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PERFECTION AND PRIORITIES UNDER THE UNIFORM COMMERCIAL CODE

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CHAPTER I

INTRODUCTION

Only a few hundred years ago the law was concerned with little else than protecting the king’s revenue and preserving the king’s peace. Today the law permiates nearly all phases of life and contributes heavily to the fulfillment of the expectations of all aspects of society. In the field of business, the law is expected to furnish a ready framework to facilitate transactions common to the business world. This may be a perfectly legitimate expectation, but the law has been slow and sometimes entirely inadequate in meeting it. Nowhere has this been more apparent than in the field of chattel security transactions which range in type from the simple pledge to the complexities encountered in industrial financing. If the businessman were to investigate, he would find that most of the uniform legislation in this area antedates the problems of mass production and distribution.

In describing the chattel security law as it was prior to the enactment of the Uniform Commercial Code, Professor Gilmore made the following observation:

Chattel mortgage law and conditional sales law are what they are, not because anyone in his right mind ever thought that such a body of law made sense, but as a result of a long process of tinkering to make late-medieval legal forms workable in an industrialized society. We might as well hope to solve our transportation problems by fitting an ox-cart with a jet-propelled engine.

The problem prior to the Code was not that chattel security financing could not be carried out, but that numerous problems arose as by-products

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1. Isaacs, Business Postulates and The Law, 41 Harv. L. Rev. 1014, 1017-18 (1928).
3. The Uniform Commercial Code is sponsored by the National Conference of Commissioners on Uniform Laws and the American Law Institute. It was first adopted in Pennsylvania on July 1, 1954, Pa. Stat. Ann. tit. 12A (1954), in the form originally approved by the national sponsors. Since the first official draft there have been amendments to the Uniform Commercial Code and some very substantial changes were made in Article 9. To date 18 states have enacted the Code. Wyoming is one of the states which has adopted the Code and the effective date in this state was January 1, 1962. All references are to the Uniform Commercial Code, Official Text (1958), which will be referred to herein as the Code. Sections will be cited as § .........
of the evolving process by which the law was created. The lender had the problem of choosing from among the many security forms that existed in his state: a pledge, a chattel mortgage, a conditional sales contract, a trust receipt, a factor's lien, a trust, an assignment of accounts receivable, a consignment, a lease or some other similar device which may have been available only under a different label. The numerous chattel security forms led to confusion, and the rigid formal requisites peculiar to each form were sometimes accidentally or mistakenly overlooked by the parties, thereby resulting in frequent invalidation of the agreement as against third parties. Overlapping of different types of security legislation was another problem. In some states it was possible for the lender to obtain a security interest in the inventory of the borrower in as many as four different ways, with the result that the lender's power became too sweeping. There was also substantive difficulties. For example in the field of inventory and accounts receivable financing the lender ran the constant risk of having his lien declared invalid as a voidable preference under the Federal Bankruptcy Act. In addition, the unnecessary complexities in the law led to exorbitant legal costs.

Of course the Code does not purport to solve all of the problems which existed in chattel security financing prior to its enactment. Some problems in this field are insoluble by the state legislature because they lie exclusively within Federal jurisdiction. However, Article 9, the chattel security article under the Code, goes a long way in response to the needs of the business world which were not being adequately served under the old law. Article 9 eliminates many of the above mentioned weaknesses of the old law and many more by providing a unified and integrated system of chattel security law under one piece of legislation. The avowed purpose of Article 9 is to provide a simple, but integrated frame work within which the immense variety of present-day security transactions can be created at less cost and with greater certainty than under prior law. This article applies to every chattel security transaction, including the sale of accounts, contract rights and chattel paper, regardless of its form, if

10. § 9-101 comment.
the parties intend to create a security interest in personal property. Thus, the mass of technical rules which applied to the numerous forms of security devices under prior law are wiped away and rules of general application are devised in such a way as to apply to secured transactions of every type.

It has been said by some that although Article 9 makes some rather sweeping changes in the area of formal requisites and terminology, it does not represent a revolutionary change in the fundamentals of chattel security financing. This appears to be true, but the changes in substance cannot be minimized. They are in areas of sufficient importance to represent a major advance in chattel security financing law. Section 9-205, which expressly repeals the doctrine of Benedict v. Ratner, need only be mentioned to demonstrate the validity of this statement.

Even the changes in terminology have momentous repercussions. Where numerous terms, such as chattel mortgage, conditional sales contract, trusts, receipt, factors lien, etc., were used to describe the various forms of chattel security devices under prior law, under the Code only one term is employed to describe all forms of security transactions, namely, a "security agreement." The party who was formerly designated as a conditional vendor, chattel mortgagee or entruster, under the Code becomes simply the "secured party." The conditional vendee or chattel mortgagor becomes the "debtor" or "account debtor." If the parties enter into a security agreement, the secured party may get a "security interest" in the collateral of the debtor. Where certain security agreements become the subject of a financing arrangement, such as through an assignment by the dealer, they are designated as "chattel paper." As a result of this streamlined terminology, numerous problems and uncertainties arising out of formal distinctions between the old security devices are eliminated.

Personal property is divided into several types of collateral: goods, instruments, documents, chattel paper, accounts, contract rights, and general intangibles. Goods are further classified as "consumer goods," "equipment," "farm products," and "inventory." To the extent that these terms are not self-explanatory, their meaning usually become quite clear when used in context. In some instances, however, it is difficult to determine into which category a particular piece of tangible personal property should be placed. For example, a physician's car may be "equipment" if purchased for use in his practice, but it might also be "consumer goods" if purchased for his personal, family or household use. Similarly,

13. Coogan, supra note 6, at 57; Kripke, supra note 9, at 602.
15. § 9-105.
16. Ibid.
17. Kripke, supra note 2, at 646-47.
goods in process which are manufactured into refrigerators as the finished product are the manufacturer's or dealer's inventory" if they are held for sale. But if they are sold to purchasers for personal, family or household use, they become "consumer goods." Although most sections of Article 9 relating to the priorities of persons claiming conflicting security interests in the same property apply without regard to the nature of the collateral, some sections contain special rules which relate only to a particular type of collateral, for example, Section 9-307.

It is not uncommon for society to expect more from the law than it is capable of providing as is indicated by the common phrase "there ought to be law against it." Although draftsmen of Article 9 have given prime consideration to the rules of equity and sound business policy, there are some variables inherent in human nature which cannot be controlled by the law, such as the dishonest debtor, and the Code does not purport to protect the secured party against this risk. But the Code does attempt to provide maximum protection of the secured party against the competing creditor and the bankruptcy risk. The remainder of this paper will consider the various financing conditions under which a secured party is protected from this type of risk through an analytical exposition of the principles governing perfection and priorities of security interests under Article 9.

CHAPTER II

CREATION OF A SECURITY INTEREST

A. ATTACHMENT AND ENFORCEABILITY.

In order for a person to become a secured creditor he must acquire a security interest in the collateral of the debtor. The point at which the debtor's property becomes subject to the security interest is the time when the security interest is said to attach. In fact creation and attachment of the security interest may occur simultaneously, and therefore the two terms are virtually synonymous. However, there is justifiable distinction between the two terms since a security interest may be created, but not yet attach to the collateral, by virtue of an agreement between the parties that the time of attachment is to be postponed. Unless explicit agreement postpones the time of attachment, a security interest will attach when three requirements are met: (1) an agreement is made, (2) value is given, (3) and the debtor acquires rights in the collateral. These events may occur in any order.

Although a security interest may be created without the necessity of the many formal requisites common to pre-Code law, such as accompany-

20. § 9-102 comment point 5.
21. § 9-303 comment.
22. § 9-204.
ing affidavits and acknowledgments, there are certain requirements which must be met before a security interest will be enforceable. To create an enforceable security interest the secured party must either take possession of the collateral or else obtain a written security agreement containing a description of the collateral and the debtor's signature. When the security interest covers crops, oil, gas, minerals or timber to be cut, a description of the land concerned is also required. Unless these minimal formal requisites are met the security interest is not enforceable against third parties or even the debtor.

B. THE FORMAL REQUISITES.

1. The Security Agreement.

A security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors, except as provided in the Code and in statutes governing usuary, small loans, retail installment sales, and the like. Obviously, the average security agreement will contain much more than the minimum requisites that are necessary for its validity. The agreement may provide for the terms and conditions of repayment, that the security interest will attach to after-acquired property of the debtor, and that future advances will be secured from the date the debtor obtains the after-acquired property. The agreement may grant the debtor complete dominion and control over accounts receivable and inventory, and it may contain any other term the parties deem expedient under the circumstances, providing the Code does not expressly prohibit the term. Since the security agreement may be used in lieu of a financing statement for filing purposes, it may also contain the signature of the debtor which is one of the requisites of a financing statement.

a. Description of the Collateral.

As has been observed, the Code makes a drastic departure from prior chattel-security law with respect to formal requisites. This is evidenced by the nature of the description of the collateral permitted by the Code. Any description of the collateral, or where necessary, of the real estate, is sufficient if it reasonably identifies what is described. A description need not be so comprehensive that it enables an interested party to determine exactly what the specific collateral is, from a reading of the security agreement or financing statement alone. It is enough if the description allows a third party, aided by information which the security agreement


24. § 9-203; This provision goes further than some pre-Code law which usually only invalidates the chattel mortgage or conditional sales contract as to third parties, but not as to the immediate parties, if some formal requisite has not been met; Symposium, supra note 23, at 382-88.

25. § 9-201.

26. § 9-204 (5).

27. § 9-204 (5).

28. § 9-205.

29. § 9-402.

30. § 9-110.
suggests, to identify the property. This liberal description rule is consistent with modern business needs which require a security agreement to be flexible enough to cover a multitude of items in the shifting stock of a manufacturer, as well as a single item such as a car being sold on the installment plan. However, it is conceivable that problems might result from the liberality of this rule. For example, a broad statement in the agreement that the security interest is claimed in the dealer's motor vehicles, might be interpreted as giving a security interest in all of the dealer's motor vehicles, which may or may not be true. Thus a sufficiently accurate description to preclude overreaching by the secured party is necessary.\(^3\)

b. **Freedom of Contract.**

The Code preserves the principle of freedom of contract but imposes certain limitations on the parties to a security agreement. The obligations of good faith, diligence, reasonableness and care may not be disclaimed by agreement.\(^2\) The parties may not disclaim warranties except in the manner and to the degree specifically provided in Article 2. The debtor cannot contract out of his right to sell or transfer any interest in the collateral he may have acquired under the security agreement.\(^3\) The parties may not create a binding term which prohibits the assignment of an account or contract right to which they are parties.\(^4\) Certain rights, for example the rights of third parties, under Section 9-301, as against an unperfected security interest, cannot be altered or destroyed by a clause in the security agreement. Nor may the meaning of the Code be varied by agreement; this must be found in the text itself, including definitions and appropriate extrinsic aids. However, the effect of the provisions of the Code may be varied by agreement, where permitted, so that the legal consequences which would otherwise flow from the provisions may be quite different.\(^5\)

In construing the terms of a security agreement, whether written or not, the course of dealing between the parties and any usage of trade which is relevant may be examined.\(^6\) Where the agreement provides for repeated transactions which are carried out with full knowledge of the parties, without objection by either party, the circumstances surrounding the performance of such continued transactions are also relevant to determining the meaning of the agreement.\(^7\)

2. **Value.**

a. **Generally.**

The definition of value is substantially the same as it is under other uniform acts. Value includes any consideration sufficient to support a


\(^{32}\) § 1-102 (3).

\(^{33}\) § 9-311.

\(^{34}\) § 9-318 (4); Spivack, Secured Transactions 56-41 (1962).

\(^{35}\) § 1-102 comment point 2.

\(^{36}\) § 1-205 (3).

simple contract, a binding commitment to extend credit whether drawn upon or not, and the acquiring of rights as security for the total or partial satisfaction of a pre-existing claim. Value is also deemed to be given if a party acquires rights by accepting delivery pursuant to a pre-existing contract for purchase, thereby converting a contingent into a fixed obligation.\(^{38}\)

b. *New Value.*

For certain purposes a distinction is drawn between *value* and *new value*. New value is not completely defined in the Code, but illustrations are given, such as making an advance, incurring an obligation or releasing a perfected security interest. If, at the inception of the agreement, the secured party gives new value in any of these or other forms, which is to be secured by after-acquired property, his interest is deemed to be taken for new value and not as security for an antecedent debt. However, in the latter case, the debtor must acquire the property in the ordinary course of business or pursuant to an express provision in the original security agreement within a reasonable time after new value is given.\(^{39}\) Thus, whether new value has been given is vital in determining whether a transfer under a security agreement is for an antecedent debt and, therefore, voidable as a preference. Another favor, extended under the Code on the basis of the giving of new value, is the 21 day grace period as to instruments and negotiable documents.\(^{40}\)

Some writers have expressed considerable doubt as to the validity of the test of new value in the event of bankruptcy of the debtor.\(^{41}\) The *Federal Bankruptcy Act*\(^{42}\) provides that any transfer of property made within four months of bankruptcy is a voidable preference if it was made in consideration of an antecedent debt by an insolvent debtor to a creditor who at the time of the transfer had reasonable cause to know that the debtor was insolvent. Since one aspect of a floating lien, which the Code sanctions, requires that what in fact is an antecedent debt, be considered valid consideration, *i.e.*, new value, for a security interest in after-acquired property, it is thought by some that the trustee in bankruptcy will be given priority over the secured party on the basis that the transaction constitutes a voidable preference, providing the secured party had reasonable cause to know of the insolvency. However, as has been noted, the Code provides that “a security interest in after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent

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38. § 1-201 (44) and comment point 44.

39. § 9-108.

40. § 9-304 (4).


42. See §§ 60 (a) (1), 60 (b).
debt. . . ." 43 In view of this, it appears that this conflict should be resolved in favor of the validity of the Code test for new value since the question of whether a creditor has a perfected security interest in the assets of the bankrupt, in priority to the claim of the trustee in bankruptcy and other creditors, is to be determined by the relevant state law. 44

In support of the validity of the Code provision on new value, the draftsmen express the view that security interests in after-acquired property have never been considered as being taken for an antecedent debt merely because of the after-acquired property feature. 45 Certainly, sound business understanding would urge the acceptance of this view. 46

3. Rights in Collateral.

As has been observed, in addition to the execution of an agreement and the giving of value, a security interest will not attach until the debtor has acquired rights in the collateral. To prevent controversy over when a debtor acquires rights, the Code singles out several types of property and states when the debtor acquires rights therein. A debtor does not have rights in crops until they are planted or otherwise become growing crops, nor in young livestock until they are conceived. Rights in fish are not acquired until caught, in oil, gas or minerals until they are extracted, and in timber until it is cut. Rights in contract rights are not acquired until the contract is made, and in an account until it comes into existence. 47 If the parties have entered into an agreement and the secured party has given value, his security interest will attach at the moment the debtor acquires rights in the collateral.

The rules in Article 9 operate without regard to the location of title, i.e., whether title is in the secured party or the debtor is immaterial. 48 If title to particular collateral should be in the secured party, nevertheless the debtor may not be prohibited, by an agreement between the parties, from creating a subsequent security interest in the same collateral in favor of a third party. 49 Of course a subsequent security interest, unless it is a purchase money security interest which may take priority under Section 9-312 (3) & (4), would be a subordinate one. Nevertheless, the debtor has sufficient "rights in the collateral" to allow the subsequent security interest to attach providing value is given pursuant to an agreement.

4. After-acquired Property.

It has been observed that under the Code a security interest does not attach until value is given pursuant to an agreement between the

43. § 9-108.
45. § 9-108 comment.
47. § 9-204.
48. § 9-101 comment.
49. § 9-311.
parties and until the debtor has acquired rights in the collateral. The Code places no limitations on the time when the debtor may acquire rights in the collateral, which of course means that he may acquire the property after the agreement is made and value is given. It is this fact which permits the operation of an after-acquired property clause, and the Code specifically validates such a clause by broadly stating that "a security agreement may provide that collateral, whenever acquired, shall secure all obligations covered by the security agreement." A security interest in after-acquired property, as in presently owned property, is not only valid against the immediate parties but against third parties as well, except to the extent provided in Section 9-312 (3) & (4).

Our present day business world demands a system of secured financing which allows the debtor to maintain possession of the collateral at the same time as giving maximum protection to the secured party against competing claims that may arise during the course of the financing relationship. Typically, a manufacturer or merchant may go to his bank and request a loan of $300,000.00 for the purposes of financing his operation for the next season. He may need $100,000.00 by July 1, another $100,000.00 by August 1, and another $100,000.00 by September 15. He states that he should be able to pay back $75,000.00 by December 1, another $150,000.00 by January 15, and the remaining $75,000.00 by March 1. During the course of the season the inventory of the merchant will be shifting, and in the case of the manufacturer, the inventory will undergo a dual change. First, the raw materials will be changed to goods in process and then into finished products. Second, the finished products will be sold and the proceeds or part of them, will be used to purchase new raw materials for replacement. Thus, the security interest of the secured party must be of such a nature that it attaches to the raw materials, shifts to the goods in process and the finished product and finally to the proceeds upon the sale of the goods by the debtor. With a considerable number of reservations and qualifications this could be done under prior law by the creation of a floating lien.

50. However, if the secured party claims to acquire his security interest in collateral pursuant to a contract of purchase under the terms of a security agreement, the debtor is required to acquire rights in the collateral within a reasonable time after new value is given. Otherwise his interest is not deemed to have been taken for new value. § 9-108.
51. § 9-204 (3): however, Section 9-204 (4) imposes a limitation on the extent to which a security interest may be claimed in crops and consumer goods under an after-acquired property clause. It is interesting to note that California's proposed version of the Code deletes crops from the limitation under 9-204 (4). Experience in California has not substantiated the peon theory on which 9-204 (4) (a) is apparently based; Project, supra note 37, at 899.
52. Birnbaum, supra note 46, at 103.
53. Coogan & Hauserman, Jr., Article Nine Secured Transactions, 4 Ann. Survey Mass. 57, 59 (1957); in most states, under pre-Code law, if the debtor went through the right formalities at the right times he could create a valid lien covering both his present and future assets in favor of one creditor so as to secure all present and future advances by the creditor. The debtor could begin by granting a chattel mortgage on all his present assets and by giving a supplemental mortgage whenever he acquired new assets. Or, the creditor could purchase a conditional sales contract from the seller whenever new equipment was acquired. The debtor's
In harmony with present day business needs and practices the Code validates the floating lien with no more formal requisites than are required to obtain a security interest in presently owned collateral, provided only that the agreement contain an after-acquired property clause. There presently owned inventory would be financed under a factor's lien act and his future inventory could be financed by the use of a trust receipt. The debtor's present accounts receivable would be assigned to the financing creditor whenever new accounts receivable were created; Coogan, Article 9 of The Uniform Commercial Code: Priorities Among Secured Creditors and The "Floating Lien," 72 Harv. L. Rev. 838, 850 (1959); thus, by going through complicated and expensive procedures a floating lien could be created in favor of the financing creditor.

However, inconvenience and exorbitant legal costs were not the only undesirable attributes of the pre-Code floating lien. There was the constant threat, until Congress amended § 60 of the Bankruptcy Act in 1950, that the party's security interest in the debtors' accounts receivable or inventory, might be voided as a preferential transfer. This possibility arose because the test of whether a transfer was valid depended upon whether it was so far perfected that a bona fide purchaser could not obtain priority. The Corn Exchange National Bank & Trust Co. v. Klauder, 318 U.S. 434 (1943), held that an assignment of accounts receivable was voidable as a preference because state statute provided that the assignee of the accounts from being defeated by a subsequent assignee who first collected or first notified the account debtor. Likewise the lien of the inventory financer was voidable since a bona fide purchaser took the property free of any subsequent lien. The accounts receivable weakness could be and was cured by any states by passing legislation providing that the first assignee would prevail over any subsequent assignee. However, the inventory problem virtually could not be solved by state legislation since it would be absurd to allow the inventory secured party to prevail over a bona fide purchaser. Thus all such interests were subject to being invalidated as voidable preferences. Fortunately, the 1950 Congress amended § 60, 64 Stat. 24 (1950), by providing that the test of whether a transfer is voidable as a preference is whether or not the lien is so far perfected that it may not be defeated by a subsequent lien creditor, rather than a bona fide purchaser. This solved the inventory security interest problem. A new provision in the Bankruptcy Act stipulated that any lien perfected within 21 days after execution of the agreement would be deemed to relate back to the date of the transfer. This provided an effective counter to the argument that the security interest was secured by an antecedent debt and therefore voidable as a fraudulent preference. Rudolph, Secured Transactions Under The Commercial Code, 15 Bus. Law 525, 540 (1961); Greenberg, Inventory and Accounts Receivable Financing, U. Ill. L.F. 601, 628 (1956); Rudolph, Inventory Financing of Hard Goods, U. Ill. L.F. 580, 599 (1956)

However, there still remained the problem that a lien claimed over after-acquired property might be considered to be secured by an antecedent debt, and therefore voidable as a preference. In addition the debtor was further restricted by the principle which arose with Benedict v. Ratner, 268 U.S. 553 (1925), requiring the debtor to constantly account to the lien holder for the proceeds of accounts and returned goods. Unrestricted dominion and control by the debtor was held to be inconsistent with a lien on the accounts and inventory in favor of a creditor. Thus, the debtor was hampered in the use of such proceeds in his own business without indulging in a somewhat expensive accounting system, and in providing for a trustee arrangement for the returned goods so that it would not appear as though the debtor had unfettered possession and control over them. Coogan & Hauserman, Jr., supra at 60-1; Funk, Pennsylvania and Massachusetts Experience Under The Uniform Commercial Code, 16 Bus. Law 525, 540 (1961); Greenberg, Inventory and Accounts Receivable Financing, U. Ill. L.F. 601, 628 (1956); Kripke, Inventory Financing of Hard Goods, U. Ill. L.F. 580, 599 (1956); Rudolph, supra at 225-26; Symposium, supra note 23, at 390-93.

54. § 9-204 comment points 2 and 8. Thus, the Code rejects the nineteenth century prejudice of the courts and legislatures against the floating lien. The prejudice was based on the theory that creditors as well as the debtor would have greater protection if the debtor were not allowed to encumber all of his assets. The draftsmen of the Code accept the soundness of this policy, but have validated the floating lien for the reason that experience proves that the policy is not being adhered to in practice. § 9-204 comment 3; Bunn, Financing Dealers: Existing Wisconsin Law and The Uniform Commercial Code, 37 Marq. L. Rev. 197, 202 (1953-54); Coogan, Operating Under Article 9 of The Uniform Commercial Code Without Help or Hindrance of the "Floating Lien," 15 Bus. Law 373, 374 (1950).
are a number of provisions in Article 9 of the Code which work together to validate the floating lien. Validation of the after-acquired property clause is a vital element in facilitating the creating of a floating lien.\(^5\) In certain circumstances a security interest in deemed to be taken for new value when in fact the consideration is of the nature of an antecedent debt.\(^5\) Provision is made for determining the relative priorities of conflicting security interests in the same collateral.\(^5\) The debtor is permitted to give present security for future advances,\(^5\) to perfect a security interest by filing a financing statement which merely describes the type of collateral,\(^5\) and to exercise unfettered dominion and control over the collateral and proceeds.\(^5\) The secured party, by the operation of a continued security interest principle, is permitted to maintain a security interest in proceeds received by the debtor upon disposition of the collateral,\(^5\) and to maintain a security interest in collateral after it has lost its identity through a manufacturing process.\(^5\) Thus, through the combined operation of all of these provisions a floating lien may be created with an extremely liberal functional framework.

5. Future Advances.

An important element in the function of a floating lien under the Code is the provision which validates future advances. The Code states simply that an agreement giving security for future advances is valid whether or not the advances or value are given pursuant to commitment.\(^5\) For example, suppose that on Monday, Bank A is consulted by X who wants a loan of $500.00. The manager of Bank A does not agree or disagree to give the loan, but merely says that he will investigate X's credit and then get in touch with him on Friday. However, the manager says he wants to file a financing statement against X's collateral now, which he does on the same day. On Tuesday, Bank B loans X $500.00 and files against the collateral the same day. On Friday, Bank A loans X $500.00. Who takes priority?\(^5\) If Section 9-204 (5) is taken at face value it would appear that Bank A takes priority simply because future advances are validated whether or not they are given pursuant to commitment. It is true that Section 9-204 (1) states that a security agreement cannot attach until value is given etc., and Section 9-303 provides that a security interest is perfected when it attaches and when all steps required for perfection have been taken. Thus it would appear that Bank A could not possibly take priority over Bank B in view of the fact that the interest of Bank A is the last to be perfected. However, where two conflicting interests are perfected by filing,

\(^5\) Section 9-204(3).
\(^6\) Section 9-108.
\(^7\) Section 9-312.
\(^8\) Section 9-204(5).
\(^9\) Section 9-402.
\(^10\) Section 9-205.
\(^11\) Section 9-306.
\(^12\) Section 9-315; Birnbaum, supra note 46, at 104; Coogan, supra note 53, at 859.
\(^13\) Section 9-204(5).
\(^14\) Professor Hawkland's Problems, Distributed in Mimeographed Form To Sales Class, University of Illinois, College of Law (1961-62).
the order of perfection becomes irrelevant. Section 9-312 (5) (a) states that where both interests are perfected by filing, the first party to file takes priority regardless of whether his interest attached first, and whether it attached before or after the filing. Thus Bank A would take priority even though the advance was not made pursuant to commitment. However, when one of the conflicting security interests has been perfected by a method other than by filing the order of perfection does become determinative of the order of priority. That is, if Bank B had taken possession of the collateral on Tuesday its claim would have been superior to that of Bank A.

The validation of a security agreement giving security for future advances whether or not the advances are given pursuant to commitment is a considerable departure from the law in some jurisdictions which, if future advances were valid at all, permitted only those advances for which the secured party legally committed himself. Usually, the agreement had to specify the exact amounts to be advanced and when the advances were to be made; in some cases the advances could not be made later than a particular period of time, such as one year. The Code validates the future advance interest without the requirement of such details being included in the agreement, provided only that the security agreement contain a future advances clause. The Code goes even further and validates "the so-called 'cross-security' clause under which collateral acquired at any time may secure advances whenever made." Thus, future advances may be secured by presently owned or after-acquired collateral.

CHAPTER III

PERFECTION OF A SECURITY INTEREST
AND THE RELATIVE NATURE OF PERFECTION

The term "perfection," drawn from Section 60 (a) of the Bankruptcy Act, is used in the Code to describe the means by which a secured party acquires maximum protection against the claims of creditors, transferees of the debtor and representatives of creditors in bankruptcy proceedings. A security interest is said to be perfected when it attaches and when all steps required for perfection under the Code have been taken. The term "perfected security interest" seems to imply that the security interest is completely invulnerable to the claims of creditors and transferees of the debtor in all circumstances. Although this is generally true, it is not always, for the reasons that the Code establishes rules for determining the relative priorities among secured parties claiming conflicting security interests in the same collateral. In some cases third parties are given priority over a

66. § 9-204 comment point 8.
67. § 9-204 comment point 5.
69. § 9-303.
perfected security interest and in a few instances they rank equally.\textsuperscript{70} It follows from this that a “perfected security interest” must be only a relative term.

Three methods of perfection are recognized by the Code: attachment, possession, and filing, with possession and filing being by far the most common methods of perfection. In some cases a particular security interest may be perfected by all three methods; in other cases perfection may be permitted only by possession, or by filing and possession, or by some other combination. The basis for the distinctions in the rules of perfection, as with most other rules in Article 9, may be found in the type of property which constitutes the collateral, the special nature of the transaction, or in public policy which gives special consideration to the protection of certain parties such as consumers and farmers.

A. Attachment.

It has been observed that a security interest will not attach until there is an agreement that it attach, value is given and the debtor has rights in the collateral. Attachment, with nothing more, creates a security interest in all types of collateral that is enforceable between the immediate parties, providing the minimum formal requisites are met. Beyond this, there are only two cases where a non-possesory security interest is given the status of a perfected security interest merely by attachment.\textsuperscript{71} These include a purchase money security interest in consumer goods of unlimited value, and farm equipment having a purchase price not in excess of $2,500.00. Fixtures and motor vehicles which fall into this category are not included.

It is to be noted that only a purchase money security interest in collateral of this type may be perfected by attachment. Generally, this includes all installment sales of consumer goods and farm equipment which, under prior law, were financed under a conditional sales contract, and also those cases where the purchase price was secured by a chattel mortgage.\textsuperscript{72} More specifically, a purchase money security interest is one which is “taken or retained by the seller of the collateral to secure all or

\textsuperscript{70} Birnbaum, \textit{A Restatement and Revision of Chattel Security}, Wis. L. Rev. 348, 367-68 (1952).

\textsuperscript{71} More accurately, perhaps it should be said that there are three cases were a security interest may be perfected by attachment, since an assignment or sale of accounts or contract rights which do not alone in conjunction with other assignment to the same assignee transfer a significant part of the outstanding accounts or contract rights of the assignor, may give a secured party a perfected security interest from the time of the assignment or sale without the necessity of filing. If, however, the assignment or sale did transfer a significant part of the outstanding accounts or contract rights, filing is necessary to perfect a security interest in the collateral. § 9-302 comment point 5; § 9-304 comment; § 9-305. If grace periods, given in particular instances under the Code, such as in Section 9-304 (4) & (5), were included there would be four instances in which a security interest may be perfected without filing or possession. However, in the case of Section 9-304 (5), the secured party’s interest must have already been perfected either by possession or filing prior to obtaining the 21 day grace period. A continuing security interest in proceeds is somewhat of a similar nature and this too could be included. § 9-306.

part of its purchase price, or 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.\textsuperscript{73} Thus where a non-purchase money security interest is given in consumer goods or farm equipment, such as to secure a loan, filing or possession is necessary to perfect the security interest.\textsuperscript{74}

The relative nature of a perfected security interest arising by attachment may be demonstrated by an illustration involving the fraudulent sale of consumer goods by one customer to another. Suppose that a retail appliance store sells a refrigerator to a debtor (for household use) who gives value and agrees to give a security interest in the goods to secure the balance. The seller's interest is now perfected without taking further steps since a purchase money security interest in consumer goods is perfected at the moment it attaches. Section 9-307 (2) provides that a subsequent buyer of consumer goods takes free of the interest of the secured party if he buys without knowledge of the security interest, for value, for his personal, family or household purposes and before a financing statement is filed by the secured party. Obviously a buyer of this type would defeat the seller's interest. Thus, the perfected security interest of the seller is only relative because the draftsmen of the Code have given recognition to public policy which gives special consideration to the consumer in situations of this type.

Of course a seller may perfect his interest in consumer goods and farm equipment by filing if he desires, and in those cases where the goods are of considerable value filing would be a worthwhile step. The seller would then be protected not only against the claims of creditors of the debtor and transferees of the debtor, but against the possible risk of a second hand sale as well.\textsuperscript{75}

The rule allowing perfection by attachment appears to have been established in recognition of the fact that in most business areas it is not customary to record or file conditional sales contracts or chattel mortgages covering sales of consumer goods and farm equipment in small amounts.\textsuperscript{76} The reason is that consumer goods and farm equipment are usually bought for the use of the individual buyer who has no intention of disposing of them, at least not until they are paid for. Thus the risk of a seller's security interest being cut off by a third party of the type mentioned in Section 9-307 (2) (which, in fact, is the only type of transferee who could defeat the seller's interest) is in reality very small. And in any case experience has shown that in jurisdictions where filing is required, the mere act of filing has not adequately provided against the risks involved in an improper disposition of the goods by the customer, since the seller may still be unable to locate the goods even though the transfer is invalid. On the other hand, the chance of a third party such as a bona fide

\textsuperscript{73} § 9-107.
\textsuperscript{74} Spivaek, Secured Transactions 94 (1962).
\textsuperscript{75} Id. at 95.
\textsuperscript{76} Kripke, supra note 72, at 379.
financer, being injured by the absence of a filing, is not very great either since such third parties are usually quite aware of the practice of farmers and consumers to buy farm equipment and consumer goods under a financing arrangement. Thus, the saving in time and filing fees outweigh the advantages that are to be gained by filing.

There is an inherent weakness in every security interest which is perfected other than by possession or filing. A holder in due course or a good faith purchaser will cut off a non-possessor interest in negotiable documents and instruments. The proceeds received from the disposition of the collateral may be dissipated beyond recovery, even within a ten day period, in the event of insolvency of the debtor.

B. Possession.

The common law doctrine of perfection of a security interest by possession is incorporated into the rules of perfection under Article 9. Personal property which may be perfected by possession includes all property which is physically capable of delivery. Thus, a security interest in goods, instruments, negotiable documents or chattel paper, and letters of credit and advices of credit because of their peculiar nature, may be, and in some cases may only be, perfected by the transfer of possession to the secured party. With the exception of instruments, letters of credit and advices of credit, a security interest in all of these types of collateral may also be perfected by filing. The Code does not give a definition of possession, but in view of the language of the Official Comments it may be assumed that the common law principles for the determination of possession under the law of pledge are applicable. Possession of collateral for the purpose of perfecting a security interest may be in either the secured party or his agent; the debtor may not hold the property on the behalf of the secured party.

Probably the the largest volume of secured financing in the United States is done among manufacturers and buyers of various types who enter into the financing relationship for the express purpose of gaining physical possession of the collateral, which is the security for financing the deal.


78. § 9-309; § 3-302-307; § 7-501-509.

79. § 9-306; Stone, Article 9: Secured Transactions, 21 Mont. L. Rev. 91, 96 (1959).


81. Kripka, supra note 72, at 377-78.

82. § 9-304, -305; Project, supra note 80, at 844. The Code makes no attempt to change the widely accepted practices relating to the use and handling of letters of credit prior to the enactment of the Code. For a discussion of this aspect of letters of credit see Chadsey, Practical Effect of The Uniform Commercial Code On Documentary Letter of Credit Transactions, 102 U. Pa. L. Rev. 618 (1954).

83. § 9-302, -304, -305.

84. § 9-305 comment point 2.

85. Kripka, supra note 77, at 605.
In view of this, possession of the collateral by the secured party as a method of perfecting a security interest at the outset of such a financing relationship is not practical, except in those cases where the collateral is not needed by the buyer or borrower for immediate use. Thus, the most common use of this method of perfection is limited to transactions between the borrower and pawn broker.  

The draftsmen of the Code were unwilling to interfere with the negotiability concept by imposing on a holder the burden of looking beyond the four corners of commercial paper. Section 9-309 provides that a holder in due course or bona fide purchaser of a negotiable instrument, negotiable document of title or security takes priority over a prior security interest, even though perfected, and filing does not constitute notice of the security interest to such holders or purchasers. Thus, when collateral of this nature is pledged as security for a loan, the only way the secured party may be sure his interest will not be defeated by a subsequent holder is for him to take possession of the collateral. Indeed, as has been observed, possession is the only method of perfecting a security interest in a negotiable instrument. Where a negotiable instrument is attached to a security agreement as part of the same transaction, the two documents taken together constitute chattel paper and a security interest therein may be perfected by filing. But in the case of chattel paper, filing does not constitute notice to a holder in due course.  

The relative nature of a perfected security interest is demonstrated by two situations related to perfection by possession. However, it should be noted at the outset that perfection by possession usually guarantees the secured party absolute priority. Although the following illustrations are related to possession, the security interests in question are perfected either by attachment or filing. The first involves a lending bank which finances the purchase of goods for the debtor. Typically, the goods are in the possession of a carrier or warehouse and the lending bank has possession of the documents of title in which it already has a security interest by virtue of possession. The only way the debtor can gain possession of the goods is to submit the documents of title to the bailee. The Code provides that if the secured party has a perfected security interest in a negotiable document representing goods in possession of a bailee, he may make available to the debtor the document for such purposes as ultimate sale, exchange, loading, unloading, storing, shipping, transshipping, manu-

86. Spivack, supra note 74, at 79.
87. Id. at 80.
89. If the collateral is negotiable instruments, securities or negotiable documents, possession will give the holder priority over all other interests, regardless of whether they were perfected prior to that of the holder. If, however, the property in question is some other type of collateral which is capable of physical possession, perfection by possession will give priority only if another interest has not been perfected previously. § 9-309, -312.
90. Birnbaum, supra note 88, at 285-86.
facturing, processing or otherwise dealing with the goods in the manner preliminary to their sale or exchange, without losing his perfected interest for a period of 21 days, even though the secured party doesn't file. In view of Section 9-309 which preserves the concept of negotiability and grants the holder in due course of a negotiable document of title priority over the claims of a prior secured party, any fraudulent transfer of the document of title by the debtor in this illustration would give a holder in due course prior title to the document, and thereby, the goods. This result would stand even though the fraudulent transfer is made within the 21 day grace period during which the lending bank is given a perfected security interest in the collateral. Thus, a perfected security interest is only a relative term because the draftsmen of the Code have preferred to give greater weight to the concept of negotiability than to protecting a secured party against the possible fraudulent transfer by a debtor. It should be noted, however, that during this period of temporary perfection the secured party's interest is superior to the claims of all other creditors or transferees, except a holder in due course.

The second situation involving the relative nature of a perfected security interest is really an extension of the first. As previously noted, filing is an alternative method of perfecting a security interest in negotiable documents and chattel paper. Suppose that in the first illustration the lending bank had filed a financing statement, thereby perfecting his security interest by filing, prior to the expiration of the 21 day grace period. The debtor then fraudulently transfers the document to the holder in due course. In view of the language of Section 9-309 the holder in due course will defeat the interest of the lending bank in spite of the fact that it has been perfected by filing, and regardless of whether the transfer was before or after the expiration of the grace period. Thus, the perfected interest of the bank is only a relative interest because the draftsmen of the Code have seen fit to preserve the concept of negotiability even above the right of parties who have perfected their interests in negotiable documents by filing. Of course the secured party is protected against all creditors and transferees except holders in due course, but the only legally effective method of perfection whereby the secured party may obtain maximum protection is by possession.

Where goods are held by a bailee other than one who has issued a

91. § 9-304 (5). The same rule applies to goods in possession of a bailee other than one who has issued a negotiable document therefore. In the case of an instrument, the perfected interest will not be lost for a period of 21 days if the purpose of delivery to the debtor was for sale, exchange, presentation, collection, renewal or registration of transfer. § 9-304 (5). Section 9-304 (4) also provides that a security interest in documents or instruments is perfected for a period of 21 days from the time it attaches, with no limitations on the purposes for which the debtor acquires possession and even though the collateral is not in the possession of the secured party, if there is a written security agreement signed by the debtor and the debtor has given new value.

92. Spivack, supra note 74, at 80.

negotiable document therefor, a person to whom a security interest in the goods is given is deemed to acquire possession of the goods at the moment the bailee is notified of the secured party's interest. This provision constitutes a change in the common law which required the bailee to acknowledge to the secured party that the goods were being held on his behalf, and on the happening of that event the secured party's interest became perfected.

In transactions involving possession as the method of perfection, the time of possession dates from the time the secured party or his agent actually gains possession of the collateral without relation back. This result may not be altered by agreement between the parties. The Code thereby falls in line with the principle set out in the Chandler Amendments to § 60 (a) (6) of the Bankruptcy Act which rejects the "equitable pledge" theory of relation back. Under the relation back theory the parties were able to enter into an agreement to give a secured party a security interest in certain collateral which was to remain in the possession of the debtor. Sometime thereafter the secured party would take possession of the collateral and perfection was deemed to relate back to the date of the original security agreement by virtue of the subsequent possession. The only exception to the rule under the Code is the 21 day grace period of perfection during which the debtor is allowed possession of the specific collateral in which there is a perfected security interest.

To provide resiliency in the matter of perfection, a security interest may be perfected either by attachment or filing, where such methods are permissible, either before or after the period of perfection by possession. For example, a security interest may originally be perfected by filing and later, because the secured party deems himself insecure, he may take possession of the collateral pursuant to the terms of an insecurity clause in the security agreement. What was originally a non-possessory security interest now becomes a possessory one. A security interest which has been originally perfected in any way under Article 9, but is subsequently perfected some other way, without an intermediate period when it was not unperfected, is deemed to be continuously perfected. Thus, in the example given, the security interest dates back not to the date the secured party took possession of the collateral, but rather back to the date of the original security agreement.

C. Filing.

A security interest in all types of collateral must be perfected by filing a financing statement except where filing is specifically excluded

94. § 9-305.
95. § 9-305 comment point 2.
97. § 9-305 comment point 3.
98. § 1-208; § 9-305.
99. § 9-302 (2).
100. Spivack, supra note 74, at 84.
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Thus, a system of notice filing, a concept not foreign to the field of security transactions under prior law, is adopted by the Code. The objective of notice filing is to provide a simple means by which creditors of the debtor may be put on notice of another creditor's present or possible future interest, leaving the details of the transaction to further inquiry by interested parties. The types of property in which a security interest may be perfected by filing are goods, documents, chattel paper, non-negotiable documents, accounts, contract rights and general intangibles. Although filing is usually an alternative method of perfection of most types of collateral, a security interest in accounts, contract rights, and general intangibles may be perfected only by filing. The filing of a financing statement may be done either before or after attachment. When the last step in filing or creation has been completed, the security interest is perfected. Thus, if a security interest has been created and all that remains to be done is the filing of a financing statement, upon the happening of that event the security interest is perfected. This provision encourages advanced filing by prospective secured parties.

The necessary elements of a financing statement are few. It must be signed by the debtor and the secured party; it must give the address of the secured party and of the debtor, and it must contain a statement describing the type of items of collateral. The security agreement itself may be used as a financing statement where the parties are not reluctant to reveal its contents to the public. However, if the security agreement is used as a financing statement it must be signed by the creditor as well as the debtor.

A financing statement which contains a maturity date of less than five years from the time of filing, is effective for the period stipulated plus sixty days. If a financing statement does not contain a maturity date, it is effective for a period of five years only. At the expiration of the sixty day grace period or of the five years respectively, the effectiveness of the financing statement will lapse, unless a continuation statement is filed at the appropriate time. At the moment a financing state-

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101. Project, supra note 80, at 843-44. Examples of collateral specifically excluded from the filing method of perfection are certain types of property subject to federal statutes, such as copyrights, aircraft, railroads, and property subject to state statutes which provide for central filing of, or indication on a certificate of title of such security interests, such as motor vehicles in Illinois. § 9-302(3) and comment point 8. As noted herein under the section on possession as a means of perfecting a security interest, filing is not an alternative method of perfecting a security interest in instruments, letters of credit and advices of credit.


103. Coogan, supra note 93, at 849.

104. However, a security interest in an assignment of accounts or contract rights consisting of less than a significant part of the outstanding accounts or contract rights of the assignor may be perfected without filing, that is, by attachment. § 9-302 (1) (e).

105. § 9-303 (1).

106. Birnbaum, supra note 70, at 573.

107. § 9-402.

108. § 9-403 (3).
ment lapses, the security interest may then be defeated by an interest which would defeat an unperfected interest as mentioned in Section 9-301. If there is a conflicting junior security interest which was also perfected by filing, it will also take priority over a prior security interest which lapses. The result is to avoid the circular priority problems which arose under some prior statutes.\(^{109}\) During the effective period, a single filing of a financing statement may cover one or more security agreements. This is particularly useful in transactions involving inventory, accounts and chattel paper where the arrangement is continuing and the collateral is changing from day to day.\(^{110}\) The Code also provides for the filing,\(^{111}\) amendment,\(^{112}\) assignment,\(^{113}\) and termination\(^{114}\) of a financing statement.

Just as in the case of perfection by attachment, a security interest perfected by filing is only relative in status and may be a subordinate interest in certain cases. This may be demonstrated by a chattel paper transaction.\(^{115}\) Assume that a furniture store sells a dining room suite to a buyer on the installment plan, and the buyer signs a security agreement to secure the balance. The furniture store then assigns the chattel paper to a finance company which perfects its interest by filing, but leaves the chattel paper in the possession of the furniture store for collection.\(^{116}\) Section 9-308 provides that a purchaser of chattel paper left in the possession of the debtor (assignor) takes priority over a security interest which has been perfected by filing, if the purchaser gives new value and takes possession in the ordinary course of business and without knowledge (derived from a marking on the face, for example) that the specific paper is subject to a prior security interest.\(^{117}\) In this illustration, if the debtor were to sell the chattel paper to a purchaser coming within the rule just mentioned, he would take free of the claims of the finance company. Thus, the perfected security interest of the finance company is only a relative one in commercial transactions of this type because the draftsmen of the Code have favored the bona fide purchased concept above the protection derived from notice filing where the secured party chooses to assume the credit risk of a fraudulent transfer by a dishonest debtor as a result of leaving the chattel paper in his possession. However, the finance company's security interest would be protected against the bankruptcy risk, that is, against creditors and transfers for an antecedent debt or other transfers not in the

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109. § 9-403 comment point 3.
110. § 9-403 comment point 2; Coogan, supra note 93, at 848.
111. § 9-401.
112. § 9-402.
113. § 9-405.
114. § 9-404.
115. Chattel paper is defined as "a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods. When a transaction is evidenced both by such a security agreement or a lease and by an instrument or a series of instruments, the group of writings taken together constitutes chattel paper." § 9-105(b).
116. Arrangements of this nature commonly occur as indicated by § 9-308 comment point 1.
117. § 9-308 sentence one. This rule also applies to non-negotiable instruments. See comment point 3.
ordinary course of business. The finance company could have protected itself against subsequent assignees by noting on the chattel paper that it is subject to a security interest and that any further sale or assignment thereof would be in violation of the terms of the security agreement. This statement would give the second assignee the type of knowledge which would be fatal to his claim to priority.

D. Purchase Money Security Interests.

The Code draws a distinction between a purchase money security interest and a non-purchase money security interest. A purchase money security interest is defined as an interest which 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.

Prior to the Code the concept of "purchase money" was generally limited to a conditional sales transaction, or a chattel mortgage transaction if the chattel mortgage were given to the seller to secure the purchase price. However, the term applied to a few cases where money was advanced to enable a purchaser to buy goods, with a chattel mortgage given in return to secure the advance. Under the Code the concept has been broadened to include cases where a debtor is enabled to acquire rights in or the use of the collateral with value received as a result of a secured party incurring an obligation, and also all cases where a security interest is taken by a secured party who makes advances to enable the debtor to acquire rights in or the use of the collateral. The purchase money secured party must be one who has acquired his interest by giving present consideration and not merely consideration in the form of an antecedent debt.

Recognizing that secured parties who create purchase money security interests are indispensable to the normal operation of our modern credit economy, the draftsmen of the Code have adopted a policy of giving such secured parties favored treatment in various circumstances. One of the most notable benefits to a purchase money secured party is that he is given a ten day grace period against a transferee in bulk or lien creditor.

A purchase money secured party takes priority over the interest of a bulk purchaser or lien creditor which arises between the time the purchase money interest attaches and the time of filing, if the secured party files with respect to the purchase money security interest within ten days after the collateral comes into possession of the debtor. Except for this grace period given to a holder of a purchase money security interest, the Code does not permit an unperfected security interest, under Section 9-301,
to take priority over an intervening interest of the status of a lien creditor or higher, upon the subsequent perfection of the security interest, even though it is perfected within ten days of attachment.\(^\text{123}\)

Under certain conditions a purchase money interest is given priority over an interest acquired under an after-acquired property clause. A purchase money security interest in inventory collateral takes priority over a conflicting interest in the same collateral if the purchase money interest is perfected before the debtor receives possession of the collateral, and if the purchase money secured party notifies anyone with a conflicting security interest of whom he knows, and anyone else who has filed with respect to the same or same type of collateral. The notice must describe the collateral in which the purchase money secured party intends to take a security interest.\(^\text{124}\) Thus, the draftsmen of the Code have taken the view that even though an inventory secured party having a security interest in the nature of a floating lien is to be protected, a purchase money secured party who facilitates the debtor by enabling him to acquire more inventory, is performing a function of sufficient importance that he ought not to be subordinated to the after acquired property clause. The practical effect of the rule is that a purchase money secured party must always search the filing records to determine whether there is an existing security interest which will attach to the debtor’s incoming inventory in the event the purchase money secured party fails to give proper notice. If a prior encumbrancer is found on record, notification may be sent to him even though the actual terms of the agreement are not known, on the assumption that the agreement contains an after-acquired property clause.\(^\text{125}\) Where the collateral being sold to the debtor is not inventory, a purchase money secured party need not give notice to other parties who may have filed with respect to the debtor’s after-acquired property. A purchase money security interest in collateral other than inventory takes precedence over conflicting security interests in the same collateral if the purchase money security interest is perfected at the time the debtor receives the collateral or within ten days thereafter.\(^\text{126}\)

With respect to consumer goods of unlimited value and farm equipment costing less than $2,500.00, a purchase money security interest is perfected merely by attachment. Thus, a maximum of protection is given to a purchase money secured party in most cases,\(^\text{127}\) with a minimum of effort on his part. Elimination of the filing requirement to perfect a purchase money security interest assumes considerable importance in certain areas of secured transactions. For example, unless a secured party who

\(^{123}\) § 9-301 comment point 5.

\(^{124}\) § 9-312 (3).

\(^{125}\) Spivack, supra note 74, at 62.

\(^{126}\) § 9-312 (4).

\(^{127}\) A purchase money security interest will be defeated by a buyer of consumer goods and farm equipment costing less than $2,500.00 if he buys for his personal, family or household use or his farming operation, and if he gives value without knowledge of the prior security interest before the secured party files. § 9-307 (2).
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claims a security interest in fixtures perfects his interest prior to the time certain subsequent interests arise in the real estate, the secured party's interest will be subordinate, regardless of whether it attached before or after affixation. These subsequent interests include an interest claimed by a subsequent purchaser for value of any interest in the real estate, a creditor with a lien on the real estate subsequently obtained by judicial proceedings, and a creditor with a prior encumbrance of record on the real estate to the extent that he makes subsequent advances. Thus, in the case of a purchase money secured party who claims an interest in consumer goods or farm equipment costing less than $2,500.00, the danger of a subsequent interest in real estate intervening before the secured party has perfected his interest is eliminated. The same considerations apply to accessions.

E. PROCEEDS.

1. Generally.

The Code provides for a continued security interest in proceeds received by the debtor upon disposition of the original collateral. Proceeds is defined as including "whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of. The term also includes the account arising when the right to payment is earned under a contract right. Money, checks and the like are 'cash proceeds'. All other proceeds are 'non-cash proceeds'."

In any unauthorized sale, exchange or other disposition of the collateral the security interest whether perfected or not, continues in any identifiable proceeds. If the debtor disposes of the property without authority of the secured party, the security interest also continues in the original collateral, with certain exceptions. Thus, in some cases the secured party will have the right to proceed against the collateral and the proceeds, but of course he may not have double satisfaction. Suppose that the secured party holds a security interest in a piece of equipment in the debtor's factory and that without authorization of the secured party the debtor trades it to a third party for a new piece of equipment of equal value. Since the right to a security interest in proceeds arises by operation of law the secured party acquires a security interest in the new piece of equipment irrespective of whether he has claimed proceeds in the security

128. § 9-313 (4).
129. § 9-314.
130. § 9-306 (1).
131. § 9-306 (2).
132. This rule helps to give the secured party maximum legal security in financing transaction where a dishonest debtor is involved. However, it has already been seen that there are limitations on this protection in such cases as purchasers of consumer goods and farm equipment under $2,500.00, (§ 9-307) holders in due course of negotiable instruments, negotiable documents, and securities, (§ 9-309) certain transferees of chattel paper, (§ 9-308) and certain transferees of goods (§ 9-301). But of course this rule does not give the secured party protection against the possibility that he will be unable to locate the collateral after the unauthorized transaction.
133. § 9-306 comment point 3.
agreement. In this instance the secured party might also follow the old equipment into the hands of the third party. Since the sale would be out of the ordinary course of business, unless the security interest were not perfected and unless the transferee were of the class mentioned in Section 9-301 (1) (c), the secured party would have the right to follow the equipment. Even if the transferee did fall within the protected class mentioned in Section 9-301 (1) (c), or if the collateral were inventory, which by definition gives the debtor authority to sell it in the ordinary course of business, thereby cutting off the secured party's right to follow it in the hands of a third party, nevertheless, the secured party acquires a security interest in the proceeds, since this right does not depend upon whether the security interest in the original collateral is maintained.

If the security interest in the collateral is perfected it will remain perfected in the proceeds, but only for a period of ten days after receipt by the debtor, unless the financing statement used to perfect the security interest in the original collateral also contains a provision covering proceeds, or unless the secured party perfects his interest within the ten day period, i.e., either by filing or by taking possession. Regardless of the mode by which the secured party's interest is perfected, so long as it is accomplished before the expiration of the ten day period, it is deemed to be perfected from the date the secured party's interest was perfected in the original collateral and not from the date he acquired an interest in the proceeds. This proposition assumes particular importance when calculating the four month period in voidable preference cases under the Federal Bankruptcy Act.

2. Insolvency Proceedings.

In the event of bankruptcy proceedings the Code defines the rights of a secured party claiming a perfected security interest in proceeds. The secured party is given a perfected security interest in identifiable non-cash proceeds and identifiable cash proceeds which are not commingled or deposited in a bank account before the commencement of insolvency proceedings. It has been argued that this provision is invalid inasmuch as it is an attempt to establish priorities of payment by the state in a field

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134. Although it is technically not necessary, it may be wise in a case like this for the secured party to amend his security agreement to cover the new piece of equipment, since he might have difficulty, later, proving that the new piece of equipment was in fact the proceed. Birnbaum, supra note 88, at 78-9. However, an indiscriminate claim to proceeds in the financing statement might work against the secured party in some cases since it could be looked upon as an implied authorization to the debtor to dispose of the collateral, thereby cutting off the secured party's rights. § 9-306 comment point 3.

135. Spivack, supra note 74, 101-02.

136. A financing statement being filed under this provision requires only the signature of the secured party. § 9-402 (2) (b).

137. § 9-306 comment point 2 (b).

138. § 9-306 (4) (a) (c). According to interpretation of this section by the Pennsylvania Courts, the pre-Code right of a secured party to trace his cash proceeds into non-cash proceeds has not been changed by Article 9. Goodwin, Article 9, Uniform Commercial Code: Pennsylvania Decisions On Secured Transactions, 3 Corp. Prac. Commentator 71, 81 (1961).
already pre-empted by the Bankruptcy Act. However, this argument has little merit when seen in light of the fact that the security interest is a claim to specific identifiable proceeds and not an attempt to permit the secured party to participate in the general assets of the bankrupt in priority to other creditors.\footnote{139}

The Code goes even further and provides that the secured party has a perfected security interest in all cash and bank accounts of the debtor, if the proceeds have become commingled, i.e., non-identifiable, but this right is limited to an amount received by the debtor within ten days of the commencement of insolvency proceedings less any amount received by the debtor as proceeds and paid over to the secured party during the ten day period.\footnote{140} In the opinion of some, inasmuch as this provision purports to give the secured party a security interest in non-identifiable proceeds after insolvency proceedings have commenced, it might not be upheld in a bankruptcy proceeding for the reason that it is an attempt by the state to legislate in a field already pre-empted by the Federal Bankruptcy Act. Section 64 if the Bankruptcy Act sets out rules of priority for the distribution of assets in a bankruptcy proceeding. However, Section 67 deals only with the order of priority of federal and state-created, statutory liens and not with genuine security interests. The criterion for determining whether a security interest is in fact a security interest and not a statutory lien appears to be whether or not the right may be enforced independently of bankruptcy proceedings. Admittedly, since the Code permits a security interest in non-identifiable proceeds only after commencement of insolvency proceedings, and not before, the right of a secured party in these circumstances appears to be more in the nature of a statutory lien within Section 67 of the Bankruptcy Act than a security interest. However, the Code carefully avoids the use of the word “priority” and uses instead “security interest” to designate the rights of a secured party. And since the secured party is restricted to non-identifiable proceeds received by the debtor within ten days before institution of insolvency proceedings, without the right of “tracing” as under the Trust Receipt Act, it is thought that the secured party’s claim to non-identifiable proceeds ought to be given the status of a genuine security interest.\footnote{141} If this were done the security interest would not be invalidated since a genuine security interest is not the kind of interest which Section 67 of the Bankruptcy Act attempts to regulate and, therefore, the Code provision is not an encroachment upon federal legislative jurisdiction.

3. Conflicting Interests in Proceeds.

Under Section 9-316 the parties are free to negotiate and agree on

\footnote{139} Spivack, supra note 74, at 105.
\footnote{140} § 9-306(4) (d). The ten day period was chosen on the basis that if the secured party is properly policing the business, he will learn before the expiration of ten days after receipt of the proceeds by the debtor, that the debtor is converting them. Kupfer, Accounts Receivable Financing, Trust Receipt, and Related Types of Financing Under Article 9 of The Uniform Commercial Code, 27 Temp. L.Q. 278, 285 (1954).
\footnote{141} Spivack, supra note 74, at 106; Symposium, supra note 80, at 422-24.
the status to be given a particular security interest as between themselves. In fact negotiations for a subordination agreement often follow as a matter of course where large sums of money are involved. But where the parties are unable to arrive at an agreement or where an interest is created without the party being aware of the existence of another conflicting interest, the rules of the Code governing priorities of conflicting interests become relevant.\footnote{142}{Homer Kripke, Speech given to the Practicing Law Institute of New York, July 12, 1962.}

Under certain conditions it is possible for a conflicting security interest to arise in the same proceeds. Where an inventory financer retains a security interest in the inventory in the hands of the debtor, the sale of which results in proceeds in the form of chattel paper, if the debtor fraudulently transfers the chattel paper to a purchaser a conflicting security interest in the proceeds will arise.\footnote{143}{Section 1-102(1) (b) provides that the rules pertaining to security interests also apply to “any sale of accounts, contract rights or chattel paper.”} Who takes priority to the chattel paper, the inventory financer or the purchaser? Section 9-308 sentence two, provides that a purchaser who gives new value and takes possession of chattel paper in the ordinary course of business takes priority over a security interest claimed merely as a “proceed” from the sale of inventory. The purchaser takes priority notwithstanding that he has actual knowledge that the specific chattel paper is subject to a security interest.\footnote{144}{In § 1-201 (9) “(a) buyer” is defined as “a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind but does not include a pawnbroker.” Although this section refers specifically to a “buyer” it is instructive on the meaning of the phrase “in the ordinary course of business.” Thus, when Section 9-308 sentence two is read in the light of this definition it indicates that even though a purchaser of chattel paper has knowledge that the chattel paper is subject to a security interest, he will take priority over the prior interest if he does not know, in addition, that the sale to him was in violation of a term of the security agreement.} The result is not changed even though the inventory financer’s security interest has been perfected by filing at the time the purchaser takes possession of the chattel paper.

Suppose that this illustration were altered a little so that the chattel paper subject to the security interest of the inventory financer taken as proceeds is sold to a purchaser who leaves the chattel paper in the possession of the debtor for the purposes of collection, and that the purchaser perfects his security interest by filing a financing statement. Then the debtor fraudulently sells the chattel paper to a second purchaser who takes possession. Who now has priority to the chattel paper? The first sentence of Section 9-308 is applicable in resolving the relative priorities of the conflicting security interests in this situation.\footnote{145}{This portion of Section 9-308 stood alone in the Uniform Commercial Code, Official Draft (1952) and what is now sentence two of Section 9-308 was Section 9-306 (4) in the Uniform Commercial Code, Official Draft (1952). By placing them together some problems have arisen in construing their independent application to returned goods situations. See note 153 infra. However, it is clear that sentence one is meant to apply to a chattel paper situation of this nature as may be seen...}
chaser will take priority if he takes possession in the ordinary course of business and without knowledge that the specific chattel paper is subject to a security interest. Thus, the second purchaser would prevail over the first, provided he did not have knowledge that the chattel paper was subject to the security interest of the first purchaser, notwithstanding the fact that the first purchaser had filed a financial statement before the second purchaser took possession of the chattel paper. The second purchaser would take priority over the inventory financer also, regardless of knowledge of his interest in the chattel paper as proceeds, provided that he did not know in addition that the transfer to him was in violation of a term of the security agreement.\textsuperscript{146}

Notice that knowledge will not defeat a purchaser if the chattel paper merely represents proceeds of the original inventory collateral. This

from a comment taken from the Uniform Commercial Code, Official Draft, § 9-308 comment point 6 (1952):

Where chattel paper is the original collateral and has been left in the debtor's possession pursuant to a filed financing statement under Section 9-308, as a matter of policy, a subsequent transferee for new value in the ordinary course of business ought not to be required to search the recording files in advance; otherwise every bank and finance company would be required to search the recording files before purchasing any chattel paper from any dealer; hence a purchaser for new value in the ordinary course of business who takes possession of such chattel paper without actual knowledge of the earlier security interest in the specific chattel paper is given priority. However, where such a purchaser is himself one who leaves the chattel paper in the dealer's possession and perfects his security interest by filing, this necessarily implies that he will go to the recording files and there is no reason to give him priority over the earlier secured party who perfected his security interest in exactly the same way. That is the reason for requiring the change of possession under Section 9-308. On the other hand, where chattel paper in the dealer's possession is not the original collateral, but is only claimed as proceeds under Section 9-306 (4), the monopolization point referred to in Comment 2 (c) of Section 9-306 is present; therefore, Section 9-306 (4) only requires "new value in the ordinary course of business." Knowledge of the asserted claim to proceeds by the inventory financer will not prevent the transferee of the chattel paper for new value in the ordinary course of business from obtaining priority for his security interest in the paper by taking possession under Section 9-305 (1), or by filing a financing statement under Section 9-308 and leaving the paper in the dealer's possession; the transfer of possession is not essential to obtaining priority over the inventory financer's claim to proceeds; however, leaving the paper in the dealer's possession under a filed financing statement subjects the transferee of the paper to the consequences of Section 9-308, i.e., that either another transferee or even the inventory financer may subsequently obtain priority by giving new value in the ordinary course of business and taking possession without actual knowledge.”

\textsuperscript{146} The effect of the first sentence of Section 9-308

... is to make filing on chattel paper left in the debtor's possession effective to protect the secured party in the event of his debtor's insolvency, since by the filing of his security interest is perfected. Against purchasers for new value he is substantially in the same position as if he had left negotiable instruments or documents in the debtor's possession. Filing gives no constructive notice to such purchasers. But since only purchasers who take possession without actual knowledge can defeat the earlier interest, the first assignee can protect himself against them also by stamping or clearly noting on the chattel paper the fact that it has been assigned to him. Uniform Commercial Code, supra note 145, at § 9-308 comment point 5. ‘‘The only prior security interest strong enough to defeat a purchaser of non-negotiable instruments or chattel paper even if he lacks knowledge, gives new value and takes possession in the ordinary course of his business, is the interest of a collecting bank.” Project, supra note 80, at 921; § 4-208.
provision gives the dealer virtually complete freedom in the disposition of his chattel paper arising from the sale of his inventory, and as a result he is not bound to accept the terms laid down by the financer of the inventory. As might be expected this provision is looked upon by some financers as being inequitable.\textsuperscript{147} However, where the chattel paper is the original collateral of the security agreement, this monopolization reasoning does not apply so that knowledge that the specific chattel paper is already subject to a security interest will defeat the subsequent transferee.\textsuperscript{148} In either case, however, a secured party who leaves chattel paper in the hands of a debtor is taking a risk of fraudulent transfer to a purchaser who may take prority. A secured party who desires to protect himself against this risk may do so by making a conspicuous notation on the chattel paper that it is subject to a security interest and that a subsequent transfer thereof would be in violation of the terms of the security agreement.\textsuperscript{149}

F. Returned Goods.

Sometimes goods sold under a security agreement are returned or repossessed, in which case there may be conflicting claims to priority in the goods. The conflicting interests may be claimed by four classes of parties: (a) the party who originally financed the goods prior to their sale, (b) the transferee of the chattel paper resulting from the sale, (c) the transferee of the account resulting from the sale, and (d) the dealer who sold the goods.

As between the dealer and any of the remaining three claimaints, the dealer's interest in the returned goods is always junior.\textsuperscript{150} If goods are returned or repossessed the dealer usually acts as a mere custodian, sometimes with authority to resell the goods, and sometimes with the obligation to repurchase the chattel, the chattel paper, or the account.\textsuperscript{151}

If the party who originally financed the goods holds a security interest which is still unpaid at the time of their return, his original security interest will attach again and continue as a perfected interest if it was perfected at the time of the sale. If his interest was perfected by a filing which is still effective at the time of the return of the goods nothing further need be done to maintain his perfected status, but if it is not perfected, he must either take possession of the goods or refile.\textsuperscript{152}

Where the claim to the goods is between the party who originally financed them and a transferee of the chattel paper, the conflict is resolved in favor of the transferee to the extent that he is entitled to priority under

\textsuperscript{148} Uniform Commercial Code, \textit{supra} note 145, at § 9-306 comment point 2 (c).
\textsuperscript{149} § 9-308 comment point 2; Birnbaum, \textit{supra} note 70, at 376.
\textsuperscript{150} § 9-306(5) (a) and (c).
\textsuperscript{151} § 9-306 comment point 4.
\textsuperscript{152} § 9-306(5) (a).
Section 9-308. Thus, if the goods were inventory and the chattel paper was received by the dealer as proceeds from the sale, the transferee will be entitled to priority in the goods over the inventory financer if he gave new value and took possession of the chattel paper in the ordinary course of business. If, however, the goods were equipment, consumer goods, or farm products, then the transferee of the chattel paper would take priority to the goods if he gave new value and took possession of the chattel paper in the ordinary course of business without knowledge that the specific chattel paper was subject to a security interest.

If the original unpaid financer has a perfected interest in the goods, either by revival of the original perfected interest or by refiling or possession, his interest is superior to that of the purchaser of the account. If the original unpaid financer does not obtain a perfected security interest before the purchaser of the account, the purchaser may be entitled to priority under Section 9-312 (5), i.e., if he were to file or take possession of the goods prior to the unpaid financer.

As has been observed, if the original financer does not claim the goods, the transferee of the chattel paper or account will take priority over the dealer, and this is true whether the transferee's interest is perfected or not. However, to obtain protection against creditors and purchasers of the dealer, the transferee must perfect his security interest.

CHAPTER IV
CONFLICTING CLAIMS AND PRIORITIES

A. Unperfected Interests.

Article 9 of the Code contains an array of integrated rules designed to resolve the relative priorities of claimants holding conflicting interests in the same collateral. The purpose of this section of the paper is to examine the application of these rules, first, where the conflict is between

153. § 9-306 (5) (b). This section has been described as being one of the most poorly drafted in the Code. Project, supra note 80, at 922. No problem arises in construing its application when the goods are inventory; sentence two of Section 9-308 is logically applicable. But what about when the returned goods are equipment? It appears that the draftsmen intended that conflicting claims to returned goods other than inventory are to be resolved by an application of sentence one of Section 9-308. However, sentence one has no particular relationship to collateral other than inventory. As we have seen earlier its proper function is for resolving conflicting claims to priority in chattel paper against which either claimant may have advanced money to acquire a security interest therein. (See note 145 supra) And from the reading of the official comments the section seems to apply more particularly to situations where the original collateral was inventory; § 9-308 comment point 2 states that the particular security interest to which it applies must arise from the advancing of money by the secured party "against the paper, whether or not he financed the inventory whose sale gave rise to it." (Emphasis added)

154. § 9-306 (5) (b); § 9-308 sentence two.
155. § 9-306 (5) (b); § 9-308 sentence one; Project, supra note 80, at 922.
156. § 9-306 (5) (c) & (d), and comment point 4.
157. § 9-306 (4) (d); see section 9-301 (1) for a list of those purchasers and creditors who prevail over the unperfected interest of a transferee of an account or chattel paper.
an unperfected security interest and a bona fide purchaser, general creditor, lien creditor, and perfected security interest; and second, where the conflict is between a perfected security interest and a bona fide purchaser, general creditor, lien creditor, and another perfected security interest. Following this will be a consideration of the rights and priorities of a perfected security interest in fixtures, accessions and commingled goods as against the rights of other parties claming an interest in the same collateral.

At the outset it should be said that the rules governing conflicting interests in the same collateral are established only as an expediency to regulate priorities in situations where the interested parties have by accident or design allowed their interests to become subject to these rules. "By design" is meant to refer to Section 9-316 which provides that the parties are free to negotiate and agree on the status which should be given to a particular security interest as between themselves. In transactions involving large sums, negotiations for a subordination agreement follow almost as a matter of course. Only when the parties have failed to negotiate, do the rules governing priorities become relevant.158

The question arises whether the problem of conflicting interests in the same collateral is a creation of the Code. To some extent it is. The provisions relating to after-acquired property, future advances and notice filing provide an opportunity for conflict which did not exist prior to the Code. However, the possibility of conflicting interests in the same collateral did exist prior to the Code. But it was not until the many possible combinations and permutations of various interests were pulled together in a unified body of law under the Code that this possibility became fully apparent. The fact that it was not apparent prior to the Code is evidence that the possibilities are somewhat rare.159 Nevertheless the Code contains an equitable and reasonable means of resolving those conflicts of interests which are likely to arise by virtue of the mere existence of the Code and of the other possible conflicts which become apparent only through development of the Code. This was not the case under pre-Code law. In addition the rules are such that they may be adapted to types of problems which do not yet exist but which are bound to arise with the increasing complexity of the commercial world.

1. An Unperfected Security Interest vs. A Bona Fide Purchase.160

The relative priorities between a holder of an unperfected security interest and a bona fide purchaser will depend upon the nature of the collateral in question, the nature of the transferee, and in some cases, the nature of the security interest, i.e., whether or not it is a purchase money security interest. This section will deal only with those purchasers who

158. Homer Kripke, supra note 142.
160. By definition a "purchaser" under the Code is any one who takes "by sale, discount, negotiation, pledge, lien, issue or re-issue, gift or any other voluntary transaction" an interest in property. § 1-201(32) & (33). Under this portion of the paper the term "purchaser" is not being used in this broad sense, as will be seen by the rules, and a more accurate term would be "transferee" or buyer.
may take priority over an unperfected security interest by virtue of Section 9-301, but would be subject to a perfected security interest themselves. Those purchasers who may take priority over even a perfected security interest, and a fortiori over an unperfected interest, will be dealt with later in the paper.

A bulk purchaser or other buyer not in the ordinary course of business who does not have a perfected security interest, but who gives value and receives delivery of the collateral without knowledge of any conflicting interest and before it is perfected, takes priority over an unperfected security interest in the case of goods, instruments, documents and chattel paper.\textsuperscript{161} It is to be noted that only buyers "not in the ordinary course of business who actually take delivery of the collateral" may qualify under this exculpatory rule. Thus, even though the purchaser gives value without knowledge of the unperfected interest, he will not take priority if he does not take delivery before the security interest is perfected.\textsuperscript{162}

However, there is an exception to the rights of a transferee in bulk under this rule when a purchase money security interest is involved. A purchase money secured party will take priority over the interest of a bulk purchaser which arises between the time the purchase money interest attaches and the time of filing, if the secured party files with respect to the purchase money security interest within ten days after the collateral comes into possession of the debtor.\textsuperscript{163}

When accounts, contract rights and general intangibles are involved, a purchaser who is not a secured party takes priority over an unperfected security interest if he gives value without knowledge of any conflicting security interest and before it is perfected.\textsuperscript{164} Under this rule delivery is not a prerequisite to the purchaser taking in priority to an unperfected security interest. This is because of the impossibility or unreasonability of a purchaser taking delivery of an intangible for which there is not a representative piece of paper in which title is traditionally locked up, as in the case of instruments and documents.\textsuperscript{165}

2. \textit{An Unperfected Security Interest vs. A General Creditor.}\textsuperscript{166}

A creditor may be a general creditor either because he had no intention

\textsuperscript{161} § 9-301 (c).
\textsuperscript{162} § 9-301 comment point 4.
\textsuperscript{163} § 9-301 (2).
\textsuperscript{164} § 9-301 (1) (d). "'Account' means any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper. 'Contract right' means any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper. 'General intangibles' means any personal property (including things in action) other than goods, accounts, contract rights, chattel paper, documents and instruments." § 9-106.

\textsuperscript{165} § 9-301 comment point 4.
\textsuperscript{166} By definition a "'creditor' includes a general creditor, a secured creditor, a lien creditor and any representative creditors, including an assignee for the benefit of creditors, trustee in bankruptcy, a receiver in equity and an executor or admin-
of taking security for giving value in the original instance or because, although he intended to take security, he failed to comply with one of the minimal, formal requisites of the Code. The rights of a general creditor, who has no intention of obtaining a security interest in the debtor’s collateral are not defined in the Code, except by deduction. The obvious inference is that such a creditor has no rights in the debtor’s collateral in his present status. However, Article 9 does delineate the rights of creditors of the type who intend to create a security interest in the debtor’s collateral, and of other creditors who rise at least to the status of a lien creditor.

A security interest will arise under the Code when value is given, a security agreement is entered by the parties, and when the debtor has rights in the collateral. For the security interest to be enforceable, the secured party must either take possession of the collateral or obtain a written security agreement signed by the debtor.\(^\text{167}\) If any one of these necessary elements is missing the creditor either does not have a security interest at all, or if he does, it is not enforceable against third parties or the debtor.\(^\text{168}\) Thus, the rights of a general creditor are subordinate to an unperfected security interest.

It is possible that a general creditor, whose claim against the collateral is merely unenforceable may be able to cure the defect, either by taking possession of the collateral or by obtaining a written security agreement, signed by the debtor. Taking possession would not only cure the unenforceability defect, but would in addition give the creditor a perfected security interest. As an alternative he may be able to perfect his security interest by filing. However, unless his interest is perfected it will remain subordinate to a prior, unperfected security interest, since the relative priorities of conflicting, unperfected security interests are resolved in the order of their attachment.\(^\text{169}\) Unless a creditor can at least claim the status of a lien creditor he has no hope of taking priority over an unperfected security interest.\(^\text{170}\)

3. **An Unperfected Security Interest vs. A Lien Creditor.**

A “lien creditor” is defined as “a creditor who has acquired a lien on the property involved by attachment, levy or the like and includes an assignee for the benefit of creditors from the time of assignment, and a trustee in bankruptcy from the date of the filing of the petition or a receiver in equity from the time of the appointment.”\(^\text{171}\) A lien creditor takes priority over an unperfected security interest if he becomes a lien creditor without knowledge of the security interest and before it is perfected.\(^\text{172}\) However, there is an exception to the rights of a lien creditor

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\(^{167}\) § 9-203 (1).

\(^{168}\) Ibid.

\(^{169}\) § 9-301 (1) (b).

\(^{171}\) § 9-301 (3).

\(^{172}\) § 9-301 (1) (b).
under this rule when a purchase money security interest is involved. A purchase money secured party will take priority over the interest of a lien creditor which arises between the time the purchase money interest attaches and the time of filing, if the secured party files with respect to the purchase money security interest within ten days after the collateral comes into possession of the debtor.\textsuperscript{173}

The application of this rule may be demonstrated as follows: Suppose that A loans money to X on January 1, taking a non-purchase money security interest in X's inventory. A does not file a financing statement. On January 2, B, relying on the inventory, loans money to X on an unsecured basis. On February 1, B learns that A has a possible interest in the inventory and accordingly he causes a judgment to be confessed against X. The next day he executes on the judgment.\textsuperscript{174} By inference from Section 9-302, A's security interest is unperfected, and by virtue of Section 9-301 (3), B is a lien creditor. B's interest takes priority over A's provided B did not have knowledge of A's interest before becoming a lien creditor. A person knows or has knowledge of a fact when he has actual knowledge.\textsuperscript{175} Thus, B's interest takes priority since B's learning only of A's possible interest in the inventory does not constitute actual knowledge.

The definition of lien creditor includes creditors for whom representatives are customarily appointed, such as an assignee for the benefit of creditors, a trustee in bankruptcy and a receiver in equity. In transactions involving representatives of creditors, the question of whether knowledge of an unperfected security interest on the part of some of the creditors will be imputed to all, has been resolved in the negative. Unless all of the creditors represented have knowledge of the unperfected security interest, the representative is deemed to be a lien creditor without knowledge even though he personally has knowledge of the unperfected security interest.\textsuperscript{176} However, there is some conflict of opinion as to whether knowledge of the unperfected interest by all of the creditors necessarily imputes knowledge to the representatives.\textsuperscript{177}


A security interest is perfected when it has attached and when all necessary steps required for perfection have been taken. If the steps required for perfecting the security interest have been taken prior to its creation, the security interest is perfected at the time of attachment.\textsuperscript{178}

Suppose that on January 1, A sells some consumer goods to X, who gives A a security interest to secure the balance owing. On January 2, X

\textsuperscript{173} § 9-301 (2).\
\textsuperscript{174} Professor Hawkland's Problems, Distributed in Mimeographed Form to Sales Class, University of Illinois, College of Law (1961-62).\
\textsuperscript{175} § 1-201 (25).\
\textsuperscript{176} § 9-301 (3).\
\textsuperscript{177} I. Birnbaum, Secured Transactions Under The Uniform Commercial Code, 66 (1954); Kennedy, The Impact of The Uniform Commercial Code on Insolvency: Article 9, 67 Com. L.J. 115, 115 (1962).\
\textsuperscript{178} § 9-301 (1).
obtains a loan from the bank which takes a security interest in the consumer goods but does not file a financing statement. Since A has a purchase money security interest in the consumer goods it is perfected merely by attachment under Section 9-302 (1) (d). Thus, A's security interest takes priority over the bank even though the bank has taken as many procedural steps as A, i.e., given value and entered into a security agreement, and there is nothing further the bank can do in the way of being prudent that will raise its status above A. Neither filing a financing statement nor taking possession of the goods will give the bank priority. Of course A's security interest may be subordinated by mutual agreement, and the Code does not prohibit this.

There is one class of creditors against whom A is not presently protected, namely, a bona fide purchaser who gives value and buys for his own family or household purposes and those purchases mentioned in Section 9-301 (1) (c). To acquire protection against these creditors A must file. The Code provides that a security interest which has originally been perfected on way, e.g., by attachment, and is subsequently perfected by another, without an intermediate period when it was not perfected, the security interest is deemed to have been continuously perfected. Thus, after filing, A's security interest is deemed to have been continuously perfected from the date of attachment until such time as the effectiveness of the financing statement is terminated.

B. PERFECTED INTERESTS.


Usually a secured party whose interest is perfected takes priority over buyers and purchasers of collateral. However, there are some specific exceptions set out in the Code, and of course these exceptions take priority over an unperfected security interest as well. The exceptions pertain to certain purchasers of goods regularly held for sale by a buyer in the ordinary course of business, purchasers of consumer goods and farm equipment costing less than $2,500.00; purchasers of chattel paper and non-negotiable instruments; and purchasers of negotiable instruments, negotiable documents, and securities. An underlying policy of the Code seems to be that a security interest will be protected as long as it does not interfere with the normal flow of commerce. Purchasers of chattel paper, non-negotiable instruments, and negotiable documents have been dealt with in Chapter III.

179. § 9-316.
180. § 9-307 (2).
181. § 9-303 (2).
182. By definition the term "purchaser," in the terminology of the Code, covers a much wider number of transferees and creditors than a mere "buyer." A purchaser is one who takes "by sale, discount, negotiation, pledge, lien, issue or re-issue, gift or any other voluntary transaction . . ." an interest in property. § 1-201 (32) & (33). Thus, a consensual creditor is a purchaser but not a buyer.
183. § 9-301 (1) (a).
185. See pages 20-21 infra.
186. See pages 16-17 infra.
A buyer of goods, other than farm products from someone engaged in farming operations, in the ordinary course of business, takes free of a prior perfected security interest even though he knows of its existence.\textsuperscript{187} A buyer in the ordinary course of business is one who buys "in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party..."\textsuperscript{188} Thus a buyer will take free of a perfected security interest under this rule if he knows the goods are subject to a security interest, but not if he knows, in addition, that the sale to him is in violation of one of the terms of the security agreement, without the authorization of the secured party. A buyer in the ordinary course of business must also be one who is in the business of selling goods of the particular kind purchased. The result is that this rule is logically restricted almost entirely to transactions involving the sale of inventory; it does apply to the sale by a dealer of his old equipment in the ordinary course of business, although very few dealers could be found in the business of selling their own old equipment.\textsuperscript{189}

A buyer of consumer goods and farm equipment costing less than $2,500.00 takes free of a perfected security interest if the purchase is for his personal, family or household use or his farming operation, and if he gives value without knowledge of the security interest before the secured party files.\textsuperscript{190} Where the secured party has helped finance the purchase of the goods he will have a purchase money security interest, and under Section 9-302 (1) (c) & (d) it is perfected merely by attachment. Nevertheless, the interest of such a secured party will be cut off by a subsequent purchaser of the type described in this rule unless he files a financing statement.\textsuperscript{191} If the interest is not a purchase money security interest (having arisen by the debtor putting up his stock as security for a loan, for example) he has no alternative but to file if he desires his interest to be perfected. If he fails to do so his interest may be defeated by purchasers under Section 9-301 (1) (c), in addition to those mentioned in Section 9-307 (2).

Other purchasers take free of a perfected security interest because the Code preserves the concept of negotiability and the rights of holders in due course and purchasers of commercial paper. These rights are determined by the application of the rules governing the particular type of paper involved.\textsuperscript{192} Article 9 specifically provides that a holder in due

\textsuperscript{187} § 9-307 (1).
\textsuperscript{188} § 1-201 (9).
\textsuperscript{190} § 9-307 (2).
\textsuperscript{191} This provision has been criticized for the reason that it requires filing to protect the secured party against a buyer of the type who rarely searches the filing records, namely, a second hand buyer, but no filing is required to perfect a purchase money security interest against those creditors who are likely to search the filing records. Kripke, \textit{Article 9: Secured Transactions Under The Uniform Commercial Code In Pennsylvania}, 15 U. Pitt. L. Rev. 602, 609-10 (1954); Project, \textit{supra} note 184, at 999-36; but see Bunn, \textit{Financing Farmers: Existing Kansas Law and The Uniform Commercial Code}, 2 Kan. L. Rev. 225, 227 (1954).
\textsuperscript{192} 9-309 comment point 1; Hawkland, Commercial Paper 78-88 & 104-111 (1959).
course of a negotiable instrument or negotiable document of title, and a bona fide purchaser of a security takes priority over a prior security interest in the negotiable paper or security, even though perfected, and filing does not constitute notice of the security interest to such holders or purchasers.\textsuperscript{193}

2. \textit{A Perfected Security Interest vs. A General Creditor.}

Under prior law many creditors who thought their interests were secured, on some occasions found themselves reduced to the status of a general creditor, even though the parties intended to create a security interest and had exercised considerable precaution in the execution of documents. It was not uncommon for a court to hold that a chattel mortgage or conditional sales contract was invalid for the reason that some formality, such as attestation of the agreement, had not been properly complied with.\textsuperscript{194} In some jurisdictions recordation of a chattel mortgage was required within a certain number of days after execution, otherwise it became void; whereas no recordation of a conditional sales contract was required. If the parties erroneously used a conditional sales contract form instead of a chattel mortgage form, and failed to record within the prescribed time, the creditor would have no claim on the collateral of the debtor, provided that the arrangement was a chattel mortgage transaction in substance. Thus, there was some considerable risk of a secured creditor becoming a general creditor for rather inconsequential reasons.

As has been observed, a security interest will arise under the Code when value is given, a security agreement is entered by the parties, and when the debtor has rights in the collateral.\textsuperscript{195} For his interest to be enforceable against third parties or the debtor he must comply with some minimal formal requisites. He must either take possession of the collateral or else demand a written security agreement signed by the debtor.\textsuperscript{196} There are no attestation requirements under the Code and the secured party's interest is not void if he fails to record. Thus, the chance of a secured party's security interest being unenforceable under the Code for failure to comply with one of the few formal requisites is immensely less than it was under prior law.

However, if a creditor becomes a general creditor either because he had no intention of taking security for his debt in the first place or because his security interest is unenforceable, he will have no claim upon the collateral of the debtor in his present status. As has already been noted his claim is subordinate to that of an unperfected security interest; \textit{a fortiori} it is subordinate to a perfected one. However, the debt of the general creditor provides him with a means of satisfaction, and after obtaining a judgment he may proceed to enforce his claim against the

\textsuperscript{193} § 9-309.

\textsuperscript{194} Coogan, \textit{Operating Under Article 9 of The Uniform Commercial Code Without Help or Hindrance of The “Floating Lien,”} 15 Bus. Law. 373, 381 (1960).

\textsuperscript{195} § 9-204.

\textsuperscript{196} § 9-203 (1).
debtor's assets. His rights as a lien creditor will then be determined by the rules of Article 9.


The Code does not specifically state that a lien creditor shall be subordinate to a perfected security interest, but this result is clearly deduced from Article 9. It has been observed that an unperfected security interest is superior to a lien creditor, except for those who become lien creditors without knowledge of the unperfected security interest. Since there is no rule in the Code subordinating a perfected security interest to a lien creditor under any conditions, the obvious implication is that a perfected security interest takes priority over a lien creditor. However, a contrary view has been suggested where the perfected security interest is claimed as security for future advances under certain circumstances.

Suppose that on March 1, M Corporation signs a security agreement giving A a security interest in all of M's trucks and that the security agreement mentions future advances, although A is under no commitment to advance any. A files a financing statement and then advances $10,000.00 to M. H, who has been injured by the driver of one of M's trucks obtains a judgment on April 1 and attaches M's trucks. On April 2, following the attachment, A advances a further $10,000.00 to M. On the following day M makes an assignment for the benefit of creditors and the trucks are sold for only $12,000,000. It is argued that because separate security interests may be created as to different obligations secured, under Section 9-204, and that because a "security interest" is defined as "an interest in . . . property . . . which secures payment or performance of an obligation," a security interest cannot exist unless there was an obligation for it to secure at the time of making the future advance. Since A was under no obligation to make future advances, H's lien takes priority over A's second advance of $10,000.00.

It is submitted that this result is wrong since it is contrary to the expressed policy of the Code which is bent on circumventing the "vaguely articulated prejudice against future advance agreements." Section 9-204(5) validates future advance agreements regardless of whether the advances are made pursuant to commitment. The official comments make it clear that the mere fact that the specific amounts of future advances are not specified in the security agreement should not make such agreements invalid. In addition, A's financing statement is on record as evidence that he has some kind of a security interest in M's trucks. If, by virtue of Section 9-213(5) (a) or (b), such filing is adequate to defeat even subsequent secured parties whose interests are perfected, surely it is intended

197. § 9-203 comment point 5.
199. § 9-204 comment point 8.
200. Ibid.
that filing should defeat subsequent lien creditors, who are inferior by nature to secured parties whose interests are perfected.

4. **Perfected Interests vs. Other Interests in the Same Collateral.**

   a. **A Perfected Security Interest vs. A Perfected Purchase Money Security Interest.**

   (i) **Inventory.**

   The Code provides for a reconciliation of the conflicting interests of an inventory financer and a purchase money secured party who have conflicting interests in the same collateral. A purchase money security interest in inventory collateral takes priority over a conflicting interest in the same collateral if the purchase money interest is perfected before the debtor receives possession of the collateral, and if the purchase money secured party notifies anyone with a conflicting security interest of whom he knows, and anyone else who has filed with respect to the same or same type of collateral. The notice must describe the collateral (by item or type) in which the purchase money secured party intends to take a security interest. Thus, the Code sanctions the practice under pre-Code law in some jurisdictions of allowing a purchase money interest to take priority over an inventory financer claiming under an after-acquired property clause. The usual practice is for a debtor to apply to an inventory financer for periodic advances against incoming inventory or for the release of old inventory from a security agreement as new inventory is added. It is conceivable that a fraudulent debtor might apply for an advance after his inventory had already become encumbered by a purchase money security interest. In order to give some measure of protection to an inventory secured party, the Code provides that a purchase money security interest will not take priority unless notice is given to the inventory secured party before the debtor receives the collateral. If a purchase money secured party has given notice of his intention to take a purchase money interest in

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201. Section 9-312 (3) & (4) contain the rules which are to be applied in resolving the priorities of conflicting perfected security interests in the same collateral, one of which is a purchase money security interest. There are some cases where a second purchase money security interest might arise in which case Section 9-312 (3) makes it clear that notice need not be given to such person, even with respect to subsequent advances under the original financing statement. However, the Uniform Commercial Code, Official Text, 1958 adds a phrase to Section 9-312 (5) which makes it clear that such subsequent purchase money security interest is still entitled to whatever priority it would otherwise have under Section 9-312 (5); Coogan, *supra* note 198, at 862; Note, *Selected Priority Problems In Secured Financing Under The Uniform Commercial Code*, 68 Yale L.J. 761, 763-65 (1959).

202. Goods are classified as "inventory" if they are held by a person who holds them for sale or lease or to be furnished under contracts of service or if he has so furnished them, or if they are raw materials, work in process or materials used or consumed in a business. "Inventory of a person is not to be classified as his equipment.” § 9-109 (4).

203. The requirement of filing before the debtor receives the goods provides protection to anyone who checks the records from making advances against the inventory which is already encumbered with a purchase money security interest. Since perfection may be either by possession or filing, it should be noted that notification is only required in those cases where possession of the inventory is delivered to the debtor and not where the secured party takes possession thereof, either personally or by his agent. § 9-305; § 9-312 (3); Coogan, *supra* note 198, at 863.

204. § 9-312 (3).
certain of the debtor's incoming inventory, presumably the inventory secured party will be amply forewarned and will make an advances to the fraudulent debtor in reliance upon expectation of getting a security interest in this particular inventory.\textsuperscript{205}

The purchase money secured party is only partially protected, however, under this rule since priority is given only when the conflicting security interests are in "the same collateral." The inference is that the purchase money secured party's prior interest in the collateral does not carry over to proceeds in the nature of chattel paper and accounts, but that it does carry over to cash proceeds, and to "proceeds of proceeds," i.e., the cash received from the sale of the chattel paper and the account. Thus the purchase money secured party must rely to a large degree upon the original collateral which still remains in the possession of the debtor upon default.\textsuperscript{206}

Assume that bank A files a financing statement on January 1 to secure a loan made to X to enable X to pay for inventory. X uses the proceeds of the loan for another purpose, and buys the goods on credit from B who files a financing statement on February 1 to secure his interest.\textsuperscript{207} The proceeds of the loan from A were not in fact used to enable X to buy the inventory, thereby preventing A's interest from rising to the level of a purchase money security interest; nevertheless, A has a perfected security interest in the inventory by virtue of the financing statement filed on January 1. B does have a purchase money security interest since it was retained by him to secure the purchase price of the inventory,\textsuperscript{208} and the conflicting interests are to be resolved under Section 9-312 (3). A will take priority over B's interest unless B notifies A of his intention to take a purchase money security interest in the inventory before X receives possession. If B duly notifies A, and the inventory is subsequently sold with the price secured by chattel paper which is sold to C, B's claim to the proceeds is subordinate to C's. However, B has priority to any cash which C advances to X in payment for the chattel paper, as well as to any inventory which remains unsold.\textsuperscript{209}

(ii) Equipment.

A purchase money security interest in collateral other than inventory takes precedence over conflicting security interests in the same collateral if the purchase money security interest is perfected at the time the debtor receives the collateral or within ten days thereafter.\textsuperscript{210} Thus, where the purchase money secured party claims an interest in collateral other than inventory he is under no obligation to give notice to other parties who may have filed a financing statement covering the same collateral, and know-

\textsuperscript{205} § 9-312 comment point 3.
\textsuperscript{206} Coogan, supra note 198, at 861 & 863.
\textsuperscript{207} Professor Hawkland's Problems, supra note 174.
\textsuperscript{208} § 9-107 (a).
\textsuperscript{209} § 9-312 (3).
\textsuperscript{210} § 9-312 (4).
ledge of other security interests does not prevent him from taking priority. Therefore, he does not have the burden of searching (although searching under a central filing system is relatively simple) the filing records before delivery of the equipment is made to the debtor. Since the purchase money secured party has a ten day grace period within which to perfect his interest, immediate possession of the equipment can be given to the debtor without prejudice to the purchase money secured party. These provisions are in recognition of the fact that in business transactions involving the sale of equipment the purchaser is usually anxious to get immediate delivery. However, elimination of the notice requirement could work some hardship on parties who may have filed a financing statement claiming similar collateral, although this is not too likely since the practice of making periodic advances on incoming collateral is restricted almost entirely to the inventory field.

Assume that A files a financing statement on January 1 against machinery of X and also after-acquired machinery of X. B files a financing statement on February 1 to secure a purchase money interest representing an advance made to enable X to acquire new machinery. Providing only that B perfects his interest prior to or within ten days after X receives the machinery, B will take priority over A.


All priorities of conflicting security interests in the same collateral (except for fixtures, accessions and commingled goods) that are not resolved by the special rules mentioned thus far, are governed by two basic rules, (a) the first-to-file rule, and (b) the first-to-perfect rule.

(i) The First-to-File Rule.

If both conflicting interests are perfected by filing, priority is given to the secured party who filed first, regardless of whether his interest attached first, and whether it attached before or after the filing. Thus, since the time of attachment is irrelevant under this rule, the first to file takes priority even though there was no agreement nor value given at the time of the filing.

Suppose that A, without loaning money, but pursuant to an agreement, files a financing statement on February 1, covering machinery owned by X. B files against the same machinery on March 1 and makes a loan of $10,000.00 to X pursuant to an agreement. A makes a loan of $30,000.00 to X on April 1. On April 15, X makes an assignment for the benefit of creditors and there are not enough assets to pay both parties. A takes priority even though B's security interest was perfected in presently-existing

211. Note, supra note 201, at 762.
212. § 9-312 (4); Coogan, supra note 198, at 863.
213. Professor Hawkland's Problems, supra note 174.
214. § 9-312 (4).
215. § 9-312 (5) (a).
216. § 9-204 (1).
collateral and before A made his loan.\textsuperscript{217} The determinative fact is that A had filed first. Even though A has knowledge of B's prior advance the result would not be altered. The justification for the rule is that the filing system must be protected. The draftsmen of the Code have adopted the policy that the first to file should have priority as to future advances, without being obligated to check the filing records before each advance.\textsuperscript{218}

However, B could have taken one of several steps before making the loan to protect his interest. Since A had not yet made an advance pursuant to his agreement with X, B could have demanded that X obtain a termination statement from A as a condition to making the loan.\textsuperscript{219} B could have required that A subordinate his priority to B.\textsuperscript{220} B could have negotiated an agreement with A providing that he would release a sufficient portion of the machinery from his agreement. Or if the circumstances were appropriate, B could have arranged for X to purchase new machinery with the money advanced, thereby creating a purchase money security interest in B.\textsuperscript{221}

Suppose that the facts were varied in the above example so that A makes an advance of $30,000 on January 1, the date of filing, pursuant to an agreement which covers future advances. B makes an advance of $10,000.00 on February 1. A makes another advance on March 1 of $20,000.00. X defaults under the agreement on March 15 and his assets are insufficient to pay both creditors. A will take priority over B to the extent of the entire $50,000.00 since the time of attachment is irrelevant. Even if the original agreement between A and X does not cover future advances, A may take priority to the extent of both loans provided that he obtains an agreement covering the second advance at some point before litigation occurs.\textsuperscript{222} Attachment would occur when the subsequent agreement was entered and the advance was made. Since filing, the only other necessary step for perfection, has already been accomplished, the security interest created by the subsequent advance would be perfected, and would date back to the original filing. However, if the original agreement did not cover future advances, and if A did not obtain a new agreement specifying the machinery to be the collateral, A's priority would not extend to the subsequent advance of $20,000.00\textsuperscript{223}

(ii) The First-To-Perfect Rule.

If one or more of the conflicting security interests is perfected by a

\textsuperscript{217} Upon default of a debtor, the proceeds from the sale of the collateral are used to pay off entirely the debt of the secured party having priority, to the extent that there are funds available, before further disposition. § 9-504 (1).

\textsuperscript{218} § 9-312 comment point 4, example 1.

\textsuperscript{219} § 9-404 (1).

\textsuperscript{220} § 9-316.

\textsuperscript{221} § 9-312 (4); Coogan, supra note 198, at 859-60.

\textsuperscript{222} B would be unable to improve his position by taking possession of the machinery before A enters such an agreement because his security interest would still be deemed to be perfected purely by filing for the purpose of determining his priority to the collateral under Section 9-312 (5). § 9-312 (6).

\textsuperscript{223} Note, supra note 201, 752-53.
method other than filing priority is given to the party who perfects his interest first, without regard to which security interest attached first or to whether it attached before or after filing, in the case of a filed security interest.\textsuperscript{224}

Assume that $X$, a jeweler, owns diamonds free of encumbrances. On February 1, Bank A agrees to make a loan of $50,000 against the security of the diamonds, and files a financing statement on that date without advancing any money. On March 1, Bank B makes a loan to $X$ for $25,000 and takes possession of the diamonds as security. On March 2, Bank A loans $25,000.00 to $X$ pursuant to the original agreement. On March 15, $X$ becomes insolvent and insufficient money is realized from the sale of the diamonds to pay both parties.\textsuperscript{225} Inasmuch as both security interests were not perfected by filing, their relative priorities are determined in the order of their perfection. If Bank A's agreement to loan $25,000.00 is a "binding commitment," it constitutes value,\textsuperscript{226} and Bank A's security interest takes priority. However, if the agreement does not rise to the level of a "binding commitment," Bank A's security interest is not perfected until March 2, in which case Bank B's security interest takes priority. In this case Bank A could have protected itself by making a nominal advance of $1.00 at the time of making the agreement with $X$.

Suppose that the facts in the above example were varied so that on February 1, after filing a financing statement, Bank A makes a loan of $5,000.00 to $X$ pursuant to a security agreement which provides for future advances, although Bank A is not obligated to make any. On March 1, having knowledge of Bank A's financing statement and believing that the diamonds could support another loan, Bank B makes a loan to $X$ of $15,000.00 and takes possession of the diamonds as security for the loan. On April 1, Bank A makes another loan to $X$ of $10,000.00. On April 15, $X$ becomes insolvent and the diamonds are sold for $10,000.00 less than the obligations due. One of the conflicting security interests was perfected other than by filing so that the priorities are to be determined in the order of their perfection. Obviously Bank A takes priority over Bank B on the original advance of $10,000.00 but does Bank A also prevail as to the second advance of $10,000.00? The answer to this question depends on whether separate security interests were created, one on February 1, and another on April 1, or whether the giving of value by Bank A on February 1 was sufficient to create one security interest which sweeps up all subsequent advances. Since a "security interest" is defined as "an interest in property . . . which secures payment or performance of an obligation," it has been argued that "the obligation" may create a security interest in the collateral only equal to the value of the obligation at the time the security interest was created, where the secured party is under no binding commitment to make future advances. Thus any subsequent ad-

\textsuperscript{224} § 9-312(5)(b).
\textsuperscript{225} Professor Hawkland's Problems, supra note 174.
\textsuperscript{226} § 1-201 (44).
vances create independent security interests subject to being subordinated by intervening secured parties who perfect by taking possession. This, clearly, would not be the result if both parties had perfected by filing, and it is submitted that in view of the language of Section 9-204 (5) which sanctions advance agreements whether or not the future advances are in fact given pursuant to commitment, and in view of the policy of the Code to give effect to the notice filing system; the subsequent advance by Bank A becomes part of the original value for which the diamonds were taken as security. Thus, in effect, a single security interest is created and the intervening loan by Bank B is subordinate. This result is not inequitable since Bank A's financing statement gave notice that Bank A had some kind of a security interest in the diamonds. By consulting a lawyer Bank B could have learned of the future advance clause and that a subsequent advance by Bank A would take priority. Bank B could then have obtained an agreement from Bank A to the effect that all future advances against the diamonds would be subordinated in priority.

**c. Fixtures.**

The Code permits a security interest to be created in fixtures which may be or become subject to conflicting interests in the real estate. Fixtures are not defined in the Code, but goods such as lumber, bricks, tile, cement, glass, and metal work which are incorporated into the structure, are specifically excluded. What constitutes a fixture is left to be determined by state law.

(i) Attachment of Security Interest Before Goods Become Fixtures.

A security interest which attaches to the goods before they become fixtures takes priority over all prior claims of all persons who have an interest in the real estate. However, certain subsequent claims take

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228. This section, 9-313, has been deleted from the proposed version of the Code now under consideration in California. It was deleted on the recommendation of the Bar Committee and the Advisory Committee on the Code in that state. The reason given is that the determination of priorities to fixtures is often dependent upon what constitutes a fixture, and changing the laws which determine priorities without defining a fixture, only adds to the confusion that already exists in this field in California. Project, *supra* note 184, at 941.
229. Fixtures would include such chattels as "heating systems, stoves, sinks, elevator cars, etc." Spivack, *Secured Transactions* 116 (1962). Where problems of injury to the real estate might arise through repossession or removal of fixtures, removal is nevertheless permitted. However, the secured party is required to give security for reimbursement of other parties with an interest in the real estate in the event any material damage is caused by the removal, although the secured party is not liable for any depreciation in the value of the property as a result of the removal § 9-313(5). A secured party might be able of guard against such liability by acquiring an agreement from prior encumbrancers to the effect that they will not enforce this right in the event the fixtures are repossessed. Birnbaum, *A Restatement and Revision of Chattel Security*, Wis. L. Rev. 348, 378 (1952).
230. § 9-313(2). Since prior real estate encumbrancers could not have relied upon the fixtures as security for their prior advances, it is reasonable that failure to give them notice, or to perfect by filing, should not prejudice a secured party whose security interest attaches before installation. However, in at least one jurisdiction (California) the reliance theory is rejected and a prior real estate mortgage takes priority over the fixtures if he was not notified prior to its installation, since
priority over a security interest if they arise without the claimant having knowledge of the security interest and before it is perfected; namely, an interest claimed by a subsequent purchaser for value of any interest in the real estate, a creditor with a lien on the real estate subsequently obtained by judicial proceedings, and a creditor with a prior encumbrance of record on the real estate to the extent that he makes subsequent advances. Thus, a security interest which attaches to goods before they become fixtures takes priority over all prior real estate encumbrancers, and if the secured party perfects his interest before affixation, he takes priority over all subsequent real estate encumbrancers as well.

Suppose that X owns real estate subject to a mortgage held by A, dated January 1, 1958. On February 1, 1962, X purchases air conditioning equipment from B, who files a financing statement after the equipment is installed, and after A has commenced foreclosure proceedings. Assuming that the state law finds the air conditioning equipment to be a fixture, the rules of Section 9-313 are to be applied in resolving this conflict. B takes priority, providing his interest has attached prior to installation, even though he did not file until later, since the time of attachment is the determining factor. If the facts in this example were varied so that A makes an advance under the mortgage just after affixation of the equipment, but before filing, A takes priority to the fixtures to the extent of the advance.

Suppose that X owns real estate free and clear of encumbrances. On February 1 he purchases air conditioning equipment from B under a security agreement and the equipment is installed on February 3. A is given a mortgage on the real estate on February 4th. B files on February 5. On February 15 a fire destroys the buildings containing the air-conditioning equipment which is insured. Again, since attachment occurred installation of the fixture may have caused him to refrain from foreclosure because of the increased value of the real estate. This reasoning seems rather specious. Project, supra note 26, at 934. All prior claims are treated alike under this section so that the rule applies to a lessor as well as to a real estate mortgagee. Symposium, 53 Nw. U.L. Rev. 315, 508 (1958).

231. § 9-313(4).

232. Since the Code does not attempt to define fixtures, barriers that now preclude the financing of certain types of collateral because of peculiar state laws, are not eliminated. For example, Pennsylvania has the "industrial plant" doctrine. Under this doctrine all machinery and equipment which is necessary for the operation of the business is deemed to be part of the real estate. Thus, equipment of this type cannot be fixtures at all. In such cases attachment of a security interest to the equipment before affixation is of no consequence; a real estate mortgage whether prior or subsequent would take priority. In fact Article 9 is not applicable at all. Robinson, Commercial Lending Under The Uniform Commercial Code, 73 Banking L.J. 77, 81-82 (1956).

233. Professor Hawkland's Problems, supra note 174.

234. This provision making attachment the key factor rectifies a problem that occurred in some jurisdictions under prior law where recordation of the conditional sales contract was required prior to affixation of the goods. If the seller delivered the goods too quickly and they became affixed before filing, the secured party would loose his priority. Kripke, Article 9: Secured Transactions Under The Uniform Commercial Code in Pennsylvania, 15 U. Pitt. L. Rev. 602, 613 (1954).

235. Professor Hawkland's Problems, supra note 174.
prior to affixation, B takes priority to the insurance proceeds even though he filed after the mortgage was given.

(ii) Attachment of Security Interest After Goods Become fixtures.

A security interest which attaches to goods after they become fixtures is subordinate to all prior interests in the real estate unless the person holding the prior interest consents to the security interest or disclaims an interest in the goods as fixtures. However, certain subsequent claims also take priority over a security interest if they arise without the claimant having knowledge of the security interest and before it is perfected; namely, an interest claimed by a subsequent purchaser for value of any interest in the real estate, a creditor with a lien on the real estate subsequently obtained by judicial proceedings, and a creditor with a prior encumbrance of record on the real estate to the extent that he makes subsequent advances.

d. Accessions.

Although the rules pertaining to fixtures adopt the same policy as that governing fixtures, the Code does not leave the determination of what is an accession to state law. An accession is what occurs when goods are affixed to other goods, without destroying their respective identities.

(i) Attachment of a Security Interest Before Goods Become Accessions.

A security interest which attaches to goods before they are installed in or affixed to other goods takes priority in the accession over all prior claims to the whole. However, certain subsequent claims to the whole take priority over a security interest in an accession if they arise without the claimant having knowledge of the security interest and before it is perfected; namely, an interest claimed by a subsequent purchaser of any interest in the whole, a creditor with a lien on the whole subsequently obtained by judicial proceedings, and a creditor with a prior perfected security interest in the whole to the extent that he makes subsequent advances.

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236. § 9-313 (3). This rule is based on the theory that where attachment of a security interest occurs after affixation any prior real estate encumbrancer will have relied on the fixture as part of his security. § 9-313 comment point 4. This is no doubt true in most cases, although it is conceivable that in some cases where chattels are affixed to property the security interest may not have attached before affixation. If there is a prior encumbrancer he will take priority over the fixture even though he has not relied upon it as security for his interest. In another respect this rule is considered to have gone too far, since the prior encumbrancer is given priority even though he has not recorded his own interest. In this case the secured party is unable to protect himself by searching the public records. Project, supra note 184, at 940.

237. § 9-313 (3) & (4) and comment point 4.

238. § 9-314. Conflicting security interests in a product or mass resulting from a commingling or a change of the goods by a manufacturing process are to be resolved by Section 9-315.

239. § 9-314 (1). By permitting a security interest to continue in an accession after affixation, the Code alters the common law in some jurisdictions which provides that a security interest in an accession ceases if removal would cause injury to the whole. Injury is limited to actual physical injury. Symposium, supra note 230, at 409.
advances. Thus, a security interest which attaches to goods before they become accessions, take priority over all claims to the whole, and if the secured party perfects his interest before affixation, he takes priority in the accessions over all subsequent claimants to the whole as well.

Suppose X owns an airplane on February 1 subject to a security interest held by A. On February 2 he buys a new motor from B and gives a security interest in the motor to secure the purchase price before installation. On February 4, A repossesses. Inasmuch as B's security interest attached before the motor became an accession, he takes priority to the motor over A. If B's financing statement had purported to claim a security interest in the whole airplane, his rights would be governed by Section 9-315, and he would not be able to remove the motor, but would share rateably in the proceeds upon sale of the airplane.

(ii) Attachment of a Security Interest After Goods Become Accessions.

A security interest which attaches to the goods after they become part of the whole is subordinate to all prior interests in the whole unless the person holding the prior interest consents to the security interest or disclaims an interest in the goods as part of the whole. However, as with the case of a pre-installation security interest, certain subsequent claims to the whole take priority over a security interest in an accession if they arise without the claimant having knowledge of the security interest and before it is perfected; namely, an interest claimed by a subsequent purchaser for value of any interest in the whole, a creditor with a lien on the whole subsequently obtained by judicial proceedings, and a creditor with a prior perfected security interest in the whole to the extent that he makes subsequent advances.

In some cases the prior secured party may have a purchase money security interest in the principal chattel, in which event it may not be on public record since it may be perfected without filing. Even if the interest is a non-purchase money security interest it need not be perfected to give the prior secured party priority over a party claiming a security interest in an accession. This fact is less significant, however, than when fixtures are involved, since cases where a security interest is given in a part of a chattel instead of the whole are extremely rare. By the same token claimants subsequent to the installation of the goods, even where the security interest is of the type which will take priority unless the accession secured party has perfected his interest, may not find much benefit from the

240. § 9-314 (3).
242. B now has the right to remove the motor subject to A's right to demand security as potential reimbursement for any physical injury that may be done to the airplane by the removal. B is not liable, however, for the diminution in value of the airplane by the removal. § 9-314 (4).
243. § 9-314 (2).
244. § 9-314 (3).
perfection requirement, since a purchase money security interest in consumer goods arises by attachment.\textsuperscript{245}

e. Commingled Goods.

There are two situations where a perfected security interest in goods continues in the product or mass after the goods have been commingled or assembled with other goods through a manufacturing process: first, if the identity of the goods is lost in the product or mass, and second, if the financing statement covers the product or mass as well as the original goods even though their interest has not been lost through the manufacturing process.\textsuperscript{246} The secured party is, therefore, required to elect at the time of filing whether he will claim a security interest in the product or merely in the accession under Section 9-314.\textsuperscript{247} Where more than one security interest attaches to the product or mass, the interests rank equally according to the ratio that the cost of the goods to which each interest originally attached bears to the cost of the total product.\textsuperscript{248}

Suppose that X, a shoe manufacturer, borrows $3,000.00 from A on February 1 and gives a purchase money security interest in leather soles acquired with the proceeds of that loan. A files a financing statement on the same date. X obtains another loan of $6,000.00 from B on February 10 and gives a purchase money security interest in the upper shoe leather to secure that loan. B files a financing statement on the same date. Neither financing statement claims the finished product. X manufactures shoes with both types of leather. Thereafter X becomes insolvent and the shoes are sold for $6,000.00. How are the proceeds to be distributed?\textsuperscript{249} The Code does not define the stage at which goods lose their identity. If it should be determined that the goods have not lost their identity, inasmuch as the parties did not claim the product in their financing statements, the problem will be solved by the rules of Section 9-314 where the time of attachment of the security interest is the determining factor in resolving conflicting interests. A would receive the first $3,000.00.\textsuperscript{250} However, if the identity of the goods is considered to be lost through the manufacturing process, and it would seem feasible that a court might reach this conclusion in view of the fact that the goods cannot be severed or removed without doing irreparable damage, the security interests of the respective parties automatically shift from the original goods to the finished product, and failure of the parties to mention the product in their financing statements is irrelevant. The proceeds will be distributed rateably so that A will receive $2,000.00 and B will receive $4,000.00.

\begin{itemize}
\item \textsuperscript{245} Project, supra note 184, at 947.
\item \textsuperscript{246} § 9-315 (1).
\item \textsuperscript{247} The right of removing an accession after it has been assembled is a rather harsh rule even though reimbursement for injury to the whole is provided. It appears that this is the reason why a party who claims a right to the original goods as well as the whole is precluded from impairing it by removing the original goods. Project, supra note 184, at 949.
\item \textsuperscript{248} § 9-315 (2).
\item \textsuperscript{249} Professor Hawkland's Problems, supra note 174.
\item \textsuperscript{250} § 9-314 (2).
\end{itemize}
Suppose that X obtains a loan of $5,000.00 from A to finance the purchase of soles and claims the final product in his financing statement. After the shoes are completed X obtains a loan of $5,000.00 from B putting up the finished product as security. B then files as to the whole. Thereafter X defaults in his payments and the shoes are sold for $7,000.00. How are the proceeds to be distributed? Since the conflicting security interests did not both date back to separate goods which were later manufactured into the finished product, Section 9-315 is not applicable in resolving the conflict. Both security interests are perfected by filing and therefore fall under Section 9-312(5) (a) for resolution; A takes priority and will be paid the first $5,000.00 and B will receive the remaining $2,000.00. Thus, the rule which allows a security interest to shift from the original goods to the resulting product protects the prior secured party against subsequent third parties other than buyers in the ordinary course of business.251

The rule is ambiguous with regard to the rights of unsecured creditors. Suppose that A finances a purchase of $100.00 worth of nails, B finances $100.00 worth of nails, and X buys $100.00 worth of nails with his own funds. A and B file. All the nails are put into a common bin and $250.00 worth are sold. How are the remaining $50.00 worth of nails to be distributed upon insolvency? The Code provides that each security interest is to rank equally in proportion to the ratio the cost of the original goods bears to the cost of the total product. This is subject to two interpretations, one that A and B are to share 2:3, i.e., 2/3rds of the remaining nails are to be distributed equally between A and B, with 1/3rd to the unsecured creditors, and second, what seems to be the better interpretation, A and B are to share ratebly in the whole remainder, i.e., each taking 1/2 interest in the $50.00 worth of nails.252

251. Project, supra note 184, at 949.
252. Ibid.