ARIZONA LAW REVIEW

VOLUME 11 | SPRING, 1969 | NUMBER 1

ACCOUNTS RECEIVABLE FINANCING: OPERATIONAL PATTERNS UNDER THE UNIFORM COMMERCIAL CODE

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Secured financing is of prime importance to the survival and growth of small and medium-sized businesses, and frequently is the only means whereby such enterprises can obtain working capital when neither risk capital nor unsecured credit is available in sufficient quantities. One method of secured financing, the financing of accounts receivable, plays a major role in supplying such capital, and with the enactment of the *Uniform Commercial Code*,[1] particularly Article 9, in virtually all jurisdictions in the United States,[2] this type of financing has come of age. This is not to say that the financing of accounts receivable was not widely utilized prior to the Code;[3] but by clarifying and simplifying the law and by removing many of the legal obstacles, the Code has, to a great extent, made receivables financing legally safer, easier, and more economical for both the borrower and the lender.[4] The Code implicitly recognizes that this method of secured financing is an integral part of our economy and should be accepted as such without prejudice. Nevertheless, although the Code

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1 Hereinafter referred to as the "Code." Citations are to the 1962 official edition of the Code. For a cross reference to the particular section of the ARIZONA UNIFORM COMMERCIAL CODE see 14 ARIZ. REV. STAT. ANN. xxxiii-xxxv (1967).

2 Louisiana is the only jurisdiction where the Code has not been enacted.

3 In 1945 the combined volume of financing and factoring of commercial receivables conducted by commercial finance companies was 2.8 billion dollars. PROCEEDINGS OF ANNUAL CONVENTION, NAT'L COMMERCIAL FINANCE CONFERENCE, INC. (1962). By 1962, just prior to the enactment of the Code in New York, Illinois and California (where the bulk of receivables financing is done), this volume had increased to over 18 billion dollars. *Id.* (1963). It is estimated that the volume of receivables financing conducted by commercial finance companies during 1967 was over 26 billion dollars. *Id.* (1967). Although banks do not report the volume of commercial receivables financing conducted by them, it is known to be substantial. Shay & Greer, *Banks Move into High-Risk Commercial Financing*, 46 HARV. BUS. REV. 149 (1968).

4 O. SPIVAK, SECURED TRANSACTIONS 2, 17 (1963). *See* § 9-101, Comment.

has taken us a long way, the journey is not over—there are still many unresolved areas of the law and even some new problems which the Code has inadvertently created. The purpose of this article is (1) to focus on those sections of the Code which directly affect the financing of accounts receivable; (2) to relate those sections of the Code to current operational patterns in accounts receivable financing and discuss the changes which they may have wrought; (3) to highlight some of the areas yet to be resolved; and (4) to suggest some devices whereby the unresolved problems can be avoided or at least minimized.

PRE-CODE METHODS OF FINANCING ACCOUNTS RECEIVABLE

Long before the adoption of the Code two distinct techniques developed in the financing of accounts receivable: factoring and accounts receivable financing. The following is a brief description of these arrangements as they existed prior to the Code.

Factoring, which traces its history to the growth of the woolen industry in England beginning in the late 14th century,[5] involved the outright purchase of accounts receivable at a discount by a factor without recourse to the assignor for inability of the account debtor to pay. In most instances, the factor notified the account debtor of the assignment by an appropriate legend on the original invoice and collected the account in its own name. Because the factor approved the credit, ledgerized, billed and collected the account, the assignor, to a large extent, was able to dispense with credit and accounts receivable departments. Factors also made advances to their clients before the accounts matured.[6]

Unlike factoring, accounts receivable financing is of relatively recent origin.[7] Under such a revolving credit arrangement,[8] the pre-Code lender

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[5] M. LAZERE, COMMERCIAL FINANCING 10-11 (1968); W. SEIDMAN, ACCOUNTS RECEIVABLE AND INVENTORY FINANCING 6-10 (1957); Greenberg, *Inventory & Accounts Receivable Financing*, 1956 U. ILL. L.F. 601, 614 (1956).

[6] LAZERE, *supra* note 5, at 74.

[7] Accounts receivable financing has developed only over the last 50 years, and was greatly stimulated by the Second World War. This period was characterized by unprecedented business growth, rising taxes, increased investment in industrial equipment, and extended terms of credit, all resulting in periods of tight money. Because of the demand for additional sources of working capital to augment capital internally generated through profits or provided by commercial banks on an unsecured basis or merely secured by fixed assets, it was quite natural that finance companies began to provide loans to businesses secured by such current assets as accounts receivable and inventory. W. SEIDMAN, *supra* note 5, at 10-12; Note, *Multi-State Accounts Receivable Financing: Conflicts in Context*, 67 YALE L.J. 402, 404 (1958).

[8] This method of financing has the characteristics of both short and long term loans: short term to the extent that collateral automatically liquidates the advances and long term in the sense that a continuing arrangement through the medium of revolving funds is contemplated. Kripke, *Current Assets Financing as a Source of Long Term Capital*, 36 MINN. L. REV. 506 (1952). For a typical revolving accounts receivable arrangement see *In re* New Haven Clock & Watch Co., 253 F.2d 577 (2d Cir. 1958).

periodically advanced the borrower such sums as the borrower requested[9] up to an agreed percentage of the outstanding accounts receivable assigned.[10] The advances were usually discretionary and payable on demand.[11] The borrower was charged an interest rate on the daily balances of the revolving loan.[11a] Although the agreement purported to cover future receivables, "confirmatory" assignments were executed from time to time covering newly created accounts.[12] Whenever possible the advances were made contemporaneously against the assignment of new accounts.[13] The agreement further provided that all collateral whenever assigned secured future as well as present advances.[14] The account debtors were usually not notified;[15] however, the lender had the right to notify them at any time. Until then, the borrower collected the accounts as the agent for the lender and remitted the proceeds,[16] which were then applied in reduc-

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[9] The borrower usually was not obligated to borrow any sum above a minimum amount; however, he was generally prohibited from borrowing on the security of his receivables or selling his receivables to anyone else.

[10] This percentage varied from 70 percent to 95 percent of the face amount of the accounts assigned. The differential afforded a margin of safety against the uncollectibility of the accounts, or fraud of the borrower. C. PHELPS, ACCOUNTS RECEIVABLE FINANCING AS A METHOD OF BUSINESS FINANCE 38 (1957).

[11] The lender generally made no commitment to lend any amount, or if he did, it was often against accounts which were "acceptable" to him. As a practical matter, however, the lender often had to continue making advancements to the borrower to keep the business afloat until some other lender could take over. Coogan, *Intangibles as Collateral Under the Uniform Commercial Code*, 77 HARV. L. REV. 997, 1007 (1964).

[11a] LAZERE, *supra* note 5, at 38-39.

[12] There was a serious question in many jurisdictions whether a present assignment could be made of accounts receivable arising *in futuro*. Craig, *Accounts Receivable Financing: Transition from Variety to Uniform Commercial Code*, 42 B.U.L. REV. 187, 190-91 (1962); Note, *Multi-State Accounts Receivable Financing: Conflicts in Context*, *supra* note 7, at 415-16.

[13] This was done to avoid the possibility that the transaction might be set aside as a voidable preference under section 60 of the Bankruptcy Act. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.5, at 1309 (1965).

[14] This so-called "dragnet" clause was frequently important where certain receivables became uncollectible and the "margin" on other accounts receivable was used to offset this deficiency. Wolf v. Aero Factors Corp., 221 F.2d 291 (2d Cir. 1955).

[15] From an early date, borrowers resisted having the account debtors notified of the assignment (even though that practice had been common in the factoring industry for many years) because they feared that the account debtors would interpret such assignment as an indication of financial weakness. Allowing the borrower to collect the accounts directly preserved the confidential nature of the arrangement. SEIDMAN, *supra* note 5, at 11. Moreover, the borrower might have lost the goodwill of his customers if they were forced to deal directly with a third party personally unknown to them.

[16] The legal necessity for such a procedure arose in the celebrated case of Benedict v. Ratner, 268 U.S. 353 (1925), where the Court held that a non-notification accounts receivable financing arrangement was, as to creditors, fraudulent and void as a matter of state law, because the assignor was permitted to use the proceeds from the accounts for his own purposes without accounting for them to the lender. The failure of the lender to assert "dominion" over the collection of the receivables "imputes fraud conclusively because of the reservation of dominion inconsistent with the effective disposition of title and creation of the lien." *Id.* at 363. This case became settled law in a majority of jurisdictions. *See* 4A J. COLLIER, BANKRUPTCY ¶ 70.77 (14th ed. 1968). The extent to which some courts carried this doctrine is illustrated by Lee v. State Bank & Trust Co., 54 F.2d 518 (2d Cir. 1931), *cert. denied*, 285 U.S. 547 (1932). There the court voided a

tion of the loan. If the assigned receivables fell below the agreed ratio of collateral to loan (as accounts became unacceptable, uncollectable, disputed or compromised), the borrower was required to repay part of the loan or assign new receivables sufficient to restore the ratio. If the proceeds from the receivables were insufficient to pay off the loan, the borrower remained liable for any deficiency.[17]

These, then, were the methods by which the financing of accounts receivable was accomplished before the Code. While factoring differed substantially from accounts receivable financing, the impact on the financial status of the assignor vis-à-vis trade creditors was substantially similar. Hence Article 9 covers not only consensual security devices but also by specific section[18] the sale of accounts, contract rights and chattel paper,[19] whether intended for security or not,[20] and with one exception[21] treats both methods of financing the same.

CREATION OF THE SECURITY INTEREST

Section 9-204(1) states three prerequisites to the existence of a security interest. There must be (1) an agreement (*i.e.*, a bargain between the parties), (2) value given, and (3) the debtor must have acquired rights in the collateral. When these three elements coexist, a security interest, in Code terminology, "attaches." However, for a security interest to be enforceable, even against the debtor, either the collateral must be in the possession of the secured party (common law pledge) or a written security agreement must have been executed by the debtor creating or providing for a security interest[22] in collateral of the debtor.[23] Since

transaction because the lender had allowed the borrower to exercise "dominion and control" over returned goods which amounted to less than 1 3/4 percent of the assigned receivables. *But cf.* Bloch v. Mill Factors Corp., 134 F.2d 562 (2d Cir. 1943).

[17] The agreement between the borrower and the lender typically provided that the lender could proceed directly against the borrower to collect the loan without first being required to exhaust his rights against the account debtors; however, the financial condition of the borrower was generally such that this right to proceed directly against the borrower was of little value.

[18] Section 9-102(1).

[19] Under section 9-104, the sale of accounts, contract rights or chattel paper as part of the sale of a business, an assignment of accounts, contract rights or chattel paper for collection purposes, and a transfer of a contract right to an assignee who is to perform the contract are excluded from Article 9.

[20] Frequently, the technique of purchasing accounts with full recourse has been construed by the courts to be a security device rather than an outright sale. Wolf v. Aero Factors Corp., 221 F.2d 291 (2d Cir. 1955); Milana v. Credit Discount Co., 27 Cal. 2d 335, 163 P.2d 869 (1945).

[21] See p. 8 & note 47 *infra*.

[22] Section 9-105(1)(h). It should be noted that if a financing statement does not contain a grant by the debtor of a security interest, it cannot serve as a security agreement. Rutkin Elec. Supply Co. v. Burdette Elec., Inc., 98 N.J. Super. 378, 237 A.2d 500 (1967); American Card Co. v. H.M.H. Co., 196 A.2d 150 (R.I. 1963).

[23] Section 9-203(1). This section, in the nature of a statute of frauds, would preclude a creditor who does not comply with these requisites from enforcing his security interest against the debtor as an "equitable" mortgage, or availing himself of the rights given to a secured party under sections 9-501 to -507.

accounts, contract rights and general intangibles are not capable of "possession" by a secured party within the meaning of the Code, a security interest in such collateral is enforceable only if the debtor has signed a written security agreement.[24]

Although section 9-110 provides that the collateral covered by the security agreement may be generally described, provided the description reasonably identifies the property, the Code may have created a trap for the unwary by the definitional distinctions drawn between the types of intangibles involved in factoring and accounts receivable financing.[25] Section 9-106 defines these intangibles as follows:

> 'Account' means any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper. 'Contract right' means any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper. 'General intangibles' means any personal property (including things in action) other than goods, accounts, contract rights, chattel paper, documents and instruments.'

At first blush, it would seem that an "account" is a matured "contract right," that a "contract right" is an account not yet earned by performance, and that a "general intangible" is a non-monetary contract right.[26] Yet, not all contract rights ripen into accounts, because the right to payment arising out of a contract may not involve "goods sold" or "services rendered"; not every account arises from a contract right, because no contract may have previously existed; and "general intangibles" may include, in addition to non-monetary rights, rights to payments which are not accounts. Assume a bank makes a loan to a contractor and takes a security interest in the "contract rights and accounts" arising from a specific construction job. The contract, in its executory stage, is clearly a "contract right," but the progress billings representing rights to payment for performance earned may not be accounts as they may not arise from "goods sold"[27] or "services rendered."[28] If not, the right to payment when earned must fall into the catch-all category of "general intangibles" and the bank, merely by describing the collateral as "contract rights and accounts,"

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[24] Rutkin Elec. Supply Co. v. Burdette Elec., Inc., 98 N.J. Super. 378, 237 A.2d 5C0 (1967).

[25] *See* 1 GILMORE, *supra* note 13, § 12.5 at 382; Coogan & Gordon, *The Effect of the Uniform Commercial Code upon Receivables Financing—Some Answers and Some Unresolved Problems*, 76 HARV. L. REV. 1529, 1531-38 (1963); Kripke, *Suggestions for Clarifying Article 9: Intangibles, Proceeds and Priorities*, 41 N.Y.U.L. REV. 687, 690-700 (1966).

[26] See the comment to section 9-106 which lends support to this interpretation.

[27] A contract to furnish labor and materials is not a contract for the sale of goods. Stammer v. Mulvaney, 264 Wis. 244, 58 N.W.2d 671 (1953); L. VOLD, SALES 27 (2d ed. 1959); Kripke, *supra* note 25 at 691-92.

[28] "Possibly, the draftsmen considered construction of a building as 'services rendered' but, considering the vast amount of material and equipment that goes into the building that term certainly does not clearly describe a building contract." Kripke, *supra* note 25, at 691-92.

may have inadvertently neglected to claim a security interest in the rights to payment arising from the contract.[29] Similarly, rights in music or literature, rights to produce or exhibit films or plays, rights to royalties for patents and copyrights, and rights to rebates or bonuses from a manufacturer exemplify contract rights which ripen into "general intangibles."[30] Advances by a commercial finance company (not represented by an instrument) must also be characterized as "general intangibles" as they do not involve "goods" or "services."[31] Lastly, there may be arrangements for the future sale of goods or services which are not reduced to formal contract, but which are assignable property rights.[32] Since there is no contract, the rights are not "contract rights"; they are "general intangibles" which ripen into "accounts" upon performance. "General intangibles," therefore, being a residuary category, may include not only the obvious patents, copyrights, and literary rights, but also rights to the payment of money which are neither contract rights nor accounts.[33]

It has been suggested that the Code be amended to broaden the definition of "accounts" to include all rights to payments, earned and unearned, and that the term "contract rights" be eliminated. "General intangibles" would then automatically be limited to non-monetary rights.[34]

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[29] If the bank had claimed only a security interest in the contract rights, a conflicting claim to the proceeds might arise if another secured party later perfected a security interest in the debtor's general intangibles. If, however, the bank had in its prior filing also claimed a security interest in the "proceeds" its security interest in the rights to payment would take priority. Section 9-312(5)(1). If not, the bank, at least, had a temporarily perfected security interest in the proceeds for a period of ten days which could be permanently perfected by filing a financing statement covering the proceeds. Section 9-306(3).

[30] Kripke, *supra* note 25, at 692.

[31] The *sale* of a participation interest in a loan by a lender to another financial institution is the sale of a "general intangible" and therefore is not covered by article 9. *See* § 9-102(1). Consequently, no financing statement need be filed covering the transaction between the lender and the participating financial institution. Coogan, Kripke & Weiss, *The Outer Fringes of Article 9; Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses and Participation Agreements*, 79 HARV. L. REV. 229, 273 (1965).

[32] 1 GILMORE, supra note 13, § 12.5 at 382. Such an arrangement exists, for example, in the dairy industry, where it is common for a dairyman to borrow from a lending institution on the security of his milk checks. These checks represent rights to payment arising out of an informal arrangement to deliver milk in the future to a particular processor. Once the milk is delivered, however, an account is created. W. COATES, LAW AND PRACTICE IN CHATTEL SECURED FARM CREDIT 9 (1954).

[33] *See* 1 GILMORE, *supra* note 13, § 12.5 at 382.

[34] Coogan & Gordon, *supra* note 25, at 1537; Kripke, *supra* note 25 at 693-700 (1966). Professor Gilmore has suggested redefining "general intangibles" to include all monetary and non-monetary rights, whether earned or unearned, thereby lumping accounts, contract rights and general intangibles into a single category. 1 GILMORE, *supra* note 13, at 380. It is, to this writer's view, still desirable to have two categories. It would be difficult conceptually, though not legally, to regard ordinary accounts receivable in the same category as a patent or copyright. Moreover, inherent in having one category are drafting problems which are not easily resolvable. Kripke, *supra* note 25, at 699-700. Such a problem would exist with section 9-102(1)(b) which makes Article 9 applicable to sales of contracts and accounts but not to general intangibles. *Id.* at 700.

Professor Kripke has suggested redefining "accounts" to include "any right to payment of money under an existing contract which is not evidenced by an instru-

In the meantime, a secured party should describe the collateral as broadly as possible, either using all three categories where there is any doubt, or describing the right in which a security interest is claimed without attempting to categorize it as an account, contract right, or general intangible.

The Code provides that a security agreement may include an after-acquired property clause which grants to the secured party a security interest in property to be acquired by the debtor subsequent to the execution of the agreement.[35] Although a debtor has no rights in a contract right until the contract is made[36] or in an account until it comes into existence,[37] the security interest attaches through the operation of an after-acquired property clause at the moment the contract is made or the account springs into existence without the necessity of confirmatory assignments being executed.[38] The Code also provides that the obligations covered by the security agreement may include future advances whether or not the advances are given pursuant to a commitment,[39] thus validating a provision in a security agreement under which collateral secures advances whenever made. However, to avail oneself of the provisions of these sections, great care should be taken in drafting the security agreement. Where the security agreement has failed to provide adequately for after-acquired collateral or for future advances, courts have refused to admit parol evidence to establish an intent to the contrary[40] or to allow other documents subsequently executed to vary the clear wording of the security agreement.[41]

Section 9-205, together with sections 9-204(3) and 9-204(5), form the cornerstone for the operation of the so-called "floating lien" on shifting or changing collateral, such as accounts or inventory. Section 9-205 provides that a security interest shall not be invalid or fraudulent as against creditors of the debtor (and therefore, a trustee in bankruptcy under section 70(e) of the Bankruptcy Act) if the lender allows the debtor to

> use, commingle or dispose of all or part of the collateral (in-

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ment or chattel paper, whether or not it has been earned by performance." *Id.* at 730. This writer suggests eliminating the phrase "under an existing contract" as there are occasions where an account may not arise out of an existing contract, *e.g.*, the right to receive an income tax refund. *See* 1 GILMORE, *supra* note 13, at 382.

35 Section 9-204(3); National Cash Register Co. v. Firestone & Co., 346 Mass. 255, 191 N.E.2d 471 (1963); Evans Prods. Co. v. Jorgensen, 245 Ore. 362, 421 P.2d 978 (1966).

36 Section 9-204(2)(c).

37 Section 9-204(2)(d).

38 It was unclear under pre-Code law whether a present assignment of an account or contract right which was not yet in existence could be made. *See* note 12 *supra*.

39 Section 9-204(5); Friedlander v. Adelphi Mfg. Co., 5 UCC Rep. Serv. 7 (N.Y. Sup. Ct. Mar. 13, 1968).

40 *In re* Taylored Prods., 5 UCC REP. SERV. 286 (W.D. Mich. April 11, 1968) (referee's opinion).

41 Safe Deposit Bank & Trust v. Berman, 393 F.2d 401 (1st Cir. 1968).

cluding returned or repossessed goods) or to collect or compromise accounts, contract rights or chattel paper, or to accept the return of goods or make repossessions, or to use, commingle or dispose of proceeds, or by reason of the failure of the secured party to require the debtor to account for proceeds or replace collateral.

Hence, instead of requiring the borrower to forward all collections to the lender— even though the proceeds might be released immediately to the borrower in the form of new loans — or risk having his security interest deemed in fraud of creditors as a matter of law,[42] the lender may now permit the borrower to use the collections directly. Although there may no longer be any legal compulsion on the lender to exercise "dominion" over the accounts, professional lenders will undoubtedly continue the "policing" procedures established long ago to insure that the accounts are bona fide and to prevent the debtor from dissipating the collateral.[43]

Generally, a security agreement provides that the secured party may at any time notify the account debtors of his security interest and collect the accounts directly. However, if the security agreement fails to contain such provision, the Code provides that on default of the borrower, the secured party is entitled to notify the account debtor to make payment to him[44] and proceed to collect the account in a commercially reasonable manner.[45] Presumably, the secured party also has the right to sell the accounts on default of the debtor, even if the security agreement does not so provide.[46]

The Code also provides that if a security agreement secures an indebtedness (*e.g.*, an accounts receivable financing arrangement), the secured party must account to the debtor for any surplus, and the debtor is liable for any deficiency.[47] If, instead, the underlying transaction is a sale of accounts or contract rights (*e.g.*, a factoring arrangement), the

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42 *See* note 16 *supra.*

43 Basically all frauds in factoring or accounts receivable financing fall into either or both of two categories: fictitious accounts or anticipatory billing, and using the proceeds from the accounts without reporting their collection to the secured party. Address by Ass't. Dist. Att'y. (N.Y. County) Wyllys S. Newcomb, Commercial Finance Industry Annual Convention, Nov. 19, 1946. Requiring periodic confirmatory assignments, copies of invoices, purchase orders and delivery receipts from the debtor, receiving and checking collections, maintaining cash and collateral records and continuously auditing, reviewing and appraising the collateral are standard procedures employed by commercial lenders to guard against fraud. Scult, Accounts Receivable Financing, 46 Bull. Robert Morris Associates, Sept. 1963, at 19; Seidman, Krause & Kripke, *Business Frauds, Their Perpetration, Detection and Redress,* 20 BUS. LAW. 83 (1964). As one writer has aptly stated: "The floating lien is not a floating policeman." Silberfeld, *Recent Litigation and Legislation in Lending,* 50 J. COM. BANK LENDING 2 (1968).

44 Section 9-502(1).

45 Section 9-502(2).

46 *See* § 9-504. This remedy, however, may be somewhat illusory since accounts receivable, unlike chattel paper or negotiable instruments, are not readily marketable.

47 Sections 9-502(2), -504(2).

debtor again is entitled to any surplus, but he is liable for a deficiency only if the security agreement so provides.[48]

ENFORCEMENT OF THE SECURITY INTEREST AGAINST THE ACCOUNT DEBTOR

Until the account debtor receives "notification that the account has been assigned and that payment is to be made to the assignee," he may pay the assignor with impunity;[49] however, from the time he receives an effective notice, he is legally obligated to pay the secured party.[50] Unless the account debtor has agreed to the contrary, he may assert any defense or claim against the assignee which arose out of the contract between the assignor and the account debtor that gave rise to the account (*e.g.*, breach of warranty), and any other defense or claim which he had against the assignor that accrued prior to the time he received notification of the assignment.[51]

Before the Code, an account debtor frequently asserted as a defense that the assignment of the account or contract right was according to its terms either void or prohibited, thus precluding recovery against him by the assignee.[52] Although it was reasonable for an account debtor to restrict the assignability of the performance of a contract, restriction of the assignment of the monetary rights due under the contract became an operational headache for lenders. To protect themselves, they had to scrutinize the contracts and purchase orders representing the assigned accounts for such clauses and attempt to get a waiver from the account debtor when they were found to exist. Since the assignment usually occurred long after the negotiations had been completed, obtaining a waiver was often extremely difficult. The Code, however, has now made accounts and contract rights fully assignable by providing that a non-assignability provision in a contract is no longer effective.[53] Although parties can no longer con-

48 Note 47 *supra.*

49 Section 9-318(3); see §§ 1-201(26), (27) for when notice is "received" and becomes effective; *cf.* General Factors v. Beck, 99 Ariz. 337, 409 P.2d 40 (1965).

50 Section 9-318(3). For a notification to be effective it must reasonably identify the rights assigned and, the assignee, if requested by the account debtor, must furnish reasonable proof that the assignment has been made. *Id.*

51 Section 9-318(1). This section merely codifies the common law.

52 Courts reluctantly sustained restrictions on the assignability of proceeds arising from a contract. *See, e.g.*, Allhusen v. Caristo Constr. Corp., 303 N.Y. 446, 103 N.E.2d 891 (1952). *But cf.* Stillman v. Twentieth Century Fox Film Corp., 3 N.Y.2d 395, 144 N.E.2d 387 (1957).

53 Section 9-318(4). Consider whether an account debtor could, by appropriate wording in his contract with the assignor, provide that: (1) an assignment constitutes a material breach by assignor, or (2) an assignment is ineffective unless notice is given to the account debtor in a prescribed way, or (3) an assignment is ineffective unless the account debtor has acknowledged the assignment in writing. Clause (1) should not be enforceable as contrary to the policy of this section. *Cf.* § 9-318(2). Clause (2) should be enforceable as long as the method prescribed is designed to "furnish reasonable proof" of the assignment. *See* § 1-201 (26). Clause (3) should not be enforceable. Since the account debtor cannot prohibit the assignment, his consent is superfluous.

tractually prohibit the assignment of monetary rights arising from a contract, an astute lender will proceed with caution in financing unusual types of intangibles, which may be subject to special statutory restrictions or requirements pertaining to their assignability.[54]

Lastly, the enforcement of a contract right or an account against the account debtor may be affected by section 9-318(2). This section provides that until a contract right becomes an account, and notwithstanding receipt of a notice of the assignment by the account debtor, the assignor and the account debtor may in "good faith and in accordance with reasonable commercial standards" make modifications in or substitutions for the contract which are binding on the assignee (although it may constitute a breach under the agreement of assignment).

PERFECTION OF A SECURITY INTEREST

Once a written agreement granting a security interest has been executed, value has been given and the debtor has acquired rights in the collateral,[55] the accounts financer may enforce his rights in the collateral against the debtor and the account debtor without taking any further action. Yet, rarely is the financial position of a debtor so strong that a lender need not be concerned with the protection of his security interest against attack by other creditors of the debtor (including a trustee in bankruptcy) and with the establishment of a priority claim in the collateral over other secured parties.[56] To achieve this preferred status under the Code, he must, in most instances,[57] take the additional step of raising his security interest from an unperfected state to a perfected one.[58] So long as the lender neglects to perfect his security interest, his rights in the collateral are subject to being subordinated to the rights of a person who becomes a lien creditor[59] without knowl-

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54 Section 9-203(2); *see* First Nat'l Bank v. Hellen, 392 F.2d 58 (1st Cir. 1968) (wage assignment void under statute which required written consent of both spouses); Southern Agency Co. v. LaSalle Cas. Co., 393 F.2d 907 (7th Cir. 1968)(assignee's claim to insurance premium receivables invalid under statute because receivables constituted trust fund for insurance company); Caristo Constr. Corp. v. Diner's Fin. Corp., 21 N.Y.2d 507, 236 N.E.2d 461, 289 N.Y.S.2d 175 (1968)(construction funds were by statute a trust fund for payment of subcontractor's materialmen and laborers and any assignment was subject to the trust).

55 *See* p. 4 *supra*.

56 The sale of a contract right or an account is also a "security interest" which must be perfected. Sections 1-201(37), 9-102(1)(b).

57 An isolated assignment of accounts or contract rights to the same assignee not comprising a significant part of the outstanding accounts or contract rights of the debtor is perfected on attachment. Section 9-302(1)(e).

58 This involves the filing of a financing statement. Section 9-302.

59 Section 9-301(3) defines "lien creditor" as:

> [a] creditor who has acquired a lien on the property involved by attachment, levy or the like [in the instance of accounts, contract rights or general intangibles, it would generally be by garnishment of the account debtor], and includes an assignee for the benefit of creditors from the time of assignment, and a trustee in bankruptcy from the date of the filing of the petition or a receiver in equity from the time of appointment.

edge[60] of the security interest,[61] and a person (other than a secured party) who is a transferee of the account, contract right or general intangible, to the extent that he has given value without knowledge of the security interest.[62] He would, however, prevail over another unperfected security interest in the same collateral if his security interest had attached first.[63] But if another secured party perfects his interest first, he would have priority even though he knew of the account financer's security interest.[64]

Although a security interest in certain intangibles, such as chattel paper[65] or negotiable documents,[66] can be perfected either by reducing them to possession or by filing,[67] and a security interest in instruments[68] can be perfected only by taking possession,[69] because accounts, contract rights and general intangibles are not capable of being reduced to possession, a security interest in them can be permanently perfected[70] only by filing[71] —with one exception.[72] To perfect a security interest in accounts, contract rights or general intangibles, the secured party may file either a "financing statement"[73] or a copy of the security agreement provided it conforms to the requirements pertaining to a financing statement.[74] The

60 "Knowledge" must be distinguished from the constructive "notice" imputed by filing a financing statement. Section 1-201(25) provides that a person has "knowledge" of a fact when "he has actual knowledge of it." This is quite different from the constructive notice which the filing of a financing statement gives to potential lenders. (Possible exception is taken to this conclusion in Note, *Priority of Future Advances Lending under the Uniform Commercial Code*, 35 U. CHI. L. REV. 128, 135 n.30 (1967).

61 Section 9-301(1)(b).

62 Section 9-301(1)(d).

63 Sections 9-301(1)(a), -312(5)(c). This is a codification of the common law doctrine of "first in time is first in right." Salem Trust Co. v. Manufacturers' Fin. Co., 264 U.S. 182 (1924); Graham Paper Co. v. Pembroke, 124 Cal. 117, 56 P. 627 (1899). Under most of the pre-Code accounts receivable filing statutes, this rule was abrogated. The cases held that where neither of two assignments were perfected, the latter would prevail, unless it had been made with knowledge of the former. The theory was that the first assignee, having failed to perfect by filing, misled the second assignee and should therefore be subordinated to the latter's interest. If the second assignee knew of the prior security interest, he could not have been misled, and thus his interest was subordinated. A subsequent filing by either assignee could not alter the priorities. Felsenfeld, *Knowledge as a Factor in Determining Priorities under the Uniform Commercial Code*, 42 N.Y.U.L. REV. 246, 253 (1967).

64 Sections 9-301(1)(d), -312(5)(a), (b). *See* § 9-312, Comment 4.

65 Section 9-105(1)(b).

66 Sections 9-105(1)(e), 1-201(15)(*i.e.*, documents of title).

67 Sections 9-304(1), -305.

68 Section 9-105(1)(g)(*e.g.*, a negotiable instrument).

69 Section 9-304(1).

70 Where the accounts arise as the "proceeds" of collateral subject to a perfected security interest, the security interest in the accounts is temporarily perfected under section 9-306(3), but becomes unperfected within 10 days unless the financing statement also covered proceeds or unless the secured party files as to the accounts before the expiration of the 10 day period.

71 Section 9-302(1)(a).

72 *See* note 57 *supra*.

73 Section 9-302(1).

74 Section 9-402(1). A security agreement need be signed only by the debtor. Section 9-203(1). A financing statement, however, must be signed by both the debtor and the secured party. Section 9-402(1). Thus, a security agreement

financing statement may be filed before or after the security agreement has been executed.[75] However, if the statement is pre-filed, perfection occurs only when the security interest ultimately attaches.[76] One consequence of this rule is illustrated by the following example:

> January 1—S files a financing statement claiming "all accounts of D."
> February 1—C, a lien creditor of D, garnishes X, one of D's account debtors.
> March 1—D executes a security agreement covering his accounts and S makes an advance without knowledge of the garnishment.

Although S had filed his financing statement before the garnishment, his security interest was not perfected until his security interest attached, *e.g.* the security agreement was executed and value was given. Since the garnishment antedated the time when S's security interest in the account had attached, S's rights in the account of X became subordinate to C's garnishment.

The basic purpose of the Code's financing statement is to give the public and, in particular, the debtor's creditors, notice that certain assets of the debtor may be subject to an outstanding security interest, the details of which may be ascertained by further inquiry by interested persons.[77] Thus, the requirements concerning the contents of the financing statement are relatively simple,[78] and no useful purpose would be served by discussing them. There are, however, two areas that deserve mention as they bear on a revolving credit arrangement. First, when appropriate language in the security agreement claims a security interest in presently owned and after-acquired collateral, the financing statement need not also specifically refer to after-acquired collateral for the security interest in the collateral when acquired to be perfected.[79] Since the function of the

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which contains only the signature of the debtor cannot serve as a financing statement. *Contra*, Strevell-Paterson Fin. Co. v. May, 77 N.M. 331, 422 P.2d 366 (1967).

[75] Section 9-402(1). This procedure enables the accounts financer to establish his priority against other potential assignees without the "race to the courthouse" which existed prior to the Code.

[76] Section 9-303(1).

[77] Thus the Code adopts the system of "notice filing," as opposed to "transaction filing." For a discussion of these systems see GILMORE, *supra* note 13, § 15.2. Section 9-208 sets forth the procedure whereby an interested party may ascertain the extent of the secured party's interest. Since the secured party "should not be under a duty to disclose details of business operations to any casual inquirer or competitor who asks for them," the right to demand disclosure is given only to the debtor. Section 9-208, Comment 2.

[78] Section 9-402(1) provides:

> A financing statement is sufficient if it is signed by the debtor and the secured party, gives an address of the secured party from which information concerning the security interest may be obtained, gives a mailing address of the debtor and contains a statement indicating the types, or describing the items, of collateral.

[79] *In re* Platt, 257 F. Supp. 478 (E.D. Pa. 1966)(financing statement which described collateral as "inventory and accounts receivable" constituted notice that security interest might exist in after-acquired property); National Cash Register Co. v. Firestone & Co., 346 Mass. 255, 191 N.E.2d 471 (1963); Evans Prods. Co. v. Jorgensen, 245 Ore. 362, 421 P.2d 978 (1966).

financing statement is merely to give public notice of the "type" of collateral in which the secured party may have a security interest, even a brief description in the financing statement such as "all accounts" should be sufficient to warn prospective creditors that a security interest may have been claimed in after-acquired accounts. Second, if the interest in the original collateral is perfected, section 9-306(3) provides that a security interest in the proceeds is continuously perfected if the financing statement which covered the collateral also covered proceeds. However, if the financing statement did not cover proceeds, the security interest ceases to be perfected unless the secured party perfects as to the proceeds themselves within 10 days after the debtor receives them either by filing a new financing statement claiming the proceeds or by taking possession of them. If he fails to do either, his rights in the collections from the accounts may thereafter be subordinated to the rights of a lien creditor (such as a trustee in bankruptcy) or the security interest of another secured creditor who does perfect.[80] Hence, a secured creditor should take special care to always claim "proceeds" in the financing statement.

Multi-State Filing Problems

Where a debtor's entire operations are confined to one state, perfection of a security interest by filing a financing statement is normally a simple procedure. The proper public office or offices for filing the financing statement are designated in section 9-104.[81] However, where a debtor's operations reach beyond the borders of a single state, problems arise under the Code in perfecting a security interest in intangibles.[82] To perfect a security interest in accounts or contract rights, filing is required in the state "where the assignor of accounts or contract rights keeps his records concerning them."[83] The underlying rationale for this rule is that the purpose of filing is to enable the creditors of the assignor to procure information about the state of his affairs, and that this purpose is best effectuated by requiring filing in the state where the creditors would normally associate with him.[84] However, sometimes the office where the assignor keeps his records of accounts or contract rights will not be the principal financial office of the enterprise. Where accounts are sold on

[80] *In re* Platt, 257 F. Supp. 478 (E.D. Pa. 1966).

[81] If the accounts, contract rights or general intangibles arise from or are related to the sale of farm products by a farmer, then section 9-401 may designate a different filing office from that required in other instances.

[82] Not that the Code created these problems—a pre-Code lender had to exercise Solomon-like judgment in deciding which state law governed a multi-state receivables financing transaction. Little assistance was provided by the established conflict of laws doctrines, which were ill suited to developing workable concepts in this area. See Note, *Multi-State Accounts Receivable Financing: Conflicts in Context, supra* note 7.

[83] Section 9-103(1).

[84] Section 9-103, Comment 2.

a continuing basis without recourse to a factor located in another state, thereby virtually eliminating the need for the assignor to maintain accounting records concerning the accounts,[85] or where the assignor utilizes the services of an electronic data processing center, perhaps hundreds of miles away, and the "records" concerning the accounts are represented only by memory tapes or discs in a computer, the Code would seem to require that a security interest in the accounts be perfected by filing in the state where the factor or the data processing center is located.[86] The assignor's creditors would not normally examine the public records of a foreign state to determine the status of his affairs. Moreover, the Code provides that a security interest in general intangibles is to be perfected by filing in the state where the assignor's chief place of business is located,[87] and if the assignor's records are kept in a place other than his chief place of business, it is possible—given the peculiarities inherent in the Code's definition of "accounts," "contract rights" and "general intangibles"[88]—that a secured party may inadvertently fail to completely perfect his security interest if he files in only one jurisdiction.[89]

Another problem in a multi-state operation is illustrated by the following example. Assume that D's chief place of business and records are in State X. For distribution purposes, though, all inventory is kept in State Y. If a security interest in inventory is perfected by filing, the filing must be in State Y;[90] however, a security interest in D's accounts is perfected by filing in State X.[91] If S, a lender, files in State Y claiming a security interest in the inventory and proceeds, has he perfected a security interest in the accounts arising from a sale of the inventory without also filing in State X as to the accounts? Since the financing statement perfecting a security interest in the original collateral (inventory) also covered "proceeds," it is arguable that the security interest in the accounts arising therefrom is continuously perfected as well.[92] If S had not claimed "proceeds" in the financing statement, when the inventory was sold (thus creating an account) he would have had 10 days after D "received" the proceeds within which to perfect his security

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[85] *See* text following note 5 *supra*.
[86] New York adopted a non-uniform amendment which provides that the office responsible for the bookkeeping, not a data processing center, determines the place for filing. N.Y. UNIFORM COMMERCIAL CODE § 9-105(1)(j).
[87] Section 9-103(2).
[88] *See* text following note 25 *supra*.
[89] Coogan & Gordon, *supra* note 25, at 1538-40; Kripke, *supra* note 25, at 700-02. Professor Kripke has suggested amending the Code by providing that a security interest in accounts and general intangibles be perfected by filing in the state where the chief place of business of the debtor is located. Although there may still be factual problems in determining where the *chief* place of business of a multi-state operation is located, the suggested amendment is a decided improvement and deserves support.
[90] Section 9-102(1).
[91] Section 9-103(1).
[92] *See* § 9-306(3).

interest in the account by filing,[93] and filing in this case would be in State X.[94] This discrepancy suggests that S may not be able to perfect a security interest in the accounts merely by filing a financing statement claiming proceeds in State Y; a separate filing in State X may be necessary. Since the Code is unclear on this point, it should be amended to require "an independent filing as to the expected types of proceeds considered as original collateral" in the place appropriate for that collateral.[95] Such an amendment would be consistent with the policy behind section 9-103 of requiring the secured party to file in the place where creditors would naturally associate with the assignor.[96] Moreover, the records concerning the accounts usually are centralized in one place while inventory may be in several locations, and it would be much less burdensome to require S to file in State X if he wishes to claim a security interest in the accounts than to require a lender who wishes to perfect a security interest in the accounts to check the filings not only in the state where the records concerning the accounts are kept but also the public offices of all other states where inventory *may* be kept for possible filing as well.[97]

Another question which the Code leaves unanswered is whether a secured party is under any duty to refile to continue the perfected status of a security interest in accounts, contract rights or general intangibles when the chief place of business of the debtor or the records concerning the accounts are later moved to another state.[98] If he is so required, must he file only when he has knowledge of the change? Within four months?[99] The Code provides no direct answer. Fortunately, in a revolving credit arrangement, as distinguished from the "one-shot" transaction, because of the intimacy between the lender and debtor, the lender will generally know of such change in the debtor's business and can act accordingly.

The Code attempts to bring some order out of the chaos which existed in perfecting a security interest in the receivables of a multi-state operation prior to the enactment of the Code.[100] But in so doing, it has aggravated some of the unresolved problems which previously existed and has even created others—many of which should be corrected by appropriate legislation. Until such time as the Code is amended to resolve these

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93 Section 9-306(3)(b).

94 *See* Kripke, *supra* note 25, at 708.

95 *Id.*

96 Section 9-103, Comment 2.

97 Kripke, *supra* note 25, at 708; *cf.* Coogan & Gordon, *supra* note 25, at 1540.

98 The only reference in the Code to this problem is found in the Comment to section 9-103 which suggests that if the record keeping office is moved into State B after the security interest has been perfected under the laws of State A, the secured party should file in State B. New York has attempted to deal with this problem. See N.Y. UNIFORM COMMERCIAL CODE § 9-103(6).

99 This period is suggested by analogy to section 9-103(3) which applies to personal property other than accounts, contract rights, or general intangibles; *see* Haydock, *Elementary Filing Rules for Interstate Transactions Under Article 9 of the U.C.C.*, 21 BUS. LAW. 361, 368 (1966).

100 *See* note 82 *supra*.

problems, a lender, in dealing with a debtor involved in a multi-state operation, should exercise great care by filing in all appropriate jurisdictions in order to insure that his security interest in the accounts, contract rights, or general intangibles of the debtor will be duly perfected.

Future Advances—the Lien Creditor Problem

Until a security interest in collateral is perfected, it is subject to being subordinated to the rights of a lien creditor who levies on such collateral without knowledge of the security interest.[101] Therefore, by negative implication, once the security interest is perfected, it takes priority from that date over a creditor who subsequently levies on the collateral.[102]

Unfortunately, in all the elaborate and complex priority provisions of Article 9, there is no explicit provision concerning priorities for future advances.[103] According to some commentators, even though a financing statement covering the debtor's collateral has been properly filed, it is possible that an advance made to the debtor pursuant to a future advance clause in the security agreement, but subsequent to a levy by a creditor of the debtor, would be subordinate to the claim of the lien creditor, unless the secured party was obligated to make the subsequent advance.[104] This problem is illustrated by the following example:

> January 1—S advances $1,000 to D under a security agreement providing for future advances secured by a tractor, and files covering the equipment.
>
> January 10—C, a judgment creditor, levies on the tractor.
>
> January 20—S makes an additional advance to D of $500.[105]

According to one view, as each advance is made by S, separate security

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[101] Section 9-301(1)(b).

[102] Section 9-201; William Iselin & Co. v. Burgess & Leigh Ltd., 52 Misc. 2d 821, 276 N.Y.S.2d 659 (Sup. Ct. 1967)(security interest in debtor's present and after-acquired inventory, properly perfected by filing, takes priority over judgment creditor who subsequently levied upon the inventory).

[103] California attempted to resolve the problem by adding a non-uniform provision. CAL. COMM. CODE § 9312 (West 1964). This amendment is analyzed and criticized in Coogan, *supra* note 11, at 1020-36.

[104] 2 GILMORE, *supra* note 13, § 35.6; Coogan, *The Effect of the Federal Tax Lien of 1966 upon Security Interests Created Under the Uniform Commercial Code*, 81 HARV. L. REV. 1369, 1390 (1968); Coogan, *supra* note 25, at 1028; Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien"*, 72 HARV. L. REV. 838, 868 (1959). Coogan & Gordon, *supra* note 25, at 1549. *See* Wier v. Galbraith, 92 Ariz. 279, 376 P.2d 396 (1962). In *Wier* installment payments under a land contract were assigned to an attorney to secure payment of legal services to be rendered from time to time. The installment payments in the hands of the attorney were subsequently garnished by a creditor of the client. The court held that the attorney was entitled to apply the money in payment of services rendered to the date of garnishment, but not to services subsequently rendered.

[105] The same problem would arise if C had perfected a security interest by taking a pledge of the tractor subsequent to S's first advance but prior to the second advance. *See* Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien"*, 72 HARV. L. REV. 838, 866 (1959).

interests are created. The argument runs that for a security interest to be perfected, it must have "attached."[106] Yet before a security interest can "attach," value must have been given.[107] Since one of the steps required for perfection—the giving of value—had not occurred at the time of C's levy, under section 9-301(1)(b) S's subsequent advance is subordinate to C's rights as a lien creditor.[108] Therefore, only as each advance is made, is that advance "perfected." It is also contended that this conclusion is supported by section 9-311 which provides that "[t]he debtor's rights in collateral may be voluntarily or involuntarily transferred (by way of sale, creation of a security interest, attachment, levy, garnishment or other judicial process)" and that the creditor's right to levy on the debtor's assets "would be ephemeral indeed if it could be defeated merely by a prior creditor's inserting a 'future advance' clause in his security agreement."[109]

An equally persuasive argument can be made that there is only a "single security interest." Although section 9-204(1) provides that a security interest cannot attach until "value is given," "value," as defined in section 1-204(44), includes "any consideration sufficient to support a simple contract." When an initial advance is made, the security interest attaches and by filing becomes perfected. In defining a "security interest," section 1-201(37) refers only to the interest in the collateral which secures an obligation without defining the extent of that interest. Therefore it may be argued that the extent of the security interest which has attached is measured by the underlying obligation which it secures, and that as the obligation expands to cover additional advances under a future advance clause, so does the security interest itself.[110] Moreover, the "single security interest" theory does not necessarily thwart the policy expressed in section 9-311 that the debtor's rights in collateral may be voluntarily or involuntarily transferred. Since an intervening security interest is, in most instances, subordinate to future advances made by a secured party who files first despite section 9-311, so then should be the lien of an unsecured creditor.[111] In addition, if the draftsmen of the Code had wanted to restrict the reach of secured creditors over the assets of the debtor and "keep the debtor's property free for additional mortgages or for sale,"[112] they should have more properly limited the oper-

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[106] Section 9-303(1).
[107] Section 9-204(1).
[108] *See* 2 GILMORE, *supra* note 13, § 35.6 at 933-39; Coogan, *supra* note 11, at 1028; Coogan, *supra* note 105, at 868. If S were *committed* to make future advances to D, this in and of itself would have provided the "value" for the security interest of S to have attached at the time of the original advance. *See* § 1-201 (44).
[109] Coogan & Gordon, *supra* note 25, at 1550.
[110] 2 GILMORE, *supra* note 13, § 35.6 at 933-39; Note, *Priority of Future Advances Lending under the Uniform Commercial Code*, *supra* note 60, at 138.
[111] 2 GILMORE, *supra* note 13, § 35.6 at 936.
[112] Coogan & Gordon, *supra* note 25, at 1550.

ation of the after-acquired property concept; for it is through the after-acquired property clause that a secured creditor can reach into the future to blanket perhaps all of the assets of the debtor. Since the draftsmen imposed no limitation on the operation of an after-acquired property clause, no such limitation should be engrafted on the operation of the future advance concept under the guise of section 9-311.[113]

Although the foregoing discussion may seem somewhat esoteric, it is by no means academic, as the outcome could have serious effects on a revolving credit arrangement.[114] For instance, assume S and D enter into a typical accounts receivable financing agreement, which provides that S may make discretionary advances to D to be secured by all present and future accounts of D. S files a financing statement and begins making advances to D. C, a judgment creditor of D, garnishes X, a sizable account debtor, without knowledge of S's security interest. S continues to make advances to D until S learns of the garnishment, which is an event of default under the agreement. Ultimately, the accounts other than X's prove insufficient to liquidate all advances, including the subsequent advances, and S attempts to assert his priority to the funds due from X.[115]

Prior to the Code this problem did not arise in accounts receivable financing, although the factor's lien acts and accounts receivable statutes contemplated future advances. Because accounts have a relatively short life, future advances were usually made against and measured by newly created accounts, with an attempt to pick up as additional collateral any old accounts remaining from the pay-off of previous advances.[116] However, under the Code, where advances made under a floating lien may not necessarily be timed to coincide with the creation of new accounts, the priority of these future advances becomes critical.

Although the "separate security interest" theory has a certain legal symmetry when applied to occasional future advances secured by non-shifting collateral, when it is applied to a revolving credit arrangement, where the outstanding loan balance may fluctuate daily as a result of advances made and collections received, this symmetry disappears. It is

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[113] *Id.*

[114] Not the least of which are the tax lien implications. Section 6323(c) of the Federal Tax Lien Act of 1966 protects advances made without knowledge of a tax lien for a period of 45 days after the filing of the lien. However, the advances will take priority only if: (1) they are made pursuant to a prior-in-time "commercial transaction financing" agreement covering "commercial finance security" (*e.g.*, accounts receivable) acquired in the ordinary course of the taxpayer's business; and (2) the security interest arising with respect to the advances "is protected under local law against a judgment lien arising, as of the time of the tax lien filing, out of an unsecured obligation." *See* Coogan, *The Effect of the Federal Tax Lien Act of 1966 upon Security Interests Created Under the Uniform Commercial Code*, 81 HARV. L. REV. 1369 (1968).

[115] Under N.Y. CIV. PRAC. LAW § 5202 (1963), S's subsequent advance would be protected if it was made without knowledge of the levy.

[116] Coogan, *supra* note 114, at 1400.

much more realistic and in accordance with business practice to view each advance as part of a single, though revolving, obligation. Some support for this conclusion is found in the decisions dealing with the nature of shifting or changing types of collateral. These decisions viewed accounts as a single unit or entity, however much the components might change from time to time by the payment of old accounts and the creation of new ones.[117] Hence, if the accounts receivable of an enterprise may be regarded as a single asset, although the individual accounts may change, by analogy the individual advances should be viewed as creating part of a single security interest, which is subject to fluctuation as accounts are collected and new advances are made. The entire security interest attaches when the first advance is made and is perfected when the financing statement is filed, thus establishing its priority. Adoption of a contrary theory would, in effect, require an accounts financer to check the public records before each advance to determine whether a garnishment may have been served upon an account debtor. Where perhaps hundreds of accounts throughout the United States might secure the obligation of a borrower, this would, to say the least, be an extremely expensive task, the cost of which ultimately would be passed on to the borrower in the form of higher interest. It would also require the lender to maintain a constant vigil over the borrower's payables to be assured that they did not become delinquent to the point where legal action could be anticipated. Such a rule might also cause a lender to prematurely begin liquidating a loan where the financial condition of the borrower became so precarious that the lender feared action by a lien creditor against the accounts through garnishment.

Furthermore, it seems that the lien creditor would not be harmed by subordination of his claim to future advances. Although the debtor's equity in the accounts[118] is diminished, his assets are not depleted; the diminution of his equity is balanced equally by the additional advances.[119] In fact, the lien creditor's chances of collecting his claim may be enhanced since the debtor has acquired a new supply of working capital.[120]

After-Acquired Property—the Bankruptcy Problem

The ultimate test of the legal effectiveness of any security device is

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117 Manchester Nat'l Bank v. Roche, 186 F.2d 827 (1st Cir. 1951); Grain Merchants of Ind., Inc. v. Union Bank & Savings Co., 408 F.2d 209 (7th Cir. 1969) *aff'g* 286 F. Supp. 597, 605 (N.D. Ind. 1968) ("In modern finance, it is far more realistic to view the entire stock of accounts receivable together as a single asset subject to a single security interest than to view individual accounts as separate assets subject to separate security interests."); Rosenberg v. Rudnik, 262 F. Supp. 635, 639 (D. Mass. 1967) ("[I]nventory subjected to a security interest should be viewed as a single entity and not as a mere conglomeration of individual items each subject to a separate lien.").

118 His equity is equal to the value of the accounts minus the amount of the advances.

119 2 GILMORE, *supra* note 13, § 35.6 at 939.

120 *Id.*

its ability to survive the ordeal of an insolvency proceeding. For the most part, the enforceability of an after-acquired property clause in bankruptcy has been substantially strengthened by the Code. Contrary to the pre-existing law in many states,[121] the Code provides that where a security agreement contains an after-acquired property clause, the security interest in an account or contract right automatically attaches the instant the account comes into existence[122] or the contract is made[123] without any further action, such as the execution of additional assignments, being required.[124] Once the security interest is perfected by filing, the security interest in the collateral thereafter acquired has priority from the date of filing over any subsequent lien creditor,[125] including a trustee in bankruptcy, who is given the status of a lien creditor, by section 70(c) of the Bankruptcy Act, "whether or not such a creditor exists."[126]

Also, in revolving credit arrangements involving inventory or accounts receivable, if a debtor is allowed by the secured party to use, commingle or dispose of the collateral or the proceeds without replacing the collateral or accounting for the proceeds, the security interest in such collateral is no longer invalid or fraudulent as against the creditors of the debtor,[126a] or a trustee in bankruptcy under section 70(e)(1) of the Bankruptcy Act. However, where a lender instead relies on the "floating lien" provisions of the Code,[126b] and in particular the operation of an after-acquired property clause, a serious question has arisen whether the collateral acquired by the debtor within four months of bankruptcy is a preferential transfer under section 60 of the Bankruptcy Act.[127] The

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[121] *See* Cohen & Gerber, *Mortgages of Accounts Receivable*, 29 GEO. L.J. 555 (1941); Note, *Multi-State Accounts Receivable Financing: Conflicts in Context*, *supra* note 7, at 415-17.

[122] Sections 9-204(1), (2)(d).

[123] Sections 9-204(1), (2)(c).

[124] Section 9-204, Comment 2.

[125] Section 9-301; William Iselin & Co. v. Burgess & Leigh, Ltd., 52 Misc. 2d 821, 276 N.Y.S.2d 659 (Sup. Ct. 1967).

[126] 11 U.S.C. § 110(c) (1964). Section 9-301(3) of the Code includes a trustee in bankruptcy within the definition of "lien creditor" and provides that "unless all the creditors represented have knowledge of the security interest such a representative of creditors is a lien creditor without knowledge even though he personally has knowledge of the security interest." If all the creditors have knowledge of the interest, the knowledge is imputed to their representative. Although this may be true with respect to state proceedings, there is some question whether, notwithstanding section 9-301(3), knowledge on the part of all creditors would preclude recovery by a trustee in bankruptcy, under section 70(c), as an "ideal creditor, irreproachable and without notice." *See In re* Waynesboro Motor Co., 60 F.2d 668 (S.D. Miss. 1932); 4A J. COLLIER, BANKRUPTCY ¶ 70.53 (14th ed. 1967). *Contra*, *In re* Komfo Prods. Corp., 247 F. Supp. 229, 237 (E.D. Pa. 1965), where the court stated that: "Section 70, sub. c. may give the trustee a strong arm, but it does not give him an outstretched hand." The validity of the trustee's claim under section 70(c) depended upon whether the secured creditor could show actual knowledge of her security interest on the part of all creditors. *See also In re* Dennis Mitchell Indus. Inc., 280 F. Supp. 433 (E.D. Pa. 1968) (by negative implication).

[126a] Section 9-205; 2 GILMORE, *supra* note 13, § 45.3.1.

[126b] Sections 9-204(3), -204(5), -205.

[127] Prior to the Code, accounts receivable financing arrangements were rarely

nuances concerning this problem can best be illustrated by the following example: S makes an advance of $50,000 secured by all present and future accounts of D and files a financing statement to that effect. Under the security agreement, D is permitted to collect the accounts and use the proceeds without having to account for them to S, but with S having the right to take over the collections at any time. The total amount of D's accounts at the date of the advance is roughly equal to the amount at bankruptcy; however, most of the accounts existing at bankruptcy had been created within the four month period prior to that time. Is the security interest in the accounts created within four months prior to bankruptcy a voidable preference?

For a transaction to constitute a voidable preference under section 60 of the Bankruptcy Act, there must have been (1) a transfer of the debtor's property, (2) to or for the benefit of a creditor, (3) for or on account of an antecedent debt, (4) while the debtor was insolvent, (5) within four months before the filing of the bankruptcy petition, (6) the effect of which transfer enables the creditor to obtain a greater percentage of his debt than some other creditor of the same class.[128] In addition, the trustee must prove that the creditor knew or had reasonable cause to believe that the debtor was insolvent at the time of the transfer.[129] Assuming the creditor knows the debtor is insolvent, the controversy generally resolves itself into a determination of when the "transfer" of the security interest in the after-acquired collateral occurred, and if it occurred within the critical four month period, whether it was "for or on account of an antecedent debt." Section 60(a)(2)[130] of the Bankruptcy Act provides that a "transfer" will be deemed to have been made at the time when the security interest became "so far perfected" under state law[131] "that no

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attacked as preferential transfers under section 60 of the Bankruptcy Act. Under compulsion of Benedict v. Ratner, 268 U.S. 353 (1925), the lender took control of the collections and new advances were made simultaneously against the assignment of each new batch of accounts or new accounts were substituted for stale or collected ones, thus supplying the contemporaneous consideration. 2 GILMORE, *supra* note 13, § 45.5; Henson, *"Proceeds" Under the Uniform Commercial Code*, 65 COLUM. L. REV. 232, 251 (1965). To the extent that an accounts financer adheres to these pre-Code practices, such an arrangement should be no more hazardous than before. Coogan & Gordon, *supra* note 25, at 1548.

Probably no other aspect of the Code has been so widely discussed and has created so much controversy. See 2 GILMORE, *supra* note 13, §§ 45.4-.7; Friedman, *The Bankruptcy Preference Challenge to After-Acquired Property Clauses Under the Code*, 108 U. PA. L. REV. 194 (1959); Gordon, *The Security Interest in Inventory Under Article 9 of the Uniform Commercial Code and the Preference Problem*, 62 COLUM. L. REV. 49 (1962); Henson, *supra*; Hogan, *Games People Play With the Bankruptcy Preference Challenge to Accounts Receivable and Inventory Financing*, 53 CORNELL L. REV. 553 (1968); Kennedy, *Trustee in Bankruptcy Under the Uniform Commercial Code, Some Problems Suggested by Articles 2 and 9*, 14 RUTGERS L. REV. 518 (1960); Krause, Kripke & Seligson, *The Code and the Bankruptcy Act: Three Views on the Preferences and After-Acquired Property*, 42 N.Y.U.L. REV. 278 (1967).

128 11 U.S.C. § 96(a) (1964).

129 11 U.S.C. § 96(b) (1964).

130 11 U.S.C. § 96(a)(2) (1964).

131 That is, article 9 of the Code (except in Louisiana).

subsequent lien upon such property . . . could become superior to the rights of the transferee."

The basis of a trustee's attack is that, notwithstanding the operation of an after-acquired property clause which causes the security interest to attach automatically as the accounts arise, the "transfer" of accounts can only occur as the specific accounts come into existence, and unless a consideration is given contemporaneously with the creation of new accounts, the security interest in the accounts arising within four months of bankruptcy is a voidable preference. To arrive at this conclusion, the trustee reasons that (1) a security interest is not "perfected" until it has "attached";[132] (2) the security interest cannot "attach" until the debtor has "acquired rights in the collateral";[133] (3) the debtor has no rights in the collateral *qua* an account "until it comes into existence";[134] (4) therefore, because "perfection" of the security interest in each specific account occurs only when the account comes into existence, it is only then under section 60(a)(2) of the Bankruptcy Act that the security interest is perfected against subsequent lien creditors and, a fortiori, it can be only then that the "transfer" takes place. However, in several recent decisions involving the operation of an after-acquired property clause,[135] the courts have held that the "transfer," within the meaning of section 60(a)(2) of the Bankruptcy Act, occurred when the security agreement was executed, the consideration given and the financing statement filed, since after that time no lien creditor could obtain a lien superior to the right of the secured party with respect to the accounts (whether then in existence or created thereafter). Moreover, the courts treated the accounts created during the critical four-month period as part of an entire stock of accounts receivable, viewing them as a single asset or entity.[136] When regarded in this manner, there was no transfer to the secured party "for or on account of an antecedent debt" as the transfer took place not as each individual account came into existence, but when the security interest in the accounts as an entity was created and the financing statement filed.[137]

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[132] Section 9-303(1).

[133] Section 9-204(1).

[134] Section 9-204(1)(d).

[135] Grain Merchants of Ind., Inc. v. Union Bank & Savings Co., 408 F.2d 209 (7th Cir. 1969) *aff'g* 286 F. Supp. 597 (N.D. Ind. 1968); Rosenburg v. Rudnik, 262 F. Supp. 635 (D. Mass. 1967); *In re* White, 283 F. Supp. 208 (D.C. Ohio 1967); *In re* Portland Newspaper Publishing Co., 271 F. Supp. 395 (D. Ore. 1967), *appeal docketed sub nom.* Williams v. Rose City Dev. Co., No. 22507-A (9th Cir., Dec. 5, 1967).

[136] An interesting pre-Code judicial statement of this concept is found in Manchester Nat'l Bank v. Roche, 186 F.2d 827, 839 (1st Cir. 1951). *See also* Mathews v. James Talcott, Inc., 345 F.2d 374 (7th Cir.), *cert. denied*, 382 U.S. 837 (1965); Wolf v. Aero Factors Corp., 126 F. Supp. 872 (S.D.N.Y. 1954), *aff'd*, 221 F.2d 291 (2d Cir. 1955); 2 GILMORE, *supra* note 13, § 45.5.

[137] Unfortunately, however, all of the decisions involved atypical "floating lien" transactions where only the collateral shifted or changed. Where a transaction involved not only shifting collateral but also revolving loans, the treatment which it may receive when attacked as a voidable preference is still an unresolved

Even if it is assumed that a "transfer" does not take place until each account comes into existence, section 9-108 provides that:

> Where a secured party makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value which is to be secured in whole or in part by after-acquired property his security interest in the after-acquired 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 such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given.

According to this provision, if the debtor acquires rights in the collateral in the ordinary course of his business, by operation of the after-acquired property clause, the security interest in the collateral is "deemed to be taken for new value" (assuming value was given at the inception of the transaction) and not "for an antecedent debt." Hence, the accounts created in the ordinary course of business during the four-month period prior to bankruptcy are considered to have been transferred for a contemporaneous consideration. Although this provision has been sharply criticized by many commentators in the past, because it attempts to define an "antecedent debt" for bankruptcy purposes,[138] it has gained judicial approval.[139]

In urging that accounts created within four months of bankruptcy have not been transferred for an antecedent debt, the "substitution of collateral" doctrine has some relevancy.[140] Premised on the idea that "exchanges that do not result in depletion of the bankrupt's general estate are unobjectionable,"[141] it provides that where collateral held by a creditor is substituted or exchanged for other property of the debtor of equal value, no preference occurs.[142] Strictly applied, the doctrine requires either that an account be substituted specifically for another account or given to secure a contemporaneous or subsequent advance.[143]

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question. *See Colloquy—UCC Brief No. 8: Floating Liens and the Bankruptcy Act*, 13 PRAC. LAW 59 (Kripke ed. 1967).

138 2 GILMORE, *supra* note 13, § 45.6; *see* Gordon, *supra* note 127.

139 In Rosenberg v. Rudnik, 262 F. Supp. 635 (D. Mass. 1967), Judge Ford observed that since the Code had been adopted in almost every jurisdiction, section 9-108 should be regarded, in accord with current business practices and understanding, as the generally accepted definition of "antecedent debt" for bankruptcy purposes. *See also* United States v. Wegematic Corp., 360 F.2d 674 (2d Cir. 1966); *In re* White, 283 F. Supp. 208 (D. Ohio 1967); *In re* Portland Newspaper Publishing Co., 271 F. Supp. 395 (D. Ore. 1967), *appeal docketed sub nom.* Williams v. Rose City Dev. Co., No. 22507-A (9th Cir., Dec. 5, 1967).

140 *See In re* Pusey, Maynes, Breish Co., 122 F.2d 606 (3d Cir. 1941), a pre-Code case which is often cited for the substitution-of-collateral doctrine. *See also* Walker v. Clinton State Bank, 216 F.2d 165 (8th Cir. 1954).

141 Gordon, *supra* note 127, at 64.

142 3 J. COLLIER, BANKRUPTCY ¶¶ 60.19-.28 (14th ed. 1968); Gordon, *supra* note 127, at 64.

143 A subsequent advance or a subsequent release of the proceeds from collateral will sustain an assignment previously made. 11 U.S.C. § 96(c) (1964).

If the lender permits the debtor to use the proceeds without requiring that they be routed to him or through a bank account so that they may be released contemporaneously with a designation of new accounts, then each new account created during the four-month period prior to bankruptcy may be considered as having been transferred for an antecedent debt. However, a strict application seems unwarranted if, by permitting the debtor to utilize the proceeds of the old accounts directly in almost equal amounts as the newly created accounts, the net effect does not deplete the debtor's estate. Certainly the unsecured creditors, who as a class are on notice of the security interest from the filed financing statement, are not harmed if the secured party's failure to "police" the collateral does not diminish the bankrupt's estate.[144] Hence, if the value of the accounts during the 4-month period remains substantially the same or less than the value of the accounts immediately prior to this period, the incoming accounts should be considered as taken in substitution for the collected accounts.[145] On the other hand, if the collateral substantially increases during the 4-month period prior to bankruptcy,[146] the accretion in value may be classed as a transfer for an antecedent debt.[147] However, it could be forcefully argued that where the accretion occurs in the ordinary course of the debtor's business or through normal routine business process,[147a] rather than through manipulative conduct on the part of the lender to "grab" assets at the last minute before the debtor's bankruptcy, the evil which section 60 of the

[144] Actually, it is the secured creditor who stands to lose by not "policing" his collateral. If the debtor is allowed to use the proceeds from the accounts, he is in a position to pay his unsecured creditors with the very funds which would otherwise have gone to liquidate the indebtedness of the secured creditor, perhaps leaving him with insufficient collateral to cover his loan. *See In re* C. E. Pontz & Son, Inc., 359 F.2d 436 (3d Cir. 1966), where a bank which had loaned money to a debtor against the security of his accounts was unable to reclaim the proceeds which had been commingled with other funds and paid to other creditors prior to the debtor's bankruptcy.

[145] Hogan, *supra* note 127, at 563. Judge Solomon suggests that it may only be necessary to compare the value of the collateral at the beginning of the four-month period to the value of the accounts at bankruptcy. *In re* Portland Newspaper Publishing Co., 271 F. Supp. 395 (D. Ore. 1967), *appeal docketed sub nom.* Williams v. Rose City Dev. Co., No. 22507-A (9th Cir., Dec. 5, 1967); *see* Grain Merchants of Ind., Inc. v. Union Bank & Savings Co., 408 F.2d 209 (7th Cir. 1969) *aff'g* 286 F. Supp. 597 (N.D. Ind. 1968).

[146] Usually the assets of a doomed business decrease sharply as bankruptcy approaches. The lender generally does not have on the day of bankruptcy more security than he had four months ago; he frequently has a great deal less. 2 GILMORE, *supra* note 13, § 45.6. Nevertheless, in some seasonal industries, such as the toy and fashion clothing industries, the accounts quite normally increase as the season approaches.

[147] Hogan, *supra* note 127, at 563-64.

[147a] Rockmore v. Lehman, 129 F.2d 892 (2d Cir. 1942), *cert. denied*, 317 U.S. 700 (1943) *rev'g* 128 F.2d 564 (2d Cir. 1942). A debtor assigned the right to receive proceeds arising out of an executory contract more than four months prior to bankruptcy. During the four-month period the debtor incurred labor and materials in completing the contract which were unpaid at bankruptcy. The court awarded the proceeds from the contract to the assignee, who was held to have perfected his rights in the resulting proceeds at the time the contract was assigned. *See* Kripke, *Priority Problems under the UCC*, 13 Prac. Law. No. 3, at 46-47 (1967).

Bankruptcy Act seeks to prevent is not present.[148] The result would be in accord with section 9-108 which protects the transaction only if the debtor acquires rights in the collateral in the ordinary course of business.[149]

A different problem arises where, within the 4-month period prior to bankruptcy, the value of outstanding accounts subject to a security interest dips below the loan balance, either through over-advances made by the accounts financer or through the collection of old accounts which are not offset by the creation of new ones. To the extent that the value of the collateral is less than the loan balance, the accounts financer is an unsecured creditor. Therefore, any increase in collateral thereafter might be considered pro tanto preferential, since the creditor, to the extent he was unsecured, would receive a "greater percentage of his debt than some other creditor of the same class."[150] In the final analysis, the policing techniques employed prior to the Code still have value in assuring a secured lender that a constant ratio of debt to collateral is maintained and that the collateral stays ahead of the loan, thus shielding the transaction from attack as a voidable preference.

PRIORITIES—CONFLICTING SECURITY INTERESTS

The concept of "priorities" under the Code involves a statutory determination of the relative rights of secured creditors, each of whom claims a security interest in the same collateral.[151]

The priority rules governing conflicting security interests are set forth in section 9-312. Where no special rule exists to cover a particular situation,[152] the general rules stated in section 9-312(5) apply. Section 9-312(5)(a) provides that priority shall be determined in the order of filing if both security interests have been perfected by filing, regardless of which security interest attached first and whether it attached before or after filing. In other words, priority is awarded to the secured creditor

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148 One of the purposes of section 60 is to eliminate secret liens perfected on the eve of bankruptcy. However, if a creditor must comply with the notice-filing provisions of the Code to perfect his security interest in the future accounts, and knowledge of his security interest is therefore available to the business community, no secret lien is involved. *See* Krause, Kripke & Seligson, *supra* note 127, at 288 (Kripke lecture).

149 *See In re* Portland Newspaper Publishing Co., 271 F. Supp. 395, 401 (D. Ore. 1967), *appeal docketed sub nom.* Williams v. Rose City Dev. Co., No. 22507-A (9th Cir., Dec. 5, 1967); Hogan, *supra* note 127, at 565-73.

150 11 U.S.C. § 96(a) (1964). *See* Hogan, *supra* note 127, at 564; Krause, Kripke & Seligson, *supra* note 127, at 283 (Krause lecture); *id.* at 300 (Seligson lecture).

151 The concept of "priorities" is related to the concept of "perfection" of a security interest. While perfection of a security interest shields it from attack by a subsequent lien creditor or a trustee in bankruptcy, unless the transaction is in fraud of creditors or a voidable preference under section 60 of the Bankruptcy Act, "perfection" under the priority scheme adopted by the Code does not insure that the security interest will take priority over all other security interests in the same collateral in every instance. *See, e.g.*, §§ 9-307, -308.

152 Sections 9-312(1)-(4) enumerate special priority rules pertaining to certain types of collateral or types of security interests.

who was the first to file regardless of when the security interests attached or were perfected. Since filing is the only method whereby a security interest can be *permanently* perfected in accounts, contract rights or general intangibles,[153] and since the Code contains no special priority rule governing conflicting security interests in this type of collateral, this rule clearly establishes priority among such security interests in the order of filing. For example:

> January 1—A files a financing statement claiming "accounts" of D. No agreement is executed at that time.
>
> February 1—B files a financing statement claiming "accounts" of D, and makes an advance to D pursuant to a security agreement covering all of D's present and future accounts.
>
> March 1—A makes an advance to D pursuant to a written security agreement covering the same collateral. A knows of B's security interest. Upon the bankruptcy of D, both A and B attempt to satisfy their indebtedness by resorting to the accounts.

The security interests of both A and B were duly perfected and are superior to any rights of a trustee in bankruptcy. However, even though A perfected his security interest with knowledge of B's, the first-to-file rule grants priority to the security interest of A.[154] Hence, this rule allows a lender, by filing a financing statement, to finance a borrower on the security of his accounts without having to search the public records for potential intervening security interests before each advance.

It was originally thought that the first-to-file rule also provided a reasonably clear answer to the question, unresolved before the Code,[155] of priority between a secured creditor who claimed the accounts as proceeds of inventory and a secured creditor who claimed the accounts as original collateral.[156] In other words, an inventory financer who filed first claiming inventory and proceeds would prevail as to the accounts over an accounts financer who subsequently filed. Where the filings were reversed the accounts financer would be awarded priority.[156a] How-

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153 See note 70 *supra*.

154 B could have avoided this trap by (1) having D demand that A file a termination statement, since at that time D was not indebted to A (§ 9-404(1)); (2) requesting that A subordinate his security interest to B's (§ 9-316); (3) requesting that A limit his financing statement to certain accounts. (Most lenders, however, shy away from split financing of accounts).

155 Under pre-Code law, where one party claimed accounts under the Uniform Trust Receipts Act as proceeds of goods sold, another claimed the same accounts under a factor's lien act, and a third party claimed them under an accounts receivable statute, seldom did these statutes recognize the possibility of a conflict, much less provide a solution. Coogan & Gordon, *supra* note 25, at 1553. A lender generally avoided the problem by either taking over the entire financing package or entering into an agreement with the other lenders adjusting their respective rights as to the accounts. Weiss, *Original Collateral as Proceeds: A Code Puzzle*, 42 N.Y.U.L. REV. 785, 800 (1967).

156 Kripke, *supra* note 25, at 710.

156a The accounts financer did everything he possibly could have done to perfect his security interest since filing is the sole method by which a security interest in accounts as original collateral may be perfected. Section 9-302(1). The subsequent ever, whether the Code necessarily compels such a result is by no means certain.[157] To illustrate this problem, assume the following:

January 1—A makes an advance to D pursuant to a security agreement covering present and future accounts and files a financing statement to that effect.

February 1—B makes an advance to D pursuant to a security agreement covering inventory and proceeds and files a financing statement to that effect.

March 1—D sells inventory on open account. A claims the resulting accounts as original collateral and B claims them as proceeds.[158]

Both A and B perfected their respective security interests by filing, but because A filed his financing statement before B, it is arguable that A should prevail as to the accounts under the first-to-file rule.[159] However, a persuasive argument can be made that the first-to-perfect rule embodied in section 9-312(5)(b) governs the priorities of the respective security interests.[160] This rule provides that where either or both of the security interests are perfected by a method other than filing, the first to perfect prevails. It is contended that although the accounts financer perfected his security interest by filing, the inventory financer's claim to the account proceeds is perfected by a method other than filing, because a

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inventory financer having full notice of the claimed security interest in the accounts before he commits himself or gives value is in the best position to attempt to resolve the potential conflict with the accounts financer. If, however, a subsequent inventory financer could gain priority over an earlier filed security interest in accounts, there would be no compulsion on him to attempt to resolve the potential conflict with the accounts financer or to subordinate his rights in the accounts. Weiss, *supra* note 155, at 793.

157 2 GILMORE, *supra* note 13, § 29.4; Coogan, *supra* note 105; Coogan & Gordon, *supra* note 125; Henson, *supra* note 127; Henson, *Counter-Suggestions Regarding Article 9: A Reply to Professor Kripke*, 42 N.Y.U.L. REV. 74 (1967); Kripke, *supra* note 25.

158 A corollary problem is the potential conflict between an accounts financer and a creditor who subsequently takes a purchase money security interest in inventory and claims the accounts as proceeds thereof. Some writers contend that the purchase money priority should carry through into the accounts as proceeds or, by analogy to section 9-312(3), that the purchase money security interest should at least prevail from the time its holder gives notice of his security interest to the accounts financer. See Craig, *supra* note 12, at 204; Henson, *supra* note 127, at 240; Coogan & Gordon, *supra* note 25 at 1568. The commercially unrealistic aspects of this "tempting proposal" are noted in Kripke, *supra* note 25, at 717-18. *See also* Weiss, *supra* note 155, at 795-96. An inventory financer who feels that his collateral might be dissipated through sale could, where practical, require the installation of a field warehouse, thereby compelling the debtor to pay for the inventory as it is released.

159 Goodwin, *Priorities in Secured Transactions—Article 9, Uniform Commercial Code*, 20 BUS. LAW. 877, 890-92 (1965); Note, *Conflicting Perfected Security Interests in Proceeds under Article 9 of the Uniform Commercial Code*, 66 MICH. L. REV. 517 (1968). If B had perfected his security interest in the inventory by a method other than by filing (*e.g.* pledge), presumably, according to these writers, the first-to-perfect rule would be applicable and B's security interest in the accounts as proceeds would have priority over A's. The view that the method of perfection of a security interest in original collateral controls a priority's contest as to proceeds has been criticized by Professor Kripke. See Kripke, *supra* note 25, at 711-12.

160 *See* authorities in note 157 *supra*.

security interest in accounts as proceeds of inventory is perfected by *operation of law* for a period of 10 days after the debtor "receives" the proceeds; the filing as to the proceeds merely continues perfection beyond that period.[161] Since a security interest is perfected only when the debtor acquires rights in the collateral,[162] both security interests are perfected simultaneously at the moment each account springs into existence,[163] thus establishing a parity of interests rather than a priority.[164]

According to another view, section 9-312(1) incorporates sections 9-306(2) and (3) by reference as a special priority rule.[165] If one accepts this initial premise, determining priority is a simple matter. Sections 9-306 (2) and (3) provide, in effect, that a security interest in inventory continues in the accounts as identifiable proceeds and that where the financing statement filed originally or within the 10-day period claims proceeds, the security interest in the accounts is a continuously perfected security interest. Since the debtor has no rights in an account until it comes into existence, the security interest of the accounts financer will not be perfected until that time. Therefore, it will always be perfected subsequent to the time when the security interest of the inventory financer is perfected, thus giving the inventory financer absolute priority over the accounts financer regardless of the order of the filings covering the accounts.[166]

The pre-eminence today of accounts receivable financing and factoring, as compared to inventory financing, clearly favors a policy of preferring the secured party who first files as to accounts, either as original collateral or proceeds.[167] Inventory is at best a secondary class of collateral; it is generally used only when the debtor's accounts are insufficient to support the needed advance.[168] Moreover, a rule requiring

[161] Section 9-306(3). If the original financing statement had not covered proceeds, the argument would seem even more forceful. *See* Kripke, *supra* note 25, at 710.

[162] Sections 9-303, -204(1).

[163] Section 9-204(1)(d).

[164] Coogan & Gordon, *supra* note 25, at 1559-62; Kripke, *supra* note 25, at 710-11; Weiss, *supra* note 155, at 786-90; *cf.* Goodwin, *supra* note 159, at 892. It also has been urged that the first-to-perfect rule grants to the inventory financer a priority. Because the perfected security interest of the inventory financer in the accounts as proceeds is continuously perfected, the time when the inventory financer's security interest in the accounts is perfected necessarily antedates the time when the security interest of the receivable financer is perfected (which can only occur when the account is created), thus granting to the inventory financer a priority. Craig, *supra* note 12, at 199-204.

[165] Hensen, *"Priorities" Under the Uniform Commercial Code,* 41 NOTRE DAME LAW. 425, 426-27, 431-32 (1966).

[166] According to other writers, however, section 9-306 merely sets forth rules pertaining to the "perfection" of a security interest in proceeds, but does not establish their "priority." Kripke, *supra* note 125, at 725-27; Weiss, *supra* note 155, at 791 n.32; *see* 2 GILMORE, *supra* note 13, at 795 n.8.

[167] 2 GILMORE, *supra* note 13, at 797; Coogan & Gordon, *supra* note 25, at 1567; Kripke, *supra* note 25, at 716-19; Weiss, *supra* note 155, at 794.

[168] Coogan & Gordon, *supra* note 25, at 1567; Kripke, *supra* note 25, at 716-17. Accounts receivable are, by their nature, self-liquidating, and represent far better security than inventory which, as raw materials or finished goods, requires a knowl-

an accounts financer to check the filing records before each advance (which might be daily) would be more burdensome and impractical than a rule merely requiring an inventory financer who desired to claim the account proceeds to check the filings before he commits himself or gives value.[169] And even if the security interest in inventory was perfected by a method other than by filing, it does not seem inequitable to require the inventory financer to file as to the account proceeds; under section 9-306 (3), he presently is required to file in order to continue his perfected security interest in the proceeds beyond the expiration of the 10-day period.[170] Lastly, a rule subjecting the security interest of an accounts financer to subordination or parity without his knowledge would encourage such lenders to take a security interest in the inventory in addition to the accounts in order to protect themselves, thus precipitating the evil of over-collateralization which many pre-Code writers feared.[171]

As so many writers have urged, this latent defect in the Code should be remedied by an amendment making the first-to-file rule the only applicable standard for determining priorities between conflicting security interests in accounts, contract rights and general intangibles.[172] Until then, or until the matter is resolved by litigation, a lender cannot safely engage in accounts receivable financing without fearing that, although no conflicting financing statement is on file at the inception of the arrangement, his security interest may not at some future date be

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edge of the borrower's industry, timing, and sometimes a great deal of effort to convert to cash. Moreover, as work-in-process it is frequently valueless. Therefore, while a lender will frequently advance up to 85 percent against current accounts receivable, the advancement against inventory is usually substantially less.

[169] According to one view, an inventory financer may perfect a security interest in the accounts as proceeds by claiming them in the financing statement filed in the jurisdiction where the inventory is located, notwithstanding that the records concerning the accounts are located in another jurisdiction. Haydock, *supra* note 99, at 366. *Contra*, Kripke, *supra* note 25, at 707-09. Hence, this rule would place the added burden on the accounts financer of checking the filing offices, not only in the state where the records are kept, but the filing offices in every state where the debtor's inventory is kept as well.

[170] Weiss, *supra* note 155, at 801.

[171] *See* Hogan, *Future Goods, Floating Liens and Foolish Creditors*, 17 STAN. L. REV. 822, 840 (1965); H. Kraetz, Credit Management and the Uniform Commercial Code, April 15, 1966 (unpublished article in Dun & Bradstreet, Inc. Library). Even this ingenious course of action is frequently unavailable to a receivable lender, for unless he is willing to advance against the inventory too, it might disrupt the debtor's relations with his trade creditors who sell to him on open account. Kripke, *supra* note 25, at 714.

[172] 2 GILMORE, *supra* note 13, at 797; Kripke, *supra* note 25, at 719; Weiss, *supra* note 155, at 800. Professor Kripke suggests achieving this result by amending the Code to eliminate the applicability of the 10-day automatic perfection period to proceeds of inventory, while retaining the period for non-inventory proceeds. He would also require a full description of the proceeds in the financing statement. Mr. Weiss has criticized this approach, contending that a priority problem should not be solved by altering the perfection provisions of the Code. This writer concurs in the suggestion of Mr. Weiss that the problem should be solved by providing a special rule similar to section 9-308 to cover accounts, contract rights and general intangibles. This would leave intact the perfection provisions of the Code which are of great importance in insolvency proceedings.

subordinated to a conflicting claim to the accounts as proceeds of inventory.

CONCLUSION

In 1967, the Permanent Editorial Board for the Uniform Commercial Code established a committee to review Article 9 of the Code. Amendments to the Code under consideration by the committee include:

(1) eliminating the term "contract right" and redefining "account" to include unearned rights (section 9-106);
(2) changing the choice of law for accounts to the jurisdiction where the debtor's "chief executive office" is located (section 9-103);
(3) clarifying the application of the Code to future advances and to proceeds; and
(4) providing that a security interest in accounts has priority over a later filed interest in inventory and proceeds.[173]

In addition, the National Bankruptcy Conference is working on a revision of section 60 of the Bankruptcy Act pertaining to preferences.[173a] It is hoped that through the work of these committees and ultimately through statutory amendment, accounts receivable financing, which has become so important to the survival and growth of small and medium size businesses, will finally be made "simple and can go forward with less cost and with greater certainty."[174]

Until then, as two writers have so aptly stated, "account financers will do well to follow basically the patterns they have followed in the past, to take the benefit of the clarification which the Code has made, but because of the unresolved problems to operate as they generally have in the past—'little bit scared.'"[175]

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[173] Braucher, *Report on the Work of the Article 9 Review Committee,* 23 BUS. LAW. 890 (1968).

[173a] A committee of the conference has proposed that transfers of receivables pursuant to a security agreement within four months of bankruptcy will not constitute preferential transfers if they arose in the ordinary course of the debtor's business. The committee also proposes a two-point test, whereby there would be a preference to the extent that the aggregate value of the receivables subject to the security interest on the date of filing the bankruptcy petition exceeds the aggregate value of the receivables subject to the security interest four months earlier regardless of any fluctuations of the collateral which might have occurred during the four-month period. See Kohn, *Preferential Transfers on the Eve of the Bankruptcy Amendments,* 2 PROSPECTUS 259, 261 (1968).

[174] Section 9-101, Comment.

[175] Coogan & Gordon, *supra* note 25, at 1568.