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*Continental Assurance and Continental Casualty Companies*

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## FINANCING INVENTORY AND PROCEEDS UNDER THE UNIFORM COMMERCIAL CODE\*

by Ray D. Henson\*\*

### I. INTRODUCTION

Isaac Newton said, "If I have been able to see farther, it is because I stood on the shoulders of giants."<sup>1</sup> Newton could not have made his scientific discoveries—indeed, we would never have heard of Newton—had he merely *looked* at the giants of the past, had he merely accepted what others had done without examining it anew and building on it. If we accept old thinking "on faith," if we blindly adhere to old doctrines without making a fresh reappraisal and questioning their validity, we cannot progress scientifically, legally, intellectually. Our ideas need to be laundered occasionally in "cynical acid."<sup>2</sup>

The adoption of the Uniform Commercial Code<sup>3</sup> provides an excellent opportunity to re-examine the function and use of secured transactions. Admittedly what was handled traditionally as a chattel mortgage transaction can probably be handled in the same mechanical way under the Code, including the use of the same forms, although the effect of some provisions in old forms might be different under the Code. But in more intricate secured trans-

\*The author wishes to express his appreciation to the staff of the Nebraska Law Review and in particular to Mr. Lloyd Hoppner for research into earlier Nebraska judicial decisions in the areas covered by this article. Because there have been so few decisions in this area and almost all of these are so old as not to be pertinent in the context of present business and legal practices, it does not appear that it would be helpful to cite them. Nebraska statutes which are specifically repealed by the UNIFORM COMMERCIAL CODE are listed in § 10-102(1) of the Nebraska Code, and Nebraska statutes which prevail over the Code, in the event of conflict, are listed in § 9-203(2).

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<sup>1</sup> Quoted in KOESTLER, *THE SLEEPWALKERS* 353 (1959).

actions, such as inventory financing, when the parties agree on what they want to do, their contractual arrangement can now be legally effectuated.

While it is possible to approach the Code from the categorized miscellany of pre-Code security devices, with an explanation of how easily the same results can be reached under the Code, it is perhaps simpler to explain that a security interest can be created and perfected in certain kinds of collateral in certain ways, quite regardless of whether or how that collateral could have been used as security before the Code. A new generation of law students will certainly approach the field in this way and will doubtless not miss the nonsensical, technical rules applicable to the various devices which an older generation has learned—or not learned, at its peril.

This is not to say that Article 9 of the Code does not contain technical rules or that it can be understood in a quick glance. Article 9 covers a great range of transactions<sup>4</sup> and requires the most careful study, but there is no comparison between the Code's coverage of the gamut of secured transactions and the multiplicity of security devices before the Code. Moreover, most of the difficult

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<sup>2</sup> See Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 461 (1897). For recent evidence that the Nebraska Supreme Court is willing to take a new view of reasonably established procedures—and to act on this view without regard to the probable consequences to the state's economy—see *Elder v. Doerr*, 175 Neb. 483, 122 N.W. 2d 528 (1963); *Stanton v. Mattson*, 175 Neb. 767, 123 N.W. 2d 844 (1963).

<sup>3</sup> Citations to the UNIFORM COMMERCIAL CODE (hereinafter referred to as U.C.C.) will be to the 1958 Official Text With Comments, as adopted by the Legislature of Nebraska in 1963. There are Nebraska changes from the 1958 Official Text in §§ 1-201(26), 9-302(3)(b), 9-401(1). § 9-403(6) has been added. § 9-407 has been omitted. On the background of the Code, see Schnader, *The New Movement Toward Uniformity in Commercial Law—The Uniform Commercial Code* the background of the Code, see Schnader, *The New Movement Toward Marches On*, 13 BUS. LAW. 646 (1958); Malcolm, *The Uniform Commercial Code: Review, Assessment, Prospect—November, 1959*, 15 BUS. LAW. 348 (1960); Davenport, *An Introduction to the Illinois Uniform Commercial Code*, 50 ILL. B. J. 20 (1961). On the operation of the Code, see Malcolm & Funk, *Pennsylvania and Massachusetts Experience Under the Uniform Commercial Code*, 16 BUS. LAW. 525 (1961).

<sup>4</sup> "This Article applies to security interests created by contract including pledge, assignment, chattel mortgage, chattel trust, trust deed, factor's lien, equipment trust, conditional sale, trust receipt, other lien or title retention contract and lease or consignment intended as security." U.C.C. § 9-102(2). In general, when goods are shipped "on consignment" to a buyer for resale, the requirements of Article 9 must be met or the goods are subject to claims of the buyer's creditors. U.C.C. § 2-326.

questions in Article 9 are priority questions involving conflicting security interests in the same collateral—problems which no prior statute even attempted to solve. The basic rules for creating and perfecting security interests are readily understandable, and in the normal course of events—indeed, our economy would collapse if it were otherwise—one need go no further, although there are detailed provisions governing what happens on default.

This paper is concerned, basically, only with financing inventory and the proceeds which arise on the sale of inventory. It must be borne in mind that some of the rules discussed are only applicable in this context, and some of the problems could not arise in any other field of secured transactions.

## II. SCOPE OF ARTICLE 9

Article 9 governs all consensual security interests in inventory and proceeds. It also governs sales of accounts, contract rights, and chattel paper;<sup>5</sup> the only exceptions are (1) a sale of accounts, contract rights, or chattel paper as part of the business out of which they arose and (2) an assignment of accounts, contract rights, or chattel paper for the purpose of collection only.<sup>6</sup> The reason for covering sales as well as assignments of these three kinds of collateral is that it is often difficult to tell which kind of transaction is involved. In general, it does not matter. The only distinction the Code makes between such sales and assignments is on default. If a sale is involved, the debtor is not liable for a deficiency or entitled to a surplus, on a disposition of the collateral, unless the agreement so provides, whereas on an assignment of security he is so liable or entitled, as the case may be.<sup>7</sup>

The Code's definition of inventory is broader than the common denotation of the term. Goods are inventory if they are held for sale or lease or to be furnished under contracts of service or if they have been so furnished, or if the goods are raw materials, work in process, or materials used or consumed in a business.<sup>8</sup> The term would include automobiles held for lease rather than sale, as well as replacement parts and gasoline and oil kept in reserve for use in servicing the cars. In the case of a dress manufacturer, for example, the term includes not only the end product of dresses held for sale but also the fabrics and thread and ornamentation acquired as raw materials, and the goods at every point in the

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<sup>5</sup> U.C.C. § 9-102(1).

<sup>6</sup> U.C.C. § 9-104(f).

<sup>7</sup> U.C.C. § 9-504(2).

<sup>8</sup> U.C.C. § 9-109(4).

manufacturing process. It would be possible for a financier (who might be the seller) of ornamentation to be used on dresses to claim a continuing security interest in the ornamentation<sup>9</sup> or an interest in the dresses as products of the particular collateral.<sup>10</sup> In other words, the financier of a manufacturer may claim a continuing security interest from the time the raw material is furnished through the manufacturing process into the finished product. When the inventory is sold to a buyer in the ordinary course of business, the buyer will take free of the security interest,<sup>11</sup> which then continues in the identifiable proceeds of the sale.<sup>12</sup>

### III. THE SECURITY INTEREST

#### A. ATTACHMENT AND PERFECTION

How does the security interest in inventory arise? Here two Code concepts require examination. First, the Code states that a security interest *attaches* to collateral when (1) there is agreement that it attach, (2) value is given, and (3) the debtor has rights in the collateral.<sup>13</sup> These events may occur in any order. Second, *perfection* is normally required for the security interest to be good against third parties.<sup>14</sup> In most cases, perfection requires an additional step beyond attachment. Perfection may be accomplished by a physical transfer of possession of the collateral in some cases,<sup>15</sup> or simply by attachment in some instances,<sup>16</sup> but usually a security interest is perfected by filing a financing statement in the appropriate office.<sup>17</sup>

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<sup>9</sup> U.C.C. § 9-314.

<sup>10</sup> U.C.C. § 9-315.

<sup>11</sup> U.C.C. § 9-307(1).

<sup>12</sup> U.C.C. § 9-306(2).

<sup>13</sup> U.C.C. § 9-204(1). The agreement may be oral in the case of a pledge of collateral. Otherwise it must be in writing; it must contain a description of the collateral; and, it must be signed by the debtor if the agreement is to be enforceable against the debtor or third parties. See *The American Card Co. v. The H. M. H. Company*, 196 A.2d 150 (R.I. 1963); U.C.C. § 9-203. "Agreement" is defined in U.C.C. § 1-201(3).

<sup>14</sup> U.C.C. § 9-301(1).

<sup>15</sup> U.C.C. §§ 9-302(1)(a), 9-304(1), 9-305.

<sup>16</sup> U.C.C. §§ 9-302(1)(b), (c), (d).

<sup>17</sup> U.C.C. § 9-302(1). As to the place of filing, compare U.C.C. § 9-401(1) with its counterpart in the Nebraska Uniform Commercial Code. Because the Nebraska filing provisions appear to be unworkable in part, no effort will be made here to state the proper place of filing to perfect secured transactions in Nebraska. The entire scheme of the Nebraska § 9-401(1) is designed for tangible collateral, particularly goods,

The term "perfection" is used in several different senses in the Code. It never means less than a security interest which is good against lien creditors—that is, an interest perfected in the bankruptcy sense. But, of course, there may be conflicting perfected security interests in the same collateral, which has always been possible. In the case of a purchase money security interest in consumer goods, the interest is perfected when it attaches, without any filing. But, if there is no filing and the consumer sells to a neighbor who buys in good faith and pays value, the neighbor will take free of the security interest.<sup>18</sup> Similarly, a perfected security interest in inventory, accomplished by filing, will normally be cut

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and cannot satisfactorily accommodate intangible collateral where the debtor is a nonresident. The Nebraska Code also introduces a new term, "security instrument," which is unnecessary and undefined. It is impossible to tell whether this term is intended to be synonymous with "financing statement" or "security agreement." Moreover, there is a conflict between U.C.C. § 9-103(3) and the portion of Nebraska § 9-401(1) covering the situation where the debtor is a nonresident and the collateral is not in Nebraska "at the time of the execution of the security instrument but the debtor intends to *immediately* bring it into and keep it in" Nebraska. (Emphasis added). And in the case of a nonresident debtor, where do you file if the collateral is not in existence when the "security instrument" is executed? And where the debtor is a nonresident and the collateral is kept in seven counties but a financing statement is filed in only two counties, what is the effect? The Nebraska provision in terms covers this situation only where filing is in *one* county. And suppose an Iowa partnership does business in a number of counties in Nebraska and designates a principal place of business in one financing statement, duly filed, which no other creditor or lender might reasonably suppose to be its principal place of business. The Nebraska Code says this designation is controlling, which is satisfactory between the secured party and debtor in the particular transaction, but what of later creditors and secured parties? These problems and others which will be apparent from a close reading of the Nebraska filing provisions illustrate why a complicated uniform act should be enacted uniformly and without local variations. On this matter generally, see Haydock, *Certainty and Convenience—Criteria for the Place of Filing Under the Uniform Commercial Code*, 3 B.C. IND. & COM. L. REV. 179 (1962).

However the problem of where to file is resolved, if a financing statement states a maturity date of five years or less, it is effective until the maturity date plus sixty days; if it states no maturity date or one in excess of five years, it is effective for five years. The secured party may file a continuation statement before the end of the effective period, and the effectiveness of the original financing statement will be continued for another five years. There is no limit on the number of continuation statements that may be filed. If none is filed, the security interest lapses. U.C.C. §§ 9-403(2), (3).

<sup>18</sup> U.C.C. § 9-307(2).

off when the goods are sold to a buyer in the ordinary course of business.<sup>19</sup>

Clearly, the concept of perfection is of primary importance in inventory financing. It is inconceivable that inventory financing of any consequence would take place without the filing of a financing statement (and a search of the records) before any funds are initially advanced by the secured party to the debtor. It is thus possible that filing will precede the occurrence of one or more of the events necessary for attachment, in which case perfection occurs when the last of the events necessary for attachment and perfection has taken place.<sup>20</sup>

The reason why filing should precede the secured party's giving of value (or, where the seller is retaining a security interest in the goods, the buyer's acquisition of rights in the goods) is the possibility of conflicting interests in the financed inventory.

#### B. PURCHASE MONEY FINANCING

A financier of inventory is either a purchase money financier or he is not. He is a purchase money financier if (1) he is a seller who retains a security interest or (2) he makes advances or otherwise gives value to enable the debtor to acquire the collateral, if the value is in fact used for such purpose.<sup>21</sup>

If he is a purchase money financier and if he files before or within ten days after the collateral comes into the debtor's possession, he takes priority over the rights of a transferee in bulk or of a lien creditor which arise between the time the security interest attaches and the time of filing.<sup>22</sup> To take priority over a conflicting security interest in the same collateral, the purchase money financier must (1) have a perfected security interest when the debtor gets possession of the collateral, (2) notify any secured party who filed as to the same kind of inventory prior to the filing by the purchase money financier, or who was otherwise known to be financing such inventory, that the purchase money financing is about to take place before the debtor gets the collateral, and (3) the notice must state that the notifier has or expects to acquire a purchase money interest in the debtor's inventory, described by item or type.<sup>23</sup> If these

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<sup>19</sup> U.C.C. § 9-307(1).

<sup>20</sup> U.C.C. § 9-303(1).

<sup>21</sup> U.C.C. § 9-107.

<sup>22</sup> U.C.C. § 9-301(2).

<sup>23</sup> U.C.C. § 9-312(3). This provision very effectively prevents one financier from tying up all of a particular debtor's financing.

simple steps are followed, the purchase money financier will take priority over any conflicting claims to the collateral. (Purchase money financiers of collateral other than inventory take priority over conflicting security interests in the same collateral if they file before or within ten days after the debtor gets possession of the collateral.)<sup>24</sup>

### C. PRIORITY

In situations not covered by the purchase money rules, priority is determined (1) in the order of filing if both interests are perfected by filing,<sup>25</sup> (2) in the order of perfection, where both are not perfected by filing,<sup>26</sup> and (3) in the order of attachment, so long as neither is perfected.<sup>27</sup> Since it is hardly likely that any litigation could arise without one or both parties filing, situation (3) can be eliminated in inventory financing. It is, however, possible for a security interest in inventory to arise under a field warehousing arrangement where filing is not required to perfect a security interest, although it is one means of perfection.<sup>28</sup> But, in most

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<sup>24</sup> U.C.C. § 9-312(4).

<sup>25</sup> U.C.C. § 9-312(5) (a). It should be borne in mind that where there are potential or actual conflicts between secured parties, they may enter into a subordination agreement. U.C.C. § 9-316.

<sup>26</sup> U.C.C. § 9-312(5) (b).

<sup>27</sup> U.C.C. § 9-312(5) (c).

<sup>28</sup> Where goods are in the possession of a bailee who has not issued a negotiable document for them, a security interest may be perfected in any one of three ways: (1) by the issuance of a document in the name of the secured party; (2) by the bailee's receipt of notification of the secured party's interest (as to "notification," see U.C.C. § 1-201(26), (27); the Nebraska variation in (26) may present some problems here); or (3) by filing as to the goods. U.C.C. § 9-304(3). Where goods are represented by a negotiable document, an interest in the goods can be perfected only by perfecting an interest in the document. U.C.C. § 9-304(2). The only effective means of perfecting an interest in a negotiable document, as against purchasers and other secured parties, is by taking possession of, while perfection by filing is permitted, filing is not notice of the security interest, and a holder to whom a negotiable document has been duly negotiated takes priority over an earlier security interest, even though perfected. U.C.C. §§ 9-304(1), 9-309. It should be noted here that a security interest in a negotiable document is perfected without filing or taking possession for 21 days from the time it attaches, to the extent it arises for new value given under a written security agreement. Where the secured party has a perfected security interest in a negotiable document or in goods in the possession of a bailee who has not issued a negotiable document for them, the interest remains perfected for 21 days without filing where the secured party makes the goods or documents available to the debtor

cases, conflicting interests will probably be perfected by filing;<sup>29</sup> it is thus advisable for the financier to file himself and then search the records to be sure no one has filed before him on the same kind of collateral. If both have filed, the first to file will prevail even though the second filer gives value against the collateral before the first does. The matter of priorities can become complicated, particularly if hypothetical examples of virtually impossible situations are used. The entire matter is not necessarily beyond the scope of this paper, but it will not be treated at any greater length because, if the proper steps are taken, as they will be in almost all instances, the questions are academic. The point to remember is the effect of filing.

#### D. THE SECURITY AGREEMENT

The security agreement, which states the arrangement between the parties, may be filed if it meets the simple requirements of the Code.<sup>30</sup> The general practice in Code states is to file a short financ-

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for the purpose of sale or exchange or manufacturing, etc. U.C.C. §§ 9-304(4), (5). It is obvious that if goods, in which there is a temporary, 21-day perfected interest but as to which no financing statement is filed, are put into a warehouse and a negotiable receipt obtained priority over the earlier secured party having a temporary, 21-day perfected security interest. U.C.C. §§ 9-309, 9-312(1). The result would be the same if the first secured party filed as to the goods and the debtor subsequently obtained a negotiable document representing them which he, fraudulently, pledged with a second financier. These are, of course, credit risks. A more interesting question arises when a purchase-money secured party, whose interest is perfected by filing, releases goods to the debtor who then deposits them in a warehouse which issues a nonnegotiable receipt in the name of a third party. Which party wins? Under U.C.C. § 9-312(5) (b), where both interests are not perfected by filing, the first to perfect has priority, so that the first secured party here wins. This result will be surprising, perhaps, to lenders who feel justified in relying on receipts issued in their names, but it clearly is required by the Code. This issue has apparently arisen only once, on more elaborate facts, in an arbitration proceeding, *The Philadelphia National Bank (Assignee) v. Irving R. Boody & Co.* (1963), in which Carl W. Funk of Philadelphia was arbitrator. See Funk, *Trust Receipt vs. Warehouse Receipt which Prevails when they cover the same goods?* 19 BUS. LAW 627 (1964).

<sup>29</sup> But note the possible exceptions in note 28 *supra*.

<sup>30</sup> U.C.C. § 9-402(1). Since it will sometimes be necessary to file multiple copies of the financing statement, the problem of a manual signature on each may arise. There should be no problem when the parties agree on using carbons or photocopies. See the definition of "signed" in U.C.C. § 1-201(39). In the absence of such an agreement, there may be a problem if the effectiveness of the statement is questioned. See *In re Kane*, 55 BERKS COUNTY L. J. 1 (1962).

ing statement containing only the necessary information: names, addresses, and signatures of the debtor and secured party, a description of the types or items of collateral, and an indication that the proceeds or products of collateral are claimed.<sup>31</sup> No formalities, such as acknowledgments, are involved. While the description of the collateral should be as specific as possible, any description is sufficient if it reasonably identifies what is described.<sup>32</sup> This is notice filing, first introduced nationally by section 13 of the Uniform Trust Receipts Act.<sup>33</sup> It is the only kind of filing which would be efficiently usable where inventory is being financed on a revolving basis.

If the financing statement substantially complies with the Code's requirements, it is effective even though it contains minor errors which are not seriously misleading.<sup>34</sup> This provision was designed to prevent the continuance under the Code of certain trends in judicial decisions by which excessively technical applications of filing requirements invalidated secured transactions although the filed statements informed everyone and misled no one as to the terms of the financing. This provision expresses a legislative purpose which any modern court should be glad to implement.

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<sup>31</sup> U.C.C. § 9-402(3).

<sup>32</sup> U.C.C. § 9-110. For a model opinion applying this section, among others, see *National Cash Register Co. v. Firestone & Co.*, 191 N.E.2d 471 (Mass. 1963). See also *In re Goodfriend*, CCH INST. CRED. GUIDE ¶ 98, 977 (1964), where ". . . inventory of merchandise to be maintained in an amount not less than \$10,000, as per agreement of sale, at seller's wholesale cost, contained in the Kiddy and Women's Wear Shop . . ." was held to be an adequate description to create a security interest in the entire inventory of the debtor.

<sup>33</sup> NEB. REV. STAT. § 69-713 (Reissue 1958).

<sup>34</sup> U.C.C. § 9-402(5). On the interpretation of this section, compare *National Cash Register Co. v. Firestone & Co.*, 191 N.E.2d 471 (Mass. 1963) (in which it was said that where a debtor's name was given on the financing statement as "Carroll, Edmund d/b/a Cozy Kitchen" and the "correct" spelling should have been "Kozy," there was a minor error not seriously misleading) with *In re Excel Stores*, CCH INST. CRED. GUIDE, ¶ 99,406 (1963) (in which the debtor was Excel Stores, Inc., but the debtor's name on the filed financing statement was erroneously given as Excel Department Stores, and this was held to be so misleading as to invalidate the filing). The *Excel* case arose on a reclamation petition in bankruptcy. It does not appear that any creditor was in fact misled by the mistake in the debtor's name, and since the proper street address was used, it is not clear whether any alert creditor could have been misled.

## IV. FINANCING INVENTORY

Although the Code does not validate any charges or practices which are illegal under other statutes, it does permit the parties to make their own agreement, and that agreement will be effective between the parties, against purchasers of the collateral, and against creditors, except as otherwise provided in the Code.<sup>35</sup> Of particular importance, in implementing this provision in the inventory financing field, are two sections of the Code. One permits after-acquired property to be covered by the security agreement,<sup>36</sup> and the other repeals the rule of *Benedict v. Ratner*<sup>37</sup> by stating that a security interest is not invalid or fraudulent against creditors because the debtor may use or commingle or dispose of collateral, or collect or compromise accounts, or use or commingle proceeds, without specific accounting to the secured party or replacing collateral.<sup>38</sup> These provisions can be effectively used because of the notice filing system and the usually applicable first-to-file priority rule.

The combination of provisions just described is often said to make possible a "floating lien." This term is not used in the Code itself, although synonymous expressions appear in the Official Comments.<sup>39</sup> It is a term which could just as well be put to rest. The term "floating lien" is used in so many different ways by various commentators that it is basically meaningless. It is sometimes used to describe a security interest in all collateral which can possibly be financed—in the case of a manufacturer, everything from fixtures to raw material, work in process, end products, receivables arising on the sale of inventory, plant equipment, and so on. At other times, the term is used to describe a security interest in more limited collateral, which necessarily varies from day to day, such as a retailer's inventory, or accounts, or chattel paper. The term in its broadest usage describes a financing transaction of theoretical interest but of limited practical value because all-inclusive financing by one secured party is extremely rare. The term "general security interest" would be more appropriate here. Where the financing covers inventory alone or accounts alone or

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<sup>35</sup> U.C.C. § 9-201. See generally, Bunn, *Freedom of Contract Under the Uniform Commercial Code*, 2 B.C. IND. & COM. L. REV. 59 (1960).

<sup>36</sup> U.C.C. § 9-204(3).

<sup>37</sup> 268 U.S. 353 (1925).

<sup>38</sup> U.C.C. § 9-205.

<sup>39</sup> See U.C.C. § 9-205 (Official Comment 1); U.C.C. § 9-204 (Official Comment 3).

chattel paper alone, it is more descriptive to refer to a security interest in inventory or accounts or chattel paper.

For a reason which may seem peculiar, the term "lien" could well be avoided under the Code. If we speak of a "lien," we invite invidious judicial comparison to the old chattel mortgage-type lien covering only specifically described property. This kind of transaction will, of course, be as common under the Code as it was before. But the Code covers more kinds of collateral than any combination of earlier statutes, and the broader security interest, to be effective, simply cannot be analogized to a chattel mortgage transaction. There is no reason why it should be. However, the use of an old term invites an old semantic reaction.<sup>40</sup> The use of a newer term invites a look at what the parties are trying to accomplish and the statute which makes their contractual arrangement possible.

It should be emphasized that the mere fact that the parties describe the collateral broadly and all-inclusively does not give the secured party a financial interest in the collateral greater than the outstanding balance of the loan. You may have \$1,000,000 worth of collateral for a \$1,000 loan, but the secured party's interest in the collateral will be limited to \$1,000.

Moreover, even though there is no legal reason, under the Code, for the secured party to police revolving collateral, there may be excellent business reasons for doing so. There is also a further reason: bankruptcy.

The Code provides that where the secured party gives value which is to be secured in whole or in part by after-acquired collateral, his interest in the collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in the collateral either in the ordinary course of business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given.<sup>41</sup>

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<sup>40</sup>This problem is discussed from various viewpoints in Henson, *The Prospective Effect of the Uniform Commercial Code on Commercial Financing*, 1962 U. ILL. L. F. 349; Henson, *A Criticism of Criticism: In re Meaning*, 29 *FORDHAM L. REV.* 553 (1961); Henson, *Liens—Seen Through a Glass, Darkly*, 2 *B.C. IND. & COM. L. REV.* 85 (1960); and Henson, *Installment Land Contracts in Illinois: A Suggested Approach to "Forfeiture,"* 7 *DE PAUL L. REV.* 1 (1957).

<sup>41</sup>U.C.C. § 9-108. See *In re Newkirk Mining Co.*, 54 *BERKS COUNTY L. J.* 179 (1962) in which the financier of after-acquired property was able to reclaim it in bankruptcy.

Some lawyers have questioned the efficacy of this provision in bankruptcy. (But then some lawyers have questioned how the Code could abolish the Supreme Court's dominion rule in *Benedict v. Ratner*,<sup>42</sup> apparently not realizing that Mr. Justice Brandeis merely purported to state a rule of New York, not federal, law. The rule had been clearly "abolished," if it ever had existed, in a number of states long before the Code.) This Code rule on when after-acquired property is taken for new value should certainly be applied in bankruptcy. We are not dealing with the situation where an unsecured lender decides, on the verge of the debtor's obviously impending bankruptcy, to take a security interest in collateral. We are concerned with a situation where a secured party, intending to be secured, took a continuing security interest in changing collateral. In a revolving credit-collateral arrangement, the interest in old collateral would terminate on sale and attach to new, substituted collateral, or to proceeds which, if not paid over, might be used to pay for the new collateral, so that the security interest is continuous and traceable.<sup>43</sup> No creditor can possibly be misled here. In no event can the security interest be asserted for a greater amount than the unpaid balance of the loan. Then, too, there are a number of criteria for a preference in bankruptcy, of which "antecedent consideration" is but one.<sup>44</sup>

Financers of revolving collateral may, for instance, continue to require a daily pay-over in specie—that is, actual checks received by the debtor, and so on—with a daily crediting and debiting of the loan balance, but this should, under the Code, be a business matter and not a legal requirement.

While a security interest usually continues in collateral despite sale or disposition, unless authorized,<sup>45</sup> this is not true in the case of inventory unless the buyer (in ordinary course of business) knows that the sale violates the security agreement.<sup>46</sup> It would be incongruous for a security agreement to prohibit the sale of inventory in the usual usage of that term, but since "inventory" in the Code includes leased goods, it may well be possible for a sale to be forbidden or else allowed only in certain circumstances, although it would be perhaps unusual for a lessor

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<sup>42</sup> 268 U.S. 353 (1925).

<sup>43</sup> See generally, Kennedy, *The Impact of the Uniform Commercial Code on Insolvency: Article 9*, 67 COMM. L. J. 113 (1962).

<sup>44</sup> See BANKRUPTCY ACT § 60; 11 U.S.C. § 96 (1958).

<sup>45</sup> U.C.C. § 9-306(2).

<sup>46</sup> U.C.C. § 9-307. See also U.C.C. § 9-307 (Official Comment 2).

of goods also to be a seller of such goods, which is essential in order to have a "buyer in ordinary course of business."<sup>47</sup> In general, then, a buyer of inventory will take free of a security interest, and the secured party acquires, in substitution, a perfected security interest in the proceeds of sale.<sup>48</sup>

## V. FINANCING PROCEEDS OF INVENTORY

A financier of inventory may, and often will, finance the proceeds of inventory, in which case the filed financing statement will disclose this fact.<sup>49</sup> The security interest in the proceeds will continue as long as the financing statement is effective. However, even though no security interest is claimed in proceeds, the inventory financier has a perfected security interest in the proceeds for ten days after the debtor receives them.<sup>50</sup> During this period the secured party may file a financing statement, signed only by himself,<sup>51</sup> claiming a security interest in the proceeds, which will continue the perfected interest for as long as the financing statement is effective.

The term "proceeds" includes whatever is received when collateral or *proceeds* is sold, exchanged, collected, or otherwise disposed of.<sup>52</sup> If an automobile dealer sells a new car, he may receive a used car in trade, a payment in cash or by check, and an installment contract representing the balance. The cash or check will be "cash proceeds," and the used car and installment contract will be "non-cash proceeds."<sup>53</sup> If the used car is in turn sold, whatever is received in exchange for it will in turn be proceeds arising from the original transaction.

There was, under the Uniform Trust Receipts Act, a conflict in the federal courts (the question seems not to have arisen in the state courts) on the original financier's right to trace proceeds.<sup>54</sup>

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<sup>47</sup> U.C.C. § 1-201(9).

<sup>48</sup> U.C.C. §§ 9-306(2), (3). Detailed rules applicable in insolvency proceedings are set forth in U.C.C. § 9-306(4).

<sup>49</sup> See the suggested form in U.C.C. § 9-402(3).

<sup>50</sup> U.C.C. § 9-306(3).

<sup>51</sup> U.C.C. § 9-402(2) (b).

<sup>52</sup> U.C.C. § 9-306(1).

<sup>53</sup> *Ibid.*

<sup>54</sup> The problem arose under UNIFORM TRUST RECEIPTS ACT § 10. On tracing proceeds under the Code, see *Girard Trust Corn Exchange Bank v. Warren Lепley Ford, Inc.* (No. 3), 25 Pa. D. & C.2d 395 (Philadelphia County 1958).

The financier's right to proceeds was recognized, properly, in *In re Harpeth Motors*<sup>55</sup> but was not recognized, through a singular approach to statutory construction, in *In re Crosstown Motors*.<sup>56</sup> Since the Code states the inventory financier's claim to proceeds in terms of a continuously perfected security interest, there can be no question about its validity, and the strained kind of construction used in *Crosstown Motors* cannot warp the Code out of shape.

The kinds of proceeds which are likely to be separately financed (either through assignments for security or sale) are three: contract rights, accounts, and chattel paper. The first is the least important.

A contract right is any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper.<sup>57</sup> Contract rights could arise under a long-term contract requiring a manufacturer to make and deliver goods in installments, with periodic payments on delivery. To finance the acquisition of the raw materials required to perform the contract, the manufacturer could assign the right to payment to a financier. Since a contract right becomes an account as the right to payment is earned,<sup>58</sup> the financier would claim both contract rights and proceeds arising under the specific contract in the filed financing statement.<sup>59</sup>

An account is any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper.<sup>60</sup> In other words, this is what is usually called an account receivable. Perfection of a security interest in accounts

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<sup>55</sup> 135 F. Supp. 863 (M.D. Tenn. 1955).

<sup>56</sup> 272 F.2d 224 (7th Cir. 1959), *cert. denied sub nom*, *Commercial Credit Corp. v. Allen*, 363 U.S. 811 (1960).

<sup>57</sup> U.C.C. § 9-106.

<sup>58</sup> See U.C.C. § 9-106 (Official Comment).

<sup>59</sup> See U.C.C. § 9-306(1). It has already been noted that the filing requirements of the Code do not apply where there is an assignment of accounts or contract rights which does not (alone or in conjunction with other assignments to the same assignee) transfer a significant part of the assignor's outstanding accounts or contract rights (U.C.C. § 9-302(e)), and that the Code does not apply to a sale of accounts, contract rights, or chattel paper as part of a sale of the business out of which they arose, nor to a transfer of them for collection only. U.C.C. § 9-104(f). It remains to be noted that the Code does not apply to the transfer of a contract right to an assignee who is also to do the performance under the contract. *Ibid.*

<sup>60</sup> U.C.C. § 9-106.

is accomplished by filing,<sup>61</sup> except for this instance where no filing is necessary: where the assignment is of an insignificant amount of the assignor's accounts (or contract rights).<sup>62</sup> Where the accounts (or contract rights or chattel paper) are sold as part of the business out of which they arose, or where the accounts (or contract rights or chattel paper) are assigned for the purpose of collection only, the Code does not apply.<sup>63</sup>

Chattel paper is a writing or group of writings which evidence both a monetary obligation and a security interest in or lease of specific goods.<sup>64</sup> The term includes, in traditional terminology, a simple conditional sale contract or a note and chattel mortgage. It also includes a lease of chattels which the lessor is transferring for his own financing purposes, whether or not the lease is in itself a security agreement.<sup>65</sup> A security interest in chattel paper may be perfected by filing or by taking possession of the paper.<sup>66</sup> It is recommended that a secured party do both for this reason: where the secured party files but does not take possession of the paper, he runs the risk that the debtor may sell the paper to a purchaser who pays value and takes possession of it in the ordinary course of business, and if this is done without knowledge of the filed security interest, the purchaser's interest in the paper has priority over the interest of the earlier secured party.<sup>67</sup> Of course, if it is desirable for some reason to leave the paper with the debtor, it can be stamped to show the secured party's interest, and there could not then be a purchaser without knowledge. It should be added that a purchaser of chattel paper who gives new value and takes possession of the paper in the ordinary course of business has priority over an earlier security interest which is claimed *merely* as proceeds of inventory which is subject to a security interest, even though the purchaser knows that the paper is subject

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<sup>61</sup> U.C.C. § 9-302(1).

<sup>62</sup> U.C.C. § 9-302(1) (e).

<sup>63</sup> U.C.C. § 9-104(f). It may bear repetition that Article 9 applies to sales of, as well as to security interests in, accounts, contract rights, and chattel paper. U.C.C. §§ 9-102(1) (a), (b), 9-105(1) (c).

<sup>64</sup> U.C.C. § 9-105(1) (b).

<sup>65</sup> The Code does not specify when a "lease" is to be deemed a security agreement, but certain criteria are set out in U.C.C. § 1-201(37). These criteria have been applied in *In re Royer's Bakery, Inc.* (No. 2) CCH INST. CRED. GUIDE ¶ 99,274 (1963), and *United Rental Equipment Co. v. Potts & Callahan Contracting Co.*, 191 A.2d 570 (Md. 1963).

<sup>66</sup> U.C.C. §§ 9-304(1), 9-305.

<sup>67</sup> U.C.C. § 9-308.

to the security interest.<sup>68</sup> Here the inventory financier can go against the proceeds received on the sale of the chattel paper.

Where inventory and the proceeds of inventory are separately financed, what happens when goods which have been sold are returned or repossessed? If the goods were sold on open account, the unpaid transferee of the account has a security interest in the goods as against the transferor, but this interest is subordinate to a security interest asserted by an unpaid financier of the goods, whose security interest reattaches to the goods.<sup>69</sup> If the sale of the goods produced chattel paper, an unpaid transferee of the paper has a security interest which is good against the transferor and which may or may not be good against the unpaid financier for whose loan the goods were originally security. The transferee will take priority as to the goods over the financier of the goods under the same circumstances in which his interest in the chattel paper would be superior to the interest of the financier of the goods in it,<sup>70</sup> as detailed in the last paragraph.

### CONCLUSION

This discussion does not by any means exhaust the problems in financing inventory and proceeds. It is merely an introduction to the field. This kind of financing is handled routinely by bankers and other financiers. In the usual course of events, if a few, simple mechanical steps are followed—some of them required by law and others dictated by business judgment—there will be no legal problems. Unquestionably, the Code provides a simpler, safer basis for this financing than the pre-Code law of any state.<sup>71</sup> This kind of financing is a necessity in the present economy of this country. It has been going on for many years even where there were inadequate laws or no laws at all to provide a base for it. But, of course, financiers exact a price for their money which is commensurate with the risk they think they undertake. The Uniform Commercial Code embodies the best current financing practices and gives them a firm foundation. This is the purpose and the *raison d'être* of commercial law.

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<sup>68</sup> *Ibid.*

<sup>69</sup> U.C.C. §§ 9-306(5)(a), (c).

<sup>70</sup> U.C.C. § 9-306(5)(b).

<sup>71</sup> There has been very little litigation under the Code, and if Article 9 was involved it has taken place, for the most part, in bankruptcy courts. Therefore the decisions are rather generally inaccessible. On the litigation to date, see Hiller, *How the Code's Secured Transactions Have Fared in the Bankruptcy Courts*, 19 BUS. LAW. 57 (1963); Goodwin, *Significant Decisions Interpreting Article 9 of the Uniform Commercial Code*, 18 BUS. LAW. 777 (1963).