According Purchase Money Status Proper Priority

Russell A. Hakes
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Priority under the Uniform Commercial Code\(^1\) for commercial purchase money security interests\(^2\) faces a mortal threat. The risk to this important commercial concept results from implications that arise by applying judicial doctrines sometimes referred to as the transformation rule\(^3\) and the dual status rule\(^4\) to certain consumer transactions. The transformation rule, the first to develop, defeats purchase money status when a purchase money obligation and a nonpurchase money obligation commingle.\(^5\) In contrast, the dual status rule recognizes that a security interest in collateral can have both a purchase money component and a nonpurchase money component,\(^6\) but only if a mechanism is available to allocate pay-
ments made between the purchase money obligation and the non-purchase money obligation to determine which part of the security interest remains purchase money.\(^7\)

Courts consistently apply the transformation rule or the dual status rule to consumer add-on transactions.\(^8\) Consumer add-on transactions are purchase money transactions in which items of collateral are acquired at different times and the debts incurred to acquire the collateral are refinanced or consolidated into a single debt. In resolving consumer add-on disputes courts implicitly treat the transaction as commingled—each item of collateral secures not only its price, a purchase money obligation, but also the price of the other collateral, a nonpurchase money obligation. By characterizing multiple purchase money acquisitions of consumer goods as commingled transactions rather than as a single ongoing transaction, courts have required a one-to-one correspondence between each item of collateral and its respective purchase price. Thus, courts have developed a limited definition of purchase money security interest. The Code definition of purchase money security interest, however, can be read as an aggregate concept—all items of collateral acquired by purchase money financing correspond to the total purchase price of all items.\(^9\)

Applying the limited item-by-item correspondence concept in a commercial context threatens purchase money financing. The threat is most evident in commercial purchase money financing of inventory which by its nature is acquired at different times. If characterized as commingled purchase money transactions, virtually all purchase money security interests in inventory would lose the priority accorded by the UCC.\(^10\) Applying the transformation rule to such transactions would defeat purchase money status. Applying the dual status rule would require the parties to provide a mechanism to allocate each payment among the purchase prices of each item of inventory or else lose purchase money status. Such a mechanism requires commercially impractical documentation or very

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\(^7\) See infra text accompanying notes 214-17.

\(^8\) See infra note 222 and accompanying text.

\(^9\) See infra text accompanying notes 330-35.

\(^10\) Purchase money creditors in inventory have priority over prior perfected security interests in the same inventory if the creditor perfects the security interest and complies with the timing and notification requirements in §9-312(3). Purchase money creditors in inventory also have priority over lien creditors and transferees in bulk whose rights arise between the time of attachment of the purchase money security interest and the filing of the financing statement if the filing occurs within 10 days after the debtor receives the collateral. U.C.C. § 9-301(2).
careful monitoring of debtors\textsuperscript{11} which is probably only commercially practicable in self-liquidating inventory financing.\textsuperscript{12} Therefore, even the dual status rule significantly threatens purchase money financing of inventory.

Are commercial purchase money financings really purchase money obligations commingled with nonpurchase money obligations? Should they be so characterized? The appropriate resolution of these questions can be determined by analyzing the nature, origin and development of the purchase money concept, the nature of inventory purchase money financing, the policies underlying the judicial doctrines that have developed in the consumer context, and the sources and ramifications of the item-by-item correspondence concept.

Purchase money is in the first instance a concept relating to priority.\textsuperscript{13} Giving priority to creditors with purchase money claims is centuries old and has a strong foundation in both formal legal rea-}

\begin{footnotesize}
\begin{enumerate}
\item One commentator who favors limiting the purchase money status of inventory financing has stated:

The result is that a purchase money secured party must carefully draft his security agreement and keep precise records that match collateral to its debt. The business costs and risks of accounting errors render the subsection 9-312(3) purchase money exception largely valueless, except in the case of the occasional credit sale of a limited number of inventory items.


A commentator with an opposing view has stated:

No doubt some combination of lawyers' drafting ingenuity and time-consuming monitoring procedures can address these questions [the one-to-one correspondence between items of collateral and their purchase prices] to the satisfaction of some future court, at least when the amounts at issue justify the effort and expense on the part of the financier. In other cases, if this decision is followed, purchase-money priority in inventory will simply be unavailable.


\item A self-liquidating loan is one in which payments are remitted to the lender for each item of inventory as it is sold. The control over inventory and payments required for such a loan is one of the reasons field warehousing was used as part of inventory financing before the Code. Field warehousing is still used today. However, the Code drafters refused to require self-liquidating loans and other formalities and gave the parties greater latitude in ascertaining their respective best interests. U.C.C. § 9-205 cmt. 1; accord D. Benjamin Beard, \textit{The Purchase Money Security Interest In Inventory: If It Does Not Float, It Must Be Dead!}, 57 TENN. L. REV. 437, 451-52, 493-95 (1990). \textit{Compare} Hansford, supra note 11, at 263 (suggesting that such self-liquidating inventory financing is the appropriate scope of U.C.C. § 9-312(3) priority).

\item See infra note 28 and accompanying text.
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soning and equitable doctrines. Purchase money status has more recently been adopted as a convenient basis for determining other nonpriority rights of creditors in consumer contexts. In such contexts purchase money status relates to enforcement rather than priority of security interests. Comparing the policies implicated in these issues requires in the first instance properly distinguishing among the different uses of the purchase money concept. Consumer uses of purchase money status have a unique set of policies that differ from those implicated by priority disputes in commercial inventory financing. Purchase money doctrines developed in consumer contexts involving enforcement of security interests should be imported into the resolution of priority disputes only after careful consideration of the policies underpinning each use.

Since the adoption of the Code, only a few courts have addressed the issue of applying an item-by-item correspondence concept to commercial purchase money financing transactions. One court simply refused to apply the transformation rule due to the existence of an unexercised future advance clause. A second woodenly applied the item-by-item concept from the transformation and dual status rules while a third rejected the concept with inadequate analysis. Pre-Code case law fails to fill this gap for two reasons. Commingling was not an issue before the Code was adopted and, although purchase money priority was a common law concept, purchase money priority in inventory was an innovation of the Code.

Although commentators have given much attention to the judicial limitations on purchase money security interests in the consumer context, less has been said regarding the implications of the

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14 See infra text accompanying notes 47-77.
15 See infra text accompanying notes 193-97.
19 See infra text accompanying notes 48-67.
20 See infra text accompanying notes 127-47.
transformation and dual status rules in the commercial context.  

A systematic analysis focusing on commercial inventory financing illuminates the application of the rules in priority disputes over non-inventory collateral as well as the nonpriority consumer contexts from which the rules arose.

Such analysis comes at an opportune time. The American Law Institute and the National Conference of Commissioners on Uniform State Laws, at the request of the Permanent Editorial Board for the Uniform Commercial Code, established a study committee to review Article 9 and determine whether changes should be made. The study committee has recommended that a drafting committee be formed to address and correct the uncertainty existing in purchase money status as a result of the transformation rule and the dual status rule.

Beard, supra note 12, provides an excellent in-depth analysis of the intent of the Code on the issue including extensive drafting history. The article provides powerful support for avoiding the item-by-item correspondence in inventory purchase money financing due to the close tie between inventory and floating lien financing. However, the article does not focus on the concerns courts have expressed in developing the current purchase money rules and is therefore an incomplete source for judicial guidance in focusing on the policy differences between priority rules and enforcement rules.

Hansford, supra note 11, at 249-58, criticizes the superficial analysis but not the result of Southtrust Bank, Nat’l Ass’n v. Borg-Warner Acceptance Corp., 760 F.2d 1240 (11th Cir. 1985). He assumes an item-by-item correspondence requirement and appears to confuse the necessity of tracing moneys advanced under § 9-107(b) to the actual collateral acquisition with tracing payments on the debt to individual items of collateral. Id. at 244, 262-63. The article contains additional background about the Southtrust Bank case gathered from files of the lawyers representing the bank in the case.

Mark B. Wessman, Purchase Money Inventory Financing: The Case for Limited Cross-Collateralization, 51 OHIO ST. L.J. 1283 (1990), provides a thorough analysis of § 9-107 and its comments and concludes that “limited cross-collateralization” sufficient to validate a floating purchase money lien is essential to the viability of purchase money financing of inventory. By characterizing such transactions as “limited cross-collateralization,” Wessman in effect accepts an item-by-item correspondence concept in the definition of purchase money security interest. The article gives only brief attention to the policy justifications of the courts in developing the transformation and dual status rules.


Only four law review articles expressly address the problem. Mary Aronov, The Transformation Rule Applied to Purchase Money Security Interests in Commercial Lending Transactions, 16 MEM. ST. U. L. REV. 15 (1985), discusses the problems created by the judicial rules in commercial contexts and criticizes the rules. However, she focuses on warning practitioners of the pitfalls and the need for payment allocations. She assumes that an item-by-item correspondence requirement exists and does not pursue the policy analysis. Id. at 57.

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I

HISTORICAL DEVELOPMENT OF THE PURCHASE MONEY CONCEPT

The starting point for an analysis of purchase money priority is an understanding of the purchase money concept and its origins. To be characterized as purchase money, a debt must be incurred to acquire property and that same property must serve as security for repayment of the debt. Purchase money debt is limited to consensual transactions and can be owed to a seller of the property or to a third-party lender.

A. Purchase Money Priority as a Counterbalance to After-Acquired Property

The purchase money concept was first used as a basis for resolving conflicting creditors' claims to property. A creditor with a purchase money claim was granted a priority right to the collateral—the property acquired by the debtor in exchange for incurring the purchase money debt—over a competing claim to the same property that would otherwise have been entitled to priority. "First in time, first in right" grounds most schemes of priority. "First to

25 See Lloyd, supra note 21, at 58, for a good discussion of the necessity of conceptualizing the purchase money secured obligation as the debt rather than the instrument or other writing evidencing the debt.

26 Only consensual security interests can be created under Article 9 of the Code. See U.C.C. § 9-102(2) and the Purposes paragraph of the Official Comment to § 9-102. Without this limitation, purchase money debt would arguably encompass liens created for the benefit of mechanics, materialmen and laborers whose work and property create or enhance the value of something. Such liens involve similar but distinct policy considerations.

27 Section 9-107(a) covers sales of property on credit with the seller taking a security interest in the property to secure the unpaid portion of the purchase price. Section 9-107(b) covers third-party lenders advancing money intended for payment of the purchase price of the property if it is so used and the property secures repayment of the advance.

Although purchase money status may involve real property, this article focuses on personal property transactions.

28 The origin of the concept appears to be with the English case of Nash v. Preston, 79 Eng. Rep. 767 (K.B. 1631), a case involving dower rights competing with a mortgagee's rights to property acquired and mortgaged in the same transaction. See, e.g., 2 Grant Gilmore, Security Interests in Personal Property § 28.1 (1965); 2 Garrard Glenn, Mortgages, Deeds of Trust, and Other Security Devices as to Land § 343 (1943); Thomas H. Jackson & Anthony T. Kronman, A Plea for the Financing Buyers, 85 Yale L.J. 1, 6 (1975); Lloyd, supra note 21, at 11-37. Professor Lloyd traces the history of the purchase money concept in personal property from that beginning through real estate law to the concept in U.C.C. § 9-107.
create," "first to give notice," "first to take physical control," or any number of other relevant events in the life of a security interest could complete this basis for priority. Whichever "first" controls, purchase money lenders are in a unique position to achieve priority because they are a party to the transaction in which the debtor acquires the collateral. Purchase money status as a priority concept achieves importance only when some rule of priority or mechanism that interferes with this natural temporal advantage is widely used. Recognition of security interests in after-acquired property provides that mechanism.

1. After-Acquired Property as Collateral

A longstanding principle of property law was that people could not transfer property prior to the time they acquired ownership. This is often expressed as the Latin rule of logic *nemo dat quod non habet.*\(^29\) As long as that rule reigned supreme, there was little need for a purchase money concept. By reserving an interest or having an interest granted simultaneously with the debtor's acquisition of the property, a party financing the acquisition of property could ensure a superior interest in the property. However, parties can more readily facilitate their intentions in certain commercial transactions if they can contract in the present for a springing interest in unowned property to arise when the debtor acquires an interest in that property. In those transactions commercial interests pressured courts to recognize and thereby legitimate security in after-acquired property.

A critical risk in adopting a law that does not follow the *nemo dat quod non habet* logical principle is that third parties who may later obtain an interest in the same property cannot discover the creditor's interest. Springing interests are generally unworkable in a system for registering interests in property, such as a grantor-grantee system of indexing real estate interests.\(^30\) In those systems, grants of future interests would create deeds that could not be lo-

\(^29\) "A man can not grant or charge that which he hath not."

\(^30\) If the registration system is based on the property there is no way to index the "after-acquired" interest until it is known precisely what property will be acquired. A related problem arises if the registration system is based on the owner's name. One traces ownership and property interests through grantor-grantee indexes by first finding the date property changes hands. To determine what property interests have been created by the new owner, one then searches the grantor-grantee index for subsequent grantees under the name of the new owner.

Fixtures are one type of property covered, at least in part, by real estate grantor-grantee recording systems where the after-acquired concept is possible.
cated by someone searching for title and other interests in the property because at the time of creation there is no known connection between the property and the potential future owner. Personal property, for the most part, is not burdened by systems registering ownership. Personal property later affixed to land is covered by earlier conveyances of the land. The law of fixtures includes implicit legal recognition of interests in after-acquired property. It is not surprising then that it was in a fixture context, financing railroad construction, that security interests in after-acquired personal property became widely recognized as enforceable property interests in the United States.

The pre-Code roots of after-acquired property as security are most easily understood by looking at three United States Supreme Court cases involving the financing of railroads in the nineteenth century. Construction of railroads was financed by bonds with the bondholders obtaining rights in the railroads to be constructed as security for the bonds. Because the process of granting new security each time new rails, ties, locomotives and cars were acquired was very cumbersome, the bonds were secured by a grant of the existing property as well as property obtained in the future as construction progressed.

Judgment creditors levying on the locomotives and cars challenged such a grant of after-acquired property in *Pennock v. Coe*. The levying creditors were holders of a second issue of bonds secured by the same property as the first issue of bonds. The locomotives and cars on which they levied had been acquired subsequent to the date of the first mortgage but prior to the date of both the second mortgage and the levy. The levying creditors were not foreclosing the mortgage securing the second issue of bonds, but were merely levying to collect a judgment obtained on the bonds they held. The Court validated the claim to after-acquired property

31 A fixture is personal property that has become affixed on a relatively permanent basis to real estate and thereby becomes subject to legal claims to the real estate. This is a functional definition adopted by the Code to avoid the doctrinal quagmire of state law defining fixtures. See U.C.C. § 9-313(1)(a) and cmts. 1-3.

32 These cases were not the first time a court in the United States sitting in equity had enforced an after-acquired property clause in a mortgage. See *Pennock v. Coe*, 64 U.S. (23 How.) 117, 123-24 (1860) (citing cases). They are, however, the first time the United States Supreme Court addressed the issue and they provide the best starting point for understanding the development of the after-acquired property clause in United States law.

33 64 U.S. (23 How.) 117 (1860).

34 Id. at 126, 131. The levy action eliminates any issues about rights to foreclose
and held for the holders of the first series of bonds.

The decision of the Court in *Pennock* is probably best described as the equitable enforcement of a clear contract to acquire and encumber property as long as third parties were not prejudiced. The Court characterized its holding as following the clear intent of the parties to the mortgage regarding after-acquired property and noted that equity would enforce the contractual obligations between those parties. The Court asserted that a court of equity would have granted specific performance if needed and requested by the bondholders to require the railroad to use the funds to complete the railroad and use the equipment in connection with the railroad. The Court also thought equity would compel the ongoing grants of security in the after-acquired property.\(^{35}\) The Court circumvented the conflict with *nemo dat quod non habet* by characterizing the mortgage of future property not as a present grant of unowned property, but as a transfer of property the railroad was obligated to acquire which would take effect at the time the grantor acquired the property. This characterization permitted the Court to assert that no principle of law was violated.\(^{36}\) The Court was thus left with only one inquiry to validate the mortgage of after-acquired property: Does it prejudice the rights of third parties?\(^{37}\) The Court concluded that the levying creditors were not prejudiced because they were holders of second mortgage bonds fully aware of their position behind the holders of first mortgage bonds. As a result, the *Pennock* Court held that the mortgage attached to the property as it was subsequently acquired.\(^{38}\)

Several important principles and policies are involved in the *Pennock* holding. First, a major concern with validating after-acquired property clauses is ensuring that interests of third parties are not prejudiced. Second, important principles and policies relevant to purchase money priority are involved implicitly in the holding. The holding relies on elements that create purchase money status. The mortgage which included the after-acquired property was a

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\(^{35}\) Id. at 129.

\(^{36}\) Id. at 128.

\(^{37}\) Id. at 128, 131.

\(^{38}\) Id. at 130.
struction mortgage with a covenant to use the bond proceeds to acquire future property—essentially a purchase money obligation secured by the purchased assets. The Court was influenced by the contractual obligation of the grantor to acquire the property that would become subject to the mortgage.\(^\text{39}\) The Court implicitly favored purchase money by focusing on the contractual obligation to use the bond proceeds to pay for the after-acquired property.\(^\text{40}\) Finally, the Court implicitly used a broad aggregation concept by protecting the security in the assets acquired at different times with the proceeds of the secured obligation.\(^\text{41}\) The holding and rationale of the case evidence a strong policy to protect security given for purchase money obligations.

Eleven years later the United States Supreme Court again addressed the issue of mortgaging after-acquired property and significantly broadened the rationale for enforcing such mortgages. In *Galveston Railroad v. Cowdrey*,\(^\text{42}\) first, second, third and fourth mortgages were given on the railroad’s property to secure different series of bonds. The fourth mortgagee intervened in an action against the trustees of a prior mortgage and asserted a priority to part of the railroad constructed with track he purportedly financed after the first three mortgages were given. The Court affirmed the enforceability of after-acquired property clauses in railroad mortgages\(^\text{43}\) without some of the baggage that appeared in the *Pennock* case. The Court did not refer to, and thus did not appear to require, a contractual obligation to acquire the property with the bond proceeds. Apparently, the court was no longer concerned with explaining that the maxim *nemo dat quod non habet* was not violated.

\(^\text{39}\) *Id.* at 127.

\(^\text{40}\) The Court also asserted that the first mortgagee—who had the after-acquired property claim—had a “superior equity” in the property. *Id.* at 131. Unfortunately, the Court does not elucidate the reasons for this assertion beyond pointing out that there was not enough value to fully satisfy the holders of the bonds secured by the first mortgage. With such lack of clarity, we are left to speculate whether this has reference to a lesser equity in a subsequent mortgagee because of its knowledge of its second position or a superior equity in the first mortgagee for having provided the funds with which the railroad was obligated to acquire the property.

\(^\text{41}\) The Court does not discuss when the assets were acquired in relation to each other or in relation to advances of the bond proceeds.

\(^\text{42}\) 78 U.S. (11 Wall.) 459 (1871).

\(^\text{43}\) *Id.* at 480-82. The Court considered the mortgagor and anyone claiming under it or in privity with it to be estopped from challenging after-acquired property clauses. *Id.* at 481. The Court considered the fourth mortgagee an assignee of the company claiming under it with full notice of the other mortgages and in privity with the company. *Id.* at 481-82.
Significantly, the Court noted that enforcement of after-acquired property clauses facilitated railroad financing by obviating the need to borrow money in small amounts as each section of the road was completed. The Court grounded its decision on the equitable principle of estoppel and did so with sweeping language. Its broad estoppel of anyone claiming under or in privity with the debtor would certainly apply to purchase money lenders whose claims are inherently consensual and have reference by contract to specific property. Taken to its extreme conclusion, this rationale would preclude purchase money lenders from ever obtaining priority because they would be estopped from challenging the after-acquired claims.

Standing alone, the *Galveston Railroad* opinion could be interpreted as hostile to purchase money priority. The case potentially raised the issue of priority for purchase money obligations, but the Court did not directly analyze the purchase money concept in regard to priority, and did not discuss equitable principles relating to purchase money security interests. The fourth mortgage holder was simply held to be subject to the three mortgages of which he had notice. The Court rejected his priority claim by relying on fixture law in Texas which stated that personalty attached to a freehold becomes part of the freehold. By financing fixtures, the Court found the fourth mortgagee had constructively consented to the liens of the prior mortgages. The Court also rejected an argument from maritime law that priority should be given to a later creditor whose loan "preserves" the collateral by permitting it to be repaired or completed. This failure to directly address or support the purchase money concept must be understood in light of the law governing fixtures. Fixture financiers should have known from prior legal precedents that the fixtures would be subject to the claims of prior mortgagees of the real estate.

On the other hand, one of the Court's key justifications for broadly validating after-acquired property clauses supports a broad

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44 Whether the loan of the fourth mortgagee was a purchase money loan is unclear in the Court's opinion. The Court refers to the rails as "his (the fourth mortgagee's) iron" and "his capital" in its opinion, *id.* at 480, but the facts also refer only to iron not yet laid as rails when the fourth mortgage was granted, *id.* at 464. Either statement may be consistent with a purchase money loan as the facts indicate that the fourth mortgage secured 9600 pounds sterling loaned previously to the railroad as well as an additional 10,000 pounds sterling loaned at the time of the mortgage. *Id.* The Court never states whether the rails were acquired from the fourth mortgagee or with the proceeds of his loan.

45 *Id.* at 482.

46 *Id.*
interpretation of what constitutes a purchase money transaction under the Code. One rationale of the *Galveston Railroad* opinion is that a failure to enforce after-acquired property clauses in mortgages would require the parties to record new mortgages for each part of the construction. This closely parallels the problem created by requiring a one-to-one correspondence between items of collateral and purchase money debt for purchase money status as opposed to an aggregation concept. Only the latter facilitates commercial transactions by eliminating the inefficiency of requiring multiple sets of documents.

2. *Purchase Money Priority*

Once springing interests in after-acquired property became legally recognized, priority disputes between the preexisting creditor with a claim to after-acquired property and the secured purchase money financier claiming newly acquired property became inevitable. Again the United States Supreme Court first addressed the issue in the context of financing railroads. The failure of *Galveston Railroad* to address purchase money priority must be understood in connection with another case decided by the Court that same year which upheld a claim to purchase money priority. In *United States v. New Orleans Railroad*, the government as holder of first and second mortgage bonds brought suit to foreclose. The mortgage purported to cover all property acquired in the future. Prior to the foreclosure sale it was discovered that the government had sold the railroad certain rolling stock and taken back a bond evidencing an obligation for the purchase price which provided for a lien on the property sold.

This gave the government the possibility of getting priority over other bondholders. In addressing the priority battle for the affected rolling stock, the Court declared that the prior mortgage only attached to the after-acquired property in the condition it is received by the grantor, subject to any purchase money lien retained by the seller. The Court also stated that the deed to the property and the purchase money mortgage encumbering it were to be regarded as a single transaction. No facts were given in the opinion to ascertain whether there was any time delay between the deed and the mort-

47 2 GILMORE, supra note 28, § 28.2.
49 Id. at 365.
50 Id.
gage. The Court distinguished \textit{Galveston Railroad} by noting that the collateral in that case became fixtures on the real estate.

The Court, although relying on a doctrinal approach, also based its decision on equitable considerations. Unfortunately, those considerations were not articulated in detail. The Court merely stated, as its rebuttal to the claim that the prior mortgage attaches as soon as the property is acquired, that application of that doctrine “would often result in gross injustice” and that its intent was to “subserve the purposes of justice, and not injustice.” Implicit support for equitable underpinnings of the holding is also found in the deference to purchase money claims evident in the Court’s holding that the failure to record the purchase money mortgage was not important. The Court pointed out that recording was designed to protect subsequent rather than prior creditors. The Court rejected such a formalistic requirement which did nothing to further the equitable considerations on which its judgment rested. This is consistent with the anti-windfall policy in equity. If the prior creditor could not have relied on the property in extending credit, and if the subsequent creditor enabled the debtor to acquire the property by the extension of credit, requiring formalities like recording a mortgage would be no more than a technical barrier to the most deserving party.

To fully understand the basis for preferring the financing creditor over the preexisting after-acquired property creditor, it is necessary to discuss another basic common law doctrine, often referred to as the “derivation rule,” which governs the transfer of title and rights in property. The derivation rule states that a transferee derives all its rights in the property from its transferor and therefore

\footnotesize{51} Id. at 364-65.

\footnotesize{52} Id. at 365. This portion of the holding presents an interesting approach to priority issues. The Court is correct in holding that recording could not have helped the prior creditor. Presumably the non-recording mortgagee would lose to a subsequent creditor who would be prejudiced by not having notice of the mortgage on then existing property.

Contrast the Court’s approach in this case with the Code’s more mechanical and formal approach of requiring the filing—perfection—in order to have purchase money priority over the prior lender. Perhaps the Code is unduly conservative here in terms of achieving justice.

cannot obtain greater rights than the transferor had. This principle is closely related to the principle *nemo dat quod non habet* which had for so long precluded after-acquired property clauses. Like that principle, it is a principle of logic and not necessarily an inviolable rule of law. In comparison to the *nemo dat* principle, however, there are more compelling reasons to resist or limit departure from the derivation rule. If a transferee is to acquire more rights than the transferor had, it is obtaining rights held by someone else who likely does not have knowledge of the transfer. Thus, exceptions to this principle need stronger justifications.

The demise of the derivation rule as an absolute rule of law has taken place in a more piecemeal fashion. The Code recognizes several exceptions to the derivative title rule. In each exception, property acquires characteristics of negotiability. That is, transferees can acquire greater rights in the property than their transferors had in the property and thereby certain commercial transactions are facilitated. The negotiability exceptions are, however, still just exceptions to the basic rule and each requires the imprimatur of either the legislature or the courts.

Applying the derivation rule to purchase money financing permitted courts to give priority to a seller of property who had retained title as security over a prior creditor with an interest in after-acquired property. The buyer only obtained a limited interest subject to the seller's retention of title. The creditor with an interest in after-acquired property could therefore only obtain the interest the buyer obtained—an interest subordinate to the seller. To resolve the conflict by using a negotiability rule would have required an exception to the basic common law rule and an appropriate commercial justification. The courts, however, saw the commercial justifications as supporting the common law derivation rule.

The pattern set by the Supreme Court for after-acquired property and purchase money priority in the railroad industry was adapted for application in industrial finance. In industrial finance the af-

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54 See *Clark*, *supra* note 53, ¶ 3.08[4].
57 This article focuses on the rules developed under federal law. A New York rule developed consistent with the federal rule and a contrary Massachusetts rule developed which denied purchase money priority. The Massachusetts rule lost ground and was clearly rejected by subsequent statutory development. A summary of the development of these rules can be found in 2 *Gilmore*, *supra* note 28, §§ 28.1–7.
ter-acquired property of concern was frequently machinery and equipment attached to real estate. This situation implicated the common law relating to fixtures and the holding of Galveston Railroad. The law of fixtures made it easy to extend the real estate creditor's claim for protection to after-acquired property, but created a barrier for purchase money protection. Debtors were permitted, with limitations, to grant interests in property they would acquire in the future to secure their obligations, and subsequent secured creditors financing the acquisition of assets could acquire a prior interest in that asset as long as it did not become attached to real estate previously mortgaged.

Application of the purchase money priority concept to ordinary industrial financing eventually resulted in an expansion of the purchase money protection given to financiers of railroads forty-five years earlier. The Supreme Court addressed the fixture issue in industrial equipment financing in Holt v. Henley and found for the purchase money lender, significantly weakening the fixture exception to purchase money priority. In Holt the after-acquired property was an automatic sprinkler system in a knitting plant. The purchase agreement for the system, with its provision for the seller to retain title, was entered into before the property was mortgaged, but the installation did not occur until after the mortgage was executed. Although the prior mortgagee of the real estate had an interest in the system as a fixture, the Court gave priority to the purchase money claimant. The test articulated by the Court was similar to the test for determining whether property is a fixture—could the property be removed without affecting the integrity of the structure. The Court, however, did not resolve the dispute by using that test to determine whether the system was a fixture subject to the mortgage. Instead, the Court combined the structure test with the derivative title rule the Court had used to uphold the claim of the purchase money lender in the railroad financing cases. The Court explained its holding against the fixture claim by stating that giving priority merely because the sprinkler system had become a fixture would "give a mystic importance to attachment by bolts and screws".

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58 These developments are succinctly traced in 2 GILMORE, supra note 28, §§ 28.3-.4.
59 232 U.S. 637 (1914).
60 Id. at 638-39.
61 Id. at 641.
62 The Court stated:
The system was attached to the freehold, but it could be removed without any
The *Holt* Court also provided insight into the equitable considerations that favor purchase money. The Court stated that the prior mortgagees had "no equity" in the property and thus the interest was not worthy of protection. In other words, purchase money lenders have equity in the collateral by having facilitated its acquisition, whereas creditors claiming under an after-acquired property clause do not. Thus, a ruling favoring the creditor with "equity" in the collateral does not prejudice preexisting creditors. This lack of "equity" in the property may differentiate this case from railroad financing cases in which prior creditors made advances while relying on future additions to the collateral, but it is not an unusual circumstance in claims to fixtures by mortgagees other than construction mortgagees.

The Court in *Holt* granted priority to the purchase money security interest over a bankruptcy trustee despite the purchase money creditor's failure to register the retention of title. The collateral was located in Virginia which had a statute giving priority to purchasers for value without notice over unrecorded reservations of title. The Court was not troubled by the purchase money creditor's failure to register its interest or the lack of knowledge of the purchase money claim by the prior creditor. The Court held that the mortgagees could not be purchasers because the mortgage was executed before the sprinkler system was installed and no advance was made in reliance on the sprinkler system.

The Supreme Court in *Detroit Steel Cooperage Co. v. Sistersville Brewing Co.* virtually realized the potential for the purchase money rule articulated in *Holt* to swallow the fixture exception established in the railroad cases. The Court expanded purchase money protection to a financier of tanks that were essential to the operation of the brewery and could not be removed without serious harm for which complaint could be made against Holt, other than the loss of the system itself. Removal would not affect the integrity of the structure on which the mortgagees advanced. To hold that the mere fact of annexing the system to the freehold overrode the agreement that it should remain personality and still belong to Holt would be to give a mystic importance to attachment by bolts and screws . . . . We believe the better rule in a case like this . . . is that "the mortgagees take just such an interest in the property as the mortgagor acquired; no more no less."

*Id.* at 640-41 (quoting Fosdick v. Schall, 99 U.S. 235, 251 (1879)).

63 *Id.* at 641.

64 *Id.* at 638-39.

65 *Id.* at 640.

66 233 U.S. 712 (1914).
mantling part of the building. The test articulated by the Court was whether removal would "physically disintegrate the property." Under this test, little was left of the fixture exception to purchase money priority. Presumably, only the actual building materials could not be removed without disintegrating the property. The Court's holding relied strongly on the reservation of title doctrine. The Court was willing to allow few situations in which actions of the conditional vendee would be adequate to deprive the conditional vendor of its rights to the property. This shows great deference to the claims of the party whose credit enabled the debtor to obtain the property. The Court in essence required a significant equitable justification to give a creditor other than the purchase money creditor priority.

A key question following the development of the purchase money concept is what types of financing should be given purchase money status. It would be possible by careful technical structuring of any purchase money financing to come within the retained title rationale and thereby prevail over the preexisting creditor with rights to after-acquired property by applying the derivitive title rule. However, if the form of the purchase money transaction were changed so that a financing seller transferred title before taking a security interest or if a third-party lender advanced money and took an interest in the property as security, the priority issue could be resolved against the financier of after-acquired property. In both of these transactions, the prior creditor's springing interest probably attaches first so that under the derivation rule the purchase money financier's rights would be subject to the rights of the preexisting creditor.

If the purchase money concept only had as its support the literal application of time-honored legal doctrines, it would be a suspect legal concept. Legal doctrines applied in an equity vacuum are sterile at best and can produce unjust results. Common law doctrines

67 Id. at 717.

68 A proper structure would have the original owner sell by conditional sale and then transfer the rights to the financing party by assignment. A court could challenge such a transaction on appropriate facts by collapsing the steps to address the transaction's substance.

69 Compare Hughbanks, Inc. v. Gourley, 120 P.2d 523 (Wash. 1941) (conditional sale devise unavailable to finance company even though title passed from owner to finance company then to purchaser under the conditional sales contract) and cases cited therein with Tri-County Finance, Inc. v. Miller, 65 N.W.2d 39 (Wis. 1954) (conditional sale valid when title passed from owner to auctioneer then immediately to purchaser under a conditional sales contract) and cases cited therein.
arose out of the resolution of real disputes in attempts to achieve justice. The concept of justice may be lost if a doctrine is applied in situations too different from those in which it developed. Thus, to attempt comprehension of purchase money priority simply by looking at the demise of the nemo dat doctrine and application of the derivative title rule would be inadequate.

Purchase money protection for lenders was claimed in the early railroad financing cases. The Sixth Circuit confronted the issue in *Harris v. Youngstown Bridge Co.* when several subsequent mortgage holders claimed priority over the first mortgagee whose mortgage covered after-acquired property. The court extended the purchase money priority to lenders so long as the loaned funds were in fact used to supply the purchase money. The court based its decision upon the equitable considerations that ground the purchase money priority rule. The purchase money claimant, unlike the after-acquired property claimant, was a purchaser for value. The first mortgagee was not defrauded because the mortgagor had no obligation to acquire the property. Because the purchase money claimant's priority only extended to the actual purchase money portion of the obligation, the first mortgagee's lien on the equity—the value of the property exceeding the secured purchase price—remained. The first mortgagee maintained priority under the law of fixtures to goods attached to realty.

The early cases enforcing after-acquired property clauses and establishing purchase money priority, particularly those before the Supreme Court, have several important implications. First, the purchase money concept by its nature was designed to address the issue of priority of interests in property. Second, the Court not only found a sound doctrinal basis for its decision on purchase money priority, but expressed concern for reaching an equitable resolution. The cases treat the purchase money party as a creditor with equity on its side. While treating fixtures as an exception to the purchase money priority demonstrated an attempt to give deference to the reasonable expectations of the prior secured party, the demise of that exception resulted from the recognition that equity favors the purchase money creditor facilitating acquisition of the collateral. Third, the lack of concern with recording the purchase money
mortgage indicates a preference for substance rather than form in resolving these matters.

The equitable content in the purchase money concept also arises out of the recognition of after-acquired property as security. This has been articulated as the anti-windfall policy discouraging unjust enrichment,\(^75\) which relies for its substance on the purchase money creditor giving new value.\(^76\) Giving priority to the claimant under an after-acquired property clause who had neither facilitated acquisition of the collateral nor specifically relied on its existence would be giving that claimant a "windfall." This would come at the expense of the party who financed acquisition of the asset and relies on it as security. A similar problem can be described from the debtor's perspective to justify purchase money priority. Such priority prevents the first creditor from obtaining a monopoly on financing.\(^77\) So long as the first creditor can claim after-acquired property, no subsequent lender could provide secured financing and obtain priority. The debtor would then be at the mercy of the prior lender regarding rates and even the availability of financing.

3. Purchase Money Priority and Inventory

The expansion of purchase money priority was arrested when creditors attempted to obtain after-acquired inventory as security. Inventory by its nature is continually sold and replenished. Obtaining a security interest in such a changing body of goods required either regular new documentation or liens on after-acquired property. While the reasons courts permitted liens on after-acquired property in railroad and industrial equipment financing were

\(^{75}\) See 2 GILMORE, supra note 28, § 29.1; Beard, supra note 12, at 480-84; Lloyd, supra note 21, at 37; Robert S. Summers, General Equitable Principles Under Section 1-103 of the Uniform Commercial Code, 72 NW. U. L. REV. 906, 920-23 (1978).

\(^{76}\) New value is used here not merely as present consideration, but also as a transfer of tangible assets to the debtor as a result of the value. It is essentially the concept embodied in U.C.C. § 9-107 and explained in Comment 2 to that section.

\(^{77}\) See, e.g., JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 26-5 (3d ed. 1988). White and Summers posit three justifications for purchase money priority in the Code: it was available under pre-Code law; the seller should not have to search to assure priority to goods it owns and is selling on secured credit; and the protection the debtor needs from a creditor who has previously filed and is unwilling to provide additional financing. White and Summers conclude that the latter justification is the most persuasive.
roughly analogous, inventory implicated another legal doctrine. For the inventory to be of any value, the debtor had to have the right to sell it. That dominion and control was inconsistent with the prevailing theory that a mortgage was a sale subject to defeasance. The barriers this time were more perplexing.

The court in Zartman v. First National Bank of Waterloo clearly articulated the concerns relating to security interests in inventory.\(^7\) Zartman involved a mortgage with an after-acquired property clause purporting to cover machinery, equipment and inventory. The validity of the lien on the machinery and equipment was not an issue. However, the lien on the inventory did not automatically arise when the property was acquired because the debtor’s rights prior to default amounted “practically, to absolute ownership, and hence the mortgage cannot operate as a lien upon such earnings to the prejudice of the general creditors until actual entry and possession taken.”\(^9\) This quote illustrates that the court had two concerns with such mortgages: adhering to the doctrinal concept of a mortgage as title subject to defeasance and permitting liens on the most likely source of recovery for general creditors.

The Zartman court extensively discussed the second concern. Enforcing the lien on after-acquired inventory would prejudice creditors and thus would be beyond the powers of equity.\(^8\) Concern with leaving an unencumbered pool of assets to protect general creditors has bubbled beneath the surface in much of the case law surrounding judicial reluctance to accept security interests in personal property.\(^8\) In fact, the discussion in Zartman may be a more explicit statement of a largely unarticulated policy underlying the historical application of the fraudulent conveyance doctrine to transfers of property as security.\(^8\) The apparent problem was that liens on inventory and accounts receivable could have precluded

\(^7\) 82 N.E. 127 (N.Y. 1907), aff’d 96 N.Y.S. 633 (App. Div. 1905).
\(^8\) Id. at 128 (quoting N.Y. Sec. & Trust Co. v. Saratoga Gas & Elec. Co., 53 N.E. 758, 759 (N.Y. 1899)).
\(^9\) Id. See U.C.C. § 9-204 cmt. 2.
\(^8\) The early cases, on their face, were concerned with whether a mortgage of personal property without the mortgagee obtaining possession was a fraudulent transfer. E.g., Sturtevant v. Ballard, 9 Johns. 337 (N.Y. Sup. Ct. 1812); Clow v. Woods, 5 Serg. & Rawle 275 (Pa. 1819); Davis v. Turner, 45 Va. (4 Gratt.) 422 (1848). However, the personal property consisted of tools of the trade or work in progress and often was not capable of possession by the creditor. The opinions on close analysis seem to establish little more than hostility to privately negotiated security interests. If the true concern were the separation of possession and ownership as the opinions purported, any lease transaction would have been equally fraudulent. However, that was not the state of the
any assets from being available to general creditors. The Zartman court considered these creditors to have “superior equities,” without adequately articulating the reason for such characterization. However, the court did give two glimpses of these “superior equities.” First, the court opined that the general creditors relied on the availability of the assets when they extended credit. Second, it stated that the general creditors directly or indirectly furnished the inventory. The latter is an assumption that general creditors, who had furnished the inventory, provided the “purchase money” and thereby had a superior equity.

This purchase money assumption reinforces the theory that reluctance by courts to enforce after-acquired property clauses covering inventory has no bearing on whether to accept purchase money priority for inventory. It is simply a question of whether courts are comfortable with contractual arrangements for after-acquired property that leave nothing for unsecured general creditors. General unsecured creditors do not care which secured creditor ultimately prevails.

The concern with dominion and control constitutes a significant difference in the way inventory was perceived prior to the Code. While other interests in after-acquired property sprang into existence upon acquisition, inventory required the additional step of establishing dominion and control. Although this requirement stems from the conception of a mortgage as a sale subject to defeasance, it was not so strict as to preclude all security interests in inventory. The concern with dominion and control being inconsistent with a mortgage focused more on control of proceeds from the sale than on the goods themselves. This is succinctly illustrated by

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83 The court stated:

[Equity] will not treat a contract to give a mortgage upon a subject to come into existence in the future as a mortgage actually then given, if the result would deprive the general creditors with superior equities so far as after-acquired property is concerned, of their only chance to collect debts. It is only when the rights of third parties will not be prejudiced that equity, treating as done that which was agreed to be done, will turn a contract to give a mortgage on property to be acquired into an equitable mortgage on such property as fast as it is acquired and enforce the same accordingly against the mortgagor, his representatives and assigns.

Zartman, 82 N.E. at 128 (emphasis added).

84 Id.

85 Id.

86 See supra text accompanying notes 35-36.
the Supreme Court's description of the doctrine in *Benedict v. Ratner*, an opinion not concerned with inventory as collateral. The Court explained that the ability of the mortgagor to sell chattels is not sufficient to make the transaction fraudulent, so long as the mortgagee retains control over the application of the proceeds of the sale. The Court contrasted the problem of lack of possession of a chattel by the mortgagee, a presumptively fraudulent transaction, with retention of dominion and control over collateral inconsistent with a lien, a conclusively fraudulent transaction.

Concerns with dominion and control over inventory collateral and the elimination of an important source of property for unsecured creditors resulted in security interests in inventory only being available under specialized procedures or statutes such as the field warehouse, the trust receipt or factoring arrangements. These devices provided enough dominion and control over the inventory to satisfy the courts. While the trust receipt and the field warehouse were very similar in some ways to purchase money security interests and could arguably be used by the truly sophisticated lender to obtain a lien on after-acquired inventory, they did not coexist with other security interests. Thus, the priority issue which the purchase money concept is designed to resolve did not arise. Without a readily available way to obtain a nonpurchase money security interest in after-acquired inventory, there was no need for the concept of purchase money priority for inventory.

**B. The Purchase Money Concept in the Code**

Drafting laws is never done in a vacuum. Drafters' perceptions...
of relevant issues and appropriate resolutions are always colored by existing case law. The drafters of Article 9 rationalized a patchwork of security devices that had developed both legislatively and judicially. The drafters not only looked to pre-Code law to determine what issues to address, but also borrowed concepts governing one security device that would rationalize the law under another security device or that would resolve issues raised by any liberalization considered for that law. Addressing issues that have not previously been litigated is much more uncertain. These issues may never get raised in the drafting process. If they are raised, the resolution may be either overly simple or unduly complex due to the lack of pertinent case law to provide guidance.

1. Pre-Code Parameters of Purchase Money Status

Issues addressed prior to the adoption of the Code are instructive in understanding why the drafters chose the purchase money rules they did and why they did not address the current problem with purchase money security interests in inventory. Once many types of after-acquired property were available to lenders as collateral, and purchase money priority was established as a limitation on the rights of a creditor claiming under after-acquired property clauses, the legislatures and the courts tackled the task of determining the scope and contours of the purchase money exception to priority based on time. The pre-Code issues most relevant to our inquiry fall under three rubrics: first, protecting the legitimate expectations of prior creditors with a right to after-acquired property from claims of purchase money priority; second, determining the extent to which third party lenders, in addition to sellers, could qualify for purchase money status or a close equivalent; and third, determining what obligations could be legitimately secured by a purchase money security interest or its equivalent.

To analyze the issue of protecting the legitimate expectations of prior secured creditors claiming the property, consider a debtor who gives both a mortgage to finance construction and a purchase money mortgage of chattels that become fixtures. The construction mortgagee intends to finance acquisition of the construction

95 See generally 1 Gilmore, supra note 28, §§ 3.2-.3; Gilmore, Purchase Money, supra note 94, at 1358-69.
96 See infra text accompanying notes 99-103.
97 See infra text accompanying notes 104-08.
98 See infra text accompanying notes 109-18.
99 The Sixth Circuit discussed this situation as being different than merely claiming
materials and fixtures attached to the new structure and to have a first claim of right to it as collateral. Under the purchase money concept, a third party could finance the fixtures, retain title, and have prior rights to the chattel, provided the fixtures had not lost their identity in the structure. Because each of the parties intends to finance the acquisition of the property, equitable considerations support both. The dispute could be resolved doctrinally by reducing the issue to which party actually financed the fixture. That resolution, however, ignores the expectations of the prior construction lender. It also ignores that the purchase money lender knows that the construction of the property on which the goods will become fixtures is being financed.

Even though construction lenders frequently won these priority battles, the rationales varied greatly. Should the law of fixtures govern, giving priority to the mortgagee's claim to fixtures as after-acquired property, or should the purchase money rule govern, permitting the fixture financier to win? Section 7 of the Uniform Conditional Sales Act addressed that question and established the following test to defeat a purchase money claim: Would removal cause a "material injury" to the freehold? The material injury test is flexible enough to lend itself to almost any interpretation. The majority rule developed by the courts interpreting that provision, however, was essentially the same rule as previously articulated in the Detroit Steel case. The purchase money claimant won unless the personal property became part of the actual building materials. The balance struck by the courts was a liberal reading of the Uniform Conditional Sales Act that gave greater protection to the

under an after-acquired property clause as a way to obtain more security in its opinion in Harris v. Youngstown Bridge Co., 90 F. 322, 329-30 (6th Cir. 1898).

100 See, e.g., id. (no priority for prior mortgagee, if mortgagor's obligations to complete construction had been satisfied); Dauch v. Ginsburg, 6 P.2d 952 (Cal. 1931) (no removal of fixtures by conditional seller if it will substantially injure or diminish the security of the prior construction lender); Waverley Co-op. Bank v. Haner, 173 N.E. 699 (Mass. 1930) (conditional seller of fixtures attached during construction lost because court construed statute authorizing recording of conditional sales to give rights against subsequent not prior parties); Future Building & Loan Ass'n v. Mazzocchi, 152 A. 776, 778 (N.J. Eq. 1931) (removal of appliances annexed to an apartment house during construction without mortgagee's assent would materially injure the institution of the structure, so conditional sales contract is void against the mortgagee); Greene v. Elkins, 235 N.Y.S. 438 (Sup. Ct. 1929) (construction mortgagee needs actual notice of conditional sale of fixture to be subject to conditional sale).


102 These developments are described in 2 GILMORE, supra note 28, §§ 28.5-.6.
purchase money lender. Both courts and legislatures showed deference to purchase money status when resolving this issue of priority.

Another example of the legitimate expectations of the prior creditor arises when essential equipment is replaced. A problem arises when the mortgagee is relying on the fully operational property that was in existence at the time the property was mortgaged to secure its loan, and the mortgagor then replaces the equipment with new equipment or new fixtures financed with a purchase money claim to the replacements. Courts struggled in these situations to determine the most equitable resolution. Although the expectations of the parties in these disputes were determinable, the situations did not lend themselves to clear solutions. The courts' struggle with the issue of replaced equipment is strong evidence of the concern with developing equitable rather than doctrinal rules. Concern with the expectations of prior parties found a more consistent resolution in contests between fixture financiers and construction lenders as the expectations were easier to infer and the solutions were more readily apparent.

The second issue—whether a third-party lender, as well as a seller, could obtain purchase money protection—was resolved in favor of the lender in early railroad financing cases. Later cases presenting a similar issue involved disputes over whether a third-party lender could obtain the same protection as a seller under a conditional sales contract. One of the early statutory exceptions to the common law rules prohibiting nonpossessory security interests in personal property was the conditional sales contract. Courts did not accept claims to conditional sale protection by lenders without clear adherence to acceptable formalities of the conditional sale. Either the third-party lender had to become the owner by

103 See, e.g., Woodliff v. Citizen's Bldg. & Realty Co., 215 N.W. 343 (Mich. 1927) (conditional seller could remove a replacement elevator from a seven-story apartment building when the buyer and the conditional vendor had not intended it to be a fixture, because it appeared the old elevator was not being used when replaced); Roche v. Thurber, 285 N.Y.S. 82 (App. Div.) (the lien of a conditional vendor of a heating plant sold to replace a removed heating plant was subordinate to a preexisting mortgage absent a showing that the removed heating plant was not operational), aff'd mem., 4 N.E.2d 814 (N.Y. 1936).

104 See supra notes 70-76 and accompanying text.

105 See, e.g., 1 Gilmore, supra note 28, § 3.2.

106 Compare Commercial Sec. Corp. Consol. v. Lindsay Mercantile Co., 267 P. 766 (Cal. Ct. App. 1928) (buyer's transfer of title to lender prior to lender's transfer of title back to buyer was not a conditional sale) and Manlove v. Maggart, 41 N.E.2d 633 (Ind. App. 1942) (no replevin by lender under a conditional sales contract, as the lender never had title) and Hughbanks, Inc. v. Gourley, 120 P.2d 523 (Wash. 1941) (court refused to
acquiring the property from a third party and then selling it to the financed buyer, or the seller had to assign the conditional sales contract to the lender. A sale from the borrower to the lender to be immediately leased back to the borrower was an attempted manipulation which met virtually universal rejection by the courts.  

Conditional sales by their nature are purchase money transactions. While the pre-Code cases addressing whether lenders could rely on conditional sales law did not involve purchase money security interests explicitly, we have seen that the purchase money concept developed out of conditional sales transactions and that title retention became a basis for finding purchase money priority.  

The policies implicated in conditional sales disputes, however, were significantly different than those relating to purchase money priority disputes. Because conditional sales were a statutory exception to the judicial hostility toward nonpossessory security interests, the judicial approach was more likely to involve strict construction. In contrast, purchase money status had been a judicial development to achieve fairness and equity and to blunt the impact of enforcing after-acquired property interests.

The third issue—what obligations could be secured—is most relevant to purchase money financing of inventory. The issue was addressed in disputes over conditional sales contracts rather than purchase money priority. The question generally asked was what types of obligations beyond the purchase price could be secured without transforming a conditional sale into a chattel mortgage. If the transaction was treated as a chattel mortgage, compliance with a different set of formalities was required and the claimant generally had not complied.

Two general approaches developed. The minority approach is illustrated by Bucyrus-Erie Co. v. Casey, a case involving a secured claim which would not have survived a common law challenge in Pennsylvania at the time. The creditor attempted to save its claim

find a conditional sale where vendor transferred title to lender who then sold to buyer on conditional sale) with Webster Hall Corp. v. Continental Bank & Trust Co., 66 F.2d 558 (3d Cir. 1933) (title transferred from seller to lender then to buyer reserving title as security was valid) and Tri-County Finance v. Miller, 65 N.W.2d 39 (Wis. 1954) (lender managing an auction could be the "seller" under a conditional sales contract).

107 1 GILMORE, supra note 28, § 3.3.

108 See supra text accompanying notes 49, 60 and 66.

109 61 F.2d 473 (3d Cir. 1932) (the secured creditor attempted to retain title to excavating machines against a receiver to secure payment of repairs to the machines and indebtedness on open account); see also Ittleson v. Hagan, 222 N.W. 145, 145 (Mich. 1928).
by relying on the broad language in the Pennsylvania Conditional Sales Act that permitted title to be retained until "the performance of any other condition or the happening of any contingency." The court refused to construe the broad statutory language to encompass any obligation beyond those conditions "incidental to such [conditional] sale," noting that such a construction would extend the conditional sale concept to one that provides security for "the unconditional purchase of other articles in the future." The Bucyrus-Erie court upheld the conditional sale as to the unpaid portion of the purchase price, but invalidated it for the unrelated obligations. A majority of courts were more liberal and permitted the conditional sale device to secure a wider range of obligations. Those courts permitted the conditional sales contract to secure sums that arose in the future or were indirectly related to the purchase price.

Litigation related to what obligations could be secured by conditional sales contracts does not appear to have arisen in consumer transactions involving a so-called add-on clause. These transactions permit the addition of subsequent purchases while the creditor retains title to the goods acquired in earlier and later purchases until all obligations are paid. This lack of cases presents an interesting contrast to post-Code case law governing purchase money security interests. The add-on clause is the standard fact pattern from which the transformation rule and the dual status rule developed. Add-on clauses generally have not been viewed favorably by courts and legislatures. It was an add-on transaction that provided the

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111 Id. § 361.
112 Bucyrus-Erie, 61 F.2d at 474.
113 Id.
115 See, e.g., Braden v. Bucyrus-Erie Co. (In re Halferty), 136 F.2d 640, 644 (7th Cir. 1943) (still a conditional sale even though the contract secured sums to become due in the future); Cloud Oak Flooring Co. v. J.A. Riggs Tractor Co., 266 S.W.2d 284, 287 (Ark. 1954) (valid conditional sale even with security for repairs and deferred installment payments).
116 The author was unable to find a pre-Code case addressing the question. William E. Hogan, in his article A Survey of State Retail Installment Sales Legislation, 44 CORNELL L.Q. 38, 53-55 (1958), suggests that such clauses may not survive challenges to their status as conditional sales. However, the authorities he cites do not involve add-on clauses.
117 See infra text accompanying note 222.
District of Columbia Court of Appeals the opportunity in *Williams v. Walker-Thomas Furniture Co.* \(^{118}\) to find a pre-Code common law right to avoid an unconscionable contract. Statutes also regulated add-on clauses prior to the enactment of the Code. \(^{119}\) That add-on cases were not challenged in the courts as defeating conditional sales status may be significant. The lack of pre-Code cases may simply manifest that nothing in the nature of an add-on clause is inconsistent with the basis for a conditional sale \(^{120}\)—the retention of title by a seller and equity favoring the creditor financing the acquisition—and that abuses could be dealt with more directly by the legislature. \(^{121}\)

Legislative deference to purchase money priority is also evidenced in section 7 of the Uniform Conditional Sales Act. The filing requirements placed upon the conditional seller to protect other real estate creditors applied only to subsequent purchasers and creditors. \(^{122}\) Prior creditors were subject to the rights of the purchase money interest—the conditional sale—even without filing. \(^{123}\) Because the seller retained title, that rule established the equivalent of purchase money priority. Filing requirements under other sections of the Uniform Conditional Sales Act, \(^{124}\) however, were not limited to protection from subsequent claimants.

2. *The Code’s Approach to Purchase Money Priority*

From our selective review of pre-Code law, we would expect the

\(^{118}\) 350 F.2d 445 (D.C. Cir. 1965).


\(^{120}\) Grant Gilmore concludes that the use of add-on clauses had not been held to be invalid under conditional sales laws. 1 GILMORE, *supra* note 28, § 3.3.

\(^{121}\) This was the approach espoused by the dissent in *Williams*, 350 F.2d at 450.

\(^{122}\) Section 7 of the Uniform Conditional Sales Act provided in pertinent part:

> The reservation of property shall be void after the goods are so affixed as against subsequent purchasers of the realty for value and without notice of the conditional seller's title, unless the conditional sale contract, or a copy thereof, together with a statement signed by the seller briefly describing the realty and stating that the goods are or are to be affixed thereto, shall be filed before such purchase in the office where a deed of the realty would be recorded or registered to affect such realty.


\(^{123}\) See 2 GILMORE, *supra* note 28, § 28.5.

\(^{124}\) UNIF. CONDITIONAL SALES ACT §§ 5, 6, 2 U.L.A. 6, 9-10 (1922) (act withdrawn 1943) established filing requirements before the conditional sale would be valid. The courts generally do not appear to have required filing to protect against prior creditors when the goods became fixtures. See 2 GILMORE *supra* note 28, § 28.5.
drafters of Article 9 to address after-acquired property and to include purchase money priority as a counterbalance. In that interrelationship, we would expect balancing legitimate expectations of prior creditors to play a role to the extent the expectations are readily determinable and could be expected to be widely held. We would expect the drafters to resolve the nature of access to purchase money status by third-party lenders as compared to sellers. In that same vein we would anticipate rules relating to which obligations could be secured by purchase money interests. On the other hand, subsequent events changing the purchase money status were not an issue that had significance before adoption of the Code. The closest analogy, conditional sales treatment of purchases under add-on clauses, had not been addressed by the courts. Although Grant Gilmore made passing note of it in his treatise *Security Interests in Personal Property* written shortly after the Code was promulgated, it did not appear to generate much concern.

When the drafters of the Code confronted the issue of liens on after-acquired property, they chose a broad enabling provision that validated almost all after-acquired property provisions. This essentially unrestricted ability of a secured party to obtain a security interest in property the debtor would acquire in the future, including inventory, was one of the most controversial innovations of Article 9. Before the Code, secured lending in inventory was available in the commercial world only through highly technical devices. The Code for the first time enabled any creditor to engage in commercially feasible nonpurchase money lending against inventory.

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125 See *supra* text accompanying notes 120-21.
126 See 1 *GILMORE*, *supra* note 28, § 3.3.
127 U.C.C. § 9-204(1) provides in pertinent part: “[A] security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral.” The sole limitation relates to consumer goods. To serve as additional collateral, such after-acquired consumer goods must be acquired within 10 days after the secured party gives value. U.C.C. § 9-204(2).

These provisions are different in wording, but not intent, from the 1962 version of the Code. See U.C.C. § 9-204, Reasons for 1972 Change (1972). The 1962 Code did have one other exception relating to crops which was eliminated in the 1972 version.
128 See 1 *GILMORE*, *supra* note 28, § 11.7; *Beard*, *supra* note 12, at 440.
130 Professor Gilmore’s characterization of factoring as nonpurchase money inventory lending would be an exception to this. See *supra* note 93. Factoring, however, was not widely available as a security device. See 2 *GILMORE*, *supra* note 28, § 5.5.
The drafters also opted for a rule governing most priority disputes between creditors claiming security interests which was far-reaching and had a high degree of certainty: Priority goes to the first secured creditor to file or perfect.\footnote{Under U.C.C. § 9-312(5)(a), priority among competing security interests dates from the earlier of the time of filing or perfection. Because of this rule, a filing predating the creation of a security interest can afford that later interest priority. In fact, U.C.C. § 9-402(2) expressly contemplates filings predating the making of a security agreement. These rules would permit creditors with prior filings to obtain priority over a creditor retaining a security interest in the property before it is transferred to the debtor if it was not for purchase money priority. Although U.C.C. § 9-312(5) provides that it applies only if another subsection of 9-312 does not and § 9-312 provides that it is to be applied only if there is no other applicable priority rule, § 9-312(5) is the priority rule governing most disputes between Article 9 security interests. See U.C.C. § 5-312 cmt. 4.} Under this rule, a creditor can file and establish its date for priority purposes before the creditor gives value or even before the debtor agrees to grant a security interest.\footnote{Under U.C.C. § 9-303(1), perfection cannot occur until the security interest has attached. Under U.C.C. § 9-203(1), attachment does not occur until the debtor has rights in the property and the creditor has given value. Thus, priority usually dates from an earlier date of filing. This will be the case in virtually all claims by secured parties with perfected security interests in after-acquired property.} The drafters made the priority rule even more powerful and far-reaching by including future advances\footnote{U.C.C. § 9-204(3) permits a security agreement to cover future advances whether or not they are to be made pursuant to a commitment.} in the obligations entitled to that priority. Section 9-312(7) gives the same priority to all future advances that the first advance obtains as long as the interest is perfected by filing.\footnote{U.C.C. § 9-312(7) provides in pertinent part: If future advances are made while a security interest is perfected by filing, ... the security interest has the same priority for the purposes of subsection (5) with respect to the future advances as it does with respect to the first advance. If a commitment is made before or while the security interest is so perfected, the security interest has the same priority with respect to advances made pursuant thereto.} Any subsequent creditor must assume that the obligations secured by the collateral described in the financing statement equal or exceed the value of the collateral regardless of the current size of the obligation since a prior creditor could give future advances. The right to after-acquired property as collateral and the right to make future advances, combined with the priority rule, enables a creditor who files a financing statement to obtain priority over all creditors filing or perfecting subsequently regardless of when credit is given by the first creditor. Thus, unless some balancing principles are established, the first creditor to file
would have a monopoly on providing credit to the debtor secured by that collateral.

One made-to-order principle emerged from pre-Code experience. Purchase money security interests had been granted priority as pre-Code courts counterbalanced security interests in after-acquired property.\textsuperscript{135} Hand in hand with the broad rights to after-acquired property as collateral, the drafters of the Code included broad priority protection for subsequent purchase money lenders. The Code provides that a purchase money security interest will take priority over prior security interests.\textsuperscript{136} In a priority battle with lien creditors or transferees in bulk, a purchase money security interest perfected before ten days after the debtor receives possession of the collateral will have priority.\textsuperscript{137} Further, purchase money financiers of fixtures can obtain priority over persons with a preexisting interest in real estate by complying with the fixture filing requirements.\textsuperscript{138} Purchase money security interests receive no special treatment in priority contests with purchasers of collateral.\textsuperscript{139}

The Code’s purchase money priority provisions are in one way more restrictive than pre-Code law. Neither the pre-Code courts\textsuperscript{140} nor the pre-Code legislatures\textsuperscript{141} felt compelled to subject purchase money security interests to the filing requirements for priority over existing creditors since filing does not benefit them.\textsuperscript{142} The Code is much more formalistic and requires the purchase money party to perfect the security interest within a limited period of time.\textsuperscript{143}

\textsuperscript{135}See supra text accompanying notes 47-77.
\textsuperscript{136}U.C.C. § 9-312(3) provides in pertinent part: “A perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory and also has priority in identifiable cash proceeds received on or before the delivery of the inventory to a buyer . . . .”
\textsuperscript{137}U.C.C. § 9-312(4) provides in pertinent part: “A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral or its proceeds . . . .”
\textsuperscript{138}U.C.C. § 9-301(2).
\textsuperscript{139}U.C.C. § 9-306(2) subjects purchasers to prior security interests unless the secured party authorizes the sale. A significant exception is for buyers in the ordinary course of business who take free of the security interest under U.C.C. § 9-307(1).
\textsuperscript{140}See supra note 52 and accompanying text.
\textsuperscript{141}See supra notes 122-24 and accompanying text.
\textsuperscript{142}Timely filing is irrelevant to creditors whose interests already exist because they are not in a position to change their situation by knowing of the filing. This was articulated by the Supreme Court in United States v. New Orleans Railroad, 79 U.S. (12 Wall.) 362 (1870).
\textsuperscript{143}For all collateral other than inventory, the purchase money priority between secured creditors is conditioned upon perfection before 10 days after the debtor obtains
perfection requirement limits the availability of purchase money priority under the Code. The perfection requirement appears to have other purposes than notice to the affected creditors. One reason for this may be that the Code's priority rules for purchase money security interests are not divided into separate rules for prior creditors and subsequent creditors. Under any scheme protecting subsequent creditors, some principle must give notoriety to the prior security interest so the subsequent creditors can obtain knowledge of the security interest. Filing is the Code's primary notoriety principle.

An examination of the limited circumstances under the Code when purchase money priority will play a role illuminates the close relationship between after-acquired property and purchase money priority. Purchase money priority is only important if the purchase money security interest would not be entitled to priority in its own right under other priority rules. Priority between Article 9 security interests is generally based on the first to file or perfect rule. Because attachment of a security interest is a precondition to perfection,¹⁴⁴ few if any creditors' security interests are perfected before a purchase money creditor's security interest.¹⁴⁵ For another creditor possession of the collateral. U.C.C. § 9-312(4). For inventory collateral, perfection must occur at or prior to the time the debtor receives possession of the inventory. U.C.C. § 9-312(3)(a). For priority disputes between a purchase money security interest and a lien creditor, perfection must occur before or within 10 days after possession by the debtor for all types of collateral. U.C.C. § 9-301(2). Purchase money priority of a security interest in fixtures over prior owners or encumbrancers of the real estate also requires filing a fixture filing before or within 10 days after the goods become fixtures. U.C.C. § 9-313(4)(a).

U.C.C. § 9-301(2) establishes filing as the normal means of perfection. The next most widely used method of perfection is possession. U.C.C. §§ 9-304, 9-305. Perfection by possession makes little sense in purchase money financings, as the equipment or inventory being acquired is of little use to the debtor without a right to possession.¹⁴⁴ U.C.C. § 9-303(1).

¹⁴⁵ Attachment cannot occur until the debtor gets rights in the property. U.C.C. § 9-203(1). The debtor obtains rights in the property as a result of the purchase money transaction and as part of the transaction where the purchase money creditor has given value.

Delaying the creation of the security interest until after the debtor has taken possession probably precludes purchase money status for third-party lenders because a court may construe the debt to be incurred to pay a preexisting indebtedness rather than the purchase price. E.g., North Platte State Bank v. Production Credit Ass'n, 200 N.W.2d 1 (Neb. 1972) (lender did not obtain purchase money security interest when advance went to pay seller after debtor had rights in the property). But see 2 GILMORE, supra note 28, § 29.2. This rationale, however, should not defeat purchase money status for a seller who could acquire the security interest later and still be securing payment of the purchase price. E.g., In re Robertson, 6 U.C.C. Rep. Serv. (Callaghan) 266 (Bankr.
to prevail, the purchase money creditor must be slow in taking the step beyond attachment that establishes perfection.\footnote{Although there is no strong policy to favor creditors who are dilatory in perfecting, the Code does provide a 10 day grace period for purchase money creditors claiming collateral other than inventory. U.C.C. § 9-312(4). Perhaps this grace period is a concession to the Code requirement of perfection before purchase money priority is available.} Thus, only rarely would a purchase money security interest lose as the first to perfect. The Code has given purchase money secured creditors in this situation a ten day grace period to perfect and still qualify for priority.\footnote{U.C.C. § 9-312(4) gives a purchase money creditor 10 days to perfect after the debtor gets possession and still qualify for the purchase money priority over creditors otherwise entitled to priority. Purchase money security interests in inventory, however, do not get the benefit of this 10 day grace period when competing with other security interests. U.C.C. § 9-312(3)(a) requires perfection before the debtor gets possession of the collateral.} It is the first to file aspect of the rule that places a purchase money creditor at a disadvantage. A creditor filing earlier could either enter into a security agreement and give value after the purchase money transaction and obtain priority\footnote{Under these limited circumstances, the creditor who files first claims the collateral without resort to a right to after-acquired property.} or give value and receive an interest in after-acquired property before the purchase money transaction and obtain priority. The special priority rules for purchase money security interests thus counterbalance two expansive rights created by the Code: the right to after-acquired property and the right to file prior to creating a security interest.

The other purchase money priority rule affecting inventory provides little advantage not otherwise available to a perfected secured creditor. Secured creditors have priority if they are perfected before a bulk sale or before a person becomes a lien creditor.\footnote{U.C.C. § 9-301(1)(b), (c).} A person becomes a lien creditor by attachment, levy, or the like.\footnote{U.C.C. § 9-301(3).} Similarly, bulk sales do not cover property in which the seller has no rights. Because purchase money creditors obtain their security interests at the time the debtor gets rights in the collateral,\footnote{See supra note 145.} such creditors will have priority if they perfect at or before that time. The Code favors purchase money secured parties in these priority contests by granting a ten day grace period for perfecting that is not available to other creditors.\footnote{U.C.C. § 9-301(2).}
small concession compared with the necessity to file a financing statement at all.

Priority for security interests in fixtures under Article 9 is governed by a first to perfect rule rather than a first to file or perfect rule.\textsuperscript{153} Purchase money status is limited to establishing priority over interests in real estate arising before the good becomes a fixture.\textsuperscript{154} Prior to that time, no interest in the fixture arises under real estate law.\textsuperscript{155} Real estate interests in fixtures are analogous to claims to after-acquired property.\textsuperscript{156} Purchase money priorities for fixtures only need to counterbalance the right to after-acquired property. Inventory by its nature will not be a fixture.

The lack of pre-Code experience with purchase money security interests in inventory\textsuperscript{157} left the drafters a clean slate upon which to establish the legal ground rules governing that priority. It also left them with only a crystal ball to ascertain what issues would become relevant. In fact, when the drafters of the Code provided the framework for purchase money priority in inventory to counterbalance the security interests in after-acquired inventory and liberal priority rules based on filing they created, some doubted whether the concept would ever become a commercial reality.\textsuperscript{158} Despite such doubts, purchase money financing of inventory has become a multi-billion dollar commercial practice.\textsuperscript{159}

The drafters of the Code followed the extensive pre-Code case

\textsuperscript{153} U.C.C. § 9-313(4)(b) requires perfection by a fixture filing prior to the recording of a real estate interest.

\textsuperscript{154} U.C.C. § 9-313(4)(a) gives the purchase money fixture financier 10 days to perfect and still qualify for this priority. The fixture financier, however, does not receive priority over a real estate interest arising between the time the good becomes a fixture and the time the fixture filing is made. \textit{Id.} Neither U.C.C. § 9-313(4)(a) nor § 9-313(4)(b) provides priority in these circumstances. Priority goes to the real estate claimant under U.C.C. § 9-313(7).

\textsuperscript{155} U.C.C. § 9-313(1)(a) defines fixture as a good which becomes related to real estate in such a way that an interest in it arises under real estate law.

\textsuperscript{156} See \textit{supra} text accompanying notes 31-32.

\textsuperscript{157} Obtaining security interests in after-acquired inventory before the Code was difficult and consequently was not a common commercial practice. 2 GILMORE, \textit{supra} note 28, § 29.3.

\textsuperscript{158} See the comments of Grant Gilmore, one of the Code's drafters, in 2 GILMORE, \textit{supra} note 28, § 29.3.

\textsuperscript{159} In 1984, a single finance company reported more than $5,300,000,000 in outstanding purchase money credit. Hansford, \textit{supra} note 11, at 235 (discussing Affidavit of George V. Burbach, Associate Counsel, Ford Motor Credit Company, Petition for Rehearing by Panel and Suggestion for Rehearing En Banc, Southtrust Bank Nat'l Ass'n v. Borg-Warner Acceptance Corp., 760 F.2d 1240 (11th Cir.) (No. 84-7396), reh'g denied en banc, 774 F.2d 1179 (11th Cir. 1985)); see also Beard, \textit{supra} note 12, at 437-38.
law governing purchase money security interests in other collateral, but distinguished inventory in a number of respects. Notification to prior creditors is required to obtain priority. In addition, the ten-day grace period was not allowed for purchase money financiers of inventory. The drafters recognized that the new rights to after-acquired inventory would create inferable expectations.

The first of these expectations is that some after-acquired inventory lenders may make future advances in reliance on the level of inventory maintained by the debtor; such lenders will expect to have first priority to the inventory. This first expectation has one concern that had not developed in the commercial world except in the context of fixtures. The drafters were cognizant of this expectation when they required the purchase money lender to notify prior secured parties. The lack of a ten-day grace period for perfection

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161 U.C.C. § 9-312(3) requires the party asserting purchase money priority over earlier perfected security interests to give notice to those interests. The concept was refined in the 1972 version of the Code. See infra note 190. The 1972 revisions required that notice be renewed if the purchase money financing continues for more than five years. U.C.C. § 9-312(3)(c) requires the notice to have been received within five years before the debtor acquires possession of the purchase money collateral.

162 U.C.C. § 9-312(3)(a) requires perfection to have occurred at or before the time the debtor receives possession of the inventory.

163 The drafters made no attempt to protect non-inventory financiers. Their perception appears to have been that such priority disputes were not common.

164 U.C.C. § 9-312(3) requires as a prerequisite to purchase money priority for a security interest in inventory that:

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

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

(d) the notification states that the person giving the notice has or expects to
of purchase money interests in inventory was also designed to accommodate the expectations of this type of prior lender. The distinctions between inventory and other purchase money collateral appear to have effectively balanced the competing concerns they were meant to address.\textsuperscript{165}

The contemporary risk to purchase money priority in inventory posed by the transformation and dual status rules, however, was beyond the reach of the clearest of crystal balls. Neither the Code nor its comments directly addresses the issue of when a purchase money security interest in inventory loses that status. The absence of any case law addressing whether add-on clauses defeat conditional sales status may explain the omission. Further, the concerns that add-on clauses were predatory practices had been addressed legislatively.\textsuperscript{166} The Code has traditionally avoided directly addressing consumer protection issues because they are too politically charged. However, the Code's limitations on after-acquired property in the consumer context suggests an intention to prevent the Code from being used against consumers.\textsuperscript{167}

The Code's treatment of related issues reflects pre-Code concerns with the legitimate expectations of prior lenders.\textsuperscript{168} Construction lenders have priority during the construction period over subsequent purchase money lenders claiming fixtures.\textsuperscript{169} Mirroring the failure of the courts,\textsuperscript{170} the Code did not attempt to resolve the dilemma of a prior mortgagee's legitimate interest in replacement of essential equipment. Rather than addressing it directly, the drafters simply created a mechanical rule that favors purchase money lenders who file in a timely fashion as long as the construction period has ended.\textsuperscript{171} In other words, the Code resolved it by choosing pre-

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\textsuperscript{165} Comment 3 to U.C.C. § 9-312 explains the unique requirements and limitations for purchase money priority to inventory as a protection for prior lenders who may make future advances against inventory. Some related concerns became apparent during the first few years under the Code and those were resolved in a similar manner in 1972. \textit{See infra} text accompanying notes 190-92.

\textsuperscript{166} \textit{See supra} text accompanying note 121.

\textsuperscript{167} \textit{See supra} text accompanying note 127.

\textsuperscript{168} \textit{See supra} text accompanying notes 99-103.

\textsuperscript{169} U.C.C. § 9-313(6).

\textsuperscript{170} \textit{See supra} text accompanying note 103.

\textsuperscript{171} U.C.C. § 9-313(6) gives priority to a prior construction lender over a purchase money lender who would otherwise have priority under § 9-313(4)(a) if the purchase
dictability rather than approximating the most just result.

The drafters of the Code included provisions analogous to those governing fixtures to address conflicts relating to accessions—security interests in property that becomes affixed to other personal property.\textsuperscript{172} There are, however, no special provisions in these rules to account for purchase money status. Special purchase money rules for accessions may have appeared to be unnecessary details.\textsuperscript{173} However, at least one of the drafters viewed the treatment given accessions as simply a manifestation of purchase money priority.\textsuperscript{174}

The Code sets up an interesting scheme for priority of purchase money security interests in consumer goods. While the broad sweep of section 9-312(4) ostensibly covers purchase money security interests in collateral other than inventory, another provision subtly eliminates virtually all purchase money priority battles over consumer goods. Section 9-204, which authorizes security interests in after-acquired property, prohibits those interests in consumer goods unless the goods are acquired within ten days after value is given.\textsuperscript{175} Without security interests in after-acquired consumer goods, purchase money priority has virtually no meaning.\textsuperscript{176} In addition, it is likely that many, if not most, after-acquired consumer goods meeting section 9-204’s requirements will be acquired in purchase money transactions.\textsuperscript{177} Purchase money status for security interests

\textsuperscript{172} U.C.C. § 9-314 established priority rules for such disputes based on the time of attachment with some important exceptions for subsequent interests in the whole. This type of dispute does not appear to have been widely addressed in pre-Code cases. See 2 GILMORE, supra note 28, § 31.1, at 837.

\textsuperscript{173} The inference can be drawn from Grant Gilmore’s comments that § 9-314 goes “into as much detail as if fifty years of active litigation had outlined the dimensions of the problem and indicated a correct solution,” id. § 31.3, at 844, and that “it remains to be seen how well-inspired the Article 9 draftsmen were in guessing that ‘accessions’ and ‘fixtures’ are identical twins,” id. § 31.3, at 845.

\textsuperscript{174} 2 GILMORE, supra note 28, § 29.2, at 779 n.8.

\textsuperscript{175} U.C.C. § 9-204 provides in relevant part: “(2) No security interest attaches under an after-acquired property clause to consumer goods other than accessions (§ 9-314) when given as additional security unless the debtor acquires rights in them within ten days after the secured party gives value.”

\textsuperscript{176} Priority is generally based on the first to file or perfect under U.C.C. § 9-312(5). The purchase money security interest, because it is automatically perfected under § 9-302(1)(d), will always be first in the absence of an effective after-acquired property clause.

\textsuperscript{177} Because the debtor must acquire the collateral within 10 days after the secured
in consumer goods is significant only for automatic perfection under section 9-302(1)(d)—not for priority under section 9-312.

The drafters permitted secured parties claiming purchase money security interests in consumer goods to perfect without giving the security interest notoriety.\(^\text{178}\) This so-called automatic perfection appears to be an outgrowth of the protection given to pre-Code purchase money security interests and a recognition that consumer goods are not common collateral for other purposes.\(^\text{179}\) Professor Gilmore, presumably reflecting a view held by a number of the drafters, argued that any filing requirement for security interests in consumer goods would be useless because those who would benefit do not search the files in consumer transactions.\(^\text{180}\) The limitation to purchase money security interests and the lack of protection against consumer buyers from the debtor\(^\text{181}\) were apparently compromises between those who wanted no filing requirements for consumer goods and those who thought consumer good financiers should be able to obtain protection against all claimants.\(^\text{182}\) According to Professor Gilmore, the compromise embodied in section 9-302(1)(d) is “the end-result of much wrangling and bickering and, like most products of unresolved strife, is satisfactory to no one.”\(^\text{183}\)

The use of purchase money status to permit automatic perfection of security interests in consumer goods was a new concept introduced in the Code to achieve an unsatisfying compromise. Its only pre-Code root was the lack of filing requirements to protect purchase money creditors from claims of prior creditors because filing would have provided them with no protection. It apparently was not the result of deliberate well-reasoned policy in the Code and now has ironically become the source of a limited view of purchase money that threatens commercial concepts.

Section 9-107 defined purchase money and addressed the issue of who could take advantage of that status.\(^\text{184}\) The drafters attempted to equalize the ability of sellers and third-party financiers to provide

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\(^{178}\) U.C.C. § 9-302(1)(d).

\(^{179}\) See 1 GILMORE, supra note 28, § 19.4; WHITE & SUMMERS, supra note 77, § 22-9.

\(^{180}\) 1 GILMORE, supra note 28, § 19.4.

\(^{181}\) Consumers who purchase consumer goods from other consumers are not protected against a security interest perfected by filing. U.C.C. § 9-307(2).

\(^{182}\) 1 GILMORE, supra note 28, § 19.4.

\(^{183}\) Id.

\(^{184}\) U.C.C. § 9-107 provides:
purchase money financing. This approach requires different definitions of a purchase money security interest for lenders than for sellers. The definition for lenders must ensure that the value advanced by the lender is in fact used to acquire the purchase money collateral. Commentators discussing whether the language differences in section 9-107 resolve the question of purchase money security interests losing that status point out that such an attempt would result in disparate treatment of sellers and third-party lenders—a result out of harmony with the intent of the drafters.

The pre-Code rule permitting obligations not related to the purchase price to be secured by conditional sales contracts was not incorporated into the Code concept of purchase money security interests. Several reasons for this departure are self-evident. The broad language used in the conditional sales statutes did not bind the drafters of the Code. In fact, it was probably not relevant since the drafters facilitated the use of all personal property as security under a single device. Moreover, the Code used purchase money security interests almost exclusively as priority devices while conditional sales contracts had been alternative devices to create security interests. The different policies implicated by these different purposes led the drafters in a different direction than drafters of the conditional sales statutes. An expansive view of purchase money security interests would completely undermine first-in-time priority. Finally, although one drafter described the Bucyrus-Erie approach as the majority rule, closer examination appears to refute this assertion.

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

185 U.C.C. § 9-107 has a two part definition of purchase money security interest. Subsection (a) covers sellers. Subsection (b) covers third-party lenders. The differences in language appear to be necessary to give two different concepts identical treatment. See U.C.C. § 9-107 cmt. 2.

186 See Beard, supra note 12, at 452-55; McLaughlin, supra note 114, at 673, 700-03; Wessman, supra note 22, at 1317-18.

187 The statute construed in Bucyrus-Erie Co. v. Casey, 61 F.2d 473 (3d Cir. 1932), permitted the conditional sale to secure “performance of any other condition or the happening of any other contingency”—which includes virtually any obligation. See supra text accompanying notes 112-13.

188 1 GILMORE, supra note 28, § 3.3.

189 See Lloyd, supra note 21, at 26-30; McLaughlin, supra note 114, at 671-73.
C. Post-Code Developments

The 1972 revisions to the Code included only two changes in the Code's scheme for purchase money priority to inventory. The revisions refined a purchase money creditor's requirements to notify prior secured parties claiming inventory.190 The 1972 revisions also established purchase money priority rules for proceeds. Again, the Code treated inventory differently by limiting purchase money priority to the cash proceeds of inventory obtained on or before delivery of the inventory to the purchaser.191 Credit sales of inventory produce accounts, chattel paper or instruments as proceeds. Purchase money priority to these proceeds would implicate expecta-

190 The 1972 amendments eliminated a requirement that the purchase money creditor give notice to other known creditors who had not filed a financing statement, added a provision establishing the length of time the notice was effective, and clarified when notice was to be given if the purchase money creditor relied in part on the 21-day automatic perfection provisions of U.C.C. § 9-304(5).

The amended Code provides, in pertinent part:

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

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

U.C.C. § 9-312(3).

The equivalent provision in the 1962 Code provided as follows:

(b) any secured party whose security interest is known to the holder of the purchase money security interest or who, prior to the date of the filing made by the holder of the purchase money security interest, had filed a financing statement covering the same items or type of inventory, has received notification of the purchase money security interest before the debtor receives possession of the collateral covered by the purchase money security interest . . . .

U.C.C. § 9-312(3) (1962).

191 U.C.C. § 9-312(3) provides in pertinent part: "A perfected purchase money security interest in inventory . . . also has priority in identifiable cash proceeds received on or before the delivery of the inventory to a buyer . . . ." In contrast, the general purchase money priority rule for proceeds in U.C.C. § 9-312(4) gives purchase money priority over "a conflicting security interest in the same collateral or its proceeds." Any transaction in which cash is not received at or prior to the time of delivery of the inventory is by definition a credit sale. Thus, the proceeds of those sales would be of a type that are potentially collateral for another type of commercial financing.

U.C.C. § 9-312(4) gives the same priority to any identifiable proceeds of non-inventory purchase money collateral as obtained for the purchase money collateral. Under § 9-312(3), however, the purchase money priority only carries over to cash proceeds obtained by the debtor on or before delivery of the inventory to a buyer.
tions of preexisting creditors with rights to after-acquired property in accounts, chattel paper, or instruments. The revision drafters took into account the commercial practice of financing accounts receivable and chattel paper and the practice of using instruments as collateral and chose to accommodate prior lenders making advances against the credit proceeds of inventory.\footnote{U.C.C. § 9-312 cmt. 3 explains why the amended version of § 9-312(3) treats the purchase money claimant differently as to proceeds other than cash received prior to the delivery of the sold inventory. The goal is to protect prior secured lenders making future advances against that type of collateral.}

The following question summarizes the most frequently litigated issue relating to purchase money security interests since the adoption of the Code: When does a security interest in collateral that secures repayment of the debt incurred to acquire the collateral not qualify as a purchase money security interest? Litigation arose in two distinct legal contexts. First, the issue of purchase money status arose in perfection disputes because purchase money security interests in consumer goods are automatically perfected.\footnote{U.C.C. § 9-302(1)(d).} Second, the issue of purchase money status arose in disputes over a debtor's attempt to defeat a security interest and remove property from the bankruptcy estate. These are again consumer cases,\footnote{In some situations debtors may rely on this provision to exempt a limited amount of business property as a "tool of the trade" or under the "wild card" provisions or a combination of the two. \textit{See}, e.g., Nazarene Fed. Credit Union v. McNutt (\textit{In re McNutt}), 87 B.R. 84 (Bankr. 9th Cir. 1988); Associates Commercial Corp. v. Dillon (\textit{In re Dillon}), 18 B.R. 252 (Bankr. E.D. Cal. 1982).} resulting from the fact that purchase money security interests, possessory security interests and nonjudicial liens are the only security interests or liens that survive a challenge under section 522(f) of the Bankruptcy Code.\footnote{11 U.S.C. § 522(f) (1988 & Supp. IV 1992). \textit{Bankruptcy Code is Title 11 U.S.C.}.} Section 522(f) protects a debtor's exempt property\footnote{Exempt property as a general rule is defined by state law. Section 522(d) of the Bankruptcy Code provides a federal definition of exempt property that can be used by a debtor as an alternative to the state definition unless the debtor's state has specifically not authorized it by statute. \textit{Id.} § 522(b)(1).}—property the debtor can exclude from the bankruptcy estate and the interests of all creditors under section 522(b).\footnote{The types of exempt property that can be claimed by a debtor free of nonpossessory nonpurchase money security interests is further limited by the Bankruptcy Code. \textit{Id.} § 523(f)(2)(A)-(C).} \footnote{\textit{Id.} § 522(b).}

The first legal rule emerging from this litigation was the transformation rule. Its origin can be traced\footnote{Aronov, \textit{supra} note 22, at 22-25; Lloyd, \textit{supra} note 21, at 48-49.} to \textit{In re Simpson}, a 1966
case from the Western District of Michigan. 199 Simpson held that a security interest was perfected because the secured creditor had possession of the collateral and the security interest did not constitute a preference under the Bankruptcy Act. 200 The secured creditor also argued that the security interest qualified for automatic perfection as a purchase money security interest. 201 In dictum the court stated that automatic perfection was not available because the security agreement contained a future advance clause which the court believed inconsistent with the purchase money concept. 202

Many courts have relied on Simpson when addressing whether a purchase money security interest exists. Although courts have not rushed to defeat purchase money status because of the mere existence of a future advance clause, 203 they have used Simpson to transform a purchase money security interest into a nonpurchase money security interest if it secures something other than the purchase price of the collateral. 204 To implicate the transformation rule, a secured transaction must involve a preexisting indebtedness, a fu-

200 Id. at 248-49.
201 The collateral was farm equipment with a value of about $2500. Under § 9-302(c) of the 1962 UCC this collateral, like consumer goods, was entitled to automatic perfection if the security interest was purchase money.
203 Several courts have cited the dictum approvingly but have decided the cases before them on different grounds. E.g., Booker v. Commercial Credit Corp. (In re Booker), 9 B.R. 710, 712-13 (Bankr. M.D. Ga. 1981) (preexisting collateral and preexisting debt included in transaction defeated purchase money status); In re Jones, 5 B.R. 655, 657 (Bankr. M.D.N.C. 1980) (additional sums loaned were secured by pre-existing collateral with debtor acquiring no new rights in the collateral).


204 See, e.g., Roberts Furniture Co. v. Pierce (In re Manuel), 507 F.2d 990, 993 (5th Cir. 1975) (add-on clause with no collateral released until all items paid for, defeated purchase money character of the first purchase); W.S. Badcock Corp. v. Banks (In re Norrell), 426 F. Supp. 435, 436 (M.D. Ga. 1977) (add-on clause for consumer purchases and security interest not released until all secured obligations are paid); In re Johnson, 1 Bankr. Ct. Dec. (CRR) 1023, 1025 (Bankr. S.D. Ala. 1975) (securing future advances defeated purchase money status); In re Jackson, 9 U.C.C. Rep. Serv. (Callaghan) 1152 (Bankr. W.D. Mo. 1971) (concerning a revolving secured consumer loan with add-on clause, title did not pass to any goods until all were paid for).
ture advance, a modification, a refinancing, or a consolidation.\textsuperscript{205} A number of courts have limited the transformation rule.\textsuperscript{206}

While it has not yet disappeared from the legal landscape,\textsuperscript{207} the transformation rule has been thoroughly discredited by all commentators\textsuperscript{208} and by many courts.\textsuperscript{209} The Code itself provides the sim-

\textsuperscript{205} The dicta in Simpson was so broad that some courts have discussed the rule as though it was invoked by the breadth of the documentation without concern for the actual substance of the transaction. One example of this is whether the mere existence of an unexercised future advance clause is sufficient to invoke the rule. See, e.g., Relpak Corp., 25 B.R. at 154-55 (existence of future advance clause alone does not transform a purchase money security interest); Mid-Atlantic Flange Co., 26 U.C.C. Rep. Serv. (Calleghan) at 208 (mere presence of unexercised add-on clause did not defeat purchase money status). Another example is whether additional collateral—that is an after-acquired property clause, whether exercised or unexercised—is sufficient to invoke the rule. That question was raised and avoided by the court in Southtrust Bank, Nat'l Ass'n v. Borg-Warner Acceptance Corp., 760 F.2d 1240 (11th Cir. 1985).

\textsuperscript{206} A rule which developed early and apparently in response to an issue reserved by the Fifth Circuit in Manuel, 507 F.2d at 994, was that if only the last purchase under an add-on clause was claimed as purchase money, the status was preserved. See Dossenbach's of Clinton, Inc. v. Bartelt (In re Beasley), 23 B.R. 404 (Bankr. E.D.N.C. 1982); In re Lay, 15 B.R. 841 (Bankr. S.D. Ohio 1981); Norrell, 426 F. Supp. at 435; Burk, supra note 21, at n.45.

Goodyear Tire & Rubber Co. v. Staley (In re Staley), 426 F. Supp. 437 (M.D. Ga. 1977) presents another modification whereby contractual release of the security interest upon payment of the purchase price, with an acceptable contractual allocation rule, removes the purchase money security interest from the operation of the transformation rule.

\textsuperscript{207} The Fifth Circuit has not overruled Manuel, which held that an add-on clause which kept all items purchased as collateral until all indebtedness was paid, transformed the purchase money status. 507 F.2d at 993-94. The Ninth Circuit adopted the rule for refinancings that were not determined to be mere loan modifications. Matthews v. Transamerica Fin. Servs. (In re Matthews), 724 F.2d 798 (9th Cir. 1984). The Eleventh Circuit has applied it in a commercial case involving inventory. Southtrust Bank, 760 F.2d 1240; see also In re Harrell, 72 B.R. 107 (Bankr. N.D. Ala. 1987); In re Faughn, 69 B.R. 18 (Bankr. E.D. Mo. 1986); Schneider v. Fidelity Nat'l Bank (In re Schneider), 37 B.R. 747, 749 (Bankr. N.D. Ga. 1984).

\textsuperscript{208} Aronov, supra note 22; Beard, supra note 12; Hansford, supra note 11; Lloyd, supra note 21; Mclaughlin, supra note 114; Stilson, supra note 21; Wessman, supra note 22; Burk, supra note 21; Chandler, supra note 21; Jones, supra note 21.

plete explanation of the rule’s demise. Section 9-107 modifies the definition of purchase money security interest with the phrase “to the extent that.” Many courts recognize that this phrase contemplates the possibility of a security interest in collateral having both a purchase money component and a nonpurchase money component.210

The “to the extent” language has been the source of the so-called dual status rule.211 This approach initially developed in cases addressing whether automatic perfection under section 9-302(1)(d) was available to a security interest claimed to have purchase money status.212 However, its real growth came after the promulgation of


Three years after Simpson, the same judge who wrote the opinion avoided the transformation rule by applying the dual status rule. In re Brouse, 6 U.C.C. Rep. Serv. (Callaghan) 471, 474-75 (Bankr. W.D. Mich. 1969) (add-on clause permitting use of dual status rule for post-1966 purchases as Michigan adopted a Retail Installment Act as of that date setting up allocation).

210 See, e.g., Billings v. AVCO Colorado Indus. Bank (In re Billings), 838 F.2d 405, 408 (10th Cir. 1988); Pristas, 742 F.2d at 800-01; Gibson, 16 B.R. at 267-68.

211 See Pristas, 742 F.2d at 800-01 (security interest is purchase money to the extent it secures price even if other obligation is secured); Schwartz, 52 B.R. at 315-16 (court adopts dual status of purchase money security interests under U.C.C. § 9-107); Lin-klater, 48 B.R. at 919 (court obligated to determine to what extent the security interest is still purchase money); Gayhart, 33 B.R. at 700-01 (applying the transformation rule strictly is inequitable and results in decisions not intended by the drafters); Russell, 29 B.R. at 274 (court should consider all factors before deciding if a security interest retains its purchase money status); Stevens, 24 B.R. at 538-39 (renewal of loans alone insufficient to transform status; the court must look to all factors); Associates Fin. v. Conn (In re Conn), 16 B.R. 454, 457 (Bankr. W.D. Ky. 1982) (court implied payment allocation rule so refinancing of purchase money debt did not transform it); Gibson, 16 B.R. at 267-68 (U.C.C. § 9-107 recognizes that a security interest can have a purchase money and a nonpurchase money part); Coomer v. Barclays Am. Fin., Inc. (In re Coomer), 8 B.R. 351, 353-54 (Bankr. E.D. Tenn. 1980) (U.C.C. § 9-107 contemplates security interest with purchase money and nonpurchase money components, but allocation mechanism is needed); Stilson, supra note 21, at 30-37 & n.106.

the new lien avoidance procedure in Bankruptcy Code § 522(f). The dual status approach acknowledges that a security interest can have both a purchase money and a nonpurchase money component and provides an exception to the transformation rule if there is a mechanism to separate the purchase money obligation from the nonpurchase money obligation. If that mechanism is available, the purchase money status is saved and the creditor is given the benefit of the purchase money rule. If no mechanism is available, the purchase money status is transformed to a nonpurchase money security interest. Three sources for this allocation mechanism are the agreement of the parties, regulatory legislation governing the contracts and providing for payment allocations, and creation by the court.

(consolidation of retail installment contracts did not defeat purchase money status for post-1966 purchases, as Michigan adopted a Retail Installment Act as of that date, setting up payment allocations; see also In re Jackson, 9 U.C.C. Rep. Serv. (Callaghan) 1152 (Bankr. W.D. Mo. 1971) (stating that consolidated purchases over time could be purchase money security interests, but not when security interest retained until all are paid for).

213 11 U.S.C. § 522(f) (1988 & Supp. IV 1992). The Bankruptcy Reform Act included § 522(f) and was enacted on November 6, 1978. For a description of this provision and its operation, see infra note 269. See also Aronov, supra note 22, at 23, 40; Hansford, supra note 11, at 245; Burk, supra note 21, at 1151.

214 E.g., Kelley v. United Am. Bank (In re Kelley), 17 B.R. 770, 772 (Bankr. E.D. Tenn. 1982) (apportionment of payments necessary when purchase money obligation is consolidated with another obligation); In re Luczak, 16 B.R. 743, 745 (Bankr. W.D. Wis. 1982) (preexisting debt consolidated with purchase money debt and no apportionment of payments was provided for); Haus v. Barclays Am. Corp. (In re Haus), 18 B.R. 413, 418 (Bankr. D.S.C. 1982) (purchase money status lost because there was no formula for application of payments between purchase price and other obligations); Coomer, 8 B.R. at 353-55 (discussing at length the appropriateness of the rule as opposed to the transformation rule, but concluding that there is no method in that case for determining how much of the secured obligation is purchase money); Mulcahy v. Indianapolis Morris Plan Corp. (In re Mulcahy), 3 B.R. 454, 457 (Bankr. S.D. Ind. 1980) (consumer goods secured their own price and the price of other goods without a payment allocation provision and lost purchase money status).


217 The approaches range from finding that an allocation mechanism is not needed on
Courts are still refining the dual status approach and broadening its application to the question of when a purchase money security interest loses that status. Commentators universally approve the dual status rule's general approach but have different recommendations for its future development. Some have criticized the rule's application to transactions which arguably do not involve nonpurchase money obligations, while others have criticized its application in cases of purchase money debt refinancing.

The transformation or dual status rules frequently have been used to challenge purchase money status in consumer add-on transactions. This application is intriguing because add-on transactions by their very nature involve two or more combined purchase money transactions. Standing alone these individual transactions would qualify for purchase money treatment. Although courts usually deny purchase money status in these cases, the rationales vary significantly. Courts sometimes characterize the transactions as refinancings and apply the dual status or transformation rule.


218 Aronov, supra note 22, at 48-59; Lloyd, supra note 21, at 70, 100; McLaughlin, supra note 114, at 677-82, 692-99; Stilson, supra note 21, at 33-37; Burk, supra note 21, at 1173-80; Chandler, supra note 21, at 861-63, 871-72; Jones, supra note 21, at 301-04.

219 E.g., Stilson, supra note 21, at 37 (courts, if necessary, should supply an equitable payment allocation formula); Burk, supra note 21, at 1174-80 (rely first on state consumer retail regulations for allocation rules; in their absence the court should develop one using FIFO, a “creditor’s bargain” model, a “two-party lowest joint cost” model, or other approach producing the most balanced result).

220 Lloyd, supra note 21, at 56-63; Burk, supra note 21, at 1164-73.

221 E.g., In re Faughn, 69 B.R. 18, 20-21 (Bankr. E.D. Mo. 1986) (consolidation of three purchase money transactions defeats purchase money status in all but the last one); Dossenbach’s of Clinton, Inc. v. Bartelt (In re Beasley), 23 B.R. 404, 406-07 (Bankr. E.D.N.C. 1982) (consolidation of purchase money contracts without providing for allocation of payments defeats purchase money status of all but the last contract); In re Hobdy, 18 B.R. 70 (Bankr. W.D. Ky. 1982) (consolidation of two purchases defeated the purchase money status of the first under a novation analysis); In re Lay, 15 B.R. 841, 842 (Bankr. S.D. Ohio 1981) (combination of prior purchase money transaction
other cases, courts consider add-on provisions to create commingled purchase money transactions which also fall victim to the transformation or dual status rule. Courts have not always explicitly described their rationale in commingling cases. However, the rationale is easy to imply—each item of collateral can only secure its own purchase price. Thus, when a second item of collateral and its purchase price are added to the contract, a cross-collateralization arguably occurs and each item not only secures its own purchase price, clearly a purchase money obligation, but also the purchase price of the other item, arguably a nonpurchase money obligation. Thus, courts defeating add-on transactions as commingled transactions have in effect required a one-to-one correspondence between each item of purchase money collateral and its respective purchase price.

This particular application of the transformation or dual status rules created an item-by-item correspondence doctrine that threatens purchase money financing of inventory. The source of the doctrine appears to be the Fifth Circuit decision in Roberts Furniture Co. v. Pierce (In re Manuel). Relying on Simpson, the Manuel court held that purchase money status for the debt incurred when the first items were purchased had been lost in a consumer add-on transaction when the second security agreement included that debt in the secured obligation. The court recognized the Simpson dis

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222 E.g., Pristas v. Landaus of Plymouth, Inc. (In re Pristas), 742 F.2d 797, 799-800 (3d Cir. 1984) (consolidation of two purchase money transactions retains status by statutory payment allocation); Schewel Furniture Co. v. Goard (In re Goard), 26 B.R. 316, 317-18 (Bankr. M.D.N.C. 1982) (consolidation of purchase money transactions saved by statutory allocation); In re James, 7 B.R. 73, 75 (Bankr. D. Me. 1980) (consolidation of two purchase money transactions protected by allocating payments); McLemore v. Simpson County Bank (In re Krulik), 6 B.R. 443 (Bankr. M.D. Tenn. 1980) (consolidation of several purchase money transactions into one cross-collateralized the obligations and defeated purchase money status); Goodyear Tire & Rubber Co. v. Staley (In re Staley), 426 F. Supp. 437, 438 (M.D. Ga. 1977) (add-on clause not fatal because payments were allocated and security interest terminated upon payment of price of the particular item).

223 507 F.2d 990 (5th Cir. 1975).

224 The court does not mention that the first purchase occurred under a purchase money security agreement and that the only impact of the second agreement was to consolidate the payments due under the first agreement and to have all purchased items secure the consolidated debt. These facts have to be gleaned from the language of the second security agreement quoted in the opinion. Id. at 991-92. The court interpreted the purpose of this arrangement to be prolonging the security interest in each item of collateral until the entire debt was paid. Id. at 992. The court also noted that the contract did not provide a way to credit payments made against the unpaid purchase
discussion as dictum, but considered it "well thought out" and inherently reasonable. The Fifth Circuit declared, without citing to any authority except the judge it was reviewing, that the "plain meaning" of section 9-107 required that purchase money security interests not "exceed the price of what is purchased in the transaction wherein the security interest is created." Limiting the terms "collateral" and "price" in section 9-107 to a single transaction is a major step in establishing an item-by-item correspondence requirement. However, a plain reading of the Code does not require this limitation.

The Fifth Circuit in Manuel expressed no opinion as to whether a purchase money security interest existed in the collateral acquired in the second transaction because the issue was not preserved on appeal. That is unfortunate because the resolution of that issue depends on whether the court was using a refinancing approach or a commingling approach. Under a commingling approach, both the first and second transactions are subject to identical criticism. Under a refinancing approach, only the first transaction was refinanced, thus only that one could be defeated. One could view the court's reservation of the question as evidence that it preferred the refinancing rationale. This view makes the transaction-by-transaction language dictum. However, courts have frequently cited the transaction-by-transaction language in transformation and dual status rule cases.

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225 Manuel, 507 F.2d at 993-94.
226 Id. at 993.
227 Must a single transaction be limited to one day or can it span a significant period of time? If not, why not? If it can, why are a single transaction to be performed over an extended period of time and multiple transactions in the same period of time different for purposes of purchase money status? For a discussion of these issues see infra part II.B.
228 Manuel, 507 F.2d at 992, 994.
After the adoption of the Code, commercial cases challenging the purchase money status of security interests in collateral other than consumer goods have been rare. The court in *John Deere Co. v. Production Credit Ass'n* addressed a commercial priority challenge to purchase money status. The court validated a purchase money security interest that relied on a future advance clause to cover the down payment on equipment and on an after-acquired property clause to encumber the purchased equipment. The remainder of the purchase price was financed by the seller and the resulting chattel paper assigned to John Deere Company. The court distinguished the transformation rule cases on policy grounds; consumer bankruptcy cases involved the exemption of property and courts were construing purchase money law in favor of exemption. The court had no difficulty keeping the purchase money obligation separate from the nonpurchase money obligation and according it priority since no payments had been made on the purchase money portion.

*Ever Ready Machinists, Inc. v. Relpak Corp. (In re Relpak Corp.)* involved a challenge to commercial purchase money security interests in nine machines purchased on secured credit in nine separately documented transactions. The court upheld the purchase money status despite cross-collateralization language in each security agreement. The court distinguished the case on the grounds that transformation and dual status rule precedents involved consumer goods and consumer policies. Because of the separate documentation, the court did not have to address the more complex issues such as one-to-one correspondence between items of collateral and their prices.

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230 *In re Simpson*, 4 U.C.C. Rep. Serv. (Callaghan) 243 (Bankr. W.D. Mich. 1966), the source of the transformation rule, involved a farmer and farm equipment. The Code at that time, however, had an automatic perfection rule for farm equipment analogous to the automatic perfection of purchase money security interests in consumer goods. It was the automatic perfection, not priority, that became the issue in that case and the language that became support for the transformation rule was dictum. *See supra* notes 199-202 and accompanying text.


232 *Id.* at 904-05.

233 *Id.* at 906-07. The court resolved the dispute between two creditors with purchase money security interests in the same collateral by resort to the rule in U.C.C. § 9-312(5) and awarded it to the first to file. *Id.* at 908.

234 *Id.* at 907.


236 *Id.* at 154.

237 *Id.*.
Since the Code's adoption, cases involving purchase money security interests in inventory have been rare. Some of the cases explained section 9-312(3)'s notification requirements while others addressed whether the purchase money secured party complied with notice requirements. Three cases have addressed whether the reliance on future advance and after-acquired property clauses defeated purchase money status. Those cases applied the transformation or dual status rules to inventory purchase money financing and have threatened the concept of purchase money priority in inventory.

Kawasho International (U.S.A.), Inc. v. Alper (In re Mid-Atlantic Flange Co.) was the first commercial case involving a challenge to purchase money security interests in inventory under the transformation rule. In Mid-Atlantic Flange, the court rejected the as-


240 Southtrust Bank, Nat'l Ass'n v. Borg-Warner Acceptance Corp., 760 F.2d 1240 (11th Cir. 1985) (use of future advance clause and after-acquired property clause in connection with inventory financing does implicate transformation and dual status rules); Kawasho Int'l (U.S.A.), Inc. v. Alper (In re Mid-Atlantic Flange Co.), 26 U.C.C. Rep. Serv. (Callaghan) 203 (Bankr. E.D. Pa. 1979) (mere presence of a future advance clause does not defeat purchase money status when only obligations secured are purchase money); Borg-Warner Acceptance Corp. v. Tascosa Nat'l Bank, 784 S.W.2d 129 (Tex. Ct. App. 1990) (purchase money security interest in inventory not defeated when inventory acquired at different times under the same documentation).

sertion that the mere existence of a future advance clause in the security agreement defeated purchase money status. The court reasoned that the security interest was purchase money because no advances other than the sale of inventory existed. The court relied on the difference between commercial transactions and consumer transactions to bolster its holding and noted that the need to protect consumers may support a stricter reading of the Code in consumer situations. The court expressly left open the question of whether purchase money status would be defeated if non-purchase money obligations were also secured.

The Eleventh Circuit in *Southtrust Bank, National Ass'n v. Borg-Warner Acceptance Corp.* was the first to address whether purchase money status in inventory could be lost if a one-to-one correspondence between items of inventory and their respective prices was lacking. The court mechanically followed the transformation rule and declared that a security interest loses its purchase money status when the secured party exercises both an after-acquired property clause and a future advance clause in its ongoing purchase money financing of inventory. The Eleventh Circuit's language was sweeping: "We hold, merely, that such a floating lien is inconsistent with a PMSI. A PMSI requires a one-to-one relationship between the debt and the collateral."

The purchase money lender in *Southtrust Bank* had argued that the rationale in the consumer cases should not govern in commercial cases and that commercial policy considerations lead to a different rule. The court's opinion neither delineates those rationales and policies nor discusses them; it merely concludes that sections 9-107 and 9-312(3) do not distinguish between commercial and consumer purchase money security interests and therefore it saw no policy reasons for doing so.

The court's failure to observe policy distinctions begs the question. First, the court's requirement of an item-by-item correspondence is not a Code rule but a judge-made rule. Naturally the Code would not distinguish between commercial and consumer situations.

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242 *Id.* at 208.
243 *Id.*.
244 *Id.*.
245 *Id.* at 209.
246 760 F.2d 1240 (11th Cir. 1985).
247 *Id.* at 1243.
248 *Id.*.
249 *Id.* at 1242.
under a rule that was not even contemplated by the drafters. Second, purchase money status in the context of section 522 of the Bankruptcy Code, where most of the development of the transformation and dual status rules occurred, is used to determine enforceability rather than priority. Enforceability and priority facilitate different goals and implicate different policies.\footnote{See infra part II.A.1.}

The Texas Court of Appeals in \textit{Borg-Warner Acceptance Corp. v. Tascosa National Bank}\footnote{784 S.W.2d 129 (Tex. Ct. App. 1990).} rejected the \textit{Southtrust Bank} holding and noted that the Code grants priority to purchase money security interests in inventory if the secured party complies with all requirements.\footnote{Id. at 133-34, 137.} The court observed that inventory in the Code is a generic concept and that the notification requirements of section 9-312(3) protect prior security interests. Unfortunately, the court did not address the policy considerations in the necessary depth to guide future courts. The court recognized that the policy of the transformation rule in consumer goods cases was to prevent add-on contracts but did not address the policy underlying purchase money priority.

In addition to not clarifying the policy issues that differentiated the purchase money financing of inventory, the Tascosa court also sowed seeds of doctrinal confusion. Purchase money security interests in inventory can only be subject to transformation if commingling with nonpurchase money obligations exists. The only way commingling could have been present in Tascosa was for the court to mechanically apply the item-by-item correspondence concept to each item or shipment of inventory. The court appears to have viewed the dual status rule\footnote{See supra notes 211-20 and accompanying text.} as being sensitive to policy concerns in section 9-107. However, the court did not articulate those concerns or show how that rule supports its holding. In fact, the rule as often applied explicitly accepts the item-by-item correspondence that creates the problem for purchase money priority in ongoing inventory financing. The court's favorable characterization of the dual status approach implies that the collateral secured some purchase money and some nonpurchase money obligations. The court's conclusion is much stronger. It finds that by complying with section 9-312(3), "the financier has a PMSI in existing and after acquired inventory, in effect a floating lien over the mass of
changing goods available for sale by the debtors to others.” Although not clearly articulated, the court's conclusion rejected the item-by-item approach.

If courts follow *Southtrust Bank*, priority for a purchase money security interest in inventory is only available if separate documentation is used for each shipment of inventory. This conclusion is contrary to the Code's intent that commercial reality and not wooden rules should govern. In contrast, *Tascosa* recognizes commercial reality and follows the Code's intent. Neither case, however, provides adequate guidance in terms of doctrine, policy or history to guide future courts.

This uncertainty in purchase money priority for inventory is occurring at a time when floating liens on a debtor's personal property are becoming the rule rather than the exception. At least one commentator has urged that the Code be “simplified” to facilitate floating liens on all personal property unless the creditor chooses otherwise. The Code also indirectly encourages creditors to seek more collateral than necessary because obtaining deficiency judgments is an uncertain venture. Recent court decisions have also increased the incentive for creditors to obtain excess collateral. In a reorganization under Chapter 11 of the Bankruptcy Code, an un-

254 *Tascosa Nat'l Bank*, 784 S.W.2d at 135.
255 See Lloyd, supra note 21, at 74.

In contrast, at the time the Code was drafted and the availability of after-acquired property was greatly expanded, Grant Gilmore viewed the expanded use of after-acquired property as not much more than a theoretical possibility. He stated:

[If secured parties rush in to take the fullest advantage of the so-called “floating lien” provisions of the Article and seek to tie up all the debtor's present and future assets, then there will undoubtedly be, next depression time, a rush of priority cases in unheard of volume and in unfamiliar contexts. There has not been sufficient experience . . . to justify a prediction whether lenders will conservatively adhere to the old pattern or whether they will rush down a steep place to destruction. What might be called the “Don't be a Pig” school of advice to Article 9 lenders has a fashionable currency and may be expected to have some influence on lending patterns. The present author is inclined to guess that the permissive floating lien, the whole-hog after-acquired property clause, will not be unduly exploited and that the nature of purchase-money priority litigation will remain about what it has been under pre-Code law.

*Id.* at 779 (footnote omitted).

257 U.C.C. § 9-504, which permits deficiency judgments after the sale of collateral, requires the lender to proceed in a commercially reasonable manner and give notice to the debtor. While these standards apply in any event, the creditor in any action for a deficiency is almost certain to be faced with a defense that the standards were violated.
dersecured creditor cannot receive as adequate protection its lost opportunity costs while an oversecured creditor is entitled to such costs. Thus, as the likelihood of an initial creditor obtaining an all-encompassing security interest increases, the ability of purchase money creditors to obtain first priority decreases.

II

ANALYSIS OF PURCHASE MONEY SECURITY INTERESTS IN INVENTORY

How should purchase money status for inventory financing be determined when analyzed against the background of the source of purchase money status, its current uses, its roles and rules under the Code, and its fate in courts resolving disputes over its availability? That background raises two important questions: first, whether the policies behind purchase money status used to resolve enforceability and perfection questions in consumer contexts differ from the policies behind purchase money priority in commercial contexts and whether those policy differences should have any impact; and, second, whether purchase money financing over time results in commingled purchase money and nonpurchase money transactions and whether a one-to-one correspondence between each item of collateral and its individual purchase price is required.

A. Examination of the Policies

Despite judicial reluctance to recognize after-acquired property clauses before the Code, judicial hostility to the clauses after the Code has been minimal. In contrast, judges favored the purchase money concept before the Code but have applied a narrow, almost hostile, construction since the Code's adoption. The early

259 11 U.S.C. § 506(b) (1988) provides:
To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.
260 Gilmore, Purchase Money, supra note 94, at 1333-34.
261 See generally WHITE & SUMMERS, supra note 77, § 25-6; Beard, supra note 12, at 450-52; Lloyd, supra note 21, at 74-75. Professor Beard points out the incongruity of accepting the after-acquired concept without extending similar protection to purchase money inventory financiers. Beard, supra note 12, at 450-52.
262 See supra text accompanying notes 48-67.
cases reflected a judicial desire to create and preserve purchase money protection, whereas, the cases developing the transformation and dual status rules reflected judicial suspicion and parsimony toward purchase money status. The *Simpson* court criticized the security agreement as an adroit attempt to expand the purchase money concept and in dicta to discouraged such "antics."\(^{263}\)

Justification or dismissal of the item-by-item correspondence concept as simply a narrow reading of the Code comparable to the pre-Code approach taken in the *Bucyrus-Erie Co. v. Casey* line of cases to limit the reach of conditional sales acts\(^{264}\) is a failure to perceive the issues involved.\(^{265}\) Purchase money status in the Code has two very different purposes—automatic perfection of security interests in consumer goods and establishment of priority among creditors. Furthermore, the Code definition has been applied to the purchase money term in section 522(f) of the Bankruptcy Code to help bankrupt consumers retain a minimum amount of property for a fresh start. The three different uses of the purchase money concept should alert us to the necessity of careful analysis before the same narrow reading of purchase money is applied to all three situations.

1. **Consumer Enforcement Policies Contrasted with Commercial Priority Policies**

One explanation for the contrasting judicial attitudes is the different contexts in which courts have considered the purchase money concept. Before the Code, courts used purchase money almost exclusively as a priority concept in a commercial context. After the Code, courts interpreted purchase money almost exclusively as an enforceability concept in a consumer context. The cases in which the transformation and dual status rules developed involved either the automatic perfection of a security interest\(^{266}\) in consumer

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\(^{264}\) *See supra* text accompanying notes 109-13.

\(^{265}\) The courts' confusion in this matter is illustrated by the discussion, in a case that did not involve priority, of the need to limit the super-priority of purchase money security interests as a policy supporting its narrow view of purchase money status. *Matthews v. Transamerica Fin. Servs. (In re Matthews)*, 724 F.2d 798 (9th Cir. 1984). The case involved a challenge to purchase money status under Bankruptcy Code § 522(f) and the court stated: "We are dealing with a statutory scheme that governs the priorities among creditors. Purchase money security is an exceptional category in the statutory scheme that affords priority to its holder over other creditors, but only if the security is given for the precise purpose as defined in the statute." *Id.* at 801. The court made no attempt to determine why the statutory scheme provided that "exceptional category."

\(^{266}\) *See supra* text accompanying notes 198-212.
goods\textsuperscript{267} or the freeing of exempt property from a security interest\textsuperscript{268} in consumer bankruptcies.\textsuperscript{269} Disputes over the perfection of security interests and over the availability of a bankruptcy exemption mechanism relate to enforcement of the security interest\textsuperscript{270} rather than its priority. The post-Code disputes also involved conflicts between consumer and commercial interests, thus implicating the various protections the law establishes for consumers and the deference courts often show them. In contrast, priority disputes involve one creditor against another, so that even if the debtor is a consumer, the debtor is indifferent to the outcome of the dispute.

In short, the current rules evidencing hostility have resulted from enforcement disputes in a consumer context, whereas the judicial attitude of flexibility was evidenced in priority disputes in a commercial context. However, enforcing a security interest and prioritizing creditors implicate very different policies and objectives. Consumer policies also differ dramatically from commercial policies.\textsuperscript{271} Judicial recognition of different policies for purchase money under the UCC and the Bankruptcy Code has been limited. Courts have not gone far beyond recommending the combination of UCC policies and bankruptcy policies.\textsuperscript{272} Professor Lloyd has been al-

\textsuperscript{267} U.C.C. § 9-302(1)(d) permits a purchase money security interest in consumer goods to be automatically perfected without filing a financing statement, obtaining possession, or performing any other act otherwise required to obtain perfected status. The 1962 Code had a similar provision for farm equipment with a purchase price of less than $2500. U.C.C. § 9-302(1)(c) (1962).

\textsuperscript{268} See supra text accompanying notes 212-17.

\textsuperscript{269} Section 522(f) of the Bankruptcy Code permits an individual debtor to avoid a security interest (thereby removing the property from the bankruptcy estate) in property that would be exempt under state, federal or local law if the security interest is not either a possessory or purchase money security interest. 11 U.S.C. § 522(b), (f) (1988 & Supp. IV 1992). Section 522(d) provides a list of exempt property that will apply as an alternative to state law exemptions in the absence of the state legislature opting out of the federal list. This lien avoidance is limited to the types of property enumerated in that subsection, which consists of consumer goods or tools of the trade.

\textsuperscript{270} Defeat of a security interest under § 522(f) of the Bankruptcy Code is a question of whether the security interest can be enforced. The perfection question is technically different. While an unperfected security interest is still enforceable under U.C.C. § 9-203, the cases have almost universally arisen in the context of a bankruptcy. In bankruptcy, U.C.C. § 9-301(1) states that an unperfected security interest is subordinate to the interest of the trustee in bankruptcy, a lien creditor within the definition of U.C.C. § 9-301(3), and therefore on par with the claims of all unsecured creditors. In essence, the security interest is unenforceable due to bankruptcy.

\textsuperscript{271} See infra part II.A.1.

\textsuperscript{272} See Transamerica Fin. Servs. v. Matthews (In re Matthews), 20 B.R. 654, 657 (Bankr. 9th Cir. 1982) (concluding that the UCC resolution of what constitutes a purchase money security interest is not controlling or even necessarily relevant), rev'd per curiam on other grounds, 724 F.2d 798 (9th Cir. 1984); Fickey v. Bank of Lafayette
most a lone voice in persuasively showing a way to resolve most of this problem by arguing for the creation of a court-made definition for purchase money security interest solely for Bankruptcy Code § 522 purposes. While this may help, the UCC/bankruptcy distinction is not the relevant distinction. The same consumer issues that affect section 522 cases also arise for automatic perfection of purchase money security interests under the UCC.

The key distinctions are priority/enforceability and commercial/consumer. The priority/enforceability distinction has not been addressed by the courts. Courts have acknowledged the commercial/consumer distinction but have not adequately explored it. Each holding, based upon the commercial/consumer distinction could have been justified by the doctrines used in the most well-reasoned consumer cases. In one case, the court attempted to modify the transformation or dual status rules by addressing the unique policies, issues and considerations involved in purchase money priority disputes and by acknowledging separate unique at-


273 Lloyd, supra note 21, at 76-82. For an argument supporting use of the same definition in both contexts see Burk, supra note 21, at 1151-53.

274 The court in Kawasho Int'l (U.S.A.), Inc. v. Alper (In re Mid-Atlantic Flange Co.), 26 U.C.C. Rep. Serv. (Callaghan) 203, 208-09 (Bankr. E.D. Pa. 1979), refused to apply the transformation rule due to the mere existence of after-acquired property and future advance clauses, noting that less concern for the debtor is needed in a commercial transaction. The court in John Deere Co. v. Production Credit Ass'n, 686 S.W.2d 904 (Tenn. Ct. App. 1984) relied on the distinction in refusing to defeat the purchase money status of a future advance used to acquire property covered under an after-acquired property clause. The court in Ever Ready Machinists, Inc. v. Relpak Corp. (In re Relpak Corp.), 25 B.R. 148 (Bankr. E.D.N.Y. 1982) refused to defeat purchase money status due to cross-collateralization clauses in security agreements relating to equipment purchases and distinguished the case on the grounds that transformation and dual status rule precedents involved only consumer goods and consumer policies. While the commercial/consumer distinction drawn by these courts is commendable, none of the opinions contain a policy analysis that is needed to clearly chart a course.

275 In Mid-Atlantic Flange, 26 U.C.C. Rep. Serv. (Callaghan) at 208-09, the refusal to apply the transformation rule to the mere existence of after-acquired property and future advance clauses is clearly supported by well-reasoned consumer cases. In John Deere Co., 686 S.W.2d 904, the dual status rule would clearly support purchase money status of a future advance used to acquire property encumbered under an after-acquired property clause. In Relpak Corp., 25 B.R. 148, the only issue was whether mere cross-collateralization would defeat purchase money status. The existence of separate obligations makes this an easy case under the dual status rule.
tributes of purchase money priority in inventory.276 Another court not only failed to differentiate, but expressed an unwillingness to consider separate purchase money doctrines in commercial and consumer cases or in cases involving different types of collateral.277

The policies behind the automatic perfection of security interests in consumer goods are not readily discoverable from the drafting process, the probable reason being that the provision was a compromise of a contentious dispute.278 Professor Gilmore, an advocate of a broader exemption for filing in consumer transactions, asserts as one justification that it is unreasonable to expect financing consumers to conduct file searches.279 Professor Hansford discerns from the court decisions the related policy of protecting the integrity of the filing system by limiting automatic perfection to purchase money interests.280 Such policies involve waiving a requirement central to the Code's scheme and would appear to suggest narrow construction. The Simpson court,281 often cited as the source of the transformation rule, seemed to be articulating this approach to support its dicta that a future advance clause in a security agreement was fatal to a claim of purchase money status. The court stated a narrow construction of purchase money status was necessary due to the benefits of having a purchase money security interest.282 The court stated that the secured party should bear the burden of preparing "a simple instrument which shall be a pure purchase money security agreement without attempting to burden it with complicated and ambiguous impedimenta."283

One can imply additional policies from the drafters' resolution to allow automatic perfection of only purchase money security interests while limiting security interests in after-acquired consumer goods. The provisions reflect both a concern with the possibility of creditors overreaching consumers and a concern with the use of

276 Borg-Warner Acceptance Corp. v. Tascosa Nat'l Bank, 784 S.W.2d 129 (Tex. Ct. App. 1990). The court did not go much beyond acknowledging that certain differences exist. Its discussion of the policy differences did little to elucidate these differences and their ramifications. See supra text accompanying notes 251-54.
278 See supra notes 178-85 and accompanying text.
279 2 GILMORE, supra note 28, § 19.4.
280 Hansford, supra note 11, at 249.
282 The case involved a claim for automatic perfection of a purchase money security interest.
283 4 U.C.C. Rep. Serv. (Callaghan) at 248.
consumer goods as collateral, but recognize that the acquisition of such goods may need to be financed on a secured basis. Both concerns encourage a narrow view of purchase money status to protect consumers.

Policies supporting the decisions under Bankruptcy Code § 522(f) are readily discoverable. The section’s legislative history indicates its purpose was avoiding overreaching.284 According to the legislative history, Congress wanted to prevent creditors from threatening consumer debtors with repossession of all household goods even though creditors cannot realize much from such collateral and are usually not inclined to repossess.285 This is the so-called “in terrorem” effect of such provisions. Cases frequently cite the prevention of overreaching and similar policies as justifications.286 Policy examples include enabling a debtor to make a fresh start, preserving the debtor’s assets for general creditors, protecting


Frequently, creditors lending money to a consumer debtor take a security interest in all of the debtor’s belongings, and obtain a waiver by the debtor of his exemptions. In most of these cases, the debtor is unaware of the consequences of the form he signs. . . . If the debtor encounters financial difficulty, creditors often use threats of repossession of all of the debtor’s household goods as a means of obtaining payment.

. . . .

The exemption provision allows the debtor, after bankruptcy has been filed . . . to undo the consequences of a contract of adhesion, signed in ignorance, by permitting the invalidation of nonpurchase money security interests in household goods. Such security interests have too often been used by overreaching creditors. The bill eliminates any unfair advantage creditors have.

Id.

285 The legislative history provides:

In fact, were the creditor to carry through on his threat and foreclose on the property, he would receive little, for household goods have little resale value. They are far more valuable to the creditor in the debtor’s hands, for they provide a credible basis for the threat, because the replacement costs of the goods are generally high. Thus, creditors rarely repossess, and debtors, ignorant of the creditors’ true intentions, are coerced into payments they simply cannot afford to make.

Id.

286 E.g., Pristas v. Landaus of Plymouth, Inc. (In re Pristas), 742 F.2d 797, 799 (3d Cir. 1984) (policy in § 522(f) is to give the debtor a fresh start); In re Moore, 33 B.R. 72, 73-74 (Bankr. D. Or. 1983) (same); Russell v. Associates Fin. Servs. Co. (In re Russell), 29 B.R. 270, 273-74 (Bankr. W.D. Okla. 1983) (to permit avoidance of security interests in already owned household goods entitled to exemption); Stevens v. Associates Fin. Servs. (In re Stevens), 24 B.R. 536, 538 (Bankr. D. Colo. 1982) (to permit debtor to eliminate consequences of adhesion contracts); In re Mattson, 20 B.R. 382, 384 (Bankr. W.D. Wis. 1982) (to eliminate nonpurchase money security interests that are used merely to harass the debtor rather than as security); In re Gibson, 16 B.R. 257,
a debtor from overcharging creditors, and freeing property from security interests that do not secure the value used to acquire the assets.\textsuperscript{287}

The above policies are particular to the bankruptcy context but have an impact similar to the policies surrounding automatic perfection of purchase money security interests in consumer goods—avoiding overreaching and debtor and unsecured creditor protection. The transformation and dual status rules derive from the contexts of automatic perfection, exempt property, and section 522(f) of the Bankruptcy Code. Those rules arose from legitimate, although perhaps misapplied,\textsuperscript{288} policy concerns. But even if we assume that the item-by-item correspondence doctrine they produced is an ideal manifestation of those policies,\textsuperscript{289} that does not justify its application in other contexts.

In purchase money priority disputes, the concerns with debtor and unsecured creditor protection do not lead to the same conclusions. Even if purchase money status is defeated, the debtor's property will still be subject to a perfected security interest. Such policy considerations are absent in the priority disputes because purchase money status is irrelevant to the enforceability of the security interest.

The consumer policy of avoiding overreaching cannot be validated in the priority context to support a narrow definition of


\textsuperscript{287} Professor Beard has identified three: (1) protect the Code's filing system; (2) penalize unconscionable actions or overreaching by creditors; and (3) provide a fresh start in bankruptcy. Beard, \textit{supra} note 12, at 447 n.51. Professor Hansford identified three: (1) avoid overreaching; (2) preserve exempt assets from creditors unless they financed the acquisition; and (3) limit the creditors financing the acquisition of exempt assets to the assets financed. Hansford, \textit{supra} note 11, at 251-52, 254-55; see also Chandler, \textit{supra} note 21, at 862; Jones, \textit{supra} note 21, at 286, 288.

\textsuperscript{288} Commentators have universally criticized the transformation rule. See Aronov, \textit{supra} note 22; Beard, \textit{supra} note 12; Hansford, \textit{supra} note 11; Lloyd, \textit{supra} note 21; McLoughlin, \textit{supra} note 114; Smith, \textit{supra} note 11, at 1483-86; Stilson, \textit{supra} note 21; Wessman, \textit{supra} note 22; Burk, \textit{supra} note 21; Chandler, \textit{supra} note 21; Jones, \textit{supra} note 21. Commentators have not attacked the dual status rule per se, but its application to refinancing of debt is eloquently challenged in Lloyd, \textit{supra} note 21. See also Burk, \textit{supra} note 21, at 1164-73.

No commentators have challenged the legitimacy of the policies articulated by the courts in support of the rules; rather, the challenges address applications of the rules that go beyond achieving those policies.

\textsuperscript{289} One commentator has noted that application of the transformation rule to refinanced obligations goes beyond the harm the section was designed to remedy. Lloyd, \textit{supra} note 21, at 56-63.
purchase money status. The idea of overreaching as used by the courts is a two-party contractual concept relating to negotiations. Overreaching in negotiations has no relevance to priority since creditors have no contractual relationship with each other. While overreaching cannot be ignored in the context of a dispute between creditors, purchase money status is not a vehicle used for that purpose. Obtaining priority is the objective of obtaining purchase money status. The Code's purchase money priority system includes mechanisms to protect third parties and avoid unfairness between creditors. Finally, any overreaching by the creditor in the commercial context can be dealt with by the unconscionability and good faith provisions of the Code.

An understanding of the policies supporting purchase money priority is necessary to determine whether the priority benefits of purchase money status demand a narrow construction of the concept. The policies underlying purchase money priority for inventory come from several sources. One source is from the policies articulated or implied by the courts when they developed the concept of purchase money priority. The Code has either incorporated or superseded the early policies. A second source comes from an examination of the nature of inventory and inventory financing. The policies unique to inventory financing have not been thoroughly articulated and deserve a more extended development.

Policies underlying purchase money priority are widely recognized and accepted. One policy is that purchase money status is a counterbalance to security interests in after-acquired property. The need for a counterbalance is stronger under the Code than it was under pre-Code law for two reasons. First, priority under the Code is based on the time of filing, which can precede creation of the security interest, thus giving a prior creditor claiming after-acquired property an increased advantage. Second, priority for future advances under the Code dates back to the first advance, which provides the prior creditor with increased power over subsequent creditors. This counterbalance policy has been articulated from an

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290 See infra text accompanying notes 354-58.
291 See supra text accompanying notes 160-65.
292 U.C.C. § 2-302.
293 Id. § 1-203.
294 See WHITE & SUMMERS, supra note 77, § 24-5; Beard, supra note 12, at 450-79; Hansford, supra note 11, at 240-41; Jackson & Kronman, supra note 76, at 1165; see also supra parts I.A.1.-2.
295 See supra notes 131-34 and accompanying text. Future advances have the same
economic analysis of secured credit and the role of purchase money priority as limiting the "situational monopoly" of the prior creditor.\textsuperscript{296}

Another policy underlying purchase money priority is that sellers should not have to search files to ensure priority.\textsuperscript{297} This appears to be meaningless for inventory lenders who are required by section 9-312(3) to identify and give notice to prior creditors. There is, however, a deeper policy revealed when one asks why sellers ought not be required to search filings to have priority. The answer is that it is equitable to permit one selling on credit or financing the acquisition of assets to have a superior claim on those assets if that credit is not repaid.\textsuperscript{298} This policy of equity was reflected in early purchase money cases. Its inverse has also been articulated as a policy supporting purchase money priority. Prior creditors are not harmed because without the purchase money creditor, the collateral would not have been acquired by the debtor and could not have been relied on by other creditors.\textsuperscript{299} This policy of equity is sometimes referred to as the anti-windfall or unjust enrichment principle because it prevents the prior creditor from being unjustly enriched at the expense of the purchase money creditor.\textsuperscript{300}

In contrast to the policies justifying the purchase money concept in consumer contexts, the policies underpinning purchase money priority benefit the debtor. The debtor is the one oppressed by the Code's situational monopoly. Purchase money priority limits that monopoly and enhances the debtor's access to credit. While purchase money priority can be characterized as an exception to the priority scheme otherwise established by the Code, that priority scheme creates advantages that need to be ameliorated. The policies in the priority context argue for a liberal interpretation of purchase money status to further its laudatory objectives.

\textsuperscript{296} Jackson & Kronman, \textit{supra} note 76, at 1167-77.
\textsuperscript{297} White & Summers, \textit{supra} note 77, \S 26-5 (acknowledging it is not as persuasive as other policies); Hansford, \textit{supra} note 11, at 240-41.
\textsuperscript{298} Professor Lloyd provides an extensive analysis to establish the basic fairness concept that connects the development of purchase money priority through various legal doctrines and theories—none of which was capable alone of providing the necessary support. Lloyd, \textit{supra} note 21, at 11-37.
\textsuperscript{299} See Aronov, \textit{supra} note 22, at 19.
\textsuperscript{300} See Summers, \textit{supra} note 75, at 920-23; Beard, \textit{supra} note 12, at 480-84; Lloyd, \textit{supra} note 21, at 37, 47.
2. Policies Relevant to Code Facilitation of Specialized Financing

An important policy question is whether the Code should recognize and facilitate specialized secured financing that comes later in time. The inquiry, particularly as it relates to purchase money security interests, has been a subject of academic debate. Professor Buckley asserted that "mandatory rules" in the Code which create priority for purchase money lenders over prior lenders create economic inefficiency.\textsuperscript{301} Professor Shupack persuasively challenged Buckley's thesis, pointing out that the efficiency Buckley analyzes is only the efficiency of the prior lender. When one also considers the efficiency of the subsequent lender and the debtor, the opposite conclusion is reached.\textsuperscript{302}

Professor Buckley's main argument against statutory facilitation appears to be that a debtor can negotiate for the priority of a subsequent lender when contracting with the prior lender. By providing such priority, however, the Code creates a virtually insurmountable barrier to a prior lender who desires to negotiate out of the priority.\textsuperscript{303} Buckley's idea of a debtor negotiating for a subsequent creditor's priority does not harmonize with the real world of finance.\textsuperscript{304} The most plausible \textit{ex ante} agreement to facilitate such financing would be for the debtor to refuse to grant security interests in all after-acquired property, thereby preserving it for future financing.\textsuperscript{305}

The contractual analysis also provides support for statutory facilitation.

\textsuperscript{301} F.H. Buckley, \textit{The Bankruptcy Priority Puzzle}, 72 VA. L. REV. 1393, 1452-69 (1986).


\textsuperscript{303} Buckley, \textit{supra} note 301, at 1463-66.

\textsuperscript{304} Although an attorney representing a debtor in a secured loan would enjoy the challenge of negotiating a right to remove after-acquired property from the prior lender's collateral, the client would need to be advised of the difficulty and expense of the task. The lender's attorney would resist such a provision mightily. The uncertainties and the potential uses and abuses of such a license would be very hard to anticipate \textit{ex ante}. Thus, the lender's attorney would advise that if such a provision were to be accepted, the lender should assume that virtually all after-acquired property would be unavailable as security. One can only speculate on the content of such provisions. Presumably after much effort they would look like the purchase money priority provisions of the Code. Such provisions would be negotiated in loan agreements only in those limited circumstances where the debtor had equal bargaining power.

\textsuperscript{305} Even with this supposedly simple approach, the lender would not readily acquiesce. What about replacements, repairs and substitutions of the collateral? Presumably, however, those legitimate concerns could be satisfied without an all-encompassing after-acquired property clause. Inventory lenders would have different concerns because inventory is sold and replaced on a rapid and reoccurring basis.
Even without the Code, subsequent secured financing with priority can be accomplished contractually after the initial financing, with the cooperation of the debtor, all existing secured parties, and the new lender, by inter-creditor and subordination agreements or through releases of specific collateral. Such after-the-fact methods of facilitating future secured financing with priority currently exist. Validating and accommodating such commercial realities is one of the express fundamental policies of the Code. A problem in relying solely on this contractual facilitation is that it is a very expensive proposition. Code facilitation of subsequent financing would be particularly important to a debtor and a subsequent creditor who cannot obtain cooperation from other creditors. The lack of cooperation may result from "overreaching" or a desire of the prior creditor to strengthen an unsecured position. The only concern with such facilitation is ensuring that the prior creditor is not unfairly deprived of its bargained-for protection. Expectations of prior creditors are woven into the fabric of purchase money priority under the Code.

The most persuasive reason for statutory facilitation of subsequent secured lending arises from the priority structure created by the Code. The Code establishes priority from the time of filing a financing statement regardless of when the secured advances are made. Thus, an existing secured lender with a blanket security interest in after-acquired property will, by the mere existence of a filed financing statement, discourage subsequent lenders who have no way to gain priority. The Code places the first lender in a monopolistic position to provide future credit to the debtor. Such power, while frequently sought by private parties in the commercial

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306 An underlying policy of the Code is "to permit the continued expansion of commercial practices through custom, usage and agreement of the parties." U.C.C. § 1-102(2)(b).

307 See, e.g., Shupack, supra note 302, at 783-86. Negotiating such a deal with the number of parties involved and the amount of documentation necessary is a last resort except in transactions involving very large sums of money.

308 See supra text accompanying notes 160-65, 168-71.

309 In the absence of special circumstances, priority between two Article 9 security interests is determined by which party was the first to either file or perfect. U.C.C. § 9-312(5). The drafters intended the priority to date from filing even if the security interest had not attached at the time. U.C.C. § 9-312 cmts. 4-8. Filing first is a powerful advantage because all future advances have the same priority as the first advance. U.C.C. § 9-312(7). The proceeds of the collateral also share this priority. U.C.C. § 9-312(6).

310 See WHITE & SUMMERS, supra note 77, § 24-5; Beard, supra note 12, at 450-79; Hansford, supra note 11, at 240-41; Jackson & Kronman, supra note 76, at 1167-77; Burk, supra note 21, at 1155-57.
world, is not the type of advantage usually created by statute. The Code expressly permits sale, encumbrance, attachment and other forms of transfer despite contrary provisions in a security agreement. Although such rights of the debtor limit the powers of initial creditors, they fall woefully short of eliminating the initial creditor's monopoly. Thus, one policy behind statutory facilitation of subsequent secured lending is a need to counterbalance Code-created monopolies. The drafters resolved certain inevitable priority conflicts in favor of the lender which is later in time and thereby consciously facilitated specialized financing.

Inventory financing certainly needed to be considered for such favored treatment. Inventory is the life blood of a business enterprise. It is the source of profit to the business and the one asset that consistently has a recognized value in excess of cost. Inventory is attractive to creditors because a market for it exists and to debtors because it can generally support a more favorable loan to value ratio. Purchase money financing of inventory is critical to a debtor in need of financing because failure to adequately maintain profitable inventory levels quickly forces a debtor out of business. Recognizing this fact is critical in light of the monopoly power that a creditor could assert over such financing if a Code alternative were not available.

3. Policy Implications of Inventory Financing

Further exploration of the unique attributes of inventory and the sources and importance of inventory financing is essential to evaluate policies supporting the facilitation of purchase money financing of inventory. Inventory generally consists of multiple identical fungible items. Debtors use general accounting techniques of “first in first out,” “last in first out,” or other hypothetical constructs to monitor their inventory rather than monitoring it item by item. Thus, for accounting purposes there is no actual one-to-one correspondence between the cost the debtor paid for any particular item

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311 U.C.C. § 9-311.
312 E.g., U.C.C. §§ 9-308, 9-306(5) (providing priority to a secured party holding chattel paper over a prior secured party with a claim to the chattel paper as proceeds of inventory); U.C.C. § 9-309 (protecting negotiable collateral); U.C.C. § 9-312(2) (giving priority to a later secured party with an interest in crops if new value is given within three months before they are planted); U.C.C. § 9-312(3), (4) (providing priority to the purchase money creditor).
313 U.C.C. § 9-109(4) defines inventory. It includes materials used or consumed in a business within that definition, but such inventory has little importance as collateral.
of inventory and the items of inventory actually in stock. A secured creditor financing inventory is also indifferent to which items of fungible inventory the security interest covers. The creditor’s interests are ensuring an enforceable claim, ensuring that the debtor maintains an adequate inventory, and ensuring that the debtor segregates and remits the proceeds.

Another unique attribute of inventory is that it turns over on a regular basis. The revolving feature of inventory has several ramifications that distinguish financing inventory from financing most other types of property. First, financing inventory cannot be accomplished by a one time infusion of capital. Second, inventory is regularly converted into proceeds. Third, inventory is the primary source of revenue for businesses who use it as collateral. As the primary source of revenue, the proceeds of inventory are used in the ordinary course to meet expenses of the business, provide working capital, acquire new inventory and pay debt service. A consequence of this attribute is that a one time financing of inventory does not produce sufficient proceeds to operate the business and acquire replacement inventory. This is particularly true if debt is being liquidated or if the business is expanding.

The unique characteristics of inventory suggest that different considerations are relevant when inventory serves as purchase money collateral. Some of the characteristics justified the different treatment inventory received under pre-Code security devices. The unique characteristics of inventory necessitated that different rules govern purchase money priority under the Code. The characteristics also present a number of challenges that justify reevaluating how the definition of purchase money status under the transformation and dual status rules should operate in purchase money inventory financing. Those rules apply to normal commercial purchase money financing of inventory only if there is a commingled transaction—an outcome dictated by the item-by-item correspondence definition of purchase money security interest. Inventory’s continual turnover, tangible nature and role in generating revenue render a one-to-one correspondence between purchase money debt and purchase money collateral inappropriate. Both the debtor and secured creditors view most inventory collateral from an aggregate rather than an item-by-item perspective. Purchase money priority doctrines should follow the commercial realities in this regard.

314 See supra part I.A.3.
315 See supra text accompanying notes 160-65.
The diverging interests of facilitating both purchase money and nonpurchase money financing of inventory and its proceeds are readily harmonized. The Code accommodates the expectations and needs of inventory lenders who do not desire that all loan proceeds go to acquiring inventory. The notice requirement placed on purchase money lenders ensures that prior inventory lenders do not rely on inventory supplied or financed by the purchase money lender. While this impacts the willingness of prior inventory lenders to make future advances, it enables them to protect advances already made. The Code gives even greater protection to lenders making advances against proceeds of credit sales of inventory. The purchase money creditor's lack of priority to those proceeds leaves prior creditors unaffected by purchase money status.

4. The Code’s Policy of Facilitating Commercial Developments

The relative scarcity of court decisions challenging purchase money status in the commercial context provides support for reconsideration of the judicial doctrines that have threatened purchase money status. The plethora of cases in the consumer bankruptcy area occurred after section 522(f) of the Bankruptcy Act was modified to permit the debtor to defeat all but purchase money claims to otherwise exempt consumer goods. Loss of purchase money status in the consumer context defeats perfection and may free the collateral from the bankruptcy estate. Thus, a debtor or trustee has great incentive to attack that status. In the commercial context, however, perfection of a purchase money security interest, like any other security interest, requires filing or possession. Thus, loss of purchase money status defeats only relative priority to other secured creditors—not perfection. A debtor or bankruptcy trustee consequently has no incentive in most commercial cases to attack purchase money status.

316 The author has found only a handful of cases in the commercial context in contrast to the myriad of cases in the consumer bankruptcy context.

317 See generally Beard, supra note 12, at 442; Hansford, supra note 11, at 261.

318 The concept embodied in § 522(f) was first introduced by the Bankruptcy Code of 1978. Only a modest number of cases arose prior to that time. Since that time, virtually no cases have addressed automatic perfection. However, the number of transformation and dual status rule cases has exploded. See Burk, supra note 21, at 1151.


320 Two situations exist in which a trustee in bankruptcy would benefit by defeating a purchase money security interest in a commercial context. First, because a trustee is a lien creditor as of the filing of the case in bankruptcy, 11 U.S.C. § 544(a)(1) (1988); U.C.C. § 9-301(3), and because a lien creditor loses to a purchase money security inter-
Although other secured creditors who were prior in time to the purchase money secured party would gain priority by the defeat of purchase money status, the dynamics are different. First, because the debtor obtained new collateral, the creditor is not in a worse position than it would have been absent the purchase money transaction.\textsuperscript{321} In fact, the lender may have avoided the necessity of making future enabling advances to acquire the property—property which presumably is for the benefit of the debtor's business operations. In the case of inventory lenders who may have been prejudiced by making future advance, against inventory subject to a prior security interest, the Code protects them by requiring the purchase money lender to give notice.\textsuperscript{322} Notice gives the prior creditor the opportunity to adjust its advances to compensate for the prior interest and avoid becoming undersecured. Thus, conscientious prior creditors should not be adversely affected by purchase money priority and should not have the economic incentive to attack it.

Moreover, prior creditors who are undersecured or could otherwise obtain an economic benefit by defeating the purchase money character face a long-term versus short-term benefit decision. If they successfully challenge purchase money status and convince a court to require item-by-item correspondence and apply the transformation or dual status rule they contribute to a noncommercial body of law that may be used against them in later transactions in

\begin{itemize}
\item est perfected within 10 days after the debtor receives possession of the collateral, U.C.C. § 9-301(1)(b), if bankruptcy is filed between the time the debtor gets possession of the collateral and the time the purchase money creditor perfects, purchase money status will be essential to priority over the trustee. Such perfection is not barred by the automatic stay in bankruptcy. 11 U.S.C. § 362 (b)(3) (1988 & Supp. IV 1992). Second, a bankruptcy trustee that could otherwise void a security interest as a preferential transfer under Bankruptcy Code § 547(b) will not be able to do so if the security interest secures an enabling loan under § 547(c)(3). 11 U.S.C. § 547 (b), (c) (1988). Enabling loans under § 547(c)(3) are virtually identical to purchase money loans. Again, in this situation, the trustee would have an incentive to challenge the "purchase money" status.

\textsuperscript{321} The logical basis for this is straightforward. The only assets to which priority is claimed would not have been acquired without the purchase money financing, and the priority is limited to the obligation incurred in connection with that acquisition. That concept, however, does not operate with such logical precision in all situations such as, if the collateral replaced property the prior lender was relying on and the lender was unaware of the replacement or unable to protect that interest in the property when no longer retained by the debtor. Such exceptions, however, are not of sufficient magnitude to scuttle the rule.

\textsuperscript{322} U.C.C. § 9-312(3) requires written notice to a prior secured party before the debtor obtains possession of the inventory for purchase money priority to be available against that lender.
which they have a purchase money interest. This dilemma is particularly true of seller-creditors whose mainstay security interest is in the purchase money interest.

Financial institutions are also heavily involved in purchase money lending as evidenced by *Southtrust Bank, National Ass'n v. Borg-Warner Acceptance Corp.*\(^3\)\(^2\)\(^3\) Borg-Warner is a commercial finance lender who extends purchase money credit.\(^3\)\(^2\)\(^4\) In *Southtrust Bank*, an *amicus* brief filed on behalf of Ford Motor Credit Company, another commercial finance lender, stated that they had advanced 5.3 billion dollars in purchase money transactions.\(^3\)\(^2\)\(^5\) BancAmerica PrivateBrands, Inc., another commercial lender, also filed an *amicus* brief in support of purchase money priorities.\(^3\)\(^2\)\(^6\)

The lack of court challenges communicates a profound message with such large sums at stake and the law in such a fragile state. The commercial world wholeheartedly accepts purchase money transactions as facilitated by the Code. Courts should be more solicitous of these commercial realities and developments to be in total harmony with the intent of the Code.\(^3\)\(^2\)\(^7\)

In summary, the policies relating to automatic perfection and exemption of assets from bankruptcy are designed to protect consumer debtors from creditor overreaching and support a narrow construction limiting access to the benefits of purchase money status. The policies behind purchase money priority have the opposite impact. The policies supporting priority for purchase money fi-

\(^3\)\(^2\)\(^3\) Hansford, *supra* note 11, at 235 (citing Affidavit of George V. Burbach, Associate Counsel, Ford Motor Credit Company, Petition for Rehearing by Panel and Suggestion for Rehearing En Banc, Southtrust Bank, Nat'l Ass'n v. Borg-Warner Acceptance Corp., 760 F.2d 1240 (11th Cir.) (No. 84-7396), *reh'g denied en banc*, 774 F.2d 1179 (11th Cir. 1985)).

\(^3\)\(^2\)\(^6\) Hansford, *supra* note 11, at 244-45 (citing Affidavit of Richard W. Moyer, Vice President and Associate General Counsel of BancAmerica PrivateBrands, Inc. f/k/a FinanceAmerica PrivateBrands, Inc., Petition for Rehearing by Panel and Suggestion for Rehearing En Banc, *Southtrust Bank* (No. 84-7396)).

\(^3\)\(^2\)\(^7\) The policies of the Code are set forth in U.C.C. § 1-102(2) as follows:

(2) Underlying purposes and policies of this Act are

(a) to simplify, clarify, and modernize the law governing commercial transactions;

(b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties;

(c) to make uniform the law among the various jurisdictions.
nancing have two primary interrelated purposes. First, they provide a break in the situational monopoly of a prior creditor created by the Code's treatment of after-acquired property, future advances and priority, thereby preventing windfalls to such creditors. Second, the policies encourage new value financing to increase a debtor's assets. These priority policies favor the purchase money concept and beg for liberal construction of purchase money status.

A key policy of the Code that supports the elimination of an item-by-item correspondence requirement is the express policy of facilitating commercial developments. Purchase money financing of inventory using aggregate collateral concepts has widespread support in the commercial world and should be facilitated by the Code and by courts interpreting the Code.

B. Item-By-Item Correspondence

Whether certain consolidated purchase money transactions are subject to challenge under the transformation or dual status rules depends on whether they are treated as commingled purchase money and nonpurchase money transactions. If only purchase money transactions have been consolidated with each other, commingling exists only if a one-to-one correspondence is required between each item of inventory and its respective price. One may find support for item-by-item correspondence in some case law, but the concept's source and validity need to be carefully evaluated.

1. The Code as a Source of Item-By-Item Analysis

The Code provides little guidance on whether the purchase money concept requires an item-by-item correspondence between collateral and price. The definition of purchase money security interest in section 9-107 does not address whether such correspondence is essential. Certainly section 9-107 does not contemplate purchase money status for more than the purchase price, but its language supports an aggregation concept. That section uses the inherently plural term "collateral" to describe what price is to be

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328 See supra note 310 and accompanying text.
329 The two rationales are not independent. Breaking the situational monopoly to allow any subsequent lender to obtain priority would create confusion in secured lending priority battles. Limiting the priority available to the subsequent lender to situations where new value is given to acquire new assets avoids the potential for confusion in priority battles. See Jackson & Kronman, supra note 76; Burk, supra note 21, at 1156-57.
330 Professor Wessman provides an extensive textual analysis in his article. He co-
secured rather than an inherently singular term such as "good" or "item of collateral." Section 9-107(b) uses the plural term "advances" although that subsection also uses the singular term "obligation." White and Summers analyze purchase money transactions involving collateral acquired at different times under an item-by-item correspondence requirement in their treatise but cite no authority for it. No other case or commentator appears to have addressed the source or justification of the item-by-item correspondence requirement. However, Professors Beard and Wessman have recently rejected item-by-item correspondence in the inventory context. The one-to-one terminology upon close analysis appears to be simply a shorthand way of stating the Code's more general requirement that the purchase money security interest cannot secure more than the purchase price.

2. Commingling of Purchase Money Transactions

Before analyzing what constitutes a truly commingled purchase money transaction, a brief analysis of the broad dicta in certain court decisions stating that the mere existence of an after-acquired property clause impacts purchase money status is appropriate. eludes that the "floating" or aggregation concept is at least as well-supported as a one-to-one concept. Wessman, supra note 22, at 1309-28.

U.C.C. § 9-107 uses the language "of the collateral to secure all or part of its price" and "rights in or the use of collateral if such value is in fact so used." Collateral is the only operative word in the section relevant to the concept.

White & Summers, supra note 77, § 22.9.

The court in Roberts Furniture Co. v. Manuel (In re Manuel), 507 F.2d 990 (5th Cir. 1975) appears to have originated the concept among the courts with its statement "the purchase money security interest cannot exceed the price of what is purchased in the transaction wherein the security interest is created," id. at 993, but gives no authority or analysis. See also McLoughlin, supra note 114, at 692-96 (assuming a one-to-one correspondence requirement and analyzing multiple items of collateral in separate transactions as creating commingling); Burk, supra note 21, at 1138, 1143 (describing such a transaction as commingled without any analysis or citation to any authority). Some authorities cite White & Summers for support, but that source contains nothing but an assertion.

Beard supra note 12; Wessman, supra note 22. The author has not found any other analysis of the question.


While this assertion has appeared in several cases, it has been rejected by courts directly addressing it and has not been the basis for denying purchase money status in any case.\textsuperscript{337} No reason exists to deny purchase money status to certain collateral just because the purchase money obligation is secured by additional nonpurchase money collateral. There is no commingling confusion by such cross-collateralization.\textsuperscript{338} The position of other creditors with respect to the purchase money lender with such security is no different than it would have been without the purchase money collateral. There is no realistic possibility of misleading other creditors by having additional nonpurchase money collateral secure a purchase money obligation. In summary, the actual existence of additional nonpurchase money collateral has no relevance in determining purchase money status, and the mere existence of an after-acquired property clause has even less relevance.\textsuperscript{339}

The issues that arise when more than one obligation is secured by the same collateral are much more complicated.\textsuperscript{340} Commingling of obligations is relevant because purchase money status is based on the nature of the secured obligation.\textsuperscript{341} What constitutes commingled obligations? First, both purchase money obligations and non-

\textsuperscript{337} The Ninth Circuit addressed the question directly and concluded the existence of additional collateral was irrelevant. Matthews v. Transamerica Fin. Servs. (In re Matthews), 724 F.2d 798, 799 n.2 (9th Cir. 1984) (per curiam); accord Ever Ready Machin­ists, Inc. v. Relpak Corp. (In re Relpak Corp.), 25 B.R. 148, 154-55 (Bankr. E.D.N.Y. 1982) (to the extent the loan was used for new collateral it was purchase money despite after-acquired property and future advance clauses); Sims Furniture Co. v. Trotter (In re Trotter), 12 B.R. 72, 73 (Bankr. C.D. Cal. 1981) (existence of add-on clause did not destroy purchase money, but subsequent consolidation of loans did); Meadows v. Household Retail Servs., Inc. (In re Griffin), 9 B.R. 880, 881 (Bankr. N.D. Ga. 1981) (unexercised add-on clause did not destroy purchase money status); Kawasho Int'l (U.S.A.), Inc. v. Alper (In re Mid-Atlantic Flange Co.), 26 U.C.C. Rep. Serv. (Callaghan) 203, 208 (Bankr. E.D. Pa. 1979) (mere presence of unexercised after-acquired property and future advance clauses did not defeat purchase money status).

In contrast, the court in Booker, 9 B.R. at 711 stated three grounds for defeating purchase money status, one of which was the existence of additional collateral. This, however, is only equivalent to the use of an after-acquired property clause not its mere existence. Even a use of the clause rationale for defeating purchase money status is troubling. The court's security for an antecedent debt rationale is more substantial and was the focus of the court's discussion. That fact renders the holding on the grounds of additional collateral little more than dictum.

\textsuperscript{338} The question whether the value that was given was used to acquire the collateral remains essential. The inquiry, however, is not made any different because of the existence of additional collateral.

\textsuperscript{339} Accord McLaughlin, supra note 114, at 690-92.

\textsuperscript{340} See generally id. at 664-83.

\textsuperscript{341} See supra text accompanying notes 25-27.
purchase money obligations, whether incurred simultaneously or consolidated at a later time, become secured by the same collateral.\footnote{342} This is true commingling. Second, several individual items of purchase money collateral are acquired at substantially the same time in either one sale or from the proceeds of one loan.\footnote{343} This is commingling only by a strict application of an item-by-item correspondence requirement. Third, two or more purchase money transactions separated in time with the same creditor are combined.\footnote{344} This is closely related to the second fact pattern and involves commingling only if item-by-item correspondence is required. A fourth fact pattern, the refinancing of purchase money debt, is beyond the scope of this discussion.\footnote{345} Each fact pattern has different issues and ramifications.

\textbf{(a) True Commingling}

The first fact pattern involves securing both a purchase money and a nonpurchase money obligation with the purchase money collateral. No distinction need be made for whether the obligations were incurred simultaneously or at different times as long as they are consolidated. This fact pattern significantly influenced the transformation and dual status rules.\footnote{346}

\footnote{342} Many cases of this type involve purchase money and nonpurchase money obligations secured by the same collateral. \textit{E.g.,} Safeway Fin. Co. v. Ward (\textit{In re Ward}), 14 B.R. 549, 552 (Bankr. S.D. Ga. 1981) (when additional sums are secured at renewal purchase money status is lost); Mulcahy v. Indianapolis Morris Plan Corp. (\textit{In re Mulcahy}), 3 B.R. 454, 457 (Bankr. S.D. Ind. 1980) (purchase money status destroyed when additional sums were advanced to be secured by the same collateral).

A significant number of other cases have been analyzed as purchase money obligations commingled with nonpurchase money obligations even though the nonpurchase money obligation is a refinanced purchase money obligation. \textit{E.g.,} Roberts Furniture Co. v. Pierce, (\textit{In re Manuel}), 507 F.2d 990 (5th Cir. 1975) (purchase of several household items consolidated with purchase of a TV set); W.S. Badcock Corp. v. Banks (\textit{In re Norrell}), 426 F. Supp. 435 (M.D. Ga. 1977) (purchase of household appliances consolidated with purchase of a vacuum cleaner).

\footnote{343} \textit{E.g.,} \textit{In re} Smallwood, 20 B.R. 699 (Bankr. W.D. Ky. 1982); Credithrift of Am. v. Littlejohn (\textit{In re Littlejohn}), 20 B.R. 695 (Bankr. W.D. Ky. 1982). The courts did not discuss cross-collateralization of security interests created simultaneously in more than one item of collateral, but did uphold purchase money status.

\footnote{344} This was the situation in \textit{Southtrust Bank} and in \textit{Tascosa Bank}. This is also descriptive of consumer add-on transactions in which separate purchase money transactions are consolidated.

\footnote{345} The issues discussed in this article are independent of the resolution of issues related to refinancing purchase money debt. A thorough treatment of refinancing and purchase money status is contained in Lloyd, \textit{supra} note 21.

\footnote{346} \textit{E.g.,} Stevens v. Associates Fin. Servs. (\textit{In re Stevens}), 24 B.R. 536 (Bankr. D. Colo. 1982) (additional advance on refinancing commingled with purchase money loan
Section 9-107 provides that a purchase money security interest exists "to the extent" it secures an amount not in excess of the purchase price of the collateral if the secured party is a seller and "to the extent" it secures an amount paid toward the purchase price if the secured party is of a third party lender. The Code definition leaves a court two choices if there is commingling resulting from this type of consolidation: apply the transformation rule and deny the purchase money status completely or apply the dual status rule and allocate payments to segregate the purchase money obligation. The Code provision clearly contemplates the latter choice by use of the phrase "to the extent." Commentators generally have argued for following any allocation set forth by the parties unless it violates the law or is in bad faith. In the absence of such contractual guidance some courts have avoided imposing an allocation method while others have felt constrained to impose one. An


347 Aronov, supra note 22, at 55-59; Lloyd, supra note 21, at 95-100; McLaughlin, supra note 114, at 681-82, 698-99; Burk, supra note 21, at 1174; Chandler, supra note 21, at 871-72.

348 Kelley v. United Am. Bank in Knoxville (In re Kelley), 17 B.R. 770, 772 (Bankr. E.D. Tenn. 1982) (apportionment of payments necessary when purchase money obligation is consolidated with another obligation); Luczak, 16 B.R. at 745 (preexisting debt consolidated with purchase money debt and no apportionment of payments was provided for); Haus, 18 B.R. at 418 (purchase money status lost because there was no formula for application of payments between purchase price and other obligations); Coomer, 8 B.R. at 353-55 (the court discusses at length the appropriateness of the rule as opposed to the transformation rule, but concludes that there is no method in that case for determining how much of the secured obligation is purchase money); Mulcahy v. Indianapolis Morris Plan Corp. (In re Mulcahy), 3 B.R. 454, 457 (Bankr. S.D. Ind. 1980) (consumer goods secured their own price and the price of other goods without a payment allocation provision and lost purchase money status).

349 See Transamerica Fin. Servs. v. Matthews (In re Matthews), 20 B.R. 654, 657 (Bankr. 9th Cir. 1982) (if no other mechanism is provided determine one on a case by case approach), rev'd on other grounds per curiam, 724 F.2d 798 (9th Cir. 1984); Russell v. Associates Fin. Serv. Co. (In re Russell), 29 B.R. 270, 274 (Bankr. W.D. Okla. 1983) (created a FIFO rule); Sprague v. Landaus of Plymouth, Inc. (In re Sprague) 29 B.R. 711, 713 (Bankr. M.D. Pa. 1983) (found allocation to least secured rule at common law to preserve money status), aff'd on other grounds sub nom. Pristas v. Landaus of Plymouth, Inc. (In re Pristas), 742 F.2d 797 (3d Cir. 1984); Stevens, 24 B.R. at 539 (same);
implied-in-law allocation in the absence of contractual or statutory guidance appears to be appropriate. The Code could be read to mandate a court allocation of payments under these circumstances.

(b) *Multiple Items of Collateral Acquired at the Same Time*

The second fact pattern involves simultaneously acquiring multiple items of purchase money collateral in a single credit transaction. It is the simplest fact pattern yet perhaps the most revealing. Requiring item-by-item correspondence results in commingled obligations—each item of collateral secures its purchase price, a purchase money obligation, and the purchase prices of all other items of collateral, nonpurchase money obligations.

This fact pattern is, however, fundamentally different than the first and raises several questions. Who, if anyone, is harmed if the items of collateral are aggregated and treated as one mass securing one aggregated purchase money obligation? Should foreclosure against fewer than all items of collateral be permitted without defeating purchase money status if the proceeds of those items will be sufficient to repay the creditor? Does there need to be an allocation of principal payments among the separate items of collateral to determine what portion of the foreclosure proceeds go to the purchase money secured creditor?

Whether item-by-item correspondence should be required when all collateral is acquired in the same purchase money transaction is best explored by analyzing the possible situations that may arise.


Such statutory schemes involve consumer protection and are currently nonexistent in the commercial realm. They are not likely to develop other than by express amendment of the Code.

351 See *Gibson*, 16 B.R. at 268-69 (U.C.C. § 9-107 requires separation of purchase money from nonpurchase money components and court must find mechanism); *Stilson*, supra note 21, at 37 (recommending that courts supply an equitable payment allocation formula); *Burk*, supra note 21, at 1174-80 (in the absence of other sources court should develop an allocation using FIFO, or other theoretical model).
The first possibility occurs when each item of collateral has declined in value so that no item is worth as much as its unpaid purchase price. This is under-collateralization. The second possibility occurs when the unpaid purchase price for each item of collateral is less than the value of that item of collateral. This is over-collateralization. The third possibility is a combination of over-collateralization and under-collateralization. Other possibilities such as missing collateral or paid obligations are merely special cases in which some of the purchase prices would not have a corresponding item of collateral or some of the items of collateral would not secure a purchase money obligation.

In the under-collateralized transaction there is no need for an item-by-item correspondence requirement because no item of collateral has any value above its purchase price. Thus, any claim of cross-collateralization is illusory. The purchase money creditor will foreclose on all the collateral and there will be no excess proceeds. The purchase money creditor will not recover all it is owed while other creditors and the debtor get nothing.

In the over-collateralized transaction each item of collateral could be said to have a cross-collateralization component. That characterization, however, has little practical significance to the purchase money secured creditor. The purchase money creditor will recover the entire secured obligation regardless of whether an item-by-item correspondence is required. Such a requirement, however, does impact creditors with earlier perfected security interests. Item-by-item correspondence requires the purchase money creditor to liquidate all purchase money collateral to receive the unpaid principal. If item-by-item correspondence is not necessary, the purchase money creditor could simply liquidate that portion of the collateral required to satisfy its debt. This result is more favorable to the competing creditor because it now has a first priority on the remaining collateral and can control its own foreclosure. It is also more favorable to the purchase money creditor because it has a simpler task of foreclosure. The lack of an item-by-item correspondence requirement may even be to the debtor’s advantage because it is potentially left with collateral to continue its business.

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352 This occurs when an item of collateral has become valueless or is lost or sold and the proceeds are unavailable.

353 This advantage to the debtor is probably illusory because nothing prevents the purchase money creditor from seizing all the collateral and selling it if it does so in good faith. Moreover, the creditor that seizes only part of the collateral is going to seize the most valuable collateral first.
The only party in an over-collateralized situation who might be adversely affected by rejecting an item-by-item correspondence requirement would be a creditor with a subordinate claim to only part of the collateral if the purchase money creditor foreclosed on that part.\textsuperscript{354} This potential adverse impact, however, is reversed by an established equitable solution. The creditor with an interest in only part of the collateral can rely on the doctrine of marshalling\textsuperscript{355} to control the collateral chosen for foreclosure by the purchase money creditor. If the prior creditor successfully invokes that doctrine, the lack of an item-by-item correspondence requirement benefits it by ensuring that there will be more equity in the remaining collateral.\textsuperscript{356} The prior creditor should prefer rejection of an item-by-item requirement if there is over-collateralization.

Over-collateralization is the most common situation and the one parties attempt to create. The lender always loans less than the value of the collateral and prefers to avoid financing collateral whose value declines faster than the debt is reduced. Neither party expects that collateral for inventory financing will be worth less than cost. Because the actual marketability of inventory cannot be known at the time of financing, the parties often incorporate a margin to allow for obsolescence, damage, changed market conditions, or sale in a distress situation.

It is only the combination transaction that raises the critical issue. In this situation certain items of collateral will not satisfy the purchase money debt for those items while other items of collateral will have excess value which under an item-by-item correspondence requirement become nonpurchase money security for the purchase money creditor. An item-by-item correspondence requirement would again result in the purchase money creditor foreclosing on all collateral. Rejecting item-by-item correspondence might dissuade the purchase money creditor from foreclosing on all collateral if the over-collateralization significantly exceeds the under-collateralization. This would benefit the prior creditor who could now control

\textsuperscript{354} Item-by-item correspondence is not a great advantage to this creditor. As it is second to the purchase money creditor, it will only get the proceeds from the over-collateralized portion which exceeds the unpaid prices of the items of inventory.

\textsuperscript{355} Marshalling is an equitable remedy that may be used by a junior creditor to force the senior creditor to first pursue collateral in which only the senior creditor has an interest. This protects the junior creditor's interest in the jointly claimed property. Marshalling is not available if it adversely affects a third party.

\textsuperscript{356} Contrast this with requiring an item-by-item correspondence in which case the junior creditor would not be able to qualify for marshalling because that would adversely affect the purchase money creditor's priority claim.
the disposition of the remaining collateral. Eliminating or requiring an item-by-item correspondence does not significantly impact the debtor because both other creditors will claim the collateral until all obligations are fully satisfied. 357

Another issue arises in the combination situation. How are the foreclosure proceeds to be allocated among creditors? Adopting an item-by-item correspondence requirement would favor the prior creditor by enabling it to claim priority to those proceeds which exceed the unpaid purchase price of an item of collateral. Eliminating an item-by-item correspondence requirement in the combination transaction would permit the purchase money creditor, who is partially under-collateralized, to recover the shortfall from the over-collateralized portion before the prior creditor recovered. The purchase money secured party also favors rejecting an item-by-item correspondence requirement because doing so significantly simplifies the administration of the purchase money financing. The purchase money creditor can foreclose on any portion of the collateral it chooses, and it need not be excessively concerned with the relative values of each item of unsold collateral and its unpaid price.

Thus, the only remaining question is which creditor should be favored in the combination situations. The question of which creditor to prefer becomes a question of which policies each choice will further. The same policies which support purchase money priority should apply here unless there is some compelling reason, such as preventing abuse of purchase money financing, to prefer the prior creditor.

Can the lack of item-by-item correspondence be exploited so the purchase money lender has an inappropriate advantage? An aggregate rather than an item-by-item concept benefits the purchase money creditor only if there is partial under-collateralization. This situation is created by the debtor or the vagaries of the market—not the purchase money creditor. The purchase money creditor has an incentive to avoid under-collateralization. Partial under-collateralization does not present risks to the prior creditor any different than the risks presented by the recognition of priority for purchase money financing. There is no abuse of purchase money financing that would be curbed by requiring an item-by-item correspondence

357 It is possible that both the purchase money creditor and the other creditor could have their debts satisfied without foreclosing on all collateral. In such a circumstance the debtor would be helped by not having an item-by-item correspondence requirement.
when multiple items of collateral are acquired with the same extension of credit.

Integral to any discussion of an item-by-item correspondence requirement is the issue of how principal payments will be allocated among the purchase prices of individual items. When the items are acquired at the same time, the possible allocation mechanisms have no great significance. The most probable allocation mechanisms would be to allocate pro rata if the collateral was obtained at the same time with the same credit or in the case of inventory to allocate payments to the first items sold as this is consistent with credit management and business practices. The only impact any allocation mechanisms would have on the foregoing analysis would be to affect the relative under-collateralization or over-collateralization. Since under the dual status rule the allocation mechanism of first choice is contractual, an item-by-item correspondence requirement would only impact those failing to provide the mechanism. More important, however, is the fact that the purchase money creditor only gains relative advantage over the prior creditor when there is partial under-collateralization. The purchase money creditor does not have an incentive to create that situation because its greatest advantage is always over-collateralization. For all types of purchase money lending, one-to-one correspondence between debt and specific items of collateral should not be required when the items of collateral are acquired simultaneously as part of the same credit transaction.

(c) Multiple Items of Purchase Money Collateral Separated in Time

The third fact pattern involves two or more purchase money acquisitions of property separated in time. This fact pattern would result in the same analysis as the previous fact pattern if the two obligations were kept separate. The combination of the two obligations, however, presents one additional issue if item-by-item correspondence is required. That issue arises from the method used to allocate principal payments to obligations. Allocation methods can be chosen to prolong the time any particular purchase money debt

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358 The potential number of allocation mechanisms is limited only by the imagination. One could, for example, allocate payments based upon projected depreciation over an item of collateral's useful life. This allocation is appropriate for equipment and would make sense for inventory only if it is perishable or otherwise predictably declines in value over time.
is outstanding. For example, if a pro rata allocation based on un­
paid principal is used, the obligation secured by the collateral
purchased earlier will not be satisfied for a longer period of time
since the new obligation does not mature until later. This type of
pro rata allocation maintains all obligations until each is paid in
full. This is precisely the evil discussed by the courts in the con­
ssumer add-on cases.\textsuperscript{359}

The allocation of payments issue has a dramatically different im­
pact in the priority context. Paying the full price of an item of col­
lateral in the consumer context either defeats perfection\textsuperscript{360} or
removes the collateral from the protection of Bankruptcy Code
§ 522(f)\textsuperscript{361}. In the priority context, payment of the purchase price
does not terminate the security interest; it merely terminates the
purchase money priority in that collateral while any nonpurchase
money obligation is still secured by the collateral. The debtor is
indifferent as to whether its property is encumbered by a purchase
money or a nonpurchase money security interest.

The most at issue is the priority of the purchase money creditor
over the creditor who had filed or perfected earlier. Can a payment
allocation scheme be used to abuse purchase money status to the
detriment of the prior creditor? Based upon the analysis for the
previous fact pattern, the only potential for abuse between secured
creditors would be an incentive to allocate payments to the obliga­
tions that are most likely to be undersecured. Unless a purchase
money creditor is certain at the time the transaction is consolidated
which obligation will be more likely to be undersecured, there is no
inherent potential for abuse.

Purchase money inventory financing provides insight into

\textsuperscript{359} E.g., Roberts Furniture Co. v. Pierce (In re Manuel), 507 F.2d 990, 991-92 (5th Cir. 1975) (characterizing purpose of add-on clause as ensuring title to nothing passes until title to all passes); In re Gibson, 16 B.R. 257, 265-66, 268-69 (Bankr. D. Kan. 1981) (court adopts FIFO payment allocation to help ensure collateral is released as soon as its price is paid and to further § 522(f) policies); W.S. Badock Corp. v. Banks (In re Norrell), 426 F. Supp. 435, 436 (M.D. Ga. 1977) (failure of security agreement to release security interest in items of collateral purchased earlier when they are paid for defeats purchase money status); In re Jackson, 9 U.C.C. Rep. Serv. (Callaghan) 1152 (W.D. Mo. 1971) (retaining security interest until all collateral is paid for defeats purchase money status and is unconscionable under the UCC).

The evil is epitomized by the potential to use foreclosure to threaten the debtor, a practice described in the legislative history to Bankruptcy Code § 522(f) as the in ter­
rorem effect. \textit{See supra} note 285 and accompanying text.

\textsuperscript{360} \textit{See supra} text accompanying note 193.

\textsuperscript{361} 11 U.S.C. § 522(f) (1988 & Supp. IV 1992); \textit{see also supra} text accompanying note 269.
whether there is potential for abuse. The primary incentive to a purchase money inventory lender is to allocate payments first to the items that have been sold and are no longer collateral.\textsuperscript{362} Priority to the proceeds of the sold inventory is already regulated by statute to protect prior creditors with interests in certain proceeds.\textsuperscript{363} The secondary incentive for allocating payments would likely be to allocate more of the payments to inventory that remained with the debtor longer as this inventory may be losing its value. Thus, there is a disincentive to retain an item of inventory as collateral for a long period of time. The parties expect that inventory acquired earlier will be sold earlier. Therefore, the rational way for a purchase money creditor to address inventory declining in value would be to allocate payments to the earlier acquired collateral. This incentive is opposite the one motivating courts to defeat purchase money status in consumer add-on cases. There is simply no meaningful abusive allocation potential that justifies requiring item-by-item correspondence. Even if such a potential existed, courts look first to contractual allocations\textsuperscript{364} which enable purchase money creditors to circumvent any protection that could be afforded by an item-by-item correspondence requirement.

Because an item-by-item correspondence requirement could impact a priority dispute, the question is whether more important policies are served by preferring the purchase money creditor or the prior creditor. As we have seen, the risks for prior creditors in rejecting item-by-item correspondence are minimal. The risks do not arise from abuses of purchase money status by subsequent lenders. The risks against which a purchase money lender could protect itself in the absence of item-by-item correspondence are more common. For all types of purchase money lending, item-by-item correspondence should not be required when the items of collateral are acquired at different times and combined into a single credit transaction.

3. Judicial Interpretations of Commingling

The preceding analysis of the issues surrounding each of the three different commingling fact patterns reveals that significant differ-

\textsuperscript{362} U.C.C. § 9-307(1) terminates all security interests created by the seller when inventory is sold to a buyer in the ordinary course of business.

\textsuperscript{363} Under U.C.C. § 9-312(3), purchase money priority only extends to cash proceeds received by the debtor on or before the time the collateral is delivered to the buyer.

\textsuperscript{364} See supra notes 214-17, 349-51 and accompanying text.
ences exist among the fact patterns. Those differences have not been adequately or accurately reflected in court decisions. The reported cases have dealt almost exclusively with the first and third fact patterns. The dual status rule that has developed adequately addresses the issues raised by the first fact pattern. However, serious questions arise as to whether the second and third fact patterns should be characterized as commingled purchase money and non-purchase money transactions. Courts have so characterized the third fact pattern by applying the transformation or dual status rules to consumer add-on transactions—purchase money obligations to the same creditor at two different times under the same agreement.

Judicial treatment of the second fact pattern presents a different picture. The courts’ discussions of the need to allocate principal payments have not provided grounds for excluding the second fact pattern from application of the item-by-item correspondence concept. However, courts have avoided defeating purchase money status in cases involving the second fact pattern without discussing the issue. Courts appear to implicitly view purchase money security

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365 See Burk, supra note 21, at 1159-61.

A number of the cases involve refinancing of the purchase money obligation. In some commingling does not occur. Frequently, however, the refinancing involves an additional advance or a consolidation in which the first or third fact pattern describes the transaction.

366 A notable exception is In re Moody, 62 B.R. 282 (Bankr. N.D. Miss. 1986) in which the court held that a security interest in several items purchased under a Sears charge account was a purchase money security interest that had been automatically perfected.

367 E.g., Transamerica Fin. Servs. v. Matthews (In re Matthews), 20 B.R. 654, 656 (Bankr. 9th Cir. 1982) (purchase money security interest in items purchased from different sellers, but with same purchase money loan—security agreement covered all personal property), rev'd on other grounds per curiam, 724 F.2d 798 (9th Cir. 1984); Roberts Furniture Co. v. Manuel (In re Manuel), 507 F.2d 990, 993 (5th Cir. 1975) (purchase money security interest cannot exceed price of what is purchased in the transaction creating the security interest); In re Smallwood, 20 B.R. 699 (Bankr. W.D. Ky. 1982) (washer and dryer purchased in the same transaction, issue was whether assignment defeated the purchase money status); Credithrift of Am. v. Littlejohn (In re Littlejohn), 20 B.R. 695 (Bankr. W.D. Ky. 1982) (various items of furniture acquired in one transaction, the issue was renewal of the loan); Booker v. Commercial Credit Corp. (In re Booker), 9 B.R. 710, 712 (Bankr. M.D. Ga. 1981) (two transactions each involving multiple items of collateral were consolidated, by implication all items of collateral that had been acquired in one transaction could have retained purchase money status); see also Burk, supra note 21, at 1160.

The cases involved more than one item of collateral acquired at the same time, but none of them involved a discussion of cross-collateralization as a result of those multiple items or any need to allocate payments. By implication there was no cross-collateralization problem with the simultaneously acquired items.
interests from an aggregate perspective when more than one item of collateral is acquired at the same time. Some commentators, however, have analyzed the second fact pattern as a cross-collateralization situation in which each item of collateral is purchase money security for its own purchase price and nonpurchase money security for the purchase price of the other items of collateral.

The realization that the narrow definition of purchase money is not applied with logical uniformity to multiple items of collateral purchased at the same time and at different times should alert us to the fact that the definition is used as a way to reach a specific result. If the true concern of courts is “cross-collateralization,” the timing of the purchase money acquisition of collateral should be irrelevant. However, the courts’ real concern is not cross-collateralization. Neither courts nor commentators have challenged the application of the item-by-item correspondence concept to consumer financing involving add-on clauses. The add-on transactions that have resulted in the item-by-item correspondence concept in the third fact pattern could with equal force of logic be characterized as one purchase money obligation for the purchase price of the aggregate body of collateral. The justification for not doing so appears to be a desire to eliminate or regulate add-on clauses in consumer contracts. A more effective and efficient solution is to regulate directly by statute and allow the purchase money status defined in the Code to use an aggregate collateral concept. If occasionally defeating add-on clauses is sufficient to justify an item-by-item correspondence requirement, it should be limited to that context.

Caution should be exercised in applying the item-by-item correspondence concept in any other circumstances. If an item-by-item correspondence requirement is uncritically applied in priority disputes involving the second and third commingling fact patterns, the

368 The author has been unable to find any cases challenging purchase money status when multiple items of collateral are acquired at the same time and provide security for the aggregate purchase price.

369 WHITE & SUMMERS, supra note 77, § 22-9, at 994, § 24-5, at 1141-45; Burk, supra note 21, at 1138, 1143 n.42, 1160 n.97. But see James C. Marshall, Commercial Law (Annual Survey of Georgia Law), 37 MERCER L. REV. 139, 153-54 (1985) (one time advance of money used to acquire collateral at different times would not implicate a one-to-one correspondence requirement); Wessman, supra note 22, at 1319 (all inventory financed in one transaction survives when inventory purchased in two transactions loses purchase money status).

370 The one-to-one correspondence is not effective in curbing the use of add-on clauses because courts recognizing the dual status rule have saved commingled security interests if an allocation mechanism is available, and because contractual allocation mechanisms are the mechanisms of choice.
Code policies relating to commercial flexibility and purchase money priority are inconsistent with the results. This is particularly true when the other circumstances involve a purchase money security interest in a changing body of inventory.

III

CONCLUSIONS AND RECOMMENDATIONS

The rules determining purchase money status should be modified to promote all implicated policies. The consumer policies of protecting the debtor and avoiding creditor overreaching only relate to the use of purchase money status for automatic perfection and for protecting exemptions under Bankruptcy Code § 522(f). Purchase money status originally developed in commercial transactions simply as a method of establishing priority between secured creditors. The Code employs purchase money priorities to counterbalance the situational monopoly of a prior lender and to encourage financing new assets for debtors. To accommodate all policies, the transformation rule should be applied only if purchase money obligations and nonpurchase money obligations are secured by the same collateral and cannot be separated. This circumstance rarely if ever occurs. The dual status rule, implicit in the Code, should be continued with a judicial obligation to create a payment allocation mechanism to separate purchase money obligations from non-purchase money obligations.

The most significant issue in harmonizing the rules with the divergent policies is determining when a transaction in fact involves commingled purchase money and nonpurchase money obligations. This issue requires careful attention by the courts and by the drafting committee revising Article 9. Reading an item-by-item correspondence requirement into the transformation and dual status rules is misguided. Unfortunately, only one court\(^\text{371}\) and two legal commentators\(^\text{372}\) have challenged the application of the item-by-item correspondence concept to the consolidation of security interests which separately would qualify for purchase money priority. Item-by-item correspondence cannot be accepted as merely a shorthand definition of the Code rule that purchase money collateral cannot secure more than the value given to acquire the collateral. The Code does not require such item-by-item analysis and is more


\(^{372}\) Beard, supra note 12; Wessman, supra note 22.
easily read to describe an aggregate concept. Close analysis of the
differences between these two conceptions of the Code's purchase
money definition when applied to the potential fact patterns con­
tuting commingling shows that the item-by-item concept is not a
result compelled by the Code or any logical analysis. Instead, it is
an overbroad attempt to reach a specific result in consumer add-on
cases.

Analysis of the item-by-item purchase money concept, its legiti­
mate uses, its relationship to priority contests, and its implications
when inventory financing is considered, argues for rejection of the
concept. Inventory purchase money financing is a major source of
commercial financing and should be facilitated, not obstructed, by
the Code. The transformation rule and dual status rule and the ill-
considered scope given to them in the cases implying an item-by-
item correspondence requirement threaten purchase money financ­
ing of inventory. Requiring formalistic gyrations of allocating pay­
ments among each individual item of collateral and calculating
what portion of the proceeds of each item are purchase money and
which are "cross-collateralized" nonpurchase money proceeds cre­
ates a formidable burden on such financing. This burden threatens
the viability of purchase money financing of inventory. The bur­
dens on the other secured parties created by eliminating the item-
by-item concept are minor if they exist at all. Applying the trans­
formation or dual status rules in their current forms to priority dis­
putes involving purchase money security interests in inventory
evidences an inadequate understanding of purchase money security
interests and the reasons for granting them priority. The policy of
facilitating new money and additional financing should be furthered
by ignoring such item-by-item correspondence requirements.

We are left with the conclusion that in the commercial context,
no strong justification exists for requiring a one-to-one correspon­
dence between items of collateral and purchase price when two
purchase money debts separated in time are consolidated. There­
fore, the item-by-item correspondence concept should either be lim­
ited to consumer add-on cases or eliminated altogether and replaced
by more appropriately designed rules to directly regulate consumer
add-on transactions.

A. Recommended Judicial Clarifications

If an item-by-item correspondence concept is adhered to rather
than resolving the concerns with the consumer add-on cases by a
more direct and effective means, then new judicial doctrines need to be developed to accommodate the needs of purchase money financiers of inventory. The best way for courts to achieve that accommodation is to establish an aggregate rule for inventory as an exception to an item-by-item correspondence rule for consumer goods.

A second, although less effective, accommodation may be available under the dual status rule by creating a judicial payment allocation rule for inventory. If all payments were allocated first to the items of inventory sold, then the remaining items of inventory would secure their own unpaid purchase prices. This allocation mechanism not only would avoid many of the problems the item-by-item concept creates but also would reflect the most rational allocation mechanism in this context. Because buyers in the ordinary course of business take free of the security interest in inventory373 and purchase money priority does not extend to proceeds of credit sales of inventory,374 lenders and debtors addressing the issue contractually would likely opt for this allocation as the most efficient way to avoid resorting to costly mechanisms designed to create a self-liquidating loan.

A third but less desirable approach would reject an item-by-item concept but still defeat add-on transactions as being commingled. The add-on cases could be distinguished under the current structure of the Code by a close analysis of the nature of the creditor’s claim. Add-on cases require two or more transactions and usually involve two or more sets of documents. Because after-acquired property claims to consumer goods are not valid if the goods are acquired more than ten days after the creditor gave value,375 the documentation from the first transaction will not cover the new consumer goods acquired in the second transaction376 unless the “value” was committed at the time of the first transaction.377 The section 9-204(2) value requirement could be read to exclude uncommitted value given subsequently and thus be limited to consumer transac-

373 U.C.C. § 9-307(1).
374 U.C.C. § 9-312(3).
375 U.C.C. § 9-204(2).
376 If the goods are acquired in the second transaction within 10 days of the first transaction there is no reason to treat them separately. The evil of the add-on clause, keeping the security interest in the first goods for a longer period of time, simply evaporates.
377 This would distinguish cases like In re Moody, 62 B.R. 282 (Bankr. N.D. Miss. 1986), in which the collateral is items purchased under a retail charge account in which the value is given when the credit line is established.
tions. Any future advances clause in the first set of documents would still be operational but the security for the second extension of credit would not be the consumer goods acquired with the credit. Thus, add-on transactions relying on the first set of documents would result in only the first purchase price qualifying as purchase money.

The second set of documents produce a similar result but create a more troubling problem. Those documents cover the second acquisition as a purchase money security interest and include the earlier purchased consumer goods as nonpurchase money collateral by taking a security interest in them as preexisting property. The earlier obligation becomes consolidated with the later obligation because the debtor is only required to make one payment. This consolidation could then be treated as a refinancing rather than a commingling so that the refinanced antecedent debt would not be entitled to purchase money status. The problem with this judicial resolution is that it requires the prior obligation to be treated as refinanced and contributes to perpetuating another noncommercial result. Refinancing of purchase money debt in the commercial context should not always result in loss of purchase money status.

B. Recommended Code Amendments

A far more effective way to rationalize the transformation and dual status rules entails amendment to the Code. An amendment facilitates uniformity among states and does not have to rely on judges in various jurisdictions adopting the same principles. Article 9 is currently undergoing a revision process making this a propitious time to resolve the concerns.

Refining the transformation and dual status rules to determine when purchase money status is lost would include eliminating the transformation rule and the item-by-item correspondence concept and addressing allocation mechanisms under the dual status approach. The allocation mechanism would accommodate the judicial concerns evident in the consumer add-on transactions. The following changes to U.C.C. section 9-107 would achieve these

378 See U.C.C. § 9-107 cmt. 2; see also supra note 229 and accompanying text. That characterization is not readily available against sellers using add-on clauses. See generally Burk, supra note 21, at 1147-50, 1164-73 for a discussion of how courts have dealt with the refinancing characterization in the consumer cases and recommendations for improvements.

379 This is the point of the article by Professor Lloyd, supra note 21, at 1. See also Burk, supra note 21, at 1164-73.
objectives. First, amend section 9-107 by adding the italicized language and deleting the language in brackets:

§ 9-107  A security interest is a "purchase money security interest" to the extent that it is
(a) taken or retained by the seller of the collateral to secure all or part of [its] the aggregate price of all items of collateral sold; or
(b) taken by a person who by making one or more advances or incurring one or more [an] obligations gives value to enable the debtor to acquire rights in or the use of all items of collateral for which [if] such value is in fact so used.

Second, add the following new subsection:

If the same collateral secures purchase money and non-purchase money obligations, any payments made shall be allocated between the obligations in any manner agreed to by the debtor, unless an applicable statute requires a different allocation. In the absence of agreement, if the collateral is inventory, payments shall be allocated first to obligations incurred to acquire collateral which has been sold by the debtor. Any payments not so allocated and payments made if the collateral is not inventory shall be allocated pro rata based on the original principal obligations.

These changes would facilitate purchase money inventory financing and remove many of the objections commentators have to the current disarray of judicial rules.380

380 Aronov, supra note 22, at 63-64 (purchase money concept in the Code should be clarified to give certainty); Beard, supra note 12, at 497 (Article 9 should facilitate a floating lien by a purchase money inventory financier); Stilson, supra note 21, at 36-37 (courts should supply an allocation formula if necessary to give effect to the Article 9 concepts); Wessman, supra note 22, at 1347-48 (limited cross-collateralization of purchase money security interests in inventory should be permitted); Burk, supra note 21, at 1180 (allocation rules should be used which approximate the bargain the parties would have reached).