer's arose under sec-

tion 9-107(a).294 Furthermore, both secured parties met the conditions for priority under revised section 9-312(3). Finance Company's security interest was perfected when Boat Dealer received possession of the inventory.295 Moreover, since no financing statements were filed against Boat Dealer's inventory when Finance Company filed, Finance Company's purchase money priority was not subject to the condition of giving written notification.296 Manufacturer's security interest also was perfected when Boat Dealer received possession,297 and Manufacturer satisfied the applicable condition of giving timely written notification.298 Thus, both secured parties qualify for the purchase money priority under revised section 9-312(3). Applying revised section 9-312(3), however, produces a less than satisfying result. On one hand, because Manufacturer has met the conditions of subsection (3), it "has priority over [the] conflicting security interest"299 asserted by Finance Company. On the other hand, Finance Company "has priority over [the] conflicting security interest"300 asserted by Manufacturer because Finance Company has also met the conditions of subsection (3).

Although other solutions have been proposed,301 most authorities would resolve the dilemma depicted in Illustration 14 either by applying the residual rule of revised section 9-312(5)(a) and awarding priority to the first secured party to file or perfect,302 or by ordering a pro rata distribution.303 In support of applying revised section 9-312(5)(a),

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301. See Johnson & Battersby, Article Nine Dual Purchase Money Financing: Creditor Priority, 67 Mich. B.J. 44 (1988). Johnson and Battersby advocate awarding priority to the seller over an institutional purchase money finance who filed first on the grounds that the institutional lender is in a better position to discover the potential conflict. Id. at 47.
302. See Framingham UAW Credit Union v. Dick Russell Pontiac, Inc., 41 Mass. App. Dec. 146 (1969); John Deere Co. v. Production Credit Ass'n, 686 S.W.2d 904, 907-08 (Tenn. Ct. App. 1984); see also White & Summers, supra note 87, § 24-5, at 1149 (when both parties comply with subsections (3) or (4) of section 9-312, priority should be determined under section 9-312(5)).
303. See B. Clark, supra note 8, ¶ 3.09[5], at 3-120; Legislation, Competing
one can argue that cases involving the conflict between two purchase money security interests that meet the conditions for a super priority "are not governed by" the rule stated in subsection (3).304 A more compelling argument in favor of applying subsection (5)(a), however, rests upon the basic structure of revised section 9-312. Although set forth as a residual rule, revised section 9-312(5)(a) can be viewed as a general priority rule which controls unless a party can establish an exception. Under this view, Finance Company is entitled to priority unless Manufacturer establishes that subsection (3) applies to award Manufacturer priority. Although Manufacturer meets the literal requirements of subsection (3), Finance Company can argue that the conflict in Illustration 14 is not within the intended scope of that provision.

The function of subsection (3) is to enable a subsequent purchase money financer to prime an earlier-filed secured party who claims the new inventory as after-acquired property.305 This special priority rule is often supported by an argument that the purchase money financer has given new value to enable the debtor to acquire the new inventory

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304. Professors White and Summers base their argument in favor of applying revised section 9-312(5) on the express language of that provision. See White & Summers, supra note 87, § 24-5, at 1149. The focus of their analysis, however, is on the parenthetic language, "(including cases of purchase money security interests which do not qualify for the special priorities set forth in subsections (3) and (4) of this section)" U.C.C. § 9-312(5) (1972) (amended 1977); S.C. CODE ANN. § 36-9-312(5) (Law. Co-op. Supp. 1989), rather than the preceeding language, "[i]n all cases not governed by other rules stated in this section" U.C.C. § 9-312(5) (1972) (amended 1977); S.C. CODE ANN. § 36-9-312(5) (Law. Co-op. Supp. 1989). White and Summers interpret the parenthetic language to cover cases in which a secured party is not "entitled to the special priority" under subsections (3) and (4). White & Summers, supra note 87, § 24-5, at 1149 (emphasis added). They then reason that if both secured parties satisfy the conditions for a purchase money priority, neither is "entitled" to priority under the special priority rules of subsections (3) and (4). Id. As a result, White and Summers conclude that the parenthetic language dictates the application of revised section 9-312(5)(a). Id.

The analysis set forth by White and Summers is not true to the language of the statute. The parenthetic language expressly covers cases in which the purchase money financiers "do not qualify for the special priorities" in subsection (3) and (4). U.C.C. § 9-312(5) (1972) (amended 1977); S.C. CODE ANN. § 36-9-312(5) (Law. Co-op. Supp. 1989) (emphasis added). In the conflict addressed by White and Summers, both secured parties "qualify" for priority under subsection (3), even though neither is "entitled" to priority under that subsection. Therefore, the argument advanced by White and Summers does not support their conclusion. A better argument in support of their position is that subsection (3) does not "govern" a conflict between two purchase money security interests which meet the conditions under that provision. See infra text accompanying note 305.

while the prior secured party has not.306 When the prior secured party is a purchase money financer, neither the purpose nor the rationale of subsection (3) is applicable. Moreover, the notification requirement is also irrelevant. The purpose of the notification requirement is to protect the prior secured party from relying on new inventory when making an advance.307 When the prior secured party is a purchase money financer, it typically will have extended credit before it receives notification. Therefore, Manufacturer arguably does not fall within the exception to revised section 9-312(5)(a) provided by subsection (3).

Initially, the application of revised section 9-312(5)(a) to resolve the dispute in Illustration 14 seems at least arguably consistent with the Code's basic policy of awarding priority based upon notice filing. Since Finance Company filed prior to Manufacturer, Manufacturer was on notice to inquire about Finance Company's security interest. Had Manufacturer made appropriate inquiries, it would have discovered that Finance Company had a purchase money security interest. Upon making this discovery, Manufacturer could have refused to go forward with the sale absent a subordination agreement. This argument is flawed, however, to the extent that revised section 9-312(3) purports to allow a purchase money financer meeting the conditions of that subsection to rely on its priority in the new inventory, even if an earlier filing covers the debtor's inventory.308 Therefore, the Code does not envision the purchase money financer making inquiry concerning the status of the security interest claimed under the earlier-filed secured party.309

Because revised section 9-312(3) encourages both purchase money financers to rely on having priority in the new inventory, subsection (3) arguably should control to the extent possible.310 Moreover, in order to afford both purchase money financers a benefit for complying with the requirements of subsection (3), their security interests arguably should rank equally and share pro rata.311 One way to justify this approach is

305. See supra notes 116-20 and accompanying text.
307. See supra notes 163-64 and accompanying text.
308. See B. CLARK, supra note 8, ¶ 3.09[5], at 3-120.
309. As a practical matter, however, when a prospective buyer tenders a down payment in the form of a check drawn by a lender payable jointly to the prospective buyer and seller, the seller should assume that the lender is engaged in purchase money financing. The seller should then withhold performance until it reaches a satisfactory agreement with the lender over the relative priority of their purchase money security interests.
310. See B. CLARK, supra note 8, ¶ 3.09[5], at 3-120; Special Project, supra note 124, at 883-84.
311. Although the Code does not expressly provide that security interests of equal rank share pro rata, this is the position adopted by Gilmore, see 2 G. GILMORE, supra note 56, § 34.5, at 913, and accepted by other commentators. See, e.g., Special Project, supra note 124, at 883 n.227.
to invoke general equitable principles under section 1-103.\textsuperscript{312} Another route to reaching a pro rata distribution is to invoke the principles of section 9-315\textsuperscript{313} to resolve the dispute.\textsuperscript{314} This latter approach is consistent with the view that the Uniform Commercial Code is a "true Code."\textsuperscript{315} Under this view of the Code, the resolution of problems not specifically addressed by the statute should be based upon principles extracted from statute.\textsuperscript{316}

The strongest argument for applying the pro rata distribution principle of section 9-315 to resolve the dispute in Illustration 14 is that in some situations section 9-315 directly controls the resolution of priority disputes between two inventory financers who both meet the conditions of revised section 9-312(3). To illustrate this point, consider the following:

**ILLUSTRATION 15**—Feed Company is in the business of manufacturing and selling animal feed consisting of a mixture of corn and soybeans. On June 1 Feed Company entered into a written agreement to purchase corn on credit from Seller I. This contract granted Seller I a security interest in the corn sold and in the manufactured animal feed to secure Feed Company's obligation to pay the purchase price of the corn. Also on June 1, Seller I filed a financing statement covering the corn and the animal feed. On June 2 Seller I delivered the corn to Feed Company.

On June 5 Feed Company entered into a written agreement to purchase soybeans from Seller II. This agreement granted Seller II a

\textsuperscript{312} U.C.C. § 1-103 (1972); S.C. Code Ann. § 36-1-103 (Law. Co-op. 1976); see B. Clark, supra note 8, ¶ 3.09(5), at 3-120.


(1) If a security interest in goods was perfected and subsequently the goods or a part of the goods have become part of a product or mass, the security interest continues in the product or mass if:

(a) the goods are so manufactured, processed, assembled, or commingled that their identity is lost in the product or mass; or

(b) a financing statement covering the original goods also covers the product into which the goods have been manufactured, processed, or assembled.

In a case to which paragraph (b) applies, no separate security interest in that part of the original goods which has been manufactured, processed or assembled into the product may be claimed under Section 36-9-314.

(2) When under subsection (1) more than one security interest attaches to the product or mass, they rank equally according to the ratio that the cost of the goods to which each interest originally attached bears to the cost of the total product or mass.


\textsuperscript{314} See Johnson & Battersby, supra note 301, at 44.


\textsuperscript{316} Id.
security interest in the soybeans and the animal feed to secure the purchase price of the beans. Also on June 5, Seller II filed a financing statement covering the soybeans and animal feed and gave written notice of its security interest to Seller I. Seller I received this notification on June 6. Seller II delivered the soybeans to Feed Company on June 7.

On June 10 Feed Company combined the corn and soybeans purchased from Seller I and Seller II, respectively, to produce animal feed. Subsequently Feed Company defaulted on its obligations to Seller I and Seller II and a priority dispute arose concerning the animal feed in Feed Company's possession.

Seller I had a purchase money security interest in the corn, and Seller II had a purchase money security interest in the soybeans. Moreover, the purchase money security interests of both Seller I and Seller II apparently continue in the animal feed. Finally, both Seller I and Seller II met the conditions for a super priority under revised section 9-312(3). As a result, Seller I and Seller II apparently find themselves in the same dilemma depicted in Illustration 14. In the present situation, however, the Code provides a special priority rule. Under section 9-315(2), the security interests of Seller I and Seller II rank equally. Consequently, they share pro rata based on the ratio of the costs of the goods each financed to the total cost of the animal feed. That the Code expressly provides a pro rata rule to resolve the conflict in Illustration 15 at least suggests that the court should apply a pro rata analysis in resolving the conflict in Illustration 14.

D. Consignments

The analysis of consignments under the Code is complicated by the fact that a manufacturer seeking a sales outlet for its goods may enter into any of four similar but legally distinct types of arrangements

321. Although revised section 9-312(3) or revised section 9-312(5)(a) could be interpreted to address the conflict in Illustration 15, under revised section 9-312(1) the special priority rule of section 9-315 controls.
with a dealer. First, the parties may enter into a standard sales contract that obligates the dealer to accept and pay for all goods conforming to the contract. Under a standard sales contract the dealer assumes the risk that it will be unable to sell the goods. In many standard sales contracts the manufacturer will extend credit to the dealer to enable the dealer to use the proceeds from the resale of the goods to pay the purchase price. When a manufacturer sells the goods on credit, it may retain a purchase money security interest in the goods to secure the dealer's obligation to pay the purchase price. For the manufacturer's security interest to prime the claims of subsequent lien creditors and secured parties, the manufacturer must perfect its security interest. Furthermore, for the manufacturer to prime an earlier-filed secured party claiming a floating lien upon the dealer's inventory, the manufacturer must satisfy the requirements of revised section 9-312(3).

The second type of agreement the manufacturer and dealer may enter into is a "sale or return" agreement. A sale or return transaction is a true sale under which title passes to the dealer when the manufacturer completes physical delivery. A sale or return transaction, however, differs from a standard sales agreement in that the buyer may return unsold goods even though they conform to the contract. Therefore, the dealer under a sale or return agreement does not assume the risk that it will be unable to sell the goods. The goods in the possession of a dealer under a sale or return are subject to the claims of the dealer's creditors. Therefore, the manufacturer in a sale or return situation must retain and perfect a purchase money security interest to be protected from the dealer's creditors. Moreover, since

324. See U.C.C. § 2-326(1)(b) (1972); S.C. CODE ANN. § 36-2-326(1)(b) (Law. Co-op. 1976). This section provides that "[u]nless otherwise agreed, if delivered goods may be returned by the buyer even though they conform to the contract, the transaction is...a 'sale or return' if the goods are delivered primarily for resale." S.C. CODE ANN. § 36-2-326(1)(b) (Law. Co-op. 1976).
326. See Winship, supra note 325, at 836.
329. See Winship, supra note 325, at 837, 849; see also U.C.C. § 2-401(1) (1972); S.C. CODE ANN., § 36-2-401(1) (Law. Co-op. 1976) ("Any retention or reservation by the seller of the title (property) in goods shipped or delivered to the buyer is limited in effect to a
the dealer in a sale or return acquires rights in the goods upon their delivery, the manufacturer must comply with the conditions of revised section 9-312(3) in order to prime the claim of the dealer’s earlier-filed inventory financer claiming a security interest in the goods pursuant to an after-acquired property clause.\textsuperscript{330}

The third potential arrangement between the manufacturer and the dealer is a consignment intended as security.\textsuperscript{331} Under a “security consignment,” the consignor’s interest in the goods is limited to an Article 9 security interest.\textsuperscript{332} In effect, a security consignment is a sale under which the manufacturer retains a purchase money security interest in the goods to secure the dealer’s obligation to pay the purchase price. Therefore, the consignor under a security consignment must comply with all the requirements of Article 9 to obtain priority over lien creditors and secured parties asserting claims to the goods in the possession of the consignee.\textsuperscript{333} These requirements include not only the perfection of the security interest, but also compliance with the requirements of revised section 9-312(3) if the adverse interest is an earlier-filed inventory financer of the debtor. As discussed below, the principal problem involving security consignments is distinguishing them from true consignments.\textsuperscript{334}

The final possible arrangement between the manufacturer and the dealer is a true consignment. In legal theory a true consignment is distinct from a pure sale, a sale or return, and a security consignment. If the manufacturer purports to retain title to the goods in a pure sale, a sale or return, or a security consignment, the manufacturer’s interest is limited to an Article 9 security interest.\textsuperscript{335} As a result, the manufacturer must comply with the provisions of Article 9 to protect its secur-

\textsuperscript{330} Cf. Winship, supra note 325, at 849 (“[If the seller [in a sale or return] gives credit to the buyer and wishes to secure payment, he should be subject to all the provisions of article 9.”).

\textsuperscript{331} See generally 1 G. Gilmore, supra note 56, § 11.2, at 337-40 (pre-Code and Code treatment of leases and consignments as security); White & Summers, supra note 87, § 21-4, at 942-43 (determination of whether a consignment is a security consignment); Hawkland, The Proposed Amendments to Article 9 of the UCC—Part 5: Consignments and Equipment Leases, 77 Com. L.J. 108, 108-10 (1972) (unless the parties intend otherwise, the net effect of the Code is to regard consignments as security interests governed by Article 9); Winship, supra note 325, at 828-58 (historical development of consignments and their treatment under Articles 2 and 9).


\textsuperscript{333} Hawkland, supra note 331, at 109; Winship, supra note 325, at 839.

\textsuperscript{334} See infra notes 374-97 and accompanying text.

ity interest against the dealer's creditors. In contrast, under a true consignment, the manufacturer does retain title to the goods, and merely transfers possession to the dealer. The dealer then acts as an agent of the manufacturer for the purpose of selling the goods to third parties. In the event the dealer makes a sale, title to the goods passes directly from the manufacturer to the buyer. The dealer collects the purchase price from the buyer, and after deducting a commission for its services, forwards the purchase price to the manufacturer. In the event the dealer does not sell the goods, the dealer must return them.

Under a true consignment the dealer is not liable for the price of the goods if it is unable to sell them. The manufacturer's interest in the goods in the dealer's possession is not limited to a security interest under a true consignment. Rather, the manufacturer remains the owner of the goods. Therefore, Article 9 does not require the manufacturer to retain and perfect a security interest in the consigned goods to be protected from the dealer's creditors. Moreover, since the dealer in a true consignment holds the goods as an agent for the manufacturer, the dealer does not have sufficient rights in the goods for an inventory financer of the dealer to assert a security interest in those goods under an after-acquired property clause. Therefore, the conditions of revised section 9-312(3) do not apply to the manufacturer's priority over an earlier-filed inventory financer of the dealer.

Although the consignor retains title to the goods in a true consignment, from the perspective of a creditor of the consignee, the consignment has the appearance of a sale of inventory to the consignee. Therefore, unless the consignor provides creditors of the consignee with some notice of its claim to the goods, the problem of apparent

336. See supra notes 323, 329 and accompanying text.
337. See 1 G. Gilmore, supra note 56, § 3.5, at 73-74; Winship, supra note 325, at 826.
338. See Greenwood Mfg. Co. v. Worley, 222 S.C. 156, 161, 71 S.E.2d 886, 891 (1952); Rio Grande Oil Co. v. Miller Rubber Co., 31 Ariz. 84, 87, 250 P. 564, 565 (1926) ("[A] consignment of goods for sale does not pass the title at any time, nor does it contemplate that it should be passed. The very term implies an agency, and that the title is in the consignor, the consignee being his agent."); Winship, supra note 325, at 826.
339. See 1 G. Gilmore, supra note 56, § 3.5, at 73-74; Winship, supra note 325, at 826.
340. See 1 G. Gilmore, supra note 56, § 3.5, at 73.
341. See supra notes 337-38 and accompanying text.
342. See Winship, supra note 325, at 840-41.
343. See id. Cf. A. Lassberg & Co. v. Atlantic Cotton Co., 291 S.C. 161, 252 S.E.2d 50 (Ct. App. 1987) (security interest does not attach to goods held by an agent unless agent has rights in the collateral such as ownership or contract rights).
ownership will arise. The Code addresses this problem in section 2-326(3) and in new section 9-114. Although the Code does not subject true consignments to Article 9, these provisions, in effect, impose the priority requirements of Article 9 on consignors in most, but not all, true consignments.

Section 2-326(3) grants the basic protection afforded to creditors of a true consignee. The provision, however, operates in a somewhat

345. U.C.C. §§ 2-326(3) (1972); S.C. Code Ann. § 36-2-326(3) (Law. Co-op. 1976). This subsection provides:

Where goods are delivered to a person for sale and such person maintains a place of business at which he deals in goods of the kind involved, under a name other than the name of the person making delivery, then with respect to claims of creditors of the person conducting the business the goods are deemed to be on sale or return. The provisions of this subsection are applicable even though an agreement purports to reserve title to the person making delivery until payment or resale or uses such words as "on consignment" or "on memorandum." However, this subsection is not applicable if the person making delivery

(a) complies with an applicable law providing for a consignor's interest or the like to be evidenced by a sign, or

(b) establishes that the person conducting the business is generally known by his creditors to be substantially engaged in selling the goods of others, or

(c) complies with the filing provisions of the chapter on secured transactions (Title 36, Chapter 9).


(1) A person who delivers goods under a consignment which is not a security interest and who would be required to file under this chapter by paragraph (3)(c) of Section 36-2-326 has priority over a secured party who is or becomes a creditor of the consignee and who would have a perfected security interest in the goods if they were the property of the consignee, and also has priority with respect to identifiable cash proceeds received on or before delivery of the goods to a buyer, if

(a) the consignor complies with the filing provision of the chapter on Sales with respect to consignments (paragraph (3)(c) of Section 36-2-326) before the consignee receives possession of the goods;

(b) the consignor gives notification in writing to the holder of the security interest if the holder has filed a financing statement covering the same types of goods before the date of the filing made by the consignor;

(c) the holder of the security interest receives the notification within five years before the consignee receives possession of the goods;

(d) the notification states that the consignor expects to deliver goods on consignment to the consignee, describing the goods by item or type.

(2) In the case of a consignment which is not a security interest and in which the requirements of the preceding subsection have not been met, a person who delivers goods to another is subordinate to a person who would have a perfected security interest in the goods if they were the property of the debtor.

indirect manner. Under section 2-326(3) certain true consignments are deemed to be sale or return transactions unless the consignor satisfies at least one of three statutory requirements. These requirements are designed to insure that the consignee’s creditors have notice that consigned goods in the consignee’s possession are the property of the consignor. The effect of deeming a true consignment to be a sale or return is to subject the goods in the consignee’s possession to the claims of the consignee’s creditors.347

For section 2-326(3) to apply to a true consignment, three circumstances must be present.348 First, the goods must be delivered to the consignee for sale.349 Second, the consignee must maintain a place of business at which the consignee deals in goods of that kind.350 Third, the consignee must do business under a name other than the name of the consignor.351 If these three circumstances are present, the true consignment will be deemed a sale or return unless the consignor meets at least one of the requirements set forth in section 2-326(3)(a) through (c).

Under subsection (a) of section 2-326(3), a consignor can prevent the recharacterization of a true consignment by complying with an applicable sign-posting statute.352 Since South Carolina does not have such a statute,353 this alternative is not available to a true consignor in a transaction subject to the law of South Carolina. Under subsection (b), a true consignment will not be deemed a sale or return if the consignor can establish that the consignee is “generally known by his creditors to be substantially engaged in selling the goods of others.”354 The protection available under subsection (b) is subject to a difficult burden of proof.355 Therefore, a consignor should not rely on subsection

353. See generally 1 G. GILMORE, supra note 56, § 3.5, at 74 n.3 (listing states that have enacted sign-posting statutes).
(b) at the planning stage of a transaction. The basic method by which a consignor can protect its interest in the goods from the claims of the consignee's creditors is provided by subsection (c). Under section 2-326(3)(c), a true consignment will not be deemed a sale or return if the consignor "complies with the filing provisions of the Article on Secured Transactions (Article 9)." Therefore, the prudent true consignor will file a financing statement covering the consigned goods.

Although section 2-326(3) reduces the problems of a consignor's apparent ownership in a true consignment, the provision does not fully protect creditors of such consignees. The shortcomings of section 2-326(3) flow from two aspects of the provision. First, section 2-326(3) does not apply to all true consignments. In those true consignments that are outside the scope of the provision, a consignor's right to the goods is not conditioned upon providing notice of its interest under subsections (a) through (c). Second, if a consignor meets the public notice requirements of subsections (a) through (c) of section 2-326(3), the consignor's ownership interest is apparently preserved against all creditors of the consignee, including an earlier-filed inventory financer holding a floating lien upon the consignee's inventory. The notice afforded under subsections (a) through (c), however, appears inadequate to protect an earlier-filed inventory financer of the consignee who may make a future advance in reliance on the consigned goods as after-acquired property subject to the financer's security interest.

Although the drafters of the 1972 Official Text did little to remedy the first shortcoming of section 2-326(3), they did address the second shortcoming in new section 9-114. Under section 9-114, in order to preserve an ownership interest in consigned goods against an inventory


356. U.C.C. § 2-326(3)(c) (1972). For the substantially same provision as adopted in South Carolina, see supra note 345.

357. See U.C.C. § 9-408 (1972) (amended 1977); S.C. CODE ANN. § 36-9-408 (Law. Co-op. Supp. 1989). The provision, enacted in 1988 in South Carolina, provides for a filing by a consignor under a true consignment. Moreover, if the consignment is subsequently determined to be a security consignment subject to Article 9, the consignor filing will be effective to perfect the consignor's security interest in the consigned goods.


360. See generally supra text accompanying notes 163-291 (section 9-312(3) requires purchase money financers to give actual notice to certain prior secured parties).

361. By enacting section 9-408 the drafters may have encouraged consignors not subject to section 2-326(3) to file a protective financing statement.
financer who filed before the consignment, most true consignors must satisfy filing and notification requirements essentially identical to those imposed upon purchase money inventory financiers under revised section 9-312(3). Section 9-114, however, does not fully protect prior inventory financiers of consignees who acquire goods pursuant to a true consignment. Section 9-114 applies only to true consignors "who would be required to file under this Article by paragraph (3)(c) of Section 2-326." 362

The courts have interpreted this language to mean that if a true consignor has or could have met the conditions of section 2-326(3)(a) or (b), the true consignor is not required to meet the filing and notification requirements of section 9-114 in order to prime an earlier-filed inventory financier of the consignee. 363 Therefore, if a true consignor can establish that the consignee "is generally known by his creditors to be substantially engaged in selling the goods of others," 364 the consignor is entitled to priority over the consignee's inventory financer despite the consignor's failure to meet the requirements of section 9-114. 365

Thus even after the enactment of the 1972 Official Text, two gaps remain in the protection afforded inventory financiers of a true consignee. First, as discussed above, if a consignor in a true consignment subject to section 2-326(3) has or could have satisfied the requirements of that provision without filing, it is not subject to the filing and notification requirements of section 9-114. 366 The second and more basic gap in the protection afforded inventory financiers arises because some true consignments are not within the scope of section 2-326(3). In those cases the consignor's interest is valid against a consignee's inventory financer despite the consignor's failure to meet any of the public notice requirements of section 2-326(3)(a) through (c). 367

Although most commercially significant true consignments are covered by section 2-326(3), some of the case law interpreting the

365. See BFC Chems., Inc., 46 Bankr. at 1019-20 (section 9-114 inapplicable when consignor satisfied sign-posting requirement of section 2-326(3)(a) or can establish general knowledge of creditors under section 2-326(3)(b)).
366. See supra notes 362-65 and accompanying text.
scope of the provision is alarming. Some courts, although a minority, have held that a consignment is not "for sale" within the meaning of section 2-326(3) when the consignee's authority is limited to soliciting offers subject to the consignor's approval.368 Moreover, courts have excluded consignments from the scope of section 2-326(3) when the consignee does not maintain "a place of business," even if the consignee deals in goods of the kind consigned.369 Finally, courts have held that section 2-326(3) does not apply when the consignee is not in physical possession of the goods.370 This limitation on the scope of section 2-326(3) can adversely affect a consignee's inventory financer when the consignee appears to have rights in the goods without taking physical possession of them.

Thus, two sets of rules are potentially applicable to resolve a priority dispute between a consignor who retained title to the consigned goods and the creditors of the consignee. If the consignment is a security, the consignor's interest in the goods is limited to a purchase money security interest.371 Therefore, Article 9 controls the resolution of conflicts between the consignor and creditors of the consignee.372 In contrast, if the consignment is a true consignment, priority disputes between the consignor and creditors of the consignee are governed by sections 2-326(3) and 9-114.373 Because the priority rules under sections 2-326(3) and 9-114 are not identical to the Article 9 priority rules applicable to purchase money inventory financers, it may be essential to determine whether a consignment is a true consignment or a security consignment. Unfortunately, the distinction between the two is not always clear.374


369. See, e.g., Roudebush, 20 Bankr. at 631; Manger, 619 P.2d at 692-93; see also Cantor v. Anderson, 639 F. Supp. 364 (S.D.N.Y.) (section 2-326 not applicable even though consignee maintained a place of business at which the consignor dealt in goods of the kind involved because creditor never saw goods at the business, but only at the consignee's home), aff'd, 333 F.2d 1002 (2d Cir. 1966).


372. See Hawkland, supra note 331, at 109; Winship, supra note 325, at 839.

373. See Hawkland, supra note 331, at 109; Winship, supra note 325, at 840-42.

374. See Duesenberg, Consignments Under the UCC: A Comment on Emerging
Under revised section 1-201(37),\(^{375}\) the issue turns upon the intent of the parties at the time they entered into the consignment arrangement.\(^{376}\) The difficult aspect of this issue is identifying the objective criteria for determining the parties' intent. Commentators have advocated a variety of tests that focus upon the function served by the consignment.\(^{377}\) Under the leading test, articulated by Dean Hawkland, a consignment is a security consignment unless it is imposed by the consignor to control retail prices.\(^{378}\)

Other tests have focused on the relationship between the consignor and consignee as one of principal and agent,\(^{379}\) or whether the consignment is the functional equivalent of a floor plan.\(^{380}\) Perhaps the most straightforward test has been advocated by Professor Winship.\(^{381}\) Under Winship's analysis, the critical consideration is when the consignee incurs an obligation to pay for the consigned goods.\(^{382}\) If the consignee incurs the obligation upon receipt of delivery, but could satisfy the obligation by returning the unsold goods for a credit, the transaction is a security consignment subject to Article 9.\(^{383}\) In contrast, if the consignee is not obligated to pay for the goods until they are sold and can return the unsold goods, the transaction is a true consignment.\(^{384}\)

Winship's test conforms to the common law notions of consignment\(^{385}\) and provides a relatively high degree of certainty. Moreover, although Winship's definition of a security consignment could include a sale or return, it does not result in an inconsistency between sections 9-201\(^{386}\) and 2-326(2).\(^{387}\) If the seller in a sale or return retains title to

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\(^{377}\) See Underwriters at Lloyds v. Shimer (In re Ide Jewelry Co.), 75 Bankr. 969, 977 (Bankr. S.D.N.Y. 1987); Duesenberg, supra note 374, at 575.

\(^{378}\) See Winship, supra note 325, at 846-49.

\(^{379}\) Hawkland, supra note 331, at 109; Hawkland, Consignment Selling Under the Uniform Commercial Code, 67 Com. L.J. 146, 148 (1962) [hereinafter Hawkland, Consignment Selling]; see Columbia Int'l Corp. v. Kempler, 46 Wis. 2d 550, 559-60, 175 N.W.2d 465, 469 (1970).

\(^{380}\) See Duesenberg, supra note 374, at 575.

\(^{381}\) See White & Summers, supra note 87, § 21-4, at 943.

\(^{382}\) Id.

\(^{383}\) Id.

\(^{384}\) Id.

\(^{385}\) See supra text accompanying note 340.


Exception as otherwise provided by this title a security agreement is effective according to its terms between the parties, against purchasers of the collateral.
the goods in the possession of the buyer, the transaction is a security consignment subject to Article 9.\textsuperscript{388} In such a case, the seller has an Article 9 security interest,\textsuperscript{389} which is valid against unsecured creditors under section 9-201 even if it is unperfected. In contrast, if the seller in a sale or return does not retain title to the goods, the goods in possession of the buyer are subject to the claims of any unsecured creditors under section 2-326(2).

Although the courts have addressed the issue of whether a consignment was intended as security in only a small number of reported decisions,\textsuperscript{390} one recent decision indicates that a court may consider a broad range of factors in determining the parties' intent.\textsuperscript{391} In Underwriters at Lloyds v. Shimer (In re Ide Jewelry Co.)\textsuperscript{392} the court listed the following factors as evidence that the consignment was intended as security: (1) the consignee set the price at which the goods were sold; (2) the consignee was billed upon shipment; (3) the consignee commingled the proceeds and failed to keep proper accounts; (4) the consignee mixed the consigned good with its own goods; and (5) the consignor purported to retain title until it was paid.\textsuperscript{393} The court in Ide Jewelry also listed the following factors as evidencing an intent to create a true consignment: (1) the consignor retaining control over the price at which the consignee sells the goods; (2) the consignee being given possession with the authority to sell only upon the consignor's express consent to the sales price; (3) the consignor being able to recall the goods; and against creditors. Nothing in this chapter validates any charge or practice illegal under any statute or regulation under the statute governing usury, small loans, retail installment sales, or the like, or extends the application of any statute or regulation to any transaction not otherwise subject to the statute or regulation.

387. U.C.C. § 2-326(2) (1972); S.C. Code Ann. § 36-2-326(2) (Law. Co-op. 1976). This section provides that "[e]xcept as provided in subsection (3), goods held on approval are not subject to the claims of the buyer's creditors until acceptance; goods held on sale or return are subject to such claims while in the buyer's possession." S.C. Code Ann. § 36-2-326(2) (Law. Co-op. 1976).
391. Ide Jewelry, 75 Bankr. at 976-79.
393. Id. at 978.
(4) the consignee receiving a commission for services and not a profit on the sale; (5) the consigned goods being separated from other property of the consignee; (6) the consignor being entitled to inspect the sales records and physical inventory of the consignee; and (7) the consignee having no obligation to pay for the goods unless they are sold.394

Although some of the factors listed in Ide Jewelry appear to be less than compelling evidence of the character of a consignment, the court's analysis incorporates the positions taken by the leading commentators. Under the Ide Jewelry opinion, whether the consignment was used to enable the consignor to control retail prices is relevant.395 Moreover, the extent of the control asserted by the consignor over the consignee's business is relevant, and thus consistent with the position that the existence of a principal-agent relationship should control the character of the consignment.396 Finally, whether the consignee incurs an obligation to pay for the goods upon delivery or upon resale is relevant.397

Fortunately, given the uncertainty over the distinction between true consignments and security consignments, the resolution of the issue is critical in only a limited number of cases. If the consignor files a financing statement pursuant to section 2-326(3)(c) in order to protect its interest in the goods from the claims of the consignee's creditors, the consignor will have a perfected security interest in the goods in the event the consignment is found to be a security consignment.398 Moreover, if a consignor complies with the filing and notification requirements of new section 9-114 in order to protect its interest from the claim of the consignee's inventory financer, the consignor will be entitled to priority over the inventory financer under revised section 9-312(3) in the event the consignment is a security consignment.

The characterization of the consignment is critical, however, in three significant situations. The first situation arises when the consignment, if a true consignment, is not within the scope of section 2-326(3), and the consignor has failed to comply with either the requirements of section 2-326(3)(a) through (c) and section 9-114, or the requirements of Article 9.399 If the consignment is a true consignment outside the scope of section 2-326(3), the consignor's interest in the goods is valid.

394. Id.
396. See Duesenberg, supra note 374, at 575.
397. See Winship, supra note 325, at 849.
against creditors of the consignee, even though the consignor failed to comply with the requirements of sections 2-326(3)(a) through (c).\footnote{400} Furthermore, since section 9-114 applies only to a consignor required to file under section 2-326(3)(c), the consignor’s failure to meet the filing and notification requirements of section 9-114 will not subordinate its interest in the goods to the consignee’s inventory financer. In contrast, if the consignment is a security consignment, the consignor’s interest is limited to an unperfected security interest subordinate to the claims of some of the consignee’s creditors, including the inventory financer.\footnote{401}

The second situation in which the classification of a consignment is critical arises when the consignment, if a true consignment, is within the scope of section 2-326(3) and the consignor satisfies the requirements of that provision in a manner other than filing. If the consignment is a true consignment, the consignor’s interest in the goods is protected from the claims of the consignee’s creditors because the consignor satisfied the conditions of section 2-326(3)(a) or (b). In contrast, if the consignment is a security consignment, the consignor’s interest is limited to an unperfected security interest.\footnote{402}

The final situation in which the classification of a consignment is critical is a variation of the second. In this final situation, however, the consignor has filed but has not met the notification requirements of section 9-114, and the adverse interest is asserted by an inventory financer claiming a perfected security interest in the consignee’s after-acquired inventory. To illustrate this situation, consider the following:

ILLUSTRATION 16—Dealer maintains a place of business at which the Dealer sells furniture. In addition, Dealer is generally known by Dealer’s creditors to be substantially engaged in selling the furniture of others. On June 1 Bank and Dealer entered into a security agreement that granted Bank a security interest in Dealer’s current and after-acquired inventory of furniture to secure a contemporaneous loan and any future advances. Also on June 1, Bank properly filed a financing statement covering dealer’s inventory of furniture.

On July 1 Dealer entered into a consignment agreement with Manufacturer under which Manufacturer agreed to consign a shipment of new furniture to Dealer. Also on July 1, Manufacturer properly filed a financing statement that listed Dealer as consignee and Manufacturer as consignor, and described the new furniture as consigned goods. Manufacturer, however, did not give written notification


\footnote{401} See, e.g., Ide Jewelry, 75 Bankr. at 969.

of the consignment to Bank. On July 5 Dealer received possession of the shipment of new furniture.

On August 1 Dealer defaulted under the terms of the security agreement with Bank, and Bank sought to enforce its security interest against the new furniture.

If the consignment between Manufacturer and Dealer was a true consignment, Manufacturer is entitled to priority over Bank. Although Manufacturer failed to meet the written notification requirements of section 9-114(1)(b) through (d), the courts have held that section 9-114 applies only to true consignments under which filing is the exclusive manner in which the consignor can satisfy the requirements of section 2-326(3)(a) through (c).\(^{403}\) In Illustration 16 Manufacturer could have satisfied the conditions of section 2-326(3) without filing by establishing that Dealer was generally known by Dealer’s creditors to be substantially engaged in selling the goods of others.\(^ {404}\) Therefore, Manufacturer is not subject to the special notification requirement of section 9-114. As a result, Manufacturer will prevail over Bank pursuant to section 2-326(3)(b).

In contrast, if the consignment between Manufacturer and Dealer is a security consignment, Bank is entitled to priority. Under a security consignment Manufacturer’s interest in the new furniture is limited to a purchase money security interest in inventory. Therefore, in order to prime Bank, Manufacturer had to meet all applicable requirements under Article 9.\(^ {405}\) Although Manufacturer met the perfection requirement of revised section 9-312(3)(a),\(^ {406}\) it failed to meet the notification requirement set forth in subsections (b) through (d) of that provision.\(^ {407}\) As a result, Manufacturer cannot claim a super priority under revised section 9-312(3). The residual priority rule of revised section 9-312(5)(a) will govern the conflict between Bank and Manufacturer. Under that provision, Bank is entitled to priority on the basis of its earlier filing.\(^ {408}\)

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405. See General Elec. Credit Corp., 437 So. 2d at 1245.
408. Illustration 16 suggests an additional issue that can arise in a priority dispute between a true consignor and an earlier-filed inventory financer of the consignee. This issue will arise when the following situation exists: (1) the true consignor has filed pursuant to section 2-326(3)(c) and cannot meet the requirements of either subsection (a) or...
In summary, although the analysis above indicates that in some cases a consignor can prevail over creditors of the consignee without meeting the requirements of sections 2-326(3)(c) and 9-114(1), the only prudent course of conduct for a consignor is to file in the manner prescribed in those sections and to comply with the notification requirements of sections 9-114(1)(b) through (d). If the consignment is a true consignment, the consignor's satisfaction of these requirements will protect its interest in the consigned goods against the claims of the consignee's creditors, including the consignee's inventory financer. Moreover, if the consignment is found to be a security consignment, compliance with these requirements will assure the consignor of a purchase money priority in the consigned goods.

The South Carolina Court of Appeals in A. Lassberg & Co. v. Atlantic Cotton Co. recently considered a priority conflict between an

(b) of that provision; (2) the true consignor has failed to meet the notification requirement of section 9-114(1)(b) through (d); and (3) despite an inability to establish that the consignee was generally known by its creditors to be substantially engaged in selling the goods of others, the true consignor can establish that the inventory financer knew that the consignee was selling goods delivered by the consignor pursuant to the true consignment. The issue presented in this situation is whether the inventory financer's actual knowledge excuses the consignor's failure to comply with section 9-114(1). Some courts have excused a true consignor's failure to satisfy the conditions of section 2-326(3)(a) through (c) when an inventory financer has actual knowledge that the consignor is selling goods consigned by the consignor. See GBS Meat Indus. Pty Ltd. v. Kress-Dobkin Co., 474 F. Supp. 1357, 1362-63 (W.D. Pa. 1979), aff'd, 622 F.2d 578 (3d Cir. 1980); First Nat'l Bank v. Olsen, 403 N.W.2d 661, 665 (Minn. Ct. App. 1987). These courts stressed that the objective of protecting creditors of a consignee from problems of apparent ownership is realized when the creditor has actual knowledge that the goods are held on consignment.

In contrast, the court in Multibank National v. State Street Auto Sales, Inc. (In re State Street Auto Sales, Inc.), 81 Bankr. 215 (Bankr. D. Mass. 1988), held that an inventory financer's actual knowledge did not excuse a true consignor's failure to comply with section 9-114(1). In essence, the court held that under the system of notification imposed under section 9-114(1), an inventory financer was entitled to rely upon goods consigned to the consignee unless the inventory financer received the written notification mandated by the statute. The court's insistence upon formal notification in State St. Auto Sales is consistent with case law interpreting the notification requirements of section 9-312(3). See Elhard v. Prairie Distriba., Inc., 366 N.W.2d 465, 468 (N.D. 1985); Manufacturers Acceptance Corp. v. Penning's Sales, Inc., 5 Wash. App. 501, 508-09, 487 P.2d 1053, 1058 (1971). Nevertheless, the court's refusal to excuse noncompliance with the notification requirements of section 9-114(1) in the face of the inventory financer's actual knowledge appears unreasonable in light of the court's conclusion that the requirements of section 9-114(1) would not apply at all if the consignor had met the general knowledge requirement of section 2-326(3)(b). See cases cited supra note 403. The decision appears even more questionable considering the fact that the consignor might have satisfied the general knowledge requirement without establishing that the inventory financer had actual knowledge.

owner who transferred cotton to a cotton broker for sale and an inventory financer of the broker. The court, however, failed to consider the effect of section 2-326 on the rights of the parties. Moreover, new section 9-114 was not in effect at the time of the transfer. Nevertheless, the facts in Lassberg suggest a number of significant issues under sections 2-326 and 9-114.

In Lassberg a cotton broker, Mahaffey, entered into a security agreement with A. Lassberg & Co. that granted Lassberg a security interest in Mahaffey's inventory of cotton. The court assumed that Lassberg properly perfected its security interest. After granting the security interest, Mahaffey entered into an arrangement with Pecot, Ltd., a Texas cotton firm, under which Mahaffey found buyers for Pecot's cotton. When Mahaffey found a buyer, he would contact Pecot, who would then ship the cotton necessary to fill the order to a warehouse in Spartanburg, South Carolina. The buyer would get the cotton from the warehouse and make payment to Mahaffey. Mahaffey, in turn, would deduct a sales commission from the purchase price and remit the balance to Pecot.410

The conflict in Lassberg involved a shipment of cotton that a buyer refused to accept. Following the rejection of the cotton, Mahaffey, apparently without Pecot's authorization, had the Spartanburg warehouse issue negotiable warehouse receipts to him covering the rejected cotton. Mahaffey held these warehouse receipts for four or five days while attempting to resell the rejected cotton. When Mahaffey was unable to resell the cotton, he sent the negotiable warehouse receipts to Pecot.411

The court ruled against Lassberg, Mahaffey's inventory financer, and in favor of Pecot on the grounds that Mahaffey did not acquire sufficient rights in the cotton delivered by Pecot for Lassberg's security interest to attach.412 The court asserted that for a debtor to have rights in collateral sufficient for a security interest to attach, the debtor must have an ownership interest or contract right in the collateral.413 The court found that Mahaffey had neither. Rather, the court found on uncontradicted evidence that Mahaffey simply served as Pecot's broker.414

The Lassberg court's conclusion that Mahaffey did not have rights in the cotton sufficient for Lassberg's security interest to attach is consistent with the general rule that an unauthorized agent cannot grant a

410. Id. at 162-63, 352 S.E.2d at 501.
411. Id. at 163-64, 352 S.E.2d at 502.
412. Id., 352 S.E.2d at 502-03.
413. Id. at 164, 352 S.E.2d at 502-03.
414. Id., 352 S.E.2d at 503.
security interest in the principal’s property.\textsuperscript{415} This general rule, however, is subject to an exception when the agent has possession of the principal’s property under a consignment which is deemed to be a sale or return under section 2-326(3).\textsuperscript{416} A significant weakness in the \textit{Lassberg} decision results from the parties’ failure to raise, and hence the court’s failure to consider, the effect of section 2-326 on the dispute in issue.\textsuperscript{417} If the transaction between Pecot and Mahaffey constituted a “sale or return,” the cotton in Mahaffey’s possession was subject to the claims of his creditor’s.\textsuperscript{418} Therefore, if the transaction was a sale or return, Pecot’s interest in the cotton was subject to Lassberg’s security interest.\textsuperscript{419}

The transaction between Pecot and Mahaffey was not a true sale or return. A true sale or return is an actual sale under which the buyer may return the goods even if they conform to the contract.\textsuperscript{420} In \textit{Lassberg} the court found on uncontradicted evidence that Pecot never sold cotton to Mahaffey.\textsuperscript{421} That the transaction was not a true sale or return, however, does not preclude the application of section 2-326(2). Even if the parties intend to create a limited bailment or a sales agency rather than a true sale or return, the transaction may be deemed a sale or return under section 2-326(3).\textsuperscript{422}

Had the parties raised section 2-326(3),\textsuperscript{423} the court in \textit{Lassberg} would have confronted two issues. First, the court would have been required to determine whether the transaction between Pecot and Mahaffey fell within the scope of subsection (3).\textsuperscript{424} Second, if the court


\textsuperscript{416} See supra notes 347-57 and accompanying text.


\textsuperscript{420} See supra notes 325-26 and accompanying text.

\textsuperscript{421} A. Lassberg, 291 S.C. at 164-65, 352 S.E.2d at 503.

\textsuperscript{422} See \textit{Bischoff}, 400 So. 2d at 364-67; First Nat’l Bank v. Olsen, 403 N.W.2d 661, 683-84 (Minn. Ct. App. 1987).


\textsuperscript{424} See supra notes 348-51 and accompanying text.
concluded that the transaction was covered by subsection (3), it would have had to decide whether Pecot met the requirements that exempt a covered transaction from being deemed a sale or return.425

To fall within the scope of section 2-326(3) a transaction must have three characteristics.426 First, the owner of the goods must deliver them to a transferee for the purpose of sale. Second, the transferee must maintain a place of business at which it deals in goods of the kind involved. Third, the transferee must operate the business under a name other than the name of the owner. If a transaction has these characteristics, it will be deemed a sale or return unless the owner meets one of the requirements set forth in subsections (a) through (c) of section 2-326(3).427

Whether the transaction between Pecot and Mahaffey fell within the scope of section 2-326(3) raises a number of issues. First, at the outset of the transaction, Mahaffey's role seems to have been limited to performing a sales contract that Pecot and the initial buyer entered into before the cotton was delivered to Mahaffey. If Mahaffey's role was so limited, some authority supports a conclusion that the transaction was not covered by section 2-326(3).428 Nevertheless, when the initial buyer rejected the cotton, Mahaffey's role was no longer so limited. Following the initial buyer's rejection Mahaffey was authorized to sell or at least solicit offers to buy the rejected cotton. Most courts have held that when a transferee is authorized to solicit offers to buy the goods, the goods have been delivered to the transferee "for sale" within the meaning of subsection (3), even though any sale is subject to the transferor's approval.429 Therefore, unless Pecot's purpose at the time it initially delivered the cotton to Mahaffey is controlling, the transaction apparently met the first requirement for the application of section 2-326(3).

The second issue in determining the applicability of section 2-326(3) is whether Mahaffey maintained a place of business at which he dealt in cotton. Although Mahaffey was in the business of dealing in

425. See supra notes 352-57 and accompanying text.
427. See supra notes 348-51 and accompanying text.
cotton and it can be fairly inferred that he did so at a place of business, the court did not expressly so find. Some courts have held that a true consignment is not within section 2-326 if the consignee does not maintain a place of business.430 In these decisions, however, the courts adopted a rigid interpretation of the statute to avoid the perceived inequities of finding a sale or return.431 Certainly it is arguable that a transaction in which goods are delivered to a person in the business of selling goods of that kind should be within the scope of section 2-326(3), since the purpose of the provision is to protect creditors of the transferee from relying upon the transferee’s apparent ownership.432 In some cases the problem of apparent ownership may arise even if the transferee does not technically maintain a place of business. In these situations the language of subsection (3) should be interpreted liberally to effect the purpose of the statute.

A third issue concerning the application of section 2-326(3) to the facts in Lassberg arises because Mahaffey never took physical possession of the cotton in issue. In In re Mincow Bag Co.433 a divided court refused to apply section 2-326(3) when a “transferee” did not take possession of the goods in issue, but simply arranged sales and had the goods shipped directly from the manufacturer to the buyer. The court reasoned that since the “transferee” never had possession of the goods, no problems of ostensible ownership arose.434 Therefore, the court concluded that the policy behind section 2-326(3) did not support its application to the facts presented.

Even if Mincow Bag is a sound decision, however, it should not control the application of section 2-326(3) to the facts in Lassberg. Although Mahaffey never had physical possession of the cotton, he obtained possession of negotiable warehouse receipts covering the cotton. Mahaffey’s possession of the negotiable warehouse receipts was the legal and commercial equivalent of possession of the underlying cotton435 and created a problem of apparent ownership. Thus there is a princi-

430. See, e.g., Allsop v. Ernst (In re Roudebush), 20 Bankr. 627, 631 (Bankr. S.D. Ohio 1982); Manger v. Davis, 619 P.2d 687 (Utah 1980); see also Cantor v. Anderson, 639 F. Supp. 364 (S.D.N.Y.) (although consignee maintained a place of business at which the consignee dealt in goods of the kind involved, section 2-326(3) was held inapplicable because creditor never saw the goods at the business), aff’d, 833 F.2d 1002 (2d Cir. 1986).
431. See, e.g., Manger, 619 P.2d at 692-93 (property consigned was a valuable ring owned by an 80 year old widow in need of money).
434. Id. at 401, 288 N.Y.S.2d at 366.
pled basis for applying section 2-326(3), despite Mahaffey’s failure to take physical possession of the cotton.

If the court in Lassberg had concluded that the transfer from Pecot to Mahaffey was within the scope of section 2-326(3), the court would have been required to determine whether Pecot met the conditions set forth in subsections (a) through (c) of section 2-326(3). If Pecot meet any one of these conditions, the transfer could not be deemed a sale or return. Since South Carolina does not have a sign-posting statute, subsection (a) was unavailable to Pecot. Furthermore, since Pecot failed to file a financing statement covering the cotton, Pecot was not protected by subsection (c). Pecot’s only hope would have been to establish that Mahaffey was “generally known by his creditors to be substantially engaged in selling the goods of others.” If Mahaffey was a broker would have assisted Pecot in this endeavor, but that fact alone probably would not have been sufficient to enable Pecot to prevail.

Even if the court in Lassberg had applied section 2-326 and concluded that the transaction between Pecot and Mahaffey was a sale or return, Pecot might have prevailed under section 7-503(1)(b). Recall that after he failed in his attempt to resell the cotton, Mahaffey sent the negotiable warehouse receipts to Pecot. If Pecot qualified as a holder to whom a negotiable document had been duly negotiated, and Lassberg acquiesced in Mahaffey’s procuring the negotiable warehouse receipts, Pecot could have claimed title to the cotton free of Lassberg’s security interest. To establish that it took by due negotiation, however, Pecot would have had to show that it took for value. The facts in Lassberg do not establish that Pecot gave value for the warehouse receipts. Therefore, without reaching the issue of Lassberg’s

440. See supra notes 75-76 and accompanying text.
acquiescence, Pecot apparently could not have prevailed under a section 7-503(1)(b) argument.

In summary, although the consignment issues were not raised in Lassberg, the analysis above indicates that in any transaction in which an owner delivers goods to a transferee for the purpose of sale, the owner should file a financing statement to protect the owner’s interest from creditors of the transferee. Moreover, with the enactment of new section 9-114, the owner also should satisfy the filing and notification requirements of that provision. This will require the owner to search for financing statements covering the transferee’s inventory and to give written notification to any party who filed before the owner filed.

III. CONFLICTING CLAIMS TO PROCEEDS OF COLLATERAL

An inventory financer seeking to enforce a security interest may find that prior to default the debtor sold substantially all the collateral to buyers in the ordinary course. In such cases the inventory financer must look to the proceeds realized by the debtor upon the sales of collateral as the primary source of security.

Determining the extent and priority of an inventory financer’s security interest in proceeds raises a broad range of issues. Two factors contribute to the scope of inquiry. First, the sale of inventory can generate proceeds in a variety of forms, including trade-ins, cash, chattel paper, and accounts. Each of these forms of proceeds presents

443. Buyers in the ordinary course take free of security interests created by their sellers. U.C.C. § 9-307 (1972) (amended 1977); S.C. CODE ANN. § 36-9-307 (Law. Co-op. Supp. 1989). Therefore, when a debtor sells encumbered inventory to a buyer in the ordinary course, the sale extinguishes the inventory financer’s security interest in the goods. For analysis of the inventory financer’s rights against buyers of the collateral, see infra notes 876-80 and accompanying text.

444. "‘Proceeds’ includes whatever is received upon the sale, exchange, collection, or other disposition of collateral or proceeds. . . . Money, checks, deposit accounts, and the like are ‘cash proceeds’. All other proceeds are ‘noncash proceeds’." S.C. CODE ANN. § 36-9-306(1) (Law. Co-op. Supp. 1989).

445. "Chattel paper" is defined under the U.C.C. to mean a writing or writings which evidence both a monetary obligation and a security interest in a lease of specific goods, but a charter or other contract involving the use or hire of a vessel is not chattel paper. 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.

446. "‘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, whether or not it has been earned by performance." U.C.C. § 9-106 (1972) (amended 1977); S.C. CODE ANN. §
special issues. Second, an inventory financer's security interest in proceeds may conflict with two distinct types of claims. One class of conflicting claims includes those of creditors who make a claim to the proceeds as proceeds. For example, if the debtor has granted conflicting security interests in inventory, the conflicting interests will transfer to proceeds when the inventory is sold. The second and more significant class of conflicting claims includes those claims asserted directly against the proceeds. For example, an inventory financer's security interest in accounts as proceeds of the encumbered inventory may conflict with a security interest of an accounts receivable financer who loaned directly against the accounts. This section of the article will focus on the most significant forms of proceeds—cash proceeds, chattel paper and accounts, and will consider an inventory financer's priority over both conflicting security interests of other inventory financers and conflicting claims asserted directly against the proceeds.

A. Attachment and Perfection of Security Interests in Proceeds

The 1988 enactment of the 1972 Amendments to the Official Text of Article 9 clarified the requirements for creation of a security interest in proceeds.\textsuperscript{447} Under the former statute it was unclear whether a secured party had to include the word "proceeds" in the description of the collateral in the security agreement for a security interest to extend to proceeds. Under the revised statute a secured party acquires a security interest in proceeds as a matter of law under section 9-306(2) and without a reference to proceeds in the security agreement.\textsuperscript{448} Revising section 9-203(3) provides that "[u]nless otherwise agreed a security agreement gives the secured party the rights to proceeds provided by Section 9-306."\textsuperscript{449}

The 1988 Amendments also addressed the requirements for perfection of security interests in proceeds. Under both the former and


revised version of section 9-306(3), a security interest in proceeds is perfected automatically for ten days if the security interest in the collateral was perfected. Moreover, both the former and the revised statutes provide that one way a secured party can continue the perfected status in proceeds beyond the ten-day period is to perfect with respect to the proceeds before the expiration of that period. The change effected by the 1988 Amendments concerns the steps a secured party may take prior to the sale of collateral to extend the perfection of the party's security interest in proceeds.

Under former section 9-306(3)(a) a security interest in proceeds remained perfected following the expiration of the ten-day period of automatic perfection if a filed financing statement covering the original collateral also covered proceeds. In practice secured parties complied

450. Former South Carolina Code section 36-9-306(3) provided:

The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a perfected security interest and becomes unperfected ten days after receipt of the proceeds by the debtor unless

(a) a filed financing statement covering the original collateral also covers proceeds; or

(b) the security interest in the proceeds is perfected before the expiration of the ten day period.


Amended South Carolina Code section 36-9-306(3) provides:

The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a perfected security interest and becomes unperfected ten days after receipt of the proceeds by the debtor unless:

(a) a filed financing statement covers the original collateral and the proceeds are collateral in which a security interest may be perfected by filing in the office or offices where the financing statement has been filed and, if the proceeds are acquired with cash proceeds, the description of collateral in the financing statement indicates the types of property constituting the proceeds; or

(b) a filed financing statement covers the original collateral and the proceeds are identifiable cash proceeds; or

(c) the security interest in the proceeds is perfected before the expiration of the ten-day period.

Except as provided in this section, a security interest in proceeds can be perfected only by the methods or under the circumstances permitted in this chapter for original collateral of the same type.


with former section 9-306(3)(a) simply by checking the proceeds box on the standard form financing statement.\textsuperscript{453}

Although compliance with the former statute imposed a minimal burden on a secured party, the provision gave rise to two problems. First, a secured party who inadvertently failed to check the proceeds box lost the perfected status of its security interest in proceeds, even though third parties could reasonably infer from the filing with respect to the collateral that the secured party had a security interest in proceeds.\textsuperscript{454} Second, in some situations checking the proceeds box on a financing statement did not provide notice that the secured party had a security interest in assets that the secured party could claim as proceeds.\textsuperscript{455}

For example, assume that a secured party filed a financing statement in the office of the Register of Mesne Conveyances (RMC) of a debtor’s residence covering farm equipment and proceeds, and that the debtor exchanged a combine for a bulldozer which he used as construction equipment. Under former section 9-306(3)(a) the secured party’s security interest in the bulldozer would be perfected even though no financing statement indicating that the debtor’s construction equipment was encumbered would be on file in the Secretary of State’s office.

Merely checking the proceeds box also could have failed to give notice when a debtor used cash proceeds to purchase goods.\textsuperscript{456} For example, assume that a secured party filed a financing statement covering a debtor’s inventory and proceeds, that the debtor sold an item of inventory for cash, and that the debtor used the cash to purchase a piece of equipment. Under former section 9-306(1) the equipment qualified as proceeds. Moreover, under former section 9-306(3)(a) the secured party’s security interest in the equipment was perfected even though the filed financing statement did not indicate that equipment was encumbered.

The application of former section 9-306(3) in these examples illustrates a significant problem with the former statute. By affording a secured party perfected status in equipment as proceeds even though the filed financing statements did not indicate that equipment was encumbered, the former statute effectively afforded priority status to a secret lien. As a result, the former statute subjected subsequent lenders who took a security interest in the apparently unencumbered equipment to the risk of being primed by a secret lien. This risk, in turn, tended to

\textsuperscript{453} See Final Report, supra note 2, app., para. E-20, at 218-19.

\textsuperscript{454} Id. para. E-21, at 219; White & Summers, supra note 87, § 22-12, at 1008-09.


reduce the availability and increase the cost of credit secured by the equipment.

Revised section 9-306(3) addresses some of the problems that arose under the former statute. Under the revised statute a secured party is not required to include a claim to proceeds in the financing statement covering the original collateral.457 As a general rule, filing as to the original collateral continues perfection of the security interest in proceeds beyond expiration of the ten-day period of automatic perfection if the proceeds are either collateral in which a security interest may be perfected by filing in the same office458 or identifiable cash proceeds.460 This rule, however, does not apply if the proceeds at issue are acquired with cash proceeds. In such a case, for the financing statement covering the original collateral to extend the perfection of the security interest in proceeds, the description of the collateral in the original financing statement must indicate the types of property constituting the proceeds.460

Revised section 9-306(3) generally simplifies an inventory financer's task by extending the perfection of its security interest to most forms of proceeds. Under revised section 9-306(3)(b) the inventory financer's filing in the Secretary of State's office with respect to the inventory continues the perfection of its security interest in identifiable cash proceeds. Moreover, if the debtor does business only in South Carolina or its chief executive office is located in South Carolina, under revised section 9-306(3)(a) the inventory financer's filing in the


Although the 1988 Amendments improve the notice requirements for perfection of security interests in proceeds, problems of secret liens still exist. For example, assume that an inventory financer has filed a financing statement in the Secretary of State's office covering only inventory, and the debtor exchanges an item of inventory for a piece of equipment. Under revised section 9-306(3)(a) the filing is effective to continue the perfection of the inventory financer's security interest in the equipment as proceeds, even though the financing statement does not disclose that the equipment may be subject to a security interest. The distinction between equipment acquired as a direct trade-in on the sale of inventory and equipment acquired with cash proceeds generated by a sale of inventory was not an inadvertent oversight. See Final Report, supra note 2, app., para. E-24, at 219-20. Presumably, the drafters of the 1972 Official Text of Article 9 viewed the problem of equipment received as direct proceeds of inventory as sufficiently rare to justify conditioning perfection upon describing the equipment in an inventory financer's financing statement.
Secretary of State's office covering inventory is effective to continue its perfected status in proceeds in the form of accounts and chattel paper.

Revised section 9-306(3) does create two potential pitfalls, however. First, as noted, for an inventory financer's financing statement to continue the perfection of its security interest in equipment acquired with cash proceeds, the financing statement must indicate that equipment is covered.461 Second, if the debtor's chief executive office is located in another jurisdiction, a financing statement covering inventory located in South Carolina which is filed in the South Carolina Secretary of State's office will not extend the perfection of a security interest to accounts or chattel paper.462 When a debtor is engaged in business in more than one state, revised section 9-103 provides that to perfect a security interest by filing in accounts and chattel paper the financing statement must be filed in the state in which the debtor's chief executive office is located.463 Since a security interest in the debtor's accounts or chattel paper could not be perfected by filing with the South Carolina Secretary of State, the South Carolina inventory filing is not sufficient to extend perfection in such proceeds under revised section 9-306(3)(a). Therefore, if a multi-state debtor is involved, to extend the perfection of a security interest to proceeds in the form of accounts or chattel paper, the inventory financer must file in the appropriate office in the state in which the debtor's chief executive office is located.

B. Cash Proceeds

1. Identification of Commingled Cash Proceeds

From the perspective of an inventory financer, cash proceeds include both cash that the debtor has received upon the sale of inventory and cash that the debtor has received upon the sale or collection of accounts and chattel paper generated by the sale of inventory.464 Although significant priority issues can arise with respect to cash proceeds, an inventory financer claiming cash proceeds as security must first be able to identify the cash at issue as proceeds. If the debtor has deposited cash proceeds in a deposit account containing only cash proceeds or is holding the cash proceeds without depositing them, identifi-

cation of the cash as proceeds does not present a problem. In contrast, if the debtor has commingled the cash proceeds with other funds by depositing them in a general bank account, substantial problems of identification arise.

The Code does not define the term "identifiable cash proceeds." The Code also does not provide that cash proceeds remain identifiable after the cash proceeds have been commingled with other funds in a general bank account. Even revised section 9-306(4)(d), which applies in the event insolvency proceedings have been instituted by or against a debtor to grant a secured party a limited security interest in a general bank account in which cash proceeds have been commingled with other funds, does not do so on the basis that the cash proceeds are identifiable.465 Moreover, Professor Gilmore asserted that a secured party loses a security interest in cash proceeds if that secured party permits the debtor to commingle the proceeds by depositing them in a general bank account.466 Nevertheless, when the debtor is not subject to an insolvency proceeding the courts have permitted secured parties to identify cash proceeds in a general bank account through tracing principles incorporated under section 1-103,467 and commentators generally have approved of this approach.468

Assuming that a secured party may identify cash proceeds that have been commingled with other funds in a debtor's bank account, the manner in which a secured party identifies proceeds depends on whether insolvency proceedings have been instituted by or against the debtor when the secured party asserts its security interest in the account. In cases in which no insolvency proceedings have been instituted, Article 9 does not specify how cash proceeds are identified. In such cases, the courts have applied the "lowest intermediate balance" method of tracing to identify cash proceeds commingled into a general


466. 2 G. Gilmore, supra note 56, § 27.4, at 735-36.


468. See, e.g., Henning, Article Nine's Treatment of Commingled Cash Proceeds in Non-Insolvency Cases, 35 ARK. L. REV. 191 (1981); Skilton, supra note 465, at 126-44.
account.\textsuperscript{469} In contrast, when insolvency proceedings have been instituted by or against a debtor, revised section 9-306(4)(d) defines and limits the extent to which a secured party may claim a security interest in a deposit account into which cash proceeds have been commingled.\textsuperscript{470} Although the revised statute is less than generous to secured parties, the 1988 Amendments have clarified the operation of the provision and to some extent enhanced the rights of secured parties.

a. Noninsolvency Situations

Article 9 is silent on the appropriate manner of identifying cash proceeds which have been commingled with other funds in a debtor's general bank account when insolvency proceedings have not been instituted by or against the debtor. Nevertheless, the courts have permitted secured parties to assert a security interest in a bank account to the extent the secured party can establish that the account represents cash proceeds under the "lowest intermediate balance" method of tracing.\textsuperscript{471}

Basically, this method of tracing involves two rules. First, commingled account withdrawals not used to pay the secured party are deemed withdrawals from nonproceeds funds; only when the non-proceeds component of the account is exhausted are proceeds invaded.\textsuperscript{472} Second, a deposit of nonproceeds funds after an invasion of proceeds does not restore the invaded proceeds unless the debtor deposits the funds with an intent to make restitution to the secured party.\textsuperscript{473}


\textsuperscript{471} See cases cited supra note 467.

\textsuperscript{472} See, e.g., \textit{Restatement (Second) of Trusts} § 202 comment i (1957); \textit{Restatement of Restitution} § 211 (1936). This rule is commonly referred to as the Rule of Jessel's Bag, after Jessel, Master of the Rolls, who developed the rule in Knatchbull v. Hallett (\textit{In re Hallet's Estate}), 13 Ch. D. 696 (1879); see Oesterle, \textit{Deficiencies of the Restitution Right to Trace Misappropriated Property in Equity and Under U.C.C.} § 9-306, 68 \textit{Cornell L. Rev.} 172, 207 n.66 (1983). For application of this rule to tracing proceeds under Article 9, see \textit{Universal C.I.T. Credit Corp.}, 358 F. Supp. at 325-26; C.O. Funk & Son, Inc., 92 Ill. App. 3d at 659, 415 N.E.2d at 1312-13. See generally, Henning, supra note 468, at 228 (detailing the "lowest intermediate balance" method of tracing).

\textsuperscript{473} \textit{Restatement (Second) of Trusts} § 202 comment j (1957); \textit{Restatement of Restitution} § 212 (1936); see generally, Oesterle, supra note 472, at 208 n.66 (brief
To illustrate the application of the lowest intermediate balance method of tracing, consider the following:

**ILLUSTRATION 17**—Finance Company holds a perfected security interest in Debtor's inventory. On May 31 the balance in Debtor's general deposit account with Bank is $5,000, no portion of which represents proceeds from the sale of inventory subject to Finance Company's security interest. On June 1 Debtor deposits $10,000 which constitute cash proceeds from the sale of encumbered inventory, raising the balance in the account to $15,000. On June 2 and June 3 Debtor makes withdrawals of $5,000 to pay unsecured creditors, reducing the balance to $5,000. On June 4 Debtor deposits $5,000 of nonproceeds funds, raising the balance to $10,000.

The issue posed by this illustration is to what extent may Finance Company claim a perfected security interest in Debtor's bank account. On June 1 the balance in debtor's account consisted of $5,000 in nonproceeds funds and $10,000 in proceeds. Under the first rule of the lowest intermediate balance method of tracing, the June 2 withdrawal to pay general creditors is deemed to have been from nonproceeds funds, with the result that the remaining $10,000 in the account consisted solely of proceeds. The June 3 withdrawal of $5,000 represented an invasion of proceeds. Finally, under the second rule of the lowest intermediate balance method, the June 4 deposit of $5,000 in nonproceeds funds did not restore the invaded proceeds unless the funds were deposited with the intent of making restitution. If Debtor did not act with this intent, Finance Company is limited to a claim of $5,000 on the $10,000 balance in Debtor's account.

As Illustration 17 demonstrates, the first rule of the lowest intermediate balance method protects a secured party asserting a security interest in a bank account into which a debtor has commingled cash proceeds with other funds. By treating withdrawals as first depleting nonproceeds funds, the first rule preserves the proceeds component of the bank account. The courts, however, also have applied the lowest intermediate balance method of tracing to determine whether goods purchased with funds withdrawn from the account are proceeds.474 Although the secured party is forced to invoke tracing to establish a se-

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curity interest in the new goods only in cases in which it cannot claim the goods under an after-acquired property clause, in such cases, treating withdrawals as first depleting nonproceeds can work to the disadvantage of the secured party. To illustrate this problem, consider the following:

ILLUSTRATION 18—Finance Company has a perfected security interest in specific items of Debtor's inventory. Finance Company does not, however, have a security interest in Debtor's after-acquired inventory. Debtor maintains a deposit account at Bank, and on May 31 the balance in the account was $5,000. No portion of this balance represented proceeds from the sale of inventory. On June 1 Debtor deposited cash proceeds of $10,000 into the account, raising the balance to $15,000. On June 2 Debtor withdrew $5,000 to purchase new inventory, reducing the balance in the account to $10,000. On June 3 Debtor withdrew the remaining $10,000 to pay unsecured creditors. On June 4 Debtor deposited $5,000 in nonproceeds funds.

Under the analysis of Illustration 17 Finance Company cannot assert a security interest upon the bank account. The June 3 withdrawal completely exhausted the proceeds component of the account. Moreover, if the June 4 deposit was not intended as restitution, that deposit did not replenish the invaded proceeds. The critical issue is whether Finance Company may claim a security interest in the inventory purchased on June 2 on the theory that the new inventory constituted proceeds of cash proceeds. Under a literal application of the lowest intermediate balance method of tracing, the answer is no. Pursuant to the first rule, the withdrawal on June 2 was of nonproceeds funds. Therefore, the new inventory was not acquired with proceeds, and hence did not qualify as proceeds.

Although the first rule of the lowest intermediate balance method of tracing apparently precludes Finance Company in Illustration 18 from establishing a security interest in the June 2 inventory, that result is inconsistent with policy underlying the rule. The purpose of the rule is to protect the secured position of the secured party. Therefore, it seems inappropriate to apply the rule in a way that undermines that policy. Moreover, in non-Code cases, the courts have recognized an exception to the first rule of tracing when a wrongdoer uses funds from a commingled account to acquire specific property. These courts have held that the specific property is acquired with trust funds, even though the account contained nontrust funds at the time of the acquisition. Therefore, in a Code case in which the issue before the court

475. See, e.g., Republic Supply Co. v. Richfield Oil Co., 79 F.2d 375 (9th Cir. 1935); Hertslet v. Oatway (In re Oatway), 2 Ch. 356 (1903).
476. Republic Supply Co., 79 F.2d at 378; Oatway, 2 Ch. at 359-60 (1903); see Oes-
is whether new property purchased with funds withdrawn from a commingled account constitutes proceeds (as opposed to whether a secured party can claim a security interest in the account), the court should not apply the first rule of the lowest intermediate balance method to preclude the secured party from establishing a claim. The secured party should have the right to claim that any property acquired with funds drawn from a commingled account was purchased with cash proceeds to the extent that the account contained cash proceeds when the debtor withdrew the funds to purchase the property. If Finance Company in Illustration 18 had such a right it could claim the June 2 inventory was proceeds, since on that date the account contained sufficient proceeds to cover the withdrawal.

A response to this argument is the assertion that Finance Company's dilemma resulted from its own negligence, and that a court should not manipulate tracing principles to assist a negligent party. Although Finance Company could have protected its claim to the June 2 inventory, either by including an after-acquired property clause in its security agreement or by precluding Debtor from commingling cash proceeds in a general bank account, the failure to establish such protection does not necessarily reflect negligence on the part of Finance Company. First, Finance Company may have had a valid business reason for not claiming a security interest in Debtor's after-acquired inventory. For example, if Finance Company financed Debtor's acquisition of the business, Finance Company may have left the Debtor's after-acquired inventory unencumbered to enable Debtor to acquire the inventory financing necessary to conduct business and generate revenues sufficient to repay Finance Company. Second, Debtor may have commingled cash proceeds even though the security agreement required Debtor to deposit all cash proceeds in a segregated account containing only cash proceeds and even though Finance Company monitored Debtor's business to insure that Debtor complied with the terms of the agreement. Therefore, the equities sometimes weigh in favor of modifying the rigors of the lowest intermediate balance method to permit Finance Company to claim the June 2 inventory as proceeds.

In summary, by employing the lowest intermediate balance method of tracing in noninsolvency situations, an inventory financer probably has the right to establish a security interest in a bank account into which cash proceeds have been commingled. Such a claim, how-

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terle, supra note 472, at 208 n.66 (briefly discussing holdings in Republic Supply and Oatway).

477. See Henning, supra note 468, at 245 (suggesting a similar rule without providing a precedential basis).
ever, may be both less than generous and difficult to prove. Therefore, an inventory financer normally is well advised to require the debtor to deposit all cash proceeds in a segregated account and to monitor the debtor's compliance with this requirement.

Furthermore, although in theory an inventory financer may be able to claim after-acquired inventory as proceeds of cash proceeds, the problems of tracing may, as a practical matter, preclude such a claim. Accordingly, if an inventory financer perceives any potential need to rely on after-acquired inventory as security, the financer should include an after-acquired property clause in the security agreement.

Although by retaining a security interest in after-acquired inventory the inventory financer may make it more difficult for the debtor to acquire subsequent financing secured by inventory, the claim to after-acquired property will not preclude such financing. If the subsequent inventory financer retains a purchase money security interest in the new inventory, the subsequent financer can prime the prior secured party under revised section 9-312(3). Moreover, the subsequent non-purchase money inventory financer may be able to obtain priority through a subordination agreement if the financing provided is essential to the operation of the debtor's business.

b. Insolvency Situations

When insolvency proceedings have been instituted by or against a debtor, revised section 9-306(4) applies to define the extent to which a perfected secured party can claim a security interest in proceeds. The most significant portion of this provision is revised section 9-306(4)(d), which limits a secured party's security interest in a bank account in which cash proceeds have been commingled with other funds. In the event that insolvency proceedings are commenced by

478. See, e.g., C.O. Funk & Son, 92 Ill. App. 3d 659, 415 N.E.2d 1308 (evidence at trial did not support finding that funds were proceeds of Funk's collateral and thus court ordered funds distributed to bank).

479. See supra notes 114-291 and accompanying text (analyzing revised section 9-312(3)).


482. See White & Summers, supra note 87, § 23-7, at 1102-05 (discussing corresponding provision of Model Act).

483. See generally B. Clark, supra note 8, ¶ 10.03, at 10-37 to -39 (discussing the problem of commingled funds); White & Summers, supra note 87, § 23-7, at 1105-09 (discussing the relationship of section 9-306(4)(d) to bankruptcy law); Skilton, The Se-
or against the debtor, revised section 9-306(4)(d) preempts the right of a secured party to establish a security interest in such an account by tracing under the lowest intermediate balance method, and normally provides the secured party with a less generous recovery than could be obtained through tracing.

The 1988 Amendments, which enacted the 1972 Official Text of section 9-306(4), clarified the rules for claiming a security interest in a bank account into which cash proceeds were commingled. Although former section 9-306(4)(d) produced rational results when a debtor either commingled cash proceeds in the debtor's general account or retained the cash proceeds without depositing them in a bank account, a literal application of the statute produced odd results when the debtor endorsed cash proceeds checks over to the secured party or other payees. The revised statute corrects these aberrations.

Revised section 9-306(4)(d)(ii) provides that a secured party's perfected security interest in a bank account into which cash proceeds have been commingled with other funds is limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings.

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484. See, e.g., First Nat'l Bank v. Martin, 48 Bankr. 317 (N.D. Tex. 1985); In re Glaubinger Mach. Co., 58 Bankr. 38 (Bankr. D.N.J. 1986). But see In re Datair Sys. Corp., 42 Bankr. 241 (Bankr. N.D. Ill. 1984) (larger recovery under section 9-306(4)(d) than would have been available under tracing principles). To the extent that section 9-306(4)(d) grants a secured party a greater interest in a commingled bank account than it could claim under tracing principles, the validity of section 9-306(4)(d) against the bankruptcy trustee is, at least, debatable. See Arizona Wholesale Supply Co. v. Itule (In re Gibson Prods.), 543 F.2d 652 (9th Cir. 1976), cert. denied, 430 U.S. 946 (1977); see generally B. CLARK, supra note 8, ¶ 6.03[4][a]-[b], at 6-40 to -44; WHITE & SUMMERS, supra note 87, § 23-7, at 1105-09; Skilton, supra note 483, at 80-87. To avoid a conflict between the Bankruptcy Code and section 9-306(4)(d), one court has interpreted the latter provision as a limitation upon otherwise identifiable proceeds. Moister v. National Bank (In re Guaranteed Muffler Supply Co.), 5 Bankr. 236 (Bankr. N.D. Ga. 1980). Under Guaranteed Muffler, a secured party claiming a security interest under section 9-306(4)(d) must first identify the cash proceeds under tracing principles. Once the cash proceeds are identified, section 9-306(4)(d) would limit the security interest to an amount not greater than the amount of cash proceeds received within the 10 days prior to the commencement of the insolvency case. Therefore, under Guaranteed Muffler a secured party cannot recover more under section 9-306(4)(d) than it could recover by tracing.


486. See generally Skilton, supra note 483, at 75-77 (comparing 1962 and 1972 versions of section 9-306(4)(d)).

The revised statute then provides that this maximum amount is subject to two reductions. First, under revised section 9-306(4)(d)(ii)(I) the maximum recovery is reduced by any payments to the secured party on account of cash proceeds received within the ten-day period prior to the commencement of the insolvency proceedings.488 Second, under revised section 9-306(4)(d)(ii)(II) the maximum recovery is further reduced by the amount of cash proceeds the debtor received within the ten-day period that the secured party can claim under revised section 9-306(4)(a) through (c).489 These reductions include cash proceeds that the debtor has deposited in a separate bank account containing only proceeds,490 cash proceeds in the form of money that the debtor has neither commingled nor deposited in a bank account,491 and cash proceeds in the form of checks that the debtor has not deposited in a bank account.492 In addition, revised section 9-306(4)(a) and (d)(ii) may be interpreted to require a reduction of the security interest in the general deposit account to the extent that cash proceeds received within ten days prior to the commencement of an insolvency proceeding can be traced to identifiable noncash proceeds.493

The operation of revised section 9-306(4)(d) can be analyzed through a series of illustrative examples. First, the basic operation of the provision is evidenced by the following:

**ILLUSTRATION 19—**Finance Company holds a security interest in Debtor’s current and after-acquired inventory, which Finance Company perfected by filing. Although the terms of the security agreement require Debtor to deposit all cash proceeds from the sale of inventory in a separate deposit account containing only proceeds, on occasion Debtor breached this requirement and deposited cash proceeds in Debtor’s general bank account and thereby commingled the cash proceeds with other funds. On May 31 the balance in the segregated account was $1,000, and the balance in Debtor’s general bank account was $20,000. Under the lowest intermediate balance method of trac-
ing, the entire $20,000 balance in the general bank account consti-
tuted cash proceeds.

On June 10 Debtor filed for relief under Chapter 7 of the Bank-
ruptcy Code. On June 10 the balance in the segregated account was
$7,000, and the balance in Debtor's general bank account was $25,000.
During the ten-day period prior to the commencement of the bank-
ruptcy case, Debtor received checks totalling $18,000 as proceeds from
the sale of encumbered inventory. Debtor deposed of these checks as
follows:

$6,000—deposited in segregated account;
$5,000—deposited in general bank account;
$4,000—placed in desk drawer and did not deposit in a bank
account prior to bankruptcy;
$3,000—endorsed over to Finance Company.

The primary issue presented in this illustration is the extent to
which Finance Company can claim a security interest in Debtor's gen-
eral bank account. To resolve this issue, however, one must consider
Finance Company's rights to both the cash proceeds deposited in the
segregated account and to those left in the desk drawer.

The analysis of Illustration 19 must commence with the obser-
vation that if Finance Company were permitted to trace proceeds under
the lowest intermediate balance method, Finance Company could
claim the entire $25,000 balance in the general bank account as cash
proceeds. Revised section 9-306(4)(d), however, precludes Finance
Company from using tracing principles to establish its security interest
in the commingled account.494 Under revised section 9-306(4)(d)(ii) Fi-
ance Company's security interest in the general bank account cannot
exceed $18,000, the amount of cash proceeds received by Debtor within
ten days before commencement of the bankruptcy. Moreover, this
maximum amount is subject to several reductions.

must be reduced by $3,000 to reflect the payment Debtor made to Fi-
ance Company.495 Since this payment was made by endorsing over
proceeds checks received within the ten days prior to bankruptcy, it is
clear that the payment was "on account of cash proceeds received by
the debtor during the [ten-day] period."496

Under revised section 9-306(4)(d)(ii)(II) Finance Company's secur-
ity interest in the general bank account is subject to two additional
reductions. First, under revised section 9-306(4)(a) Finance Company

494. See sources cited supra notes 484-85 and accompanying text.
is entitled to a perfected security interest in the segregated bank account, which contains only proceeds.\(^{497}\) Therefore, Finance Company's security interest in the general bank account must be reduced to the extent that cash proceeds received within the ten-day period were deposited in the segregated account. Finance Company's security interest in the general bank account thus must be reduced by an additional $6,000. A second reduction results under revised section 9-306(4)(d)(ii)(II) because Finance Company is entitled to a perfected security interest in the checks in the desk drawer under revised section 9-306(4)(c).\(^{498}\) Accordingly, Finance Company's security interest in the general bank account is subject to an additional reduction of $4,000. Thus, under revised section 9-306(4)(d)(ii) Finance Company's perfected security interest in Debtor's general bank account is limited to $5,000.

As applied in Illustration 19, the rules of revised section 9-306(4)(d) are unambiguous and produce an unremarkable result. Although Finance Company's security interest in the general bank account is limited to $5,000, Finance Company is entitled to the benefit of the entire $18,000 in cash proceeds collected within the ten-day period. This result is unremarkable because all the cash proceeds in issue were directly and demonstrably related to improving the Finance Company's position.

The operation of revised section 9-306(4)(d) becomes somewhat remarkable when cash proceeds received within the ten-day period are demonstrably applied for purposes other than paying to or providing security for a secured party. To illustrate this situation consider an example inspired by a well-known decision.\(^{499}\)

**ILLUSTRATION 20**—Finance Company has a perfected security interest in Debtor's current and after-acquired inventory. Debtor maintains a general bank account into which cash proceeds have been mingled with other funds. On May 31 the balance in Debtor's account is $24,000, $4,000 of which constitute proceeds under the lowest intermediate balance method of tracing. On June 10 Debtor filed for relief under Chapter 7 of the Bankruptcy Code. On June 10 the balance in Debtor's account was $25,000. During the ten-day period prior to the commencement of the bankruptcy case, Debtor received $21,000 in

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cash proceeds in the form of checks. Of this amount Debtor deposited $1,000 in Debtor's general bank account and endorsed $20,000 to meet current expenses and pay unsecured creditors.

Although under the lowest intermediate balance method of tracing, the proceeds component of Debtor's bank account could not exceed $5,000, under revised section 9-306(4)(d) Finance Company's perfected security interest in the account equals $21,000. This result raises two issues. First, how can the Code justify awarding Finance Company a $21,000 security interest in the bank account on account of cash proceeds received within ten days prior to the commencement of the insolvency proceedings, when only $1,000 of those proceed were deposited in the bank account? In response, the secured party can assert that because unsecured creditors have been paid with cash proceeds that rightfully belonged to the secured party, neither the unsecured creditors nor the bankruptcy trustee as their representative should be heard to complain when the secured party is awarded a compensating interest in the bank account.\(^500\)

The more difficult issue raised by this illustration is whether revised section 9-306(4)(d) is invalid against the bankruptcy trustee to the extent that it grants Finance Company a larger interest in the bank account than it would have had insolvency proceedings not been instituted. Although commentators have discussed this issue,\(^501\) the courts have yet to resolve it.\(^502\)

Although the propriety of the outcome in Illustration 20 is questionable, the language of the statute is not ambiguous. Any problem of statutory interpretation in Illustration 20 arises because of the apparent conflict with the Bankruptcy Code.\(^503\) Some situations, however, do disclose ambiguities in the language of the provision. To illustrate two problems of interpretation, consider the following:

**Illustration 21**—Finance Company has a security interest in Debtor's current and after-acquired inventory, which it perfected by an appropriate filing. Debtor maintained a general bank account into which Debtor commingled cash proceeds with other funds. On May 31

500. See White & Summers, supra note 87, § 23-7, at 1105-06.
501. See, e.g., B. Clark, supra note 8, § 6.03[4][a]-[b], at 6-40 to -44; 2 G. Gilmore, supra note 56, § 45.9, at 1336-40; White & Summers, supra note 87, § 23-7, at 1105-09; Skilton, supra note 483, at 80-87.
503. See Guaranteed Muffler, 5 Bankr. at 238.
the balance in Debtor's account was $20,000, no portion of which constituted cash proceeds. On June 10 Debtor petitioned for relief under Chapter 7 of the Bankruptcy Code. On June 10 the balance in the account was $19,000. During the ten days prior to the commencement of the bankruptcy case Debtor made the following transactions:

1. On June 1 Debtor drew a check for $5,000 to Finance Company, which was paid on June 3;
2. On June 4 Debtor received $8,000 in cash proceeds, which Debtor immediately deposited in Debtor's account and for which Debtor was given immediate credit;
3. On June 5 Debtor drew a check on Debtor's account for $4,000 payable to Finance Company, which was paid on June 7;
4. On June 8 Debtor received cash proceeds in the form of a $3,000 check, which Debtor immediately endorsed over to a supplier in exchange for new inventory.

During the ten days before the commencement of the bankruptcy case Debtor received cash proceeds totalling $11,000. Therefore, Finance Company's security interest in the bank account cannot exceed $11,000. The issue presented is whether this amount must be reduced pursuant to revised section 9-306(4)(d)(ii)(I) or (II).

Under revised section 9-306(4)(d)(ii)(I) Finance Company's maximum claim must be reduced by payments to it "on account of cash proceeds received by the debtor during the [ten-day] period [prior to the commencement of the insolvency proceedings]." The issue raised is whether the June 3 payment of $5,000 and the June 5 payment of $4,000 are within the scope of this statutory language. It is clear that the June 3 payment was of nonproceeds funds, since when the check was paid Debtor's account did not contain any proceeds. The June 5 payment is more troublesome. When the June 5 check was paid, the account contained both $15,000 of nonproceeds and $8,000 of cash proceeds. The $4,000 withdrawal might have been made from either the proceeds or the nonproceeds component of the account. Moreover, rather than attempting to trace the withdrawals to the proceeds and nonproceeds, one could invoke an analysis under which all payments from the account during the ten-day period would be deemed on account of cash proceeds received within the ten-day period to the extent that cash proceeds were deposited in the account.

Choosing among the suggested alternatives raises several issues. To the extent that the payments from the account are not deemed "on account of cash proceeds," the provision invites a challenge under the Bankruptcy Code. If Finance Company were undersecured when the

payments were made, the payments could be challenged as a preference unless they were offset by a compensating reduction in Finance Company's security in the bank account.\(^{505}\) Thus, avoiding a conflict with the Bankruptcy Code suggests an application of a net result approach. This approach also is consistent with the basic function of revised section 9-306(4)(d), in that it eliminates the need to trace the payments to component parts of the fund.\(^{506}\)

As noted, however, the net result approach does not fit comfortably within the statutory language. It is difficult to maintain that the June 3 payment is on account of cash proceeds when it clearly was paid with nonproceeds funds. On the other hand, to presume that the June 5 payment was made from proceeds as opposed to nonproceeds is consistent with the statutory language. On balance, the resolution most consistent with the language of the statute and the conflicting policies at play would be one finding that only the $4,000 payment was on account of cash proceeds reached during its ten-day period. Thus, the reduction under revised section 9-306(4)(d)(ii)(I) would be limited to $4,000. Accordingly, if the trustee is to recover the $5,000 payment, the trustee will have to do so directly by avoiding it as a preference rather than attacking it indirectly through reducing Finance Company's security interest in the bank account.\(^{507}\)

The final issue presented in Illustration 21 is whether Finance Company's security interest in the bank account must be reduced by $3,000 to reflect Finance Company's security interest in the inventory acquired on June 8. The new inventory in Illustration 21 is identifiable noncash proceeds because the inventory was obtained in exchange for cash proceeds. Therefore, under revised section 9-306(4)(a) Finance Company is entitled to assert a perfected security interest in the inventory. The critical question is whether Finance Company's security interest in the bank account must be reduced by noncash proceeds to which Finance Company is entitled under paragraph (a).

A literal reading of revised section 9-306(4)(d)(ii)(II) indicates that

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\(^{505}\) See 11 U.S.C. § 547(b)(5) (1988); see also Barash v. Public Fin. Corp., 658 F.2d 504 (7th Cir. 1981) (holding that regular installment payments on consumer debt voidable to the extent they are credited to unsecured claims).

\(^{506}\) See generally, Skilton, supra note 483, at 77-79 (discussing extent of secured party's claim versus the fund subject to claim).

\(^{507}\) In the event the trustee sought to attack the payment as a preference, Finance Company could assert a defense under 11 U.S.C. § 547(c)(2) (1988), which excepts from avoidance certain ordinary course payments. See generally, B. CLARK, supra note 8, ¶ 6.03[2][b][i] at 6-32 to -33 (discussing defenses against trustee's preference powers). But see Broome, Payments on Long-Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendments, 1987 DUKE L.J. 78 (arguing on policy grounds that section 547(c)(2) should be inapplicable to except payments on long-term debt from avoidance as preferences).
Finance Company's security interest in the bank account should be reduced only by the amount of cash proceeds that Finance Company can claim under paragraphs (a) through (c). Thus, the security interest in the bank account arguably should not be reduced by the amount of noncash proceeds to which Finance Company is entitled under paragraph (a). Such an interpretation of the statute, however, effectively allows Finance Company a double recovery, since it would have a $3,000 security interest in both the inventory and the bank account. Although one might argue that allowing the double recovery is reasonable in light of the statutory bar to claiming a security interest in the account through tracing, under the facts of Illustration 21, such a recovery might well call into question the validity of the statute against the bankruptcy trustee. Therefore, revised section 9-306(4)(d)(ii)(II) should be interpreted as requiring a reduction of the security interest in the bank account to the extent Finance Company can claim, under paragraphs (a) through (c), either cash proceeds received within the ten-day period or noncash proceeds obtained with cash proceeds. Thus, Finance Company's security interest in the bank account should be reduced by an additional $3,000 to reflect the June 8 inventory.

A variation in Illustration 21 discloses a final problem with the application of revised section 9-306(4)(d). If Debtor had deposited June 8 cash proceeds in the bank account and purchased the inventory with a check drawn on that account, it would be unclear whether the inventory constituted identifiable noncash proceeds. Assuming the check was presented and paid on June 9, when the balance in Debtor's account was $19,000, the check could have been paid with either proceeds or nonproceeds funds. Under conventional tracing principles, the account contained at least $4,000 of proceeds on June 9. If the inventory is deemed to have been purchased with proceeds, and revised section 9-306(4)(d)(ii)(II) requires a reduction for noncash proceeds which can be traced to cash proceeds, Finance Company's security interest in the bank account must be reduced by $3,000.

In contrast, if the inventory is deemed to have been purchased with nonproceeds, then section 9-306(4)(a) and (d)(ii) do not require a reduction in Finance Company's security interest in the bank account. Under modern tracing principles, withdrawals by a trustee from a commingled account are deemed made from nontrust funds until those funds are exhausted. Moreover, some courts have applied this principle even when the withdrawals resulted in the trustee's acquisition of identifiable property. If the latter interpretation were adopted, how-

508. The stated rule is commonly known as the Rule of Jessel's Bag. See supra note 472.
509. See, e.g., Covey v. Cannon, 104 Ark. 550, 149 S.W. 514 (1912).
ever, Finance Company would realize a double recovery because of the $3,000 in cash proceeds received on June 8. Receipt of these cash proceeds would enhance Finance Company’s security interest in the bank account.

Additionally, although Finance Company could not claim the June 8 inventory as proceeds, Finance Company could claim a security interest in the inventory under the after-acquired property clause in its security agreement with Debtor. This double recovery is difficult to justify. Revised section 9-306(4)(d)(ii) thus should be interpreted as mandating a reduction in Finance Company’s security interest in the bank account to the extent that the account contained cash proceeds sufficient to cover the check at the time it was drawn and paid.510

The above analysis shows that an inventory financer asserting a security interest in cash proceeds may encounter substantial problems in establishing a security interest in a deposit account in which a debtor has commingled cash proceeds. If insolvency proceedings have not been instituted by or against the debtor, the inventory financer can claim a security interest in a general deposit account only to the extent the financer can trace cash proceeds into the account. If insolvency proceedings have been commenced, however, revised section 9-306(4)(d)(ii) limits an inventory financer’s security interest in a deposit account in which cash proceeds have been commingled with other funds to an amount not greater than the amount of cash proceeds received by the debtor within ten days prior to the commencement of the insolvency proceedings.511

An inventory financer can attempt to avoid the problems of claiming a security interest in a general bank account by requiring the debtor to deposit all cash proceeds in a segregated account containing only proceeds. Such protection, however, may prove to be illusory because a financially embarrassed debtor is likely to breach this requirement and deposit cash proceeds in a general account in order to have access to the funds. As an alternative form of protection, an inventory financer can obtain a security interest directly in the deposit account. Although revised section 9-104(l)512 provides that Article 9 does not

510. Although the authorities are divided, a line of cases affords a party invoking tracing the opportunity to claim identifiable property when a wrongdoer has withdrawn funds from a commingled account to acquire the property. See, e.g., Republic Supply Co. v. Richfield Oil Co., 79 F.2d 375 (9th Cir. 1935); General Ass’n of Davidian Seventh Day Adventists, Inc. v. General Ass’n of Davidian Seventh Day Adventists, 410 S.W.2d 256 (Tex. Ct. App. 1966); see generally Oesterle, supra note 472, at 208 n.66 (describing the approaches taken by the courts).


apply to a transfer of an interest in a deposit account, by obtaining an assignment of the debtor's interest in the account, the inventory financer may be able to acquire a non-Code security interest in the account.

Under South Carolina law it appears that priority among assignees of a chose in action is determined by the order of assignment and without reference to which party first notified the obligor. Therefore, an inventory financer may be able to establish a prior claim to the entire balance in a debtor's general bank account simply by obtaining an assignment of the account in the security agreement. Nevertheless, to enhance its priority in the account against the depositing bank, which may assert a right of set off, the inventory financer should give the bank notice of the assignment.

2. Priority of Conflicting Claims to Cash Proceeds

An inventory financer's claim to cash proceeds may conflict with two types of interests. First, other creditors claiming an interest in the inventory may claim the cash proceeds as proceeds of their collateral. Second, other creditors may claim the cash proceeds as their primary collateral. This section first considers conflicts between inventory financers over cash proceeds, then analyzes the more complex issue of whether an inventory financer's interest in cash proceeds is entitled to priority over creditors who claim an interest directly in the cash proceeds.

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513. The revised section defines a deposit account as "a demand, time, savings, passbook, or like account maintained with a bank, savings and loan association, credit union, or like organization, other than an account evidenced by a certificate of deposit." U.C.C. § 9-105(1)(e) (1972) (amended 1977); S.C. Code Ann. § 36-9-105(1)(e) (Law Co-op. Supp. 1989).

514. See McLaughlin, Security Interests in Deposit Accounts: Unresolved Problems and Unanswered Questions Under Existing Law, 54 BROOKLYN L. REV. 45, 70-72, 74-75 (1988); see generally Zubrow, Integration of Deposit Account Financing into Article 9 of the Uniform Commercial Code: A Proposal for Legislative Reform, 68 MINN. L. REV. 899 (1984) (arguing that deposit account financing should be integrated into Article 9).


516. See McLaughlin, supra note 514, at 85; see generally infra notes 579-618 and accompanying text (analyzing priority of a bank's right to set-off).
a. Inventory Financers Asserting Conflicting Article 9 Security Interests in Cash Proceeds

As a general rule under the revised statute, an inventory financer's priority with respect to inventory will carry over to cash proceeds received in exchange for the inventory. Revised section 9-312(6) provides that for purposes of determining priority under the first to file or perfected rule of revised section 9-312(5)(a), "a date of filing or perfection as to collateral is also a date of filing or perfection as to proceeds."\(^{517}\) Therefore, if an inventory financer were entitled to priority with respect to the inventory as the first secured party to file or perfect, the inventory financer also would be entitled to priority with respect to the cash proceeds realized on the sale of the inventory. Moreover, if an inventory financer were entitled to priority with respect to inventory under revised section 9-312(3),\(^{518}\) the financer's purchase money priority would extend to "identifiable cash proceeds received [by the debtor] on or before the delivery of the inventory to a buyer."\(^{519}\) To illustrate the application of these rules consider the following:

**ILLUSTRATION 22**—On June 1 Bank entered into a written security agreement with Debtor under which Bank retained a security interest in Debtor's current and after-acquired inventory to secure an initial loan and any future advances. On June 1 Bank properly filed a financing statement to perfect its security interest. On July 1 Seller entered into a written contract with Debtor under which Seller agreed to sell certain items of inventory to Debtor on credit. The contract granted Seller a purchase money security interest in these items of inventory to secure Debtor's obligation to pay the purchase price. On July 1 Seller properly filed a financing statement to perfect its security interest. On July 10 Seller delivered the new inventory to Debtor. Seller, however, failed to give Bank written notice of its purchase money security interest before Debtor received possession of the new inventory.

On August 1 Debtor sold the new inventory to Buyer. Buyer paid for the inventory by cashier's check. On August 15 Debtor deposited the cashier's check in Debtor's general bank account. On August 20 Debtor defaulted on Debtor's obligations to both Bank and Seller, and both secured parties claimed a security interest in Debtor's general bank account.

Both Bank and Seller in Illustration 22 had perfected Article 9 security interests in the new inventory sold by Debtor on August 1.

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518. See supra note 114.
Additionally, the cashier's check received by Debtor in exchange for the inventory was cash proceeds under revised section 9-306(1).\textsuperscript{620} Therefore, under revised section 9-306(2) the security interests of both Bank and Seller continued in the cashier's check in the possession of Debtor because the check was "identifiable proceeds."\textsuperscript{621} Under revised section 9-306(3) the security interests of the Bank and Seller were automatically perfected for ten days following Debtor's receipt of the check.\textsuperscript{622} Moreover, since both Bank and Seller had filed financing statements covering the inventory sold, under revised section 9-306(3)(b) their security interests continued perfected after the expiration of the ten-day period, provided the proceeds remained "identifiable cash proceeds."\textsuperscript{623}

The first significant issue raised by Illustration 22 is whether the cash proceeds remained identifiable after Debtor commingled the cash proceeds with other funds by depositing the cashier's check in Debtor's general bank account. If the cash proceeds ceased to be identifiable upon commingling, the security interests of Bank and Seller would not merely cease to be perfected, they would cease to exist. Although cash proceeds arguably lose their identity when commingled with other funds in a general deposit account,\textsuperscript{624} as discussed above, if no insolvency proceedings have been instituted by or against the debtor, the courts have permitted secured parties to identify cash proceeds commingled in a general deposit account by tracing under the lowest intermediate balance method.\textsuperscript{625} Therefore, to the extent Bank and Seller can identify the cash proceeds by tracing, both secured parties can claim perfected security interests in the bank account.

Since both Bank and Seller can assert conflicting perfected security interests in the bank account, the priority conflict must be resolved. In resolving this dispute, one must first determine whether the conflict is within the scope of revised section 9-312(3), which defines the purchase money priority with respect to both inventory and proceeds.\textsuperscript{626} Although Seller had a purchase money interest in the new inventory\textsuperscript{627} and perfected it in a timely manner,\textsuperscript{628} Seller failed to give

\textsuperscript{520} See supra text accompanying note 464.
\textsuperscript{521} See supra text following note 464.
\textsuperscript{522} See supra notes 450-51 and accompanying text.
\textsuperscript{523} See supra text accompanying notes 457-61.
\textsuperscript{524} See 2 G. Gilmore, supra note 56, § 27.4, at 736.
\textsuperscript{525} See supra notes 467-68 and accompanying text.
\textsuperscript{528} See U.C.C. § 9-312(3)(a) (1972) (amended 1977); S.C. CODE ANN. § 36-9-
Bank prior notification as required under revised section 9-312(3)(b) through (d). Therefore, Seller is precluded from asserting a purchase money priority in the cash proceeds, and the conflict between Bank and Seller must be resolved under the residual first to file or perfect rule of revised section 9-312(5)(a). Under former section 9-312(5) resolution of this type of dispute between Bank and Seller was a matter of some uncertainty. A plausible argument could be made that the security interests of both Bank and Seller in the proceeds, as distinct from the inventory, were originally perfected automatically under former section 9-306(3). Therefore, the conflict was subject to the first to perfect rule of former section 9-312(5)(b). Under this rule the security interests of Bank and Seller arguably were perfected simultaneously when Debtor acquired rights in the cash proceeds. As a result, one could argue that the security interests of Bank and Seller were of equal priority. Fortunately, the revised statute clarifies the application of the residual priority rules to proceeds. As noted above, revised section 9-312(6) provides that for

529. See generally supra text accompanying notes 162-291 (analysis of notification requirement under section 9-312(3)).
532. See supra note 37 and accompanying text.
533. See, e.g., Weiss, supra note 531, at 789-90.
534. See Final Report, supra note 2, app., paras. E-33 to -38, at 223-26; see also S.C. CODE ANN. § 36-9-312 reporter's note 6 (Law. Co-op. Supp. 1989) (describing the 1972 text's treatment of priority in proceeds). The resolution of one significant issue, however, remains debateable under the revised statute. This issue can arise when a debtor has granted two or more inventory financers perfected security interests in distinct items of inventory. The debtor then sells items of inventory securing the various loans and commingles the cash proceeds realized into the debtor's general bank account. Finally, the debtor files for relief under the Bankruptcy Code. In such a case revised section 9-306(4)(d) defines the extent to which the inventory financers can claim a perfected security interest in the commingled account. See supra notes 460-514 and accompanying text. The priority issue arises when the balance in the account is insufficient to satisfy all of the claims established under revised section 9-306(4)(d). In Ford Motor Credit Co. v. Troy Bank & Trust Co., 76 Bankr. 836 (M.D. Ala. 1986), the court addressed this priority issue. First the court rejected the argument that revised section 9-312(5)(a) determined priority based upon the order of filing. The court reasoned that revised section 9-312(5)(a) applies only when both secured parties have a perfected security interest in the same collateral, and hence was inapplicable when the secured parties perfected in different items of collateral. Id. at 839. The court then held that the bank account should be divided pro rata between the inventory financers on the basis of
purposes of subsection (5), the date of filing or perfection with respect to the collateral is the date of filing or perfection with respect to proceeds. Therefore, because Bank filed on June 1 and Seller filed on July 1, Bank is entitled to priority with respect to the cash proceeds identified in Debtor’s general bank account.

A slight variation in the facts of Illustration 22 will illustrate the application of the purchase money priority to cash proceeds of inventory. If Seller had given Bank proper written notice of its purchase money security interest before Debtor received possession of the new inventory, Seller would have primed Bank as to that inventory under revised section 9-312(3). The question then posed is whether Seller’s purchase money priority extends to the cash proceeds Debtor received on the sale of the collateral.

The 1962 Official Text of Article 9 did not expressly address either this question or the basic issue of whether priority in inventory extended to proceeds. The failure of the 1962 Official Text to address this basic question created an unacceptable degree of uncertainty in inventory financing and spawned an outpouring of academic commentary advocating various resolutions. One of the virtues of the revised statute is that it provides clear rules defining the extent to which the purchase money priority extends to proceeds. Although the wisdom of various aspects of these rules is debatable, as applied to our variation of Illustration 22, the rules produce a result that is both certain and rational.

As a general rule, revised section 9-312(3) does not extend the purchase money priority in inventory to proceeds. The statute, however, does afford a purchase money financer of inventory who meets the conditions of revised section 9-312(3)(a) through (d) priority in “identifiable cash proceeds received on or before the delivery of the inventory to a buyer.” Therefore, since Seller in the variation of Il-

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their security interests established under revised section 9-306(4)(d). Id.; see also Murphy & Peitzman, Without a Trace: The Secured Creditor’s Interest in Deposit Account Proceeds, 49 AM. BANKR. L.J. 303, 318-20 (1975).


Illustration 22 had a purchase money priority in the inventory sold, it had priority under revised section 9-312(3) in the cashier's check the debtor received on delivery of the inventory to Buyer. Moreover, assuming that the cash proceeds remained identifiable following the deposit of the check, Seller can claim priority in the bank account.

Awarding Seller a purchase money priority in the cash proceeds in the variation of Illustration 22 is consistent with the basic Code policy of encouraging purchase money financing. Unless a purchase money financer of inventory is assured of priority with respect to the cash proceeds the debtor realizes upon sale of the collateral, the financer's purchase money priority would afford little incentive to extend credit.

The notable aspect of revised section 9-312(3) as applied to cash proceeds, however, is the limited extent of purchase money priority. For example, if the debtor sells the collateral on credit and collects the purchase price after delivery of the goods to the buyer, the purchase money priority does not extend to the cash proceeds. This result clearly was intended.539

As discussed below, the purchase money financer is denied priority in order to protect secured parties who lend against a debtor's accounts.540 The literal language of revised section 9-312(3), however, also may deny a purchase money priority in cash proceeds even when a debtor did not extend credit to the buyer. For example, if a debtor sold the inventory under a contract that authorized the debtor to ship the goods, delivery would occur when the debtor put the goods in the possession of a carrier under a proper contract for transportation and notified the buyer.541 The buyer, however, would not be obligated to tender payment until the buyer received the goods and had a reasonable opportunity to inspect them.542 Therefore, even though the debtor did not extend credit to the buyer, the debtor would not receive payment until after delivery.

Under revised section 9-312(3) the purchase money priority would not extend to this type of payment. This result may have been intended. If accounts financiers lend against "contingent" accounts, which arise when goods are shipped and prior to acceptance by the buyer, the result is consistent with the decision to insulate accounts and the proceeds thereof from the purchase money priority of a inven-

539. See Final Report, supra note 2, app., para. E-38, at 224-26; Coogan, supra note 2, at 517.

540. See infra notes 945-58 and accompanying text; see also sources cited supra note 539.


tory financer. Nevertheless, depriving a purchase money financer of priority in this context all but eliminates the financer's priority in cash proceeds. The purchase money financer will prevail over a floating li- nor, as to cash proceeds, only if the buyer pays for the goods before the debtor ships them.

Although analyzed in more detail below, an apparent irony in the rule limiting the purchase money priority in proceeds should be noted at this point. The Code restricts a purchase money inventory financer's priority in proceeds in order to insure that the subsequent inventory financer will not prime an accounts financer who filed first. This rationale, however, does not appear to support a rule subordinating a purchase money financer's interest in proceeds to the claim of a prior inventory financer claiming the proceeds as proceeds of after-acquired property unless the prior financer relies upon the accounts in making advances. Nevertheless, that the 1972 Amendments adopted this rule provides insight into the nature of inventory financing under revised Article 9.

b. Inventory Financers Versus Creditors Asserting an Interest Directly in Cash Proceeds

An inventory financer asserting a security interest in cash proceeds may confront creditors who claim an interest directly in the cash pro- ceeds. For example, a secured party may claim a security interest di- rectly in the cash proceeds or in a bank account into which the debtor has deposited cash proceeds. The most significant adverse claim as- serted directly in cash proceeds, however, is that of a creditor bank asserting a right to set off against a deposit account containing cash proceeds. This section will analyze the resolution of these conflicts.

(i) Pledges of Cash Proceeds

The cash proceeds a debtor receives upon a sale of encumbered inventory will consist of checks and money. In theory, the debtor can grant Article 9 security interests in both the checks and the money. The checks are instruments and a transaction creating a security interest in instruments is within the scope of Article 9. A security in-

543. See infra text accompanying notes 987-1000.
terest taken directly in checks, however, must be perfected by taking possession of the collateral.\textsuperscript{547} The treatment of money as collateral was unclear under the 1962 Official Text.\textsuperscript{548} Under revised sections 9-304(1) and 9-305, however, it is clear that a creditor can perfect a security interest in money through possession.\textsuperscript{549}

Although it is unlikely that a debtor would pledge money or checks that an inventory financer claimed as cash proceeds, a pledge of checks is at least conceivable. Moreover, a debtor may use proceeds checks to pay debts and meet operating expenses. Therefore, an inventory financer may confront transferees asserting a claim directly in checks that the financer claims as cash proceeds. In these priority conflicts the inventory financer will be able to assert a perfected security interest in the checks. Under revised section 9-306(3)(b) an inventory financer’s filing with respect to inventory continues the perfected status of its security interest in identifiable cash proceeds beyond the ten-day period of automatic perfection.\textsuperscript{550} Moreover, the proceeds checks would remain identifiable following their transfer provided they have not been paid on presentment. In addition, under revised section 9-312(6) the date on which the inventory financer filed with respect to the inventory fixes its priority with respect to proceeds for purposes of revised section 9-312(5)(a).\textsuperscript{551} Therefore, if the residual first to file or perfect rule of revised section 9-312(5)(a) governs a dispute between the inventory financer and a transferee of a proceeds check, the inventory financer will prevail. The problem confronting the inventory financer is that one of two special priority rules may preempt revised section 9-312(5)(a) and award priority to the transferee.

If the transferee of a proceeds check qualifies as a holder in due course,\textsuperscript{552} section 9-309\textsuperscript{553} applies and grants the transferee priority

\footnotesize{(Law. Co-op. Supp. 1989).}


\textsuperscript{548} See B. Clark, supra note 8, ¶ 7.02, at 7-4 to -6.


\textsuperscript{550} See B. Clark, supra note 8, ¶ 10.01[2][a] n.19, at 10-5. But see id. ¶ 3.06, at 3-63 to -65.

\textsuperscript{551} See supra text accompanying note 517.

\textsuperscript{552} For a transferee of a proceeds check to qualify as a holder in due course the transferee must take possession of a properly endorsed check for value, in good faith, and without notice of the inventory financer’s claim to the check. U.C.C. § 3-302(1) (1972), § 1-201(20) (1977); S.C. CODE ANN. §§ 36-3-302(1), -1-201(20) (Law. Co-op. 1976).


Nothing in this chapter limits the rights of a holder in due course of a negotiable instrument (Section 36-3-302) or a holder to whom a negotiable doc-
over the inventory financer. To qualify as a holder in due course the transferee must take the check without notice of the inventory financer's claim to it. The mere fact that the inventory financer has filed, however, does not constitute notice of its security interest, even if the filing expressly covered cash proceeds in the form of checks.

If the transferee of a proceeds check has actual notice of the inventory financer's security interest, and hence fails to qualify as a holder in due course, the transferee may still prime the inventory financer under revised section 9-308(b). As amended, section 9-308 applies to purchasers of instruments as well as chattel paper who give new value and take possession in the ordinary course of their business. Therefore, if the transferee of a proceeds check gives new value and takes possession of the check, the transferee will prime an inventory financer who claims the check merely as proceeds, even though the transferee has knowledge of the inventory financer's security interest.

(ii) Assignees of Bank Accounts into Which Cash Proceeds Have Been Commingled

If a debtor neither pledges nor spends cash proceeds, the debtor


554. See generally B. CLARK, supra note 8, ¶ 3.06, at 3-64 (arguing that granting the transferee priority in this situation is one of the most important aspects of section 9-309).

555. Id.


559. See B. CLARK, supra note 8, ¶ 3.06, at 3-65 to -67. Although analyzed in the context of cash proceeds in the form of checks, the extension of section 9-308 to cover instruments may be of greatest significance when the proceeds of inventory take the form of a negotiable note. If the note is transferred to a holder with notice of the inventory financer's proceeds claim, section 9-309 will not protect the transferee because the transferee fails to qualify as a holder in due course. Nevertheless, if the transferee gave new value and took possession of the note in the ordinary course of his business, under revised section 9-308(b) the transferee will prime the inventory financer claiming the note, even if the transferee had knowledge of the inventory financer's security interest.
likely will deposit the cash proceeds in a bank account.\textsuperscript{560} Assuming an inventory financer can identify the cash proceeds deposited in the bank account,\textsuperscript{561} the financer may confront two conflicting claims made directly upon the account. First, a creditor may have a non-Code security interest in the account. Second, and more significantly, the right to set-off may be asserted by the bank in which the debtor maintains the account.

Revised section 9-104(1) provides that Article 9 is inapplicable to a transfer of an interest in a deposit account other than an interest claimed as proceeds.\textsuperscript{562} Nevertheless, a creditor may be able to establish a non-Code security interest in a debtor's bank account either by a pledge of a passbook or through an assignment of the debtor's right to withdraw funds from the account.\textsuperscript{563} If a creditor has established a non-Code security interest in a debtor's bank account through an assignment, one must determine whether this non-Code security interest is entitled to priority over an inventory financer's security interest in the account to the extent of identifiable cash proceeds.

The resolution of this conflict is not clear.\textsuperscript{564} Revised section 9-104(1) suggests that revised section 9-312 can be applied to determine priorities with respect to proceeds in a deposit account.\textsuperscript{565} Revised section 9-312(5)(a) and (6), which set forth the residual priority rules with respect to proceeds, however, apply only if both competing claims are perfected Article 9 security interests.\textsuperscript{566} Therefore, revised section 9-312 should not apply to resolve a conflict between a non-Code security interest on the account and a perfected Article 9 security interest in cash proceeds.


\textsuperscript{561} See supra text accompanying notes 464-73.


\textsuperscript{563} See Guardian Fidelity Corp. v. First S. Sav. Bank, 297 S.C. 63, 374 S.E.2d 690 (Ct. App. 1988) (security interest in nontransferable certificate of deposit created by assignment); see also B. Clark, supra note 8, ¶ 7.09[2], at 7-34 to -35 (nontransferable certificate of deposit should be considered a type of deposit account excluded from Article 9 and perfection of security interests therein should be governed by common-law principles); see generally McLaughlin, supra note 514, at 60-75 (discussing creation and perfection of security interests in nonpassbook deposit accounts).

\textsuperscript{564} McLaughlin, supra note 514, at 79-80.


At least three plausible rules may apply to resolve this conflict. First, the inventory financer asserting a security interest in cash proceeds can argue that section 9-201 provides the applicable priority rule. 667 Section 9-201 provides that the terms of a security agreement are effective against creditors unless the Code otherwise provides. 668 If section 9-201 is applied, the inventory financer invariably will prime the assignee of the account because the Code nowhere otherwise provides priority to the holder of a non-Code security interest in a deposit account.

The second plausible source for a priority rule is the body of law giving rise to the non-Code security interest. For example, the courts have consistently turned to landlord-tenant law to resolve priority disputes between an Article 9 secured party and a landlord asserting a non-Code landlord’s lien. 669 If this approach were adopted, the South Carolina law on assignments would provide the priority rule.

The South Carolina courts apparently resolve conflicts between competing assignees by awarding priority to the first assignee to obtain an assignment. 670 Under this rule an inventory financer would prime an assignee of the debtor’s bank account if the financer obtained a security interest in the account before the debtor assigned the account to the conflicting creditor. Application of this rule in a typical commercial context is fraught with uncertainty because, unlike Article 9, the common law does not validate present assignments of future rights. 671


Except as otherwise provided by this title a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors. Nothing in this chapter validates any charge or practice illegal under any statute or regulation under the statute governing usury, small loans, retail installment sales, or the like, or extends the application of any statute or regulation to any transaction not otherwise subject to the statute or regulation.


571. See 4 A. Corbin, supra note 570, § 874, at 503; E. Farnsworth, Contracts § 11.5, at 766-68 (1982); Restatement (Second) of Contracts § 321(2) (1979).
Therefore, a security agreement which granted an inventory financer a right to future cash proceeds of unsold and after-acquired inventory would not effect a valid assignment.\textsuperscript{572} Moreover, although some courts recognize equitable assignments of future rights, an equitable assignment is not valid against a subsequent good faith purchaser who obtained an assignment of the right after it came into existence.\textsuperscript{572} Under this analysis a secured party who obtained an equitable assignment of a debtor's future cash proceeds under a security agreement would lose to an assignee of the debtor's bank account who took an assignment after the cash proceeds had been deposited.\textsuperscript{574}

Finally, it has been suggested that the rules applicable in noninsolvency situations for determining priority conflicts between a secured party claiming cash proceeds in a commingled account and a bank exercising a right to set-off be applied to resolve the conflict between a secured party and the older of a non-Code security interest.\textsuperscript{575} The basis for this suggestion and its possible effect are unclear. As discussed below, under the "legal rule" a bank exercising its right to set-off is entitled to priority unless it had knowledge or notice that the account contained cash proceeds.\textsuperscript{576} Under the "equitable rule" the bank is entitled to priority only if it relied upon the cash proceeds deposited in the account.\textsuperscript{577} Apparently, under the legal rule the assignee of the account would prime the secured party unless the assignee had notice that cash proceeds had been commingled into the account. Under the equitable rule, however, the assignee would prevail only if the assignee relied upon the cash proceeds by making a loan against the commingled account.

In summary, while it is probable that a creditor can obtain a non-Code security interest in a deposit account, the priority of that interest against an inventory financer's Article 9 security interest in identifiable cash proceeds in the account is highly uncertain. This uncertainty supports the argument that Article 9 should be amended to encompass security interests in deposit accounts.\textsuperscript{578}

\textsuperscript{572} See sources cited supra note 571.
\textsuperscript{573} See E. Farnsworth, supra note 571, § 11.5, at 770.
\textsuperscript{574} See, e.g., Stokely Bros. & Co. v. Conklin, 131 N.J. Eq. 552, 26 A.2d 147 (Ch. Div. 1942).
\textsuperscript{575} See McLaughlin, supra note 514, at 79-80.
\textsuperscript{576} See infra text accompanying notes 608-10.
\textsuperscript{577} See infra text accompanying notes 611-14.
\textsuperscript{578} See McLaughlin, supra note 514, at 82-93; Zubrow, supra note 514, at 899.
As discussed above, an inventory financer's ability to identify cash proceeds is jeopardized when the debtor commingles the cash proceeds with other funds by depositing them in a general deposit account. The inventory financer's problems are exacerbated if the debtor maintains the deposit account at a creditor bank. In the event the debtor defaults on an obligation to the creditor bank, the bank may claim the deposit account under the common law right to set-off. Therefore, when cash proceeds have been deposited in a general account at a creditor bank, an inventory financer must not only identify the commingled cash proceeds, but also establish that its security interest is entitled to priority over the bank's right to set-off.

An analysis of the conflict between a secured party asserting a security interest in a deposit account to the extent of identifiable cash proceeds and a bank asserting a right to set-off against the account must commence with an analysis of the right to set-off. The right to set-off is limited to mutual debts. When a bank exercises a right to set-off, the debts at issue are the loan obligation of the depositor to the bank, and the deposit account, which is a debt the bank owes to the depositor.

If the depositor defaults on an obligation to the bank, the bank can set-off its debt to the depositor against the depositor's debt to the bank, provided the debts are mutual. For the debts to be mutual, the depositor must have incurred the loan obligation to the bank and created the debt from the bank (i.e. the deposit account) in the same capacity. As a general rule if a depositor borrows from the bank in the depositor's personal capacity and maintains a trust account with the bank as a trustee for a third party, the bank cannot set-off the trust account against the depositor's personal debt in the event the depositor defaults on the personal loan obligation.

The courts, however, have recognized two exceptions to this gen-

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579. See supra text accompanying notes 464-516.
581. See Clark, supra note 580, at 197; Zubrow, supra note 514, at 942; Note, supra note 580, at 238.
582. See Zubrow, supra note 514, at 942.
583. See Clark, supra note 580, at 197.
584. See RESTATEMENT (SECOND) OF TRUSTS § 324 comment i (1959).
eral rule of mutuality. First, some courts invoke the "legal rule" under which the bank can set-off against a trust account if the bank lacks knowledge or notice that the deposit account is a trust account.\(^{585}\) Second, other courts invoke the "equitable rule" which affords a more narrow exception to the requirement of mutuality.\(^{586}\) Under the equitable rule, even if the bank lacks knowledge or notice that the account is a trust account, a court will sustain a set-off against the trust account only if the bank reasonably relied upon the account as a personal account of the depositor.\(^{587}\)

The mutuality requirement and its exceptions could resolve the issue of whether a bank can set-off against identifiable cash proceeds in a deposit account. If a deposit account is deemed to be a trust account to the extent it contains identifiable cash proceeds, the bank apparently has no right to set-off against the cash proceeds component of the account, unless the bank can establish an exception to the mutuality requirement under the legal or equitable rule. Therefore, a secured party claiming a security interest in cash proceeds can assert that unless the legal or equitable rule applies, a bank has no right to set-off against a debtor's deposit account to the extent the account consists of identifiable cash proceeds. In short, the secured party can argue that no priority conflict exists because the bank has no right to set-off against cash proceeds.

Most courts, however, have not resolved the conflicting claims of a secured party and a bank exercising a right of set-off in terms of the scope of the bank's right. Rather, the courts have viewed the conflict as raising a priority question. Moreover, although some courts have invoked the requirement of mutuality and the exceptions thereto as an applicable priority rule,\(^{588}\) a majority of courts have turned to Article 9 to determine priority.\(^{589}\)

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585. See, e.g., National Acceptance Co. of Am. v. Virginia Capital Bank, 498 F. Supp. 1078, 1085 (E.D. Va. 1980), rev'd in part on other grounds, 673 F.2d 1314 (4th Cir. 1981); see also Restatement (Second) of Trusts § 324 comment j (1959) (bank must lack notice both at time deposit is made and at time debt arises); Note, supra note 580, at 251-52 (arguing legal risks should be changed to protect bank that has a prior interest and that has given notice).

586. See, e.g., Commercial Discount Corp. v. Milwaukee W. Bank, 61 Wis. 2d 671, 214 N.W.2d 33 (1974).


588. See, e.g., National Acceptance Co. of Am., 498 F. Supp. 1078 (legal rule, alternative grounds); Commercial Discount Corp., 61 Wis. 2d 671, 214 N.W.2d 33 (equitable rule).

When confronted with conflicting claims to a bank account asserted by a secured party claiming a security interest in cash proceeds and a bank claiming a right of set-off, most courts commence their analysis by interpreting revised section 9-104(i).590 This provision states that Article 9 does not apply "to any right of setoff."591 All authorities agree that this section means that Article 9 does not apply to the creation of the right to set-off.592 The question that remains is whether revised section 9-104(i) should be read as rendering the priority rules of Article 9 inapplicable to resolve disputes between Article 9 secured parties and creditors exercising a right to set-off.593 Under a narrow interpretation of the exclusion, the priority rules of Article 9 would remain applicable. Under a broad interpretation, however, non-Code priority rules would be applied to resolve the conflict between a security interest and a right of set-off.

Although the authorities are divided, most courts have interpreted section 9-104(i) narrowly and have applied Article 9 priority rules to resolve priority disputes between secured parties and creditors asserting a right to set-off.594 The principal reason advanced by the courts adopting a narrow interpretation of revised section 9-104(i) is that revised section 9-306(4)(d)(i)595 sets forth a priority rule applicable to the right to set-off, and the presence of this priority rule undercuts the argument that the drafters intended to exclude priority conflicts involving set-off from the scope of Article 9.596

The analysis, however, does not end with a decision to apply Article 9. If insolvency proceedings have been instituted by or against the debtor when the creditor asserts a right to set-off, Article 9 appears to provide a specific priority rule: under revised section 9-306(4)(d)(i) a secured party's security interest in the deposit account is "subject to


593. See Clark, supra note 580, at 219-20.


any right to set-off." If revised section 9-306(4)(d)(i) is a priority provision, then in all cases in which the right to set-off is asserted after insolvency proceedings have been instituted, the bank asserting the right to set-off will prime a secured party asserting a perfected security interest in the deposit account.

Revised section 9-306(4)(d)(i) applies, however, only if insolvency proceedings have been instituted by or against the debtor when the bank asserts its right to set-off. Therefore, a court adopting a narrow interpretation of revised section 9-104(i) must look elsewhere in Article 9 for a priority rule to resolve disputes that arise when the right to set-off is asserted before insolvency proceedings are commenced.

The rule that the courts have applied in noninsolvency situations is the fundamental priority rule of section 9-201. Section 9-201 provides, "[e]xcept as otherwise provided by this title a security agreement is effective according to its terms . . . against creditors." In applying section 9-201, the courts reason that for purposes of Article 9 a creditor exercising a right to set-off is simply an unsecured creditor, and that with the exception of revised section 9-306(4)(d)(i), the Code does not provide such a creditor priority over a secured party. Therefore, the courts have applied section 9-201 to award priority to the secured party in cases in which the bank has exercised its right to set-off before the commencement of insolvency proceedings by or against the debtor.

The application of Article 9 priority rules to resolve conflicts over deposit accounts between secured parties asserting a security interest in identifiable cash proceeds and banks asserting a right of set-off produces clear results. If insolvency proceedings have been instituted by or against the debtor before the bank asserts its right of set-off, revised section 9-306(4)(d)(i) awards priority to the bank. In contrast, if in-

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solvency proceedings have not been instituted by or against the debtor when the bank exercises its right to set-off, section 9-201 awards priority to the secured party. 605 Although these results are certain, they are disturbing. The Article 9 priority rules provide different results depending upon whether insolvency proceedings have been instituted before the bank exercises its right to set-off. These different results militate against reading revised section 9-104(i) narrowly and applying the priority rules of Article 9.

A minority of courts have interpreted revised section 9-104(i) broadly to exclude from the scope of Article 9 both the creation of the right to set-off and the determination of the priority of that right when it conflicts with an Article 9 security interest. 606 The courts adopting this broad interpretation of the exclusion of set-off have brushed aside the argument that revised section 9-306(4)(d)(i) establishes that the drafters intended Article 9 to govern priority disputes between a secured party and a creditor exercising a right to set-off. These courts have interpreted the provision to mean that a secured party’s security interest in a commingled account in an insolvency situation is subject to whatever priority the right to set-off may have under applicable non-Code law. 607 The virtue of a broad interpretation of revised section 9-104(i) is that it produces a single priority rule applicable in both insolvency and noninsolvency situations. A problem with the broad interpretation is that at least two non-Code priority rules could apply.

A court applying non-Code law to determine whether a bank’s right to set-off primes a security interest in identifiable cash proceeds could invoke the “legal rule.” 608 Under the legal rule, a bank cannot set-off against funds that it knows or has reason to know are subject to


606. See, e.g., State Bank v. First Bank, 320 N.W.2d 723 (Minn. 1982); Bank of Crystal Springs v. First Nat’l Bank, 427 So. 2d 968 (Miss. 1983); First Nat’l Bank v. Lone Star Life Ins. Co., 529 S.W.2d 67 (Tex. 1975); see also Citibank, N.A. v. Interfirst Bank, N.A., 784 F.2d 619 (5th Cir. 1986) (set-off versus possessory security interest in nonnegotiable certificate of deposit); Clark, supra note 580, at 221-22 (discussing possible readings of section 9-306(4)(d)(i)); Skilton, supra note 483, at 79-80 (discussing the “subject to any right of set-off” language of section 9-306(4)(d)).


a third party's security interest.609 Therefore, if the bank knows that a debtor has deposited cash proceeds subject to a security interest in the account, the creditor bank has no right to set-off against the account to the extent of the identifiable cash proceeds. Moreover, even if the bank lacks actual knowledge that the account contains cash proceeds, the legal rule subordinates the bank's right of set-off if the bank has knowledge of facts that would cause a reasonably prudent person to inquire as to the source of the funds, and a reasonable inquiry would have disclosed that the funds were cash proceeds subject to a security interest.610

The alternative non-Code priority rule that a court could invoke is the "equitable rule," which further limits a bank's right to set-off.611 Under the equitable rule even if the bank has neither knowledge nor notice that the accounts contains cash proceeds, the bank cannot set-off against and retain the cash proceeds unless it has detrimentally changed its position in reliance on the debtor's ownership of the funds.612 Moreover, merely setting off against a depositor's account is not sufficient reliance to invoke the equitable rule.613 To benefit from this rule the bank must either release collateral or extend credit in reliance upon the depositor's account.614

The South Carolina courts have not resolved the question of which priority rules govern conflicts between a secured party and a bank exercising a right to set-off. On balance, the best solution would be to resolve such conflicts under non-Code law. Such a resolution focuses on the extent of the right to set-off, rather than a mechanical application of statutory language. Moreover, application of non-Code law would not produce different results in insolvency as opposed to noninsolvency situations. If the South Carolina courts adopt a broad interpretation of revised section 9-104(i), the courts probably would recognize the "equitable rule" as the only exception to the doctrine of mutuality.615 Under the equitable rule, the secured party would prevail over the bank only if the bank had no knowledge or notice that the account contained

610. See supra note 585.
611. See, e.g., Commercial Discount Corp. v. Milwaukee W. Bank, 61 Wis. 2d 671, 214 N.W.2d 33 (1974).
612. See Clark, supra note 580, at 220-21; Skilton, supra note 465, at 191-96; TeSelle, supra note 609, at 72.
614. Id.
615. See Peurifoy v. Boswell, 162 S.C. 107, 126, 160 S.E. 156, 163 (1931); see also Commercial Discount Corp., 61 Wis. 2d at 680-81, 214 N.W.2d at 37-38 (listing South Carolina among jurisdictions adopting equitable rule).
cash proceeds and the bank reasonably relied upon the depositor's account in releasing collateral or extending credit.

Although application of non-Code law to resolve disputes between secured parties and banks exercising a right to set-off conforms the priority rules to the nature of the right to set-off, one policy argument can be made in favor of the majority position that Article 9 provides the priority rules. When a bank exercises its right to set-off against a financially embarrassed debtor's general bank account, the impact upon the debtor is both immediate and pronounced. The loss of its account may preclude the debtor from paying employees and suppliers, and thus force the debtor into bankruptcy. The debtor's bankruptcy, in turn, may injure its employees and unsecured creditors.616

Congress recognized this phenomenon and drafted section 553(b) of the Bankruptcy Code to discourage banks from exercising a right to set-off.617 Under section 553(b), a bank that exercises a right to set-off within 90 days before a debtor files for relief under the Bankruptcy Code can be forced to disgorge funds upon which the bank could have established a secured claim had it refrained from asserting its right to set-off until after the commencement of the bankruptcy case.618

Albeit coincidentally, application of the Article 9 priority rules furthers the policy effected by section 553(b) of the Bankruptcy Code. If a bank exercises a right to set-off before insolvency proceedings have been instituted by or against the debtor, section 9-201 applies to grant a secured party priority over the bank when the secured party is claiming a security interest in commingled but identifiable proceeds. In contrast, if the bank refrains from asserting its right to set-off until after

616. See generally 2 W. NORTON, NORTON BANKRUPTCY LAW AND PRACTICE § 33.03 (1981) (detering set-off against financially troubled debtor may allow debtor to avoid bankruptcy).

617. See 11 U.S.C. § 553(b) (1988). This section provides:

(b)(1) Except with respect to a setoff of a kind described in section 362(b)(6), 362(b)(7), 365(h)(2), or 365(f)(2) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of —

(A) 90 days before the date of the filing of the petition; and

(B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

(2) In this subsection, "insufficiency" means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.

Id. (footnote omitted).

618. See, e.g., Exxon Corp. v. Compton Corp. (In re Compton Corp.), 22 Bankr. 276 (Bankr. N.D. Tex. 1982); see also Clark, supra note 580, at 229-31.
the insolvency proceedings have been commenced, revised section 9-306(4)(d)(i) applies and awards priority to the bank. Thus, application of the Article 9 priority rules furthers the policy of discouraging banks from exercising a right to set-off prior to the institution of insolvency proceedings.

C. Non-Cash Proceeds

The principal types of noncash proceeds generated by the sale of encumbered inventory are chattel paper and accounts. An inventory financer asserting a security interest in such proceeds may face two distinct types of priority conflicts. First, another inventory financer may claim a conflicting security interest in the chattel paper or accounts as proceeds. Second, the inventory financer’s security interest in proceeds may conflict with a security interest asserted directly in the chattel paper or accounts.

The 1962 Official Text left many of these priority disputes unresolved. In contrast, the 1972 Official Text provides definite rules for resolving priority disputes which involve secured parties asserting security interests in accounts and chattel paper as proceeds of encumbered collateral. These priority rules, however, reflect the drafters’ pre-occupation with a single priority conflict involving noncash proceeds of inventory.

The drafters focused on the conflict between an accounts financer who files covering a debtor’s current and after-acquired accounts, and a subsequent purchase money inventory financer who claims accounts as proceeds. The priority dispute arose when items of new inventory were sold, generating an account subject to the security interests of both the accounts financer and the inventory financer. The drafters of the 1972 Official Text concluded that an earlier-filed accounts financer should prime a subsequent purchase money inventory financer claim-

622. See Final Report, supra note 2, app., para. E-38, at 224-26; A Second Look at the Amendments to Article 9 of the Uniform Commercial Code, 29 BUS. LAW. 973, 1000-03 (1974) (remarks by R. Haydock, Jr., H. Kripke, P. Coogan, and J. Edmonds presented in a program of section’s committee on U.C.C. in Washingt on, D.C. on August 8, 1973) [hereinafter Second Look]; see generally Henson, supra note 537, at 239 (noting that former version of Code did not explicitly resolve conflicts between financers with claims to proceeds).
ing accounts as proceeds of collateral.\textsuperscript{623} Therefore, the drafters included provisions in revised section 9-312 to effect this result.\textsuperscript{624} Although one may question the wisdom of this decision, the principal concern with the drafters’ resolution of this conflict is the manner in which they effected the result. The revisions adopted to enable an accounts financer to prime a subsequent purchase money inventory financier’s claim to accounts as proceeds also produce results in other priority conflicts involving noncash proceeds of inventory.\textsuperscript{625} The resolution of these conflicts, however, largely defines the role of inventory financing under the revised Code.

1. Chattel Paper as Proceeds

Chattel paper is one of the two principal types of noncash proceeds generated by the sale of encumbered inventory. The Code defines chattel paper as “a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods.”\textsuperscript{626} Perhaps the most common form of chattel paper is the installment sales contract. Under such a contract a retailer sells goods to a consumer on credit and retains a purchase money security interest in the goods sold to secure the consumer’s obligations to pay the purchase price and finance charge in periodic installments.\textsuperscript{627} If the retailer making the installment sale previously had granted a secured party a security interest in the item of inventory sold, the inventory financer can assert a security interest upon the installment sales contract as proceeds of its collateral.\textsuperscript{628}

An inventory financer asserting a perfected security interest in chattel paper as proceeds may face several conflicting claims to the chattel paper. First, other creditors with security interests in the debtor’s inventory also may claim the chattel paper as proceeds. Second, and more significantly, the inventory financer may face conflicting claims of secured parties who assert security interests directly in the


\textsuperscript{625} See infra text accompanying notes 669-84, 969-1000.


chattel paper. This class includes both creditors who retain security interests in a debtor's chattel to secure a loan,629 as well as purchasers who buy a debtor's chattel paper.630 Moreover, an inventory financer claiming chattel paper as proceeds also may encounter a priority dispute with a purchaser of the chattel paper over the underlying goods if those goods are returned to or repossessed by the debtor.631 This section will analyze these priority problems.

a. Conflicting Claims of Inventory Financers to Chattel Paper as Proceeds

Revised sections 9-312(5)632 and (6)633 control the resolution of priority disputes between inventory financers asserting conflicting security interests in chattel paper as proceeds. Revised section 9-312(6) provides that for purposes of the first to file or perfect rule of revised section 9-312(5)(a), the date of filing or perfection as to collateral is the date of filing or perfection as to proceeds.634 The application of these provisions to conflicting security interests in chattel paper as proceeds of inventory would be unremarkable but for the fact that revised section 9-312(5)(a), rather than revised section 9-312(3),635 governs a purchase money inventory financer's priority in chattel paper as proceeds.

Revised section 9-312(3) provides that purchase money priority with respect to inventory extends to proceeds only if the proceeds are

cash proceeds received on or before delivery of inventory to a buyer.\textsuperscript{636} This limitation has the effect of relegating the determination of a purchase money financer’s priority with respect to chattel paper as proceeds to the residual rule of revised section 9-312(5). To illustrate the problem raised by the limited scope of revised section 9-312(3), consider the following:

**ILLUSTRATION 23**—On June 1 Bank and Dealer entered into a written security agreement, which granted Bank a security interest in Dealer’s current and after-acquired inventory to secure a contemporaneous loan and any future advances. Also on June 1, Bank filed a financing statement in the Secretary of State’s office covering Dealer’s inventory. On June 30 Seller and Dealer entered into a written contract under which Seller agreed to sell new inventory to Dealer on credit. This contract granted Seller a purchase money security interest in the new inventory to secure Dealer’s obligation to pay the purchase price. Also on July 1, Seller properly filed a financing statement covering the new inventory in the Secretary of State’s office. Finally on July 1, Bank received written notification stating that Seller had a purchase money security interest in the new inventory and describing that inventory by item. On July 10 Seller delivered the new inventory to Dealer. On August 1 Dealer sold an item of the new inventory to Consumer under an installment sales contract, which granted Dealer a security interest in the goods sold to secure Consumer’s obligation to pay purchase price and finance charge in period installments. On September 1 Dealer defaulted on both obligations to Bank and Seller, and both secured parties sought to assert their respective security interests in the installment sales contract, which remained in Dealer’s possession.

Had the dispute in Illustration 23 been over the item of new inventory before its sale to Consumer, Seller would have had priority over Bank. Although Bank was the first secured party to file or perfect, Seller established a purchase money “super priority” in the new inventory under revised section 9-312(3).\textsuperscript{637} The dispute in issue, however, involves chattel paper as proceeds of the new inventory.\textsuperscript{638} The critical question is whether Seller’s purchase money priority in the new inventory extends to proceeds of that inventory.

The resolution of the priority conflict in Illustration 23 under the


\textsuperscript{637} See supra notes 126-30 and accompanying text.

\textsuperscript{638} Note that if Dealer does business only in South Carolina, or has its chief executive office in South Carolina, the filings of Bank and Seller with respect to inventory will be effective to continue the perfected status of their security interests in the chattel paper as proceeds under revised section 36-9-306(3)(a). See supra text following notes 460-63.
1962 Official Text was uncertain. The former statute did not expressly address either priority conflicts over proceeds or the extent to which a purchase money priority in collateral extended to proceeds. In contrast, the 1972 Official Text enacted in South Carolina in 1988, addresses these issues and awards priority to Bank in Illustration 23. Although a clear priority rule is preferable to uncertainty, application of the revised statute in Illustration 23 calls the wisdom of the new priority rules into question.

Under the 1962 Official Text, application of the residual priority rules of former section 9-312(5)(a) and (b) to proceeds was a matter of some uncertainty. A court applying the 1962 Official Text probably would extend the purchase money priority to the chattel paper so as to award priority to Seller in Illustration 23. A court applying the 1962 Official Text, however, possibly could apply the first to file rule of former section 9-312(5)(a) and award Bank priority in the chattel paper. As a final possibility, a security interest in proceeds could be viewed as distinct from a security interest in the collateral, and thus originally perfected automatically under former section 9-306(3) when the debtor received the proceeds. Under this interpretation of the 1962 Official Text, the first to perfect rule of former section 9-312(5)(b) would control the dispute between Bank and Seller in Illustration 23. Moreover, under this interpretation the security interests of Bank and Seller would be co-equal liens because their security interests were simultaneously perfected when Dealer received the chattel paper.

Revised section 9-312(3) expressly addresses the extent to which a purchase money priority in inventory extends to proceeds. Under this section the purchase money priority in inventory extends to proceeds only if the proceeds are "identifiable cash proceeds received on or before the delivery of the inventory to a buyer." Therefore, revised section 9-312(3) does not afford Seller in Illustration 23 a purchase money priority in the chattel paper as proceeds of its collateral. Since revised section 9-312(3) is inapplicable, the resolution of the conflict between Bank and Seller must be resolved under the residual priority rule of revised section 9-312(5)(a).

639. See R. Henson, supra note 621, at 136-39.
641. See Gilmore, supra note 115, at 1383.
642. See 2 G. Gilmore, supra note 56, § 29.4, at 796; Coogan & Gordon, supra note 537, at 1562-63.
The 1972 Official Text clarifies the application of the residual priority rule to proceeds. As provided under revised section 9-312(6), the date of filing or perfection as to collateral is also the date of filing or perfection with respect to proceeds. Therefore, under the revised statute Bank in Illustration 23 primes Seller with respect to the chattel paper because Bank was the first to file or perfect with respect to inventory.

Although the result in Illustration 23 is clear under the revised statute, the illustration raises an obvious question. Why should Seller, who was entitled to priority with respect to the item of inventory sold under revised section 9-312(3), be subordinated to Bank with respect to the chattel paper as proceeds? This result undercuts the Article 9 basic policy of encouraging purchase money financing by affording purchase money financers priority over conflicting security interests which attach to the collateral as after-acquired property. Therefore, the rationale for awarding priority to Bank in Illustration 23 should be compelling. This article maintains that when a purchase money financer has met the conditions of revised section 9-312(3) there is no satisfactory justification for subordinating a purchase money financer's claim to proceeds in the form of chattel paper to the claim of an earlier-filed secured party who held a subordinate interest in the inventory.

Any justification for the result in Illustration 23 stems from the fact that the question presented in the illustration is but one manifestation of the most celebrated priority issue under the 1962 Official Text of Article 9. Broadly stated, this issue was whether a purchase money priority in collateral extends to proceeds generated by the sale of the collateral. As noted, the 1962 Official Text did not expressly resolve this issue. This issue was, however, discussed at length by commentators, and this scholarship played a significant role in the drafting of the revised statute.

The commentators viewed the issue of whether the purchase money priority extended to proceeds as arising primarily in a context distinct from that presented in Illustration 23. Specifically, the commentators were concerned about the priority conflict between an accounts financer who was the first secured party to file and a subsequent purchase money financer of inventory who asserted a perfected

645. See, e.g., 2 G. GILMORE, supra note 56, § 29.4, at 791-95; Coogan & Gordon, supra note 537, at 1558-66; Gilmore, supra note 115, at 1383-85 (1963); Henson, supra note 537, at 239-40.
security interest in accounts as proceeds of the financed collateral. 647 Most commentators asserted that accounts financing was more significant than purchase money inventory financing, and that to extend the purchase money priority in inventory to accounts as proceeds would significantly impair accounts financing. 648

Basically, these commentators asserted that an accounts financer who filed first should be entitled to rely upon the priority with respect to all subsequent accounts generated by the debtor, including those that arose out of sales of purchase money collateral. Moreover, the commentators argued that preferring the prior accounts financers would benefit purchase money inventory financers, since the accounts financers would make future advances to the debtor in reliance on after-acquired accounts and the debtor would typically use these advances to pay the debtor's inventory suppliers. 649

In drafting the priority rules of the 1972 Official Text, the drafters adopted the position of these commentators. By limiting the purchase money priority in proceeds under revised section 9-312(3) to cash proceeds received on or before delivery of the inventory to a buyer, and by including revised section 9-312(6), the drafters insured that a prior accounts financer would prime a purchase money inventory financer's security interest in accounts as proceeds. 650

Although the necessity of awarding a prior accounts financer an unqualified priority over the proceeds claim of a subsequent purchase money inventory financer is questionable, 651 the decision to prefer the accounts financer is not unreasonable. The problem with the revised statute is the method selected by the drafters to prefer the prior accounts financer. In subordinating the proceeds claim of the purchase money inventory financer to the claim of an earlier-filed accounts financer, subsections (3), (5)(a), and (6) of revised section 9-312 also subordinate the purchase money financer's proceeds claim to the proceeds claim of an earlier-filed inventory financer who had a subordinate position in the inventory sold.

647. See id.
648. See, e.g., Second Look, supra note 622, at 1002.
I think everybody said that if one could practically protect the financer who furnishes new inventory, without cutting the heart out of accounts financing, we would have been willing to do it, but the difficulty is that if you protected the inventory financer you make the accounts financing so problematical that you cut off the most likely source of cash that is going to be used to pay the inventory financer.
Id. (comment of Peter Coogan). But see Gilmore, supra note 115, at 1383-85.
649. See, e.g., Second Look, supra note 622, at 1000-03.
651. See Gilmore, supra note 115, at 1383-85.
The source of this problem is revised section 9-312(3). Arguably, this provision is irrelevant to the resolution of a conflict between a prior accounts financer and a purchase money financer of inventory who claims accounts as proceeds, since revised section 9-312(3) addresses conflicts between a purchase money security interest in inventory and conflicting security interests in the same inventory. Because an accounts financer does not have a conflicting security interest in inventory, a dispute between an accounts financer and a purchase money inventory financer claiming accounts as proceeds is not within the scope of the provision. In other words, the limitation in revised section 9-312(3) on the extent to which the purchase money priority extends to proceeds is unnecessary to protect a prior accounts financer. Since revised section 9-312(3) is limited to disputes between inventory financers, it does not provide a basis for affording a purchase money inventory financer priority over an accounts financer. Therefore, even if the proceeds limitations were omitted for revised section 9-312(3), the priority dispute would be subject to the rules of revised sections 9-312(5)(a) and (6).

Under section 9-312(5)(a) and (6), the prior accounts financer would prevail. Accordingly, the proceeds limitation of revised section 9-312(3) controls priorities only if the security interests of a purchase money inventory financer and a nonpurchase money inventory financer conflict over proceeds. Moreover, the proceeds limitations affect the resolution of such conflicts only in cases in which the purchase money financer would have been entitled to priority with respect to the collateral. In such cases the proceeds limitations operate to subordinate the proceeds claim of the purchase money financer to all proceeds other than identifiable cash proceeds received by the debtor on or before delivery of the inventory to a buyer. At first blush this result appears difficult to defend.652

Before concluding that the proceeds limitations of revised section 9-312(3) produce an anomalous result when applied in Illustration 23, one must determine whether there is a rational basis for preferring a prior floating lienor over a subsequent purchase money inventory financer with respect to proceeds in the form of chattel paper. One possible basis for favoring the floating lienor (i.e., Bank in Illustration 23) is that the floating lienor may rely on after-acquired chattel paper in

652. See id. at 1383 (asserting that subordinating the purchase money financer to a prior-filed floating lienor "seems to be completely wrong and should be avoided if humanly possible"); see also Boss, Purchase Money Security Interests, in 1B SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 19.04[3][a][iii], at 19-64 to -65 (P. Coogan, W. Hogan, D. Vagts & J. McDonnell eds. 1987) (discussing the problems arising when proceeds are claimed by both a purchase money financer and an accounts financer).
making future advances. This rational, however, should be rejected for at least three reasons.

First, a secured party with a floating lien on inventory probably would not rely on after-acquired chattel paper in making future advances. Second, the notice the purchase money inventory financer gives the floating lienor to obtain priority with respect to the inventory effectively warns the floating lienor not to rely on chattel paper generated by a sale of that inventory.653 Third, if the floating lienor does make future advances in reliance on after-acquired chattel paper, under revised section 9-308(b) the floating lienor can prime the purchase money financer's claim to chattel paper as proceeds if the floating lienor takes possession of the chattel paper.654 In short, the legitimate interests of the floating lienor can be protected without subordinating the purchase money financer's claim to proceeds under section 9-312(3).

b. Inventory Financer's Claim to Chattel Paper as Proceeds Versus Secured Party's Claim of Security Interest Directly in Chattel Paper

The security interest an inventory financer claims in chattel paper as proceeds may conflict with a security interest claimed directly in the chattel paper. The conflicting security interest may be claimed by a creditor who retained a security interest in the chattel paper to secure the debtor's obligation to repay a loan.655 In the alternative, the conflicting security interest may be asserted by a buyer of the chattel paper.656 This section analyzes the rules applicable to resolve priority disputes between an inventory financer asserting a perfected security interest in chattel paper as proceeds and a secured party claiming a perfected security interest directly in the chattel paper.

Article 9 provides that a security interest in chattel paper as collateral may be perfected either by filing a financing statement657 or by taking possession of the chattel paper.658 These methods of perfection,

653. See U.C.C. § 9-312(3)(b) to (d) (1977); S.C. Code Ann. § 36-9-312(3)(b) to (d) (Law. Co-op. Supp. 1989); see generally supra notes 162-291 and accompanying text (analysis of notification requirement for purchase money priority).
654. See infra notes 710-43 and accompanying text.
however, are not equivalent. As the analysis below illustrates, perfection by possession affords substantially greater protection to a secured party than does perfection by filing. The priority conflict between an inventory financer claiming chattel paper as proceeds and a secured party asserting a nonpossessory security interest in the chattel paper which was perfected by filing will be considered first. The conflict between the inventory financer's proceeds claim and a possessory security interest in the chattel paper then will be analyzed.

(i) Nonpossessory Security Interests in Chattel Paper

A conflict between an inventory financer claiming a perfected security interest in chattel paper as proceeds and a secured party asserting a perfected nonpossessory security interest directly in the chattel paper can arise in several contexts. The rules for resolving such conflicts, however, remain constant. The residual priority rules of revised section 9-312(5) and (6) will control the outcome of all such disputes. To illustrate the most straightforward of these disputes, consider the following:

ILLUSTRATION 24—On June 1 Bank enters into a written security agreement with Debtor under which Bank obtains a security interest in Debtor's current and after-acquired chattel paper to secure a contemporaneous loan and any future advances. Also on June 1, Bank filed a financing statement in the Secretary of State's office covering Dealer's chattel paper. On July 1 Finance Company entered into a written security agreement under which it obtained a nonpurchase money security interest in Debtor's current and after-acquired inventory to secure a contemporaneous loan and any future advances. Also on July 1, Finance Company filed a financing statement in the office of the Secretary of State. On August 1 Debtor sold an item of inventory to a buyer under an installment sales contract. On September 1 Debtor defaulted on both obligations to Bank and Finance Company and these parties sought to enforce their respective security interests in the installment sales contract, which remained in Debtor's possession.

Assuming the installment sales contract in Illustration 24 evidenced both a monetary obligation and a security interest in the goods sold, the contract constituted chattel paper. Under section 9-304(1)
Bank’s filing in the Secretary of State’s office was effective to perfect its security interest in the installment sales contract. Since Debtor received the installment sales contract in exchange for inventory subject to Finance Company’s security interest, the installment sales contract constituted proceeds subject to Finance Company’s security interest. Moreover, under revised section 9-306(3)(a) Finance Company’s filing with respect to Debtor’s inventory was effective to continue the perfected status of its security interest in the installment sales contract as proceeds. Thus, Illustration 24 presents a priority conflict between two secured parties holding conflicting perfected non-possessionary security interests in chattel paper.

The Code does not provide a special priority rule for resolving this conflict. One must, therefore, turn to the residual priority rules set forth in revised section 9-312(5)(a) and (6). Bank’s date for determining priority under the first to file or perfect rule is June 1, the date on which it filed with respect to Debtor’s chattel paper. Pursuant to revised section 9-312(6), Finance Company’s date for determining the priority of its security interest in the chattel paper as proceeds is the date on which it filed with respect to Debtor’s inventory on July 1. Consequently, under revised section 9-312(5)(a) Bank in Illustration 24


666. Revised section 9-303 provides a special priority rule applicable to certain purchasers of chattel paper. To claim priority under this provision, however, the purchaser must have a possessionary security interest as required by section 9-308. See U.C.C. § 9-303 (1972) (amended 1977); S.C. CODE ANN. § 36-9-308 (Law. Co-op. Supp. 1989).

is entitled to priority over Finance Company. 668

The analysis of Illustration 24 indicates that the order of filing will
determine the priority of a claim to chattel paper as proceeds against a
nonpossessory security interest asserted directly in the chattel paper.
Therefore, if Finance Company had filed with respect to Debtor's in-
ventory before Bank filed with respect to the chattel paper, Finance
company would have been entitled to priority with respect to the in-
stallment sales contract in issue. From the perspective of an inventory
financer asserting a security interest in chattel paper as proceeds, how-
ever, the more significant question is whether that security interest can
ever prime an earlier-filed chattel paper financer. The response is not
encouraging.

Consider first the rights of an inventory financer who held a
purchase money security interest 666 in goods sold to generate the chat-
tel paper. This conflict can be raised by varying Illustration 24 to pro-
vide that Finance Company held a purchase money security interest in
the goods sold by Debtor under the August 1 installment sales con-
tract. As a purchase money financer of inventory, Finance Company
could prime conflicting security interests in the inventory by meeting
the requirements of revised section 9-312(3). 670 Establishing a purchase
money priority in the inventory, however, appears irrelevant to Fi-
nance Company's dispute with Bank. Revised section 9-312(3) ad-
dresses only conflicting security interests in inventory, 671 and Bank
does not assert such an interest.

Moreover, even if revised section 9-312(3) were applicable to the
dispute, it would afford Finance Company no protection. Under this
provision the purchase money priority in inventory extends to proceeds
only if the proceeds are cash proceeds secured on or before the delivery
of the inventory to the buyer. 672 Therefore, the purchase money prior-
ity would not extend to proceeds in the form of chattel paper. As a
result, even if Finance Company established a purchase money priority
in the inventory sold on August 1, the priority of its security interest in
the resulting chattel paper would be determined under revised section
9-312(5)(a) and (6). Under these provisions Finance Company's secur-
ity interest in the installment sales contract would be subordinate to

670. See supra notes 114-291 and accompanying text.
Co-op. Supp. 1989); see generally supra notes 535-43 and accompanying text (analysis of
purchase money priority in cash proceeds).
that of Bank.

The drafters clearly intended to subordinate a purchase money inventory financer's security interest in chattel paper as proceeds to the claim of an earlier-filed chattel paper financer who asserted a conflicting security interest under an after-acquired property clause. The justification for this decision, however, is somewhat illusive. Apparently the drafters sought to protect the chattel paper financer's ability to rely upon its priority in after-acquired collateral in making future advances. If this were the drafters' objective, it could have been realized without completely undercutting the position of the purchase money inventory financer. For example, the drafters could have conditioned the extension of the purchase money priority to proceeds in the form of chattel paper on the inventory financer's giving prior written notice of its purchase money security interest to the chattel paper financer. This notice would alert the chattel paper financer not to make future advances in reliance on a nonpossessory security interest in the after-acquired chattel paper generated by the sale of inventory subject to the inventory financer's purchase money security interest.

The suggestion that an extension of the purchase money priority to chattel paper proceeds should be conditioned on prior notice to a chattel paper financer is not entirely novel. The drafters considered and rejected a comparable proposal conditioning the extension of the purchase money priority to proceeds in the form of accounts upon the inventory financer giving prior notice to an earlier-filed accounts financer. The drafters rejected this proposal because it would be difficult for an accounts financer to trace after-acquired accounts to the particular items of inventory subject to the purchase money security interest and because accounts financing cannot be easily or safely terminated on receipt of the inventory financer's purchase money notice. These difficulties may well have justified the rejection of the proposal to extend conditionally the purchase money priority to proceeds in the form of accounts. They provide a much less firm foundation, however, for rejecting the proposal with respect to proceeds in the form of chattel paper.

673. Cf. Funk, The Proposed Revision of Article 9 of the Uniform Commercial Code, 26 Bus. LAW. 1465, 1489 (1971) (offering justification for comparable decision not to extend purchase money priority to accounts as proceeds); Second Look, supra note 622, at 1000-03 (offering justification for comparable decision not to extend purchase money priority to accounts as proceeds).

674. See Gilmore, supra note 115, at 1384-85 (advocating a notice requirement for the extension of the inventory purchase money priority to proceeds in the form of accounts).


676. Id.
Chattel paper financers probably do not routinely make future advances in reliance on a nonpossessory security interest in after-acquired chattel paper. Therefore, the extension of the purchase money priority to proceeds in the form of chattel paper would not appear to upset a more significant form of financing.\(^{677}\) Furthermore, the task of tracing items of purchase money inventory to chattel paper probably is significantly less difficult than tracing such inventory to accounts. Moreover, the task of tracing could be simplified by conditioning priority on a more demanding notice than required under revised section 9-312(3)(d). For example, a statute could be enacted to require the inventory financer to provide the chattel paper financer with the serial numbers of all items of collateral on which it claimed a purchase money security interest. Such a requirement does not appear unreasonable for "big ticket" items such as motor vehicles, over which priority with respect to proceeds in the form of chattel paper can be crucial.

More significantly, however, even if the purchase money priority were extended to proceeds in the form of chattel paper, a financer making a future advance against after-acquired chattel paper could prime the inventory financer by taking possession of the chattel paper. Under revised section 9-308(b)\(^{678}\) a purchaser of chattel paper who gives new value and takes possession of the chattel paper in the ordinary course of his business has priority over a conflicting perfected security interest claimed merely as proceeds of inventory, even though the purchaser knows the chattel paper is subject to the inventory financer's security interest.\(^{679}\) No comparable new value priority provision applicable to accounts exists. Therefore, a decision to extend the purchase money priority to proceeds in the form of accounts would preclude an accounts financer giving new value in exchange for an interest in the accounts claimed as proceeds from priming the inventory financer.

In summary, the justification advanced in support of the decision not to extend the purchase money priority to proceeds in the form of accounts does not support the decision to preclude an inventory financer from establishing a purchase money priority in proceeds in the form of chattel paper. Therefore, it appears that in principle a priority rule extending the purchase money priority to proceeds in the form of chattel paper, provided that prior notice were given to an earlier-filed

\(^{677}\) The drafters based their fundamental decision not to extend the purchase money priority to proceeds in the form of accounts upon the significance of accounts financing. See id.; Second Look, supra note 622, at 1000-03.


\(^{679}\) See generally infra notes 697-743 and accompanying text (analysis of priority afforded to holders of possessory security interests in chattel paper).
chattel paper financer, would have been preferable to the rules adopted by the drafters.\textsuperscript{680}

A return to the variation of Illustration 24 will demonstrate the operation of the proposed priority rule. If Finance Company failed to give Bank timely written notice of its purchase money security interest in the specified items of inventory, Bank would be entitled to priority with respect to the August 1 chattel paper.\textsuperscript{681} In contrast, if Finance Company provided Bank with a timely purchase money notice, Finance Company would be entitled to priority over Bank's nonpossessory security interest in the August 1 chattel paper as after-acquired property.\textsuperscript{682} Such a result is reasonable because it preserves the secured position of Finance Company without jeopardizing the position of Bank. Bank is protected because Finance Company's notice effectively warned Bank not to make additional advances in reliance on the nonpossessory security interest. If Bank, after receipt of Finance Company's purchase money notice, elects to make an advance against the August 1 chattel paper, it can do so by taking a possessory security interest in the chattel paper. Under revised section 9-308(b) Bank's possessory security interest would prime Finance Company's security interest in the chattel paper as proceeds, even though Finance Company's security interest qualifies for the purchase money priority.

As illustrated above, the proposed rule extending the purchase money priority to proceeds in the form of chattel paper is consistent with the Article 9 basic policy of encouraging new value financing.\textsuperscript{683} Finance Company gave new value to Debtor in exchange for its purchase money security interest in the inventory. If Finance Company is diligent and gives timely and adequate notice to Bank, Finance Company's position is preserved by awarding its proceeds claim in the chattel paper priority over Bank's claim under an after-acquired property clause. If Bank gives further new value by making an advance against the chattel paper and is diligent by taking possession of the chattel paper, then Bank, the most recent party to extend new value, is awarded priority.\textsuperscript{684}

The residual priority rules of revised Article 9 preclude an inven-

\textsuperscript{680} That such a rule is preferable in principle does not establish that a jurisdiction should enact an inconsistent amendment providing such a rule. Arguably, considerations of uniformity outweigh the consequences of the flow in the Official Text.

\textsuperscript{681} See generally notes 162-291 (analysis of notification condition on section 9-312(3) priority).

\textsuperscript{682} Id.


tory financer from establishing a nonpossessory security interest in chattel paper as proceeds that will prime a nonpossessory security interest in the chattel paper asserted by a chattel paper financer who was the first party to file. If the inventory financer is to prime an earlier-filed nonpossessory security interest in chattel paper, the financer must do so under a special priority rule. Therefore, the questions become whether such a rule exists, and, if so, whether the inventory financer can bring himself within its protection.

Revised section 9-308(a) affords the inventory financer the possibility of priming a nonpossessory security interest in chattel paper. To prime a security interest in chattel paper perfected by a permissive filing, the inventory financer must qualify as a purchaser of chattel paper who gave new value and took possession of the chattel paper in the ordinary course of his business and without knowledge that the specific chattel paper is subject to a security interest. The inventory financer will qualify as a purchaser of chattel paper if the financer holds an Article 9 security interest in the chattel paper. To qualify under revised section 9-308(a), the inventory financer must give new value. An original loan made to finance the acquisition of the inventory is not new value. In contrast, an advance made directly against the chattel paper after the sale of the underlying inventory apparently constitutes new value. The inventory financer must also take possession of the chattel paper to be protected, and thus cannot rely on having filed. Finally, and most critically, the inventory financer must give value and take possession of the chattel paper without knowledge that the chattel paper is subject to the chattel paper financer’s security interest. If the chattel paper financer has stamped the chattel paper indicating its se-

687. See generally B. Clark, supra note 8, ¶ 3.05[2], at 3-60 to -61 (analyzing purchaser’s rights when chattel paper is claimed directly).
curity interest, the inventory financer will take with knowledge of the security interest.\textsuperscript{692} Moreover, although the mere filing of a financing statement will not disqualify the inventory financer under revised section 9-308(a),\textsuperscript{693} if the inventory financer has discovered the financing statement before taking possession of the chattel paper, the inventory financer apparently cannot prevail.

Accordingly, although revised section 9-308(a) affords an inventory financer the possibility of prevailing over an earlier-filed chattel paper financer if the inventory financer gives new value and takes possession of the chattel, the absence of knowledge requirement probably severely limits the utility of this provision. Furthermore, if the inventory financer fails to meet the requirements of revised section 9-308(a), both a nonpossessory security interest in the chattel paper as proceeds and a possessory security interest in the chattel paper which secures the new value will be subordinate to the security interest of the chattel paper financer under the residual first to file or perfect rule of revised section 9-312(5)(a).\textsuperscript{694}

In summary, revised Article 9 provides an inventory financer little hope of succeeding in a priority dispute with an earlier-filed chattel paper financer over chattel paper generated by the sale of encumbered inventory. The only oasis for the inventory financer on this bleak landscape is the fact that revised section 9-308 discourages chattel paper financers from taking nonpossessory security interests.\textsuperscript{695} If chattel paper financers took only possessory security interests, an inventory financer could gain protection by taking possession of the chattel paper that constituted proceeds of its collateral.\textsuperscript{696} On closer inspection, however, this oasis may be a mirage. A secured party that lends against substantially all of a debtor's chattel paper and regularly takes possession of its collateral is well advised to further collateralize its loans by taking a blanket security interest in the debtor's chattel paper and to perfect by filing. If the chattel paper financer takes this precaution and its filing is prior in time to that of the inventory financers, the chattel paper financer will prime the inventory financer's claim to the chattel paper as proceeds. Moreover, despite the fact that the inventory financer took possession of the chattel paper, the financer's claim under


\textsuperscript{695} See generally B. CLARK, supra note 8, ¶ 3.05[1], at 3-58 to -60 (chattel paper claimed as mere proceeds of inventory).

\textsuperscript{696} Id.
revised section 9-308(a) will fail unless the financer also gave new value and acted without knowledge of the chattel paper financer's security interest.

(ii) Possessory Security Interests in Chattel Paper

If an inventory financer files before a secured party claiming a nonpossessory security interest in chattel paper, the inventory financer's security in chattel paper as proceeds will be entitled to priority over the claim of the chattel paper financer under revised section 9-312(5)(a). The inventory financer, however, also may face a challenge from a subsequent purchaser of chattel paper claiming a possessory security interest in the chattel paper. Although the inventory financer would prime this purchaser under the residual first to file or perfect rule, the purchaser with a possessory security interest in the chattel paper may be able to establish priority under the special rules of revised section 9-308.697

Revised section 9-308 sets forth two special priority rules under which certain purchasers of chattel paper can prime an earlier perfected nonpossessory security interest in chattel paper. To qualify for protection under either of these rules a purchaser must give new value and take possession of the chattel paper in the ordinary course of his business. The critical requirement is taking possession of the chattel paper, since the protection available under section 9-308 is limited to secured parties holding security interests perfected by possession. Moreover, this requirement reflects the policy of making chattel paper quasi-negotiable.688

The new value requirement has been interpreted in light of section


A purchaser of chattel paper or an instrument who gives new value and takes possession of it in the ordinary course of his business has priority over a security interest in the chattel paper or instrument:

(a) which is perfected under Section 36-9-304 (permissive filing and temporary perfection) or under Section 36-9-306 (perfection as to proceeds) if he acts without knowledge that the specific paper or instrument is subject to a security interest; or

(b) which is claimed merely as proceeds of inventory subject to a security interest (Section 36-9-306), even though he knows that the specific paper or instrument is subject to the security interest.


698. See generally 2 G. Gilmore, supra note 56, § 25.5, at 666-70 (discussing the Article 9 treatment of chattel paper as a commercial specialty); White & Summers, supra note 87, § 24-18, at 1181 (discussing the quasi-negotiable treatment of chattel paper under Article 9 as accommodating business expectations).
9-108, 699 which lists making an advance, incurring an obligation, and releasing a perfected security interest as illustrations of new value. 700 The courts have held that a purchaser does not give new value for chattel paper when chattel paper is taken in satisfaction of a prior debt. 701

The effect of the ordinary course of his business requirement is uncertain. The requirement may simply mean that the purchaser must be in the business of discounting chattel paper or lending against chattel paper. 702 The sole decision on this issue held that a purchaser satisfies the requirement if the purchaser acquires the chattel paper at issue in the same manner in which the purchaser normally purchases chattel paper, even though failing to comply with regular commercial practices. 703 More significantly, however, there is no authority for reading the requirements of section 1-201(9), 704 which defines a buyer in the ordinary course, into the ordinary course requirement of section 9-308. Indeed, the existing authority is to the contrary. 705 Therefore, a purchaser of chattel paper apparently can qualify for protection under revised section 9-308, even if the purchaser knows that the sale is in violation of the security interest of a third party. 706

Revised section 9-308(a) sets forth the first special priority rule applicable to purchasers of chattel paper. Under subsection (a), a purchaser of chattel paper who gives new value and takes possession in the


700. See U.C.C. § 9-108 (1972) (amended 1977); S.C. CODE ANN. § 36-9-108 (Law. Co-op. Supp. 1989); see also WHITE & SUMMERS, supra note 87, at 1181 (stating that if transactions go beyond the examples of new value given in the Code, courts are on their own in defining the term).


702. See 2 G. GILMORE, supra note 56, § 25.5, at 667.


705. See Rex Fin. Corp., 23 Ariz. App. at 289, 522 P.2d at 561 ("The term 'buyer in the [sic] ordinary course of business' with its requirements of good faith, as used elsewhere in the Uniform Commercial Code, is to be distinguished from the use here of 'buyer' in the ordinary course of his business.'" (emphasis in original) (brackets in original)); WHITE & SUMMERS, supra note 87, § 24-18, at 1183 ("The 'ordinary course of business' requirement of 9-307 is totally different from the 'ordinary course of his business' requirement of 9-308." (emphasis in original)).

706. 2 G. GILMORE, supra note 56, § 27.3, at 731.
ordinary course of his business primes all previously perfected nonpos-
sessory security interests in chattel paper, provided that the purchaser
acquires the chattel paper without knowledge\(^707\) of the security inter-
est.\(^708\) The "without knowledge" limitation enables a secured party
holding a nonpossessory security interest in chattel paper to preclude a
subsequent purchaser from establishing a prior claim under subsection
(a) by stamping the chattel paper with a notice conspicuously stating
that the paper is subject to the purchaser's security interest.\(^709\)

Although revised section 9-308(a) can be significant to an inven-
tory financer,\(^710\) the second special priority rule, set forth in subsection
(b), is much more important. Under revised section 9-308(b), a pur-
chaser of chattel paper who gives new value and takes possession in the
ordinary course of his business primes a prior perfected security inter-
est "claimed merely as proceeds of inventory subject to a security in-
terest,"\(^711\) even though the purchaser knows the chattel paper is sub-
ject to the security interest.\(^712\) Since an inventory financer normally
claims a security interest in chattel paper merely as proceeds, subsec-
tion (b) will control most priority disputes between an inventory fi-
nancer and a purchaser of chattel paper. If subsection (b) applies, a
purchaser who meets the basic requirements of section 9-308 will prime
the inventory financer, even if the purchaser knows that the chattel
paper purchased was subject to the inventory financer's security inter-
est at the time of the purchase.\(^713\) Moreover, such a purchaser appar-
tently will prevail even if such purchaser also knew that the sale was in
violation of the security interest held by the inventory financer.\(^714\)

To illustrate the application of revised section 9-308, consider the
following:

**ILLUSTRATION 25—** On June 1 Bank and Dealer entered into a
written security agreement under which Dealer granted Bank a secur-

1976) (knowledge means actual knowledge).

\(^708\) See generally B. Clark, supra note 8, ¶ 3.05[2], at 3-60 to -61 (discussing prior-
ity when chattel paper claimed directly).

\(^709\) See U.C.C. § 9-308 comment 3 (1972) (amended 1977); S.C. Code Ann. § 36-9-

\(^710\) See infra notes 735-45 and accompanying text.

\(^711\) U.C.C. § 9-308(b) (1972) (amended 1977); S.C. Code Ann. § 36-9-308(b) (Law.

\(^712\) See generally B. Clark, supra note 8, ¶ 3.05[1], at 3-58 to -60 (reviewing court
decisions and examples of situations in which chattel paper financers who take posses-
sion and give new value prime financers who claim chattel paper as proceeds).

\(^713\) See, e.g., Rex Fin. Corp. v. Great W. Bank & Trust, 23 Ariz. App. 286, 532 P.2d
558 (1975); Commercial Credit Corp. v. National Credit Corp., 251 Ark. 541, 473 S.W.2d
876 (1971).

\(^714\) See 2 G. Gilmore, supra note 56, § 27.3, at 731.
ity interest in Dealer's current and after-acquired inventory of appliances to secure a contemporaneous loan and any future advances. The security agreement further required Dealer to surrender all proceeds from the sale of the collateral to Bank. On June 1 Bank filed a financing statement in the Secretary of State's office covering Dealer's inventory. On July 1 Dealer sold an appliance to Buyer under an installment sales contract, which granted Dealer a purchase money security interest in the appliance to secure Buyer's obligation to pay the purchase price and finance charge in periodic installments. Also on July 1, Dealer sold the installment sales contract to Finance Company, which was in the business of discounting chattel paper. Finance Company paid cash in exchange for the contract and immediately took possession of the contract. Dealer used the funds derived from the sale of the contract to meet current operating expenses. On August 1 Bank rightfully declared Dealer in default under the terms of the June 1 security agreement and asserted a security interest in the installment sales contract in the possession of Finance Company.

The installment sales contract constitutes chattel paper on which both Bank and Finance Company can claim a perfected Article 9 security interest. Bank's security interest attached to the chattel paper as proceeds of its collateral, and remained perfected by virtue of its filing with respect to Dealer's inventory. Although Dealer sold the chattel paper to Finance Company, the transaction was within the scope of Article 9 and Finance Company acquired a security interest in the chattel paper. Finance Company perfected its security interest by taking possession of the chattel paper.

If the residual priority rule of revised section 9-312(5)(a) controlled the dispute between Bank and Finance Company, Bank would be entitled to priority. Bank filed with respect to Dealer's inventory on June 1 and the date of this filing determines Bank's priority in the


chattel paper as proceeds.\textsuperscript{721} Finance Company did not perfect its security interest until it took possession of the chattel paper on July 1.\textsuperscript{722} Therefore, under the first to file or perfect rule of revised section 9-312(5)(a), bank would prime Finance Company.

Finance Company, however, will assert that the special priority rules of revised section 9-308 preempt the residual rule of revised section 9-312(5)(a), and that under revised section 9-308 Finance Company is entitled to priority. Finance Company can establish that Bank's security interest is vulnerable to a qualified purchaser of chattel paper, since bank holds a perfected nonpossessory security interest in the chattel paper as proceeds from the sale of its collateral. Moreover, under the facts stated, Bank has no basis for asserting that its security interest is not claimed merely as proceeds of encumbered inventory. Therefore, if Finance Company can establish that it purchased the chattel paper for new value and took possession of the chattel paper in the ordinary course of its business, Finance Company can claim priority over Bank under either subsection (a) or subsection (b) of revised section 9-308.

If Finance Company purchased the chattel paper without knowledge that the specific chattel paper was subject to Bank's security interest, Finance Company can establish priority under revised section 9-308(a). If Finance Company knew at the time it purchased the chattel paper that the chattel paper was subject to Bank's security interest, Finance Company can establish priority under revised section 9-308(b), since Bank's security interest was claimed merely as proceeds of inventory.

Under the facts in Illustration 25, Finance Company also can establish that it qualifies as a purchaser of chattel paper entitled to protection under revised section 9-308. As a buyer of the chattel paper, Finance Company was clearly a purchaser of chattel paper.\textsuperscript{723} By paying cash for the chattel paper, Finance Company gave new value as well.\textsuperscript{724} Furthermore, under the facts of Illustration 25, Finance Company took possession of the chattel paper. Finally, Finance Company

\textsuperscript{721} See U.C.C. § 9-312(6) (1972) (amended 1977); S.C. Code Ann. § 36-9-312(6) (Law. Co-op. Supp. 1989); see generally supra text accompanying note 517 (analysis of revised section 9-312(5)(a), (b)).


was in the business of purchasing chattel paper and followed its normal business practices in purchasing the chattel paper at issue. Finance Company thus satisfied the requirement of giving new value and taking possession of the chattel paper "in the ordinary course of [its] business." Accordingly, Finance Company in Illustration 25 primes Bank's security interest in the chattel paper.

The special priority rules of revised section 9-308 apparently undercut the position of an inventory financer. If the debtor has sold the encumbered inventory to a buyer in the ordinary course of his business, the proceeds of that sale are the inventory financer's sole source of security. Revised section 9-308 then undercuts the inventory financer's claim to proceeds in the form of chattel paper by enabling the debtor to grant a purchaser of the chattel paper priority in the paper, even if the purchaser has knowledge of the inventory financer's security interest. Nevertheless, several solid arguments support a conclusion that the priority rules of revised section 9-308 are not inconsistent with the interests of inventory financers.

First, although revised section 9-308 subordinates the security interest of an inventory financer in chattel paper as proceeds to the claim of a qualified purchaser of chattel paper, the inventory financer can claim a security interest in the new value given by the purchaser in exchange for the chattel paper. In most cases, however, the new value will be cash proceeds. Because cash proceeds can be easily disbursed or commingled with other funds giving rise to tracing problems, the protection the inventory financer derives from a security interest in the new value may be illusory. Therefore, this argument standing alone is not fully persuasive.

Second, even if a security interest in the new value is unlikely to protect the position of an inventory financer in the event of default, by rendering chattel paper "quasi-negotiable," revised section 9-308 may enhance the position of inventory financers generally. Because revised section 9-308(b) grants a new value purchaser of chattel paper priority

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725. See supra notes 702-06 and accompanying text.
729. See generally supra text accompanying notes 464-516 (analysis of identification of commingled cash proceeds).
730. But see B. Clark, supra note 8, ¶ 3.05[1], at 3-58 to -59 (because inventory financer has security interest in new value given by purchaser of chattel paper as proceeds of proceeds it "is not really harmed by the rule (of revised § 9-308(b)).").
over inventory financers claiming the chattel paper as proceeds, the provision encourages sales of chattel paper. By selling or discounting chattel paper, a debtor accelerates the date on which the debtor receives payment for the sales of inventory. Moreover, in the normal course of events the debtor will use the cash derived from the sale of the chattel paper to pay the inventory financer. Therefore, revised section 9-308 tends to enhance a debtor's ability to repay the inventory financer in a timely fashion.731

Finally, if the risks posed by revised section 9-308 are unaccept-able to an inventory financer, the financer can adopt some strategies to avoid the effect of the provision. The most straightforward course of action is for the inventory financer to take possession of all chattel paper generated by the sale of the collateral.732 Although such a practice entails monetary costs733 and may be ineffective in the event of fraud,734 it limits the risk that the debtor will grant a purchaser a prior right to the chattel paper that the inventory financer claims as proceeds. In order to prime an inventory financer under revised section 9-308, a purchaser must take possession of the chattel paper. Therefore, if the inventory financer takes possession of the chattel paper, no purchaser can establish a prior claim to the paper under revised section 9-308.

An inventory financer who elects not to take possession of chattel paper can adopt an alternative strategy to protect a security interest in the chattel paper from subordination under revised section 9-308. The basic thrust of this strategy is to remove the conflict with the purchaser of chattel paper from the scope of revised section 9-308(b), and to defeat purchaser under revised section 9-308(a). If the inventory financer can establish that subsection (a) rather than subsection (b) controls the priority dispute, the inventory financer will prevail if the chattel paper purchaser had knowledge of the inventory financer's security interest in the chattel paper.735

The inventory financer can take steps that will reasonably insure

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731. Cf. Second Look, supra note 622, at 1003 (comparable analysis to justify priority to accounts financer over purchase money inventory financer claiming accounts as proceeds).
733. See id.
734. For example, if a debtor prepared duplicate installment sales contracts for a single transaction and surrendered one to the inventory financer and sold the other to a chattel paper purchaser, the chattel paper purchaser should prevail. Cf. Walter E. Heller W., Inc. v. Foothill Capital Corp. (In re New Mexico Ice Mach. Co.), 32 U.C.C. Rep. Serv. (Callaghan) 1647 (Bankr. D.N.M. 1981) (fraud by sale of single equipment lease to two chattel paper purchasers).
735. See B. Clark, supra note 8, ¶ 3.05[1], at 3-58 to -60; 2 G. Gilmore, supra note 56, § 27.3, at 731-32.
that a purchaser will acquire the chattel paper with knowledge of the inventory financer's security interest. If the inventory financer prepares the form contracts used by the debtor to effect sales of inventory, and those contacts conspicuously disclose that they are subject to the inventory financer's security interest, a purchaser will have a difficult time establishing that the purchase of the chattel paper was without knowledge of the security interest. The purchaser's knowledge of the security interest, however, will not entitle the inventory financer to priority unless the financer can remove the conflict from the scope of revised section 9-308(b). Therefore, to prime the purchaser, the inventory financer also must establish that the security interest is not "claimed merely as proceeds of inventory."

It is not an easy task for an inventory financer to establish that the security interest in chattel paper is not claimed merely as proceeds. Merely including chattel paper in the description of collateral in the security agreement and financing statement will not enable an inventory financer to avoid the effect of revised section 9-308(b). The comments indicate that an inventory financer's security interest in chattel paper arises merely as proceeds unless the financer has entered into a "new transaction" with the debtor under which the financer acquired a specific interest in the chattel paper.

Gilmore asserts that the new transaction envisioned by the Official Comment occurs when a debtor repays an inventory advance after selling an item of encumbered inventory, and then draws a new advance from the inventory financer secured by a nonpossessor security interest in the chattel paper generated by the sale. The parties can com-

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738. See, e.g., B. CLARK, supra note 8, ¶ 3.05[2], at 3-60 ("It is . . . extremely difficult to imagine a situation where the chattel paper is other than mere proceeds, at least if the creditor is lending against the dealer's inventory.").

739. See, e.g., International Harvester Credit Corp. v. Associates Fin. Servs. Co., 133 Ga. App. 488, 211 S.E.2d 430 (1974); see also B. CLARK, supra note 8, ¶ 3.05[1], at 3-58 to -59 (the "substance" of giving new value wins over the "form" of including chattel paper in the description in the security agreement). But see WHITE & SUMMERS, supra note 87, § 24-18, at 1182 (when loan is secured by inventory and proceeds, but lender relied primarily on chattel paper proceeds in making loan, authors are inclined to allow lender to so testify to establish that chattel paper is not claimed merely as proceeds).


741. 2 G. GILMORE, supra note 56, § 27.3, at 351; see also B. CLARK, supra note 8, ¶ 3.05[2], at 3-61 (recognizing possibility of transaction, but asserting that "[s]uch a transaction is about as rare as ice on the Sahara"); WHITE & SUMMERS, supra note 87, § 24-18, at 1182 n.11 (suggesting that a lender's claim may become more than mere proceeds if
press the repayment of the inventory advance and the new loan against
the chattel paper into a single transaction. Therefore, the transaction
is, in effect, a discount of the chattel paper with the proceeds of the
discount being used to pay the inventory financer. As a result, it is
reasonable to treat the inventory financer as a secured party who per-
fected by permissive filing and whose rights against subsequent pur-
chasers who take possession are defined under section 9-308(a).

In summary, under the new transaction strategy, the inventory fi-
nancer must insure that the chattel paper generated by the financer's
debtor discloses the security interest. Furthermore, the financer must
execute the formalities of the new transaction described above. These
formalities include both a security agreement granting the inventory
financer a security interest in the chattel paper to secure the chattel
paper advances and a financing statement covering chattel paper. An
assertion by an inventory financer that the security interest in chattel
paper was not claimed merely as proceeds would be substantially un-
dercut if the financer were forced to rely upon revised section 9-306(2)
and (3) to establish the existence and perfection of the security interest
in the chattel paper.\textsuperscript{742} Given the formalities of the new transaction
strategy, it is as cumbersome as taking possession of the chattel paper.
Nevertheless, when chattel paper financing is done under an "indirect
collection" method,\textsuperscript{743} the new transaction device affords protection to
the inventory financer.

c. Inventory Financers Versus Chattel Paper Purchasers with
Respect to Returns and Repossessions

The preceding subsection analyzed the resolution of priority dis-
putes over chattel paper between an inventory financer claiming the
chattel paper as proceeds and a purchaser of the chattel paper. The
potential conflicts between these parties, however, are not limited to
disputes over chattel paper. In the event the goods, the sale of which
generated the chattel paper, are returned to the debtor, a priority dis-
pute will arise between the inventory financer and the purchaser of the
chattel paper concerning the returned goods. The critical provision in

\textsuperscript{742} See supra text accompanying notes 447-63 (analysis of attachment and perfec-
tion of security interests in proceeds).

\textsuperscript{743} Under an indirect collection method of financing the chattel paper is left in the
possession of the dealer-debtor, and account debtors make payments to the dealer-
debtor who in turn remits the payments to the chattel paper purchaser. See U.C.C. § 9-
308 comment 1 (1972) (amended 1977); S.C. Code Ann. § 36-9-308 comment 1 (Law. Co-
analyzing this dispute is section 9-306(5). Section 9-306(5) not only grants both the inventory financer and chattel paper purchaser a security interest in the returned goods, but also provides rules for perfection and priority. This subsection will analyze the application of sec-


(5) If a sale of goods results in an account or chattel paper which is transferred by the seller to a secured party, and if the goods are returned to or are repossessed by the seller or the secured party, the following rules determine priorities:

(a) If the goods were collateral at the time of sale, for an indebtedness of the seller which is still unpaid, the original security interest attaches again to the goods and continues as a perfected security interest if it was perfected at the time when the goods were sold. If the security interest was originally perfected by a filing which is still effective, nothing further is required to continue the perfected status; in any other case, the secured party must take possession of the returned or repossessed goods or must file.

(b) An unpaid transferee of the chattel paper has a security interest in the goods against the transferor. The security interest is prior to a security interest asserted under paragraph (a) to the extent that the transferee of the chattel paper was entitled to priority under Section 36-9-308.

(c) An unpaid transferee of the account has a security interest in the goods against the transferor. The security interest is subordinate to a security interest asserted under paragraph (a).

(d) A security interest of an unpaid transferee asserted under paragraph (b) or (c) must be perfected for protection against creditors of the transferor and purchasers of the returned or repossessed goods.


745. See generally B. Clark, supra note 8, ¶ 10.02[2], at 10-23 to -32 (discussing the general rules of priority governing returned or repossessed goods); 2 G. Gilmore, supra note 56, § 27.5, at 736 (discussing priorities in returned goods); Barnes, Reaffirming the Dominance of Notice in Article 9: A Proposed Modification of Priorities in Returned and Repossessed Goods, 48 U. Pa. L. Rev. 353 (1987) (criticizing section 9-306(5) and proposing a modified statute); Kriple, A Draftsman's Wishes that He Could do Things Over Again—U.C.C. Article 9, 26 San Diego L. Rev. 1, 7-20 (1989) (analyzing drafting history and flaws in section 9-306(5)); Lord, Rights of Secured Creditors in Returned and Repossessed Goods Under the Uniform Commercial Code: A Study of Section 9-306(5), 16 Duq. L. Rev. 165 (1976) (discussing problems that may develop between creditors over returns and repossessions and the relevant case law); Skilton & Dunham, Security Interests in Returned and Repossessed Goods Under Article 9 of the Uniform Commercial Code, 17 Willamette L. Rev. 779 (1981) (discussing potential disputes between creditors regarding repossessed and returned goods and analyzing pertinent cases).

At the outset it must be noted that section 9-306(5) purports to control priorities in "repossessions" as well as returns. See supra note 744. Moreover, the courts have applied 9-306(5) in cases in which a chattel paper transferee has repossessed goods following a keeper's default and returned the repossessed goods to the dealer to await sale under section 9-504(3). See, e.g., J.I. Case Co. v. Borg-Warner Acceptance Corp., 669 S.W.2d 543 (Ky. Ct. App. 1984). Nevertheless, section 9-306(5) should not be interpreted to apply to such a repossession. See Permanent Editorial Board for the Uniform Commercial Code, Commentary on Section 9-306(5), published in 8 U.C.C. Rep. Serv. 2d (Callaghan)
tion 9-306(5) to conflicts between an inventory financer and a chattel paper purchaser with regard to returns.

To analyze the resolution of such conflicts, consider the following:

**ILLUSTRATION 26**—Dealer is in the business of selling construction equipment. On June 1 Bank and Dealer entered into a written security agreement, which granted Bank a security interest in Dealer’s current and after-acquired inventory of construction equipment to secure a contemporaneous loan and any future advances. Also on June 1,
Bank properly filed a financing statement in the Secretary of State’s office covering Dealer’s inventory. On July 1 Dealer sold a bulldozer to Contractor, a buyer in the ordinary course of business, under a conditional sales contract, which granted Dealer a security interest in the bulldozer to secure Contractor’s obligation to pay the purchase price in monthly installments. On July 2 Dealer sold the conditional sales contract to Finance Company, which gave new value for and took possession of the contract in the ordinary course of its business. On July 2 Finance Company also filed a financing statement in the Secretary of State’s office to perfect its assigned security interest in the bulldozer. This financing statement listed Contractor as the debtor. On August 10, before making any installment payments, Contractor rightfully revoked acceptance and returned the bulldozer to Dealer. On September 1 Bank rightfully declared Dealer in default under the terms of the June 1 security agreement and sought to enforce its security interest against the bulldozer, which remained in Dealer’s possession.

The primary issue presented in this illustration is whether Bank is entitled to priority over Finance Company with respect to the returned bulldozer. Section 9-306(5) applies to provide the rules for resolving the priority issue. In applying section 9-306(5), however, two preliminary sub-issues must be resolved before the ultimate issue of priority may be addressed. First, do Bank and Finance Company hold security interests in the returned bulldozer? Second, if the parties have security interests in the returned bulldozer, are those security interests perfected?

Bank has a security interest in the returned bulldozer under section 9-306(5)(a). Under this provision, if the goods in issue were collateral at the time of the sale and the debt of the seller remains unpaid, “the original security interest attaches again to the goods” when they are returned to the seller. Under facts in Illustration 26, however, Bank could claim a security interest in the returned bulldozer under the after-acquired property clause in its security agreement. Therefore, the grant of a security interest under section 9-306(5)(a) apparently is significant only when a secured party does not have a security interest in after-acquired property. The failure of an inventory financer to claim a security interest in after-acquired property is common only in purchase money financing. Moreover, even in such cases, the se-

746. See supra note 744 (quoting text of section 9-306(5)).
748. See Skilton & Dunham, supra note 745, at 784.
749. See Southtrust Bank v. Borg-Warner Acceptance Corp., 760 F.2d 1240 (11th Cir. 1985) (secured party could not claim a purchase money security interest when it
cured party could argue that the returned goods were proceeds of proceeds and hence subject to the secured party's security interest under revised section 9-306(2).750

Finance Company has a security interest in the returned bulldozer against Dealer under section 9-306(5)(b). This provision expressly grants an unpaid transferee of chattel paper a security interest in returned goods against the transferor of the chattel paper. Since Finance Company has not received the installment payments under the assigned conditional sales contract, Finance Company is an unpaid transferee of chattel paper within the meaning of section 9-306(5)(b).751 An interesting question arises concerning whether Finance Company could claim a security interest in the returned bulldozer independently of section 9-306(5)(b). By virtue of its purchase of the conditional sales contract, Finance Company acquired a security interest in the bulldozer against Contractor. This security interest, however, does not directly assist Finance Company because it must have a security interest in the returned bulldozer against Dealer. In the absence of section 9-306(5), Finance Company could argue that the returned bulldozer was proceeds of the chattel paper and hence subject to Finance Company's security interest under revised section 9-306(2).752 Although this argument is reasonable in the case of returned goods, one must strain in order to characterize a repossession as a "sale, exchange, or other disposition" of the chattel paper.753

Although both Bank and Finance Company have security interests in the returned bulldozer against Dealer, only Bank's security interest is clearly perfected.754 Section 9-306(5)(a) not only grants an inventory financer a security interest in goods returned to the seller, but also sets forth the rules governing the perfection of that security interest. If the inventory financer's security interest in the goods was perfected at the time of the sale, the security interest continues perfected when the goods are returned.755 Moreover, if the security interest was originally perfected by filing and that filing is still effective when the goods are

exercised a future advance clause and an after-acquired property clause).

750. See 2 G. Gilmore, supra note 56, § 27.5, at 737; Commentary on Section 9-306(5), supra note 745, at 3; see also Skilton & Dunham, supra note 745, at 798-801, 806 (returns but not repossessions are proceeds of chattel paper).

751. See Skilton & Dunham, supra note 745, at 788 n.34.

752. See sources cited supra note 750.

753. See Skilton & Dunham, supra note 745, at 799; see generally supra note 745 (arguing that section 9-306(5) does not apply to most repossessions).


returned, no further action by the inventory financer is required to continue its perfected status. Because Bank's security interest in the bulldozer was perfected by filing when Dealer sold the bulldozer and that filing was still effective when Contractor returned the bulldozer, Bank's security interest in the returned bulldozer is perfected.

Although the issue of Finance Company's perfection is more complex, most authorities conclude that its security interest in the returned bulldozer against dealer is unperfected. Finance Company did file to perfect its security interest in the bulldozer against Contractor, but most authorities assert that this filing is ineffective to perfect its security interest against Dealer. Moreover, Finance Company's security interest in the chattel paper against Dealer was perfected by possession. Nevertheless, section 9-306(5)(d) indicates that perfection as to the chattel paper does not carry over to returned goods.

Finally, Finance Company could assert that Dealer was acting as its agent when Dealer accepted the return of the bulldozer. On this basis Finance Company could argue that its security interest was perfected by Dealer's possession. This argument, however, must be rejected. In the transaction at issue, Dealer is Finance Company's debtor, and possession by the debtor cannot perfect a security interest. Finance Company may assert, however, that the returned bulldozer is proceeds of the chattel paper and hence its security interest in the returned bulldozer was automatically perfected under revised section 9-306(3) for ten days. Even if Finance Company were to prevail on this point, though, the victory would not enhance Finance Company's position in Illustration 26, since the period of temporary perfection.

757. See, e.g., B. Clark, supra note 8, ¶ 10.02[2][a], at 10-23 to -27. But see infra notes 755-70 and accompanying text.
758. See, e.g., U.C.C. § 9-306 comment 4 (1972) (amended 1977); S.C. CODE ANN. § 36-9-306 comment 4 (Law. Co-op. Supp. 1989); see also In re Haugabook Auto Co., 9 U.C.C. Rep. Serv. (Callaghan) 954 (Bankr. M.D. Ga.), (when dealer repossessed automobiles that were subject to assignee's security interest, noted on certificate of title, the trustee's rights were superior to assignee's because the automobiles had become part of dealer's inventory and perfection under the certificate of title statute excluded interests in inventory), aff'd, 9 U.C.C. Rep. Serv. (Callaghan) 1095 (M.D. Ga. 1971); Skilton & Dunham, supra note 745, at 828 (when returned goods are involved, Code requires more than filing against the buyer to protect against conflicting claims to the goods).
760. See Skilton & Dunham, supra note 745, at 792.
762. See sources cited supra note 750.
763. See supra notes 450-51 and accompanying text.
tion expired before Bank asserted its security interest.

Although Finance Company's security interest in the returned bulldozer appears to be unperfected, Finance Company can advance an additional argument to claim perfected status. As discussed below, the success of this argument is critical to Finance Company. If Finance Company's security interest in the returned bulldozer is unperfected, under section 9-306(5)(d) Finance Company's interest will be subordinate to the claims of subsequent creditors of Dealer, including a bankruptcy trustee and purchasers of the returned bulldozer. Moreover, under South Carolina law, as articulated in *Finance America Corp. v. Galaxy Boat Manufacturing Co.*, if Finance Company's security interest in the returned bulldozer is unperfected, its claim will be subordinate to the security interest asserted by Bank under section 9-306(5)(a).

Finance Company's argument that its security interest in the returned bulldozer is perfected rests upon revised section 9-402(7). This section provides that "[a] filed financing statement remains effective with respect to collateral transferred by the debtor even though the secured party knows of or consents to the transfer." The most obvious application of the transfer rule of revised section 9-402(7) is in cases in which a debtor makes an unauthorized sale of collateral subject to a properly perfected security interest to a buyer other than a buyer in the ordinary course. In such a case, the buyer takes subject to the perfected security interest under revised sections 9-306(2) and 9-307(1). Moreover, under revised section 9-402(7) the filing against the seller is effective to perfect the secured party's security interest against conflicting claims asserted by transferees of the buyer.

In Illustration 26, Finance Company can invoke revised section 9-402(7) by asserting that the return of the bulldozer by Contractor was a transfer of the collateral by the debtor. If the return is viewed as such a transfer, the financing statement filed against Contractor re-

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764. See infra notes 807-21 and accompanying text.
765. See infra note 852 and accompanying text.
767. See infra notes 807-21 and accompanying text.
771. See infra text accompanying notes 862-64.
772. See infra text accompanying notes 865-67.
mains effective to perfect Finance Company’s secured interest after the bulldozer is returned to Dealer. The effect of the revised section 9-402(7) argument is to render a chattel paper purchaser’s perfection in the goods against creditors of the buyer effective against creditors of the dealer in the event the goods are returned. This result is inconsistent with the generally accepted interpretation of section 9-306(5)(d). Nevertheless, characterization of a return effected through a revocation of acceptance as a transfer appears reasonable, since the buyer has returned possession of the goods to the dealer in exchange for a release from the obligation to pay the purchase price.

After analyzing the question of perfection, the issue of priority must be addressed. If a court accepts Finance Company’s argument that its security interest in the returned bulldozer was perfected against creditors of Dealer pursuant to revised section 9-402(7), the priority analysis is straightforward. Section 9-306(5)(b) provides that “[t]he security interest [of an unpaid transferee of chattel paper] is prior to a security interest asserted under paragraph (a) to the extent that the transferee of the chattel paper was entitled to priority under Section 36-9-308.” Under this provision, Finance Company clearly is entitled to priority in the returned bulldozer because it had priority over Bank with respect to the chattel paper under revised section 9-308(b). Bank’s claim to the chattel paper was merely as proceeds of inventory. Therefore, Finance Company, which purchased the chattel paper for new value and took possession in the ordinary course of its business, would prime Bank as to the chattel paper, even if it had knowledge of Bank’s security interest.

The priority issue is more complex if the court finds that Finance Company’s security interest in the returned bulldozer is unperfected against creditors of the dealer. One might reasonably assume that Bank’s perfected security interest primes the unperfected security interest of Finance Company. The provisions of section 9-306(5), however, do not dictate this result. Section 9-306(5) appears to provide two arguably inconsistent priority rules that could apply to the conflict between Bank and Finance Company. Finance Company can argue that

775. See, e.g., B. Clark, supra note 8, ¶ 10.02[2][a], at 10-26 to -27.
776. A repossession by a dealer, as opposed to a return to a dealer, lacks the element of an exchange; but, it also appears to constitute a transfer of the goods by the debtor.
778. See supra notes 710-14 and accompanying text.
779. See supra notes 738-41 and accompanying text.
780. See supra notes 710-14 and accompanying text.
section 9-306(5)(b) is the applicable priority rule,\textsuperscript{781} and that under that provision Finance Company primes Bank despite the fact that Finance Company failed to perfect. In response Bank can argue that section 9-306(5)(d) controls the resolution of the priority dispute. Section 9-306(5)(d) provides that "[a] security interest of an unpaid transferee asserted under paragraph (b) or (c) must be perfected for protection against creditors of the transferor and purchasers of the returned or repossessed goods."\textsuperscript{782}

If this provision controls the conflict over the returned bulldozer, Bank is entitled to priority. Under section 1-201(12)\textsuperscript{783} Bank qualifies as a creditor of Dealer. Since Finance Company’s security interest in the returned bulldozer is unperfected, under a literal application of section 9-306(5)(d), Finance Company’s security interest is not protected against Bank’s claim to the returned bulldozer.

The apparent conflict between subsections 9-306(5)(b) and (d) has produced a small body of case law,\textsuperscript{784} including a recent decision of the South Carolina Supreme Court.\textsuperscript{785} Before these decisions are analyzed, however, the basic Article 9 policies applicable to inventory financing should be considered to see if they suggest a proper resolution of the conflict depicted in Illustration 26.

Any argument in favor of awarding a chattel paper purchaser priority over an inventory financer with respect to returns and repossessions must begin by considering the positions of the parties immediately before the return or repossession. Assuming that Contractor qualified as a buyer in the ordinary course,\textsuperscript{786} Contractor took free of Bank’s security interest in the bulldozer.\textsuperscript{787} Moreover, by permitting Dealer to sell the resulting chattel paper to Finance Company, Bank

\textsuperscript{781} See 2 C. Gilmore, supra note 56, § 27.5, at 738-39.


\textsuperscript{783} U.C.C. § 1-201(12) (1972); S.C. Code Ann. § 36-1-201(12) (Law. Co-op. 1976).

\textsuperscript{784} See, e.g., Crocker Nat'l Bank v. Clark Equip. Credit Corp., 724 F.2d 696 (8th Cir. 1984); Northwest Acceptance Corp. v. Lynnwood Equip., Inc., 1 U.C.C. Rep. Serv. 2d (Callaghan) 980 (W.D. Wash.), reconsidered, 1 U.C.C. Rep. Serv. 2d (Callaghan) 1701 (W.D. Wash. 1986), aff’d, 841 F.2d 918 (9th Cir. 1987); J.I. Case Co. v. Borg-Warner Acceptance Corp., 669 S.W.2d 543 (Ky. Ct. App. 1984); see generally Commentary on Section 9-306(5), supra note 745, at 1-6 (analyzing conflicting decisions and asserting intended resolution).


lost its prior claim to the chattel paper as proceeds.\(^{788}\) Therefore, until the bulldozer was returned by Contractor, Bank's security was effectively limited to a security interest in the cash proceeds realized by Dealer upon the sale of the chattel paper.\(^{789}\)

In contrast, immediately prior to the return of the bulldozer Finance Company had a prior claim to the chattel paper.\(^{790}\) By virtue of its claim to the chattel paper, Finance Company was entitled to the installment payments made by Contractor.\(^{791}\) Moreover, to the extent that Contractor failed to make these payments, Finance Company had a prior claim to the bulldozer. Thus, immediately before the return of the bulldozer, and while Bank had no claim to the bulldozer, Finance Company had a security interest in the bulldozer that protected Finance Company in the event Contractor failed to make the installment payments.

Against this background, a compelling case can be made for affording Finance Company a prior claim to the bulldozer upon its return to Dealer. Granting Finance Company a prior claim to the returned bulldozer preserves Finance Company's secured position.\(^{792}\) In contrast, if Bank is awarded a prior claim in the returned bulldozer, Bank's secured position is improved solely because of the return. Moreover, this improvement in Bank's position is at the expense of Finance Company. If Bank has a prior claim to the returned bulldozer, it can claim both the bulldozer and the new value advanced by Finance Company, leaving Finance Company without security. Therefore, the Article 9 priority rules governing conflicts among inventory financiers, buyers of inventory in the ordinary course, and purchasers of the resulting chattel paper provide a basis for awarding Finance Company

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\(^{790}\) See B. CLARK, supra note 8, ¶ 10.02[2][a], at 10-25.


\(^{792}\) See Skilton & Dunham, supra note 745, at 806.
priority in the returned bulldozer.

Awarding Finance Company priority in the returned bulldozer, however, arguably is inconsistent with the policy effected by sections 9-114(1)\(^9\) and 9-312(3).\(^9\) From Bank's perspective, the returned bulldozer is after-acquired property subject to its security interest. Therefore, Bank might rely on the returned bulldozer by making a future advance under the assumption that it had a prior claim. In analogous situations, to protect an inventory financer from relying to its detriment on after-acquired property, Article 9 conditions the priority afforded consignors\(^9\) and purchase money financers of new inventory.\(^9\)

In order to prime an earlier-filed inventory financer, a consignor or purchase money financer must both file or perfect with respect to the new inventory\(^9\) and give written notice\(^9\) to the earlier-filed inventory financer before the debtor receives possession of the new inventory.\(^9\) Assuming the debtor deals in used goods, the problem confronting an inventory financer when inventory is repossessed or returned is identical to the one that arises when inventory is acquired in a purchase money transaction or by consignment. Therefore, the protection afforded the inventory financer arguably should be identical. Thus, in principle, Finance Company's priority in the returned bulldozer should be conditioned on Finance Company's filing with respect to the returns and giving Bank notice of its security interest in returns before Dealer obtains possession of the returned bulldozer.\(^9\)

The general priority rules applicable to inventory financing, therefore, indicate that a purchaser of chattel paper should be entitled to priority over an inventory financer with respect to returns and repossessions if, but only if, the chattel paper transferee perfects with respect to and gives the inventory financer prior written notice of its claim in returns and repossessions. The language of section 9-306(5), however, cannot be interpreted as imposing this rule. Unless the repossession or return can be classified as a consignment of the goods by the


\(^{795}\) See supra note 346 and text accompanying note 362.

\(^{796}\) See supra notes 114-291 and accompanying text.


\(^{798}\) U.C.C. §§ 9-114(1)(b) to (d), -312(3)(b) to (d) (1972) (amended 1977); S.C. CODE ANN. §§ 36-9-114(1)(b) to (d), -312(3)(b) to (d) (Law. Co-op. Supp. 1989).

\(^{799}\) See supra notes 114-291, 346, 362 and accompanying text.

\(^{800}\) See Kripke, supra note 745, at 19-20.
The chattel paper purchaser's priority of the chattel paper purchaser cannot be conditioned upon prior written notice to the inventory financer. Nevertheless, satisfaction of the perfection requirement of section 9-306(5)(d) can be interpreted as a condition on the priority afforded the transferee of chattel paper under section 9-306(5)(b). The perfection requirement provides the inventory financer some notice not to rely upon the returned or repossessed goods by making a future advance. Thus, section 9-306(5) would conform to the priority rules of


803. Revised Article 9 includes a variety of rules to protect an earlier-filed secured party, who may rely on after-acquired property by making a future advance, against the claims of a subsequent financer who gives new value. The most protective provision is section 9-313(6), which precludes a fixture financer from asserting the purchase money priority of revised section 9-313(4)(a) over the lien of an earlier-recorded construction mortgage. See U.C.C. § 9-313(6) (1972) (amended 1977); S.C. CODE ANN. § 36-9-313(6) (Law. Co-op. Supp. 1989). Next in order of protection are the rules of revised sections 9-114(1) and 9-312(3), which provide two conditions to be met before a consignor and purchase money inventory financer can be afforded priority over an earlier-filed inventory financer claiming the goods as after-acquired property. They must both file and give written notice to the prior inventory financer before the consignor or debtor obtains possession of the new inventory. See U.C.C. §§ 9-114(1), -312(3) (1972) (amended 1977); S.C. CODE ANN. §§ 36-9-114(1), -312(3) (Law. Co-op. Supp. 1989).

Next in order of protection is the rule of revised section 9-314(3)(c), which conditions an accession financer's priority over a prior secured party claiming a security interest in the whole to the extent the secured party has made an advance after the accession is installed, upon perfecting with respect to the accession before the advance is made. See U.C.C. § 9-314(3)(c) (1972) (amended 1977); S.C. CODE ANN. § 36-9-314(3)(c) (Law. Co-op. Supp. 1989). Finally, revised section 9-312(4) illustrates the least protective rule. Under this section, the priority afforded a purchase money financer of goods, other than inventory, over a conflicting security interest is conditioned on the purchase money financer's perfecting within 10 days after debtor receives possession of the new goods. See U.C.C. § 9-312(4) (1972) (amended 1977); S.C. CODE ANN. § 36-9-312(4) (Law. Co-op. Supp. 1989). The Code provides in section 9-313(4)(a) a similar rule, which applies to purchase money financers of fixtures in conflict with real estate interests other than construction mortgages that arose before the goods became fixtures. Under revised section 9-313(4)(a), a fixture financer's purchase money priority is conditioned on making a fixture filing before the goods become fixtures or within 10 days thereafter. See U.C.C. § 9-313(4)(a) (1972) (amended 1977); S.C. CODE ANN. § 36-9-313(4)(a) (Law. Co-op. Supp. 1989); see generally supra text accompanying notes 138-61 (comparative analysis of various conditions upon purchase money priority).

Interpreting section 9-306(5)(d) as conditioning a chattel paper purchaser's priority in returns upon perfection in goods against the seller would provide a rule comparable to revised sections 9-312(4) and 9-313(4)(a). The chattel paper purchaser could claim an automatically perfected security interest in the returns for 10 days under revised section 9-306(3) on the theory that the returns were proceeds of the chattel paper. See sources cited supra note 750. Continuing its perfection in the returns would require the chattel
Article 9 if subsection (b) were interpreted as awarding an unpaid transferee of chattel paper priority in returns and repossessions, provided the transferee satisfies the perfection requirement of subsection (d).

The courts are divided over the resolution of the conflict depicted in Illustration 26. In a decision consistent with the position of most commentators,\textsuperscript{804} the court in J.I. Case Co. v. Borg-Warner Acceptance Corp.\textsuperscript{805} awarded priority to the chattel paper transferee under section 9-306(5)(b), despite the transferee's failure to perfect with regard to returns and repossessions. The court reasoned that the perfection requirement of section 9-306(5)(d) applied only to interests which arose after the goods were returned or repossessed, and hence was inapplicable to a prior inventory financer asserting a security interest under section 9-306(5)(a).\textsuperscript{806} In contrast, the court in Crocker National Bank v. Clark Equipment Credit Corp.\textsuperscript{807} held that under section 9-306(5)(d) a chattel paper transferee's failure to perfect in returns and repossessions rendered its security interest subordinate to an inventory financer claiming the goods under section 9-306(5)(a).\textsuperscript{808} Significantly, in Finance America Corp. v. Galaxy Boat Manufacturing Co.,\textsuperscript{809} the South Carolina Supreme Court followed the decision in Crocker National Bank.

In Finance America, Galaxy retained a security interest in boats it manufactured and sold to a dealer for retail sale. In apparent compliance with the applicable certificate of title statute,\textsuperscript{810} Galaxy perfected its security interest in the dealer's inventory by retaining the original certificate of title to the boats.\textsuperscript{811} The dealer sold a boat to purchasers, the Marions, under a credit sale contract, which the dealer subsequently sold to Finance America. Although the opinion does not state

\textsuperscript{167}
that Finance America took possession of the contract, it is reasonable to assume it did. Finance America then filed a financing statement covering the boat. The opinion, however, does not expressly state whether this financing statement was filed against the Marions or the dealer. Nevertheless, the clear indication drawn from the opinion is that the financing statement was filed against the Marions.

Subsequently, the Marions revoked acceptance of the boat and agreed to return it to Finance America in exchange for release from the credit contract. The boat, however, was at the dealer’s place of business for repairs, and while there was repossessed by Galaxy to enforce its security interest. Finance America then brought a claim and delivery action against Galaxy asserting that it had a prior security interest in the boat under former section 9-308 and section 9-306(5)(b). Although Finance America prevailed on this theory in the trial court, the supreme court ruled in favor of Galaxy on the grounds that Finance America’s security interest in the returned boat was not perfected.812

The court in Finance America ruled that compliance with the South Carolina Certificate of Title Statute covering watercraft813 provided the exclusive method for perfecting security interests in the boat at issue.814 Therefore, the court held that Finance America’s security interest was unperfected815 and apparently found that Galaxy’s security interest was perfected.816 That Finance America’s security interest

812. Id. at 496-97, 357 S.E.2d at 460-61.
814. Finance Am., 292 S.C. at 496, 357 S.E.2d at 461.
815. Id.
816. Although the court found that Galaxy had retained the original certificate of title covering the boat, id. at 495, 357 S.E.2d at 460, the court did not expressly hold that Galaxy's security interest was perfected. Under the law applicable when the transaction arose, Galaxy's attempted perfection through the certificate was proper. See S.C. CODE ANN. § 36-9-302(4) (Law. Co-op. 1976) (amended 1988). Significantly, neither former section 36-9-302(3)(b) and (4) nor the certificate of title statute applicable to watercraft, S.C. CODE ANN. §§ 50-23-10 to -280 (Law. Co-op. 1976 & Supp. 1989), excluded security interests in goods held as inventory by a dealer from perfection under the certificate of title statute. To be perfected under the certificate of title statute, however, it appears that Galaxy had to have its security interest indicated on the certificate. See S.C. CODE ANN. §§ 50-23-50(a) to (b)(1), -90(a)(3), -140(a) (Law. Co-op. 1976); see also S.C. CODE ANN. § 60-23-140(c) (Law. Co-op. Supp. 1989) (enacted in 1984) (providing that a security interest in a watercraft is perfected by delivering to the Wildlife and Marine Resources Department an application for a certificate of title containing the name of the secured party). Therefore, unless Galaxy’s security interest was indicated on the certificate of title, its security interest apparently was unperfected.

If Galaxy had properly perfected in the boat as inventory of the dealer, its security interest apparently would have remained perfected when the boat was returned. Section 9-306(5)(a) provides that if the security interest of an inventory financer was “originally perfected by a filing which is still effective” when the goods are returned, the security interest in the returned goods continues to have perfected status. U.C.C. § 9-306(5)(a)
was unperfected would not have subordinated its claim if the court had adopted the plaintiff's interpretation of section 9-306(5)(b). 817 Finance


A literal reading of section 9-306(5)(a) suggests that since Galaxy's security interest was originally perfected through the certificate of title statute rather than by filing, its security interest in the returned boat was not continually perfected without further action. This suggestion, however, must be rejected. Compliance with a mandatory certificate of title statute is the legal equivalent of filing. Revised section 9-302(4) provides that "[c]ompliance with a statute . . . described in subsection (3) [i.e., a mandatory certificate of title statute] is equivalent to the filing of a financing statement under this chapter . . . ." S.C. CODE ANN. § 36-9-302(4) (Law. Co-op. Supp. 1989). Although South Carolina's 1966 enactment of the 1962 Official Text did not expressly so provide, under South Carolina Code section 36-11-108, the 1988 amendment to section 36-9-302(4) should be considered as declaratory of the meaning of South Carolina's 1966 version of the Uniform Commercial Code. See S.C. CODE ANN. § 36-11-108 (Law. Co-op. Supp. 1989).

If Galaxy did not comply with the requirements of the certificate of title statute, it arguably still perfected its security interest in the boat through possession when it repossessed the dealer's inventory. See U.C.C. § 9-305 (1972) (amended 1977); S.C. CODE ANN. § 36-9-305 (Law. Co-op. Supp. 1989). Whether Galaxy's possession of the boat perfected the security interest, however, is at least debatable. Former section 36-9-302(3)(b) provided that "[t]he filing provisions of this chapter [Article 9] do not apply to a security interest in property subject to a statute . . . which requires indication in a certificate of title." S.C. CODE ANN. § 36-9-302(3)(b) (Law. Co-op. 1976) (amended 1988).

Read in isolation, this provision suggests that notation on a certificate of title displaced perfection by filing only, and that perfection by possession remains viable. See, e.g., Transport Acceptance Corp. v. Crosby (In re Crosby), 19 Bankr. 436 (Bankr. E.D. Tenn. 1982). Former section 36-9-302(3)(b), however, cannot be read in isolation. Former section 36-9-302(4) provided that "[a] security interest in property covered by a statute described in subsection (3) [could] be perfected only . . . by indication of the security interest on a certificate of title." S.C. CODE ANN. § 36-9-302(4) (Law. Co-op. 1976) (amended 1988); see U.C.C. § 9-302(4) (1962) (amended 1977). In light of subsection (4), it is difficult to conclude that the certificate of title statute does not displace perfection by possession under Article 9. But see Mack Fin. Corp. v. Peterbilt, Inc. (In re Glenn), 20 Bankr. 98, 101 (Bankr. E.D. Tenn. 1982) (holding that if repairman had maintained possession of truck, repairman's lien would have had priority over secured party who perfected under certificate of title statute).

Moreover, the court in Finance America indicated that the certificate of title statute provided the exclusive method of perfection. See Finance Am., 292 S.C. at 496, 357 S.E.2d at 461. In cases in which the applicable certificate of title statute was the exclusive manner of perfection of a security interest, the courts have held that a secured party's taking possession of the collateral is not effective to perfect its security interest. See, e.g., Bucci v. IRS, 655 F. Supp. 479 (D.R.I. 1987); Waldschmidt v. Associates Comm. Corp. (In re Groves), 75 Bankr. 227 (M.D. Tenn. 1987); In re Davis, 57 Bankr. 351 (Bankr. D.S.D. 1985).

817. See supra text accompanying notes 804-06, 812.
America apparently primed Galaxy with respect to the credit sale contract under former section 9-308.818 Therefore, if section 9-306(5)(b) were the exclusive provision governing priorities in returns, Finance America would have prevailed with respect to the returned boat.

In finance America, however, the court rejected the plaintiff's theory and with little independent analysis adopted the reasoning of the Eighth Circuit in Crocker National Bank v. Clark Equipment Credit Corp.819 The court in Finance America held that under section 9-306(5)(d) Finance America's failure to perfect its security interest in the returned boat precluded it from prevailing over Galaxy.820 Relying on section 9-306(5)(a), the court then awarded priority to Galaxy.821 In essence, the decision in Finance America can be read as conditioning a chattel paper purchaser's priority over an inventory financer, with respect to returns, on the chattel paper purchaser's perfection in the returns must be analyzed with reference to the basic policies evidenced by the Article 9 general priority rules governing inventory financing.

Two aspects of the decision in Finance America merit discussion. First, the opinion raises a number of issues concerning the perfection of security interests in inventory and returns of goods subject to certificate of title statutes. Second, the decision to condition a chattel paper purchaser's priority over an inventory financer, with respect to returns, on the chattel paper purchaser's perfection in the returns must be analyzed with reference to the basic policies evidenced by the Article 9 general priority rules governing inventory financing.

The decision in Finance America turned on the court's conclusion that Finance America's filing was ineffective to perfect its security interest. This conclusion raises several issues concerning the relationship between the perfection requirements of Article 9 and perfection pursuant to an applicable certificate of title statute. The court in Finance America failed to analyze these issues fully under then applicable law. More significantly, the adoption of the 1988 Amendments to the Uniform Commercial Code has had a substantial impact on the resolution of these issues.

The first perfection issue raised in Finance America is whether Finance America had a perfected security interest in the returned boat under the law in effect when the case arose. The resolution of this

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821. Id. at 497, 357 S.E.2d at 461.
question turned on the interplay between the certificate of title statute covering watercraft and the 1966 South Carolina version of the U.C.C. then in effect. Former section 36-9-302(3)(b) and (4)\textsuperscript{822} defined the relationship between the perfection requirements of Article 9 and the certificate of title statute. Former section 36-9-302(3)(b) provided that the filing provisions of Article 9 did not apply to a security interest in goods subject to a mandatory certificate of title statute.\textsuperscript{823} Moreover, former section 36-9-302(4) provided that a security interest in goods subject to a mandatory certificate of title statute could be perfected only by indication of the security interest on the certificate of title.\textsuperscript{824}

The court then reasoned that because the certificate of title statute required a lien to be indicated on the certificate of title, former sections 36-9-302(3)(b) and (4) rendered Finance America's filing ineffective to perfect its security interest.\textsuperscript{825} The court clearly was correct to the extent that it held the financing statement apparently filed against the Marions was ineffective to perfect Finance America's security interest against creditors of the Marions. Moreover, even if the filing had been effective against creditors of the Marions, most authorities agree that the filing would have been ineffective against creditors of the dealer following the return of the boat.\textsuperscript{826} Therefore, if the financing statement filed by Finance America listed the Marions as the debtor, the court was on firm ground in holding that Finance America's security interest in the returned boat was unperfected.

The second perfection issue raised in \textit{Finance America} concerns the manner in which Finance America should have perfected its secur-

\textsuperscript{822} S.C. Code Ann. § 36-9-302(3)(b), (4) (Law. Co-op. 1976) (amended 1988). Former subsections (3)(b) and (4) provided:

(3) The filing provisions of this chapter do not apply to a security interest in property subject to a statute

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(b) of this State which provides for central filing of, or which requires indication in a certificate of title of, such security interests in such property, including, but not limited to, the filing provisions of § 30-11-20, Code of Laws of South Carolina, 1976, for a security interest in property of any description or any interest therein created by a mortgage made by a railroad company as defined in § 58-17-20, Code of Laws of South Carolina, 1976.

(4) A security interest in property covered by a statute described in subsection (3) can be perfected only by registration or filing under that statute or by indication of the security interest on a certificate or title or a duplicate thereof by a public official.


\textsuperscript{825} Finance Am., 292 S.C. at 496-97, 357 S.E.2d at 461.

\textsuperscript{826} See, e.g., B.Clark, supra note 8, ¶ 10.02 [2][a], at 10-23 to -27. But see supra notes 768-73 and accompanying text (section 9-402(7) argument).
ity interest in the returned boat. More specifically, the question presented is whether Finance America would have been perfected in the returned boat if it had filed a financing statement listing the dealer as the debtor. The resolution of this question depends on the watercraft certificate of title statute and the provisions of former section 36-9-302.

Most certificate of title statutes include an exception for goods held by a dealer as inventory.\(^{827}\) For example, the South Carolina Motor Vehicle Certificate of Title Statute does not control the perfection of a security interest created in a vehicle by a dealer who holds the vehicle for sale.\(^{828}\) As a result, former section 36-9-302(3)(b) and (4) did not apply to security interests in the inventory of a car dealer, and such security interests were perfected pursuant to the filing provisions of Article 9.\(^{829}\) Since goods returned to a dealer become inventory upon their return, a person who purchased chattel paper from an automobile dealer could perfect a security interest in returns by filing against the dealer. Nevertheless, under the law in effect when Finance America was decided, Finance America could not have perfected its security interest in the returned boat by filing against the dealer. Curiously, the South Carolina Watercraft Certificate of Title Statute does not contain an exception for goods held by a dealer as inventory. As a result, when Finance America was decided, security interests in a boat dealer's inventory had to be perfected under the certificate of title statute by indicating the security interest on the certificate of title. Therefore, to perfect its security interest in the returned boat, Finance America should have indicated its security interest on the boat's certificate of title. Certificate of title statutes, however, contemplate in rem perfection and not perfection against particular debtors.\(^{830}\) Therefore, if a certificate of title had been issued to the Marions indicating Finance America's security interest as the retail financer, Finance America would have been perfected against creditors of the dealer when the Marions returned the boat.

The next perfection issue is whether the adoption of the 1988 Amendments to South Carolina's version of the U.C.C. affected the manner in which a chattel paper purchaser perfects a security interest in boats returned to a boat dealer. Revised section 36-9-302(3)(b)\(^{831}\) provides that the filing of a financing statement is neither necessary nor effective to perfect a security interest in goods subject to either the

\(^{827}\) See Skilton & Dunham, supra note 745, at 829.


\(^{830}\) See Skilton & Dunham, supra note 745, at 828.

motor vehicle or watercraft certificate of title statutes. Revised section 36-9-302(3)(b), however, has an express exception for inventory. The exception provides that "during any period in which collateral is inventory held for sale by a person who is in the business of selling goods of that kind, the filing provisions of this chapter (Part 4) apply to a security interest in that collateral created by him as debtor . . . ." 832

In effect, this exception amends the watercraft certificate of title statute to require inventory financiers of boat dealers to perfect their security interests by filing under Article 9, rather than by having their security interests indicated on the certificate of title. Moreover, revised section 36-9-302(3)(b) apparently requires chattel paper purchasers, such as Finance America, to perfect their security interests in returns by filing against the dealer. 833 Thus, to be fully protected a purchaser of chattel paper covering goods subject to a certificate of title statute must take possession of the chattel paper, 834 have its security interest indicated on the certificate of title, 835 and file against the dealer with respect to returns. 836

To explore this issue further, consider the plight of a chattel paper purchaser that has its security interest indicated upon the certificate of title but fails to file with respect to returns. Specifically, what can the chattel paper purchaser argue under the revised Article 9 to claim that its security interest in a returned vehicle or boat is perfected, and hence entitled to priority under the interpretation of section 36-9-306(5) adopted by the court in Finance America? If the chattel paper purchaser acts promptly upon the return of the goods, the chattel pa-


834. By taking possession of the chattel paper, a purchaser of chattel paper for new value can establish priority in the chattel paper over an inventory financer claiming the paper merely as proceeds under revised section 36-9-308(b). See supra notes 697-701, 710-13 and accompanying text.


836. By filing against the dealer with respect to returned goods the chattel paper purchaser perfects its security interest in the goods against creditors of the dealer. See supra notes 831-33 and accompanying text. Moreover, under Finance America, 299 S.C. 494, 357 S.E.2d 460, such perfection appears essential to establishing priority over an inventory financer asserting a security interest in the returned goods under section 36-9-306(5)(a).
per purchaser can assert that the returned goods are proceeds of the chattel paper, and that the security interest in the returned goods is automatically perfected for ten days. Then, within the ten-day period, the chattel paper purchaser can file against the dealer with respect to the boat.

The question becomes more interesting, however, if the chattel paper purchaser does not file within the ten-day period. Under these facts the chattel paper purchaser apparently has two arguments. First, the chattel paper purchaser can argue that revised section 36-9-302(3)(b) does not except security interests arising under section 36-9-306(5)(b) from the certificate of title statute. The exception in revised section 36-9-302(3)(b) applies to security interests in goods created by the dealer as debtor. The chattel paper purchaser can argue that the dealer as debtor created a security interest in the chattel paper but not the goods. The chattel paper purchaser would then assert that the security interest in the boat arose as a matter of law under section 9-306(5)(b).

Since the security interest in the returned boat was created by statute, rather than by the dealer, the chattel paper purchaser will argue that perfection in the returned boat is controlled by the certificate of title statute rather than Article 9. Moreover, since perfection of a security interest under the certificate of title statute is in rem, the chattel paper purchaser can assert that the indication of a security interest on the certificate of title issued in the buyer's name is sufficient to perfect the security interest in the returned boat. The weakness in this argument is that by creating a security interest in the chattel paper, the dealer necessarily created a security interest in the proceeds of the chattel paper. Moreover, section 9-306(5)(b) can be read as simply affirming the fact that a chattel paper purchaser obtains a security interest in returned goods as proceeds of the chattel paper.

The second argument concedes that perfection in the returned goods is governed by Article 9. Under this argument the chattel paper purchaser argues that perfection against the buyer under the certificate of title statute is effective against the dealer as a transferee of the boat under revised section 9-402(7). Revised section 9-402(7) provides that "[a] filed financing statement remains effective with respect to collateral transferred by the debtor even though the secured party

837. See supra note 750 and accompanying text.
839. See supra text accompanying note 832.
840. See Skilton & Dunham, supra note 745, at 799.
841. See id.
842. See supra notes 768-73 and accompanying text.
knows of or consents to the transfer.\textsuperscript{843} The chattel paper purchaser can argue that under revised section 9-302(4) the notation of its security interest on the certificate of title is the legal equivalent of filing a financing statement,\textsuperscript{844} and that the return of the goods to the dealer constitutes a transfer by the debtor within the meaning of revised section 9-402(7).

If a court accepts these arguments, a chattel paper purchaser's perfection in the goods sold against creditors of the buyer will perfect the security interest in the goods against creditors of the dealer when the goods are returned to the dealer. Significantly, acceptance of these arguments would avoid the effect of Finance America. Because the chattel paper purchaser's security interest in the goods remains perfected following their return under revised section 9-402(7), the chattel paper purchaser satisfies the requirements of section 9-306(5)(d). Therefore, even under the holding in Finance America, the chattel paper purchaser can establish priority over an inventory financer of the dealer under section 9-306(5)(b).

Transcending the perfection issues raised by the certificate of title statute, Finance America is clear in holding that an unpaid transferee of chattel paper must perfect in returns to claim priority over an inventory financer asserting a perfected security interest under section 9-306(5)(a). Therefore, unless the court accepts the revised section 9-402(7) perfection argument discussed above,\textsuperscript{845} a court applying South Carolina law would resolve Illustration 26 in favor of Bank.

Although most commentators would resolve the problem in favor of Finance Company under section 9-306(5)(b), despite its failure to perfect,\textsuperscript{846} the decision in Finance America represents a sound accommodation of the conflicting policies reflected in the basic priority rules governing inventory financing. The decision does not preclude an unpaid transferee of chattel paper from priming an inventory financer when the underlying goods are returned or possessed. By meeting the perfection requirements of section 9-306(5)(d), the chattel paper transferee can extend the new value priority in the chattel paper to the returned or repossessed inventory. Moreover, by conditioning a chattel paper transferee's subsection (b) priority upon satisfaction of the subsection (d) perfection requirements, the court in Finance America afforded inventory financiers some notice of the chattel paper transferee's


\textsuperscript{844} See supra note 810.

\textsuperscript{845} See supra notes 768-73, 842-44 and accompanying text.

\textsuperscript{846} See, e.g., B. Clark, supra note 8, ¶ 10.02[2][a], at 10-23 to -37; 2 G. Gilmore, supra note 56, § 27.5, at 739.
claim to the returned goods. Therefore, the decision affords inventory financers some protection against making future advances in reliance upon returned inventory upon which a chattel paper transferee has a prior claim.847

Unless the chattel paper transferee has filed a financing statement against the dealer covering returns, the inventory financer can make an advance secured by the returns with the assurance that it will be entitled to priority. If the chattel paper transferee files with respect to returns, the inventory financer is put on notice that it must investigate the manner in which the debtor acquired the additional inventory. If the inventory financer discovers that the additional inventory constitutes returns, the inventory financer should not rely on the goods.

The mechanics of complying with the requirements of section 9-306(5)(d) raise several issues. First, although an inventory financer would be more effectively protected if the chattel paper transferee were required to give the inventory financer prior written notice of its security interest in the specific returned or repossessed goods, section 9-306(5) does not condition the transferee's priority under section 9-306(5)(b) upon the giving of notice to the inventory financer.848 Moreover, although a financing statement listing the specific goods in which the chattel paper transferee claims a security interest under section 9-306(5)(b) would provide a more effective warning to the inventory financer, a blanket financing statement covering all returns and repossessions apparently satisfies the requirements of section 9-306(5)(d).849

The time at which a chattel paper transferee must file to comply with section 9-306(5)(d) also presents a problem. Gilmore has argued that from the perspective of the chattel paper transferee, returns are proceeds of the chattel paper.850 If this argument is accepted, the chattel paper transferee's security interest in the returns is automatically perfected for ten days under revised section 9-306(3).851 Therefore, under Gilmore's analysis, the chattel paper transferee's filing is timely and preserves its priority if made within ten days after the goods are returned or repossessed. Treating the returns as proceeds, however, gives the chattel paper transferee a secret but prior lien on the returns. This lien may prejudice the inventory financer if it makes a future advance before the chattel paper transferee files. Therefore, a court would act rationally if it refused to find that returns are proceeds of

847. See Kripke, supra note 745, at 19-20.
848. But see infra notes 853-53 and accompanying text (treatment of return as a consignment subject to notice requirements of revised section 9-114).
849. See Kripke, supra note 745, at 14 ("professional financers of chattel paper . . . now routinely file in advance to claim a security interest in returns").
850. See 2 G. GILMORE, supra note 56, § 27.5, at 737.
851. See supra notes 450-51 and accompanying text.
chattel paper.

The lesson to be drawn from Illustration 26 and Finance America is that a chattel paper transferee should file against the transferor with respect to returns. Finance America, however, does not increase the burden borne by a chattel paper transferee. Even if a chattel paper transferee primed an inventory financer with respect to returns without meeting the perfection requirements of section 9-306(5)(d), the transferee would have to file to prevail over subsequent creditors of the transferor, including the bankruptcy trustee. 852 Thus, Finance America merely gives the chattel paper transferee an additional reason to file with respect to returns.

A final issue related to Illustration 26 is whether a chattel paper transferee who complies with the perfection requirement of section 9-306(5)(d) can lose to an inventory financer on the grounds that a return constituted a consignment to the debtor by the transferee. If the return is a consignment, the chattel paper transferee must satisfy the requirements of new section 9-114(1) to prevail over the inventory financer. 853 Section 9-114 conditions a consignor’s priority over the consignee’s inventory financer upon the satisfying of two requirements. First, the consignor must file a financing statement before the consignee receives possession of the goods. 854 Second, the consignor must give a filed inventory financer written notice of the consignment, which must be received by the inventory financer before its consignee receives possession of the goods. 855 If section 9-114 applies to a chattel paper transferee, in order to prevail over an inventory financer with respect to returns and repossessions the transferee would have to file against the dealer with respect to returns and repossessions and give the inventory financer written notice before the goods at issue were returned to the possession of the dealer. 856


853. See supra notes 361-68 and accompanying text.


856. See Home Sav. Ass’n v. General Elec. Credit Corp., 101 Nev. 595, 708 P.2d 280 (1985); see also Buchanan v. Mobile Home Guar. Corp. (In re International Mobile Homes), 14 U.C.C. Rep. Serv. (Callaghan) 1150 (Bankr. E.D. Tenn. 1974) (defendant could not prevail over bankruptcy trustee because the property was in dealer’s possession and defendant had not given the notice required by Article 9); In re Bro Cliff, Inc., 8 U.C.C. Rep. Serv. (Callaghan) 242 (Bankr. W.D. Mich. 1970) (finance company could not prevail over bankruptcy trustee because goods were in possession of dealer and no notice
The critical question is whether a return or repossession constitutes a consignment within the scope of section 9-114. If the chattel paper transferee owned the goods at issue when they were returned to the dealer, the return can be viewed as a consignment. For example, if the purchaser of a conditional sales contract repossesses the goods upon the buyer's default and retains the goods in satisfaction of its assigned security interest, a subsequent transfer of the goods to the dealer for resale would appear to be a consignment. The court in Home Savings Association v. General Electric Credit Corp., 857 however, found a consignment under less compelling facts. In Home Savings the chattel paper transferee repossessed the goods from the buyers, but did not retain the goods in satisfaction of its security interest. Rather, the chattel paper transferee returned the goods to the dealer for the purpose of resale to enforce its security interest. Although the chattel paper transferee's interest in the returned goods was merely a security interest, the court found that the return was a consignment. 858 Because the chattel paper transferee had not satisfied the requirements of sections 2-326(3) 859 and 9-114(1), the court awarded the priority in the returned goods to the dealer's inventory financer. 860

Under the facts presented in Home Savings, the consignment analysis does not appear inappropriate. More significantly, the application of section 9-306(5) to resolve the conflict therein would have been inappropriate.861 Although the chattel paper transferee had repossessed the goods and delivered them to the dealer for the purpose of sale, title to the goods remained in the buyer. 862 The dealer's mere possession with the power to sell did not constitute sufficient rights in the repossessed goods for the inventory financer's security interest to attach.863 Therefore, section 9-306(5)(a) should not be interpreted to grant the inventory financer a security interest.864 If the inventory financer cannot claim a security interest in the repossessed goods, a con-

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858. Id. at 599-604, 708 P.2d at 284-86.
859. See supra notes 352-57 and accompanying text.
861. See Kripke, supra note 745, at 12.
864. See Kripke, supra note 745, at 12; see also Commentary on Section 9-306(5), supra note 745, at 2-3 (dealer must have rights in the collateral to claim a security interest in returned or repossessed goods, and implying that simple repossession by dealer or possession of repossessed goods to which the buyer has title does not establish rights in the collateral).
flict within the scope of section 9-306(5) is not present.

Admittedly, the consignment analysis of *Home Savings* is somewhat strained. In a typical consignment the owner of the goods delivers them to a consignee for the purpose of sale. In *Home Savings* the chattel paper transferee, who held only a security interest in reposessed goods, delivered them to the dealer. Nevertheless, upon the buyer's default, the chattel paper transferee was entitled to possession of the goods, and upon repossessing them was under an obligation to the debtor to dispose of them in a commercially reasonable manner. Therefore, is not unreasonable to view the chattel paper transferee as acting on behalf of the buyer in delivering the goods to the dealer for sale. Moreover, since the dealer presumably maintained a place of business at which the dealer dealt in goods of that kind under a name other than that of the chattel paper transferee, the transaction falls within the scope of section 2-326(3). More significantly, from the perspective of the dealer's inventory financer, the transaction gave rise to the same problem of apparent ownership that flows from a consignment. Unless the inventory financer had prior notice of an adverse claim to the goods, it may make an advance against the goods on the assumption that they constitute after-acquired inventory subject to its security interest. Therefore, it is reasonable to condition the chattel paper transferee's claim to the repossessed goods upon compliance with notification requirements sections 2-326(3) and 9-114.

Although the consignment analysis adopted in *Home Savings* is defensible, at last one court has viewed the decision as "aberrant." Nevertheless, the lesson to be drawn from *Home Savings* is clear: when a chattel paper purchaser repossesses goods upon a buyer's default and delivers them to the dealer, or simply authorizes the dealer to repossess the goods on behalf of the chattel paper purchaser, the chattel paper purchaser should comply with the requirements of section 9-114(1). The chattel paper purchaser should not only file against the dealer with respect to returns and repossessions at the time of the purchase of the chattel paper, but also give the inventory financer

865. See generally *supra* text accompanying notes 335-43 (attributes of true consignment).
868. See *supra* notes 348-51 and accompanying text.
869. See *supra* notes 344-46 and accompanying text.
870. See Kripke, *supra* note 745, at 13 n.37.
872. Id.
timely written notice of its security interest in returns and repossessions.

Illustration 26 and the analysis above assumed that Contractor, the buyer of the bulldozer, qualified as a buyer in the ordinary course. As a result, under section 9-307(1),873 Dealer’s sale to Contractor had the effect of discharging Bank’s original security interest in the bulldozer.874 Therefore, in the conflict depicted in Illustration 26, Bank claimed a security interest in the returned bulldozer only pursuant to section 9-306(5)(a).875 A more complex priority conflict between an inventory financer and a chattel paper purchaser arises when the debtor’s sale of the inventory which generated the chattel paper does not discharge the inventory financer’s security interest.

In most situations an inventory financer cannot look to the inventory as collateral after it has been sold by the debtor. An inventory financer typically will authorize the debtor to sell the collateral.878 If a sale of inventory is authorized, section 9-306(2)877 provides that the inventory financer’s security interest does not continue in the goods following their sale. Moreover, even if the debtor’s sale was unauthorized and section 9-306(2) does not shield the buyer from the security interest of the inventory financer, the buyer will take free of that security interest under section 9-307(1)878 if the buyer qualifies as a buyer in the ordinary course.879 The protection afforded a buyer, however, is not absolute. If the debtor’s sale was unauthorized and the buyer does not qualify as a buyer in the ordinary course, the buyer acquires the goods subject to the inventory financer’s security interest.880 In short, in such cases the inventory financer has priority over the buyer.

The discussion which follows will consider priority conflicts between an inventory financer who has priority over the buyer and the buyer’s retail financer. This analysis begins by considering a dispute between an inventory financer and a purchaser of chattel paper over

874. See supra notes 14, 443 and accompanying text.
875. Bank also could have claimed a security interest in the returned bulldozer under an after-acquired property clause. See supra note 745 and accompanying text. The significant point, however, is that the sale discharged Bank’s security interest and that the security interest did not reattach until the goods were returned.
876. See White & Summers, supra note 87, at 1066.
878. See supra notes 14, 443 and accompanying text.
ILLUSTRATION 27—Manufacturer produces bulldozers and markets its product through a network of authorized dealers. On January 1 Manufacturer granted D Corporation a dealership. Under the dealership contract Manufacturer agreed to sell D Corporation its requirements of bulldozers. On January 1 the parties also executed a security agreement that granted Manufacturer a security interest in all bulldozers sold by Manufacturer to D Corporation to secure D Corporation's obligation to pay the purchase price of the bulldozers. The security agreement also provided that any sale by D Corporation of an encumbered bulldozer without obtaining Manufacturer's prior written consent was unauthorized and an event of default. Finally on January 1, Manufacturer filed a financing statement to perfect its security interest in the bulldozers it would sell to D Corporation.

In authorized transactions D Corporation sold bulldozers to various buyers under conditional sales contracts. These contracts granted D Corporation a security interest in the bulldozer sold to secure the buyer's obligation to pay the purchase price in installments. D Corporation also routinely discounted these conditional sales contracts to Finance Company. On February 1 Finance Company filed a financing statement against D Corporation to perfect its security interest in all returned and repossessed bulldozers.

In May, D Corporation began to experience cash flow problems. In an attempt to meet the demands of its unsecured creditors, D Corporation devised a sham transaction. On June 1 D Corporation purported to sell a bulldozer to D, the president of D Corporation, under a conditional sales contract. D Corporation did not obtain Manufacturer's prior written consent before making this sale. Immediately following the execution of the conditional sales contract, D Corporation sold the contract to Finance Company which gave new value and took possession of the contract. D Corporation used the funds advanced by Finance Company to pay the claims of unsecured creditors. On June 1 Finance Company filed a financing statement against D covering the bulldozer sold to D. D took possession of the bulldozer on June 1, but returned it to D Corporation on June 5. D Corporation continuously listed this bulldozer as unsold inventory.

D made the July 1 installment payment to Finance Company, but thereafter defaulted on its obligations under the assigned conditional sales contract. On September 1 Manufacturer rightfully declared D Corporation in default under the terms of the January 1 security agreement. Also on September 1, Manufacturer repossessed all of D Corporation's inventory of bulldozers, including the bulldozer sold to D.

The issue presented in this illustration is whether Manufacturer can prime Finance Company with respect to the bulldozer sold to and returned by D. If Manufacturer's security interest in the bulldozer arose solely under section 9-306(5)(a), Finance Company would be en-
titled to priority under sections 9-306(5)(b) and (d),\footnote{881} unless D's return of the bulldozer was on consignment and the provisions of section 9-114 controlled.\footnote{882} Manufacturer, however, can make a compelling argument that its security interest arose independently of section 9-306(5)(a). Manufacturer can assert that its original security interest in the goods as inventory of D Corporation was not discharged by the sale to D. First, Manufacturer will assert that the sale to D was unauthorized and therefore its security interest continued in the bulldozer notwithstanding the sale.\footnote{883} Second, Manufacturer will assert that since D must have known that the sale to D was in violation of Manufacturer's security interest, D does not qualify as a buyer in ordinary course.\footnote{884} Accordingly, Manufacturer will assert that D did not take free of Manufacturer's security interest under section 9-307(1).

If Manufacturer establishes that the sale to D did not discharge its security interest, Manufacturer's security interest in the bulldozer in D's possession apparently primes the security interest asserted by Finance Company. As a general rule, a debtor cannot grant a secured party a greater interest in collateral than the debtor owned.\footnote{885} Since D's title to the bulldozer was subject to Manufacturer's security interest, the security interest D granted D Corporation was also subject to Manufacturer's security interest. Therefore, Manufacturer will assert that its security interest in the bulldozer in D's possession was prior to the security interest in the bulldozer asserted by Finance Company because Finance Company is an assignee of D Corporation's subordinate security interest.

Assuming Manufacturer establishes that its security interest in the bulldozer in D's possession was prior to Finance Company's security interest, the issue becomes whether that result should affect the resolution of a priority dispute over the returned bulldozer. This issue turns upon whether section 9-306(5)(b) should be interpreted as awarding a chattel paper transferee priority over an inventory financer asserting a security interest in returned goods when that interest was not dis-

\footnote{881}{See supra notes 744-852 and accompanying text.}
\footnote{882}{See supra notes 853-70 and accompanying text.}
\footnote{884}{See U.C.C. § 1-201(9) (1972); S.C. Code Ann. § 36-1-201(9) (Law. Co-op. 1976 & Supp. 1989).}
charged by the original sale. Although the courts have so interpreted section 9-306(5)(b), the policy behind the provision does not support this result.

As discussed above, the rationale of section 9-306(5)(b) is to preserve the priorities that existed before the goods at issue were returned or repossessed. If the original sale discharged the inventory financer's security interest, the chattel paper transferee would have the only claim to the goods before they were returned or repossessed. In such cases the priority rule of section 9-306(5)(b) preserves the secured position of the chattel paper transferee and precludes the inventory financer from realizing a windfall by virtue of the return or repossession. In contrast, the application of section 9-306(5)(b) to award priority to Finance Company in Illustration 27 would seem to undercut the secured position of Manufacturer and award a windfall to Finance Company by virtue of the return. Therefore, section 9-306(5)(b) should not be applied to award priority to chattel paper transferees if the inventory financer's claim to the returned goods is based on a security interest that was not discharged by the original sale.

Although the analysis of Illustration 27 advanced above is consistent with the language and apparent policy of the applicable provisions, it has not been accepted by the courts. On facts essentially identical to those presented in Illustration 27, the Court in Borg-Warner Acceptance Corp. v. C.I.T. Corp. rejected an inventory financer's argument that it should prevail over the chattel paper transferee because the buyer in the original sale did not take free of the inventory financer's security interest. Moreover, in cases not involving returns or repossessions, the courts have held that the security interest of a chattel paper purchaser in the underlying goods is prior to the security interest of an inventory financer, even though the sale of the inventory was unauthorized and the buyer failed to qualify as a buyer in the ordinary course. In effect, these decisions reject the doctrine

887. See supra text accompanying notes 787-92.
888. See cases cited supra note 886.
890. See, e.g., American State Bank v. Avco Fin. Servs. of the United States, Inc., 71 Cal. App. 3d 774, 139 Cal. Rptr. 658 (opinion omitted from official reporter), nonpublication directed, 570 P.2d 463, 141 Cal. Rptr. 447 (1977); Chrysler Credit Corp. v. Sharp, 56 Misc. 2d 261, 288 N.Y.S.2d 525 (Sup. Ct. 1968); see generally, Skilton, Buyer in Ordinary Course of Business Under Article 9 of the Uniform Commercial Code (And Related Matters), 1974 Wis. L. Rev. 1, 76-88 (status of buyer should not be controlling in
of derivative title. Under these decisions a buyer who acquired goods subject to an inventory financer's security interest can grant a retail financer a security interest in the goods that is not subject to the claim of the inventory financer.

In reaching this conclusion, some courts have stressed that section 9-308(b) provides that a purchaser of chattel paper has priority over the inventory financer's claim to the paper. Section 9-308(b), however, does not expressly provide a comparable rule with respect to the underlying goods. Ultimately these decisions turn on a policy of protecting chattel paper purchasers and efficiently allocating risk. The courts have asserted that chattel paper purchasers must be entitled to rely on the validity of the security interest represented by the paper. Moreover, the courts have maintained that the inventory financer is in a better position than the chattel paper purchaser to guard against the sham transactions which give rise to the problem.

The protection afforded by the courts to chattel paper purchasers when the underlying sale did not discharge an inventory financer's security interest is understandable. The chattel paper purchaser has given new value in reliance on an apparently valid and prior security interest in the underlying goods. Subordinating the inventory financer's security interest in these cases, however, is inconsistent with the protection generally afforded to such financers when the original sale of the collateral does not discharge their security interest. For example, assume that D Corporation in Illustration 27 had made an unauthorized sale of the bulldozer to an affiliated equipment dealer for nominal consideration in a transaction that the affiliated dealer knew violated Manufacturer's security interest. Assume further that the affiliated dealer then resold the bulldozer to a buyer in the ordinary course. Under the "created by his seller" limitation of section 9-307(1), the buyer in the ordinary course would take subject to the priority conflict between inventory financer and chattel paper purchaser).

891. See Borg-Warner Acceptance Corp. v. Massey-Ferguson, Inc., 713 S.W.2d 351, 357 (Tex. Ct. App. 1986) (on rehearing); see also Skilton, supra note 890, at 87 (resolution of conflict should depend on assessing the risks an inventory financer can be said to assume).

892. See, e.g., American State Bank, 139 Cal. Rptr. at 663-66 (opinion omitted from official reporter); Aetna Fin. Co. v. Hendrickson, 526 N.E.2d 1222, 1228 (Ind. Ct. App. 1988); Borg-Warner Acceptance Corp., 713 S.W.2d at 357; see generally Skilton, supra note 890, at 84-85 (discussing potential difficulties of a chattel paper purchaser in discovering a buyer's status).

893. See, e.g., Borg-Warner Acceptance Corp., 713 S.W.2d at 357.

894. U.C.C. § 9-307(1) (1972) (amended 1977); S.C. CODE ANN. § 36-9-307(1) (Law. Co-op. Supp. 1989). This section limits the protection afforded a buyer in the ordinary course to security interests "created by his seller." See generally, B. CLARK, supra note 8, ¶ 3.04[3], at 3-50 to -53 (discussing whether a security interest is created by a seller
Manufacturer's security interest. Thus, the courts have extended more protection to purchasers of chattel paper than to buyers of goods in the ordinary course.

Although the South Carolina courts have not ruled upon the precise question presented in Illustration 27, the decision in Sebrite Corp. v. Transouth Financial Corp. indicates that the court would hold in favor of the chattel paper purchaser. In Sebrite, Transouth held a perfected security interest in the inventory of a partnership engaged in the retail sale of mobile homes. The partnership sold a mobile home to one of its partners. This sale was financed by Sebrite, which perfected a purchase money security interest in the mobile home against the partner. The partnership concealed the sale from Transouth. When the partner defaulted on his obligation to Sebrite, however, a priority dispute arose between Sebrite and Transouth.

The dispute in Sebrite should have been resolved under sections 36-9-306(2) and 36-9-307(1). If the partnership's sale to the partner was authorized by Transouth, its security interest in the mobile home would not have continued following the sale. As a result, Sebrite would have had the only security interest in the mobile home. Moreover, even if the sale were unauthorized the partner would have taken free of Transouth's security interest under section 36-9-307(1) if the partner qualified as a buyer in the ordinary course. Again, the result would be that Sebrite had the only security interest in the mobile home.

The fact that the partnership concealed the sale from Transouth, however, at least suggests that the partnership's sale was unauthorized. If the sale were unauthorized, the partner who bought the mobile home certainly knew that the sale to him violated Transouth's security interest. Therefore, if the sale were unauthorized, the partner did not qualify as a buyer in the ordinary course entitled to protection under section 36-9-307(1). Furthermore, if the partner bought subject to

under various circumstances).

897. Id. at 484-85, 252 S.E.2d at 873-74.
898. See B. Clark, supra note 8, ¶ 3.04[3], at 3-51 n.144.
901. See U.C.C. § 1-201(9) (1972) (amended 1977); S.C. Code Ann. 36-1-201(9) (Law. Co-op. 1976 & Supp. 1989). This section provides that the buyer does not qualify as a buyer in ordinary course if buyer knows that the sale is in violation of the security interest of a third party.
Transouth’s security interest, Sebrite’s security interest also would appear to be subject to Transouth’s claim.\(^{902}\)

The court in Sebrite, however, did not even mention sections 36-9-306(2) and 36-9-307(1) in resolving the case. The court indicated that Sebrite was entitled to priority over Transouth under section 36-9-312(4) because Sebrite had a purchase money security interest in the mobile home.\(^{903}\) The court’s reliance upon section 36-9-312(4) was misplaced. The priority rules of section 36-9-312 assume that the conflicting security interests secure obligations of the same debtor.\(^{904}\) Since Transouth’s security interest secured an obligation of the partnership-seller and Sebrite’s security interest secured an obligation of the partner-buyer, section 36-9-312(4) was not applicable to resolve the conflict.

Ultimately, the decision in Sebrite turned on the court’s perception of proper policy, rather than on an application of the statutory provisions of Article 9. The court doubtlessly was aware of sections 36-9-306(2) and 36-9-307(1). Although inexplicably citing as authority section 36-9-109(4), the definition of inventory, the court asserted that “[a] buyer, in the ordinary course of the dealer’s business, is given priority over the dealer’s inventory financier.”\(^{905}\) The court probably did not pursue an analysis under sections 36-9-306(2) and 36-9-307(1) because these provisions would have dictated a decision in favor of Transouth. In the eyes of the court, such a decision appeared indefensible.

The court disclosed the reason for its decision in favor of Sebrite when it stated that “[t]o hold that an innocent purchaser for value, or an innocent retail lender for valuable consideration, must investigate the right of the dealer to sell and give good title, would stagnate retail sales so necessary to commerce.”\(^{906}\) Thus, the decision in Sebrite is consistent with those decisions that award a chattel paper purchaser priority over an inventory financier in the underlying goods, even though the inventory financier’s security interest in the goods was not discharged by the sale.\(^{907}\) Therefore, Sebrite leaves little doubt that a South Carolina court would award priority to Finance Company in Illustration 27.

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902. See B. Clark, supra note 8, ¶ 3.08[4], at 3-91 to -92; Harris, supra note 885, § 22A.04[4][b].


904. See Harris, supra note 885, § 22A.04[4][b].

905. Sebrite, 272 S.C. at 487, 252 S.E.2d at 875.

906. Id.

2. Accounts as Proceeds

a. Inventory Financer Versus Financer Holding a Floating Lien on Accounts

No issue produced greater debate under the 1962 Official Text than priority conflict between an inventory financer claiming accounts as proceeds and a secured party claiming the accounts as original collateral. As an illustration of this issue, consider the following:

ILLUSTRATION 28—Dealer is in the business of selling building materials on unsecured credit terms. On June 1 Bank and Dealer entered into a written security agreement that granted Bank a security interest in Dealer’s current and after-acquired accounts to secure a contemporaneous loan and any future advances. Also on June 1, Bank filed a financing statement in the Secretary of State’s office covering Dealer’s accounts. On July 1 Finance Company and Dealer entered into a written security agreement that granted Finance Company a security interest in Dealer’s current and after-acquired inventory and proceeds to secure a contemporaneous loan and any future advances. Also on July 1, Finance Company filed a financing statement in the Secretary of State’s office covering Dealer’s inventory. On August 1 Dealer sold some inventory on unsecured credit to a buyer in the ordinary course, thereby generating an account. On September 1 Dealer defaulted under the security agreements with both Bank and Finance Company. Both secured parties assert a security interest in the August 1 account.

Bank in this illustration claims a security interest in the account as original collateral under the after-acquired property clause in its June 1 security agreement. Finance Company asserts a security interest in the account as proceeds of its inventory collateral. The issue presented is whether Bank’s claim to the August 1 account as original collateral is entitled to priority over Finance Company’s claim to the account as proceeds.

The priority conflict depicted in Illustration 28 is significant because its resolution largely defines the respective roles of inventory and accounts financing. From the perspective of an inventory financer, a prior position with respect to a debtor’s inventory provides less than complete security if that priority does not extend to the proceeds. In contrast, financing secured by a floating lien on accounts becomes

908. See, e.g., Coogan & Gordon, supra note 537, at 1556-68; Henson, supra note 537, at 239-42; Kriple, supra note 536, at 709-27; Weiss, supra note 531, at 785.

problematic unless a secured party who files first with respect to the debtor's accounts is assured of priority with respect to after-acquired accounts. Therefore, if the Code were to award priority to Bank in Illustration 28, the security of inventory financers would be undercut. On the other hand, if Finance Company were awarded priority in the account as proceeds, the viability of accounts financing would be impaired.910

Given the significance of the issue raised in Illustration 28, it is surprising that the 1962 Official Text did not provide a clear resolution.911 The drafters of the 1962 Official Text apparently assumed that Bank would prevail over Finance Company under former section 9-312(5)(a),912 but that result was not dictated by the statute. A literal application of the 1962 Official Text produces a "Solomon-like" result.913 Bank's security interest in the account was perfected by its June 1 filing. Under former section 9-306(3),914 Finance Company's security interest in the account was originally perfected automatically.915

910. If the Code provided that an inventory financer's priority in inventory extended to proceeds in the form of accounts, an accounts financer could obtain priority with respect to after-acquired accounts by retaining a security interest and filing first with respect to both the debtor's inventory and accounts. See Kripke, supra note 536, at 714; Weiss, supra note 531, at 795. The ability of an accounts financer to respond to a priority rule that extended priority in inventory to accounts in the form of proceeds is significant for two reasons. First, it illustrates that if the Code's priority rules are clear, the parties can structure a transaction to achieve an intended result. Second, to avoid the effect of a rule that extended the priority in inventory to accounts as proceeds, a financer lending against accounts would have to obtain a prior security interest in inventory in order to obtain priority in after-acquired accounts. Forcing an accounts financer to encumber inventory in order to obtain priority with respect to after-acquired accounts, however, may be an unattractive alternative because it may preclude the debtor from buying inventory on unsecured credit terms. See Kripke, supra note 536, at 714; Weiss, supra note 531, at 795. Moreover, the accounts financer's response suggests that dual financing of accounts and inventory may be unrealistic under a rule that extends priority in inventory to proceeds in the form of accounts. See infra text accompanying note 999.

911. See Kripke, supra note 536, at 709-10 ("Without doubt the single area of uncertainty in the present article 9 [1962 Official Text] affecting the largest volume of operations is the question of priority between a claim to accounts as the proceeds of inventory and a claim to accounts as original collateral.").

912. Id. at 710.

913. See Kripke, supra note 536, at 710 (arguing that, in such a situation, the conflicting claims would have parity); Weiss, supra note 529, at 786-90 (simultaneous perfection possible under former section 9-312(5), with the result that neither party has priority).


Technically, the effect of Finance Company’s July 1 filing, which covered proceeds, was to extend Finance Company’s perfection in the account beyond the ten-day period of automatic perfection.\(^916\) Therefore, Bank’s security interest was originally perfected by filing, and Finance Company’s security in the account was originally perfected automatically. Former section 9-312(6)\(^917\) provided that for purposes of the residual priority rules of former section 9-312(5),\(^918\) the manner of original perfection controlled. Therefore, the dispute at issue is subject to the “first to perfect” rule of former section 9-312(5)(b),\(^919\) rather than the “first to file” rule of former section 9-312(5)(a).\(^920\)

The application of former section 9-312(5)(b) to Illustration 28 requires one to determine the dates on which Bank and Finance Company perfected their respective security interests in the August 1 account.\(^921\) Under former and current section 9-303(1), a security interest is perfected when it has attached and all steps necessary for protection have been taken.\(^922\) Former section 9-204(1) provides that a security interest cannot attach until there is an agreement that it attach, the secured party has given value, and the debtor has rights in the collateral.\(^923\) Bank took the steps necessary to perfect its security interest when it filed on June 1. Bank also had a security agreement and gave value on June 1. Moreover, Finance Company did not take the steps to perfect until it filed on July 1 and it did not have a security interest or give value until July 1.

The critical issue, however, is when did Dealer have rights in the August 1 account? Former section 9-204(2)(d) provided that a debtor had no rights in an account until it came into existence.\(^924\) Therefore, the security interests of Bank and Finance Company arguably attached simultaneously when the account arose on August 1, and hence were

\(^{916}\) See Weiss, supra note 531, at 789.


\(^{921}\) See generally supra text accompanying notes 35-39 (analysis of time of perfection and former section 9-312(5)(b)).


perfected simultaneously on August 1. As a result, under former section 9-312(5)(b), the security interests of Bank and Finance Company would have been of equal rank and the parties would have divided the August 1 account on a pro rata basis.925

The pro rata distribution of the August 1 account, however, was not the only resolution possible under the 1962 Official Text. Some commentators argued that an inventory financer such as Finance Company should not be allowed to assert that its security interest in the account was originally perfected automatically.926 These commentators argued that the issue should be resolved under the first to file rule of former section 9-312(5)(a).927 Under this analysis, Bank would prevail because of its earlier filing. In contrast, other commentators argued that since Finance Company had a prior claim to the inventory, its priority should extend to the proceeds of the inventory under the provisions of former sections 9-312(1) and 9-306(1) through (3).928 As a result, at least three resolutions of Illustration 28 were possible under the 1962 Official Text: granting Bank priority; granting Finance Company priority; and granting Bank and Finance Company claims of equal priority. Obviously, this degree of uncertainty was unacceptable.928

The uncertainty under the 1962 Official Text was compounded when a subsequent inventory financer claimed a purchase money security interest.930 To illustrate this problem, vary the facts of Illustration 28 by assuming that Finance Company had a purchase money security interest in the inventory sold on August 1. Assume that Finance Company also met any applicable requirements for a purchase money priority under former section 9-312(3). The purchase money priority status of inventory financer's security interest in inventory does not appear to enhance its rights against an earlier-filed accounts financer.931 Some commentators asserted, however, that purchase money priority status further justified extending the inventory financer's priority to proceeds in the form of accounts.932 In any event, the purchase

925. See Kripke, supra note 536, at 710; Weiss, supra note 531, at 788-89.
926. See Goodwin, supra note 915, at 890-92; Kripke, supra note 536, at 711.
927. See Goodwin, supra note 915, at 891; Kripke, supra note 536, at 711.
928. See Henson, Priorities Under the Uniform Commercial Code, 41 Notre Dame Law. 425, 432 (1966); Henson, Countsuggestions Regarding Article 9: A Reply to Professor Kripke, 42 N.Y.U. L. Rev. 74, 75-77 (1967).
929. See Kripke, supra note 536, at 709, 715; Weiss, supra note 531, at 786.
930. See generally supra text accompanying notes 114-291 (analysis of purchase money priority in inventory).
931. See Kripke, supra note 536, at 718.
932. See Henson, supra note 537, at 240; see generally 2 G. Gilmore, supra note 56, § 29.4, at 791-97 (discussing whether a purchase money interest in inventory carries over to proceeds).
money problem further muddied the waters under the 1962 Official Text.

Resolution of the conflicts depicted in Illustration 28 and its purchase money variation constituted one of the most controversial tasks the drafters undertook in formulating the 1972 Official Text.\textsuperscript{933} In adopting rules to resolve these conflicts, the drafters had to make a critical decision on the relative significance of accounts and inventory financing. A rule that extends an inventory financer's priority in inventory to proceeds in the accounts would make accounts financing highly problematic. Under such a rule an accounts financer such as Bank in Illustration 28, who filed first with respect to a debtor's accounts and before an inventory financer filed, would not be assured of priority with respect to after-acquired accounts. A subsequent inventory financer such as Finance Company could encumber the debtor's inventory and prime the accounts financer with respect to the accounts generated by the sale of that inventory.

In contrast, a rule that awarded priority to an accounts financer such as Bank would have a pronounced negative impact on inventory financing. An inventory financer accepts the fact that the debtor will sell the inventory and thereby terminate the security interest in the original collateral.\textsuperscript{934} Following the sale of the original collateral, the inventory financer can look only to proceeds and after-acquired inventory as security. Therefore, a rule that grants an earlier-filed accounts financer priority in proceeds in the form of accounts significantly undercut the security available to the inventory financer.

The drafters of the 1972 Official Text addressed the issue raised in Illustration 28 and determined that an earlier-filed financer with a floating lien on a debtor's accounts should prime a subsequent inventory financer claiming accounts as proceeds.\textsuperscript{935} The decision to protect an earlier-filed accounts financer apparently rested primarily on two related arguments, both of which stressed the significance of trade credit. First, the drafters apparently concluded that financing secured by a dealer's accounts was more important than financing secured by a floating lien on inventory.\textsuperscript{936} The argument supporting the primacy of

\textsuperscript{933} See Final Report, supra note 2, app., para. E-38, at 224-25.


\textsuperscript{935} See Final Report, supra note 2, app., para. E-38, at 225.

\textsuperscript{936} See id.; see also 2 G. Gilmore, supra note 56, §29.4, at 797 (giving priority to receivables financer is justified as long as new value is given); Coogan & Gordon, supra note 537, at 1567(serving interests of accounts financers provides greater advantage to the business community); Kripke, supra note 536, at 716-19 (protecting first-filed ac-
accounts financing rests on the observation that dealers typically purchased their inventories from suppliers on unsecured trade credit.\textsuperscript{927}

The proponents of this argument stressed that suppliers would be unwilling to extend trade credit to dealers who had encumbered their inventories with floating liens.\textsuperscript{938} As a result, commentators asserted, debtors were reluctant to grant floating liens on their inventories.\textsuperscript{939} These commentators thus contended that financing secured by a floating lien on inventory had evolved as a secondary form of financing used only when a debtor's accounts were inadequate to secure all the financing sought by the debtor.\textsuperscript{940} Because a rule that granted a subsequent inventory financer priority in accounts as proceeds would undercut the more important financing secured by a floating lien on accounts, this rule was rejected.

The second argument in favor of awarding priority to an earlier-filed accounts financer was that a rule which granted priority to a subsequent inventory financer, with respect to proceeds in the form of accounts, would impair the availability of trade credit.\textsuperscript{941} Commentators asserted that in order to avoid the effect of such a rule, accounts financers would insist upon security interests in both a debtor's accounts and inventory and would file first with respect to both forms of collateral.\textsuperscript{942} Thus, to obtain accounts financing a debtor would have to grant a floating lien on the debtor's inventory that, in turn, would discourage suppliers from selling to the debtor on trade credit. Therefore, a rule that awarded priority to an earlier-filed accounts financer was necessary to preserve the availability of trade credit.\textsuperscript{943}

Additionally, a rule that awards priority to an earlier-filed accounts financer does not necessarily work to the disadvantage of a subsequent financer claiming a floating lien on a debtor's inventory. If the accounts financer is assured of priority with respect to all after-acquired accounts, the accounts financer can make advances to the debtor in reliance upon the accounts. In the normal course of events the debtor will use these advances to purchase additional inventory that will secure the inventory financer's loan or to pay down the loan

\textsuperscript{927} See Weiss, supra note 531, at 795.
\textsuperscript{938} Id.
\textsuperscript{939} Id.
\textsuperscript{940} See 2 G. Gilmore, supra note 56, § 29.4, at 797; Kripke, supra note 536, at 716-17; Weiss, supra note 531, at 794.
\textsuperscript{941} See Weiss, supra note 531, at 795.
\textsuperscript{942} Id.
\textsuperscript{943} Id.
balance. Moreover, the inventory financer can include provisions in its security agreement under which the debtor will be in default if the collateral does not exceed the debt by a defined ratio. Therefore, the inventory financer can limit its exposure by not making advances against accounts or by requiring that advances made be used to purchase additional collateral or to reduce the debt.

The drafters of the 1972 Official Text also considered the more controversial issue of whether a subsequent purchase money inventory financer should take priority over an earlier-filed accounts financer. In essence, they addressed whether to provide a purchase money exception to the rule awarding priority to an earlier-filed accounts financer who claimed a security interest in accounts also claimed as proceeds by a subsequent inventory financer. Arguably, a purchase money inventory financer has a stronger claim to the accounts than a financer claiming a floating lien on a debtor's inventory, since a purchase money financer gives new value in exchange for a security interest in the collateral sold to generate the account. Moreover, a purchase money inventory financer typically does not claim a security interest in a debtor's after-acquired property. Therefore, after the sale of the collateral, a purchase money financer can look only to proceeds for security.

A purchase money inventory financer also can argue that its claim to accounts as proceeds is stronger than claims by earlier-filed accounts financers who claim the account pursuant to an after-acquired property clause. The primary basis for this argument is that the purchase money financer gave new value in exchange for a security interest in the collateral that generated the account.

The response to the argument for awarding unconditional priority to a subsequent purchase money inventory financer was that the earlier-filed accounts financer might rely on the account generated by the sale of the purchase money collateral by making an advance under a future advance clause. To accommodate these conflicting arguments,

945. See Final Report, supra note 2, app., para. E-38, at 225; see generally Gilmore, supra note 115, at 1383-85 (discussing purchase money priority in proceeds).
947. See 2 G. Gilmore, supra note 56, § 29.4, at 797 ("The inventory financer's purchase-money interest by definition reflects a new value advance: he should not be subordinated to the competing interests of a secured party who, taking advantage of the Code's floating lien provision, claims all the debtor's receivables under an all-embracing after-acquired property clause.").
948. See id. (accounts financer who extends new value in reliance on after-acquired accounts can make a persuasive case that the accounts financer should be entitled to
commentators proposed a limited purchase money exception to the general rule that awarded priority to the earlier-filed accounts fi-
nancer.949 Under this proposal, inspired by former section 9-312(3),950 a subsequent purchase money inventory financer could prime an earlier-
filed accounts financer if the inventory financer gave the accounts fi-
nancer prior notice of its purchase money security interest.951 The
thought was that the notice would preclude prejudice to the accounts
financer by warning the accounts financer not to rely upon the ac-
counts generated by the sale of the purchase money collateral.952

The drafters of the 1972 Official Text considered, but ultimately
rejected, a proposal under which a purchase money inventory financer
would prime an earlier-filed accounts financer with respect to proceeds
in the form of accounts if the inventory financer gave the accounts fi-
nancer prior notice.953 The drafters noted two reasons for their deci-
sion. First, they asserted that it would be difficult to trace the purchase
money priority into accounts as proceeds when only a portion of the
debtor's inventory was subject to the purchase money security inter-
est.954 The difficulty in tracing would create a problem for accounts
financers because they would be unable to determine whether they
could rely on the debtor's after-acquired accounts in making future
advances.

The second reason given for the rejection of the purchase money
exception was that "[a]ccounts financing is intricate, and not easily or
safely terminated on receipt of an inventory purchase-money no-
tice."955 Apparently the drafters concluded that accounts financers fre-
quently furnished a debtor's working capital.956 Therefore, if an ac-
counts financer responded to a purchase money notice by terminating
the relationship and refusing to make additional advances, the ac-
counts financer might cause the financial collapse of the debtor. In this

949. See Coogan & Gordon, supra note 537, at 1568; Gilmore, supra note 115, at
1384-85.
Co-op. 1976) (amended 1988) (conditioning a purchase money inventory financer's prior-
ity with respect to inventory upon giving prior notice to an earlier-filed inventory
financer).
951. See Gilmore, supra note 115, at 1384-85.
952. See id. at 1385. But see Kripke, supra note 536, at 717-18 (arguing that notice
provision not adequate to protect accounts financer); Weiss, supra note 531, at 796 (noti-
fication not a solution to problem).
953. See FINAL REPORT, supra note 2, app., para. E-38, at 225.
954. Id.; see also Kripke, supra note 536, at 718 (arguing that notice is a less than
adequate remedy).
955. FINAL REPORT, supra note 2, app., para. E-38, at 225.
956. See Weiss, supra note 531, at 796.
case, the debtor's prenotification accounts upon which the accounts fin-
nancer had a prior claim might well become uncollectible.\textsuperscript{957} Therefore, business realities might preclude the accounts financer from terminating the financing arrangement upon receipt of the purchase money notice.\textsuperscript{958}

Having concluded that an accounts financer who files first should be awarded priority over a subsequent inventory financer claiming accounts as proceeds, the drafters of the 1972 Official Text adopted provisions to effect this result. The critical provision for resolving priority disputes of the type depicted in Illustration 28 is revised section 9-312(6).\textsuperscript{959} This subsection provides that for purposes of determining priority under the first to file or perfect rule of revised section 9-312(5)(a),\textsuperscript{960} a secured party's date of filing or perfection with respect to the collateral is also that party's date of filing or perfection with respect to proceeds. As applied to Illustration 28, section 9-312(6) operates to award priority to Bank, the accounts financer. Bank filed with respect to accounts on June 1. Finance Company filed with respect to inventory on July 1. Under revised section 9-312(6) Finance Company's July 1 filing also constitutes its date of filing with respect to proceeds. Therefore, Bank primes Finance Company with respect to the August 1 account because of Bank's earlier filing.

Revised sections 9-312(5)(a) and (6) also award priority to an earlier-filed accounts financer when the subsequent inventory financer relies on section 9-312(3)\textsuperscript{961} to assert a purchase money priority. To illustrate this point, return to the variation of Illustration 28 in which Finance Company claimed a purchase money security interest in the inventory, which generated the August 1 account and complied with all applicable requirements for a purchase money priority under revised section 9-312(3).\textsuperscript{962} Arguably, section 9-312(3) applies only to conflicts in which both secured parties claim a security interest in inventory and thus the provision is inapplicable to the variation of Illustration 28.

Moreover, even if revised section 9-312(3) is technically applicable

\textsuperscript{957} Id.
\textsuperscript{958} Id.
\textsuperscript{962} See supra notes 126-29 and accompanying text.
to a conflict between an earlier-filed accounts financer and a subsequent purchase money inventory financer claiming accounts as proceeds, the provision affords no protection to Finance Company. Revised section 9-312(3) limits the proceeds upon which an inventory financer can assert a purchase money priority to "identifiable cash proceeds received on or before the delivery of the inventory to a buyer." Therefore, the purchase money priority under revised section 9-312(3) does not extend to proceeds in the form of accounts. Since revised section 9-312(3) is inapplicable, priority is determined under revised sections 9-312(5)(a) and (6), which award priority to Bank because of its earlier filing.

In summary, the 1972 Official Text dispells the uncertainty concerning the priority between an earlier-filed accounts financer and a subsequent inventory financer claiming accounts as proceeds. Under the revised statute the accounts financer will prevail. This rule holds true even if the subsequent inventory financer has met the requirements for the purchase money priority under revised section 9-312(3). In large part, the rules promulgated by the 1972 Official Text were premised upon the assumption that accounts financing is more significant than inventory financing and that secured parties took security interests in inventory only as secondary collateral. Under the revised statute, inventory is clearly a secondary form of collateral when the debtor sells on unsecured credit and has granted a prior security interest in accounts. In such cases, an inventory financer can look for security only to inventory in the debtor's possession and to cash proceeds that are not collections on accounts. Significantly, the inventory financer's security vanishes upon the sale of an item of inventory. Under section 9-307(1) the sale terminates the inventory financer's security interest in the goods sold. Moreover, revised sections 9-312(3), 9-312(5)(a) and 9-312(6) subordinate the inventory financer's security interest in accounts as proceeds to the claim of the earlier-filed accounts financer.

From the analysis above, one might conclude that the primary objective of the drafters of the 1972 Official Text was to favor accounts financers over inventory financers because of the greater commercial significance of accounts financing. Certainly revised sections 9-312(3), 9-312(5)(a), and 9-312(6) foster accounts financing by protecting an earlier-filed accounts financer from the claim of a subsequent inventory financer claiming a security interest in accounts as proceeds.

965. See supra text accompanying notes 959-64.
provisions, however, do not invariably protect an accounts financer. For example, if an inventory financer files first, its security interest in accounts as proceeds will prime the security interest of a subsequent accounts financer.\textsuperscript{966} Moreover, these provisions resolve disputes between inventory financers when they both claim accounts as proceeds.\textsuperscript{967} Interestingly, in the case of a subsequent purchase money financer, the provisions do not extend the priorities in the inventory to the proceeds.\textsuperscript{968}

\subsection*{b. Inventory Financer Versus Subsequent Purchaser of Accounts}

The next two subsections consider two additional illustrations involving priority conflicts over accounts as proceeds of inventory. An analysis of these illustrations will complete the assessment of the relationship between inventory financing and accounts financing under revised Article 9.

\textbf{ILLUSTRATION 29}—On June 1 Bank entered into a written security agreement with Dealer that granted Bank a security interest in Dealer's current and after-acquired inventory to secure a contemporaneous loan and any future advances. Also on June 1, Bank properly filed a financing statement covering Dealer's inventory. During the month of June, Dealer sold items of inventory on unsecured credit. On July 1 Dealer entered into a written agreement under which Dealer sold the accounts the Dealer's resulting from June sales of inventory to Finance Company. Finance Company gave new value in exchange for the June accounts. Also on July 1, Finance Company filed a financing statement in the Secretary of State's office covering the assigned accounts. On August 1 Bank rightfully declared Dealer in default and sought to enforce its security interest against the accounts sold to Finance Company.

The issue presented is whether Bank has priority over Finance Company with respect to the June accounts. Bank has a security interest in the June accounts as proceeds of its inventory collateral.\textsuperscript{969} Assuming that Dealer does business only in South Carolina or that its chief executive office is located in the state, Bank's June 1 filing in the Secretary of State's office was effective to continue perfection in the

\begin{itemize}
\item \textsuperscript{966} See infra text accompanying notes 969-73.
\item \textsuperscript{968} See infra text accompanying notes 967-96.
\item \textsuperscript{969} See U.C.C. § 9-306(1) to (2) (1972) (amended 1977); S.C. CODE ANN. § 36-9-306(1) to (2) (Law. Co-op. Supp. 1989); see generally supra notes 444-49 and accompanying text (analysis of attachment of security interest in proceeds).
\end{itemize}
accounts as proceeds.\textsuperscript{970} Moreover, pursuant to revised section 9-312(6), Bank's June 1 filing fixes its date of filing or perfection for purposes of determining priority in the accounts under revised section 9-312(5)(a).\textsuperscript{971} Although Dealer sold the June accounts to Finance Company, the transaction is within the scope of Article 9\textsuperscript{972} and Finance Company's claim to the accounts is limited to a security interest.\textsuperscript{973} Therefore, Finance Company's date of filing or perfection with respect to the accounts is July 1. As a result, under section 9-312(5)(a), Bank primes Finance Company with respect to the June accounts.

The lesson to be drawn from Illustration 29 is clear. If a secured party has filed with respect to a debtor's inventory, a subsequent financer should not lend against accounts generated by the sale of inventory absent a subordination agreement. The issue raised by Illustration 29 is whether the application of revised sections 9-312(5)(a) and (6) to resolve the conflict in favor of Bank is a sound policy decision.

The policies reflected in the resolution of Illustration 29 can be assessed with reference to revised section 9-308(b),\textsuperscript{976} which sets forth a special priority rule applicable when chattel paper is claimed as proceeds of inventory.\textsuperscript{976} Under revised section 9-308(b), a purchaser of chattel paper who gives new value and takes possession of the paper in the ordinary course of his business primes an earlier-filed inventory financer who claims a security interest in the chattel paper merely as proceeds, even if the chattel paper purchaser has knowledge of the inventory financer's security interest.\textsuperscript{976} Revised section 9-308(b) evidences a policy of preferring a new value financer to a financer claiming a conflicting interest as proceeds. This policy suggests that in Illustration 29 Finance Company should prevail over Bank, since Finance Company gave new value in exchange for the accounts which Bank claimed merely as proceeds.\textsuperscript{977} The drafters of the 1972 Official Code will likely be the subject of a later article on this topic.


\textsuperscript{975} See supra note 697.

\textsuperscript{976} See supra text accompanying notes 710-14.

\textsuperscript{977} Comments 2 and 3 to section 9-308 indicate that an inventory financer's security interest is claimed merely as proceeds unless in a new transaction it has given value against the chattel paper. See Weiss, supra note 531, at 805-06 (interpreting U.C.C. sec-
Text, however, did not provide a special priority rule comparable to revised section 9-308(b) applicable to purchasers of accounts. The absence of such a provision requires an explanation, especially in light of drafter's apparent goal of protecting accounts financing.

Prior to the promulgation of the 1972 Official Text, commentators considered\(^{978}\) and even advocated\(^{979}\) a new value priority provision for accounts financers comparable to revised section 9-308(b). The principal reason such a rule was not adopted appears to have been that accounts "were more intimately interrelated with and less able to be separated from inventory financing"\(^{980}\) than chattel paper.\(^{981}\) Revised section 9-308(b) and its 1962 Official Text predecessor reflect an established pattern of independent financing of inventory and chattel paper.\(^{982}\) Lenders who finance the inventory of a debtor who sells under conditional sales contracts frequently are willing to subordinate their interest in chattel paper as proceeds to the claim of a purchaser of the chattel paper.\(^{983}\)

The inventory financer benefits from this practice because the debtor can use the funds received upon the sale of the chattel paper to pay the inventory financer or purchase additional items of inventory which will constitute collateral. The drafters apparently found that no comparable pattern of separate financing of inventory and accounts had evolved.\(^{984}\) Rather, a floating lien inventory financer of a debtor who sells on unsecured credit was viewed as lending against an aggregate of current and after-acquired inventory and accounts.\(^{985}\) In essence, the collateral of the inventory financer included accounts as well as inventory. Therefore, a floating lien inventory financer who filed first merits protection against a subsequent accounts financer, even when the accounts financer gave new value.

The failure to adopt a rule comparable to revised section 9-308(b), which would allow a subsequent accounts financer who gave new value to prime an earlier-filed inventory financer who claimed the accounts as proceeds, provides insight into the relationship between inventory financing and accounts financing under the 1972 Official Text. Although revised sections 9-312(3), 9-312(5)(a), and 9-312(6) assure an

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978. See Coogan & Gordon, supra note 537, at 1567; Kripke, supra note 536, at 714-16; Weiss, supra note 531, at 797-800, 805-08.
979. See 2 G. Gilmore, supra note 56, § 29.4, at 797.
980. Kripke, supra note 536, at 715.
981. See Kripke, supra note 536, at 714-15; Weiss, supra note 531, at 798.
982. See Kripke, supra note 536, at 715-16; Weiss, supra note 531, at 798.
983. See Kripke, supra note 536, at 716-16.
984. Id. at 716.
985. Id.
earlier-filed accounts financer priority over a subsequently filed inventory financer claiming accounts as proceeds,86 the provisions cannot be read as reflecting a policy of favoring financers who claim accounts as original collateral over those who claim the accounts as proceeds of inventory.

Rather, the uniform application of the first to file or perfect rule to resolve all disputes between accounts financers and inventory financers claiming accounts as proceeds establishes that the 1972 Official Text views accounts financing and inventory financing as essentially alternative forms of financing. Although an accounts financer who files first does not have a security interest in a debtor's inventory, the accounts financer will prime a subsequent inventory financer who claims accounts as proceeds. Therefore, if a secured party has filed against a debtor's accounts, a subsequent-secured party should not lend against the debtor's inventory if priority with respect to proceeds in the form of accounts is a significant factor in making a credit decision.

More significantly, under the 1972 Official Text a secured party who files first with respect to a debtor's current and after-acquired inventory is, in effect, both an inventory financer and an accounts financer. Under revised sections 9-312(5)(a) and (6), the security interest of the inventory financer in accounts as proceeds will prime the security interest of a subsequent accounts financer in the accounts as original collateral. Therefore, if a secured party has filed against a debtor's inventory, a subsequent financer should not lend against the debtor's accounts absent a subordination agreement. Moreover, because the first-filed inventory financer is entitled to priority with respect to accounts as proceeds, it can make future advances against those accounts.

c. Nonpurchase Money Inventory Financer Versus Purchase Money Inventory Financer

The conclusion that the 1972 Official Text views a secured party with a floating lien on a debtor's inventory as both an inventory financer and an accounts financer is further supported by the proceeds limitations imposed on a purchase money priority under revised section 9-312(3). To this point, conflicts between an inventory financer claiming accounts as proceeds and an accounts financer claiming the accounts as original collateral have been considered. Priority disputes also can arise between two inventory financers who claim the accounts as proceeds. Under the 1972 Official Text, revised sections 9-312(5)(a) and (6) control these disputes and award priority to the first secured

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86. See supra notes 959-64 and accompanying text.
party to file covering the debtor’s inventory.\textsuperscript{987} The application of the residual priority rule to resolve these conflicts is unremarkable when both inventory financers assert a nonpurchase money security interest in the collateral. When, however, the first-filed financer claims a floating lien on the debtor’s current and after-acquired inventory and the subsequent financer establishes a purchase money priority in the inventory sold, the legislative decision to determine priorities in the resulting account under the residual rules requires an explanation. The only rational explanation for this decision is that a first-filed inventory financer claiming a floating lien upon a debtor’s inventory should be treated as a first-filed accounts financer. To illustrate this problem, consider the following:

\textbf{ILLUSTRATION 30—}\textit{On June 1 Bank and Dealer entered into a written security agreement that granted Bank a security interest in Dealer's current and after-acquired inventory of building supplies to secure a contemporaneous loan and any future advances. Also on June 1, Bank filed a financing statement covering Dealer's inventory of building supplies. On July 1 Lumber Company and Dealer entered into a written contract under which Lumber Company agreed to sell lumber to Dealer on credit. The contract granted Lumber Company a security interest in the lumber sold to secure Dealer's obligation to pay the purchase price. Also on July 1, Lumber Company filed a financing statement covering the lumber subject to the contract. On July 2 Lumber Company gave Bank written notice of its purchase money security interest in the lumber. Bank received the notice on July 5. On July 10 Lumber Company delivered the lumber to Dealer. On August 1 Dealer sold the lumber to Contractor on unsecured credit with payment due in thirty days. On September 1 Dealer defaulted on the obligations to both Bank and Lumber Company and these creditors claimed the August 1 account as proceeds.}

Both Bank and Lumber Company have a perfected security interest in the August 1 account as proceeds.\textsuperscript{988} Moreover, if revised sections 9-312(5)(a) and (6) control the resolution of this priority conflict, Bank will prevail because of its earlier filing with respect to Dealer’s inventory. The question presented is whether Lumber Company can claim priority under the special priority rule applicable to purchase money inventory financers.

Although Bank was the first party to file with respect to Dealer’s inventory, Lumber Company had priority in the lumber on July 10

\footnotesize{987. See \textit{supra} notes 959-60 and accompanying text.}

\footnotesize{988. See U.C.C. § 9-306(1) to (3) (1972) (amended 1977); S.C. CODE ANN. § 36-9-306(1) to (3) (Law. Co-op. Supp. 1989); see \textit{generally supra} text accompanying notes 444-63 (analysis of attachment and perfection of security interests in proceeds).}
under revised section 9-312(3). Lumber Company had a purchase money security interest in the lumber and met the perfection and notice requirements for a purchase money priority in inventory. Therefore, the issue becomes whether the purchase money priority in inventory extends to proceeds in the form of accounts. The 1962 Official Text did not provide a clear answer to this question. The 1972 Official Text addresses this question in revised section 9-312(3) and awards priority to Bank. Section 9-312(3) provides that purchase money priority extends to proceeds only if the proceeds are "identifiable cash proceeds received on or before the delivery of the inventory to a buyer." Because the purchase money priority does not extend to proceeds in the form of accounts, the conflict between Lumber Company and Bank over the August 1 account must be resolved under the residual priority rules. As noted, under these rules Bank is entitled to priority.

The failure to extend the purchase money priority to accounts as proceeds of inventory in the context depicted in Illustration 30 initially appears illogical. The sale to Contractor as a buyer in the ordinary course terminated Lumber Company's security interest in the lumber. Moreover, Lumber Company did not claim a security interest in

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992. See Gilmore, supra note 115, at 1383-85. Gilmore recognized that former section 9-312(3) could be interpreted as applying only to inventory, not to proceeds. Under this interpretation an earlier-filed secured party with a floating lien on a debtor's inventory could prime a subsequent purchase money financer of inventory with respect to proceeds based on the residual first to file rule of former section 9-312(5)(a). Gilmore, however, asserted that such a result "seems to be completely wrong and should be avoided if humanly possible." Id. at 1383. The case law under the 1962 Official Text provides some support for Gilmore's interpretation. See Appliance Buyers Credit Corp. v. Perrotto Refrigeration, Inc. (In re Perrotto Refrigeration, Inc.), 38 Bankr. 284 (Bankr. E.D. Pa. 1984). It should be noted that if the residual rules of former section 9-312(5) applied to resolve the conflict over proceeds, a case can be made that both parties' security interests in the proceeds were originally perfected automatically under former section 9-306(3). Therefore, pursuant to former section 9-312(6), the first to perfect rule of former section 9-312(5)(b) would control. Under this interpretation the secured parties would have co-equal liens and share pro rata. See supra text accompanying notes 913-25.
994. See Gilmore, supra note 115, at 1383-85.
after-acquired property.\textsuperscript{996} Therefore, following the sale of the lumber to Contractor, Lumber Company's security was limited to its security interest in the account as proceeds.

By granting Bank priority in the account, the 1972 Official Text strips Lumber Company of even this security and renders purchase money inventory financing less attractive.\textsuperscript{997} The drafters' rationale for not extending purchase money priority to accounts as proceeds of inventory was that an earlier-filed secured party should be able to rely on the accounts in making future advances.\textsuperscript{998} This rationale is reasonable if the prior secured party is an accounts financer, since an accounts financer typically makes future advances in reliance on after-acquired accounts. When the prior secured party is an inventory financer, however, the rationale is valid only if inventory financers lend against accounts.

Ultimately the drafters' decision to subordinate a purchase money inventory financer's security interest in accounts as proceeds to the claim of an earlier-filed secured party with a floating lien on a debtor's inventory must rest on the conclusion that inventory and accounts are inseparable collateral.\textsuperscript{999} In essence, the 1972 Official Text views an inventory financer such as Bank as lending against a combined mass of inventory and accounts, rather than against inventory alone. If dual financing of accounts and inventory was uncommon when the 1972 Official Text was adopted, the drafters' decision to treat a secured party with a floating lien on inventory as an accounts financer was reasonable. Moreover, if the holder of the floating lien is in essence an accounts financer, the purchase money notice that establishes a priority in the inventory is at least arguably insufficient to justify a priority in the resulting accounts.\textsuperscript{1000}

Whether the assumptions as to inventory and accounts financing were valid when the 1972 Official Text was adopted is no longer a critical issue. The priority rules of revised sections 9-312(3), 9-312(5)(a) and 9-312(6) now discourage dual financing of inventory and accounts absent a subordination agreement. A secured party with a floating lien on a debtor's inventory who files with respect to the inventory before a conflicting secured party files as to the debtor's inventory or accounts,

\textsuperscript{996} See generally Southtrust Bank v. Borg-Warner Acceptance Corp., 760 F.2d 1240 (11th Cir. 1985) (exercise of after-acquired property and future advance clauses precluded inventory financer from establishing a purchase money security interest); see also B. Clark, supra note 8, ¶3.09[2][e], at 3-97 to -99 (approving of analysis in Southtrust).

\textsuperscript{997} See Coogan, supra note 2, at 517.


\textsuperscript{999} See Kripke, supra note 636, at 716.

\textsuperscript{1000} See supra text accompanying notes 956-58.
has an effective floating lien on both the inventory and the accounts. Moreover, and somewhat ironically, the inventory financer's priority in after-acquired accounts is higher than its priority in after-acquired inventory. Although a subsequent purchase money financer can prime the floating lienor as to after-acquired inventory, the floating lienor's security interest in accounts as proceeds is prior to the claims of both the subsequent purchase money financer and any subsequent accounts financer.

d. Inventory Financer Versus Accounts Financer with Respect to Returns

The potential conflicts between an inventory financer and an accounts financer are not limited to disputes over accounts that the inventory financer claims as proceeds. The parties also may contest priority over goods returned to the debtor by an account debtor. The rights of an inventory financer and an accounts financer in returned goods are controlled by section 9-306(5)(c).\textsuperscript{1001} To illustrate the conflict between an inventory financer and an accounts financer envisioned in section 9-306(5)(c), consider the following:

ILLUSTRATION 31—On June 1 Bank entered into a written security agreement with Dealer that granted Bank a security interest in Dealer's current and after-acquired inventory of building materials. Also on June 1, Bank filed a financing statement covering Dealer's inventory. On July 1 Dealer sold a large quantity of building materials to Contractor on unsecured credit with payment due in ninety days. On July 1 Dealer also sold the account generated by this sale to Factor. Finally on July 1, Factor gave new value for the account, and filed a financing statement against Dealer covering the account. On July 10 Contractor returned the building materials to Dealer alleging that the materials were defective.

Although the ultimate issue presented in Illustration 31 is the determination of priority with respect to the returned materials, it is useful to begin by considering the relative priorities of Bank and Factor with respect to the July 1 account. Factor unquestionably bought the account, but its interest in the account was limited to a security interest.\textsuperscript{1002} Factor perfected its security interest by filing on July 1. Bank had a security interest in the account as proceeds of inventory,\textsuperscript{1003} and

\textsuperscript{1003} See U.C.C. § 9-308(1), (2) (1972) (amended 1977); S.C. Code Ann. § 36-9-
Bank's June 1 filing with respect to inventory was effective to continue perfection of its security interest in the account as proceeds. Therefore, because Bank filed with respect to Dealer's inventory before Factor filed with respect to the account, Bank had priority in the account under revised sections 9-312(5)(a) and 9-312(6).

When Contractor returned the building materials to Dealer, presumably Bank would prime Factor as to the returned goods. In a sense, the returned goods are proceeds of the account and priorities in the account should control priorities in the returned goods. This assumption is borne out by the provisions of section 9-306(5) as applied to Illustration 31. Section 9-306(5)(a) grants Bank a perfected security interest in the returned materials. Section 9-306(5)(c) grants Factor, as "[a]n unpaid transferee of the account," a security interest in the returned goods. Section 9-306(5)(c) also resolves the priority conflict between Bank's security interest under subsection (5)(a) and Factor's security interest under subsection (5)(c) by awarding priority to Bank.

Under the facts of Illustration 31, Factor did not perfect directly in the returned goods. As against Bank, such perfection would not have enhanced Factor's position. Nevertheless, Factor should have filed against the returns. Under section 9-306(5)(d), this filing was necessary to protect Factor's security interest against creditors of and purchasers from the Dealer. In effect, section 9-306(5)(c) preserved the relative


1005. See supra text accompanying notes 969-73.

1006. See Skilton & Dunham, supra note 745, at 798-99 (returned goods are proceeds); Cf. 2 G. Gilmore, supra note 56, § 27.5, at 737 (returns may be viewed as proceeds of chattel paper); Commentary on Section 9-306(5), supra note 745, at 3 (same).

1007. See Skilton & Dunham, supra note 745, at 807.


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positions of the parties in Illustration 31 when the goods were returned. Bank had priority in the July 1 account and section 9-306(5)(c) granted Bank priority in the underlying goods.

Section 9-306(5)(c) provides a more controversial result in cases in which an accounts financer files before an inventory financer. To illustrate this problem, consider the following:

ILLUSTRATION 32—On June 1 Bank and Dealer entered into a written security agreement that granted Bank a security interest in Dealer's current and after-acquired accounts to secure a contemporaneous loan and any future advances. Also on June 1, Bank filed a financing statement covering Dealer's accounts. On July 1 Finance Company and Dealer entered into a written security agreement that granted Finance Company a security interest in Dealer's current and after-acquired inventory of building materials to secure a contemporaneous loan and any future advances. Also on July 1, Finance Company filed a financing statement covering Dealer's inventory. On August 1 Dealer sold some building supplies to Contractor on unsecured credit. On August 15 Contractor returned the building supplies to Dealer.

Under revised section 9-312(5)(a) and (6) Bank in the above illustration had priority over Finance Company with respect to the August 1 account.1012 When the goods subject to that account were returned to Dealer, they were, in essence, proceeds of the account.1013 Therefore, Bank arguably would be entitled to priority in the returns. Section 9-306(5)(c), however, awards priority to Finance Company by expressly providing that a security interest claimed by an unpaid transferee of an account under paragraph (c) is subordinate to a security interest of an inventory financer under paragraph (a).1014

The result reached in Illustration 32 is arguably inconsistent with the policy of the priority rules of the 1972 Official Text governing conflicts between accounts and inventory financers. If an accounts financer has filed before an inventory financer, the 1972 Official Text encourages the accounts financer to make future advances in reliance on after-acquired accounts by granting the accounts financer priority in the accounts that constitute proceeds of the inventory.1015 The effect of section 9-306(5)(c) is to undercut the accounts financer's ability to rely upon such accounts. If the goods subject to an account are returned, section 9-306(5)(c) subordinates the accounts financer's security interest to that of the inventory financer, even if the accounts financer

1012. See supra notes 959-60 and accompanying text.
1013. See supra note 1066.
1015. See supra text accompanying note 944.
made an advance in reliance upon the account. Therefore, section 9-306(5)(c) arguably should have been amended by the 1972 Official Text to afford an accounts financer priority in returns if the accounts financer had priority in the underlying account.\[1016\] In response, however, one could argue that the risk that Finance Company in Illustration 32 might make an advance in reliance on the returned goods as after-acquired collateral justifies awarding Finance Company priority.

A prior accounts financer such as Bank in Illustration 32 may be able to avoid the effect of section 9-306(5)(c) by claiming a security interest in returns in its security agreement and financing statement. In *Citizens & Southern Factors, Inc. v. Small Business Administration*\[1017\] the Alabama Supreme Court held in favor of an accounts financer whose security agreement and prior filing covered returned goods. The court reasoned that the priority rule in section 9-306(5)(c) applied only when that provision created the accounts financer's security interest in the returned goods.\[1018\] When the accounts financer obtained a security interest in returns under the terms of the security agreement, the court held that priorities were controlled by section 9-312 rather than section 9-306(5)(c).\[1019\]

Moreover, since the accounts financer filed a financing statement covering returns before the inventory financer filed, the court held that the accounts financer was entitled to priority under the first to file rule of former section 9-312(5)(a).\[1020\] Thus, *Citizens & Southern Factors* establishes a second reason for an accounts financer to file with respect to returns at the outset of the transaction. Not only does such a filing protect the accounts financer against creditors of and purchasers from the debtor under section 9-306(5)(d),\[1021\] but it also may enable the accounts financer to avoid the effect of section 9-306(5)(c) in a conflict with an inventory financer asserting a security interest in returned goods.\[1022\]

The *Citizens & Southern Factors* decision suggests a final priority issue with respect to returns. The problem will arise when an accounts financer claims a security interest in returns as well as accounts and files a financing statement covering accounts and returns. After the accounts financer has filed, an inventory financer obtains a purchase

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1017. 375 So. 2d 251 (Ala. 1979).
1018. *Id.* at 255; *see generally* Lord, *supra* note 745, at 188 (section 9-306(5)(c) subordinates interests that arise by operation of law and does not apply to consensual agreements).
1019. *Citizens & S. Factors, Inc.*, 375 So. 2d at 255.
1020. *Id.*
1021. *See supra* note 1011 and accompanying text.
money security interest in the debtor's inventory and meets the requirements for a purchase money priority under revised section 9-312(3).\textsuperscript{1023} The debtor then sells an item of the purchase money financer's collateral generating an account. Finally, the buyer returns the purchased item to the debtor. As to the item of inventory prior to its sale, the purchase money financer was entitled to priority under revised section 9-312(3).

As to the account generated by the sale, the accounts financer was entitled to priority under revised section 9-312(5)(a) and (6).\textsuperscript{1024} If the accounts financer had not claimed a security interest in returns in its security agreement, the purchase money financer would have been entitled to priority in the returned item under section 9-306(5)(c). Under the rule of \textit{Citizens & Southern Factors}, however, section 9-306(5)(c) does not control priorities in the returned item arising independently of subsection (5)(c). \textit{Citizens & Southern Factors} further holds that section 9-312 controls the priority issue. The question presented is to whom does revised section 9-312 award priority.

Purchase money financers can argue that since they had priority in an item of inventory prior to its sale, they should have priority upon the item's return. Although this argument has some appeal, it ignores the creation of the intervening account. Under revised section 9-312(3), a purchase money financer's priority does not continue in the account as proceeds of the inventory. Conceptually, the return is proceeds of the account.\textsuperscript{1025} Since the purchase money financer did not have priority in the account as proceeds, the purchase money financer should not have priority in the return as proceeds of proceeds.

This argument is not mere conceptual formalism. The clear policy of the 1972 Official Text is to encourage accounts financers who file first to make future advances in reliance on after-acquired accounts.\textsuperscript{1026} To effect this policy, the 1972 Official Text awards an accounts financer priority over a purchase money inventory financer claiming accounts as proceeds if the accounts financer filed first.\textsuperscript{1027} This policy would be undercut if a purchase money financer were awarded priority in returns. An accounts financer could not make advances against the full value of a debtor's accounts because a purchase money financer might be entitled to priority if the underlying goods were returned. Moreover, unlike Finance Company in Illustration 32, the purchase money financer is unlikely to rely upon the returned goods as after-

\textsuperscript{1023} See supra notes 126-29 and accompanying text.
\textsuperscript{1024} See supra notes 961-64 and accompanying text.
\textsuperscript{1025} See supra note 1006.
\textsuperscript{1026} See supra notes 937-58 and accompanying text.
\textsuperscript{1027} See supra notes 961-64 and accompanying text.
acquired property.\textsuperscript{1028}

IV. Conclusion

Without attempting to summarize the analysis of the priority conflicts set forth above, several conclusions can be advanced concerning the impact of revised Article 9 upon inventory financing. Revised Article 9 provides for two basic forms of inventory financing. Under the first form of financing, the secured party retains a floating lien upon the debtor's current and after-acquired inventory to secure an initial loan and any future advances. Under the second form of financing, the secured party retains a purchase money security interest in inventory to secure the extension of credit that enabled the debtor to acquire the collateral. Part II of this article analyzed rules of revised Article 9 governing the resolution of priority conflicts in the debtor's inventory. The most significant of these rules is the purchase money priority provision of revised section 9-312(3), which enables a purchase money financer of new inventory to prime an earlier-filed floating lienor asserting a security interest upon the new inventory under an after-acquired property clause.\textsuperscript{1029}

Although the rules governing conflicting security interests in inventory are significant, they do not address the most critical issues confronting an inventory financer. The fundamental dilemma confronting an inventory financer is that security interests in inventory are extinguished when the debtor sells the inventory to a buyer in ordinary course of business.\textsuperscript{1030} Therefore, priority in a debtor's inventory is significant only to the extent the debtor retains unsold inventory at the time of default. Furthermore, unless the inventory financer is repaid upon the sale of the collateral, the inventory financer must look to the proceeds realized upon the sale of after-acquired property for security. Furthermore, since a purchase money financer may not claim a security in after-acquired inventory,\textsuperscript{1031} and the floating lienor's security interest in after-acquired inventory may be subordinate to the claim of a subsequent purchase money financer,\textsuperscript{1032} proceeds constitute the primary potential source of additional security. Thus, the most significant priority issues involve the question of whether a priority in inventory extends to proceeds.

Part III of this article analyzed the rules governing priority con-

\textsuperscript{1028} See supra note 996.
\textsuperscript{1029} See supra text accompanying notes 114-291.
\textsuperscript{1030} See supra text accompanying note 14.
\textsuperscript{1031} See supra note 126.
\textsuperscript{1032} See supra text accompanying notes 114-291.
flicts concerning proceeds of inventory. In addition to cash proceeds, the most significant forms of proceeds of inventory are chattel paper and accounts. An inventory financer's claim of a security interest in either chattel paper or accounts as proceeds may conflict with two types of claims. First, the inventory financer's security interest may conflict with the security interest of another inventory financer claiming the receivable (i.e., accounts or chattel paper) as proceeds. Second, the inventory financer's proceeds claim may conflict with a security interest asserted directly in the receivable. The rules for resolving these conflicts under revised Article 9 are significant not only because they provide certainty, but also because they largely define and limit the role of inventory financing.

As established in Part III, the priority rules of revised Article 9 governing conflicts over the proceeds of inventory generally favor financers who lend directly against the receivable. For example, under revised section 9-308(b), a subsequent purchaser of chattel paper can prime the security interest of an inventory financer claiming the chattel paper as proceeds.1033 Therefore, when the proceeds of inventory consist of chattel paper, section 9-308(b) precludes an inventory financer from relying upon a proceeds claim to the chattel paper. To be assured of protection with respect to the chattel paper, the inventory financer must either take possession of the paper or insure that cash paid by a chattel paper purchaser is applied to the inventory financer's loan.

The impact of the priority rules governing proceeds upon the sale of inventory financing, however, is most pronounced when the proceeds are accounts. Under revised Article 9 the first secured party to file with respect to either a debtor's inventory or accounts will be entitled to priority in the accounts that constitute proceeds of the debtor's inventory.1034 In contrast to the result under revised section 9-308(b), an inventory financer who files first and claims accounts as proceeds is entitled to priority over a subsequent purchaser of the accounts for new value.1035 Moreover, under revised section 9-312(3) the purchase money priority in inventory does not extend to proceeds in the form of accounts.1036 Therefore, a secured party claiming a floating lien upon a debtor's current and after-acquired inventory, who files first with respect to the inventory and before another secured party files with respect to the debtor's accounts, is assured of priority in the accounts generated by the sale of inventory. This priority rule, therefore, effec-

1033. See supra text accompanying notes 710-25.
1034. See supra text accompanying notes 908-1000.
1035. See supra text accompanying notes 969-86.
1036. See supra text accompanying notes 945-68, 987-1000.
tively converts the inventory floating lienor into an accounts financer. In contrast, if an accounts financer has filed first, the security gained by a subsequent inventory financer is limited to the inventory in the debtor's possession at the time of default. Thus, inventory and accounts financing can rarely coexist.

In summary, the principal benefit an inventory floating lienor gains by filing first is a prior claim to proceeds in the form of accounts. The floating lienor's claim to the original inventory is fleeting and the floating lienor's priority in after-acquired property is uncertain. The floating lienor's security interest in the original inventory will be extinguished upon a sale to a buyer in ordinary course of business. Moreover, the purchase money priority rule of revised section 9-312(3) may subordinate the floating lienor's claim to after-acquired inventory. Nevertheless, under revised Article 9 the floating lienor is assured of priority in all accounts resulting from the sale of inventory. Therefore, under revised Article 9 it is fair to characterize a secured party holding a floating lien upon a debtor's inventory as an accounts financer who has retained a security interest in inventory as additional security to insure primarily against the event of the debtor's bankruptcy.