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The Priority Battle Over Returned and Repossessed Goods

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NOTES

The Priority Battle Over Returned and Repossessed Goods: Inventory Financers Versus Chattel Paper Financers

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I. INTRODUCTION

Article 9 of the Uniform Commercial Code (the Code) governs secured transactions in personal property and fixtures.¹ When more than one creditor has a security right in the same piece of collateral, the Article 9 rules of priority determine the order in which each creditor may satisfy his claim.² The creditor with the highest priority rank gets paid first, and, if his claim exceeds the amount of the proceeds, junior creditors take nothing.³ Consequently, creditors want to determine their priority rights in collateral before extending credit. If one creditor determines that another creditor will have priority over its security interest, then it may wish to require substitute collateral or to increase the interest rate for the loan. Priority rules should be uniform and readily determinable so that creditors can allocate their risks in extending credit and adjust the terms of the credit accordingly.

Because of disagreement among the courts, however, the priority rules governing interests in returned or repossessed goods are neither uniform nor readily determinable.⁴ The split among the courts centers on whether, under Section 9-306(5) of the Code, a perfected inventory financier⁵ subordinates an unperfected chattel paper financier.⁶ The fol-

1. U.C.C. § 9-101 comment (1987). Unless otherwise noted, all Code references will be to the 1987 Official Text of the Uniform Commercial Code.

2. See U.C.C. §§ 9-301 to -318 (Article 9's priority rules).

3. See U.C.C. § 9-504.

4. See *infra* Part IV.

5. For the purposes of this Note, inventory financiers are creditors who secure credit with the debtor's current and future inventory.

6. For the purposes of this Note, a chattel paper financier is a purchaser of chattel paper. See U.C.C. § 9-308 (outlining the necessary steps to purchase chattel paper and at the same time subordinate other security interests).

The split among the courts can also be characterized as a disagreement on whether inventory financiers should be defined as creditors or purchasers for the purposes of § 9-306(5)(d). If subsection (5)(d)'s definitions are read to exclude inventory financiers, then, regardless of perfection, chattel paper financiers' security interests are protected from competing interests held by inventory financiers. See *infra* subpart IV (A). Articles addressing the split in authority and ways to amend

lowing example illustrates a typical situation in which priority conflicts arise.⁷

Dealer Bulldozer Company (Dealer) could not afford to purchase the inventory of bulldozers it needed directly from the manufacturer and applied to Inventory Finance Company (Inventory Finance) for a one million dollar loan. Because Inventory Finance did not believe Dealer was established well enough to extend it an unsecured loan, Inventory Finance required a security interest in Dealer's current and after-acquired inventory as collateral.⁸ Inventory Finance took all the necessary steps to perfect its interest in Dealer's inventory through filing.⁹

On February 1, Dealer sold six bulldozers, one-third of its inventory, to Joe's Construction Company (Joe's) for \$600,000. Joe's paid Dealer \$100,000 down and signed a long-term note—"chattel paper" under Section 9-105(1)(b) of the Code¹⁰—that granted Dealer a security interest in the bulldozers. Inventory Finance had a perfected security interest in the chattel paper as proceeds from the sale of the collateral on its loan.¹¹

Without immediate cash Dealer could not replenish its inventory. Dealer realized that the payments from Joe's on the long-term note would not meet its immediate cash needs. In hope of alleviating its cash-flow problem, Dealer contacted the Paper Finance Company (Paper Finance), a purchaser of commercial paper, which agreed to purchase the chattel paper. On February 1, Dealer received a cashier's check for \$425,000, and Paper Finance took possession of the chattel paper. Under Section 9-308 of the Code, Paper Finance gained priority over Inventory Finance's perfected security interest in the chattel

the Code include Barnes, *Reaffirming the Dominance of Notice in Article 9: A Proposed Modification of Priorities in Returned or Repossessed Goods*, 48 U. PITT. L. REV. 353 (1987), and Skilton & Dunham, *Security Interests in Returned and Repossessed Goods Under Article 9 of the Uniform Commercial Code*, 17 WILLAMETTE L. REV. 779 (1981).

7. The basic fact pattern and names of some of the parties in this example come directly from an article by Professor Richard Barnes. See Barnes, *supra* note 6, at 357-59.

8. See *infra* notes 111-15 and accompanying text.

9. For a discussion of perfection through filing, see *infra* notes 29-32 and accompanying text.

10. Article 9 defines chattel paper as a writing or writings that evidence a monetary obligation and a security interest. U.C.C. § 9-105(1)(b).

11. When the debtor disposes of collateral through sale, the secured party gains a security interest in the property given in exchange. U.C.C. § 9-306(1), (3). In this example, because the cash down payment and the chattel paper were the proceeds of the sale of the bulldozers, Inventory Finance had a security interest in both. See *id.* The security interest in the chattel paper was perfected automatically for at least 10 days, and would have been perfected for longer had Inventory Finance filed a financing statement covering the inventory in the same office in which a financing statement covering chattel paper would be filed. See U.C.C. § 9-306(3)(a).

paper.¹²

By April 1, Joe's had missed three payments to Dealer.¹³ On April 2, a group of Paper Finance's repossessioners descended stealthily on Joe's and repossessed the six bulldozers.¹⁴ After the repossession, Dealer asked Paper Finance to bring the bulldozers to Dealer so it could try to resell them. On April 3, Paper Finance delivered the bulldozers to Dealer and took no subsequent steps to perfect its security interest in the bulldozers. The bulldozers remained on Dealer's lot for five months but none were sold. During this period, Dealer became indebted deeply to a number of unsecured creditors. Dealer also missed several installments on its note with Inventory Finance. Realizing that Dealer could not repay the note, Inventory Finance repossessed all the bulldozers on Dealer's lot as partial satisfaction of Dealer's debt. Paper Finance, however, claimed priority over Inventory Finance in the six bulldozers formerly owned by Joe's. Unable to reach an agreement, the parties went to court to resolve their priority dispute.

Section 9-306(5) of the Code governs priority disputes between secured creditors over returned or repossessed goods such as the six bulldozers.¹⁵ Subsection (d) of Section 9-306(5) provides that either creditors of the seller or purchasers of the returned goods may subordinate an unperfected chattel paper financier.¹⁶ Some courts have held that inventory financiers are creditors of the seller and, thus, may subordinate an unperfected chattel paper financier.¹⁷ Other courts, however, have held that sound commercial policy requires the exclusion of inventory financiers from the protection of subsection 5(d).¹⁸ These courts have concluded that an unperfected interest in returned goods held by a chattel paper financier subordinates a perfected inventory financier.¹⁹ As the case law demonstrates, a court's interpretation of sub-

12. See U.C.C. § 9-308(b). The text of § 9-308(b) appears *infra* at note 44. See also *infra* notes 72-79 and accompanying text (outlining the elements of § 9-308).

13. For the purposes of this example, the missed payments constitute a default on the monetary obligation.

14. The Code gives Paper Finance the right to repossess collateral upon Joe's default without recourse to the courts provided that the repossession does not breach the peace. See U.C.C. § 9-503.

15. U.C.C. § 9-306(5). See *infra* note 39.

16. In the example, Inventory Finance represents the secured creditor discussed in § 9-306(5)(a). Paper Finance represents the chattel paper transferee discussed in § 9-306(5)(b). Dealer represents the debtor referred to throughout § 9-306.

17. See, e.g., *Crocker Nat'l Bank v. Clark Equip. Credit Corp.*, 724 F.2d 696 (8th Cir. 1984); *Finance Am. Corp. v. Galaxy Boat Mfg. Co.*, 292 S.C. 494, 357 S.E.2d 460 (1987).

18. See, e.g., *International Harvester Credit Corp. v. Associates Fin. Servs. Co.*, 133 Ga. App. 488, 211 S.E.2d 430 (1974); *J.I. Case Co. v. Borg-Warner Acceptance Corp.*, 669 S.W.2d 543 (Ky. Ct. App. 1984).

19. See cases cited *supra* note 18.

section (5)(d) often determines the outcome of a priority dispute between a chattel paper financier and an inventory financier.

This Note addresses the proper interpretation of subsection (5)(d). Part II of this Note outlines the framework of relevant Code sections. Part III explains the status and rights of both the chattel paper financier and the inventory financier. Part IV examines the different judicial responses to Section 9-306(5)(d). Part V reviews the different methods of interpretation courts have used in applying subsection (5)(d). This Note concludes that Section 9-306(5)(d) encompasses inventory financiers and, thus, that an inventory financier may subordinate an unperfected chattel paper financier.

II. EXPLORING THE RULES OF PRIORITY

A. Secured and Unsecured Creditors

The Code establishes two general categories of creditors: secured creditors and unsecured creditors.²⁰ A secured creditor takes an interest in the debtor's collateral to ensure payment or performance of an obligation.²¹ If the debtor defaults on the obligation, the secured creditor may satisfy the debt through retention or disposal of the collateral.²² An unsecured creditor, however, has nothing to ensure repayment of a debt beyond the solvency of the debtor and the right to reduce the claim to judgment.²³

All security interests are effective against the debtor.²⁴ To ensure that its security interest is effective against other creditors, however, the secured party must perfect that interest.²⁵ Perfection occurs when the creditor takes a security interest in the debtor's property and supplies constructive notice to other creditors that the security interest exists.²⁶ Article 9 provides two alternate modes of perfection: perfection by filing²⁷ and pledge perfection.²⁸

20. The terms are mutually exclusive. A secured creditor has collateral and an unsecured creditor does not. *See* U.C.C. § 9-105(m) (stating that a secured party is a creditor with a security interest).

21. U.C.C. § 1-201(37).

22. U.C.C. §§ 9-503, -504(1), -505(2).

23. Article 9 protects unsecured creditors only after they have reduced their claims to judgment. *See, e.g.*, U.C.C. § 9-301(1)(b) (providing that lien creditors subordinate unperfected secured creditors).

24. U.C.C. § 9-203(2). Before an agreement is classified as a security interest it must attach. U.C.C. § 9-303 comment 1. Attachment occurs when a security agreement has been executed, the creditor has given value, and the debtor has rights in the collateral. U.C.C. § 9-203(1).

25. *See* U.C.C. § 9-303 comment 1 (noting that "in general after perfection the secured party is protected against creditors and transferees of the debtor and in particular against any representative of creditors in insolvency proceedings instituted by or against the debtor").

26. U.C.C. §§ 9-302, -304 to -306.

27. U.C.C. § 9-302(1); *see* U.C.C. §§ 9-401 to -402 (outlining the procedure for filing).

To protect a security interest through filing, the secured party must meet Article 9's filing requirements.²⁹ First, the secured party must obtain a written financing statement from the debtor that contains the names and addresses of the debtor and the secured party, describes the collateral by item or type, and includes the debtor's signature.³⁰ Next, the creditor must file the financing statement in the appropriate filing office.³¹ At the office, a clerk will index the financing statement under the debtor's name so that a reasonable credit search will reveal the financing statement and, thus, the perfected creditor's security interest in the debtor's property. In this manner, the perfected creditor notifies prudent second-comers of its security interest.³²

In most cases, the pledge, or perfection through possession, provides an alternative mode of perfection.³³ The pledge is a common-law device that the Code expressly retains.³⁴ To pledge collateral, the secured party or an agent of the secured party takes possession of the collateral away from the debtor.³⁵ Perfection continues as long as the secured party controls the collateral.³⁶ Because a reasonable creditor should inquire why an asset of the debtor is no longer in the debtor's control, the pledge will reveal the security interest and notify subsequent creditors that the debtor has encumbered the pledged property. Both modes of perfection supply notice of a secured creditor's interest and make necessary financial information concerning the debtor's assets available to the prudent creditor.

B. Sections 9-301(1)(a) and 9-306(5): Rules of Priority

Creditors want perfected, rather than unperfected, security interests. Comment 2 of Section 9-301 states that, "*a fortiori*," a perfected security interest takes priority over an unperfected security interest,³⁷

28. U.C.C. §§ 9-302(1)(a), -305 (establishing rules for pledge of collateral).

29. See U.C.C. §§ 9-401, -402.

30. U.C.C. § 9-402(1).

31. To determine which state law governs the rules of filing, see U.C.C. § 9-103. To determine where to file within the appropriate state, see U.C.C. § 9-401(1) (providing three alternatives from which the states may choose).

32. The purpose of the filing system set forth in Article 9 is to notify creditors of the debtor's prior liens. See U.C.C. § 9-205 comment 3.

33. U.C.C. § 9-304 comment 1. When negotiable instruments or cash serve as collateral, possession of the collateral is the sole method of perfection. U.C.C. § 9-304(1). Perfection through pledge also eliminates the need for a written and signed security agreement. U.C.C. § 9-203 comment 1.

34. Sections 9-304(1) and 9-305 codify the common-law device of perfection by possession. See U.C.C. § 9-305 comment 1.

35. U.C.C. § 9-305.

36. *Id.*

37. U.C.C. § 9-301 comment 2.

and a perfected security interest in collateral extends to the proceeds of collateral.³⁸ Section 9-306 outlines the requirements for maintaining a perfected security interest in proceeds. Subsection (5) of Section 9-306 addresses the comparative rights of inventory financiers and chattel paper financiers in returned and repossessed goods³⁹ and is organized into subparts that govern the rights of these creditors.

Subsection (5)(a) governs the rights of inventory financiers who have extended credit to the seller using the seller's inventory as collateral.⁴⁰ If the inventory financier has a perfected security interest in goods when they are sold, then upon return or repossession of the goods, the creditor's security interest reattaches and reperfects provided that the creditor still has an effective financing statement.⁴¹

Subsection (5)(b) governs the rights of chattel paper financiers, such as Paper Finance, who have purchased chattel paper that results from a sale of goods.⁴² Subsection (5)(b) gives the chattel paper financier a security interest in the goods upon their return or repossession.⁴³ If the chattel paper financier meets the requirements of Section 9-308,⁴⁴

38. Proceeds include whatever is received upon disposition of the collateral. U.C.C. § 9-306(1).

39. Section 9-306(5) provides in part:

(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. Such 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 9-308.

....
(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 and repossessed goods.

U.C.C. § 9-306(5) (emphasis added).

40. U.C.C. § 9-306(5)(a).

41. *Id.*

42. Subsection (5)(b) refers to the purchaser of the chattel paper as the "transferee" of the paper. U.C.C. § 9-306(5)(b). To fall within this section the transferee must remain unpaid. *Id.* Furthermore, the subsection separates transferees into two groups: transferees who meet the requirements of § 9-308 and transferees who do not. *Id.* See *infra* notes 45-46 and accompanying text.

43. U.C.C. § 9-306(5)(b).

44. Section 9-308 provides:

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

the subsection deems the chattel paper financier's security interest prior to that of a subsection (5)(a) inventory financier.⁴⁵ Subsection (5)(d) also addresses the rights of the chattel paper financier and provides that either creditors of the seller or purchasers of the goods may subordinate a chattel paper financier's unperfected interest in returned or repossessed goods.⁴⁶

The introductory example⁴⁷ helps clarify the provisions of Section 9-306(5). Inventory Finance had a perfected security interest in the bulldozers at the time of the sale to Joe's. Because subsection (5)(a) applies to parties who have security interests in goods at the time of sale, subsection (5)(a) governs Inventory Finance's security rights.⁴⁸ Paper Finance purchased the chattel paper, and the underlying obligation of the chattel paper remains unpaid. Subsection (5)(b) applies to parties who are unpaid transferees of chattel paper, so subsection (5)(b) governs the rights of Paper Finance.⁴⁹

Under subsection (5)(a) Inventory Finance has a perfected security interest in the repossessed bulldozers,⁵⁰ and under subsection (5)(b) Paper Finance has a security interest in the bulldozers.⁵¹ As long as Paper Finance had possession of the bulldozers it had a perfected security interest.⁵² When it transferred the bulldozers to Dealer's lot, however, Pa-

or instrument

(a) which is perfected under Section 9-304 (permissive filing and temporary perfection) or under Section 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 9-306) even though he knows that the specific paper or instrument is subject to the security interest.

U.C.C. § 9-308.

45. U.C.C. § 9-306(5)(b). It is important to note that subsection (5)(b) does not say that the chattel paper financier has priority over the subsection (5)(a) creditor. Subsection (5)(b) states merely that a subsection (5)(b) security interest is "prior" to that of a subsection (5)(a) creditor. *Id.* A security interest may be prior to one interest and still be subordinate to another. *See* U.C.C. § 9-301(1)(a) (providing that an unperfected interest is subordinated by a later perfected interest regardless of when either interest attached); U.C.C. § 9-312(5) (providing that priority between perfected security interests is determined by which party is the first to file or perfect and that the timing of attachment of interests has no bearing on priority).

46. Subsection (5)(d) refers to the rights granted to the creditor by subsection (5)(b). U.C.C. § 9-306(5)(d).

47. *See supra* notes 7-15 and accompanying text.

48. U.C.C. § 9-306(5)(a).

49. U.C.C. § 9-306(5)(b).

50. Under subsection (5)(a) creditors have perfected interests if they have an effective financing statement that covers the returned goods. U.C.C. § 9-306(5)(a). Because a filed financing statement remains effective for five years, U.C.C. § 9-403(2), Inventory Finance's original financing statement remains effective until five years from the date of filing. Therefore, Inventory Finance regains a perfected security interest in the repossessed and returned bulldozers.

51. U.C.C. § 9-306(5)(b).

52. U.C.C. § 9-305.

per Finance lost its perfected status because it neither filed a financing statement nor had possession. Therefore, under subsection (5)(d), Dealer's other creditors and purchasers of the collateral may subordinate Paper Finance because Paper Finance has not maintained a perfected interest in the six bulldozers. Whether inventory financiers like Inventory Finance are creditors or purchasers under subsection (5)(d) is the issue that divides the courts. How the courts resolve this issue will determine whether Inventory Finance or Paper Finance has priority in the repossessed bulldozers.

III. THE PARTIES

In order to understand better the priority conflict between chattel paper financiers and inventory financiers, one must explore the status and rights of each party.

A. *Chattel Paper Financers*

Chattel paper is a writing or writings that evidence both a monetary obligation arising from the sale or lease of goods and a security interest in the goods.⁵³ Financing secured by chattel paper is one of the more confusing methods of finance because of the schizophrenic personality of chattel paper. Although chattel paper is nonnegotiable, Article 9 has given it at least one quasi-negotiable feature.⁵⁴ Similar to negotiable instruments, which cannot be perfected through filing, notice filing of chattel paper may not protect creditors against the rights of subsequent financiers.⁵⁵ Furthermore, chattel paper financiers derive payment rights from two distinct sources: a monetary obligation and a security interest in goods.⁵⁶ While the chattel paper reflects a security interest in goods, it is unclear whether the chattel paper embodies the actual goods.⁵⁷ Examining these distinctions in greater detail provides a better understanding of Section 9-306(5).

53. U.C.C. § 9-105(1)(b).

54. See Barnes, *supra* note 6, at 387-89 (discussing the negotiable quality of chattel paper); Jackson, *Embodiment of Rights in Goods and the Concept of Chattel Paper*, 50 U. CHI. L. REV. 1051, 1058-61 (1983) (same).

55. See U.C.C. § 9-308 (providing that a subsequent chattel paper financier can subordinate a filed interest in chattel paper).

56. U.C.C. § 9-105(1)(b). Chattel paper arises when a party purchases goods on credit from a seller who retains a security interest in the goods. See U.C.C. § 9-105(1)(b) comment 3; U.C.C. § 9-308 comment 1. The writing or writings that evidence the purchaser's debt and the security interest are chattel paper. *Id.* § 9-105(1)(b). The chattel paper financier has the right to receive the purchaser's installment payments on the debt, and, if the purchaser defaults, the chattel paper financier may repossess the goods. See *id.* § 9-504(1).

57. See *infra* notes 88-102 and accompanying text.

1. The Quasi-Negotiable Nature of Chattel Paper

Possession is the only mode of perfecting negotiable instruments.⁵⁸ A creditor in possession of negotiable instruments need not search filing offices to ensure that no competing security interests exist, but instead must establish its rights by taking possession of the instruments in question.⁵⁹ In this way, the flow of credit increases because the creditor's confidence in the collateral increases.⁶⁰ Although the Code retains filing as a mode of perfection for interests in chattel paper, in certain instances, perfection through possession may subordinate perfection through filing, regardless of constructive notice.⁶¹ Thus, Article 9 grants chattel paper one quasi-negotiable feature.⁶²

This quasi-negotiable aspect of chattel paper is necessary for retail businesses.⁶³ Retailers often finance their inventory through floating liens.⁶⁴ An inventory financier with a floating lien automatically gains a perfected security interest in the retailer's new inventory.⁶⁵ Because an inventory financier subordinates all subsequent nonpurchase money inventory financiers,⁶⁶ subsequent creditors seldom rely on inventory as collateral.⁶⁷ A credit crunch may thus arise when inventory is the re-

58. U.C.C. § 9-304(1). Instruments, however, may be perfected temporarily without possession. U.C.C. § 9-304(4)-(5). In part, temporary perfection allows the secured creditor to deliver the instrument to the debtor so that specific acts, such as collection, may be performed without the threat of subordination. See U.C.C. § 9-304 comment 4 (explaining the reasons for temporary perfection).

59. Jackson, *supra* note 54, at 1060.

60. *Id.*

61. See U.C.C. § 9-308(b) (providing that knowledge of the competing security interest does not subordinate the chattel paper financier).

62. See Barnes, *supra* note 6, at 387-89; Jackson, *supra* note 54, at 1058-61.

63. See Barnes, *supra* note 6, at 392.

64. For a discussion of inventory financiers and retailers, see *infra* notes 111-16 and accompanying text.

65. U.C.C. § 9-204(1).

66. See U.C.C. § 9-312(5)(a) (providing that the perfected creditor that is first to file or perfect has priority).

67. See Panel Discussion, *A Practical Approach to the Uniform Commercial Code for the Practicing Lawyer*, 19 BUS. LAW. 20, 52 (1963). A variation of the example clarifies the problem faced by subsequent inventory financiers. Suppose Inventory Finance gave only one dollar secured by its perfected security interest over Dealer's inventory, which is worth \$500,000. Three weeks later Acme Finance lent Dealer \$400,000 in exchange for a subsequent interest in Dealer's inventory. Acme knew of Inventory Finance's prior interest but disregarded it because the interest secured only one dollar. One day later Inventory Finance made an additional advance of \$499,999 secured by the inventory. The original security agreement and financing statement now secures Inventory Finance's total debt of \$500,000, see U.C.C. § 9-204 comments 1 and 5 (providing that a security agreement may cover subsequently incurred obligations without the need for further agreement), and Inventory Finance's interest subordinates Acme's interest for the entire amount of the collateral. See U.C.C. § 9-312(5) (providing that a prior perfected interest subordinates later interests). Thus, Acme foolishly relied on the original debt of one dollar when Inventory Finance, through future advances, could continually increase the amount of its senior interest.

tailer's most valuable asset and the original inventory financier withholds future advances.

A retailer's extension of long-term credit to its buyers exacerbates the credit problem. Because long-term credit entails payment in smaller installments, the retailer may experience cash-flow problems and, thus, needs an efficient way to convert chattel paper into money or new value. Even here, however, the inventory financier's supremacy appears. The inventory financier automatically gains a security interest in chattel paper as proceeds.⁶⁸ To protect retailers from the power of inventory financiers, the Code, through Section 9-308, developed a method of financing that both converts chattel paper into cash or new value and avoids the inventory financier's security interest in proceeds.⁶⁹

Under Article 9 both filing and possession are modes of perfecting a security interest in chattel paper.⁷⁰ Normally, when the Code allows perfection either through filing or by possession, the two are equivalent alternatives.⁷¹ Section 9-308, however, runs counter to this presumption. Under this Section a subsequent purchaser of chattel paper who meets specified requirements subordinates the perfected security interest of an inventory financier.⁷² To qualify, the purchaser must purchase chattel paper in the ordinary course of his business⁷³ and must give new value for, and take possession of, the chattel paper.⁷⁴ The purchaser, however, can avoid only a chattel paper security interest that an inventory secured creditor claims as the proceeds of inventory.⁷⁵ If the inventory financier claims the interest merely as the proceeds of inventory, the chattel paper purchaser prevails whether or not the purchaser is

68. U.C.C. § 9-306(1)-(3). The Code defines proceeds as whatever a party receives on disposition of collateral or on disposition of proceeds already received from an earlier disposition of collateral. U.C.C. § 9-306(1). For example, if a diamond ring serves as collateral for a debt and the debtor trades the ring for a motorcycle, the motorcycle is the proceeds of the ring. Under § 9-306(1), the creditor would be entitled to claim the motorcycle as collateral in lieu of the ring. If the debtor then sells the motorcycle for cash, the creditor likewise would be able to claim the cash proceeds of the sale as collateral.

69. The primary purpose of chattel paper financing is the injection of new value into businesses. See Barnes, *supra* note 6, at 366.

70. U.C.C. §§ 9-304(1), -305.

71. See U.C.C. § 9-312(5)(a) (setting forth the general priority rule for competing perfected creditors). If Creditor A perfects through filing and Creditor B perfects through possession, priority goes to A if A filed before B took possession. *Id.* Likewise, priority goes to B if B took possession before A filed. *Id.*

72. In the example, *supra* note 71, A had priority over B when A filed before B took possession. *Id.* Under § 9-308, however, even when A, the inventory financier, files first, B, the chattel paper financier, may subordinate A by a later possession of the collateral. U.C.C. § 9-308.

73. U.C.C. § 9-308.

74. *Id.*

75. *Id.*

aware of the competing security interest.⁷⁶ Otherwise, the chattel paper purchaser prevails only if it lacks knowledge of the inventory financier's security interest.⁷⁷ In this situation, however, constructive notice does not suffice to show knowledge.⁷⁸ If the chattel paper purchaser meets the specified requirements, possession of chattel paper determines priority.⁷⁹ In this way, chattel paper assumes negotiable features.⁸⁰

The inventory financier is the obvious target of the quasi-negotiable nature of chattel paper.⁸¹ Ideally, however, Section 9-308 does not harm the inventory financier.⁸² If the retailer uses the new value to replace inventory, then the inventory financier has a security interest in the new inventory.⁸³ Furthermore, if the inventory financier wants its debt paid directly from the new value, then the inventory financier may include a provision in the security agreement requiring the retailer to turn over the new value.⁸⁴ Finally, the inventory financier can eliminate any possibility of chattel paper financing by taking possession of the chattel paper or, if appropriate, by stamping the chattel paper.⁸⁵

In the introductory example,⁸⁶ if Inventory Finance did not want to lose its security interest in the chattel paper, Inventory Finance should have taken possession of the paper. Inventory Finance also could have structured its security agreement into a form known as a floor plan,⁸⁷ under which Inventory Finance would have had more control over Dealer. Either of these alternatives would reduce the potential role and concomitant threat of a chattel paper financier, such as Paper Finance.

76. U.C.C. § 9-308(b).

77. U.C.C. § 9-308(a) & comment 3.

78. See U.C.C. § 1-201(25)-(27) (defining knowledge and notice); see also 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 21.6, at 591 (1965).

79. G. GILMORE, *supra* note 78, § 27.3, at 728.

80. See *supra* notes 58-62 and accompanying text.

81. An inventory financier is the party who invariably will gain a security interest in chattel paper as proceeds. Section 9-308 avoids this interest.

82. Barnes, *supra* note 6, at 366.

83. See *supra* note 68 (describing the movement of a security interest through disposition of collateral and proceeds of collateral).

84. Barnes, *supra* note 6, at 366-67. The inventory financier, however, must police the collateral to ensure that the retailer complies with the security agreement. *Id.*

85. U.C.C. § 9-308 comment 3 (explaining that inventory financiers may stamp or otherwise note their interest on the chattel paper as direct notice to subsequent creditors).

86. See *supra* notes 7-15 and accompanying text.

87. For an excellent description of an inventory financier "floor plan," see *Chemical Bank v. PIC Motors Corp.*, 87 A.D.2d 447, 452 N.Y.S.2d 41 (1982), *aff'd*, 58 N.Y.2d 1023, 448 N.E.2d 1349, 462 N.Y.S.2d 438 (1983).

2. Embodiment and Proceeds Theories

Chattel paper embodies two rights: a right to the account debtor's payments and a security interest in goods.⁸⁸ The primary obligation on which a chattel paper financier relies is the account debtor's payment.⁸⁹ The financier desires a steady flow of money, not the troubles associated with the acquisition and disposal of collateral. For this reason, one commentator describes the security interest in goods as an ancillary right that serves primarily to increase the value of the chattel paper.⁹⁰ The extent to which the security rights of chattel paper embody returned or repossessed goods, however, has caused considerable confusion.⁹¹

A brief discussion of negotiable documents⁹² best explains the controversy surrounding the embodiment theory of chattel paper. Under Article 9, as long as a negotiable document is outstanding, the document "locks up" the title to the goods, and the proper way to perfect an interest in the goods is to perfect an interest in the negotiable document.⁹³ Thus, for the purposes of secured transactions, Article 9 makes a negotiable document the legal equivalent of the goods in which the document represents an interest.⁹⁴

The embodiment theory of chattel paper posits that chattel paper similarly should lock up the title to the goods underlying the paper. Under this theory, a chattel paper secured creditor should need to perfect only its interest in the chattel paper to perfect its interest in the underlying goods.⁹⁵ In contrast, the nonembodiment theory requires a holder of chattel paper to perfect its interest in the goods themselves in order to protect that interest from subordination.⁹⁶

If the embodiment theory were correct, however, ostensible ownership problems would arise.⁹⁷ Chattel paper financiers who perfect solely through possession of the paper give no other external indicia of their interests in returned goods possessed by the dealer or debtor. The dealer has complete dominion over the goods, and no financing state-

88. U.C.C. § 9-105(b).

89. Barnes, *supra* note 6, at 388-89. In the introductory example, *supra* notes 7-15 and accompanying text, Joe's is the account debtor.

90. Jackson, *supra* note 54, at 1058.

91. Barnes, *supra* note 6, at 389.

92. A negotiable document arises when a bailee controls goods and, in the regular course of business, issues a writing that lists the goods and provides that the person in possession of the writing is entitled to possession of the listed goods. U.C.C. § 1-201(15); *id.* § 9-105(1)(f).

93. U.C.C. § 9-304 comment 2.

94. *Id.*

95. Jackson, *supra* note 54, at 1057-67 (addressing the conflicting views of chattel paper embodiment).

96. *Id.*

97. See Barnes, *supra* note 6, at 393-403.

ment exists to alert creditors that the dealer does not own them.⁹⁸ Because the dealer's other creditors have no reliable, independent means of discovering the security interest in the returned or repossessed goods, these creditors cannot allocate risks accurately. The commercial necessity of protecting creditors from this form of ostensible ownership or secret lien, therefore, argues against a strict embodiment theory.⁹⁹

Priority rules should not allow the chattel paper financier to cure the ostensible ownership problem simply by filing a financing statement identifying the chattel paper. Although filing of an interest in chattel paper would notify creditors that encumbered chattel paper exists, creditors still would not know what goods gave rise to the chattel paper.¹⁰⁰ Therefore, a prudent creditor must incur the additional expense of investigating just what goods the chattel paper embodies to ensure that portions of a dealer's inventory are not returned goods covered by a chattel paper financier's superior interest. The cost of such investigation, however, undesirably increases finance costs.¹⁰¹

Under both embodiment and nonembodiment approaches, the chattel paper financier has the same burden: to file a financing statement to cure the ostensible ownership problem. The embodiment approach, however, also burdens nonchattel paper creditors with the duty of investigating the extent to which chattel paper embodies the goods that the dealer offers as collateral. Because the nonembodiment view requires a description of returned or repossessed goods in the chattel paper financier's financing statement, other creditors need not incur the expense of investigating the status of chattel paper. The nonembodiment view is more economically efficient, and for this reason commentators concur that chattel paper should not embody the underlying goods.¹⁰²

Commentators, however, continue to debate whether returned or repossessed goods are proceeds of chattel paper.¹⁰³ Their debate focuses

98. In contrast, the chattel paper financier's possession of the paper provides adequate notice of the financier's interest in the paper itself. See *supra* notes 33-37 and accompanying text.

99. See Barnes, *supra* note 6, at 384-86 (addressing the elimination of ostensible ownership through Article 9).

100. Jackson, *supra* note 54, at 1065.

101. *Id.* One goal of Article 9 is the reduction of financing costs. U.C.C. § 9-101 comment. The embodiment theory is counterproductive to this goal because it increases costs by forcing creditors to conduct independent investigations of chattel paper.

102. See, e.g., Barnes, *supra* note 6, at 394 (observing that "extending . . . embodiment to rights in the goods may go further than necessary to protect commercial expectations"); Jackson, *supra* note 54, at 1087 (suggesting that "the justification for embodiment lasts only so long as the [dealer] is out of possession of the collateral").

103. Proceeds are whatever the dealer receives upon the disposition of collateral or the disposition of proceeds stemming from the original collateral. See U.C.C. § 9-306(1). Thus, proceeds are property received in substitution for the collateral. See U.C.C. § 9-306 comment 2(a).

on the need to reform Section 9-306(5).¹⁰⁴ Professors Skilton and Dunham, for example, argue that returned or repossessed goods are proceeds of chattel paper¹⁰⁵ and that the general rules applicable to proceeds also should govern priority in returned or repossessed goods.¹⁰⁶ Under this view, the priority rules of Section 9-306(5) are unnecessary, and, thus, Professors Skilton and Dunham advocate their elimination from the Code.¹⁰⁷

Professor Barnes, however, argues that returned or repossessed goods are not proceeds of chattel paper.¹⁰⁸ He maintains that Section 9-306(5) plays the important role of giving a security interest in the returned or repossessed goods to the chattel paper financier whereas the general rules applicable to proceeds would not do so.¹⁰⁹ Nevertheless, Professor Barnes acknowledges that Section 9-306(5) is drafted poorly and, thus, recommends that it be amended for the sake of clarity.¹¹⁰

The debate concerning the necessity of Section 9-306(5), however, does little to aid the courts in their interpretation of priority rights. Section 9-306(5) exists and, regardless of its benefit or detriment to the chattel paper financier, continues to govern priority in returned or repossessed goods. To protect its interests in returned or repossessed goods, a chattel paper financier must fulfill the perfection requirements of Section 9-306(5)(d).

Under the rules applicable to proceeds, a security interest in collateral continues in proceeds of that collateral. U.C.C. § 9-306(2); *see also supra* note 68 and accompanying text. If the security interest in the original collateral is perfected, then the security interest in the proceeds is perfected temporarily. U.C.C. § 9-306(3). Under appropriate circumstances, perfection in proceeds continues beyond the temporary period. *Id.*

104. When the goods in question are returned or repossessed goods, commentators recognize that the priority rules of § 9-306(5) supersede any general priority rules applicable to proceeds. Barnes, *supra* note 6, at 412 (acknowledging that § 9-306(5) controls transactions involving returned or repossessed goods); Skilton & Dunham, *supra* note 6, at 805 (observing that "Section 9-306(5) sometimes dictates results . . . that would not be achieved if [the general rules applicable to proceeds] were the sole point of reference"). Commentators discuss the relationship between proceeds and returned or repossessed goods in order to understand better how more efficient priority rules might be drafted. Barnes, *supra* note 6, at 416-18 (proposing a modification of § 9-306(5)); Skilton & Dunham, *supra* note 6, at 857-58 (concluding that better priority rules would eliminate § 9-306(5)).

105. Skilton & Dunham, *supra* note 6, at 803.

106. *Id.* at 857-58.

107. *Id.* (noting the opinion of the authors that "Article 9 would have been better if there had been no subsection (5)").

108. Barnes, *supra* note 6, at 412 (arguing that "it is, at the very least, an enormous stretching of the concept of proceeds to say the 'destruction' of the security interest in the goods . . . is a disposition of the chattel paper").

109. *Id.*

110. *Id.* at 416-18.

B. Inventory Financers

1. After-Acquired Property Clauses and the Floating Lien

Wholesalers and retailers buy and sell inventory continually. If the inventory financier's security interest cannot float onto future inventory, its interest erodes as the debtor sells the original inventory. This erosion causes the inventory financier to contract the line of credit. To offset this contraction Article 9 expressly provides for floating liens.¹¹¹

The inclusion of an after-acquired property clause¹¹² in a security agreement creates a floating lien. Under this clause an inventory financier gains a security interest in the retailer's future inventory that relates back to the original security agreement and financing statement.¹¹³ This future security interest has equal status with the security interest in the original collateral.¹¹⁴ Because the floating lien allows an inventory financier to make future advances without fear of intervening security interests, it speeds the flow of credit and, consequently, benefits the debtor as well as the inventory financier.

The floating lien, however, also provides an opportunity for creditor overreaching.¹¹⁵ Because the lien subordinates intervening interests, subsequent creditors will not rely on the burdened inventory as collateral. As a result, an unscrupulous inventory financier may be able to wrench unfair concessions from the debtor by threatening to dry up the line of credit.¹¹⁶

Article 9 recognizes this potential for abuse and attempts to safeguard the debtor. Purchase money secured parties,¹¹⁷ for example, can subordinate the inventory financier's security interest in purchase money inventory.¹¹⁸ Allowing this subordination facilitates the debtor's search for additional inventory purchase money. The Code, however, does not leave inventory financiers completely at the mercy of debtors and purchase money secured parties. To take priority, not only must

111. U.C.C. § 9-204(1).

112. Property acquired by the debtor after the execution of a security agreement can serve as collateral for the debt if the parties so stipulate. The Code uses the term "after-acquired collateral" to describe the property subject to a floating lien. *Id.*

113. *See id.* (stating that the secured party need not obtain a supplemental agreement covering the new collateral).

114. U.C.C. § 9-204 comment 1.

115. *Id.*

116. *See supra* note 67.

117. U.C.C. § 9-107 defines a purchase money security interest as follows:
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.

118. U.C.C. § 9-312(3).

purchase money secured parties perfect, but they also must send written notice outlining their security interests to the inventory financier.¹¹⁹ These requirements ensure that the inventory financier has complete information on which to base decisions regarding future extensions of credit and other financing matters involving the debtor.¹²⁰ Thus, while the Code protects debtors by providing alternate avenues of financing, it also protects the inventory financier by requiring direct notification of potentially prior interests.

Section 9-308 also weakens the inventory financier's potential control over the debtor.¹²¹ If a purchaser of chattel paper meets the prerequisites of Section 9-308,¹²² the purchaser's interest subordinates a security interest held by an inventory financier. Thus, the Code helps advance the common goals of purchase money financing and chattel paper financing: infusing new value into the business community and avoiding the inventory financier's interest. Section 9-306(5) supplies the priority rules for returned and repossessed goods.

2. The Inventory Financier and Section 9-306(5)

Under Section 9-306(5)(a) an inventory financier regains a security interest in returned or repossessed goods, and the interest continues as a perfected security interest if a filed financing statement is still effective.¹²³ Section 9-306(5)(b), however, curtails the rights granted under subsection (5)(a) by granting a chattel paper financier a security interest in the same goods.¹²⁴ Furthermore, if the chattel paper financier meets the requirements of Section 9-308, then subsection (5)(b) deems his security interest prior to the inventory financier's interest.¹²⁵

Subsection (5)(d), however, circumscribes the rights subsection (5)(b) grants to the chattel paper financier. Subsection (5)(d) provides that a chattel paper financier must perfect its security interest to subordinate the interests of the retailer's other creditors or purchasers of the retailer's goods.¹²⁶ The courts, however, disagree about whether the inventory financier is a creditor or purchaser under subsection

119. U.C.C. § 9-312(3)(b)-(d).

120. U.C.C. § 9-312 comment 3.

121. See *supra* notes 70-85 and accompanying text.

122. See *supra* notes 70-79 and accompanying text.

123. U.C.C. § 9-306(5)(a). When goods financed by an inventory financier are sold to a buyer in the ordinary course of business, the buyer takes the goods free of the inventory financier's interest. U.C.C. § 9-307(1). If for any reason, however, the buyer returns the goods or the seller or the chattel paper financier repossesses them, § 9-306(5)(a) reinstates the inventory financier's security interest in the goods. U.C.C. § 9-306(5)(a).

124. U.C.C. § 9-306(5)(b).

125. *Id.*

126. U.C.C. § 9-306(5)(d).

(5)(d).¹²⁷

Without reference to the various policy justifications that some courts have used to alter general definitions of the Code when applied to specific sections,¹²⁸ the inventory financier is obviously a creditor of the retailer. Furthermore, careful analysis of the Code reveals that the inventory financier is also a purchaser of the returned or repossessed goods.¹²⁹ Section 1-201(33) defines a purchaser as one who takes by purchase,¹³⁰ and Section 1-201(32) defines "purchase" as a voluntary transaction creating an interest in property.¹³¹ The inventory financier's security interest arises from a voluntary transaction that creates a property interest in the retailer's inventory¹³² and, pursuant to Section 9-306(5)(a), an interest in returned or repossessed goods. As a result, an inventory financier is a purchaser of returned or repossessed goods.¹³³ Consequently, a strict reading of Section 9-306(5)(d) leads to the conclusion that an inventory financier is both a creditor and a purchaser. The split among the courts turns on whether policy considerations merit an alteration in the general definitions of creditor and purchaser in order to exclude inventory financiers from subsection (5)(d).

IV. INTERPRETATION OF SECTION 9-306(5)(d) BY THE COURTS

Commentators agree that an inventory financier is not a creditor or a purchaser within the meaning of Section 9-306(5)(d).¹³⁴ The courts, however, have divided when faced with the same issue. This section examines a representative case from each side of the split.

A. Chattel Paper Financier As Victor

In *Northwest Acceptance Corp. v. Lynnwood Equipment, Inc.*¹³⁵ the court resolved a priority dispute that arose between a perfected in-

127. See *supra* notes 15-19 and accompanying text.

128. See, e.g., *infra* subpart IV(A) (discussing the judicial justification for excluding inventory financiers from § 9-306(5)(d)).

129. See *In re Samuels & Co. Inc.*, 526 F.2d 1238, 1241 (5th Cir.) (en banc), cert. denied sub nom. *Stowers v. Mahon*, 429 U.S. 834 (1976) (observing that under a "meticulous and dispassionate reading" of the Code, one must conclude that a purchaser includes a secured creditor with a floating lien such as the inventory financier).

130. U.C.C. § 1-201(33).

131. U.C.C. § 1-201(32).

132. See U.C.C. § 9-102(2) (noting that contracts create Article 9 security interests).

133. All courts agree that an Article 9 secured creditor is a "purchaser" of the collateral under § 1-201(32)-(33) of the Code. See, e.g., *In re Bowman*, 25 U.C.C. Rep. Serv. (Callaghan) 738, 742-43 (Bankr. N.D. Ga. 1978); see also U.C.C. Case Dig. ¶ 1201.33 (Callaghan 1986).

134. See, e.g., 2 G. GILMORE, *supra* note 78, § 27.5; Barnes, *supra* note 6, at 367; Skilton & Dunham, *supra* note 6, at 805-06; Note, *Priority Contests Under Article 9 of the Uniform Commercial Code: A Purposive Interpretation of A Statutory Puzzle*, 72 VA. L. REV. 1155 (1986).

135. 1 U.C.C. Rep. Serv. 2d (Callaghan) 980, *aff'd on rehearing*, 1 U.C.C. Rep. Serv. 2d (Cal-

ventory financier and a chattel paper financier. Lynnwood Equipment (LEI) was a retail dealer of heavy logging and construction equipment.¹³⁶ Northwest Acceptance Corporation (Northwest) financed and had a perfected floating lien in all of LEI's inventory.¹³⁷ When LEI sold equipment, the transactions often resulted in chattel paper that Seattle-First Bank (Seattle-First) purchased. When a customer defaulted on the chattel paper, Seattle-First sometimes would repossess the equipment; otherwise, LEI would repossess and hold the equipment for resale.¹³⁸ Seattle-First, however, failed to perfect its interest in the repossessed goods held by LEI.¹³⁹ Northwest brought suit to establish its priority in LEI's inventory and Seattle-First counterclaimed for priority in the goods that once were subject to its chattel paper, including priority in the equipment that had given rise to the defaulted chattel paper.¹⁴⁰

The court addressed the issue of priority under subsection (5)(d) in two separate opinions: *Northwest I*¹⁴¹ and *Northwest II*.¹⁴² In *Northwest I* the court acknowledged that the outcome of the dispute turned on the court's interpretation of subsection (5)(d) and addressed the question of whether Northwest was a creditor under Section 9-306(5)(d) of the Code.¹⁴³ Relying primarily on a treatise by Professor Grant Gilmore which concluded that subsection (5)(d) excluded inventory financiers, the court held that, for the purposes of subsection (5)(d), Northwest was not a creditor of LEI.¹⁴⁴

In *Northwest II* the court addressed whether Northwest was a purchaser of the goods under subsection (5)(d).¹⁴⁵ The court acknowledged that, under some circumstances, an inventory financier may be a purchaser of returned goods under Article 2,¹⁴⁶ but found that, for purposes of subsection (5)(d), the definition of purchasers excluded inventory

laghan) 1710 (W.D. Wash. 1986), *aff'd on other grounds*, 841 F.2d 918 (9th Cir. 1988).

136. 1 U.C.C. Rep. Serv. 2d (Callaghan) at 982.

137. *Id.* at 981.

138. *Id.* at 982.

139. The court actually did not reach the issue of whether Seattle-First perfected its interest in the goods repossessed by LEI. *Id.* at 982 n.3. The court indicated that even if Seattle-First was unperfected the resolution of the case would be the same. *Id.* Therefore, the court implicitly assumed that Seattle-First was unperfected, the worst-case scenario for Seattle-First, when determining priority in the goods.

140. *Id.* at 980-81.

141. *Id.* at 980.

142. 1 U.C.C. Rep. Serv. 2d (Callaghan) 1710.

143. 1 U.C.C. Rep. Serv. 2d (Callaghan) at 983-84.

144. *Id.* at 984. The court referred to G. GILMORE, *supra* note 78.

145. 1 U.C.C. Rep. Serv. 2d (Callaghan) at 1710-11 & n.1.

146. *Id.* at 1711 n.1.

financers.¹⁴⁷ The court based its conclusion on the Code's goal of facilitating chattel paper financing and discounted the danger that secret liens may dupe inventory financiers into giving new value based on collateral already encumbered by an unknown chattel paper financier.¹⁴⁸ Instead, the court believed that inventory financiers were in a position to monitor the secured inventory, and, thus, that inventory financiers bore the risk if they extended value based on encumbered inventory.¹⁴⁹

B. Inventory Financer As Victor

In *Crocker National Bank v. Clark Equipment Credit Corp.*¹⁵⁰ the Eighth Circuit reached the opposite conclusion. Doyle-Lunstra Equipment Company (DLE) was a retailer of heavy equipment.¹⁵¹ Clark Equipment Credit Company (Clark) was DLE's inventory financier.¹⁵² DLE's sales of inventory frequently produced chattel paper and Credit Alliance Corporation (Alliance) provided secondary financing to DLE by purchasing the chattel paper.¹⁵³

DLE sold a loader on credit, and Alliance purchased the chattel paper from the sale.¹⁵⁴ Eventually, the buyer defaulted, and Alliance repossessed the loader and returned it to DLE.¹⁵⁵ Alliance did not file a financing statement covering the loader¹⁵⁶ and, therefore, had an unperfected security interest. After taking control of DLE's inventory, however, Clark had a perfected interest in the loader.

In determining who had priority in the loader, the court focused its analysis on subsection (5)(d) and noted that commentators, including Professor Gilmore, had interpreted subsection (5)(d) to exclude inventory financiers.¹⁵⁷ The court, however, found that interpretation of the Code by commentators, although instructive, could not prevail over the plain wording of the statute.¹⁵⁸ Subsection (5)(d) protected creditors of DLE from Alliance's unperfected interest.¹⁵⁹ Because Clark was a creditor of DLE, the court concluded that, under subsection (5)(d), Clark's (the inventory financier's) perfected interest subordinated Alliance's

147. *Id.*

148. *Id.* at 1711; see *supra* notes 61-83 and accompanying text.

149. *Id.* at 1711.

150. 724 F.2d 696 (8th Cir. 1984). *Crocker* involved disputes over a number of items involving various parties. This Note examines only the priority dispute between Alliance and Clark.

151. *Id.* at 697.

152. *Id.*

153. *Id.*

154. *Id.* at 699.

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.* at 700.

(the chattel paper financier's) unperfected interest.¹⁶⁰ Professor Barnes describes the court's approach as the plain meaning interpretation of subsection (5)(d).¹⁶¹

V. RULES OF THE GAME: INTERPRETING SECTION 9-306(5)

Professor McDonnell has stated that judicial interpretation based on strict adherence to the plain meaning of a Code section amounts to judicial legislation aimed at effectuating the court's goals, not the Code's goals.¹⁶² He recommends an interpretation of the Code that seeks the underlying purposes of each particular section as revealed by statutory language, the Official Comments, and statutory history.¹⁶³ Other commentators, however, employ a more expansive interpretation that includes inquiry into the overall purposes of the Code.¹⁶⁴ This section examines both methods of analysis. This section also investigates the implications of the Bankruptcy Code in the interpretation of Article 9. Finally, this section considers the continuing influence of Professor Gilmore in current interpretations of Section 9-306(5).

A. Influences Under the Code

1. Exploring Statutory Language and the Official Comments

This analysis focuses on Sections 9-306(5) and 9-308, which Section 9-306(5)(b) incorporates by reference. Clearly, the primary purpose of Section 9-308 is to develop a secondary financial market based on the negotiable elements of chattel paper.¹⁶⁵ Subordination of the primary financial interest, that of the inventory financier, is the natural outgrowth of Section 9-308's developmental purpose.¹⁶⁶ Section 9-306(5)'s purpose, however, is not as clear.

Section 9-306(5) attempts to preserve the priority relationships established in Section 9-308.¹⁶⁷ Subsection (5)(b) provides that the Section 9-308 chattel paper financier's security interest in returned or repossessed goods is prior to the inventory financier's security interest in the same goods.¹⁶⁸ This subsection benefits the chattel paper financier

160. *Id.*

161. See Barnes, *supra* note 6, at 382.

162. McDonnell, *Purposive Interpretation of the Uniform Commercial Code: Some Implications for Jurisprudence*, 126 U. PA. L. REV. 795, 853 (1978) (positing that courts following the "plain meaning" of the Code actually are engaging in "surreptitious judicial legislation").

163. *Id.* at 853-54.

164. *E.g.*, Note, *supra* note 134, at 1167.

165. See *supra* subpart III(A)(1).

166. See *supra* note 81 and accompanying text.

167. U.C.C. § 9-306(5)(b) comment 4.

168. U.C.C. § 9-306(5)(b); see also *supra* note 45.

by facilitating the growth of a secondary market in chattel paper and, thus, reinforces the purpose of Section 9-308. The Official Comments to Section 9-306(5) further reinforce this purpose by acknowledging that Section 9-308 governs the priority rights in returned or repossessed goods.¹⁶⁹ Although the Official Comments fail to indicate whether the chattel paper financier must perfect its interest in order to protect its position over the inventory financier, subsection (5)(d) indicates that the chattel paper financier must perfect to retain priority.¹⁷⁰

Critics of this interpretation argue that allowing inventory financiers to gain priority in returned goods under Section 9-306(5)(d) destroys the effect of Section 9-306(5)(b).¹⁷¹ Certainly, any interpretation of subsection (5)(d) that nullifies subsection (5)(b) is untenable because such an interpretation would reduce subsection (5)(b) to surplusage. Nevertheless, one must question whether including inventory financiers within the definition of a subsection (5)(d) creditor or purchaser truly renders subsection (5)(b) meaningless.

Some commentators, and arguably the drafters of Article 9, believe that returned or repossessed goods are neither proceeds of the chattel paper nor embodied in the chattel paper.¹⁷² Under this view, absent the provisions of subsection (5)(b), the chattel paper financier would not have an interest in returned or repossessed goods in the dealer's possession. Subsection (5)(b) grants the chattel paper financier its security interest in these goods and this grant remains in place whether or not subsection (5)(d) includes inventory financiers.

Subsection (5)(b) also alters the general rule of priority among perfected creditors. Normally, the perfected party that is first to file or was first to perfect has priority.¹⁷³ Subsection (5)(b), however, deems a perfected chattel paper financier's security interest first in time even when an inventory financier's perfected interest actually arose first and, therefore, allows a perfected chattel paper financier to subordinate a preexisting perfected inventory financier.¹⁷⁴ Without subsection (5)(b) the priorities would reverse.¹⁷⁵ In this way, subsection (5)(b) continues to play a role in the general framework of Section 9-306(5) whether or not subsection (5)(d) includes the inventory financier. Thus, the plain mean-

169. *Id.* at comment 4.

170. *See supra* notes 130-33 and accompanying text.

171. *See, e.g.,* Note, *supra* note 134, at 1165 (arguing that subsection (5)(b) expressly provides that chattel paper financiers meeting § 9-308's requirements always subordinate an inventory financier).

172. *See supra* notes 103-10 and accompanying text.

173. *See* U.C.C. § 9-312(5).

174. U.C.C. §9-306(5)(b).

175. U.C.C. § 9-312(5). Without subsection (5)(b), the prior in time, prior in right provisions of § 9-312(5) would govern the rights of the parties.

ing interpretation of Section 9-306(5)(d) need not destroy the efficacy of subsection (5)(b).

Critics of the plain meaning approach also argue that the plain meaning interpretation of subsection (5)(d) disrupts the growth of secondary markets in chattel paper.¹⁷⁶ If this is true, then the better interpretation of subsection (5)(d) certainly would exclude the inventory financier. An interpretation of subsection (5)(d) that includes inventory financiers, however, appears to have no such negative effect on the prudent chattel paper financier.

Reasonable business practice mandates that chattel paper financiers file whether or not the inventory financiers fall within subsection (5)(d), and a prudent chattel paper financier will file a financing statement under the dealer's name describing the underlying goods as soon as the chattel paper transaction begins.¹⁷⁷ Filing protects chattel paper financiers from subordination by other interests. If, for example, a judicial lien covers the dealer's inventory, the lien creditor immediately subordinates the unperfected chattel paper financier's rights in goods returned to the dealer.¹⁷⁸ Delayed filing also may lead to a preference problem in bankruptcy.¹⁷⁹ Thus, immediate filing should be a standard business practice, and the interpretation of subsection (5)(d) should not alter the chattel paper financier's commercially reasonable course of conduct. The restrictive interpretation of subsection (5)(d) merely shelters negligent chattel paper financiers from some of the adverse consequences of failing to file. This is hardly the purpose of Section 9-306(5) or the Code.¹⁸⁰ The plain meaning interpretation of subsection (5)(d) better accords with the purposes of Section 9-306(5).

2. Article 9 and the Code Purposes Applicable to Section 9-306(5)

The overarching aim of Article 9 is to provide a simple and unified structure within which secured transactions can go forward with in-

176. See, e.g., *Crocker Nat'l Bank v. Clark Equip. Credit Corp.*, 724 F.2d 696, 700 n.3 (8th Cir. 1984). In an unusual move, Chief Judge Lay, the author of the majority opinion in *Crocker*, dissented from one point in his own opinion in a footnote. The judge stated that allowing subordination of an unperfected chattel paper financier would add elaborate procedures and expense to the financier's transaction costs. For a discussion of *Crocker*, see *supra* subpart IV(A).

177. See 2 G. GILMORE, *supra* note 78, § 27.5, at 738 (observing that good business practice requires the chattel paper financier to file a financing statement covering returned or repossessed goods in order to be protected from other creditors of the debtor).

178. Subsection (5)(d) clearly gives a lien creditor priority over the unperfected chattel paper financier. U.C.C. § 9-306(5)(d); see also *Skilton & Dunham*, *supra* note 6, at 845-47.

179. See Note, *supra* note 134, at 1173-75.

180. As a general rule of priority, failure of a secured creditor to follow the rules of perfection results in subordination to a competing perfected creditor. U.C.C. § 9-312(5). Therefore, to hold that a negligent creditor deserves priority runs counter to the basic priority principle of the Code.

creased certainty and diminished cost.¹⁸¹ To achieve unity the drafters replaced the hodgepodge of pre-Code financing statutes with an Article applicable to all secured transactions in personal property and fixtures.¹⁸² To increase certainty and decrease cost the drafters supplied a "liberal sprinkling of hard and fast rules" so that a financier could determine its rights in a projected loan quickly and easily.¹⁸³ Because priority affects the financier's allocation of risks, clear and concrete rules are well suited to Article 9's priority provisions.¹⁸⁴ Nevertheless, clarity evaporates when courts divide over the meaning of a Code section. To benefit the business community, courts should strive toward uniformity when selecting an appropriate method of interpretation.

a. Where to Find a Code Purpose: The Conflict Among Uniformity, Policy, and Equity

The Code seeks to unite the commercial law.¹⁸⁵ A unified system of law decreases administrative costs by permitting financiers to lend money without undergoing the onerous and expensive task of familiarizing themselves with the laws of numerous states. A unified system also increases certainty because the financier is better able to gain mastery over a single system of law than the numerous individual systems that the drafters of the Code designed it to replace. Despite the Code's overarching goal of uniformity,¹⁸⁶ independent judicial systems still must administer it in the varying forms enacted by the states.¹⁸⁷ The inability of any one court to make interpretations binding in all jurisdictions places limits on the Code's aspirations of unity.

Helping to counteract these obstacles, the Code has several features that promote unity. The general structure of the statute confines the interpretations of the various jurisdictions¹⁸⁸ and averts some fundamental differences in the law of secured transactions. Independent judicial interpretations of the Code still may lead to variations in the

181. U.C.C. § 9-101 comment.

182. *Id.*; see also U.C.C. § 9-102 (defining the scope of Article 9).

183. Everett, *Securing Security*, 16 LAW & CONTEMP. PROBS. 49, 52 (1951).

184. See *id.* at 51 (stating that a financier should be able to calculate rapidly his rights in a projected loan and that concrete rules aid this purpose).

185. U.C.C. § 1-102(2)(c) (stating that the Code's "underlying purposes and policies . . . are . . . to make uniform the law among the various jurisdictions").

186. *Id.*; see also U.C.C. § 1-102(2)(a) (stating that the Code's underlying purpose is to "simplify, clarify, and modernize" commercial law).

187. In some sections, the Code includes various options from which state legislatures may select. See, e.g., U.C.C. § 9-401(1), (3) (providing options for determining the proper place to file security interests). Furthermore, because legislative adoptions of the Code are state law, each state judiciary is free to interpret the Code independently.

188. Each court must begin at the same starting point—the statute itself. Therefore, to some degree, the Code restrains variations in the commercial law.

law, however. To minimize divergent interpretation, the drafters provided the Official Comments in addition to the text of the statute¹⁸⁹ to serve as a uniform guidepost for interpretation. In appropriate instances, the Appendix also reviews prior law that the Code has altered, and, when the Code has been amended, the Appendix generally enumerates the reasons for the changes.¹⁹⁰ Therefore, to some degree, the Appendix helps provide a uniform statutory history of the Code. Employing a method of interpretation that coordinates these features of the Code enhances its uniform interpretation and application.¹⁹¹

In addition to these uniform elements of interpretation, some courts and commentators also examine the commercial policies underlying a particular Code section.¹⁹² Some courts, for example, have relied on specifically tailored policy considerations in interpreting Section 9-306(5).¹⁹³ Generally, the policy considerations chosen reflect a court's view of an equitable interpretation of subsection (5).

A method of interpretation that attempts to achieve equity, however, often invites fragmented decisionmaking and damages uniformity. Contemplations of fairness vary from judge to judge, and interpretations driven by equitable policies will vary in similar fashion. One should question whether equitable policy considerations actually do equity in the commercial law environment.

In a commercial environment an equitable approach should focus on a method of interpretation that allows the business community to predict accurately how a rule of law will operate.¹⁹⁴ Accurate predictions, however, are difficult to make when policy considerations chosen by the courts alter, rather than affect, the clear meaning of a Code sec-

189. For a discussion of the legal effects of the Official Comments, see Skilton, *Some Comments on the Comments to the Uniform Commercial Code*, 1966 Wis. L. Rev. 597, 598-606.

190. See COMMERCIAL & DEBTOR-CREDITOR LAW: SELECTED STATUTES 907-62 (D. Baird, T. Eisenberg & T. Jackson eds. 1989) (enumerating the reasons for the 1972 amendments to the Code).

191. See McDonnell, *supra* note 162, at 853-54 (formulating an interpretive approach to the Code that focuses on the underlying purposes of specific sections).

192. See Note, *supra* note 134, at 1165-73 (expanding on the purposive approach by considering the Code's normative goals).

193. See *Crocker Nat'l Bank v. Clark Equip. Credit Corp.*, 724 F.2d 696, 700 n.3 (8th Cir. 1984) (acknowledging that "[i]f this risk were not on the inventory financier, chattel paper purchasers . . . would be forced to go through elaborate and expensive auditing procedures"); *Northwest Acceptance Corp. v. Lynnwood Equip., Inc.*, 1 U.C.C. Rep. Serv. 2d (Callaghan) 1710, 1711 (W.D. Wash. 1986) (stating that the "underlying rationale of the Uniform Commercial Code [is] to protect the chattel paper holder who has given new value"); see also Note, *supra* note 134, at 1172-73 (maintaining that the inventory financier "has a comparative advantage in monitoring the debtor's activities") *aff'd on other grounds*, 841 F.2d 918 (9th Cir. 1988).

194. As Judge Frank Easterbrook has observed: "Rules of law affecting parties to voluntary arrangements do not operate 'inequitably' in the business world—at least not once the rule is understood. Prices adjust." *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186, 1198 (7th Cir. 1989) (emphasis added).

tion and its Official Comments. An interpretation of the Code that emphasizes its statutory language and the Official Comments best enhances uniformity and, ultimately, commercial equity. Nevertheless, interpretations of subsection (5)(d) continue to turn on individual judicial impressions of underlying financial policies.¹⁹⁵ Therefore, a thorough analysis of Section 9-306(5) requires an examination of the purposes and policies that supposedly merit the subordination of the perfected inventory financier under subsection (5)(d).

b. Subordinating Secret Liens: The Primacy of Perfected Security Interests

At the heart of Article 9 is its use of notice requirements to eliminate the threat of ostensible ownership.¹⁹⁶ Because a creditor who perfects through pledge or effective filing provides notice of its interest to other creditors, subsequent creditors can take the prior interest into account when determining whether to extend credit and on what terms.¹⁹⁷ A secured creditor who does not supply notice, however, holds a secret lien and, thus, has an unperfected interest.¹⁹⁸ A fundamental rule of priority is that perfected security interests subordinate unperfected security interests.¹⁹⁹ This rule increases certainty in the collateral because it assures perfected creditors of their priority over secret lien holders. The plain view interpretation of subsection (5)(d) adopts this reasoning.²⁰⁰

When the unperfected chattel paper financier has not given constructive notice of its interest in returned goods, through either filing or possession of the goods, the inventory financier has no independent means of discovering the chattel paper financier's interest, and the chattel paper financier has a secret lien. Under the plain view interpretation the inquiry would end here, and the perfected interest would prevail.²⁰¹ For various policy reasons, however, some courts have concluded that the inventory financier does not require the notification rights enjoyed by all other creditors of the retailer and, with respect to inventory financiers, have inverted the general rule that perfected security inter-

195. See sources cited *supra* note 193.

196. See Llewellyn, *Problems of Codifying Security Law*, 13 LAW & CONTEMP. PROBS. 687, 697-99 (1948) (arguing in favor of a notification filing system as the centerpiece of a uniform security law).

197. See *supra* subpart II(A).

198. See *supra* notes 29-36 and accompanying text.

199. U.C.C. § 9-301(1)(a) & comment 2.

200. The inventory financier should not be subordinated by a possibly unknown lien when the inventory financier was not given constructive notice through possession of the goods by the chattel paper financier or through filing.

201. See cases cited *supra* note 17.

ests subordinate unperfected security interests.²⁰²

The courts base this abnormal subordination on the unique status of the inventory financier.²⁰³ Many inventory financiers maintain a great deal of control over the debtor and the collateral.²⁰⁴ The financier is often in a position to know of the debtor's activities even when the debtor gives no formal notice. This situation leads courts and commentators to conclude that an inventory financier knows of a chattel paper financier's rights in returned goods whether or not the latter has perfected.²⁰⁵ Under this view inventory financiers do not require constructive notice because of their superior position and their supposed ability to guard against unperfected interests.²⁰⁶

This reasoning, however, contains several flaws. First, until a court alters a Code section through policy interpretation, creditors are likely to rely on the plain meaning of the statute. Even inventory financiers who know of the chattel paper financier's interest may not allocate against the risk of subordination until after an initial court decision grants priority to the unperfected chattel paper financier.²⁰⁷ Second, the conclusion that all inventory financiers have complete control over the debtor and awareness of the debtor's activities is an overgeneralization. Nothing requires the inventory financier to take the debtor's collateral hostage, and the degree of control over the debtor will vary from case to case.²⁰⁸ The conclusion that all inventory financiers have de facto notice of an unperfected interest is simply incorrect. Finally, the history of the Code reveals its intent that a perfected security interest should subordinate an unperfected security interest even when the perfected party has knowledge of the competing interest.²⁰⁹ Therefore, the discussion of subsection (5)(d) should not end with the conclusion that inven-

202. See sources cited *supra* note 193.

203. See *Crocker Nat'l Bank*, 724 F.2d at 700 n.3 (stating that the inventory financier merits this detrimental treatment because it is better able to guard against the risk of subordination); *Northwest Acceptance Corp.*, 1 U.C.C. Rep. Serv. 2d (Callaghan) at 1711 (maintaining that "the inventory financier is in a position to monitor the inventory when it is returned or repossessed and can thus protect against the danger" of the secret lien); see also Note, *supra* note 134, at 1172-73 (arguing that "[b]ecause the [inventory financier] literally holds the debtor's assets 'hostage,' he has a comparative advantage in monitoring the [dealer's] activities . . . that gives rise to priority contests").

204. See *supra* notes 63-69 and accompanying text.

205. See sources cited *supra* note 203.

206. See sources cited *supra* note 203.

207. In other words, until each jurisdiction has interpreted subsection (5)(d), inventory financiers may be unable to determine their rights in returned or repossessed goods.

208. See Note, *supra* note 134, at 1172 (describing the inventory financier as holding the collateral "hostage"). One must remember that inventory financiers may vary widely in sophistication and experience. An inventory financier can be anyone: a bank, a relative, or a nonprofit group. All that is needed is money and a security interest.

209. See *infra* notes 248-49 and accompanying text.

tory financiers lose priority simply because they may have knowledge of an unperfected interest. Instead, the Article 9 sleuth should investigate the priority relationships between the inventory financier and other creditors in order to determine whether the drafters of the Code actually intended to dilute the notification rights of the inventory financier.

Purchase money financiers, like chattel paper financiers, are able to subordinate the inventory financier's interest in certain pieces of collateral.²¹⁰ If the restrictive interpretation of subsection (5)(d) is sound, then the inventory financier knows of the purchase money financier's interest, regardless of filing, because the inventory financier has complete control over the collateral. Under this reasoning, inventory financiers always can protect themselves from unknowingly advancing undersecured credit. Thus, purchase money financiers should not have to perfect their interests to subordinate the inventory financier. The Code, however, rejects this conclusion.²¹¹

Under Section 9-312(3)(a) the purchase money financier must perfect its security interest before the debtor takes possession of the collateral or the inventory financier subordinates the purchase money financier's interest.²¹² The purchase money financier also has other responsibilities. Under Section 9-312(3)(b) the purchase money financier must send written notification of its conflicting security interest to the inventory financier,²¹³ and if the purchase money financier fails to provide notice, the inventory financier subordinates even a perfected purchase money financier.²¹⁴ The extra notification requirement reflects the Code's fear that an inventory financier, relying on its floating lien, will not recheck the filing offices before making future advances to the debtor.²¹⁵ These special notification requirements protect the inventory financier from making undersecured advances.²¹⁶ The framework of the Code, therefore, supports the view that the inventory financier requires greater notification rights than other creditors.²¹⁷

210. U.C.C. § 9-312(3) (providing that "a perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory").

211. U.C.C. § 9-312(3)(a).

212. *Id.*

213. U.C.C. § 9-312(3)(b). The purchase money financier must give notice before the date of filing or the beginning of a temporary perfection period. *Id.* Furthermore, the inventory financier must receive the notice at least five years before the debtor takes possession of the purchase money collateral. § 9-312(3)(c). The notice must describe the affected collateral by item or type. § 9-312(3)(d).

214. U.C.C. § 9-312(3). Nevertheless, a perfected purchase money interest that arises before the inventory financier perfects its interest still subordinates the inventory financier. U.C.C. § 9-312(3)(a).

215. U.C.C. § 9-312 comment 3.

216. *Id.*

217. In addition to the purchase money secured parties, consignors who would have a prior-

The policy conclusion that an inventory financier does not merit even constructive notice from the chattel paper financier is misguided. The drafters structured the Code to safeguard the inventory financier from an overreliance on the collateral. By eliminating the requirement of perfection by the chattel paper financier, courts strip away all the inventory financier's rights to notification by chattel paper financiers. Clearly, this result is at odds with the special treatment afforded the inventory financier elsewhere in the Code. While the plain meaning of subsection (5)(d) does not provide for written notification, it at least supplies the basic notification rights currently enjoyed by all other creditors. The better interpretation would place the inventory financier within the protection of subsection (5)(d).

c. Allocation of Risks and Circularity

The Code's aversion to the secret lien stems from Article 9's goal of enhanced certainty in the allocation of business risks.²¹⁸ The secret lien, however, is not the only enemy of certainty. When a circularity of rights occurs, certainty also is lost.²¹⁹ A modification of the introductory example²²⁰ helps explain the problems presented by circularity. Suppose that before Inventory Finance had an opportunity to repossess the bulldozers, Judgment Time Supply Co. (Judgment), a general creditor of Dealer, obtained a judgment lien covering Dealer's inventory, including the six returned bulldozers.²²¹ Thus, three parties—Inventory Finance, Paper Finance, and Judgment—now claim priority in the six bulldozers. If the court holds that the subsection (5)(d) definition of creditor or purchaser excludes inventory financiers, such as Inventory Finance, then Paper Finance subordinates Inventory Finance. Judgment, however, is clearly a creditor of Dealer. Since Paper Finance did not perfect its interest in the six bulldozers, Judgment's lien has priority over Paper Finance's security interest. Inventory Finance's perfected security interest, however, has priority over Judgment's lien because Inventory Finance filed before the lien arose. Consequently, Inventory Finance beats Judgment, Judgment beats Paper Finance, and Paper Finance beats Inventory Finance. The priorities circle; all parties have both won

ity interest in the dealer's inventory must also take perfection-like steps and give notification to the inventory financier. U.C.C. §§ 2-326(3), 9-114.

218. Barnes, *supra* note 6, at 407.

219. See 2 G. GILMORE, *supra* note 78, § 39.1, at 1020-21 (observing that the problem of circularity has caused a great deal of commentary; yet the courts have rejected various solutions). Professor Gilmore compares the judge faced with circularity to "a bull who has been goaded by the picadors: he paws the ground and roars with rage." *Id.*

220. See *supra* notes 7-15 and accompanying text.

221. See U.C.C. § 9-301(3) (defining lien creditors).

and lost.

The proceeds from the six bulldozers will not satisfy all three creditors. The creditors must untangle their intertwined priorities in order to determine the amount each party will receive from the collateral. If the creditors cannot reach agreement on a priority scheme, then litigation is likely. Unfortunately, the courts have not developed a uniform solution to circular priorities.²²² Furthermore, judges often are unable to find an equitable way to determine priority when the priorities circle.²²³ Protracted, costly litigation may ensue, and thus circularity decreases certainty and increases cost, which is the inverse of Article 9's goal. The better interpretation of the Code would eliminate circularity. Under the plain meaning approach Inventory Finance subordinates Judgment as well as Paper Finance.²²⁴ Thus, the plain meaning approach avoids circularity and better fulfills the Code's goals.

B. *The Bankruptcy Code's Effect on Section 9-306(5)(d)*

Bankruptcy courts routinely settle priority disputes. Therefore, an examination of the effect of bankruptcy law on subsection (5)(d) can provide guidance in determining whether a perfected inventory financier should subordinate an unperfected chattel paper financier.²²⁵

In bankruptcy the trustee has the status of a lien creditor over all the debtor's property.²²⁶ The trustee also may step into the shoes of an existing unsecured creditor in order to avoid a competing security interest.²²⁷ To explore the trustee's effect on the subsection (5)(d) priority dispute, another modification of the introductory example²²⁸ will be helpful.

Assume that before Inventory Finance had an opportunity to repossess, Dealer filed for Chapter 7 liquidation.²²⁹ Upon filing, the bankruptcy trustee obtains the status of a lien creditor over all of Dealer's

222. See 2 G. GILMORE, *supra* note 78, § 39.2, at 1023 (noting that "[t]here has never been agreement on the correct solution of circular systems which arise . . . from . . . inconsistent rules of priority").

223. *Id.* § 39.1, at 1020-21 (noting that judges have great difficulty administering circular priorities).

224. See U.C.C. § 9-312(5).

225. See Note, *supra* note 134, at 1173-76 (examining the trustee's role in § 9-306(5)(d)).

226. 11 U.S.C. § 544(a)(1) (1988).

227. 11 U.S.C. § 544(b). The trustee's avoiding powers allow the trustee to assume the status of any existing unsecured creditor, and the trustee may use this status to subordinate any interest the secured creditor could avoid. *Id.*

228. See *supra* notes 7-15 and accompanying text. During a liquidation under Chapter 7 of the Bankruptcy Code, a trustee collects and disposes of the debtor's assets and distributes the proceeds to the creditors. 11 U.S.C. § 704.

229. 11 U.S.C. §§ 701-766.

property.²³⁰ Subsection (5)(d) applies to the trustee, as a creditor of Dealer. Thus, Paper Finance must have perfected its interest in order to protect its collateral from the trustee's competing claim, and the trustee subordinates unperfected Paper Finance. The trustee, exercising its avoiding powers, now may assume Paper Finance's rights against Inventory Finance.²³¹ If the plain meaning of subsection (5)(d) applies, Inventory Finance subordinates the trustee as both a lien creditor and as the embodiment of Paper Finance.²³² Therefore, Inventory Finance has the primary interest. If, however, subsection (5)(d) excludes Inventory Finance, the trustee, through its avoiding powers, can use Paper Finance's rights to subordinate Inventory Finance.²³³ As a result, to the extent of Paper Finance's interest, the trustee has complete priority. Consequently, courts and commentators who argue for the exclusion of inventory financiers from subsection (5)(d) in order to benefit chattel paper finance once again are misguided. Under bankruptcy law the creditors who benefit from the restrictive interpretation of subsection (5)(d) are the unsecured creditors. This interpretation both harms Inventory Finance and fails to benefit Paper Finance. With an eye to bankruptcy, a plain meaning interpretation of subsection (5)(d) once again is preferable.

C. *The Power of Professor Grant Gilmore*

Professor Gilmore's treatise on secured transactions²³⁴ has influenced, and continues to influence, the courts' interpretations of Section 9-306(5).²³⁵ In his treatise Professor Gilmore concluded that subsection (5)(d) should exclude inventory financiers.²³⁶ Unfortunately, the courts and commentators embracing Professor Gilmore's conclusion have ignored the reasoning Professor Gilmore used to reach the conclusion. In doing so, these courts and commentators have failed to notice that the 1972 amendments to the Code soundly rejected Professor Gilmore's rea-

230. 11 U.S.C. § 544(a)(1).

231. 11 U.S.C. § 544(b); *see supra* note 227.

232. Inventory Finance subordinates the trustee's lien because Inventory Finance filed before the lien arose. *See* U.C.C. § 9-312(5) (setting forth the first in time first in right rule). Furthermore, under the plain meaning of subsection (5)(d), Paper Finance does not subordinate Inventory Finance. Therefore, the trustee gains no additional powers by stepping into Paper Finance's position.

233. As a lien creditor the trustee's interest still is subordinated. *Id.* The trustee, however, can now use Paper Finance's subsection (5)(b) rights to subordinate Inventory Finance. *See* U.C.C. § 9-306(5)(b); 11 U.S.C. § 544(b).

234. 2 G. GILMORE, *supra* note 78.

235. *See, e.g.,* J.I. Case Co. v. Borg-Warner Acceptance Corp., 669 S.W.2d 543, 546-47 (Ky. Ct. App. 1984) (quoting Professor Gilmore's treatise on secured transactions and reaching Professor Gilmore's conclusion that subsection (5)(d) excludes inventory financiers).

236. 2 G. GILMORE, *supra* note 78, § 27.5, at 738-39.

soning, thus casting doubt on his conclusion.

Professor Gilmore based his interpretation of subsection (5)(d) on his theory of lapse.²³⁷ A brief example illustrates the type of situation that gives rise to lapse. Creditor *A* has a perfected security interest and Creditor *B* has a junior perfected security interest in the same collateral. Creditor *A*'s financing statement lapses, leaving *A* unperfected.²³⁸ Before the 1972 amendments, the statutory language of the Code did not state expressly whether *A* lost priority to *B* after the lapse. The Official Comments, however, clearly stated that *B* prevailed.²³⁹ Professor Gilmore believed this conclusion was unjust and rejected the Comment.²⁴⁰

Under Professor Gilmore's theory of lapse, *A* retained priority over *B*.²⁴¹ Professor Gilmore believed that *B* had allocated its risks with knowledge of *A*'s senior interest and, thus, that *B* should not profit from *A*'s lapse.²⁴² Professor Gilmore buttressed his conclusion with an analogy to lien creditors.²⁴³ At that time a lien creditor could not subordinate an unperfected interest of which the lien creditor had knowledge.²⁴⁴ Professor Gilmore extrapolated that *B* should not subordinate *A* because *B* had knowledge of the interest.²⁴⁵ Professor Gilmore carried the reasoning over to his interpretation of subsection (5)(d).²⁴⁶ Because the inventory financier should have known of the chattel paper financier's senior interest in the paper, Professor Gilmore concluded that a lapse in the interest as to the returned goods should not alter the original priorities.²⁴⁷ Therefore, inventory financiers should take a subordinate interest because of their prior knowledge.

The 1972 amendments to Article 9 squarely reject Professor Gilmore's theory of lapse and, thus, the reasoning behind his interpretation of subsection (5)(d). First, the amendments to Section 9-403(2) expressly give priority to a junior creditor, Creditor *B*, upon lapse.²⁴⁸

237. *Id.* at 739. For Professor Gilmore's theory of lapse, see 1 G. GILMORE, *supra* note 78, § 21.6.

238. U.C.C. § 9-403(2).

239. U.C.C. § 9-403 comment 3 (1962).

240. 1 G. GILMORE, *supra* note 78, § 21.6, at 589.

241. *Id.*

242. *Id.* (comparing the ascendance of the junior interest to gambling, *i.e.*, "a game of roulette").

243. *Id.* at 590-91.

244. U.C.C. § 9-301(1)(b) (1962).

245. See 1 G. GILMORE, *supra* note 78, § 21.6, at 590-91.

246. 2 G. GILMORE, *supra* note 78, § 27.5, at 739.

247. *Id.*

248. The drafters amended § 9-403(2) to include the following language: "If the security interest becomes unperfected upon lapse, it is deemed to have been unperfected as against a person who became a purchaser or lien creditor before lapse." U.C.C. § 9-403(2). See COMMERCIAL &

The drafters, therefore, placed into the statutory language the gist of the Official Comment rejected by Professor Gilmore. Second, the amendments to Section 9-301(1)(b) expressly eliminate knowledge as a factor in subordinating a lien creditor.²⁴⁹ Thus, the premise of Professor Gilmore's analogy to the lien creditor no longer exists. The 1972 amendments to the Code have undermined Professor Gilmore's reasoning against the plain meaning of subsection (5)(d). Thus, a court that emphasizes Professor Gilmore's subsection (5)(d) policy conclusions is adopting reasoning that is no longer valid. Finally, the 1972 amendments re-emphasize the cardinal rule that a perfected security interest takes priority over an unperfected security interest.²⁵⁰ Consequently, the 1972 amendments to the Code offer indirect support for the plain meaning interpretation of subsection (5)(d).

VI. CONCLUSION

A chattel paper financier must perfect its interest in returned or repossessed goods for protection from creditors of the retailer or purchasers of the goods. Because the definitional sections of the Code define an inventory financier as both a creditor and a purchaser, a strict interpretation of Section 9-306(5)(d) would include the inventory financier. If all courts followed a plain meaning interpretation, the split in authority over subsection (5)(d) would not have occurred, but both commentators and the courts have resisted the plain meaning method of interpretation. At the heart of this view of statutory interpretation is a belief that the drafters cannot give life to the purposes of the Code merely through its statutory language. Even if courts adopt a purpose method of interpretation, however, a perfected inventory financier should still subordinate an unperfected chattel paper financier. Inclusion of the inventory financier in subsection (5)(d) would eliminate the ostensible ownership problems that occur when the unperfected financier has priority. Subordination of the unperfected chattel paper financier also avoids circular priorities.

Predictions that the plain meaning of subsection (5)(d) will stunt chattel paper financing have proved to be unfounded. Reasonable business practice requires immediate filing as to the goods by the chattel paper financier regardless of the inventory financier's place within subsection (5)(d). Inclusion of the inventory financier will not alter the rea-

DEBTOR-CREDITOR LAW, *supra* note 190, at 950 (enumerating the changes in § 9-403(2) made by the 1972 amendments).

249. The 1972 amendments to § 9-301 eliminate knowledge as a factor in lien creditor priority. See COMMERCIAL & DEBTOR-CREDITOR LAW, *supra* note 190, at 923-24.

250. U.C.C. § 9-301 comment 2.

sonable chattel paper financier's course of conduct. Interpretations of subsection (5)(d) based on either the plain meaning or the purposes of the Code lead to the same conclusion: a perfected inventory financier subordinates an unperfected chattel paper financier's interest in returned or repossessed goods.

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