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The Priority Conflict Between a Purchase Money Security Interest and a Prior Security Interest in Future Accounts Receivable

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NOTES

The Priority Conflict Between a Purchase Money Security Interest and a Prior Security Interest in Fntnre Acconnts Receivable*

I. Introduction

Article 9 of the Uniform Commercial Code established an exhaustive scheme for the determination and control of security interest in personal property and fixtures[1] which is now the law of all but one of the states and the District of Columbia.[2] Not the least momentous of the provisions in Article 9 are those that govern priorities among conflicting security interests in the same collateral. The purpose of this inquiry is to examine the rules of priority that the U.C.C. provides for a conflict between the holder of a purchase money security interest in inventory and proceeds[3] and a holder of a prior security interest in accounts receivable.[4] Conflict between the security interests of suppliers and bankers is not uncommon in an economy where many businesses use both trade and bank financing.

In a typical business situation, a retailer finances his business by obtaining a loan from a bank. In order to secure the loan, the bank is given an assignment of the retailer's accounts receivable, both presently existing and arising in the future. Subsequently, the retailer purchases from a seller a quantity of inventory on credit. The parties agree that, as security for the outstanding purchase price, the seller will retain title to the merchandise. The conditional sales contract empowers the retailer to sell the inventory in the ordinary course of his business. As a protection to the seller in the case of sales, the

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1. Uniform Commercial Code § 9-101, Comment (1962 version) [hereinafter cited as U.C.C.].

2. Louisiana has not adopted the U.C.C.

3. Section 9-107 of the U.C.C. provides that "[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."

4. Section 9-106 of the U.C.C. defines an "account" as "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper."

retailer assigns to the seller any claim for the purchase price which he might acquire by future sale of the inventory. During the weeks that follow the retailer sells and delivers the inventory to numerous customers on credit. The principal issue of this investigation, to express it in terms of this factual situation, is as follows: should the holder of the security interest in accounts receivable or the subsequent holder of the purchase money security interest in inventory and proceeds have the superior claim to the accounts receivable representing the proceeds from the sale of the inventory?

The current provisions of the U.C.C. do not provide a clear solution to this problem, and in order to determine the proper solution, this note will briefly explore the historical background of both the purchase money security interest and accounts receivable financing in an effort to ascertain the policies underlying each. Thereafter, a consideration of possible solutions, including those utilized in non-U.C.C. jurisdictions, will be undertaken in an effort to determine what resolution of the conflict is most consistent with the underlying policies of the purchase money security interest and accounts receivable financing as carried forward in the U.C.C.

II. HISTORICAL BACKGROUND

The essential feature in the development of accounts receivable financing has been an effort to establish the integrity of book accounts as a workable type of collateral.[5] In the process, several different rules have developed governing accounts receivable financing. While this development naturally involved the question of priority between several assignees of the same accounts, it appears that the principal purpose of the rules was not to entrench particular priorities but to establish the validity of such an assignment in the first place. Certainly, this was the central concern of the development from 1925 on, when first *Benedict v. Ratner*[6] and then *Corn Exchange National Bank & Trust Co. v. Klauder*[7] threatened to bring an end to the effective use of accounts receivable as collateral. *Benedict v. Ratner* required that assignees of book accounts avoid a reservation in the assignor of dominion inconsistent with effective disposition of title.

5. For a detailed study of the development of the purchase money security interest, see G. OSBORNE, MORTGAGES (1951); Gilmore, *The Purchase Money Priority*, 76 HARV. L. REV. 1333 (1963).

6. 268 U.S. 353 (1925).

7. 318 U.S. 434 (1943).

Klauder, on the other hand, created the possibility that assignments of book accounts would be treated as voidable preferences under section 60(a) of the Bankruptcy Act[8] if perfection were not accomplished as against a good faith purchaser more than four months prior to the filing of a petition in bankruptcy. The reaction to the *Klauder* decision was an adoption of the so-called New York rule by those states that did not already follow it. The New York rule gave priority, as between several assignees of the same accounts receivable, to the one who was first in time regardless of whether notice had been given to the debtor of the subsequent assignee.[9] The fact that *Klauder* forced the wholesale adoption of new priority rules in many states supports the conclusion that the principal objective behind the development of accounts receivable financing was the legal recognition and security of such financing—the accompanying priority rules being but a necessary consequence of the principal undertaking.[10]

At the same time, the fundamental characteristic underlying the development of the purchase money security interest has been the establishment of a rule of priority—a rule that gives priority to a purchase money security interest even as against antecedent claims. As early as 1631,[11] the courts recognized that the purchase money security interest should be afforded a unique status. From the beginning there was little question but that a seller could take a security interest or mortgage covering property delivered to the purchaser. Consequently, the principal concern in the development of

8. As amended by the Chandler Act of June 22, 1938, § 60(a) of the Bankruptcy Act read: "A preference is a transfer, as defined by this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition in bankruptcy . . . the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class. For the purposes of subdivisions a and b of this section, a transfer shall be deemed to have been made at the time when it became so far perfected that no bona-fide purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein, and, if such transfer is not so perfected prior to the filing of the petition in bankruptcy. . . it shall be deemed to have been made immediately before bankruptcy." 318 U.S. at 435-36, *citing* 52 Stat. 840, 869-70, 11 U.S.C. § 96(a)(1)-(2) (1964).

9. *See, e.g.,* Williams v. Ingersoll, 89 N.Y. 508 (1882). *See also* MacDonald v. Kneeland, 5 Minn. 352 (1861); Meier v. Hess, 23 Or. 599, 32 P. 755 (1893); Brander, Williams & Co. v. Young, 12 Tex. 332 (1854); and Tingle v. Fisher, 20 W.Va. 497 (1882), where other courts adopted the New York rule.

10. For an account of the rash of so-called validation statutes that followed in the wake of the *Klauder* decision, see Craig, *Accounts Receivable Financing: A Reappraisal of Validation Statutes in Light of Amended 60 (a)*, 65 HARV. L. REV. 627 (1952).

11. *See* Nash v. Preston, 79 Eng. Rep. 767 (1631).

the purchase money security interest was not one of establishing the validity of the interest but of determining the position it should occupy in relation to other security interests in the same collateral. Because the purchase money secured party supplies his own collateral and because of the desirability of maintaining an unhindered flow of goods in the usual course of trade, a priority for the purchase money security interest has been recognized even as against antecedent claims.[12] The only real controversy in its development concerned the extent to which the purchase money priority should be given such recognition. Decisions on this point suggest that only in the very narrow class of cases where the property sold subsequently becomes attached to realty and is not susceptible of removal without serious harm to the freehold should the purchase money priority be denied. As for inventory, there appears to be no restriction whatsoever on a seller's right to take a purchase money security interest superior to all other claims of creditors.

The U.C.C. carries forward these fundamental policies underlying the development of both accounts receivable financing and the purchase money security interest. The U.C.C. recognizes the validity of a security interest in "any right to payment for goods sold."[13] Thus the principal purpose behind the development of accounts receivable financing—the establishment of book accounts as valid collateral—is preserved and continued under the U.C.C. and applies to future as well as existing accounts.[14] Likewise, the fundamental feature of the purchase money security interest as it finally developed under pre-U.C.C. law is provided for by sections 9-312(3) and (4) which give a purchase money secured party who follows the necessary steps priority over all competing security interests in the property sold. The potential for the conflict, however, is far from resolved by the U.C.C.'s many provisions governing priority of security interests.

III. The Uniform Commerical Code—Development of the Conflict

A. *Creation of a Security Interest in Existing and Future Accounts Receivable*

Prior to the U.C.C., the field of secured transactions was characterized by the development of a wide variety of security

12. *See* Holt v. Henley, 232 U.S. 637 (1914); Porter v. Pittsburgh Bessemer Steel Co., 122 U.S. 167 (1887); United States v. New Orleans R.R., 79 U.S. (12 Wall.) 362 (1871).

13. U.C.C. § 9-106.

14. *Id.* § 9-204(2)(d).

devices.[15] The pre-U.C.C. evolution of two of these—the purchase money security interest and accounts receivable financing—was examined in some detail since they constitute the focal point of the priority conflict to be examined and because the interests, as they finally developed, were, for the most part, incorporated into the general scheme of Article 9.[16]

Assuming the existence of an assignment of existing and future accounts receivable from the retailer to the bank in exchange for credit, the creation of a perfected security interest in accounts receivable requires adherence to several essential steps set forth in the Code.[17] To perfect a security interest in accounts, which the Code defines as "any right to payment for goods sold,"[18] the interest must attach, and all applicable steps required for perfection must be taken.[19] In the case of a security interest in accounts receivable, the step required for perfection is the filing of a financing statement[20] unless the assignment embraces only an insignificant part of the assignor's outstanding accounts.[21] Consequently, most assignments require such a filing if they are to be perfected. While a copy of the security agreement itself may be filed, the financing statement is adequate and requires only the signatures and addresses of the parties and a description of the collateral.[22] Any description that reasonably identifies the collateral is adequate for this purpose.[23]

Although the filing procedure is a fairly simple requirement and easily accomplished, the secured party will have no enforceable claim in any property to which the security interest has not attached.[24] There

15. The adoption of Article 9 was accompanied by the repeal of the Uniform Conditional Sales Act, Uniform Trust Receipts Act, and any acts regulating chattel mortgages, factor's liens or assignments of accounts receivable. U.C.C. § 10-102(1).

16. Under the U.C.C., the traditional distinctions among security devices were not retained. Article 9 applies to all transactions intended to create a security interest in personal property. *Id.* § 9-101, Comment. This does not abolish the pre-U.C.C. security devices such as the conditional sale, but simply makes it subject to the rules of Article 9. *Id.* § 9-102, Comment 2.

17. *Id.* § 9-102, Comment 2.

18. *Id.* § 9-106.

19. *Id.* § 9-303.

20. *Id.* § 9-302(1).

21. This exception "is to save from *ex post facto* invalidation casual or isolated assignments. . . . [Yet] [a]ny person who regularly takes assignments of any debtor's accounts should file." *Id.* § 9-302, Comment 5.

22. *Id.* § 9-402.

23. *Id.* § 9-110.

24. Girard Trust Corn Exch. Bank v. Warren Lepley Ford, Inc., 13 Pa. D. & C.2d 119, 127 (1957).

are three prerequisites to an attachment:[25] (1) an agreement that the security interest attach, (2) a giving of value by the assignee, and (3) a right of the debtor or assignor in the collateral.[26] The third element necessary for an attachment—a right of the debtor in the collateral—comes into existence only when the account comes into existence.[27] Consequently, where an assignment of accounts is taken, assuming the other elements have been satisfied, the debtor's security interest will, at the time of the transaction, attach only to existing accounts.

Prior to the U.C.C., the courts occasionally proved antagonistic to the practice of assigning a security interest in future accounts.[28] Furthermore, a similar hostility was not unknown in pre-U.C.C. legislation such as that which followed *Klauder*.[29] The U.C.C., on the other hand, gives its endorsement to such financing, so that where an assignment is made of both existing and future receivables, the assignee's security interest, again assuming all other requirements are complied with, will attach to the future accounts at the moment they come into existence.[30]

As often occurred before the U.C.C., a situation may arise where several creditors have taken security interests in the same accounts receivable. The U.C.C. sets forth three rules that govern all questions of priority among these interests. First, where, as between such security interests, one is perfected and the other unperfected, the party claiming under the perfected interest has priority.[31] Because a secured party cannot take possession of accounts receivable, any perfection of a security interest in such collateral must be accomplished by filing a financing statement.[32] Accordingly, the second rule, which applies to the situation where there is a conflict between two or more perfected security interests,[33] resolves any conflict between such interests by

25. "*Attachment* is the term of art employed by Article 9 to describe those rights which a secured party has in collateral upon creation of the security interest. . . . *Perfection*, on the other hand, is a Code term of art which describes the rights a secured party has in collateral and regulates those rights as they may come into contact or conflict with the rights of third persons, such as buyers from or judgment creditors of, the debtor." O. SPIVACK, SECURED TRANSACTIONS 33 (3d ed. 1963).

26. U.C.C. § 9-204.

27. *Id.* § 9-204(2)(d).

28. *See* Taylor v. Barton Child Co., 228 Mass. 126, 117 N.E. 43 (1917).

29. MASS. ANN. LAWS ch. 107A, § 1 (1946) (repealed 1957).

30. U.C.C. § 9-204(2)(d).

31. *Id.* § 9-301(1)(a).

32. *Id.* § 9-302(1)(a) recognizes a perfected security interest without filing in cases where the collateral is possessed by the secured party under section 9-305.

33. *Id.* § 9-312(5)(a).

simply giving priority according to the order of filing.[34] The third rule applies in the situation where a conflict arises involving two or more interests that have not been perfected. In such a case the U.C.C. looks to the order of attachment to resolve questions of priority. With respect to existing accounts receivable, a creditor's security interest will attach under section 9-204(1) when he has given value pursuant to an agreement which provides that a security interest shall attach. In effect, where a conflict develops between unperfected security interests in accounts receivable which existed when the agreements were entered into, the U.C.C. follows the view that existed under the New York Rule, namely, that a first assignee has priority over a subsequent taker. This rule applies to security interests in future accounts as well. However, it should be noted that the requirements imposed by section 9-204(1), by their nature, make attachment impossible prior to the time the accounts are created.[35]

The foregoing suggests that the U.C.C.'s favorable treatment of accounts receivable financing affords creditors the opportunity to obtain a valuable security interest in both existing and future accounts. Moreover, such a security interest is not made invalid by reason of a debtor's liberty to exercise control over and dispose of the collateral.[36] When a creditor, for example a bank, has filed a financing statement and advanced money to the retailer under a written agreement that the bank will have a security interest in all existing and future accounts receivable of the retailer, it has, under the provisions just examined, attained the most advantageous position against subsequent creditors provided by the U.C.C. Such a position would normally assure priority as against persons subsequently taking a security interest in the same accounts. Yet the U.C.C., as did the common law cases examined earlier, established rules that afford favored treatment for those claiming under a purchase money security interest and thereby create a possible source of dissipation to an otherwise invulnerable interest.

34. *Id.*

35. Application of this rule might prove difficult where several assignees had completed all steps required for attachment but the taking by the debtor of an interest in the collateral. In such a situation all the security interests would be perfected simultaneously upon the creation of future accounts. The obvious solution in such a case would be a filing by one of the parties, thereby gaining priority under the first rule.

36. U.C.C. § 9-205 & Comments.

B. Creation of a Subsequent Purchase Money Security Interest in Inventory and Proceeds

The purchase money security interest has long been a favored child of the law. The few limitations that the common law placed on its generally accepted priority over antecedent claims in the same collateral were, as pointed out earlier, restricted to the fixture cases, and even then the denial of priority was not absolute.[37] Because none of the limitations imposed by the common law suggested any restriction on the priority of a purchase money security interest in inventory, it is not surprising that the U.C.C. adopted special priority rules to protect a purchase money interest in such collateral.[38] With the bank holding a perfected security interest in future accounts receivable and perhaps other creditors holding perfected security interests in the retailer's after-acquired inventory,[39] the absence of special treatment for a purchase money secured party might prove fatal to the retailer's efforts to obtain new inventory on credit. But, under the U.C.C., our seller can make a delivery of goods to the retailer for resale and, by utilizing the provisions available, assure himself of priority over all antecedent and subsequent security interests in the inventory sold and perhaps the proceeds as well.

To obtain a purchase money security interest in inventory collateral that will prevail over other creditors, the U.C.C. requires that two conditions be met. First, the security interest must be perfected at the time the inventory passes to the debtor.[40] Since by its very nature a sale of inventory contemplates possession of the same by the purchaser, perfection requires the filing of a financing statement[41] in addition to attachment of the security interest.[42] Attachment, as in the case of the bank's security interest in accounts receivable, is accomplished when there is an agreement that the security interest attach, value is given, and the debtor has a right in

37. *See* Detroit Steel Co. v. Sisterville Brewing Co., 233 U.S. 712 (1914).

38. The pre-U.C.C. device used to create a purchase money interest depended to some extent on the nature of the collateral, but the trust receipt was the commonly accepted instrument to establish a purchase money interest in business inventory. *See* Coogan, *Article 9 Of The Uniform Commercial Code: Priorities Among Secured Creditors and "The Floating Lien,"* 72 HARV. L. REV. 838, 843 (1959).

39. U.C.C. § 9-204(3).

40. *Id.* § 9-312(3)(a). Note that a purchase money security interest in collateral other than inventory need not be perfected at the time the debtor takes possession, but need only be accomplished within ten days thereof. *Id.* § 9-312(4).

41. *Id.* § 9-302(1).

42. *Id.* § 9-303(1).

the inventory.[43] The second condition necessary to the perfection of a purchase money security interest is a giving of notice by the secured party to other individuals who might have a security interest in the same collateral. Specifically, such notice must be given to any person who has a security interest that is actually known to the holder of the purchase money security interest and to any person who has filed a financing statement covering the same type of inventory prior to the filing of the purchase money security interest.[44] To be effective, the notification must contain a description of the property[45] and state that the individual giving the notice has or expects to acquire a purchase money security interest in the inventory of the debtor.

With these general rules in mind, let us turn now to a consideration of the specific steps required of the seller if he is to assure priority of his security interest as against the bank's interest in the retailer's future accounts receivable. When inventory is delivered to a debtor, the secured party gives an implied, if not expressed, authorization that the collateral may be sold.[46] The effect of such an authorization is to surrender any claim in the inventory as against one who makes a purchase from the debtor in the ordinary course of business.[47] Consequently, it is not only practical but necessary, if the seller is to maintain any collateral at all, that his security interest reach the proceeds as well as the inventory itself.[48] The policy considerations fundamental to the recognition of a priority in a purchase money security interest in inventory—among them the assurance of a continuing flow of needed goods to struggling businesses—would, in large part, be thwarted if such protection were not allowed. In response to this need, the U.C.C. provides for the extension of a purchase money security interest in inventory, with continuous perfection, to proceeds.[49] This may be accomplished in one of two ways. The secured party may perfect his security interest in the

43. *Id.* § 9-204(1).

44. *Id.* § 9-312(3)(b).

45. *Id.* § 9-312(3)(c).

46. Inventory is defined as "[g]oods . . . held . . . for sale or lease or to be furnished under contracts of service." *Id.* § 9-109(4).

47. *Id.* § 9-306(2).

48. The official comments suggest that it may not always be wise to include, as the U.C.C. allows one to do, a claim in the original financing statement to a security interest in proceeds. The danger suggested is that in cases where the original collateral is by its nature not normally delivered to a debtor with authority to resell, a claim to proceeds might be construed as an authorization and result in the loss, upon resale, of any claim to the collateral as against the purchaser. U.C.C. § 9-306, Comment 3.

49. *Id.* § 9-306(3).

procceds at any time within ten days of their creation,[50] but this, particularly in the case of a security interest in inventory, would involve close attention to the debtor's business operations and probably the filing of a new financing statement every ten days. The preferable alternative approach for the holder of a security interest in inventory is simply to include in the original financing statement language that covers 'proceeds as well as the inventory.[51] While the value of such a security interest might otherwise be eroded by the difficulties of tracing proceeds that have been commingled or deposited in a bank account,[52] accounts receivable are comparatively easy to trace and therefore, together with the fact that a large part of present day proceeds are in that form, constitute a most attractive type of collateral.

In addition to the assertion in his original financing statement of a claim to a security interest in the proceeds,[53] the seller must be certain that any person who is holding a security interest in the retailer's accounts receivable and who has recorded under an earlier financing statement is given notice of the intended security interest before the inventory is delivered to the retailer. Usually section 9-312(3)(b) would require only that such notice be given to persons with security interests in the inventory itself if the purchase money security interest is drafted to cover only inventory. But where the original financing statement claims an interest in the proceeds as well, holders of security interests in future accounts receivable come within the class of creditors intended to be protected by the requirement of notification. The essential purpose of notification is to protect secured parties who typically rely upon a continuous flow of new collateral to replace that extinguished in the ordinary course of business activity.[54] According to our hypothetical, the seller would be under an obligation to give such notice to the bank. Failure to do so would leave the bank with a priority in any of the retailer's accounts receivable not made subject to seller's security interest within ten days after their creation.[55] Likewise, the failure of either the bank or the seller to follow one of the essential steps outlined would result in a fairly

50. *Id.* § 9-306(3)(b).

51. *Id.* § 9-306(3)(a).

52. A security interest in proceeds is limited to those, both cash and non-cash, that are identifiable. *Id.* § 9-306(4)(a) & (b).

53. This step meets the requirements of both *id.* §§ 9-312(3)(c) and 9-306(3)(a).

54. *See id.* § 9-312, Comment 3.

55. *Id.* § 9-306(3)(b).

routine solution to any dispute concerning the retailer's future accounts receivable.[56] Unfortunately, the same cannot be said of the situation where the bank and the seller have both followed all the steps outlined.

C. The Conflict Under the Uniform Commercial Code

The uncertainty concerning the solution to the hypothetical arises from the antithetic interpretations that can be given to sections 9-306 and 9-312. The general purpose of section 9-306 is to give a secured party a continuously perfected security interest in any proceeds resulting from the debtor's sale of the original collateral. Under one view of the section, it might be concluded that the purpose of giving a "continuously perfected" security interest was merely to afford the party with a security interest in the original collateral the advantage of his perfection date for the original collateral.[57] If this is the sole function of section 9-306, the bank would retain a priority over the seller if the respective rights of the parties were determined by the order of filing.[58] On the other hand, section 9-306, if viewed not simply as giving a securcd party the advantage of an earlier filing date but also an extension to proceeds of the security interest as it existed in the original collateral, a different result would follow. Under this view, the seller would enjoy the benefit of the favored treatment afforded a purchase money secured party and take priority over the bank.[59]

A difficulty with the second approach to section 9-306 results from the fundamental nature of section 9-312(3)—the sole provision from which the seller derives the status necessary to prevail over the bank. While section 9-306 speaks of extending a security interest to cover proceeds, section 9-312(3) does not create a security interest. Rather, its fundamental role is the determination of priorities—a matter not mentioned in the former section. Consequently, objection might be made that the benefit derived from section 9-312(3) is not intended to be continued by section 9-306. The answer to this is obvious. While it is true that section 9-306 speaks only of continuing a security interest in proceeds, this is, in effect, nothing more than a

56. *Id.* §§ 9-301 & 9-312.

57. The advantage would be to allow the secured party to prevail over creditors who took security interests in the same collateral subsequent to the secured party's original perfection or filing but prior to the time he would otherwise have perfected a new interest in the proceeds.

58. U.C.C. § 9-312(5)(a).

59. *Id.* § 9-312(3).

continuation of one's claim in the original collateral and, as such, essentially a question of priorities.[60]

Having made these general observations concerning the difficulty of the dilemma, the focus turns now to a more detailed consideration of the probable solution to our hypothetical under the present Code. One suggested solution turns on the pivotal determination of how the purchase money secured party's security interest in the proceeds is perfected.[61] Recall that the seller filed a financing statement that claimed a security interest in the inventory sold to the retailer and included, in addition, any proceeds resulting from the sale thereof. Upon the sale by the retailer of any of the inventory, the security interest therein having been perfected, the seller would have a continuously perfected security interest in the proceeds according to section 9-306.[62] Had the original financing statement not been drafted to include a security interest in the proceeds, section 9-306(3)(b) would require the seller to file a new statement within ten days to retain his security interest beyond that time. Accordingly, for up to ten days the seller would, assuming a perfected security interest in the inventory itself, have a perfected security interest in the proceeds without any need for filing.[63] The fact that filing is immaterial to the seller's security interest during this ten day period is substantiated by additional language to the effect that "[a] financing statement must be filed to perfect all security interests except . . . a security interest temporarily perfected . . . in proceeds for a 10 day period under section 9-306 . . . ."[64] If perfection for this ten day period is treated as accomplished without filing, it would seem a tenable position that perfection might be viewed as resulting from means other than filing. In particular, perfection of the seller's security interest in proceeds may be said to be the consequence, not of filing, but of the fact that his original perfected security interest covered proceeds. Under the

60. The U.C.C. states that "[s]ecurity interest means an interest in personal property or fixtures which secures payment or performance of an obligation." *Id.* § 1-201(37).

61. This solution is suggested by Charles C. Craig. Mr. Craig's hypothetical differs from the instant one in that there the party taking the security interest in accounts receivable did so after delivery to the debtor of inventory. According to the situation presented by Mr. Craig, however, the security interest in the accounts receivable was filed before that of the person selling the inventory, and thus the solution suggested there is applicable to our situation. Craig, *Accounts Receivable Financing: Transition from Variety to Uniform Commercial Code*, 42 B.U.L. REV. 187, 201 *et seq.* (1962).

62. U.C.C. § 9-306(3).

63. *Id.* § 9-306(3)(b).

64. *Id.* § 9-302(1)(b).

provisions of section 9-312, when there is a conflict between secured parties holding security interests in the same collateral, unless both interests are perfected by filing, the determination of priorities is based on the order of perfection.[65] At this point it is important to note that while our hypothetical involves two conflicting claims to identical accounts receivable, the bank's claim is made to the accounts as original collateral while the claim of the seller is made to the accounts as proceeds. This distinction becomes critical in light of the different rules for perfection in original collateral and proceeds. As was noted earlier, the bank took its security interest before the seller became involved with the retailer and was, as between the two, the first to file a financing statement. Yet, his interest in future accounts receivable did not become perfected until after the seller's since perfection requires attachment and this, in turn, could not take place with regard to future accounts receivable until they came into existence.[66] According to our hypothetical, the seller's security interest was perfected at the time the inventory was delivered to the retailer. Since section 9-306(3) gives the seller a continuously perfected security interest in the proceeds, the perfection of his interest in the proceeds also occurred on the date that the retailer received the inventory. Consequently, the seller had a perfected security interest in the retailer's future accounts receivable before they existed and, therefore, necessarily before the bank could have perfected his interest in them.

If the foregoing analysis is correct, and according to a leading authority in the field it is "a perfectly plausible . . . and perhaps the preferable reading,"[67] the U.C.C. would always give priority in such a situation to the purchase money secured party if he had included a security interest in proceeds in his original financing statement[68] or perfected a security interest in the accounts within ten days of their creation.[69] On the other hand, it has been observed that section 9-312 (6) may invalidate the whole theory.[70] That section states that for purposes of the priority provisions in section 9-312(5) a continuously

65. *Id.* § 9-312(5)(b). The section expressly applies to cases of purchase money security interests that do not qualify for the special treatment afforded by sections 9-312(3) & (4).

66. *Id.* § 9-204(2)(d).

67. JOINT COMM'N ON CONTINUING LEGAL EDUC. OF THE AMERICAN LAW INSTITUTE AND THE AMERICAN BAR ASS'N, ADVANCED ALI-ABA COURSE OF STUDY ON BANKING AND SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE 214 (1968) [hereinafter cited as ALI-ABA Course.].

68. U.C.C. § 9-306(3)(a).

69. *Id.* § 306(3)(b).

70. ALI-ABA COURSE, *supra* note 67, at 216.

perfected security interest shall be treated at all times as though perfected by filing if it was originally perfected in that manner.[71] Consequently, because the seller's original security interest was perfected by filing, section 9-312(6) would require that the continuously perfected security interest claimed under section 9-306(3)(b) be treated as perfected by filing. Thus, in an effort to establish priority over the bank, the seller would be unable to rely on section 9-312(5)(b) and the fact that his security interest in the accounts receivable was perfected before that held by the bank. Instead, the outcome would depend on other considerations.

Another approach has been suggested that would also give the seller priority over the bank, even if section 9-312(6) precludes the use of a "first to perfect" priority rule.[72] Fundamentally, the approach is based on a policy determination that the favored treatment afforded a purchase money secured party by section 9-312(3) ought to be preserved in the proceeds as well. Consequently, under this approach, section 9-306(3) is simply read as though it provides that a "security interest in proceeds is a continuously perfected security interest"[73] *and entitled to the same priority given the security interest in the original collateral.* The effect is to make the solution to our hypothetical rest on an application of section 9-312(3) to the extent that it modifies the "first to file" rule of section 9-312(5)(a).[74] As observed earlier, section 9-312(3) gives a purchase money security interest in inventory priority over holders of antecedent security interests, but only to the extent that they cover the "same collateral." Assuming the prerequisites required by section 9-312(3) have been followed, the seller's claim to priority over the bank would depend on whether the proceeds collected by the retailer constituted, within the meaning of section 9-312(3), the "same collateral" as the inventory sold. Since section 9-306 may be read as treating proceeds as the same collateral—though admittedly in a somewhat different form—it is not an unreasonable conclusion that the proceeds do, in fact, constitute the "same collateral" within the meaning of section 9-312(3).[75] Consequently, the seller would have priority over

71. U.C.C. § 9-312(6).

72. The solution is that offered by Professor Grant Gilmore of the University of Chicago Law School. *See* ALI-ABA COURSE, *supra* note 67, at 214.

73. U.C.C. § 9-306(3).

74. Such an interpretation of section 9-306(3) cannot result from a literal reading of the provision, but requires one to interpolate. However, this is not objectionable since one must always interpolate to derive a clear understanding of a provision, and moreover, the conclusion reached in the instant case is probably the intended result. ALI-ABA COURSE, *supra* note 67, at 215. (comments of Professor Gilmore).

75. *Id.* at 216.

the bank in any accounts receivable created by the retailer's sale of the seller's original collateral.[76]

Though the views expressed to this point suggest that the seller should prevail under current provisions of the U.C.C., there is substantial support for the opposite conclusion.[77] As was noted in the approach last examined, section 9-312(3) gives the seller priority over the bank only in the same collateral. The seller's priority under that view depended on the conclusion that the proceeds resulting from sale of the seller's original collateral was "the same collateral" within the meaning of section 9-312(3). An equally legitimate position is to view the words "the same collateral" as expressing the rule that a purchase money secured party's priority shall not extend to accounts receivable as proceeds.[78] The adoption of this view, together with the position that section 9-312(6) requires the application of a "first to file" priority rule in the resolution of our hypothetical, results in the conclusion that the bank should prevail. But even this solution is not free from difficulty. Under this approach, the position that proceeds is not the same collateral as the inventory gives credence to the suggestion that the seller's security interest in the proceeds be treated as a different security interest, though continuously perfected by section 9-306(3), that is perfected by the fact that the original security interest included language to cover proceeds. In other words, the first premise required under this approach militates against the second and suggests that a "first to perfect" rule should determine the priorities of the bank and the seller. As was pointed out, this would result in an outcome favorable to the seller.

Under current U.C.C. provisions, the solution to our hypothetical is anything but certain,[79] and "there is no rational way

76. While Professor Gilmore first adopted the foregoing as the appropriate solution to our hypothetical, he has since taken the position that the party holding the security interest in accounts receivable as original collateral, the bank, should prevail. *Id.* at 215.

77. Not only has Professor Gilmore been converted to this point of view, but such outstanding authorities as Peter F. Coogan, member of the Massachusetts Bar and Planning Chairman of the *1967 Advanced ALI-ABA Course on Banking and Secured Transactions Under the Uniform Commercial Code*, and William E. Hogan, Professor at Cornell Law School, have suggested that the priority given a purchase money secured party by section 9-312(3) does not extend to proceeds. *See id.* at 215-16.

78. "I think that [a contrary view] is pretty frightening. Section 9-312(3) says that the purchase money man gets his priority over a conflicting security interest 'in the same collateral'. I take it that that means the thing doesn't spill over onto the accounts." *Id.* at 216 (remarks of Professor Hogan).

79. "Now, the Code just doesn't give an answer. You can rationalize any one of several answers, but there is no result which you can say a court must reach on this point." *Id.* at 215 (remarks of Mr. Coogan).

of reaching a clear solution or giving a good opinion of counsel."[80] Because of this uncertainty from both the accounts receivable and the inventory financer's point of view, a consideration of possible alternatives seems appropriate.

IV. ALTERNATIVE SOLUTIONS

A. *The Civil Law*

The first alternative to be considered is the solution that exists under the law of Louisiana—the only state that has not adopted the U.C.C. In Louisiana the solution to our hypothetical rests on a consideration of two statutes—the Accounts Receivable Act[81] and the Chattel Mortgage Act.[82] The former statute was adopted in 1952 and governs the assignment of accounts receivable.[83] The Accounts Receivable Act recognizes the validity of any written assignment of accounts made for a valuable consideration provided it takes place within the effective period of the "statement of assignment"[84] required to be filed as notice of the transaction.[85] Thus the Act recognizes the validity of an agreement that includes future accounts. The assignment becomes fully perfected on the date that the assignment is made,[86] meaning the time at which each individual account, after it has come into existence, is assigned.[87] Consequently, under the civil law as applied in Louisiana, the bank in both our hypothetical and under the U.C.C., could take an interest in future accounts receivable from the retailer, the interest being perfected as it was actually assigned.

Louisiana's civil law also affords the seller the opportunity to acquire a "security interest" in inventory he might sell to a retailer.

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80. *Id.* at 215 (comment of Professor Gilmore).

81. LA. REV. STAT. ANN. §§ 9:3101-10 (Supp. 1969).

82. *Id.* §§ 9:5351-66 (1950, Supp. 1969).

83. The historical development of non-notification accounts receivable financing is based on the civil code provisions concerning pledge. *Id.* §§ 9:4321-23 (1950). *See* Comment, *Security Rights in Movables under the Uniform Commercial Code and Louisiana Law—A Transactional Comparison*, 40 TUL. L. REV. 744, 857 (1966).

84. The statement is effective for a period of two years. Thereafter a new filing may be made to acquire an additional period. LA. REV. STAT. ANN. § 9:3106 (Supp. 1969).

85. *Id.* §§ 9:3102 & 9:3103.

86. *Id.* § 9:3102.

87. "Therefore, in Louisiana, under a strict reading of the statute, priority is established in two distinct steps: A statement of assignment is filed. Then a written assignment to the party named in the statement is made after the aceounts come into existence but within the effective period of the statement." Comment, *supra* note 83, at 868.

Under the French Civil Code, a nonpossessory interest in movables was unknown, and consequently under the subsequent Louisiana Civil Code, the sole means of creating a consensual security interest in movables was by pledge.[88] The Chattel Mortgage Act now provides, however, that a mortgage may be taken in "stocks of merchandise, or other things in bulk, [though] changing in specifics, including without limitation, stocks of merchandise in retail, wholesale or manufacturing establishments."[89] To perfect the interest against third persons, the seller need only follow the steps set out in the Act.[90] Nevertheless, there is a fundamental distinction between the interest that the seller would acquire under Louisiana law and that afforded by the U.C.C. We have examined in detail the favored treatment afforded a purchase money secured party under both the commonlaw and the U.C.C. The only advantage given to such a party under the law of Louisiana is a so-called "vendor's privilege" on movables. The Civil Code provides that "[h]e who has sold to another any movable property, which is not paid for, has a preference on the price of his property, over the other creditors of the purchaser, whether the sale was made on a credit or without, *if the property still remains in the possession of the purchaser.*"[91] Accordingly, once any property delivered by the seller to the retailer leaves the retailer's possession, the Louisiana law terminates whatever security interest the seller might have in the collateral.[92] But more important and determinative of our hypothetical conflict is the fact that the civil law of Louisiana denies the seller any security interest in proceeds.[93] Consequently, in the hypothetical situation, the bank would have the sole security interest in accounts receivable resulting from the retailer's sale of the seller's collateral.[94]

88. Comment, *supra* note 83, at 876.

89. LA. REV. STAT. ANN. § 9:5351 (Supp. 1969).

90. *Id.* § 9:5353 (Supp. 1969) requires (1) authentication, (2) filing, and (3) payment of a nominal recording fee.

91. LA. CIV. CODE ANN. art. 3227 (West 1952) (emphasis added).

92. LA. REV. STAT. ANN. § 9:5354 (Supp. 1969) (provided there has been a proper filing).

93. For a full consideration of the solution to our hypothetical under Louisiana law, see *supra* note 83, at 873.

94. A similar outcome seems to result under the law of France as well. The French Civil Code provides that a debtor may assign all claims, actions, or future rights not otherwise made non-tranferable or prohibited by law. Since an assignment of existing and future accounts receivable is not prohibited, the bank could, presumably, take an assignment of the retailer's accounts. Because French law has rejected the concept of a mortgage on inventory, however, the only interest that the French civil law affords the seller is a "vendor's privilege" similar to that existing under Louisiana law. In France, then, as in Louisiana, the bank would take its security interest in the retailer's accounts receivable without challenge from the seller. *See* Sachse, *Using Inventory as Security: A Civil-Law Perspective*, 39 TUL. L. REV. 397, 404 *et seq.* (1965).

The most obvious advantage derived from the civil law approach to our hypothetical is simply the fact that the conflict encountered under the U.C.C. is avoided. Consequently, both the bank and the seller are permitted to enter into transactions such as that hypothesized without the uncertainty that would otherwise face them. The civil law approach, however, fails to remedy the difficulty that, perhaps, is the strongest argument in favor of a purchase money security interest and, especially in the case of inventory, a right to continue the security interest to proceeds—namely, the importance of making a continued flow of goods on credit available to a businessman who, because of prior encumbrances, might not otherwise be able to acquire such goods and would consequently become a business easualty.

B. Canada (The Ontario Act)

A sharp contrast to the civil law alternative is now developing in Canada. There is no single body of commercial law that can be said to govern throughout the Commonwealth. Instead, each province presently has its own provisions governing assignments of accounts receivable and security interests in inventory. However, in recent years there has developed a recognition of the need for greater uniformity of commercial law among the various provinces of the Commonwealth.[95] The recently enacted Personal Property Security Act of Ontario[96] has received a favorable response in several of the provinces and may well become the nucleus of any subsequent movement toward uniformity.[97] It is this statute that offers another alternative to the dilemma posed by our hypotheticai.

The Ontario solution is quite simple. The Act provides that "a purchase money security interest in inventory *or its proceeds* has priority over any other security interest in the same collateral, if . . ." certain steps are taken by the secured party at the time the security interest is created.[98]

Consequently, while the civil law has adopted a policy that gives assignees of accounts receivable priority by excluding sellers of inventory from taking a security interest in proceeds, the Ontario Act

95. A committee was established in 1963 by the Commercial Law Section of the Canadian Bar Association for the purpose of assisting in the development of a uniform act on security interest in personal property.

96. STATUTES OF ONTARIO, ch. 73 (1967) [hereinafter cited as P.P.S.A.].

97. Alberta's legislature has given consideration to the Ontario Act and the provinces of Manitoba and Saskatchewan have expressed interest in such a statute. *See* Ziegel, *The Draft Uniform Personal Property Security Act*, 11 CAN. BAR J. 270, 272 (1968).

98. P.P.S.A., *supra* note 96, at § 34(2) (emphasis added).

has moved to the other extreme by giving a purchase money secured interest priority over all competing security interests whether in the original collateral or proceeds.

Like the civil law solution, the Ontario Act dispells any uncertainty concerning the outcome of a contest between the bank and the seller over the retailer's accounts receivable. In addition, the Ontario Act leaves a businessman such as the retailer with an unhindered ability to acquire the inventory or other goods needed to carry on a successful business venture.

Necessarily, the giving of such broad protection to a purchase money secured party results in a detriment to the security interest of a party who takes an assignment of accounts receivable. Because accounts receivable have become one of the most significant assets of the contemporary businessman and one often used as a vehicle for obtaining credit, the policy decision as to which interest should prevail is not without difficulty.

Certainly, valid arguments can be advanced in support of a priority for either security interest, but there are two significant points which suggest that the alternative embodied in the Ontario Act is more consistent with Article 9 as it now exists than that found under the civil law. First, there is the similarity of the two statutes. The general schemes of both Article 9 and the Ontario Act are analogous in that each undertakes to establish a comprehensive system for the regulation of all security interests in personal property and fixtures. In addition to this similarity, a substantial portion of the language in the two acts is nearly identical.[99] In particular, only the addition to section 9-312(3) of the words "or its proceeds" would be required to incorporate under Article 9 the solution embodied in the Ontario Act.[100] More important, however, than the literal similarity of the two statutes is the fact that the result reached under the Ontario Act, if incorporated into the U.C.C., would give effect to the generally favorable treatment given a purchase money security interest by Article 9 and reach a result seemingly intended by the U.C.C.'s original draftsmen.[101]

99. For example, compare the language of U.C.C. § 9-312(3) and P.P.S.A., *supra* note 96, at § 34(2); U.C.C. § 9-204 and P.P.S.A., *supra* note 96, at §§ 12-15; U.C.C. § 9-105 and P.P.S.A., *supra* note 96, at § 1; U.C.C. §§ 9-312(5) & (6) and P.P.S.A., *supra* note 96, at § 35.

100. The same result could be accomplished by changing the language of section 9-306(3) to read a "security interest in proceeds is a continuously perfected security interest" *and entitled to the same priority given the security interest in the original collateral.* Of the two, revision of section 9-312(3), if only for the sake of ease and clarity, would seem the preferable approach to take.

101. ALI-ABA COURSE, *supra* note 67, at 215.

C. A Third Alternative—Compromise

The civil law and the Ontario alternatives, as well as previous interpretations of the U.C.C., have one thing in common—each has assumed that either the assignee of accounts receivable or the purchase money secured party must prevail. But another and equally plausible alternative is some compromise between the two competing interests. Such a solution would recognize the value of both interests while concluding as a matter of policy that neither was of such nature as to warrant special treatment. A compromise solution might be reached in one of several ways.

One such solution might be to give the bank and the seller priority in the accounts receivable to which both had claims in proportion to the respective values of the bank credit extended or inventory supplied. But there are difficulties with this solution. First, it would produce twofold uncertainty for both the bank and the seller. Each would be subject to the diminution of his interest as a consequence of any additional advances by the other. Moreover, both would face such a loss by the subsequent entry of a third creditor, since, so far as the factors of filing, perfection, and attachment are concerned, all secured parties are on equal footing under this approach. In other words, the element of time would be immaterial to the protection given the competing security interests. Another difficulty with such an approach is the failure to take account of the overall situation of the various creditors. For example, assuming all the inventory delivered by the seller had been sold, the accounts would constitute the seller's only remaining collateral.[102] But he would be required to share equally with the bank even though the bank might have additional collateral in the form of accounts receivable created by the retailer's sale of other inventory. Under other circumstances, an equally unjust result could occur to the detriment of the bank. While the latter objection might be avoided simply by changing the source used to determine the respective shares, it seems that any compromise involving a sharing of the accounts would necessarily fail to dispel the uncertainty created by the instant solution. Because of the reluctance of both banks and suppliers of inventory to extend credit in the face of this uncertainty, it would appear that this solution is unsatisfactory.

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102. The seller would have some limited claim to cash proceeds, but because of the difficulties of tracing, it is not unreasonable to disregard this source. *See* U.C.C. § 9-306.

V. Conclusion

The conflict between a purchase money security interest in inventory and proceeds and an antecedent security interest in accounts receivable is not resolved under the current provisions of the U.C.C. Under section 9-312, the U.C.C. gives a seller of inventory a purchase money security interest that takes priority over all competing security interests in inventory. Section 9-306 gives the same seller a continuously perfected security interest in any proceeds that result from the debtor's disposal of the inventory. Yet, because section 9-312 fails explicitly to provide for priority of the seller's security interest in the proceeds as well as the original collateral and because section 9-306 is silent with respect to any continuing priority, the answer to the question whether such a seller would take priority over one holding an earlier security interest in accounts receivable is uncertain.[103]

The solution to our hypothetical under the Ontario Act is consistent with the fundamental policy underlying the pre-Code development of both accounts receivable financing and the purchase money security interest. Like the U.C.C., the Personal Property Security Act of Ontario recognizes and gives effect to the importance of accounts receivable as a business asset, and provides for the use of such accounts as a means of obtaining needed credit. Similarly, the Ontario Act recognizes the favored treatment afforded the purchase money security interest for over 300 years by giving priority to such a security interest even as against antecedent claims. The alternative solution embodied in the Ontario Act is preferable to that existing under the current provisions of the U.C.C. With the exception of its solution to our hypothetical, the Ontario Act's general approach to accounts receivable financing and to the purchase money security interest is similar to the U.C.C. approach. However, the Ontario Act has the advantage of giving a definite solution to our hypothetical. Certainly the Ontario solution is consistent with the favored treatment long given the purchase money secured party. Moreover, it is not inconsistent with the development of accounts receivable financing. By allowing a purchase money secured party to continue his security interest and priority into accounts receivable as proceeds, the Ontario Act recognizes the validity of accounts receivable financing to no less extent than it would if priority were given to one taking his security interest in accounts as original

103. ALI-ABA Course, *supra* note 67, at 215 (comment of Professor Gilmore).

collateral. In either case, the accounts serve to secure additional credit for the assignor of the accounts. Because the question is purely a question of priority, the Ontario Act gives full recognition to and carries forward the fundamental aspects of both the purchase money security interest and accounts receivable financing.

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