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THE PURCHASE MONEY SECURITY INTEREST IN INVENTORY VERSUS THE AFTER-ACQUIRED PROPERTY INTEREST—A "NO WIN" SITUATION

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> *Ford Credit has relied on its belief that it had and has a valid purchase money security interest in the collateral financed by it utilizing documents containing an after-acquired property clause and future advance clauses in making its wholesale loans . . . .*
>
> *As of 12/31/84, Ford Credit had in excess of $5.3 Billion in outstanding obligations on which it extended credit believing that it had a valid purchase money security interest . . . .*
>
> *Assuming that some method can be devised whereby Ford Credit would be able to maintain its purchase money security position while utilizing future advance and after-acquired property clauses in its documentation, it would then be necessary for Ford Credit to attempt to re-document its existing financing agreements with over 3500 dealers located throughout the United States. The cost of such a re-documentation process would be substantial.*[1]

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1. Affidavit of George V. Burbach, Associate Counsel, Ford Motor Credit Company, Southtrust Bank v. Borg-Warner Acceptance Corp., 760 F.2d 1240, *reh'g denied mem.*, 774 F.2d 1179 (11th Cir. 1985) (Petition for Rehearing by Panel and Suggestion for Rehearing En Banc).

I. INTRODUCTION

Extending credit entails risk. Seldom is a creditor absolutely assured of complete payment of his debt. Not only is there a risk in almost every loan, but the types of risks that must be weighed are manifold. The debtor may be a poor business person and never make a profit sufficient to repay the debt. The debtor class is replete with scoundrels and outright crooks who borrow money without any intention to service the debt. The economy may slump to such a degree that even astute business persons are pressed to pay their outstanding obligations. The creditor's collateral may deteriorate or vanish, and even if the collateral is preserved, another creditor may have first claim on the debtor's property.

A creditor prices the loan with an appropriate interest rate to offset these risks insomuch as he is able to assess them at the time he extends credit. Also, the creditor will often demand that the debtor grant him a security interest in the debtor's property that has value in excess of the loan. The law of debtor-creditor relations has evolved in such a manner as to help reduce loan risks, so that both the creditor and the debtor have benefited from this evolution. The creditor enjoys greater likelihood of debt satisfaction, and the debtor is able to obtain easier credit at lower interest rates.

Article Nine of the Uniform Commercial Code (U.C.C.)[2] is the most modern statement of the law with respect to the securing of loans with the debtor's personal property. The U.C.C. has attempted to develop, and in most instances has succeeded in developing, an orderly and certain system of creditor and debtor protection.[3] Article Nine simplifies the traditional procedure by which a creditor obtains a security interest in the debtor's personal property and thus helps ensure that the creditor has valuable collateral to support the outstanding debt. The drafters of the U.C.C., however, were not completely successful in achieving the goals of order and simplicity in commercial lending.

This article will assess one of the many risks that a creditor may confront when he extends credit. The risk is one that the drafters of the U.C.C. created in implementing two of their most innovative

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2. U.C.C. § 9 (1978).

3. A discussion of the inadequacy of pre-U.C.C. security devices is presented in 1A P. COOGAN, W. HOGAN, D. VAGTS & J. MCDONNELL, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 7.01[4] (1985) [hereinafter cited as SECURED TRANSACTIONS].

concepts—the after-acquired property clause and the purchase money provisions.[4] Generally stated, the risk that a secured creditor faces related to these concepts is whether he may lose his priority in the debtor's property to another creditor. The more narrow issue that this article addresses is the conflict between the secured creditor, relying on an after-acquired property clause in inventory, and a purchase money secured party.

The rule that the purchase money secured party has priority over an earlier perfected secured party is elementary. Many authors have written on this principle over the last three decades since the U.C.C. announced it.[5] The point of this article is not to weigh the rule's value or to discuss its general application.[6] Rather, this article will analyze the operation and scope of the rule in the limited case of inventory financing, and in light of the policy reason underlying it.[7] Furthermore, the article proposes (1) that a secured party relying on an after-acquired property clause cannot assure future creditors of first priority in any of the debtor's after-acquired inventory once a purchase money secured party comes into existence, and (2) that a purchase money security interest in inventory is of little, if any, value to a creditor. The purchase money interest muddies the water without aiding the purchase money party or the debtor to a great degree. The cases which deal with purchase money lending accompanied by security agreements containing a debt add-on clause, a cross-collateral clause, a future advance clause, or an after-acquired property clause, support these propositions.

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4. U.C.C. §§ 9-204, 9-107 (1978).

5. *See, e.g.*, Baker, *Priority Conflicts Involving Purchase-Money Security Interests*, PRAC. LAWS., Oct. 1983, at 67; McLaughlin, *Qualifying as a Third-Party Purchase-Money Financier: The Hurdles to Be Cleared, the Advantages to Be Gained*, 13 U.C.C. L.J. 225 (1981); Note, *The Priority Conflict Between A Purchase Money Security Interest and a Prior Security Interest In Future Accounts Receivable*, 22 VAND. L. REV. 1157 (1969).

6. For a discussion of the rule's application in determining priority among creditors, see Baker, *Priority Conflicts Involving Purchase Money Security Interests*, 29 PRAC. LAW. Oct. 1983, at 67.

7. A very interesting article that relies on economic analysis in explaining the reason for the purchase money exception and its limitations is Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979).

II. Priority Scheme of the Uniform Commercial Code

A. *General Rule*

Section 9-312 establishes the priority scheme of the U.C.C.[8] Subsection 9-312(5) is the general conflict rule and states the method for determining priority between conflicting security interests in situations not covered in the prior subsections.[9] The basic priority rule of Article Nine is the "first-in-time, first-in-right" rule. The measuring point for the first-in-time, first-in-right rule is either the filing of a financing statement or the perfection of the security interest. The first secured party to perfect his security interest or file a financing statement has superior rights in the collateral. The drafters of the U.C.C. selected this race-type rule for its simplicity and certainty. The rule is easy to apply, and it preserves the filing system. A rule that creates certainty is comprehendible, enhances commercial activity, reduces the cost of doing business, and helps the debtor obtain credit.[10]

B. *Purchase Money Security Interest*

However, the U.C.C. does recognize one type of security interest that is exempt from the first-in-time, first-in-right rule, and it gives this interest a priority over an earlier perfected Article Nine security interest.[11] The type of security interest that the U.C.C.

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8. U.C.C. § 9-312 (1978) states rules for establishing priority among creditors. This section specifically addresses security interests in crops, inventory, and other collateral, and also states a general rule for determining priority between those types of conflicting security interests not specifically addressed.

9. U.C.C. § 9-312(5) (1978) states as follows:

> In all cases not governed by other rules stated in this section (including cases of purchase money security interests which do not qualify for the special priorities set forth in subsections (3) and (4) of this section), priority between conflicting security interests in the same collateral shall be determined according to the following rules:
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> (a) Conflicting security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither filing nor perfection.
>
> (b) So long as conflicting security interests are unperfected, the first to attach has priority.

Id.

10. *Id.* § 9-312 comment 4.

11. The specific language is as follows:

> (3) A perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory and also has priority in identifiable cash proceeds received on or before the delivery of the inventory to a buyer if
>
> (a) the purchase money security interest is perfected at the time the debtor re-

singles out for special priority and other special treatment is the purchase money security interest.[12] A purchase money security interest is defined in U.C.C. section 9-107.[13] The principal feature of a purchase money security interest is that the debtor uses the money borrowed, i.e. the debt, to purchase the property that serves as the collateral for the security interest.[14] A security interest is a

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ceives possession of the inventory; and

(b) the purchase money secured party gives notification in writing to the holder of the conflicting security interest if the holder had filed a financing statement covering the same types of inventory (i) before the date of the filing made by the purchase money secured party, or (ii) before the beginning of the 21 day period where the purchase money security interest is temporarily perfected without filing or possession (subsection (5) of Section 9-304); and

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

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

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

Id. § 9-312(3), (4) (1972).

12. U.C.C. § 9-302(1)(d) (1978) establishes a special perfection rule for purchase money security interests in consumer goods:

> A financing statement must be filed to perfect all security interests except . . . a purchase money security interest in consumer goods; but filing is required for a motor vehicle required to be registered; and fixture filing is required for priority over conflicting interests in fixtures to the extent provided in Section 9-313.

Id.

U.C.C. § 9-301(2) (1978) establishes a priority rule in a conflict between a purchase money security interest and a lien creditor:

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

Id.

13. U.C.C. § 9-107 (1978) states as follows:

> A security interest is a "purchase money security interest" to the extent that it is
>
> (a) taken or retained by the seller of the collateral to secure all or part of its price; or
>
> (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

Id.

14. Under pre-U.C.C. law, a purchase money security interest was granted special priority. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 28-2 (1965). Accordingly, the author noted:

> As to business inventory, the purchase-money security interest was achieved through the trust receipt and a non-purchase-money security interest, through the so-called factor's lien. The U.C.C.'s purchase-money security interest in consumer goods is, of

purchase money security interest to the extent that the debtor uses the loan proceeds to purchase the collateral.

The U.C.C. recognizes two types of purchase money security interests. The first, and perhaps most common, occurs in the case where the vendor sells goods to a customer on time and retains a security interest in the goods. The customer has actually borrowed the money from the seller and is thus a debtor of the seller. One of the seller's motivations in agreeing to the loan is that he retains an Article Nine security interest in the goods.

The second type of purchase money security interest arises when the creditor makes the loan to the debtor with the express understanding that the debtor will use the proceeds to purchase certain property, and the property is in fact purchased. This form of purchase money security interest usually follows three steps: (1) the creditor obtains a security agreement from the debtor covering the collateral to be purchased; (2) the creditor advances money to the debtor; and (3) the debtor purchases the collateral with the money advanced.

C. *Reasons for the Purchase Money Exceptions*

Subsections 9-312(3) and (4) make special priority provisions for a purchase money secured party and allow his interest to defeat an earlier perfected security interest. In these two instances, the U.C.C. sanctions exceptions to the general first-in-time, first-in-right rule. The traditional reasons for granting these exceptions are both debtor- and creditor-oriented.[15] First, the debtor may need protection from a prior creditor who has a security interest with an after-acquired property clause. This after-acquired property clause acts as a shadow over all of the debtor's business. If the secured party is unwilling to extend further credit, the debtor would normally find other lenders reluctant to advance funds if they were to receive only a subordinate interest. Because the purchase money exception exists, the prior creditor cannot tie up the debtor's property in this fashion, thereby forcing the debtor to deal with him on his own terms. The debtor may buy inventory or equipment from

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course, merely a new name for the conditional sale of the same kind of collateral; the purchase-money security interest in inventory is, among other things, a continuation of the trust receipt . . . .

1A SECURED TRANSACTIONS, *supra* note 3, § 7.01[6] (footnote omitted).

15. J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 25-5 (2d ed. 1980).

the seller on credit, and the seller will have first claim to the property as a purchase money secured party.[16]

The second reason offered for the exception to the first-in-time, first-in-right rule is the policy that a seller of property should not be forced to check the filing system with respect to property he has sold the debtor. The law should never force a seller of property to lose priority in property he has sold to the debtor on credit.[17]

D. *After-Acquired Property Clauses*

It is the after-acquired property clause that creates the necessity for the purchase money exception. U.C.C. section 9-204[18] provides that a creditor may take a security interest in the existing property of the debtor and property that the debtor may acquire after he grants a security interest to the creditor. Therefore, when the debtor buys property, the perfected security interest of the earlier creditor attaches to the new property under the after-acquired property clause. The purchase money exception allows a seller of property in a credit purchase to take a security interest that is superior to this earlier after-acquired property security interest.[19]

E. *Purchase Money Interest in Inventory and Other Collateral*

The U.C.C. establishes one priority rule for purchase money interests in inventory and another rule for purchase money priority in all other types of collateral. Subsection 9-312(4),[20] which deals with collateral other than inventory, is the simpler of the two sets of purchase money rules with which to comply. If the creditor per-

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16. *Id.* at 1043.
17. *Id.*
18. U.C.C. § 9-204 (1978) states as follows:

> (1) Except as provided in subsection (2), a security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral.
>
> (2) No security interest attaches under an after-acquired property clause to consumer goods other than accessions (Section 9-314) when given as additional security unless the debtor acquires rights in them within ten days after the secured party gives value.
>
> (3) Obligations covered by a security agreement may include future advances or other value whether or not the advances or value are given pursuant to commitment (subsection (1) of Section 9-105).

Id.
19. *Id.* § 9-312 comment 6, example 4 (1978).
20. The text of U.C.C. § 9-312(4) (1978) is set out *supra* note 11.

fects his purchase money security interest within ten days after the debtor receives possession of the collateral, the security interest is superior to any earlier after-acquired property liens. The collateral covered by subsection 9-312(4) will be equipment in almost all instances. Consumer goods are subject to a very limited form of after-acquired property interest,[21] and practically, accounts are not the type of collateral that fit within section 9-107's definition of a purchase money security interest.

Subsection 9-312(3)[22] establishes a special purchase money exception for inventory that differs from the subsection (4) exception. The primary differences are the perfection time frame and the notice requirement. In order to qualify for this purchase money exception, the secured party must have perfected his interest by the time the debtor receives possession of the inventory. Subsection (3) does not grant the ten-day unperfected grace period which subsection (4) allows. Moreover, the purchase money secured party must give notice of his security interest to any holder of a conflicting security interest.[23]

Comment three to section 9-312 explains the reason for the notice requirement in the inventory situation. Inventory financing often involves a secured party who has agreed to make future advances based upon his after-acquired property clause covering future collateral of the debtor. Notice by a purchase money financier of his interest in collateral makes the earlier secured party aware that he should not rely on newly purchased collateral to support any future advances. In fact, the comment presumes that the earlier secured party will not make any extensions of credit after this notice from a purchase money party.[24]

III. Model Commercial Case

Southtrust Bank v. Borg-Warner Acceptance Corp.[25] is a prototypical case of the conflict between a secured party relying upon an after-acquired property clause and a purchase money secured

21. "No security interest attaches under an after-acquired property clause to consumer goods other than accessions (Section 9-314) when given as additional security unless the debtor acquires rights in them within ten days after the secured party gives value." *Id.* § 9-204(2).

22. The text of U.C.C. § 9-312(3) (1978) is set out *supra* note 11.

23. *See id.* § 9-312(3).

24. *Id.* § 9-312 comment 3.

25. 760 F.2d 1240, *reh'g denied mem.*, 774 F.2d 1179 (11th Cir. 1985).

party who asserts priority under subsection 9-312(3). The case is a useful vehicle to demonstrate the risks confronting both of these parties.

The debtors in *Southtrust Bank* were a group of appliance stores in Alabama and Georgia. The creditors were Southtrust Bank and Borg-Warner Acceptance Corporation. Both creditors obtained a valid security interest in the inventory of the debtors' appliance stores. Both Southtrust and Borg-Warner filed financing statements, which identified the collateral, with the proper state officials in Alabama and Georgia in order to perfect their respective security interests. In each instance, Southtrust was first to file and obtained a perfected security interest in the existing inventory of the debtors and their after-acquired inventory. Borg-Warner advanced money over a period of time to the debtors, and the debtors used these funds to acquire inventory. Borg-Warner retained a security interest in the property the debtors purchased. Borg-Warner understood that its security agreement with the debtors created a purchase money interest, and it intended to claim a purchase money priority. Accordingly, the company complied with subsection 9-312(3) by sending notice to Southtrust and perfecting before the debtors received the inventory.[26]

Borg-Warner's security agreement contained the following provision:

> In order to secure repayment to Secured Party of all such extensions of credit made by Secured Party in accordance with this Agreement, and to secure payment of all other debts or liabilities and performance of all obligations of Debtor to Secured Party, whether now existing or hereafter arising, Debtor agrees that Secured Party shall have and hereby grants to Secured Party a security interest in all Inventory of Debtor, whether now owned or hereafter acquired, and all Proceeds and products thereof.[27]

Thus, according to the terms of the security agreement, Borg-Warner claimed property purchased with the proceeds of its loan, as well as the existing property of the debtor and later-acquired

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26. Southtrust Bank contended that notice of Borg-Warner's interest was never received and this issue was argued in the United States District Court. *See* Southtrust Bank v. Borg-Warner Acceptance Corp., No. 83-G-0951-5 (N.D. Ala. 1984). A secured party's failure to follow the notice rule of § 9-312(3), and his resultant failure to come within the exception, is not the lending risk this article studies.

27. *Southtrust Bank*, 760 F.2d at 1241-42.

property of the debtor, as collateral for the loan. The security interest attempted both to claim purchase money status and to attach to the after-acquired property as it came into the debtor's possession.

On each occasion that a debtor purchased an appliance, the outstanding debt on that item was secured by the item itself and by all other existing inventory of the debtor. Of course, Borg-Warner had in fact financed the purchase of this other inventory and believed it was justified in seeking the extra security. This arrangement, however, operated as a typical cross-collateral clause. Moreover, whenever any item of inventory was sold and the corresponding loan had not yet been paid, Borg-Warner considered itself to still be secured by the other items of inventory which the debtor had not sold, but for which the debtor had paid all or some part of the corresponding loan. This procedure, coupled with the after-acquired property clause, operated as a debt add-on clause. Borg-Warner provided no mechanism in its agreements with the debtors, and employed no mechanism in practice, to allocate the debtors' payments first to the unpaid loans on the particular item that gave rise to the debt and then to other unpaid indebtedness of the debtors. When a debtor sold items of inventory, there was no requirement that the unpaid balance of the loan referable to that item be paid off with the proceeds of the sale.[28]

An inventory financier's inclusion of an after-acquired property clause in a security agreement for which it intends to seek purchase money priority is not unusual. The affidavits of officials of two major inventory lenders, which were presented on a petition for rehearing in the *Southtrust Bank* case, acknowledge that this practice is their normal procedure.[29] Both BancAmerica PrivateBrands, Inc. and Ford Motor Credit Company, which have combined outstanding obligations of approximately six billion dollars with over 16,000 dealers, incorporate an after-acquired property clause in their security agreements. These companies often rely upon their purchase money status to achieve priority over ear-

28. Occasionally Borg-Warner refinanced the debt in such a manner as to add on debt to collateral that was already in the appliance store's possession. Deposition of Jere Jackson at 55, 57, 64, 66, *Southtrust Bank*, No. 82-G-051-5.

29. Affidavits of George V. Burbach, Associate Counsel of Ford Motor Credit Company, and Richard W. Moyer, Vice President and Associate General Counsel of BancAmerica PrivateBrands, Inc. f/k/a FinanceAmerica PrivateBrands, Inc., *Southtrust Bank*, 774 F.2d 1179 (11th Cir. 1985) (petition for rehearing by panel and suggestion for rehearing en banc).

lier secured parties.[30]

IV. Conflicts Between After-Acquired Interests and Purchase Money Interests

The questions that arise from consideration of the prototype are: (1) what effect does the inclusion of an after-acquired property clause have on the secured party's purchase money status, and thus on its superiority over earlier secured parties?; (2) of what real value is a purchase money security interest without an after-acquired property clause?; and (3) to what extent can a secured party, which perfected its interest in after-acquired property before a purchase money creditor came into existence, rely upon any of the debtor's property as collateral?

The courts often have reviewed the special rights that the law affords a purchase money secured interest. This review has occurred principally in two areas of the law, and in both, the issue centers on whether the secured party can qualify for purchase money status. The first area of the law where the issue arises is under the U.C.C.'s special perfection and priority rules for a purchase money party.[31] The second area in which cases have discussed this problem, and the area in which most of the litigation has occurred, is bankruptcy law.[32]

V. The Section 9-302 Purchase Money Secured Party

A. *The Section 9-302 Cases*

The first cases that dealt with the issue of purchase money status arose in the bankruptcy courts and centered on subsections 9-302(1)(c) and (d) of the U.C.C. These subsections provide for automatic perfection of purchase money security interests in consumer goods, and formerly provided for automatic perfection in farm equipment with a purchase price not in excess of $2,500.[33] This

30. Affidavits of George V. Burbach, Associate Counsel of Ford Motor Credit Company, and Richard W. Moyer, Vice President and Associate General Counsel of BancAmerica PrivateBrands, Inc. f/k/a FinanceAmerica PrivateBrands, Inc., *Southtrust Bank*, 774 F.2d 1179 (11th Cir. 1985) (petition for rehearing by panel and suggestion for rehearing en banc).

31. U.C.C. §§ 9-302(1)(d), 9-312 (1978); *see infra* notes 33-53 and accompanying text.

32. 11 U.S.C. § 522(f) (1982); *see infra* notes 55-80 and accompanying text.

33. U.C.C. § 9-302(1) (1962) allowed special perfection for both purchase money security interests in consumer goods and in farm equipment with a purchase price over $2,500. The 1972 revision of Article Nine removed the farm equipment provision. The provision for automatic perfection of security interests in consumer goods is contained in U.C.C. § 9-

type of purchase money interest is perfected immediately upon attachment of the security interest, without the necessity of filing a financing statement. Since the Bankruptcy Code charges trustees with overseeing the rights of the general creditors of the debtor,[34] one of the first points the trustee scrutinizes is the secured party's mode of perfection. If the trustee can prove that the Article Nine secured party has not perfected his interest, he can break the claim of the secured party to the collateral and use it for the benefit of the general creditors.[35]

The first case to consider this issue was *In re Simpson*.[36] In *In re Simpson*, the court concluded that a security agreement covering farm equipment was not a purchase money security interest because the purchased item secured more indebtedness than just the purchase price of the farm equipment. The court determined that a literal reading of the section 9-107 definition of purchase money secured interest might allow the interest to be purchase money "to the extent that it is taken or retained by the seller . . . to secure all or a part of its [purchase] price";[37] however, this meaning was not the result the drafters of the U.C.C. intended. The court stated its view of the law to be that

> [o]ne of the purposes of the Code is to "simplify, clarify and modernize the law governing commercial transactions." One of the few exceptions to the requirement that notice by filing be a prerequisite to perfection of a security agreement is the purchase money security interest under certain conditions. If a vendor or lender desires to take advantage of this non-filing requirement, the burden should be on him to prepare a simple instrument which shall be a pure purchase money security agreement without attempting to burden it with complicated and ambiguous impedimenta. Much of the litigation which filled our courts under pre-code law was due to the effort of adroit drafters to determine how far they could go in concocting instruments that would give maximum rights to vendors and lenders while still qualifying as conditional sales contracts and thus avoiding the necessity of filing. It is to be hoped that such antics will not occur under the Code.[38]

302(1)(d) (1978), the text of which is set out *supra* note 12.

34. *See* 11 U.S.C. §§ 323, 541 (1982).

35. *See id.* § 544(b).

36. 4 U.C.C. Rep. Serv. (Callaghan) 243 (W.D. Mich. 1966).

37. *Id.* at 247.

38. *Id.* at 248 (citation omitted). *In re* Simpson involved the § 9-302(1)(c) exception for low priced farm equipment. Commentators have argued that the § 9-302(1)(c) exception is

The commissioners who drafted the subsection 9-302(1)(d) exception explained their action in comment four to that section: "In many jurisdictions under prior law security interests in consumer goods under conditional sale or bailment lease were not subject to filing requirements. Paragraph 1(d) follows the policy of those jurisdictions."[39] In order to understand the limits the drafters intended for the purchase money interest in this section, it is thus necessary to discover the reason for this pre-U.C.C. policy that the U.C.C. adopts.

A purchase money security interest is a direct descendant of the pre-U.C.C. conditional sales contract.[40] Professor Grant Gilmore, in his classic treatise on security in personal property, states that

> [t]he keystone of modern conditional sales theory came to be that the device was limited to use in financing sales transactions. It could not be used in any situation where a loan was to be secured by property owned by the borrower at the time the loan was made.
>
> . . . .
>
> Another aspect of conditional sales theory which reflected the sales background was the apparently general assumption that the only obligation which could be secured was the purchase price of the goods plus expenses connected with, or incidental to, the sale or the financing transaction.[41]

Professor Gilmore further explains the reason for the rule in pre-U.C.C. law and thus the drafters' motivation in continuing it under the U.C.C.:

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of little value, and not worth the disruption it might cause the filing system. *See* 1 G. GILMORE, *supra* note 14, § 19.3, at 533. The § 9-302(1)(c) exception was eliminated from the U.C.C. in 1972, for the reason that "[t]he analogy drawn in the 1962 Code of farm equipment to consumer goods (for which a similar nonfiling rule is provided in [9-302(1)(d)]) [was] believed to be inappropriate." U.C.C. § 9-302 comment (1978) (reasons for 1972 change).

The fact that *In re Simpson* was concerned with a purchase money security interest in farm equipment rather than consumer goods, and that the court's discussion of purchase money status is actually dictum, has diminished the reliance other courts have been willing to place on the decision.

39. U.C.C. § 9-302 comment 4 (1978).

40. A conditional sales contract is "a purchase money security transaction, subject in most states to statute, in which title to the goods was retained by the seller or his assignee until the full purchase price had been paid usually in periodic installments." 1 G. GILMORE, *supra* note 14, § 3.7, at 81.

41. *Id.* § 3.3, at 68, 71.

> It is surely not unreasonable to conclude that a filing system in this area [i.e., purchase money security interest in consumer goods] . . . is useless; none of the creditors or purchasers for whose benefit the files are maintained will ever look at them, either because they are not interested in the information or because . . . they are not capable of consulting files and not enough money is involved to make anyone think of hiring a lawyer.[42]

While subsection 9-302(1)(d) provides for automatic perfection without filing, the exception to the filing requirement is not without limitations. More specifically, a security agreement purporting to use collateral to secure debt other than its own price will not qualify as a purchase money interest entitled to be perfected without filing. The point is illustrated in two cases.

The most widely quoted case with respect to automatic perfection of a purchase money security interest in consumer goods is *In re Manuel*.[43] In *In re Manuel*, the debtor had paid approximately $150, on a total indebtedness of $900, for seven pieces of furniture and a television set. The merchant-seller kept no record to identify those items for which the debtor had paid and those for which the debtor still owed money. Moreover, the security agreement did not provide for a method, such as "first bought first paid," to allocate the payments.[44] The court concluded that a plain reading of U.C.C. section 9-107 indicated that it required a purchase money security interest to be in the item purchased and that this type of security interest could not exceed the price of consumer goods purchased.[45] Since the security interest at issue did not qualify for purchase money status, it was not automatically perfected under U.C.C. section 9-302(1)(d).[46] Since the seller had not filed a financing statement, the security interest was unperfected. Beyond this reasoning, the court basically adopted the ideas expressed in *In re Simpson*, and cited it with approval.[47]

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42. *Id.* § 19.4, at 535.

43. 507 F.2d 990 (5th Cir. 1975).

44. *Id.* at 993.

45. *Id.*

46. *Id.* In the bankruptcy context, courts have adopted a judicial first-in, first-out rule to save a purchase money security interest. *See, e.g.*, *In re* Gibson, 16 Bankr. 257 (D. Kan. 1981); *see also infra* notes 75-76 and accompanying text.

47. *See id.* In *In re* Staley, 426 F. Supp. 437 (M.D. Ga. 1977), the court determined that *In re Manuel* did not apply since the security agreement explicitly provided that the security interest in items purchased was to terminate as soon as the debtor paid the purchase price of the item. *Id.* at 437-38.

In *In re Norrell*,[48] the court addressed the secured party's argument that his purchase money status was preserved by the operation of a state consumer protection statute.[49] The statute provided that payments on revolving accounts were to be applied first to goods which the debtor first purchased.[50] The court concluded that the statute did not apply to the "creation, duration, definition, or enforcement of purchase money security interests in consumer goods, and, specifically, [did] not purport to terminate a security interest contrary to the clear terms of a security agreement."[51] Because the security agreement at issue provided that, as long as any indebtedness was outstanding, property stood as collateral not only for its price but for the price of property subsequently acquired on credit, the security interest was not a purchase money interest, and the subsection 9-302(1)(d) exception did not apply.[52] The creditor could not rely on the state statute to tailor the security interest in such a manner that it became purchase money.[53]

B. *Policies Underlying the Section 9-302 Decisions*

Cases that have addressed the subsection 9-302(1)(d) perfection without filing exception for purchase money security interests indicate an overriding policy of protecting the filing system. Absent clear justification to dispense with the filing requirement, the reasons underlying automatic perfection lack weight to render the exception applicable. Thus, only in the strict case of the well-delineated purchase money security agreement, which ties price to the purchased collateral, will the filing system be regarded as useless; only in this situation will the U.C.C. allow perfection without filing.

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48. 426 F. Supp. 435 (M.D. Ga. 1977).

49. The statute involved was Georgia's Retail Installment and Home Solicitation Sales Act, GA. CODE ANN. § 10-1-8 (1981).

50. 426 F. Supp. at 436.

51. *Id.*

52. *Id.*

53. *Id.*

VII. THE SUBSECTION 522(f)[54] PURCHASE MONEY SECURITY INTEREST

A. *The Subsection 522(f) Case*

Like the U.C.C., the Bankruptcy Code of 1978[55] establishes some special protections in its scheme of debtor and creditor rights. Under subsection 522(f)(2) of the Bankruptcy Code, the debtor may avoid nonpossessory, nonpurchase money security interests in certain types of exempt property.[56] Thus, just as in the U.C.C. section 9-302 situation, the trustee in bankruptcy will carefully scrutinize all security interests in the debtor's property that come within the terms of subsection 522(f) to determine if he can attack them as nonpurchase money interests.[57] Since the property which is subject to the security interest is exempt property, most of the bankruptcy cases have involved consumer goods as collateral.[58]

Since the purchase money secured interest under section 522(f) is singled out for special treatment, the reason for such treatment becomes pertinent, as does the question whether courts should define a purchase money security interest broadly or narrowly in order to achieve the desired result. The cases demonstrate that courts have gone through a sifting process in establishing the limits of the purchase money secured interest under section 522(f).[59]

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54. 11 U.S.C. § 522(f) (1982).

55. *Id.* §§ 1-151326.

56. 11 U.S.C. § 522(f) (1982) provides as follows:

> Notwithstanding any waiver of exemptions, the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is—(1) a judicial lien; or (2) a nonpossessory, nonpurchase-money security interest in any—(A) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor; (B) implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor; or (C) professionally prescribed health aids for the debtor or a dependent of the debtor.

Id.

57. The Bankruptcy Code of 1978, 11 U.S.C. §§ 1-151326 (1982) does not define the term "purchase money security interest." The Bankruptcy court has defined a § 522(f) purchase money security interest by reference to U.C.C. § 9-107 (1972). *See In re* Haus, 18 Bankr. 413 (D. S.C. 1982).

58. 11 U.S.C. § 522(f) (1978) identifies exempt property for bankruptcy purposes. Under 11 U.S.C. § 522(b), exempt property may be either the property identified in § 522(d) or exempt property as defined by state laws.

59. The following cases have discussed the purchase money status under § 522(f): Pristas v. Landaus of Plymouth, 742 F.2d 797 (3d Cir. 1984); *In re* Matthews, 724 F.2d 798 (9th Cir.

Most of the bankruptcy cases have opted for the view that the thrust of section 522 is, first, to save the debtor's exempt property from creditors other than those that have actually sold the debtor the item, and second, to protect the debtor from the seller's claims to property other than the property they actually sold.[60] In other words, courts view the goal of subsection 522(f) as being to discourage the seller's greed and to prevent him from tying up the debtor's property with his security interest.

The legislative history of subsection 522(f) indicates that Congress' intent in creating the section was to protect consumers from overreaching:

> Frequently, creditors lending money to a consumer debtor take a security interest in all of the debtor's belongings, and obtain a waiver by the debtor of his exemptions. In most of these cases, the debtor is unaware of the consequences of the form he signs . . . .

1984); *In re* Middleton, 37 Bankr. 36 (D. Minn. 1983); *In re* Sprague, 29 Bankr. 711 (M.D. Pa. 1983); *In re* Russell, 29 Bankr. 270 (W.D. Okla. 1983); *In re* Goard, 26 Bankr. 316 (M.D. N.C. 1982); *In re* Cameron, 25 Bankr. 410 (N.D. Ga. 1982); *In re* Wilson, 25 Bankr. 276 (D. Neb. 1982); *In re* Stevens, 24 Bankr. 536 (D. Colo. 1982); *In re* Fickey, 23 Bankr. 586 (E.D. Tenn. 1982); *In re* Georgia, 22 Bankr. 31 (S.D. Ohio 1982); *In re* Littlejohn, 20 Bankr. 695 (W.D. Ky. 1982); *In re* Mattson, 20 Bankr. 382 (W.D. Wis. 1982); *In re* King, 19 Bankr. 409 (M.D. Ga. 1982); *In re* Haus, 18 Bankr. 413 (D. S.C. 1982); *In re* Hobdy, 18 Bankr. 70 (W.D. Ky. 1982); *In re* Kelley, 17 Bankr. 770 (E.D. Tenn. 1982); *In re* Rosen, 17 Bankr. 436 (D. S.C. 1982); *In re* Luczak, 16 Bankr. 743 (W.D. Wis. 1982); *In re* Conn, 16 Bankr. 454 (W.D. Ky. 1982); *In re* Ashworth, 16 Bankr. 645 (C.D. Cal. 1981); *In re* Gibson, 16 Bankr. 257 (D. Kan. 1981); *In re* Holland, 16 Bankr. 83 (N.D. Ohio 1981); *In re* Lay, 15 Bankr. 841 (S.D. Ohio 1981); *In re* Ward, 14 Bankr. 549 (S.D. Ga. 1981); *In re* Trotter, 12 Bankr. 72 (C.D. Cal. 1981); *In re* Buchanan, 10 Bankr. 846 (S.D. Ohio 1981); *In re* Griffin, 9 Bankr. 880 (N.D. Ga. 1981); *In re* Booker, 9 Bankr. 710, (M.D. Ga. 1981); *In re* Carnes, 8 Bankr. 599 (W.D. Okla. 1982); *In re* Jebbia, 9 Bankr. 542 (S.D. Ala. 1980); *In re* Slay, 8 Bankr. 355 (E.D. Tenn. 1980); *In re* Coomer, 8 Bankr. 351 (E.D. Tenn. 1980); *In re* James, 7 Bankr. 73 (D. Me. 1980); *In re* Coronado, 7 Bankr. 53 (D. Ariz. 1980); *In re* Krulik, 6 Bankr. 443 (M.D. Tenn. 1980); *In re* Jones, 5 Bankr. 655 (M.D. N.C. 1980); *In re* Scott, 5 Bankr. 37 (M.D. Pa. 1980), *In re* Mulcahy, 3 Bankr. 454 (S.D. Ind. 1980); *In re* Norrell, 21 U.C.C. Rep. Serv. (Callaghan) 1185 (M.D. Ga. 1977); *In re* Brouse, 6 U.C.C. Rep. Serv. (Callaghan) 471 (W.D. Mich. 1969).

60. At least one author has proposed that

> [t]ransformation of nonpurchase money security interests upon refinancing, which is inherent in the *Simpson* rationale, does not fairly balance the interests of the parties involved in bankruptcy proceedings. Good faith creditors lend purchase money in reliance that their security interests will have purchase money priority; this should not be avoided by refinancing. If courts continue to follow the *Simpson* rationale and deny creditors purchase money status, debtors will find refinancing difficult to obtain. The interests of both creditors and debtors will be advanced if the lead taken by *Conn* is followed and *Simpson* is ultimately rejected.

Note, *Section 522(f): A Proposal For the Survival of Purchase Money Security Interests Following Refinancing*, 18 TULSA L.J. 280, 304 (1982).

> The exemption provision allows the debtor, after bankruptcy has been filed . . . to undo the consequences of a contract of adhesion, signed in ignorance, by permitting the invalidation of nonpurchase money security interests in household goods. Such security interests have too often been used by over-reaching creditors. [Section 522] eliminates any unfair advantage creditors have.[61]

Courts have lined up on both sides of the issue, with the weight of the authority expressing the view that a security interest by a seller of goods[62] that claims collateral other than the items sold is not a purchase money security interest. If the lien does not qualify as a purchase money interest, the debtor can avoid it under section 522(f).

The courts adopting this view adhere to the rule of *In re Manuel*[63] that "if consumer goods serve any price other than their own, and there is no formula for application of payments, the security interest in those goods is not purchase money."[64] In *In re Jebbia*[65] and *In re Booker*,[66] both courts reviewed security interests under subsection 522(f), and adopted the reasoning of *In re Manuel* as applied to purchase money interests under section 9-302 in concluding that the security interests at issue were not purchase money.[67] Similarly, in *In re Mulcahy*,[68] the court found no reason to apply a different rule to security agreements executed as part of

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61. Stevens v. Associates Fin. Serv., 24 Bankr. 536 (D. Colo. 1982) (quoting H.R. REP. No. 595, 95th Cong., 1st Sess. 127 (1977), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 6088).

62. *In re* Dillon, 18 Bankr. 252 (E.D. Cal. 1982) is one of the few cases that addresses the § 522(f) purchase money concept where goods other than consumer goods are involved. The collateral in question in that case was a tractor. The debtor argued the tractor was a tool of the trade under § 522(f), and that he could therefore avoid a nonpurchase money security interest in it. The court determined that the tractor was a tool of the trade, and followed *In re* Manuel, 507 F.2d 990 (5th Cir. 1975), in ruling that the interest was not a purchase money security interest because it included other collateral. The debtor was therefore allowed to avoid the lien. *Dillon*, 18 Bankr. at 254-55. Although *Dillon* involved equipment, rather than items traditionally recognized as consumer goods, the case really does not aid in understanding the scope of purchase money interests since the equipment was a type of property specifically listed in § 522(f). Congress decided that its policy of discouraging vendors from overreaching applied to this type of equipment, i.e., tools of the trade, with the same force that it applied to consumer goods. *Id.* at 256.

63. 507 F.2d 990 (5th Cir. 1975).

64. *In re* Mulcahy, 3 Bankr. 454, 457 (S.D. Ind. 1980).

65. 9 Bankr. 542 (S.D. Ala. 1980).

66. 9 Bankr. 710 (M.D. Ga. 1981).

67. *Id.* at 712-13.

68. 3 Bankr. 454 (S.D. Ind. 1980).

refinancing loans.[69]

In *In re Mulcahy*, the trustee attacked each security interest as nonpurchase money under section 522(f). The secured party advanced the debtor funds to pay off his entire debt, and then took a security interest in all property he had earlier sold the debtor to support the debt. The court stated that "[h]ad the Mulcahys gone to a third party lender and borrowed money to pay off Morris Plan [the secured party], that paying off would certainly have had [the] effect [of destroying purchase money status]. The court sees no reasons why a different rule should apply merely because Morris Plan transferred money from its right pocket to its left."[70] The refinancing of the debt by the same creditor destroyed the purchase money status in the same manner that a refinancing by a second non-seller creditor would have.[71]

Few of the cases adopting the reasoning of *In re Manuel* have considered the notion that the policies underlying definition of a section 9-302 purchase money security interest might not apply to subsection 522(f). The principal case that rejects the *In re Manuel* rule in the context of subsection 522(f) is *In re Gibson*.[72] In a well developed opinion, the court reviewed all the cases on purchase money status. The court recognized that the purchase money issue may arise in three different contexts: (1) perfection without filing under subsection 9-302(1)(d); (2) the bankrupt's right to avoid a lien under subsection 522(f); and (3) the priority conflict rules of subsections 9-312(3), (4), and (5).[73] The court then examined some of the reasons for the special treatment accorded purchase money security interests by each of these rules. Judge Pusateri concluded that the policy of subsection 522(f) to limit overreaching by creditors was clear but that "Congress enacted [subsection] 522(f) to allow the consumer debtor 'to avoid security interests in their already owned, used household goods.' "[74] Thus, Congress never intended that a debtor could use subsection 522(f) to avoid a purchase money lien first created by the vendor to secure a debt on one item sold to the debtor, but which the vendor simply contin-

69. *Id.* at 457.

70. *Id.* at 456-57.

71. *See also In re* Haus, 18 Bankr. 413 (D.S.C. 1982). *But see In re* Slay, 8 Bankr. 355 (E.D. Tenn. 1980) (finding that loan consolidation did not affect purchase money status if debtor had made no payments).

72. 16 Bankr. 257 (D. Kan. 1981).

73. *Id.* at 265-66.

74. *Id.* at 266 (quoting *In re* Coomer, 8 Bankr. 351, 354 (E.D. Tenn. 1980)).

ued after the price was paid in order to secure a debt on a second item subsequently purchased from the vendor.

Finally, relying extensively on an article by Professor Gerald McLaughlin, the court catalogued its responses to *In re Manuel* and its progeny: (1) the U.C.C. nowhere states that a purchase money security interest is transformable; (2) the "to the extent" language of section 9-107 authorizes a broad scope for purchase money interest; (3) *In re Manuel* may be limited to the subsection 9-302(1)(d) situation and only applies to the filing exemption for a consumer good; and (4) the transformation rule defeats the purpose of the uniform priority system and discourages creditors from advancing money to consumer debtors to acquire new assets.[75] Accordingly, the court devised a court-made first-in, first-out rule and determined that the creditor applied the loan payment to items first purchased. When the debtor had paid the total price on that item, it was released as collateral under the security agreement. Since no collateral secured a debt other than its outstanding purchase price under the court-made rule, the security interest was purchase money.[76]

B. *Policies Underlying the Subsection 522(f) Decisions*

The holdings in the subsection 522(f) cases indicate three policies the courts have recognized and sought to accommodate. The first policy is that of preventing overreaching by creditors.[77] The legislative history clearly shows that Congress intended this policy to be the primary thrust behind subsection 522(f). The law should not allow a seller-creditor to create a security interest in all of a debtor's existing household and personal goods in order to back up a credit sale to the debtor.

The second policy apparent in the subsection 522(f) cases is the notion that a seller has a right to maintain an interest in any prop-

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75. *Id.* at 267-69 (citing McLaughlin, *"Add On Clauses" in Equipment Purchase Money Financing: Too Much of a Good Thing*, 49 FORDHAM L. REV. 661 (1981)).

76. *Id.*; *see also In re* Stevens, 24 Bankr. 536 (D. Colo. 1982). In *In re* Keller, 29 Bankr. 91 (M.D. Fla. 1983), the court found that the security agreement properly allocated the debtor's payments so as to preserve the vendor's purchase money status. The court in *In re* Mulcahy, 3 Bankr. 454 (S.D. Ind. 1980) held that the Indiana version of the U.C.C. provided for the creditor to allocate payments on a first-in, first-out basis. However, the *Mulcahy* court also found that the U.C.C. did not apply to the creditor in this situation because he was an assignee of the original seller.

77. *See* Stevens v. Associates Fin. Servs., 24 Bankr. 536 (D. Colo. 1982); *see also supra* note 61 and accompanying text.

erty that he has sold the debtor.[78] Moreover, the interest remains valid and appropriate even if the debtor has paid off the purchase price of an item. The seller simply retains his interest in the item to secure the price of property sold to the debtor at a later time. The basis for this line of reasoning is that Congress intended to limit a creditor's rights in a particular way under subsection 522(f). Subsection 522(f) prevents a seller from taking a security interest in the existing property of the debtor, to the extent that the secured party cannot take a security interest in the debtor's property which the seller-creditor did not sell to him. The concept of overreaching does not preclude a seller's continued interest in property he earlier sold the debtor.

The third trend in the subsection 522(f) cases is the courts' willingness to salvage a true purchase money interest in the debtor's property, even when the creditor has overreached.[79] Some courts allow the seller-creditor to retain his interest in merchandise he sold to the debtor, when the debtor still owes on the property, even though the security agreement claims property for which the debtor has paid. The courts that have devised a first-in, first-out rule, or that have looked to outside factors such as state consumer statutes to find a first-in, first-out device, illustrate this willingness to save a true purchase money security interest from the effect of section 522(f). The language of U.C.C. section 9-107 provides support for this position.[80]

VIII. The Section 9-312(3)[81] Purchase Money Secured Party

A. *General Requirements*

In terms of monetary impact, U.C.C. subsection 9-312(3)'s treatment of a purchase money secured party is clearly more important than the treatment provided for in either U.C.C. section 9-302 or subsection 522(f) of the Bankruptcy Code. Both section 9-302 and subsection 522(f) apply to consumer goods, which are usually relatively inexpensive.[82] Subsection 9-312(3) deals with the impact of a

78. *See In re* Coomer, 8 Bankr. 351 (E.D. Tenn. 1980).

79. *See In re* Gibson, 16 Bankr. 247 (D. Kan. 1981); *see also supra* notes 72-76 and accompanying text.

80. U.C.C. § 9-107 (1978) provides that a "security interest is a 'purchase money security interest' *to the extent* that it is (a) taken or retained by the seller of the collateral to secure all or a part of its price." (emphasis added).

81. *Id.* § 9-312(3).

82. U.C.C. § 9-109 (1) (1978) defines "consumer goods" as those used or bought for use

purchase money security interest on inventory collateral.[83] This type of collateral secures billions of dollars of debt.

Under subsection 9-312(3), a purchase money secured party who gives notice to a prior secured party, and who perfects by the time the debtor receives the property, will defeat the earlier secured party's interest in purchased property. Although the notice and perfection requirements of the section may raise some technical questions, the significant issue is who qualifies as a subsection 9-312(3) purchase money secured party.[84] The only case that directly discusses this issue is *Southtrust Bank v. Borg-Warner Acceptance Corp.*[85]

B. *The* Southtrust Bank *Case*

As explained earlier in the article,[86] Southtrust Bank perfected a security interest in all of the debtor's existing and after-acquired property. Subsequent to the Bank's perfection, Borg-Warner Acceptance Corporation sold property to the debtor over an extended period and retained a security interest in the property sold. Borg-Warner claimed to have a purchase money security interest. The questionable feature of Borg-Warner's security interest was the after-acquired property clause in the security agreement. Under this clause, Borg-Warner sought to secure its loan with the property which created the indebtedness and with property the debtor later purchased. Southtrust Bank argued that this scheme entirely destroyed any purchase money character of Borg-Warner's security interest.[87] The United States Court of Appeals for the Eleventh Circuit agreed with the bank.[88]

The court first ruled that prior cases regarding the perfection of

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primarily for personal, family or household purposes.

83. U.C.C. § 9-109(4) (1978) provides that

> goods are . . . 'inventory' if they are held by a person who holds them for sale or lease or to be furnished under contracts of service or 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.

84. A principal issue in Southtrust Bank v. Borg-Warner Acceptance Corp., 760 F.2d 1240 (11th Cir. 1985), not discussed in this article, was whether Borg-Warner had given Southtrust notice of its proposed purchase money security interest. Some of the notice problems of a § 9-312(3) priority are presented in 2 R. ALDERMAN & R. DOLE, A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE 1070-73 (2d ed. 1983).

85. 760 F.2d 1240 (11th Cir. 1985).

86. *See supra* notes 25-28 and accompanying text.

87. 760 F.2d at 1242.

88. *Id.*

purchase money status under section 9-302 were applicable with respect to the priority rule of subsection 9-312(3).[89] Thus, the court relied on *In re Manuel* for the proposition that a purchase money interest must be limited to the item purchased at the time of the agreement and cannot exceed the price of that item.[90] The court specifically stated that the type of collateral claimed by the secured party had no place in defining a purchase money secured party; whether the purchase money secured party is a vendor of inventory, or of consumer goods, his security agreement must meet the same test.[91] Next, Borg-Warner raised the point that a simple boiler plate after-acquired property clause, which the creditor has not exercised (in that he has not claimed collateral under the clause), should not affect purchase money status. The court never reached this interesting issue since it ruled that Borg-Warner did claim collateral under its after-acquired property clause.[92]

The court was content to rely upon cases that defined purchase money security status under the perfection rule of section 9-302, and through those cases to rely upon the support of the subsection

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89. *Id.*

90. *Id.* (citing *In re* Manuel, 507 F.2d 990, 993 (5th Cir. 1975)).

91. *Id.* at 1243.

92. *Id.* The court did not rule on the question of whether an after-acquired property clause in a purchase money security agreement destroys the purchase money nature of the security interest where the secured party makes no claim to the after-acquired property. This type of case is unlikely to occur since it is very difficult to determine if a purchase money secured party is exercising an after-acquired property clause until after default. Further, it is unlikely that a secured party will draft an after-acquired property clause into his secured agreement and then assert he has never claimed any interest in that collateral.

Mere inclusion of the clause in the agreement is grounds for the earlier Article Nine secured party to assert that the purchase money secured party has exercised the broad after-acquired property provision. On the other hand, in cases like *In re* Gibson, 16 Bankr. 257 (D. Kan. 1981), the court has been willing to find a portion of a security interest to be purchase money. Therefore, if a suitable case of an unexercised after-acquired property clause reached a court, the purchase money secured party might save part of his interest.

Mid-Atlantic Flange Co. v. Alper, 26 U.C.C. Rep. Serv. (Callaghan) 203, 208 (E.D. Pa. 1979) supports the proposition, the court stating that "we think that the Fifth Circuit might well agree that Manuel [sic] should be confined to those situations where non-purchase money debts are actually incurred." However the court noted as follows:

> Since there were . . . no sales previous to the signing of the security agreement, and no extensions of credit from [the secured party] to the bankrupt other than as part of a conditional sale, [the court left] for another day the question of whether such extensions of credit would totally prohibit the characterization of the security agreement as a purchase money security agreement, or whether they would merely limit the purchase money character of the security interest to that portion of the debt secured which is taken or retained to secure the purchase price of the collateral.

Id. at 209.

522(f) bankruptcy decisions.[93] The court failed to study the reasons and purposes of the subsection 9-312(3) rule to determine if the policies underlying the section 9-302 and subsection 522(f) cases justified reliance on them for purposes of identifying a subsection 9-312(3) purchase money party.[94]

C. *The Purpose of the Section 9-312(3) Exception*

The well-documented policy underlying the subsection 9-312(3) and (4) exceptions is based on the idea of protecting the debtor from a secured party with an interest in the debtor's after-acquired property.[95] If the U.C.C. did not provide for the purchase money exception, an inventory supplier of the debtor would be reluctant to sell to the debtor on credit. Any goods the supplier sold the debtor would be subject to the security interest of the prior after-acquired property lender, and thus the supplier would have only a second priority security interest in the very goods he sold the debtor. The drafters intended the subsection 9-312(3) exception to enable the debtor to purchase from the supplier on credit, and not be under the control of the financier's decisions regarding further extensions of credit. The after-acquired property financier does not have first priority in all the debtor's collateral; the purchase money secured party can create a security interest that is superior to all earlier Article Nine interests.

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93. The court stated that it saw "no policy reasons for creating a distinction [in consumer and commercial transactions] where the drafters [had] not done so." Southtrust Bank v. Borg-Warner Acceptance Corp., 760 F.2d 1240, 1242 (11th Cir. 1985).

94. In Raleigh Indus., Inc. v. Tassone, 74 Cal. App. 3d 692, 141 Cal. Rptr. 641 (1977), the court interpreted a non-uniform state version of U.C.C. § 9-102. The California statute provided that

> [n]o nonpossessory security interest, other than a purchase money security interest, may be given or taken in or to the inventory of a retail merchant held for sale, except in or to inventory consisting of durable goods having a unit retail value of at least five hundred dollars . . . . The phrase "purchase money security interest" as used in this subdivision does not extend to any after-acquired property other than the initial property sold by a secured party or taken by a lender as security as provided in Section 9107.

Id. at 700, 141 Cal. Rptr. at 646 (quoting CAL. COM. CODE § 9102(4) (West 1964) (currently located as amended in Cum. Supp. 1986)). The court held that under this provision a purchase money lender could not claim a security interest in after-acquired property. The interesting point in the case is that the court did not discuss the effect of the after-acquired property claim on the true purchase money collateral. The purchase money security interest is unaffected by the after-acquired property claim under this provision of the California Commercial Code.

95. B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 3.9(1) (1980).

If the purpose of the subsection 9-312(3) purchase money exception is to allow the debtor to bargain effectively for future extension of credit in order to maintain his inventory, the next issue involves the scope of the exception required in order to achieve this policy. The U.C.C. drafters have provided some direction regarding the scope of the exception in subsection 9-312(3) itself.[96] First, the drafters limited the exception to those purchase money parties that fulfill the subsection's conditions. These conditions are that the purchase money secured party must give notice,[97] and be perfected, at the time the debtor received possession of the inventory. Second, the drafters limited the collateral that the purchase money could claim. The exception basically applies only to original collateral, and not to the proceeds of the collateral.

The notice requirement benefits the earlier secured party with an after-acquired property clause. It makes him aware that he cannot extend future advances in reliance on the debtor's recently purchased inventory. The notice should be a warning that he may have a second priority security interest in some of the debtor's collateral.[98]

D. *The Limitation on Proceeds*

In the 1972 amendments to Article Nine, the Permanent Editorial Board of the U.C.C. settled the dispute that had arisen over the purchase money party's claim for priority in proceeds of inventory. Normally, a secured party's perfected interest carries over into the proceeds of the collateral.[99] Moreover, this continued security interest in proceeds will usually remain perfected.[100] Since proceeds of inventory in most instances are accounts that are created when the debtor sells his inventory, the conflicting claim to

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96. It was proposed at one time that U.C.C. § 9-107 provide for a purchase-money interest to the extent of value advanced for the purpose of financing new acquisitions within 10 days of the debtor's receiving possession of the new goods even though the value was not in fact used to pay the price. The paragraph was deleted, according to the sponsors, because it extended the purchase-money interest too far. 2 G. GILMORE, *supra* note 14, § 29.2, at 782 n.6.

97. The notice requirement of § 9-312(3) may itself cause problems for the purchase money secured party. Section 9-312(3) is subject to conflicting interpretations as to when and where notice must be given. Baker, *The Ambiguous Notification Requirement of Revised U.C.C. Section 9-312(3): Inventory Financers Beware!*, 98 BANKING L.J. 4 (1981).

98. U.C.C. § 9-312 comment 4 (1978).

99. *Id.* § 9-306(2).

100. *Id.* § 9-306(3).

those proceeds comes from an account financier with an after-acquired property clause.[101] The 1972 amendment gives the secured party with an after-acquired property clause in his security agreement priority in the proceeds, i.e., accounts, over a purchase money secured party whose original collateral was inventory.[102] The drafters believed that the implementation of subsection 9-312(3) warranted affording a purchase money party less protection than the U.C.C. normally affords a secured party. A debtor can still bargain effectively for credit with a vendor, even when the vendor knows that he can only achieve a first priority position in the original collateral, and recognizes that this interest in proceeds is subordinated to an earlier Article Nine secured party claiming an interest in the collateral.

E. *The Type of Collateral Affects the Nature of the Purchase Money Interest*

The background of subsection 9-312(3) lends strong support to the idea that the scope of a purchase money secured party's interest can vary depending upon the results the drafters intended to achieve. It is conceivable that a party can have purchase money status under one section of the U.C.C. and in other circumstances

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101. One author has observed:

> Because Section 9-306 provides for a perfected security interest to continue in identifiable proceeds, there has been considerable discussion about whether the purchase money inventory financer's priority continued in accounts arising when inventory was sold so as to take priority over an earlier accounts financer. This issue is resolved in Revised Section 9-312(3) by giving the purchase money security interest priority over conflicting security interests in the same collateral and "in identifiable cash proceeds received on or before delivery of the inventory to a buyer" provided the required steps are taken. Since the cash must be received before the debtor gets the goods, the cash cannot be proceeds of an account, and since the cash must be identifiable, the priority is probably restricted to checks, unless the secured party is extremely agile and assiduously polices the debtor's conduct of his business.

R. HENSON, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE 137-38 (2d ed. 1979).

102. As the U.C.C. explains:

> One of the most widely discussed questions under the 1962 Code was the question of the priority between a person claiming accounts as proceeds of inventory and a person claiming the accounts by direct filing with respect thereto. One issue was whether the special position of an inventory financer as a purchase money financer or as the first financer in the business cycle of the debtor gave him any special position as to accounts resulting from the inventory. In general, as revised, a negative answer has been given, and a prior right to inventory does not confer a prior right to any proceeds except identifiable cash proceeds received on or before the delivery of the inventory.

U.C.C. § 9-312 comment (1978) (reasons for 1972 change to (2)(c)).

not enjoy the same status under another section. However, the notion expressed in *Southtrust Bank*, that a purchase money secured party's status does not hinge to some degree on the class of collateral involved, is questionable.[103]

Section 9-312 itself treats purchase money security interests differently, depending on the collateral involved. The U.C.C. singles out inventory for special treatment in subsection 9-312(3) and lumps all other types of collateral under subsection 9-312(4). The purchase money secured interest in inventory does not extend to proceeds. However, a purchase money interest under subsection 9-312(4), which will usually be an interest in equipment, does extend to proceeds. The *Southtrust Bank* court relied on section 9-302 cases that involved consumer goods in defining a subsection 9-312(3) purchase money security interest in inventory. The counseling point is that to simply conclude that all purchase money interests are identical, for all types of collateral, does not take the analysis far enough. The *Southtrust Bank* court should have studied the reason for the rule.

F. *The Commercial Effectiveness of Subsection 9-312(3)*

The paucity of cases in this area may indicate that very few lenders ever truly rely upon their purchase money status for priority. Most major inventory financiers probably have priority because they are first to perfect. If these lenders have an on-going relationship with the debtor, such as in the case of the automobile manufacturer and his dealer, the parties entered into the security agreement when the debtor commenced business. In other cases, where the debtor changes from one brand of inventory to another, or where the debtor has a large outstanding operating loan at the time the debtor starts purchasing inventory, the inventory financier will obtain a subordination agreement from the prior secured party. The earlier secured party is willing to subordinate his interest in many situations so that the debtor can continue in business and the earlier secured party will not have to advance further

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103. The *Southtrust Bank* court stated that "[n]othing in the language of U.C.C. § 9-312(3) or § 9-107 distinguishes between consumer and commercial transactions or between bankruptcy and nonbankruptcy contexts." 760 F.2d at 1242. The court therefore saw "no policy reasons for creating a distinction where the drafters have not done so." *Id.*

The court in Mid-Atlantic Flange Co. v. Alper, 26 U.C.C. Rep. Serv. [Callaghan) 203 (E.D. Pa. 1979), takes a different view, stating that "different conditions apply" to commercial, as opposed to consumer, transactions. *Id.* at 208.

money to the debtor. Through this method the debtor acquires money from another source, and the infusion of cash allows him to continue making payments to both secured creditors. The *Southtrust Bank* fact situation may actually be an abnormality since the second creditor relied upon the subsection 9-312(3) exception for priority.[104] The security agreement that Borg-Warner used in the case is a standard agreement with a standard after-acquired property clause. Borg-Warner probably did not originally draft the security agreement to cover the purchase money situation.

G. *The Present Status of the Subsection 9-312(3) Exception*

In light of the limitations that the drafters placed on the subsection 9-312(3) exception and the commercial realities of inventory financing, the court in *Southtrust Bank* reached the proper result in limiting the scope of the subsection 9-312(3) purchase money security interest. The court reached this result even though it failed to properly develop a firm foundation for, and relied too heavily on section 9-302 cases in reaching, its decision.[105] The court should have explored the reason for the subsection 9-312(3) exception and the drafters' intention regarding its operation, in addition to the section 9-302 and subsection 522(f) cases it did address.

To qualify as a purchase money secured party under subsection 9-312(3), the creditor must limit his security interest to the item purchased at the time of the agreement, and the debt cannot exceed the price of that item. This result respects the sanctity of the single priority rule of the U.C.C., which is based on precedence in time of filing or perfection.

The narrow reading of purchase money security interest intended by the U.C.C. drafters[106] also gives the debtor some bargaining power without destroying the earlier security interest. Inventory moves quickly; the debtor is selling items and replacing them continuously. If the purchase money secured party were to be given superior priority in property he sold the debtor and in the debtor's after-acquired property, then the earlier secured party soon would completely lose his place on the priority ladder and be totally subordinated to the purchase money lender.

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104. Southtrust Bank v. Borg-Warner Acceptance Corp., 760 F.2d 1240, 1242, *reh'g denied mem.*, 774 F.2d 1179 (11th Cir. 1985).

105. *Id.* at 1242-43; *see also supra* notes 89-94 and accompanying text.

106. *See supra* notes 96-98 and accompanying text.

Under the *Southtrust Bank* rule, the debtor can obtain inventory from sources other than an existing secured creditor even though the rule restricts the purchase money secured party's ability to prime the earlier perfected interest. An occasional purchase of inventory on credit is within the *Southtrust Bank* rule, and this type of interest is small enough that the secured party can prove it. The main requirement of the rule is that the debtor maintain a complete accounting record, so that the "purchase-price" debt is always matched to the collateral that gave rise to the debt.[107] Moreover, the debtor should extinguish the outstanding debt on any inventory sold. Of course, the purchase money secured party bears the risk that the records are not thorough enough.[108]

IX. CONCLUSION

The courts should give the subsection 9-312(3) purchase money security interest a narrow scope. The limitations that the subsection places on proceeds, and the fact that it distinguishes inventory from other collateral, demonstrate that the drafters' purpose in creating the subsection 9-312(3) exception can best be achieved through a more limited application.

The practical application of the rule that a purchase money se-

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107. Jackson and Kronman observe:

> The most compelling argument is that the strict tracing requirement of § 9-107(b)—which is the root of this difference in treatment—is itself desirable. First, this tracing requirement helps to distinguish the true purchase money lender from the ordinary lender with "hindsight wisdom" or fraudulent intent. Second, it protects other creditors by compelling the purchase money lender to keep a close watch over his debtor's affairs. The fact that a financing buyer generally will be unable to satisfy a strict tracing requirement is therefore reason enough to deny him priority over previously perfected security interests in the same collateral.

Jackson & Kronman, *A Plea for the Financing Buyer*, 85 YALE L.J. 1, 32 (1975) (footnotes omitted).

108. The purchase money secured party must prove his claim to purchase money status. In the case of Ever Ready Machinists, Inc. v. Relpack Corp., 25 Bankr. 148 (E.D.N.Y. 1982), the court stated:

> The policy expressed in the Uniform Commercial Code is to give priority to the secured creditor first in time. In this case, Gibraltar is clearly first in time; its financial [sic] statements were filed long prior to those filed by Ever Ready. Ever Ready can only prevail if it brings itself within the exception carved out for purchase money security interests under certain conditions. It is a long-established rule of statutory construction that the person claiming the benefit of an exception must show himself to be covered by it. If the record is blank—as the record now is—regarding whether a critical requirement of § 9-312(4) has been satisfied, the exception is not proved and the general rule prevails.

Id. at 152-53.

cured party must limit his interest to property sold to the debtor, and that there must be a strict matching of debt to property sold, limits the value of the purchase money secured interest and the after-acquired property clause in the earlier security interest. First, the purchase money secured interest can only have first priority in a limited amount of collateral, i.e. collateral on which an indebtedness is outstanding. If, in any provision of his security agreement, the secured party claims an interest in property other than the exact property that is the subject of the debt, he totally destroys his purchase money security interest. Second, if in his security agreement the secured party provides for an interest in property other than that which produced the debt, and yet does not make claim to the other collateral, he may still lose his special purchase money status. This is so because of the presence of the unexercised after-acquired property clause, and in view of the uncertainty of the law on this point. The courts have not responded adequately to the effect of an unexercised after-acquired property provision.[109]

The result is that a purchase money secured party must carefully draft his security agreement and keep precise records that match collateral to its debt. The business costs and the risks of accounting errors render the subsection 9-312(3) purchase money exception largely valueless, except in the case of the occasional credit sale of a limited number of inventory items. A secured party such as Borg-Warner, who supplies inventory to a debtor over an extended period of time, can never rely safely on subsection 9-312(3) for first priority status. The cost of records matching collateral to debt exceeds normal bookkeeping costs, and the risks that these records will not be accurate, current, or complete are insurmountable. A major inventory financier can only deal with a debtor who is subject to an earlier perfected security interest with an after-acquired property clause if he first obtains a subordination agreement from the earlier secured party.

Once the purchase party has given notice of his claim to an earlier secured party, the notice is in effect for five years. Thus, any prior secured party is operating in the dark after receipt of the notice. He does not know the exact items of inventory in which the purchase money secured party asserts his superior priority, nor does he know in which items of inventory the purchase money se-

109. Mid-Atlantic Flange Co. v. Alper, 26 U.C.C. Rep. Serv. (Callaghan) 203 (E.D. Pa. 1979) is the only case to discuss this issue. *See supra* note 92.

cured party can prove his claim of purchase money status. Even the debtor probably does not have this information. The only source of record-keeping information is the purchase money secured party himself, and he is a rather unreliable one since at the time of default he will be an adversary.

The purchase money secured party bears the risk that he cannot match collateral to debt and prove his purchase money priority. However, the after-acquired property secured party bears the risk that the purchase money party can match collateral to debt and meet his burden of proof. Both of these risks are substantial. In light of the sketchy information available to the earlier secured party, any loans after the creation and perfection of the purchase money security interest are in danger of being under-collateralized, or subordinated in priority to a subsequent loan. On the other hand, a major inventory financier cannot afford to rely on a purchase money claim for priority because of the limited scope of subsection 9-312(3), the cost of the accounting, and the potential inability to trace funds and debt to collateral.