Purchase Money Security Interest in Inventory: If It Does Not Float, It Must Be Dead!

D. Benjamin Beard
University of Idaho College of Law, beardb@uidaho.edu

Follow this and additional works at: https://digitalcommons.law.uidaho.edu/faculty_scholarship
Part of the Commercial Law Commons

Recommended Citation
57 Tenn. L. Rev. 437 (1990)
THE PURCHASE MONEY SECURITY INTEREST IN INVENTORY: IF IT DOES NOT FLOAT, IT MUST BE DEAD!

D. BENVJAMIN BEARD*

I. INTRODUCTION

Inventories in this country constitute a major source of potential financing capital. The total value of manufacturing and trade inventories in this country amounts to almost three quarters of a trillion dollars.1 The total outstanding amount of commercial loans is measured in the hundreds of billions of dollars.2 Specifically, purchase money financing of inventories, in reliance on the priority accorded purchase money security interests under Article 9 of the Uniform Commercial Code (UCC),3 alone amounts to billions of dollars

---

* Associate Professor of Law, University of Idaho, College of Law. Copyright 1989, All Rights Reserved.

ACKNOWLEDGEMENT: I would like to thank Professors Elizabeth Barker Brandt, Dennis C. Colson, Kenneth S. Gallant and Joann P. Henderson, of the University of Idaho College of Law, for their very helpful comments on earlier drafts of this Article.


2. As of December 31, 1988, the total outstanding amount of commercial and industrial loans made by large commercial banks reporting weekly to the Federal Reserve System amounted to $301,013,000,000. Id. at 64. The statistics relating to commercial loans do not distinguish between secured and unsecured loans, or the types of collateral, if any, involved. The amounts set forth relating to inventories and loans are merely provided to demonstrate the scope of the economic activity relating to inventories and commercial loans. The numbers are not intended as direct correlations of the amount of secured credit advanced on the security of inventories. For additional data concerning the scope of secured lending, see Scott, A Relational Theory of Secured Financing, 86 COLUM. L. REV. 901, 938-940, app. at 971-977 (1986).

3. Unless otherwise noted, all references to the "Uniform Commercial Code," "UCC" or "Code" are to the 1987 Official Text. References to "Article 9" are to Article 9 of the Code.
annually. Given the magnitude of purchase money secured credit advanced against inventory, the provisions of Article 9 relating to purchase money security interests must be interpreted and applied properly to facilitate this important economic activity.

Article 9 has succeeded, as a general proposition, in providing a uniform and smoothly functioning system for securing commercial credit. This unified system of securing credit has perhaps no greater significance than in the area of inventory financing. Through the validation of the "floating lien" and the related exception for the purchase money security interest (PMSI), Article 9 has made the vast inventories of business more easily and readily available as a source of credit. Despite the current debate about whether a system of secured credit constitutes the most efficient means for obtaining and extending credit, Article 9 facilitates the provision of working

---

4. Affidavit of Richard C. Goldman, Senior Vice President and General Counsel, ITT Commercial Finance Corp. [hereinafter Goldman Affidavit]; Affidavit of Richard W. Moyer, Vice President and Associate General Counsel, BancAmerica Private Brands Inc. [hereinafter Moyer Affidavit]; and Affidavit of George V. Burbach, Associate Counsel, Ford Motor Credit Company [hereinafter Burbach Affidavit]; Southtrust Bank of Ala., Nat'l Ass'n v. Borg-Warner Acceptance Corp., 760 F.2d 1240 (11th Cir. 1985), reh'g denied, 774 F.2d 1179 (1985) (Petition for Rehearing by Panel and Suggestion for Rehearing En Banc). Mr. Goldman stated that ITT Commercial Finance Corp. had outstanding purchase money loans in the amount of $1,100,000,000, Mr. Moyer stated that BancAmerica Private Brands had outstanding purchase money loans in the amount of $688,492,000, and Mr. Burbach stated that Ford Motor Credit had outstanding purchase money inventory loans in the amount of $5.3 billion. In their affidavits, Messrs. Goldman, Moyer and Burbach each indicated that the documentation for such financing included after-acquired property clauses and future advance clauses, which they believed were effective and would not jeopardize the priority accorded their purchase money security interests under the Code.

5. As used in this Article, the terms "floating lien" and "floating charge" mean that security interest obtained in after-acquired property, and as security for future advances, by virtue of the operation of §§ 9-204, 9-205 and 9-108 of the UCC.

6. See infra text accompanying note 77.

7. See supra notes 1-2; see also infra note 9; Memorandum of Mr. Robert W. Weeks, Submitted on Behalf of the John Deere Plow Company, December 23, 1954, reprinted in 2 N.Y. State Law Revision Comm'n 1954 Report, Legis. Doc. 65H, Item 20, 61 (1954) [hereinafter Weeks Memo]. Mr. Weeks concluded that Article 9 "provides for a floating lien in the inventory field, available wherever it can be useful, without eliminating other methods of obtaining security. By doing so, it makes many new types of inventory usable as collateral, provides a more adaptable security device, makes possible the elimination of expensive paper work and eliminates some otherwise unavoidable risks peculiar to inventory financing." Id. at 71.

8. See, e.g., Jackson & Kronman, Secured Financing and Priorities Among Creditors, 88 YALE L.J. 1143 (1979); Schwartz, Security Interests and Bankruptcy Priorities: A Review of Current Theories, 10 J. LEGAL STUD. 1 (1981); Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 YALE L.J. 49
capital and acquisition financing in a manner that permits the ex-
pansion of capital in business.9

Through the combination of a unitary device, the "security
interest", and the validation of the floating lien, Article 9 permits
lenders to obtain security in the inventory of the borrower simply,
at relatively low cost, and without the necessity of extensive, technical
and burdensome on-going monitoring and paper work for purposes
of maintaining priority.10 The creation of a single form of consensual
lien11 simplified the task of obtaining security by eliminating the
overly technical distinctions between the various forms of chattel
security that existed prior to the Code.12 Equally important to the
financing of inventory, the Code validated the floating lien.13 Unlike
equipment and consumer goods that the borrower generally retains
during the life of the financing, the borrower buys, sells and replen-
ishes inventory in the ordinary course of business. This posed great
difficulties under pre-Code chattel security law because of the re-
quirement that the creditor retain significant controls over its collat-
eral in order to maintain its security.14 Such controls required technical
and burdensome monitoring in order to satisfy the creditor's need
for security while at the same time permitting the debtor the necessary
freedom to carry on business.15 Though complicated and difficult, it
was possible to accommodate the business needs of the debtor and
the security needs of the creditor under pre-Code chattel security
laws.16

9. There has been a clear, steady increase in manufacturing and trade
inventories over the past twenty years. See Business Statistics, supra
note 1, at 9. Although numerous factors contributed to this expansion, it is reasonable to believe
that the availability of a relatively simple and inexpensive system of secured credit
was not an insignificant factor in such expansion. See Scott, supra note 2, at 938-
39 and 943-44.

10. See Weeks Memo, supra note 7. This is not to say that, in the context
of purchase money inventory financing, there are no legal requirements for the
tracing of collateral and debts. See infra notes 82, 289-92 and accompanying text.
However, the legal as opposed to the business requirements of monitoring and
tracing have been kept to the minimum necessary to protect the competing interests
of the secured creditor, other creditors and the debtor. See infra notes 170, 303-12
and accompanying text.

11. A consensual lien is a lien existing by mutual consent without a formal
writing. BLACK'S LAW DICTIONARY 276 (5th ed. 1979).
13. See infra Part IV.B.1.b.
15. See infra note 170 and accompanying text.
16. See infra notes 135-37 and accompanying text.
Validation of the floating lien was a natural development that the drafters believed simply gave effect to a state of affairs that existed under pre-Code law.\textsuperscript{17} Notwithstanding the drafters' views, the validation of the floating lien met significant opposition.\textsuperscript{18} Perhaps the single greatest source of comment and concern during the drafting and adoptive history of Article 9 related to this development, which many considered to be revolutionary.\textsuperscript{19} The possibility that a prior secured creditor, through the utilization of the floating lien, could obtain a stranglehold on a debtor, precluding the acquisition of alternate financing, particularly concerned some critics.\textsuperscript{20} The drafters, however, provided the debtor with an escape mechanism from this dilemma through the use of the PMSI and the numerous privileges accorded it.\textsuperscript{21} Principal among the privileges accorded the PMSI

\textsuperscript{17} UCC § 9-204, comment 2 (1987); see also infra note 137 and accompanying text.


\textsuperscript{20} "Would not the operation of the general lien [floating charge] necessarily throttle such competition [among providers of credit] by the blanketing or freezing of the borrower's credit position?" Statement of the National Commercial Finance Conference, supra note 8, 2 N.Y. Law Revision Comm'n 1954 Report, at 1034. See also, 2 N.Y. Law Revision Comm'n 1954 Report 1054 (1954) (Correspondence of H. F. Birnbaum to John W. MacDonald); 2 N.Y. Law Revision Comm'n 1954 Report 1092-1211 (1954) (Stenographic Report of Hearing on Article 9 of the Uniform Commercial Code, at 1098 (Comments of Harold Sherman), at 1150-1151 (Comments of Milton Kupfer), at 1193 (Comments of J. Francis Ireton)).

\textsuperscript{21} See, Gilmore, Purchase Money Priority, 76 Harv. L. Rev. 1333-37 (1963). Special protections accorded the PMSI include (1) exemption from Article 9 filing requirements to perfect a PMSI in consumer goods under UCC § 9-302; (2) grace periods for the filing of UCC financing statements in order to perfect the PMSI under 9-302 (consumer goods) and 9-312(4) (non-inventory collateral); (3) protection from the avoidance power of a bankruptcy trustee under Bankruptcy Code § 522(f); and (4) most importantly for the purposes of this article, the priority accorded the PMSI over prior, perfected security interests in after-acquired property of the debtor under UCC §§ 9-312(3) and 9-312(4). See Aronov, The Transformation Rule Applied to Purchase Money Security Interests in Commercial Lending Transactions, 16 Mem. St. U.L. Rev. 15, 18-19 (1985).
is the priority over earlier security interests in after-acquired property.\textsuperscript{22}

Casual observation of the operation of secured lending today indicates that the fear that validation of the floating lien would eliminate alternate sources of credit has not materialized.\textsuperscript{23} Certainly the existence of the purchase money priority serves to expand the debtor's available sources of credit, as the drafters intended.\textsuperscript{24} It is significant that since the adoption of the Code, litigation challenging the priority of the properly perfected PMSI has been rare. Only a few cases have dealt directly with the specific issue of competing priority in the same inventory collateral between the properly perfected PMSI in inventory\textsuperscript{25} versus the properly perfected security interest in after-acquired property.\textsuperscript{26} The overwhelming majority of

\begin{itemize}
\item \textsuperscript{22} See UCC § 9-312(3) (1987). See also, 2 G. Gilmore, Security Interests in Personal Property § 29.1, at 777-78 (1965).
\item \textsuperscript{23} See supra note 4. See also 14 West's Legal Forms § 57.3, Form 17 (2d ed. 1985).
\item \textsuperscript{24} As Professor Gilmore stated, "No previous security statute has so warmly embraced the once-despised after-acquired property interest. It is also true that no previous statute has so sternly insisted on the priority for purchase money interests." Gilmore, supra note 21, at 1334; see also In re Daniels, 35 Bankr. 247, 249 (Bankr. W.D. Okla. 1983) where the Court stated:

The drafters of the Code realized the impact upon commercial flow which would result should a debtor be strangled by a prior secured creditor. Such a creditor by not providing additional funds could cripple a debtor's commercial operation. The debtor, on the other hand, would be hamstrung in receiving other financing since another creditor would have no collateral protection. The purchase money security interest rescued the debtor from this commercial impasse.

\item \textsuperscript{25} As used in this Article, a "properly perfected purchase money security interest in inventory" means a PMSI in inventory with respect to which all of the requirements of UCC § 9-312(3), see infra note 92, have been duly and timely fulfilled, to-wit, prior to the receipt of possession of the intended collateral by the borrower, the purchase money party has properly perfected (usually by filing) its interest in the collateral, and duly notified all other parties having an interest in the same type of collateral of the purchase money party's acquisition of a PMSI.
cases involving conflicts between purchase money financiers and general financiers involve the issue of the purchase money financier’s compliance with the technical requirements of UCC section 9-312(3) and (4). That secured parties themselves understand that the Code grants the purchase money financier priority in all collateral which its credit enabled the debtor to acquire, provides one explanation for the dearth of case law on the direct priority battle.

The fact that, for many businesses, inventory is the single largest asset demonstrates the necessity for a floating lien. Unless a lender’s security interest can float over the fluctuating pool of inventory, the


Professor Hansford has suggested that the lack of litigation in this area results from the fact that (1) “most major inventory financiers probably have priority because they are first to perfect;” or (2) the subsequent inventory financier obtains a subordination agreement from the prior lender; or (3) “very few lenders ever truly rely upon their purchase money status for priority.” Hansford, The Purchase Money Security Interest in Inventory Versus the After-Acquired Property Interest—A “No-Win” Situation, 20 U. Rich. L. Rev. 235, 261 (1986). Whether “most” inventory financiers gain priority by perfecting first or obtaining subordination agreements must await further empirical study. However, Hansford’s contention that “very few lenders ever truly rely” on purchase money priority is belied by the Goldman Affidavit, Moyer Affidavit and Burbach Affidavit, supra note 4, wherein each affiant stated that they entered into purchase money financing transactions in reliance on the priority accorded purchase money security interests under the Code, including priority accorded to future purchase money obligations and after-acquired purchase money collateral.

28. See infra notes 135-36 and accompanying text.
lender's ability to conduct on-going inventory financing is severely restricted. At the same time, the existence of the floating lien, in the hands of the general financier, does pose a threat to the debtor's ability to obtain alternate financing. Yet, with the PMSI priority coupled with the floating lien, the debtor can retain flexibility in financing its inventory as the drafters intended.

The following hypothetical will serve to illustrate the proper construction of the floating lien in the context of the PMSI in inventory. Borrower desires to open an automobile parts store to sell all manner of automobile parts, from tires and batteries to gaskets, hoses, and belts. Borrower negotiates and enters into a standard working capital financing arrangement with a local Bank. To secure a line of credit of $500,000, Bank acquires and duly perfects a blanket security interest in all of Borrower's equipment, inventory and accounts, then owned and thereafter acquired. Borrower opens the auto parts store and for three years Borrower's business grows and the relationship with Bank is mutually beneficial. After three years, however, Borrower finds it desirable to take advantage of other financing opportunities. Borrower may desire to expand the lines of merchandise offered. It may be that Bank does not believe that the Borrower's market can support such expansion. In another case, Borrower may wish to expand into new lines of inventory because Suppliers offer to extend more favorable financing on the new merchandise. This may result from the Suppliers' expertise in monitoring this type of collateral, or because of the ready market available to Supplier to sell the inventory in the event of a default. For whatever reason, Borrower wishes to obtain inventory financing from sources other than the Bank, although it is content with respect to the general working capital arrangements with the Bank. On the other hand, the Bank is not willing to extend the necessary additional credit or meet the more favorable terms available to Borrower from other sources.

The Code permits the Borrower to grant Supplier a PMSI in the inventory provided by Supplier. So long as the advances, loans or other credit advanced by Supplier result in Borrower's acquisition of

30. See infra notes 68-70 and accompanying text.
31. Bank supplies the financing as well as significant financial and investment counseling to get Borrower's business off to a solid start. See infra notes 265-72 and accompanying text.
32. The new project (inventory expansion) represents a risk Bank did not contemplate. See infra notes 282-84 and accompanying text.
33. For purposes of this hypothetical, the purchase money party is referred to as "Supplier." Such "Supplier" may be a seller of goods or a third-party financier. See infra notes 286-87.
34. See infra notes 286-87, and accompanying text.
35. See UCC § 9-107 (1987) and comment 1.
inventory (such advances, loans or other credit being referred to as “purchase money obligations”), Supplier will retain priority in all inventory so acquired (“purchase money collateral”) to secure all purchase money obligations. The ability to secure all outstanding purchase money obligations with the fluctuating pool of purchase money collateral recognizes the nature of inventory finance as an ongoing relationship, as well as the difficulty of structuring inventory financing on a self-liquidating basis. It is the validation of the floating lien in the purchase money context that makes inventory financing possible. Indeed, if the floating lien is not available to the purchase money financier of inventory, the PMSI in inventory is a dead letter for all practical purposes.

The PMSI in inventory, if not dead, is in critical condition in the United States Circuit Court for the Eleventh Circuit where one recent case held that the floating lien is unavailable to, and inconsistent with, a PMSI in inventory. This Article will demonstrate that such a construction of the PMSI is wholly inconsistent with the purpose, policy and history of the Code. Indeed, only by giving effect to the floating lien in the context of PMSIs in inventory can the scheme and purpose of the Code be realized to the benefit of the debtor, general financier and purchase money financier.

Part II of this Article will discuss the current assault on the purchase money security interest in the context of inventory financing. Part III will demonstrate that the current text and comment of the Code do not support invalidation of the floating lien in the context of the PMSI in inventory. In Part IV of this Article, pre-Code legal developments and the drafting and legislative histories of the Code will be analyzed to establish the clear, strong preference the drafters accorded to so-called “new value” given to a borrower. This preference, manifested both in the common law on the eve of the drafting of the Code, and in the first drafts of what was to become Article 9, clearly illustrates that limitations placed on the scope of the PMSI in inventory (by precluding the efficacy of the floating lien), based solely on the definition of PMSI in UCC section 9-107, are without foundation. Part IV of the Article will conclude that under

a purposive analysis of the present Code and its historical antecedents, the PMSI in inventory must be accorded the benefits of the floating lien in order to effectuate the purposes of preferring "new value" additions to the borrower's estate. In Part V, it will be argued that equity and fairness require that the PMSI in inventory be accorded broad priority vis-a-vis the prior financier claiming under an after-acquired property clause. Further, without entering directly into the current debate concerning whether secured credit is efficient or not, it will be shown that the floating lien in the context of PMSIs in inventory is entirely consistent with Professor Scott's *Relational Theory of Secured Financing.* Finally, using the foregoing hypothetical as a model, Part VI will set forth the limits and bounds of the PMSI in inventory.

II. GENERAL BACKGROUND

A purchase money security interest under Article 9 constitutes an exception to the Code's general rule of priority among competing security interests, i.e., first in time. The holder of a PMSI in certain collateral obtains priority with respect to that collateral even though such collateral is subject to an earlier perfected security interest. Further, the PMSI is also accorded special protection in bankruptcy. Notwithstanding the special priority and other protections afforded the PMSI under the UCC and the Bankruptcy Code, a judicial bias against the PMSI has manifested itself, culminating in the development of the so-called "transformation rule." The transformation

42. *Id.*
43. 11 U.S.C. § 522(f) (1987) (allowing the debtor to avoid non-possessory, non-purchase money security interests in certain exempt assets) (unless otherwise noted, all references to the "Bankruptcy Code" are to the Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-151326 (1982), as amended (Supp. 1987)) (§§ 101-1501 to 151326 were repealed).
44. *See In re* Simpson, 4 U.C.C. Rep. Serv. (Callaghan) 243 (Bankr. W.D. Mich. 1966); *In re* Manuel, 507 F.2d 990 (5th Cir. 1975); *In re* Matthews, 724 F.2d 798 (9th Cir. 1984); Schneider v. Fidelity Nat'l Bank (*In re* Schneider), 37 Bankr. 747 (Bankr. N.D. Ga. 1984). *See also* Aronov, *supra* note 21, at 22-23; Lloyd, *Refinancing Purchase Money Security Interests,* 53 TENN. L. REV. 1, 48-54 (1985). While the purpose of this Article is to set forth the proper interpretation and scope of the floating lien and purchase money security interest in the inventory context, the impetus for this Article came from the 1985 decision of the Eleventh Circuit Court of Appeals in Southtrust Bank of Ala., Nat'l Ass'n v. Borg-Warner Acceptance Corp., 760 F.2d 1240, *reh'g denied,* 774 F.2d 1179 (11th Cir. 1985). In *Southtrust,* the court, interpreting Alabama and Georgia law under the UCC, applied the "transformation rule" to deprive a purchase money inventory financier of priority over a prior perfected lender claiming under an after-acquired property clause. The
rule provides that a purchase money security interest in collateral may be "transformed" into a nonpurchase money security interest if the collateral secures payment of indebtedness or liabilities other than the purchase price of the specific item of collateral and/or the creditor attempts to secure the payment of the purchase price with property other than the specific item of collateral. Upon application of the transformation rule, the PMSI loses all of the special protections afforded PMSIs and becomes a standard, general security interest. Of particular importance to the present discussion, the purchase money financier loses priority in all purchase money collateral when courts invoke the transformation rule. The transformation rule has been developed and applied almost exclusively in the area of consumer bankruptcy under the Bankruptcy Code. Application of the transformation rule in the consumer bankruptcy area may be justified, given the distinctions made by the UCC between consumer goods, inventory, and equipment, and the court held that "a floating lien is inconsistent with a PMSI" and ruled that the failure of the purchase money financier to establish "a one-to-one relationship between the debt and the collateral" resulted in the loss of purchase money priority under the UCC. This decision effectively destroys the UCC provisions according purchase money financiers priority, particularly in the inventory context. See infra note 228 and accompanying text. 45. Schneider v. Fidelity Nat'l Bank (In re Schneider), 37 Bankr. 747, 749 (Bankr. N.D. Ga. 1984). 46. See supra note 21; Aronov, supra note 21, at 22; Lloyd, supra note 44, at 2-4. 47. Southtrust, 760 F.2d at 1243. 48. See supra note 44. Also see the cases cited in Stilson, The "Overloaded" PMSI in Bankruptcy: A Problem in Search of Resolution, 60 Temp. L.Q. 1, 1 nn.1 & 2, 2 n.4 (1987); Aronov, supra note 21, at 23. 49. UCC § 9-109 defines consumer goods, equipment and inventory as follows: Goods are (1) "consumer goods" if they are used or bought for use primarily for personal, family or household purposes; (2) "equipment" if they are used or bought for use primarily in business (including farming or a profession) or by a debtor who is a non-profit organization or a governmental subdivision or agency or if the goods are not included in the definitions of inventory, farm products or consumer goods; (4) "inventory" if they are held by a person who holds them for sale or lease or to be furnished under contracts of service or if he has so furnished them, or if they are raw materials, work in process or materials used or consumed in a business. Inventory of a person is not to be classified as his equipment. Comment 2 to § 9-109 states, "The classes of goods are mutually exclusive; the same property cannot at the same time and as to the same person be both equipment and inventory, for example." The classification of goods into mutually exclusive categories is a fundamental organizing feature of the Code. The purpose of such
UCC's specific rules relating to the treatment of security interests in different types of collateral based on the function of such collateral. Further justification for application of the transformation rule in the context of consumer bankruptcy may be found in the policies of the Bankruptcy Code to protect the consumer debtor. Such policy justifications do not exist in a commercial context. In the commercial context, different policies must be advanced that demonstrate the impropriety of the transformation rule.

mutually exclusive categories was to allow development of specific rules addressing the particular needs and functions of such forms of collateral in commercial practice. See infra Part IV.B.1.a.


51. Among the policy rationales for application of the transformation rule in the consumer and bankruptcy contexts are: (1) protection of the filing system of the Code, arising by virtue of the Code's automatic perfection of a security interest in consumer goods, without filing, under U.C.C. § 9-302(d). See Hansford, supra note 28, at 249. (2) Penalizing creditor overreaching and unconscionable actions such as occurred in Williams v. Walker Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965), where the creditor attempted to secure consumer credit with all consumer purchases until the entire indebtedness was satisfied. See Stilson, supra note 48, at 12 see also Bankruptcy Code § 522(f); Hansford, supra note 28, at 254; Stilson, supra note 48, at 23; and Aronov, supra note 21, at 41. (3) The fresh start policies underlying the Bankruptcy Code. See Stilson, supra note 48, at 28 and Aronov, supra note 21, at 41.

52. While this author believes that the transformation rule is not justified in any context, by virtue of the "to the extent" language in U.C.C. § 9-107, see Lloyd, supra note 44, at 63-67; and Aronov, supra note 21, at 42, it is possible to justify its application in the context of consumer bankruptcy under one or more of the above policies, particularly policies derived from the Bankruptcy Code. "[T]he policies of the U.C.C are arguably supplanted by those of the [Bankruptcy Code] by virtue of the Supremacy Clause of the Federal Constitution." Stilson, supra note 48, at 35. However, the Bankruptcy Code lacks any provision parallel to § 522(f) for the avoiding of non-purchase money security interests in commercial forms of collateral (e.g., equipment and inventory), and the policies of the UCC and the Bankruptcy Code to protect consumers are not present in the commercial context. See infra note 53. Finally, the Code's policy of debtor protection is fundamentally different in the consumer and commercial contexts. See, infra note 56.

It is not the purpose of this article to demonstrate the improprieties of the transformation rule per se. For such scholarship, see the articles by Hansford, Aronov, Stilson and Lloyd supra, respectively, at notes 28, 21, 48 and 44. The true purpose of this article is to demonstrate that the UCC and its provisions concerning PMSIs in inventory and the floating lien, if construed in light of all the policies and purposes of the Code, address the needs, and adequately protect the interests, of the debtor, the general financier and the purchase money financier, making the strict, hypertechnical tracing requirements of the transformation rule, as adopted by the court in Southtrust, wholly inappropriate and unnecessary. See supra note 44.

53. UCC § 1-102 sets forth the general policies of the Code in the context of commercial finance. The Code is to be liberally interpreted to foster its policies. UCC § 1-102(1) (1987). While protections for the debtor, creditors and purchasers must be balanced, the drafters of the Code recognized that these protections are not of equal importance in every context. See infra Part IV.B.1.a.; Kawasho Int'l,
The UCC policies of advancing commercial practice, keeping commercial law modern and consistent with commercial reality, and promoting uniformity must be considered in any discussion of the proper interpretation of UCC provisions. In order to construe specific provisions of the Code in accordance with these overriding policy considerations, the context in which the specific provisions are to be applied becomes very significant. Simply because the transformation rule may be justified in one situation, it cannot be taken as carte blanche to apply the transformation rule in every situation involving a PMSI. Indeed, the same policy considerations which indicate that the transformation rule may be appropriate in one situation, for example, consumer finance, may indicate the total impropriety of the transformation rule in another setting, like inventory finance. Analysis of the pertinent provisions of the Code in the context of commercial inventory finance, demonstrates the Code's method and framework for the proper scope and application of the floating lien and the PMSI in inventory.

The rise of the transformation rule has not gone unnoticed; however, the case law and the commentary dealing with the permissible scope of the PMSI in inventory focus principally on the definition in section 9-107, without detailed analysis of the floating lien provisions as applied to the PMSI. Consideration of the PMSI together with the floating lien provides insight into the "patent

---

55. See note 51 supra.
56. For example, in the consumer context the policy of debtor protection may support application of the transformation rule to prevent creditor overreaching, while in the context of inventory finance it supports a broad validation of the PMSI, including the validation of the floating lien, to avoid overreaching and creditor misbehavior by the prior secured lender relying on the after-acquired property clause. See infra notes 277-84 and accompanying text; Scott, supra note 2, at 962-963; In re Daniels, 35 Bankr. 247 (Bankr. W.D. Okla. 1983) (explanatory comment supra note 24).
reason" underlying the purchase money provision. To properly interpret the Code provisions dealing with PMSI in inventory it is necessary to construe "individual provisions holistically, that is, as part of a Code." Accordingly, while the definition of PMSI in section 9-107 is certainly relevant to a discussion of the proper scope of the PMSI in inventory, appreciation of the intended scope and benefit to be accorded purchase money obligations and security interests requires consideration of (1) the general purposes and policies of the Code set forth in section 1-102; (2) supplemental principles of law, particularly equity, under section 1-103, which inform the proper construction of specific Code provisions; (3) the floating lien provisions of the Code in section 9-204 concerning the validation of after-acquired and future advance clauses and section 9-205 concerning the level of monitoring of collateral to preserve priority; and (4) section 9-312(3), and its relation to section 9-109 on classification of collateral, concerning the requirements for, and purposes of, the priority accorded to PMSIs in inventory.

Existing scholarship provides advice for avoiding the effects of the transformation rule, suggests legislative corrections for the effects of the rule, and urges the courts to deal with the allocation of payments in a more flexible manner to give effect to PMSIs. Such analyses and advice, while properly critical of the transformation rule, fail to address the proper construction of the Code itself. Rather, in those situations where a purchase money financier restricts

58. See infra notes 100 and 144 (regarding Karl Llewellyn's principle of the patent reason).
59. Professor Lloyd has gone beyond the bare definition of a PMSI in section 9-107 and demonstrates the early bias and judicial favor in protecting the priority accorded it. Lloyd, supra note 44 at 10-37. See infra notes 140-42, 202 and 207-08 and accompanying text.
60. Barnes, supra note 53, at 118.
61. See, e.g., Aronov, supra note 21, at 59-63. The author suggests that the purchase money financier assure priority by obtaining lien subordination agreements from prior secured parties. Id. Ms. Aronov further suggests that through a properly drafted subordination agreement, "allocations of collateral between the secured parties might be done in more general terms by simply giving each creditor priority to that collateral specifically financed by each of them." Id. at 63. Properly construed, the floating lien and purchase money provisions of the Code accomplish this result, without the need of obtaining the prior lender's consent to subordination which Ms. Aronov concedes is a problem. Id. at 63. See infra Part V. Indeed, requiring the purchase money financier to obtain lien subordination agreements to assure priority, frustrates the policy of the Code behind the purchase money priority, which is to prevent the first lender from exercising a stranglehold on the debtor's ability to obtain alternative sources of credit. See infra notes 139-43, 188-93 and 217 and accompanying text.
62. Aronov, supra note 21, at 48-55.
63. Id. at 55-59; Stilson, supra note 48, at 34-36; Lloyd, supra note 44, at 86-100.
itself solely to providing purchase money obligations that result in the acquisition of purchase money collateral, the Code itself, given its history and purposes, properly analyzed, will result in the proper allocation of the inventory collateral to the respective secured parties with the least cost and greatest benefit to all parties.

III. The Language of the Code and Comments

A. The Text of Article 9

1. Express Overriding Policies Under Article 1

Before analyzing the pertinent text, comment, and history of Article 9 as it relates to the PMSI in inventory, the overall policies and purposes of the Code found in Article 1 must be considered. The Code itself mandates that its provisions "be liberally construed and applied to promote its underlying purposes and policies." The Code expressly requires that its provisions be interpreted and applied to promote simplicity, clarity, and modernity in the law of commercial transactions, accommodation of expansion of commercial practices recognized in the applicable trade, and uniformity of the law among the various jurisdictions. Recognition of the validity of the floating lien in the context of purchase money financing of inventory clearly follows from these policies.

Validation of the floating lien generally, through the provisions of sections 9-204 and 9-205, simplified and modernized commercial lending. Supporters of the floating lien provisions realized that the equivalent of the floating lien was available to lenders under the myriad laws existing on the eve of the drafting of the Code, albeit at excessive cost and difficulty. The floating lien provisions of the

---

64. The transaction contemplated throughout this Article is one in which the purchase money financier limits advances to the debtor solely to purchase money obligations secured solely by purchase money collateral. *See supra* text following note 35. Where a purchase money financier attempts to commingle purchase money and nonpurchase money obligations and collateral, some allocation will be required. *See infra* note 82.
67. UCC § 9-204, comment 2; *see infra* note 137 and accompanying text.

One opponent of the floating lien provisions of the Code testified before the N.Y. Law Revision Commission that:

Mr. Ireton [a supporter of the Code's floating lien provisions] suggests that he is already getting what is the equivalent of the floating lien. That indicates that people who have intelligence and imagination can get it without any new law. I think that it should be limited to those people so that people with less intelligence and perhaps a lower degree of moral
Code brought the byzantine laws of chattel security into line with then-existing commercial practice. Recognition of the floating charge in the context of purchase money inventory financing promotes the policies of modernization and accommodation to commercial lending practice.

The efficacy of purchase money financing of inventory is more important today than even the drafters anticipated. Professor Gilmore failed to fully anticipate the course of commercial financing under the Code when he stated his view that "the pre-Code pattern under which the long-term financing of the fixed assets of an enterprise was divorced from the short-term financing of its inventory and receivables" would continue under the Code. Whether for better or for worse, Gilmore "guessed" wrongly. More recently, Professor Lloyd summarized the reality of current financing practices:

Today the purchase money priority is more necessary than even the UCC's drafters foresaw. Although the drafters foresaw the possibility that some lenders would take a blanket security interest in all of the borrower's personal property, they did not expect it would be commonly done. Today, it is a standard practice in commercial lending.

As a result of this development in commercial practice, validation of the floating lien in the context of the PMSI in inventory becomes imperative if the purposes of the Code—to modernize the law of commercial lending in accord with developed commercial practice, and to protect the debtor from the potential stranglehold of the general financier's after-acquired property clause—are to be realized.

Article 9 modernized commercial law largely through the order and simplicity it brought to the area of chattel security. Such order and simplicity ranks as perhaps the greatest accomplishment of Article 9. The transformation rule threatens this order and simplicity by
forcing a retreat to complicated, expensive and detailed machinations to acquire the effective equivalent of a pooling arrangement for securing purchase money financing of inventory.\textsuperscript{72} Today, even under a restrictive construction of a PMSI in inventory, the equivalent of a limited floating charge can be obtained by using an allocation formula that places the PMSI on a self-liquidating basis.\textsuperscript{73} If self-liquidation is not feasible, the secured party may resort to the old field warehousing technique as an alternative solution.\textsuperscript{74} Through a field warehouse, the lender can segregate physically the purchase money collateral from all other inventory. The lender resolves the issue of tracing by requiring payments on the loan each time certain, identified collateral is removed from the warehouse.\textsuperscript{75} Of course, these solutions require significant expense and potential delay to implement, contrary to the purposes of simplifying and modernizing the law of secured transactions. In addition, they provide no greater protection to the prior secured party than the concept of "pooling" advocated herein.\textsuperscript{76}

2. The Provisions of Article 9

With the general policies of the Code firmly in mind, the next place to turn in analyzing the scope and meaning of any PMSI must be to the language of the Code. Section 9-107 defines purchase money security interest as follows:

A security interest is a "purchase money security interest" to the extent that it is
(a) taken or retained by the seller of the collateral to secure all or part of its price; or
(b) taken by a person who by making advances or incurring an

\textsuperscript{72} See supra notes 44-53 and accompanying text.
\textsuperscript{73} Southtrust Bank of Ala., Nat'l Ass'n v. Borg-Warner Acceptance Corp., 760 F.2d 1240, 1243 (11th Cir. 1985) (in dicta, the court approved of contractual allocations of payments tied to collateral). However, such an allocation formula is not always possible. Where the goods are fungible and not individually identifiable (see infra Part VI), an allocation formula is not possible. In any event, the self-liquidation scenario is problematic in many cases and is no longer the process required by the Code. See infra notes 78-83, 181-85 and 197-203 and accompanying text. See Lloyd, supra note 44, at 86-100.
\textsuperscript{74} See generally UCC § 9-305 (1987); Clark, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 7.12 (1980).
\textsuperscript{75} Id. Such tracing may require that the debtor only have the ability to obtain from the warehouse a minimum amount of items, such as a full lot of shirts. This may be unnecessary in light of debtor's business but nonetheless be required by the secured party to permit paying off the debt associated with an identifiable unit of goods, thereby preserving priority in the remaining inventory.
\textsuperscript{76} See infra notes 90-99 and accompanying text and Parts V.C. and VI.
obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.\textsuperscript{77}

This language creates a discrepancy between the treatment of the seller as purchase money party and the third party lender as purchase money party. Under section 9-107(a), the seller acquires a PMSI to the extent that "the collateral" secures "all or part of its price."\textsuperscript{78}

There appears to be an express requirement that the collateral in which priority is claimed secure nothing other than the specific price (obligation) relating to that particular item of collateral.\textsuperscript{79} On the other hand, the language of subpart (b),\textsuperscript{80} only requires that the obligation to be secured enables the debtor to acquire rights in or the use of some collateral. There is no \textit{express} tie between the obligation incurred at any particular time and the collateral utilized to secure that obligation, so long as both the obligations and the collateral qualify as "purchase money."\textsuperscript{81} Therefore, it may be argued that a third party purchase money financier may claim purchase money status under UCC section 9-107(b) with respect to any purchase money collateral acquired by the debtor with purchase money obligations, without regard to a specific correlation between any particular item of purchase money collateral and any particular purchase money obligation. That is, the third party purchase money financier, under the express language of section 9-107(b), may "pool" all purchase money obligations and secure them with all purchase money collateral.\textsuperscript{82} Such an analysis of the text of UCC section 9-
107 creates a situation where the third party purchase money financier is accorded better treatment than the seller purchase money financier. Such an inconsistent result is not warranted and all purchase money parties, whether they are sellers or third party financiers, should be entitled to "pool" purchase money obligations and purchase money collateral. The language of sections 9-204, 9-205, and 9-312(3) all contribute to the conclusion that such blatant inconsistency was not intended. Except with respect to consumer goods, section 9-204 imposes no limitation on the type of collateral capable of being included in an after-acquired property clause. Section 9-204 does not include any restriction at all with respect to the ability to secure future advances under a security agreement. Further, section 9-204 does not limit the effect of an after-acquired property or future advance clause in the context of purchase money security interests.

are not used by the debtor to acquire new assets are not purchase money obligations and are not given priority as to the purchase money collateral. Similarly, purchase money obligations are not accorded priority in any of the debtor's assets other than those assets constituting purchase money collateral. Where purchase money obligations and non-purchase money obligations have been advanced by the same lender, Professor Lloyd has shown persuasively that the purchase money lender retains priority in purchase money collateral to the extent of outstanding purchase money obligations. See generally Lloyd, supra note 44, at 70-86.

83. Particularly when the collateral is inventory, a pooling concept seems implicit in Article 9. As numerous courts and commentators have recognized, inventory is by its nature a floating pool of assets, and its value as collateral depends on that characteristic. Hence, a 'plain reading' of the Section 9-107 reference to 'collateral' in the case of inventory suggests a pool of assets as to which the constituent items change over time. UCC Survey: Secured Transactions, 41 Bus. Law. 1463, 1485 (1986). See also Holzman v. L.H.J. Enters., 476 F.2d 949 (9th Cir. 1973), and Rosenberg v. Rudnick, 262 F.Supp. 635 (D. Mass. 1967) (each recognizing that liens in inventory, by the nature of inventory, are in a floating mass of goods rather than in individual items).

84. § 9-204 provides:

(1) Except as provided in subsection (2), a security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral.

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

(3) Obligations covered by a security agreement may include future advances or other value whether or not the advances or value are given pursuant to commitment (subsection (1) of Section 9-105).


85. In his article dealing with the effect of the Code on purchase money financing, Professor Hogan noted that
Rather, other substantive Code provisions govern the effect to be given to such clauses.\(^8^6\)

Not only does the text of section 9-204 place no restrictions on the types of collateral or advances that validly may be included under a security agreement, but in addition section 9-205 makes clear the continued effectiveness of a security interest notwithstanding the debtor’s ability to use or commingle the collateral, or more significantly, to fail to account to the secured party for proceeds or dispositions of collateral.\(^8^7\) Although such actions by a debtor may well deprive a purchase money financier of any collateral to secure purchase money obligations,\(^8^8\) section 9-205 expressly provides that the security interest is “not invalid or fraudulent” against other creditors, simply because the debtor has liberty to use and dispose of the collateral without accounting.\(^8^9\) The effect of invalidating the floating lien, and requiring a strict, one-to-one correlation between

---

may take advantage of the flexibility of the newer security techniques. Providing notice filing, authorizing central filing, validating after-acquired property clauses, abolishing dominion rules, authorizing future advances—all will help both the secured party and the debtor to use effectively this class of inventory as collateral. . . . When the purchase money financier dealing with such collateral finds that another financier has made a prior filing, the purchase money holder should realize that the nature of the collateral itself rather than any set of legal rules will create serious problems.


86. UCC § 9-204, Comment 2 (1987), quoted infra at text accompanying note 109.

87. § 9-205 provides:
A security interest is not invalid or fraudulent against creditors by reason of liberty in the debtor to use, commingle or dispose of all or part of the collateral (including returned or repossessed goods) or to collect or compromise accounts or chattel paper, or to accept the return of goods or make repossessions, or to use, commingle or dispose of proceeds, or by reason of the failure of the secured party to require the debtor to account for proceeds or replace collateral. This section does not relax the requirements of possession where perfection of a security interest depends upon possession of the collateral by the secured party or by a bailee.

UCC § 9-205 (1987). See also Hogan, supra note 85 at 151-152.


89. UCC § 9-205 (1987).
debt and collateral in order to maintain purchase money priority in the inventory context, as a practical matter, eliminates section 9-205 in the context of purchase money inventory financing.\textsuperscript{90} The Court in \textit{Southtrust} required just such a strict accounting and payments on debt (tied to particular items of collateral) to maintain the validity and priority of the PMSI.\textsuperscript{91}

Section 9-312(3)\textsuperscript{92} sets forth the substantive rules relating to the requirements for obtaining priority with respect to a PMSI in inventory. In particular, sections 9-312 (c) and (d) indicate that on-going purchase money financing was intended. The notice that the purchase money financier must give to prior secured parties claiming an interest in the same inventory constitutes the most significant requirement for obtaining purchase money priority in inventory.\textsuperscript{93} Section 9-

\begin{quote}
\textsuperscript{90} Validation of the purchase money floating lien has no effect on the prior secured creditor's floating lien. Such validation simply allows the purchase money lien to retain the priority provided by § 9-312(3).

\textsuperscript{91} \textit{Southtrust Bank of Ala., Nat'l Ass'n v. Borg-Warner Acceptance Corp.}, 760 F.2d 1240, 1243 (11th Cir. 1985). It has been asserted that, if the strict correlation of debt to collateral required by \textit{Southtrust} "is followed, purchase-money priority in inventory will simply be unavailable." \textit{UCC Survey: Secured Transactions}, 41 \textit{Bus. Law.} 1463, 1486 (1986).

\textsuperscript{92} § 9-312(3) provides:

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

(a) the purchase money security interest is perfected at the time the debtor receives possession of the inventory; and

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

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

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

\textit{UCC} § 9-312(3) (1987).

\textsuperscript{93} In order to obtain purchase money priority in collateral \textit{other than inventory}, \textit{UCC} § 9-312(4) merely requires that the purchase money security interest be perfected within ten days after the debtor receives possession of the collateral. In order to acquire purchase money priority in inventory, all holders of prior security interests in the same type of collateral who have filed financing statements, must be notified of the competing interest and the purchase money security interest must be perfected \textit{before} the debtor receives possession of the collateral. \textit{Id.} This procedure assures that prior security interest holders will not be misled, to their detriment, by the existence of the purchase money party. \textit{See infra} notes 114-122 and accompanying text and Part IV.B.
PURCHASE MONEY SECURITY

312(3)(c) provides that the requisite notice is effective for five years, by analogy to the period of effectiveness of a financing statement.\textsuperscript{94} It is reasonable to presume that, given the nature of inventory financing as an on-going relationship,\textsuperscript{95} this clarification was made to simplify the development of on-going purchase money financing relationships in inventory.\textsuperscript{96} If the drafters contemplated one-shot transactions, they would have required the purchase money financier to give notice each time a PMSI in inventory was anticipated.

In addition, section 9-312(3)(d) requires that the collateral that is to be subject to the PMSI need only be described by “item or type.”\textsuperscript{97} While the purchase money financier is wise to be as specific in this description as possible in order to facilitate the later identification of its collateral,\textsuperscript{98} the broad nature of the permissible description facilitates an on-going relationship when the particular items to be supplied may not be known in advance. If the drafters intended to limit purchase money financing to one-shot transactions, a more specific description would not be an undue burden and would have been required.\textsuperscript{99}

\textbf{B. The Comments}

The statements of purpose contained in the comments to the previously discussed sections support the foregoing construction of the Code provisions relating to purchase money financing of inventory.\textsuperscript{100} Comment 1 to section 9-107 refers to the “existing” prefer-

\textsuperscript{94} This construction is clarified in the 1972 Reason for Change 2(a) accompanying the 1972 Amendments to Article 9, and is implicit in the text of § 9-312(3)(c). The notice must be received by the prior secured party “within five years before the debtor receives possession of the inventory.” Accordingly, a notice sent in 1982 will still be effective with respect to a delivery of inventory in 1986. See infra note 96.
\textsuperscript{95} Kripke, \textit{Current Assets Financing as a Source of Long-Term Capital}, 36 \textsc{Minn. L. Rev.} 506 (1952); Weeks, “\textit{Floating Liens}” in Inventory Financing, 1956 \textsc{U. Ill. L. F.} 557 (1956); Gilmore, \textit{supra} note 21 at 1380-1382; see \textit{supra} notes 83 and 85, and infra notes 174-181 and accompanying text; and infra Part V.C. See also Holzman v. L.H.J. Enters., 476 F.2d 949 (9th Cir. 1967) and Rosenberg v. Rudnick, 262 F.Supp. 635 (D. Mass. 1967) (explanation, \textit{supra} note 83).
\textsuperscript{96} “[... ][T]he purchase money financier may satisfy the requirement [of notice] for a series of transactions by a single notice.” Hogan, \textit{supra} note 85, at 144. See infra note 215 and accompanying text.
\textsuperscript{97} UCC § 9-312(3)(d) (1987); Hogan, \textit{supra} note 85, at 141.
\textsuperscript{98} See \textit{supra} notes 82 and 85.
\textsuperscript{99} Even in the context of “fungible” items of inventory, such as hardware or shirts, a more specific description, for example including the quantity of goods delivered, is possible in a single transaction. However, where on-going financing is anticipated, the only description possible is a general description by item or type.
\textsuperscript{100} The importance and propriety of the comments in the interpretation of the provisions of the Code have been the subject of considerable debate. See Skilton,
ence for "purchase money obligations." From the outset, the drafters intended to protect the new value lender against the party who simply improves its position vis a vis other creditors. "Thus a purchase money obligation has priority over an interest acquired under an after-acquired property clause." Comment 2 to section 9-107 has been construed as limiting a PMSI solely to the price or obligation incurred for specific collateral. This construction is based on the premise that the purchase money financer, by asserting priority as to subsequent deliveries of collateral as security for earlier purchase money advances, obtains a "security interest in the subsequent collateral taken as security for or in satisfaction of a pre-existing claim or antecedent debt [the purchase money obligation relating to the first shipment]." While this inter-

---

Some Comments on the Comments to the Uniform Commercial Code, 1966 Wis. L. Rev. 597 (1966); Braucher, The Legislative History of the Uniform Commercial Code, 58 Colum. L. Rev. 798 (1958). Suffice to say that careful analytical use of the comments, to a greater extent than the drafting and legislative history of the Code, see note 144 infra, is indispensable in determining the proper purpose and policy underlying the Code's provisions. As Professor Gedid has noted, "The Code commentary was a major part of the patent reason device employed by Llewellyn in drafting the Code. Llewellyn argued that the use of written statutory commentary was a necessary condition for the sound development of commercial law by the courts, and that the purpose of a commentary was to guide and connect the development of legal material as a whole. . . . [T]he comments would also show the purpose, policy, or reason for a Code section, group of sections, article, or articles. The commentary was thus an indispensable part of Llewellyn's patent reason technique. . . ."


101. UCC § 9-107, comment 1 (1987) (emphasis supplied). This preference for securing the obligation advanced to the debtor for acquisition of new assets is firmly rooted in the pre-code common law relating to purchase money financing. See Lloyd, supra note 44, at 16, where the author concludes that modern authority has recognized that, at common law, "it is the nature of the debt rather than the technicalities surrounding the execution and delivery of the security device that is responsible for the purchase money priority."

102. See infra Part IV.B.1.c.


104. When a purchase money interest is claimed by a secured party who is not a seller, he must of course have given present consideration. This section therefore provides that the purchase money party must be one who gives value "by making advances or incurring an obligation": the quoted language excludes from the purchase money category any security interest taken as security for or in satisfaction of a pre-existing claim or antecedent debt.


105. Id. This construction of the comment was first put forward in In re Simpson, 4 U.C.C. Rep. Serv. (Callaghan) 243, 246 (Bankr. W.D. Mich 1966) and was followed uncritically by the Fifth Circuit Court of Appeals in In re Manuel, 507 F.2d 990, 992 (5th Cir. 1975).
pretation may be appealing initially, given the Code's preference for new value and the recognition of inventory financing as an on-going relationship, this construction takes an unduly narrow view of the protections afforded the purchase money financier by the Code. A view more in line with the policies of the Code results in approaching the purchase money inventory arrangement as a "pooling concept." At the time of the subsequent shipment, the purchase money financier makes a contemporaneous advance. That is, the purchase money financier supplies new value each time new assets are provided to the debtor and makes repeated infusions of assets to the borrower's estate. Accordingly, the collateral securing the indebtedness does secure the price of all the collateral made available by the purchase money financier. In the context of a pure purchase money on-going relationship, every dollar advanced to the debtor, in fact, constitutes value given "to enable the debtor to acquire rights in or the use of collateral," which is all the collateral that is claimed (or can be claimed) by the purchase money financier. Therefore, the purchase money financier has satisfied the requirements of the section and the comment. More to the point, this comment, in the overall context and scheme of the Code's purchase money provisions, does no more than restate the distinction drawn by the drafters between old value and new value in the earlier drafts.

106. See supra note 83. For further criticism of this construction of comment 2, see Aronov, supra note 21, at 43-44 and Lloyd, supra note 44, at 49-50.


108. Professor Gilmore's discussion of the concept of "new value"/"present consideration" in the context of § 9-107(b) is instructive. The 'person' described in [§ 9-107(b)] is evidently one who gives what the Uniform Trust Receipts Act called 'new value.' In 9-108, which deals with the problem of when interests in after-acquired property are to be considered as having been taken for new value or for old debt, there is a reference to a secured party who "makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value ...." [§ 9-108 quoted in part.]

There is no apparent reason why the concept of 'new value' with respect to a purchase money security interest under 9-107 should be any less broad than the concept as it appears in 9-108. Evidently no past consideration or antecedent debt will support the 9-107 purchase money interest. Something must be given, more or less simultaneously with the debtor's acquisition of property, which is intended to, and which does, enable him to acquire the property. ... Taken literally, 9-107 seems to say that only 'making advances' or 'incurring an obligation' (which would presumably include a commitment to the debtor to make an advance as well as a binding promise, by way of guaranty or otherwise, to pay the seller) qualify as 'value' for the purpose of 9-107. It is suggested, in line with the 9-108 comment, that the references to advances and obligations be taken in 9-107, as they clearly must be taken in 9-108, as merely illustrations of the underlying concept of 'new value.' (Citation to § 9-107, comment.)

Gilmore, supra note 21, at 1374-1375.
The comments to section 9-204 demonstrate the drafters’ intention to validate, in the broadest fashion, the floating lien. Noting the nineteenth century prejudice against the floating charge the comment states that early courts were of the opinion that a commercial borrower should not be allowed to encumber all his assets present and future, and that for the protection not only of the borrower but of his other creditors a cushion of free assets should be preserved. That inarticulate premise has much to recommend it. This Article decisively rejects it not on the ground that it was wrong in policy but on the ground that it was not effective. . . . This Article, in expressly validating the floating charge, merely recognizes an existing state of things.

The substantive rules of law set forth in the balance of the Article are designed to achieve the protection of the debtor and the equitable resolution of the conflicting claims of creditors, which the old rules no longer give.109

This comment makes clear the universal scope of an after-acquired property clause, except as specifically limited by section 9-204(2) relating to consumer goods. Section 9-204 validates the floating charge in all contexts and with respect to all forms of collateral.110 It is left to the “substantive rules of law” set forth elsewhere in Article 9 to establish the necessary debtor protections and resolve the resulting conflicts between creditors.111

The strict tracing of purchase money obligations to the specific purchase money collateral giving rise to that specific obligation does not take account of the relaxation of the control required to be exercised by the secured party under section 9-205. The section repeals specifically the rule of Benedict v. Ratnor.112 The comment states

The principal effect of the Benedict rule has been, not to discourage or eliminate security transactions in inventory and accounts receivable—on the contrary such transactions have vastly increased in volume—but rather to force financing arrangements in this field to a self-liquidating basis. Furthermore, several lower court cases . . . required lenders operating in this field to observe a number of needless and costly formalities: for example it was thought necessary for the debtor to make daily remittances to the lender of all collections received, even though the amount remitted is immediately

110. See Hogan, supra note 85.
111. As noted, see supra notes 79-83 and accompanying text, nothing in the text of § 9-107 limits the efficacy of the after-acquired property clause in the purchase money context. Indeed, the “substantive rules of law” which govern conflicting claims of creditors in the purchase money context are found in § 9-312(3)-(4) and § 9-313.
Comment 3 notes that the policing requirements of Benedict, which section 9-205 repeals "in matters of form," must be reconsidered in light of the notice provisions required by the filing rules in section 9-302. That is, providing notice of the security interest avoids the problems of fraud and misleading that concerned Justice Brandeis in Benedict. This is critical in the context of the PMSI in inventory. Not only must the purchase money financier of inventory perfect its interest before the debtor's receipt of the goods, but it must also give notice of the claimed PMSI to any creditor who has filed a financing statement. Accordingly, the notice provisions of section 9-312(3) eliminate the opportunity for deception of other creditors by assuring that all interested parties possess knowledge of the situation and can take appropriate measures to protect their interests.

Comment 3 to section 9-312 applies this idea of notice directly to the purchase money situation involving inventory.

The reason for the additional requirement of notification is that typically the arrangement between an inventory secured party and his debtor will require the secured party to make periodic advances against incoming inventory or periodic releases of old inventory as new inventory is received. A fraudulent debtor may apply to the secured party for advances even though he has already given a security interest in the inventory to another secured party. The notification requirement protects the inventory financier in such a situation: if he has received notification, he will presumably not make an advance; if he has not received notification (or if the other interest does not qualify as a purchase money interest), any advance he may make will have priority.

Once the prior inventory financier receives notice that a purchase money financier exists, it can protect its interest by not making further advances against the purchase money inventory. It is true that the prior financier may lose all inventory collateral by virtue of the sale of the existing (nonpurchase money) inventory collateral. It is also true, however, that "presumably," the prior financier has not advanced any new funds against the purchase money inventory and, if necessary, can decrease the amount of the outstanding ad-
vances, and the prior financer, in most cases, will have a prior security interest in accounts receivable created by the sale of the purchase money inventory in the ordinary course of debtor's business. The text and comments to sections 9-107, 9-204, 9-205 and 9-312 all evince a purpose to give the purchase money inventory financier the ability to enter into an on-going relationship with the debtor. Such a relationship can only be effective if the purchase money financier enjoys the benefits of the floating lien. As the third comment to section 9-312 notes: "Prior law, under one or another theory, usually contrived to protect purchase money interests over after-acquired property interests.... While this Article broadly validates the after-acquired property interest, it also recognizes as sound the preference which prior law gave to the purchase money interest." Viewed as a whole, the text and comments of the pertinent provisions of Article 9 demonstrate a clear preference for purchase money interests and obligations. The Article also recognizes the reality of inventory financing and the need for flexibility on the part of the secured party to permit the debtor to operate his business without undue technical interference, made necessary solely to protect the priority of the secured party. Taken together these policies require validation of the floating lien in the context of the PMSI in inventory. Such a broad construction is not, however, limitless. Properly construed, the PMSI will have no detrimental effects on the prior lender, but will allow the debtor to obtain additional credit from an outside source.

Analysis of the drafting and legislative history of the relevant provisions of Article 9 will demonstrate the validity of the foregoing construction. The pre-Code development of the after-acquired property clause and purchase money preference greatly influenced the earliest drafts of Article 9. The after-acquired property provisions and the purchase money provisions of Article 9 complimented and reinforced the policies and purposes of the Code to facilitate commercial transactions while protecting the legitimate interests of all parties. This symbiotic relationship between the floating lien and the PMSI manifested itself from the earliest drafts of the Code and

120. By applying payments received from the debtor and not readvancing except against collateral as to which the prior lender maintains priority, i.e., non-purchase money collateral.
121. See supra note 69 and accompanying text, regarding standard general secured financing practices utilizing blanket liens.
122. See U.C.C. § 9-312(3) (1987). See infra Part VI regarding the scope of the PMSI in inventory and the lack of prejudice to the prior secured party.
123. UCC § 9-312, comment 3 (1987).
124. See infra Part VI (regarding the proper limitations on the scope of the PMSI inventory and the rights and duties of the parties).
PURCHASE MONEY SECURITY

confirms the broad validation of the purchase money priority advocated herein.

IV. HISTORICAL ANTECEDENTS: PRE-CODE INVENTORY FINANCING AND THE DRAFTING AND LEGISLATIVE HISTORY OF ARTICLE 9

A. Pre-Code Inventory Financing

The PMSI, whether in inventory or other collateral, may be viewed as a sort of "quid pro quo" following the validation of the after-acquired property clause. Consequently, in order to fully appreciate the proper scope to be accorded the PMSI in inventory under the Code, it is necessary to review, briefly, how pre-Code law dealt with the after-acquired property clause in the context of inventory financing.

The common-law courts had a conceptual difficulty with the idea that one could mortgage property that one did not yet own. As a result of such "metaphysical" difficulties, early common-law courts generally were unwilling to recognize the efficacy of after-acquired property clauses. With the advent of expanding commerce in the latter nineteenth century, however, courts began to validate the after-acquired property clause as it related to fixed assets.

Notwithstanding the trend toward validation of after-acquired property clauses vis-a-vis fixed, relatively permanent assets, such as equipment, difficulties remained concerning application to the "mortgage on a shifting stock," that is, inventory liens. The courts were concerned by the appearance of a large bulk of unencumbered assets, coupled with the perceived inability to give adequate notice of the lien to other creditors, which could mislead unsecured creditors as

125. See supra note 24 and infra note 140; Gilmore, supra note 21, at 1334.
127. Cohen & Gerber, supra note 126, at 635; 1 GILMORE, PERSONAL PROPERTY, supra note 126, at 33; Skilton, supra note 126, at 399.
129. Cohen & Gerber, supra note 126, at 654; 1 GILMORE, PERSONAL PROPERTY, supra note 126, at 39.
to the availability of unencumbered assets for realization.\textsuperscript{130} If the inventory, by its nature, was constantly manufactured, sold, and replaced by new inventory, the question became how could other creditors keep track of the lien and the collateral subject thereto.\textsuperscript{131} The issue of control also worried the courts. The use of a liquid asset, such as inventory, as collateral lent itself to fraudulent machinations by debtor and secured creditor. The debtor and creditor could arrange their affairs in such a way that the debtor made minimal payments on the secured debt and retained the proceeds of the inventory for its own use.\textsuperscript{132} Finally, the courts believed that the debtor should be required to maintain a "pool" of free, unencumbered assets for the satisfaction of claims of unsecured creditors.\textsuperscript{133} As a result of this bias against the after-acquired property clause as it related to inventory (and accounts receivable), such assets remained largely unavailable as a source of credit for debtors.\textsuperscript{134} The needs of expanding commerce and the realization that for many debtors, inventory comprised the largest asset and source of credit,\textsuperscript{135} all led to piecemeal legislation to validate the lien on

\begin{itemize}
  \item \textsuperscript{130} Professor Skilton traces the bias against the after-acquired property clause in inventory to the traditional concern over the fraudulent propensities of such a device. \textit{See generally}, Skilton, \textit{supra} note 126, at 359-89.  
  \item \textsuperscript{131} On this issue, Gilmore stated:  
    An alternative way of rationalizing the invalidity of the stock in trade mortgage came to be the idea that there was something wrong—or "inconsistent" with the nature of a mortgage—in a shifting mass of collateral. The lien had to be "certain"; if the mortgage security was in a constant state of flux as the mortgagor sold the existing stock and replaced it with new stock, then the required certainty of lien was gone. \textit{1 Gilmore, Personal Property, supra} note 126, at 41.  
  \item \textsuperscript{132} \textit{See supra} note 130. This was the principal concern of Justice Brandeis in \textit{Benedict v. Ratnor}, 268 U.S. 353 (1925), though that case involved accounts receivable.  
  \item \textsuperscript{133} \textit{UCC} § 9-204 comment 2 (1987).  
  \item \textsuperscript{134} Professor Gilmore set forth the traditional concerns regarding the floating lien in the following words:  
    The case against the floating lien, ... consists principally of two points:  
    1) the availability of a floating or blanket lien on all present and future assets will leave nothing to satisfy the claims of unsecured creditors and will consequently tend to dry up the sources of such credit; 2) the law should protect a necessitous borrower against himself by refusing to allow him to encumber all the property he may ever own in order to secure a present loan.  
    Gilmore, \textit{supra} note 21, at 1335. Cohen and Gerber added to these concerns a third: "Interrelated [with the substance of the concerns noted by Gilmore] is the constant problem of notice to creditors and purchasers that the property is subject to a lien in order that there be no reliance upon a false appearance of prosperity." Cohen & Gerber, \textit{supra} note 126, at 647.  
\end{itemize}
inventory. The conditional sale, the chattel mortgage, the trust receipt, field warehousing, and factor's liens acts provided some basis for the present realization (through secured credit) of future assets comprised of inventory. Because of these developments, a state of affairs existed on the eve of the drafting of the Code which led Gilmore to assert that, although very complicated and difficult, one could effectively obtain credit on the security of present and after-acquired inventory. That is, the floating lien on inventory did exist.

2. The Purchase Money Security Interest

Although the after-acquired property clause gained grudging acceptance by the courts and legislatures, one problem remained. As one author put it, the validation of the after-acquired property clause resulted in "a somewhat refined sort of peonage." Once validated, the after-acquired property clause permitted a debtor to mortgage all present and future assets to a single creditor. Accordingly, no assets remained to secure or satisfy other creditors, and the threat persisted that the secured creditor with a blanket lien maintained a stranglehold on the debtor's ability to obtain financing or credit from other sources.

The courts responded to this threat to the independence and viability of the debtor by developing the parallel concept of the purchase money priority. Notwithstanding the existence of a valid floating lien he stated:

I suggest that the law of New York as it is, and this is also true of the law of all other jurisdictions, is what you might call a 95 per cent floating charge deal and that the only change the Code really makes is to go from 95 per cent to 100 per cent and get rid of the vestiges of confusion and arbitrary formalism, which are today all that is left of the original nineteenth century prohibition or rule as of about 1850, that there should be no floating charge at all.

2 N.Y. STATE LAW REVISION COMM'N 1954 REPORT at 1180 (1954). See also, Gilmore, supra note 21, at 1335.

136. Gilmore, Chattel Security I, supra note 126, passim; Gilmore, Chattel Security II, supra note 126; Stilson, supra note 48, at 11-14; Aronov, supra note 21, at 15-17.

137. Professor Gilmore, in 1954, testified before the New York Law Revision Commission studying the adoption of the UCC in New York. In support of the floating lien he stated:

As a matter of history, however, the triumph of the after-acquired property interest has been regularly followed by an important limitation or qualification. The after-acquired interest, wherever it has been recognized as valid against the borrower's creditors and in his bankruptcy, has been subordinated to subsequent purchase money interests which arise in connection with the financing of new acquisitions by the borrower.

Id.
after-acquired property clause, a creditor who actually provided the funds that enabled the debtor to acquire new assets received priority in those assets, to secure the obligation arising from the acquisition of such collateral, ahead of a prior after-acquired property lien. 4

By allowing the debtor to grant such a priority, the courts enabled the debtor, to a certain extent, to obtain financing from other sources. No prejudice to the prior secured creditor would result because the property securing the purchase money financier is in addition to the collateral already available to (and presumably relied upon by) the prior secured creditor. 142

On the eve of the drafting of the Code, therefore, the situation was such that, with a great deal of time and effort, a creditor could obtain a “blanket lien” on all of a debtor’s particular assets, whether then owned or thereafter acquired. 143 To offset this power, the courts established purchase money priority that empowered the debtor to grant a prior lien to a creditor, whether seller or financier, who provided funds to augment the debtor’s estate through the acquisition of specific new assets.

B. Inventory Financing Under the Code—The Drafting and Legislative History of the After-Acquired Property Clause and Purchase Money Priority

1. The Early Drafts

Notwithstanding the debate among scholars concerning the appropriate use of the drafting and legislative history of the Code in interpreting the provisions of the present Code, in light of the stated purposes and policies of the Code it is important to understand what the drafters of the Code attempted to accomplish. 144 Consequently,
prior drafts and comments are instructive in seeking a better understanding of the purposes and policies behind today's Code.\textsuperscript{145} Certainly the drafters intended to simplify the many security devices that antedated the Code.\textsuperscript{146} The unification and simplification of pre-Code security devices were the most revolutionary features of the new Code. In the area of after-acquired property and purchase money priority, however, the Code merely took to its logical conclusion the development of the law through the middle of the twentieth century.\textsuperscript{147}

The evolution of the drafting of the Code establishes three relevant themes for an analysis of the floating lien in relation to the purchase money priority: (1) that the subject of chattel security required a unified approach, subject to the drafters' realization that different types of collateral required different rules in light of the function of such collateral in a particular context;\textsuperscript{148} (2) that the reality of commercial finance as it had developed up to the time of the drafting of the Code required the validation of the so-called "floating lien" or "blanket security interest" (the after-acquired property clause);\textsuperscript{149} and finally, (3) that a clear preference must be given to "new value" additions to the debtor's estate, manifested by the purchase money priority provisions.\textsuperscript{150}
a. Classification of Types of Collateral

From the very outset the drafters recognized that, not only were the various forms of security (chattel mortgage, conditional sale, trust receipt, etc.) an unnecessary complication, but that commercial transactions were hampered "by a conceptual approach to problems which need diverse treatment." Consequently, the drafters determined to proceed along functional lines, keeping in mind the need to balance the fundamental, often conflicting, objectives of chattel security, identified as (1) protection of the debtor; (2) protection of creditors; and (3) protection of purchasers. The drafters recognized that "[t]hese objectives are not of equal importance in all situations where financing occurs, yet legislation designed to protect the debtor, where the debtor is a consumer for example, often has been drafted so as to apply even to a large loan obtained by a large commercial enterprise." This premise, that the protections of various parties required different emphasis depending on the transactional context, resulted in an initial approach to the article on secured transactions that delineated separate parts setting forth the rules for differing situations, for example, separate parts for consumer transactions, farming transactions, and inventory financing. The drafters perceived that such an organizational framework would permit legislation that could properly balance the often conflicting primary protections. Specifically, in the area of inventory financing, the insecurity of the "mortgage on a shifting stock" was considered a primary problem. The drafters believed that "[t]he preferable approach . . . is to validate a security interest in inventory and then define the rights of third parties.

The drafters abandoned the approach of creating a Code with separate parts for differing commercial transactions in the September Revisions to the 1949 Draft of the Article on Secured Transactions. The drafters, however, did not abandon the concept of special treatment of various types of collateral based upon the collateral's function in a particular context, for example, consumer goods financing as opposed to inventory financing. The comment to section 8-101 of the September 1949 Revisions states that "[t]he theory of

151. Kelly, Drafts Vol. 4, at 285 (Comment to Tentative Draft No. 1 - Article VII (1948)).
152. Id. at 286.
153. Id.
154. Id. at 287.
155. Id.
156. Id. at 288.
158. See supra text accompanying note 153.
the Article stems from the function of security." Comment 4 to section 8-102 of the same draft states, "While most Sections of this Article apply to a security interest without regard to the nature of the collateral or its use, some sections state special rules with reference to particular types of collateral."

The evolution from separate treatment for differing transactions to a more unified approach with special rules for different types of collateral is significant in two respects. First, this change in style reflects the view that chattel security should be approached on a more unified basis. The numerous technicalities surrounding chattel security should be eliminated to the greatest extent possible, consistent with the purpose of making the rules relating to chattel security responsive to the varying needs of commerce in different settings. Second, this evolution reflects the drafters' judgment that, in certain circumstances, the type of collateral should affect the rules. This further supports the conclusion that the drafters intended to create a system of chattel security that reflected the functions and purposes of the collateral serving as security in accordance with commercial need and reality. The resulting statute unifies the body of chattel security law to the greatest extent possible, and yet, maintains the functional differences among the types of collateral in the commercial world.

159. UCC § 8-101 comment (September 1949 Revisions), Kelly, Drafts Vol. 8, at 283 (emphasis supplied).

160. UCC § 8-102 comment 4 (September 1949 Revisions), Kelly, Drafts Vol. 8, at 285. Although the index of sections following this comment has changed through the drafts of the Code, it is significant that the prefatory language of this comment (setting forth the underlying philosophy of the Code in this context) is identical to the language of the present UCC § 9-102 comment 5 (1987).


162. See supra notes 159-60 and accompanying text; Hansford, supra note 28, at 307-08.

163. See supra notes 159-61 and accompanying text.

164. As noted earlier in notes 44-51 and accompanying text, the transformation rule developed and has been applied almost entirely in the context of consumer bankruptcy litigation. In the course of analyzing the applicability of the transformation rule in the commercial setting of the PMSI in inventory, the court in Southtrust Bank of Ala., Nat'l Ass'n v. Borg-Warner Acceptance Corp., 760 F.2d 1240 (11th Cir. 1985), stated, "Nothing in the language of UCC § 9-312(3) or § 9-107 distinguishes between consumer and commercial transactions or between bankruptcy and non-bankruptcy contexts. We see no policy reasons for creating a distinction where the drafters have not done so." Southtrust, 760 F.2d at 1242. While the "language" of § 9-107 admittedly makes no such distinction, see Lloyd, supra note 44, at 52 n.247, the underlying purposes and policies of the Code do make this distinction and support a broad construction of the PMSI in inventory. See supra Part II and Part III.B. With respect to the reference to § 9-312(3), the Court is simply wrong. Section 9-312(3) relates solely to inventory collateral, a commercial form of collateral. See supra notes 49 and 52. The purchase money
b. The "Floating Lien" and Inventory Finance

As already noted,165 the "mortgage on a shifting stock" was insecure and difficult to accomplish prior to the Code in light of judicial bias against the floating lien. The Introductory Comments to Tentative Draft No. 2 stated the concern as follows:

How could something be security which was likely to be consumed or gone before the debt was paid off? Wasn't this really an attempt to appear secured and to defeat the unsecured creditors when in reality there was no security since the mortgagee had no control over the security? At any rate, the common law said that a chattel mortgage on a stock of merchandise was either void against creditors or it was presumptively fraudulent.166

The comment sets forth three forms of inventory security that were potentially available under pre-Code law to avoid this judicial concern.167 First, the parties could attempt to utilize the floating lien. However, this was subject to invalidation in bankruptcy under the preference rules and further, because of the control requirement imposed by cases following Benedict v. Ratnor. A second method was the trust receipt type of financing where, upon sale of the inventory by the debtor, a set portion of the indebtedness relating to the item sold, would be satisfied. The problems here related to the deprivation of the debtor's sole source of capital for running the business and to the impracticability of such an arrangement when the inventory was comprised of small, fungible goods such as "shirts,
small hardware, etc." 169 To avoid this practical problem and prevent the debtor’s loss of needed working capital, a third method, a “revolving loan” arrangement, could be utilized. In this case, the debtor would remit all proceeds of inventory sales to the secured creditor on a daily basis and the creditor would relend amounts needed by the debtor. This, of course, entailed significant and costly monitoring and paper work by both the debtor and the creditor. 170

The drafters recognized the inherent problems in the foregoing machinations utilized to avoid restrictions on the floating lien in inventory. Accordingly, the drafters decided to recognize the reality of inventory financing by validating the floating lien through the after-acquired property and future advance provisions, and the specific overruling of the control requirements of Benedict v. Ratnor. In the area of inventory financing, the evolution to this position is instructive. In Tentative Draft No. 2, September 1948, the drafters developed the concepts of the “Specific Inventory Lien” and the “General Inventory Lien.” 171 The Draft limited the availability of the specific inventory lien to situations where the collateral was of a type that would permit self-liquidation of the indebtedness upon sale of the inventory. Section 302(4) of Tentative Draft No. 2 provided:

- An inventory lien is “specific” when it is on the borrower’s interest in identified or segregated units of inventory and when a specified portion of the obligation secured by the lien is to be paid or discharged when each unit of such inventory is sold, consumer [sic], or so disposed of as to lose its separate identity. 172

Any other lien on inventory was a “General Inventory Lien.” 173 Under section 308(2) the specific lien could not include after-acquired

---


170. Though daily collection and relending has certain benefits in terms of ease of payment and monitoring, the comment notes that:

Against these advantages must be set the rather expensive machinery of separate bank accounts, daily reports, special auditors and other procedures necessary to make it appear that the financier is getting the proceeds from the sale of the goods subject to his lien even though on the following day he loans all or part of the preceding day’s collections back to the borrower.

Kelly, Drafts, Vol. 5, at 158 (emphasis supplied). While so-called “lock-box” arrangements continue to be utilized, these arrangements are implemented as a control feature in the lending relationship rather than as a requirement for the legal protections of the secured lender’s priority. See generally Scott, supra note 2, at 943-59. Certainly, where a working capital lender is in place, a purchase money financier of inventory cannot utilize this arrangement.


172. Id. (emphasis supplied).

173. Id.
property.\footnote{174} By definition, it was not possible to have a specific lien "float" over all inventory, since a prerequisite to its validity as a specific lien was the inclusion of a "release price" tied to discrete items of inventory. This was not the case with a general lien that could attach to after-acquired property.\footnote{175} Further, section 314(1) gave priority to any specific lien that competed with a general lien, including a general lien that incorporated an after-acquired property clause.\footnote{176} However, the drafters of the Code recognized a problem in this context:

[If because of the nature of the goods, a specific lien cannot be used and the [prior financier] has a general lien, there will be no way the borrower can get new capital on security of his inventory without a subordination agreement from the [prior financier].]

Advice is requested on the solution of this problem.\footnote{177}

Solving this problem involved deletion of the concepts of specific and general inventory liens, general validation of after-acquired property clauses in the inventory setting, and the creation of purchase money priority.

Although the definition of specific inventory lien excluded after-acquired property (the trust receipt concept being the model),\footnote{178} the drafters realized that the nature of inventory financing generally resulted in an on-going financing relationship.\footnote{179} Accordingly, notwithstanding the prohibition on after-acquired property, section 308\footnote{180} did permit later advances to be secured by all collateral in debtor's possession at the time of the latter advance so long as subsequent advances were made in good faith, and the original contract provided for such subsequent advances in the ordinary course. Subsequent acquisitions of collateral, however, did not secure prior advances.

\footnote{174} UCC § 308(2) (Tentative Draft No. 2, Sept. 1948), Kelly, \textit{Drafts}, Vol. 5, at 137.
\footnote{175} UCC § 308(1) (Tentative Draft No. 2, Sept. 1948), Kelly, \textit{Drafts}, Vol. 5, at 137.
\footnote{177} UCC § 301 comment 4 (Tentative Draft No. 2, Sept., 1948), Kelly, \textit{Drafts}, Vol. 5, at 163. (Emphasis supplied.)
\footnote{180} UCC § 308(2) and comment (Tentative Draft No. 2 September 1948, Kelly, \textit{Drafts}, Vol. 5 at 137.
These provisions reveal the drafters' recognition of the limited availability of the specific lien where inventory is "in bulk" and not discrete and identifiable, and that inventory financing is conducted generally on an on-going basis. The question became how to best address these characteristics of inventory financing so as to protect the interests of the debtor, the secured party, and other creditors.

The September 1949 Revisions of the May 1949 Draft marked a major shift in response to these problems. The September Revisions deleted the distinction between the general inventory lien and the specific inventory lien and, at the same time, provided a specific definition of, and rules relating to, PMSIs. It was also in the September Revisions that the drafters adopted a unified approach to all security interests, with special rules for particular collateral. For the first time, section 8-202 specifically validated the after-acquired property clause as a general proposition, with certain restrictions that have not survived to the current Code. Section 8-202 validated the after-acquired property clause generally with respect to inventory, without exception based upon the type of inventory involved, specific or general. Finally, the general framework for priorities among competing interests in inventory was set forth in section 8-406, with priority being accorded the PMSI.

c. New Value and the Purchase Money Security Interest

While the efficacy and scope of a floating lien in inventory was initially of some concern to the drafters, the preference to be accorded "new value" obligations was never in doubt. In the Introductory Comment to Tentative Draft No. 1, the drafters stated:

It seemed desirable to make one basic division to run throughout the article. That division is to distinguish the security transaction where security is taken to secure some performance that resulted in a current addition to the borrower's assets and well-being from that in which the security is taken solely to better an existing creditor's position in relation to other existing creditors. This is the new value old value distinction found in the Uniform Trust Receipts Act. In its simplest form it is the purchase money mortgage contrasted with the security belatedly obtained by an unsecured creditor.

This distinction is justified. The objective of the Commercial Code is to unify laws dealing with commerce. Security transactions which facilitate the distribution of goods should be the focus of our consideration. This is, of course, the secured commercial trans-

181. See supra notes 166-80 and accompanying text.
182. UCC § 8-105(3)(a) (Sept. 1949 Revisions), Kelly, Drafts Vol. 8, at 292.
183. UCC § 8-102 (Sept. 1949 Revisions), Kelly, Drafts Vol. 8, at 283-84.
184. UCC § 8-202 (Sept. 1949 Revisions), Kelly, Drafts Vol. 8, at 307-08.
185. UCC § 8-406 (Sept. 1949 Revisions), Kelly, Drafts Vol. 8, at 341-42.
action that facilitates purchase of goods and services—the old conditional sale contract, the purchase mortgage and the trust receipt. . . .

. . . [W]e have eliminated the old value mortgage from the picture so that validation of the mortgage on the stock in trade or the inventory exists only as to new value.186

Obviously, the sentiment in the last sentence has not continued through the drafts of the Code.187 These comments, however, can be viewed as setting the course for the future drafts of the Code. The very strong preference for new value obligations is clearly manifest and continues throughout the drafts of the Code. In the second comment to section 8-105 of the September 1949 Revisions, wherein PMSI is defined, the drafters state that "[u]nder existing rules purchase money obligations have an advantage over other obligations. . . . This preference for such obligations is continued in this Article."188 In the comment to section 8-108, relating to the definition of new value, the drafters note:

This Article does not so limit [as did the Uniform Trust Receipts Act] the security interests permitted to those given for new value. It does however in some instances give preferred treatment to interests in property obtained for new advances or on new acquisitions by the borrower. The theory of this distinction is that a lender who brings new assets to the borrower is entitled to better treatment than a creditor who merely improves his position with reference to other creditors.189

Although the definition of new value was deleted in the May 1950 Draft, the preference for new value (purchase money) obligations continued through all the drafts of the Code.190

With the May 1950 Draft, the basic outline of the provisions relating to PMSIs and priorities was established. The definition of PMSI in section 9-107 of the May 1950 Draft is substantially the same as the current definition, with the exception that, in the Supplement No. 1 to the 1952 Draft, the drafters deleted the conclusive presumption relating to the tracing of value.191 The reason for the deletion was that it went beyond the common law.192 Further,

186. Introductory Comment (Tentative Draft No. 1 April 1948), Kelly, Drafts Vol. 4, at 286, 288.
187. See infra note 189 and accompanying text.
188. UCC § 8-105 comment (Sept. 1949 Revisions), Kelly, Drafts, Vol. 8, at 293.
189. UCC § 8-108 comment (Sept. 1949 Revisions), Kelly, Drafts, Vol. 8, at 300.
192. UCC § 9-107 comment (Supp. No. 1 to 1952 Official Draft), Kelly, Drafts, Vol. 17, at 382-83. See infra notes 204-08 and accompanying text.
while the definition of new value was deleted in the May 1950 Draft, the preferred treatment for PMSIs as new value obligations continued. Comment 2 to section 9-108 of the May 1950 Draft states, "Purchase money security interests ... are by definition new value obligations, and the preferred treatment given such interests is indicative of the approach of this Article." 193

2. The Later Drafts

The importance of the Tentative Drafts and the 1949 Drafts of the Code lies in the fundamental policy formulations they establish. Beginning with Proposed Final Draft No. 1, in May 1950, the drafters began the process of revising and fine tuning the actual provisions of Article 9. As noted, the basic definition of PMSI appeared in the September 1949 Revisions of the May 1949 Draft, as did the principal validating provisions relating to after-acquired property. 194 Finally, the fundamental requirements for priority of the PMSI in inventory were established in section 9-312(2) of the May 1950 Draft. 195

With the May 1950 Draft, the drafters established a firm foundation for a unified approach to the body of chattel security law and the terms for the classification of collateral along functional lines. This was a critical development and the current Code has changed little in this regard from May 1950. 196 This approach makes clear the intention of the drafters to treat all security interests in a uniform manner, except where it is necessary to make specific rules for specific types of collateral, in order to accommodate the necessary protection of the debtor, secured party, and other creditors in accord with the realities of commercial finance.

In this regard, the following points are worth noting. First, from the earliest drafts, the definition of PMSI made no distinction between the types of collateral involved. 197 Equally important, the

193. UCC § 9-108 comment 2 (May 1950 Draft), Kelly, Drafts Vol. 11, at 220; see Gilmore quote, supra note 108.
194. See supra notes 182-85 and accompanying text.
195. UCC § 9-312 and comments (May 1950 Draft), Kelly, Drafts Vol. 11, at 269-73. While § 9-312, the basic priority provision of Article 9, has been revised more extensively than perhaps any other provision in Article 9, the basic concepts underlying the priority of PMSIs in inventory appeared as early as the May 1950 draft, to-wit, prior filing and notice to other secured parties. Indeed, as early as the September 1949 Revisions, the concept of prior notice for purchase money priority in inventory appeared. See UCC § 8-406(2) (Sept. 1949 Revisions), Kelly, Drafts, Vol. 8, at 342-43.
196. See supra note 160.
197. UCC § 9-107 (1951 Text edition) provides:
A security interest is a "purchase money security interest" to the extent that it is

(a) taken or retained by the seller of the collateral to secure all or a
draft provisions relating to after-acquired property and future advances similarly made no distinctions in the area of inventory collateral or between a general security interest and a PMSI. The only pertinent area in which the drafters created a distinction on the basis of inventory collateral relates to the requirements for obtaining a valid purchase money priority under section 9-312. Indeed, these requirements support the thesis that holders of PMSIs in inventory are entitled to the benefits of the floating lien so long as all debt and all collateral are in fact purchase money.

The evolution of the provisions relating to after-acquired property and future advances demonstrates the validity of such provisions in the purchase money context. The distinction in the earlier drafts between the specific lien, as to which after-acquired property could not be included, and the general lien, as to which such property could be included, was abandoned. Having dropped the model of the Uniform Trust Receipts Act, the drafters moved to a general floating lien on inventory. At the same time the drafters added the specific concept of a PMSI. While the provisions relating to after-

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; or (c) taken by a person who for the purpose of enabling the debtor to pay for or acquire rights in or the use of collateral makes advances or incurs an obligation not more than ten days before or after the debtor receives possession of the collateral even though the value given is not in fact used to pay the price.

Kelly, Drats Vol. 12, at 270-71. A comparison to UCC § 9-107 (1987), see supra text accompanying note 77, demonstrates that, with the exception of the deletion of subparagraph (c) by Supp. No. 1 to the 1952 Draft, see infra notes 204-08 and accompanying text, the definition above and the definition in the current Code are identical.


With the exception of security interests in consumer goods (and, formerly, farm goods), any collateral may be subject to inclusion under an after-acquired property clause, and there is no distinction between a general security interest and a PMSI. See Hogan, supra note 85.


200. See supra text accompanying note 36.

201. See supra notes 171-80 and accompanying text.

202. Professor Gilmore, admitting dissatisfaction with the priority provisions in the Code that the N.Y. Law Revision Commission was considering, stated: ‘‘I think some provision like 9-312(4) giving purchase money interests priority over
acquired property expressly limited the ability to encumber after-acquired property in the context of consumer goods and crops, no such limitation was placed upon inventory collateral or purchase money interests in collateral.\textsuperscript{203} The lack of any limitation in section 9-204 with respect to inventory collateral or PMSI’s, coupled with the fact that inventory financing is normally conducted on an ongoing basis, leads to the conclusion that the drafters did not intend the inclusion of after-acquired property or future advance clauses or both in PMSIs to affect the priority or validity of such interests.

Much has been made of the deletion of subparagraph (c) of section 9-107,\textsuperscript{204} in the Supplement No. 1 to the 1952 Draft. Subparagraph (c) provided a conclusive presumption concerning the use of proceeds to acquire collateral.\textsuperscript{205} The reason for the deletion was to return to the concept of purchase money interests that existed at common law.\textsuperscript{206} Professor Lloyd’s analysis of the development of the purchase money concept at common law\textsuperscript{207} indicates that, at common
law, the priority of the PMSI extended to after-acquired purchase money collateral.\textsuperscript{208} So long as the purchase money party identifies the purchase money collateral retained by the debtor and proves the amount and character of the outstanding purchase money obligations, the PMSI should be afforded priority.\textsuperscript{209} The precise one-to-one correlation of debt to collateral required by the transformation rule as adopted in \textit{Southtrust} is not required.

The evolution of the requirements for obtaining purchase money priority in inventory further confirms that the purchase money inventory financier is entitled to obtain the benefit of after-acquired (purchase money) collateral. In Supplement No. 1 to the 1952 Draft, the drafters eliminated from the requisite notice to be given by the purchase money inventory financier, the reference to the \textit{amount} of the interest to be acquired.\textsuperscript{210} Earlier drafts required the purchase money financier to advise the prior financier of the amount of the purchase money interest to be obtained.\textsuperscript{211} The deletion does not affect the prior financier, since by giving notice of the types of inventory, as to which the prior financier is not entitled to rely,\textsuperscript{212} the purpose of the notice is fulfilled and the prior financier is given the means to protect its interest.\textsuperscript{213} By deleting the amount requirement from the notice, the prior financier loses no ability to monitor the actual situation, while the deletion promotes flexibility between the debtor and purchase money financier by permitting them to structure and adjust their financing relationship to meet unforeseen needs and circumstances.\textsuperscript{214}

\textsuperscript{208} Professor Lloyd demonstrates that, at common law, the courts manifested a desire to preserve purchase money status to the extent possible where the same collateral secured both purchase money debt and non-purchase money debt. Accordingly, the courts adopted the “dual status” rule allowing purchase money debt to retain priority while subordinating non-purchase money debt. The common law courts did not automatically destroy the purchase money priority where non-purchase money debt was also secured by purchase money collateral. This clear bias in favor of the purchase money party results in a finding that, so long as purchase money debt was secured by purchase money collateral (albeit possibly different purchase money collateral than gave rise to the specific outstanding purchase money debt), the courts would uphold the priority of the purchase money party. \textit{See} Lloyd, \textit{supra} note 44, at 36 n.174 and accompanying text. “\textquote{W}hat emerges from the cases is the sense that the courts would adopt whatever theory would best protect the purchase money lender, and they would bend that theory as far as it had to be bent to accomplish this objective.” \textit{Id.} at 37.

\textsuperscript{209} \textit{See infra} Part VI.


\textsuperscript{211} \textit{See} UCC § 9-312(2)(b) (1950 Proposed Final Draft); Kelly, \textit{Drafts}, Vol. 11, at 269.

\textsuperscript{212} \textit{See infra} Part VI.

\textsuperscript{213} UCC § 9-312, comment 3 (1987).

\textsuperscript{214} \textit{See infra} Part V.C.
Additional flexibility in the on-going relationship between debtor and purchase money financier occurred through the 1972 amendments to Article 9 which clarified that the notice given by the purchase money financier was effective for a period of five years.\(^\text{215}\) If a one-shot transaction was anticipated, certainly a five-year period of effectiveness was not needed. Only in the context of an on-going financing relationship, which, given the nature of inventory, requires the efficacy of after-acquired collateral, does a five year period of effectiveness make sense.

Analysis of the state of pre-Code law together with close study of prior drafts of the Code, strongly reinforces the broad construction of the current Code advocated herein for validating the floating lien in the context of PMSIs in inventory. From the outset, the drafters manifested the purpose to simplify the area of chattel security in harmony with commercial practice of their day.\(^\text{216}\) This required the validation of the after-acquired property clause, not necessarily on the basis of policy, but on the ground that the floating lien was a *fait accompli* that was available to those parties intent on acquiring its benefits. Given this state of affairs, the drafters proceeded to provide the borrower with the means of avoiding the potential stranglehold by the general financier, made possible by the validation of the floating lien. The purchase money priority developed at common law as a counter-weight to the after-acquired property clause and was warmly embraced by the drafters.\(^\text{217}\) The purposes, policies and objectives of the drafters in validating the after-acquired property clause and adopting the strong preference for new value, purchase money obligations demonstrate that the restrictive scope given to purchase money interests by the court in *Southtrust* is completely unwarranted. Further support for the proposition that the transformation rule gives unduly narrow scope to the operation of purchase money interests in inventory derives from equitable and normative considerations that supplement the Code, as well as from the nature of inventory finance as an on-going, relational form of financing.

V. BEYOND TEXT, COMMENT, AND HISTORY

As shown in Parts III and IV, the text and comments of the Code and the historical antecedents thereto demonstrate that the drafters intended to accord the PMSI in inventory all of the benefits of the floating lien as it related to purchase money collateral. The view that obtaining and maintaining a PMSI in inventory is wholly


\(^{216}\) Part IV.B.1.a., *supra*.

\(^{217}\) See *supra* note 135 and 140 and accompanying text.
consistent with the inclusion of an after-acquired property or future advance clause derives additional support from the writings of Professors Summers, Barnes and Scott. Professor Summers identifies a number of equitable principles that, when applied pursuant to section 1-103 to supplement the Code provisions relating to the floating lien and PMSIs in inventory, demonstrates the propriety of the broad construction advocated herein. Similarly, Professor Barnes' proposed methodology for interpretation and construction of the provisions of the Code, which gives effect to fundamental premises and principles underlying the overall functioning of specific Code provisions, reinforces the thesis that the drafters intended to validate the floating lien in the purchase money context. Finally, Professor Scott has put forth an economic justification for the value of secured debt. This justification is entirely consistent with the proposition that inventory financing, whether on a general or purchase money basis, results in an on-going relationship between the debtor and the financier that can only be accomplished through the validation of the floating, blanket lien in the purchase money context.

A. Equitable Principles, the Floating Lien, and the Purchase Money Security Interest in Inventory

Section 1-103 provides that principles of law and equity outside the Code, "unless displaced," supplement the provisions of the Code. Professor Summers identifies numerous equitable principles that are not displaced by specific Code provisions and that inform the construction of the Code. Of particular relevance to the present discussion are the equitable principles of comparative diligence, and the related anti-windfall and unjust enrichment principles.

219. Barnes, supra note 53.
220. Scott, supra note 2.
221. Summers, supra note 218, at 913-27, 945-46.
222. Barnes, supra note 53.
223. Scott, supra note 2.
224. UCC § 1-103 (1987) provides:
   Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.
225. Summers, supra note 218, at 913-923.
226. See, id. at 920-23. Professor Lloyd demonstrates in his article that such equitable principles provided the early rationale for the common law protections accorded the purchase money priority. "In the early decisions, the courts openly acknowledged they were basing their decision on general considerations of fairness
One author, approving the result reached by the court in *Southtrust*, concludes that "[t]he courts should give the subsection 9-312(3) PMSI a narrow scope." Yet, even if one accepts the technical, narrow construction of the purchase money provisions of the Code applied by the court in *Southtrust*, the result obtained in that case was inequitable. From the opinion in that case, Borg-Warner and equity, preferring the lender who had parted with her money over the spouse or creditor looking for a windfall." Lloyd, *supra* note 44, at 37. See also *id.* at 47 (discussing general equitable theory as it applies to the proper construction of purchase money interests under the Code).

227. See Hansford, *supra* note 28, at 263. Professor Hansford, while approving the result in *Southtrust*, criticizes the court's analysis *id.* at 258.

228. The discussion of the *Southtrust* case in this Article is based upon the official opinion published by the court. See 760 F.2d 1240 (11th Cir. 1985). The court sets the factual setting of the conflict between Southtrust and Borg-Warner as follows:

Both the Bank [Southtrust] and BWAC [Borg-Warner] have perfected security interests in the inventory of the debtors. In each case, the Bank filed its financing statement first. BWAC contends that as a purchase money lender it falls within the purchase money security interest exception to the first to file rule and therefore is entitled to possession of the inventory.

*Id.* at 1241.

Because the court went on to hold that the exercise by Borg-Warner of the after-acquired property and future advance clauses contained in its security agreement "transformed" Borg-Warner's security interest into a non-purchase money security interest junior in priority to that of Southtrust, the court did not analyze the issues relating to Borg-Warner's satisfaction of the procedural requirements of § 9-312(3). *Id.* at 1243. Nor did the court analyze the composition of the debt owed to Borg-Warner in terms of purchase money versus non-purchase money obligations. *Id.*

Southtrust claimed to have "no record" of receiving the requisite notification relating to two of the four debtors financed by Southtrust and Borg-Warner. Brief of Appellee at 10, Southtrust Bank of Ala., Nat'l Ass'n v. Borg-Warner Acceptance Corp., 760 F. 2d 1240 (11th Cir. 1985) [hereinafter Appellee's Brief]. Further, Southtrust raised factual issues concerning the nature of the debt outstanding to Borg-Warner. Southtrust asserted that a portion of the debt was not purchase money, that Borg-Warner had engaged in questionable bookkeeping practices including the issuance of "dummy" invoices by suppliers of the inventory financed by Borg-Warner, in order to give the appearance that all outstanding debt resulted in the acquisition of new assets, when, in fact, the original acquisition debt had been fully paid and the existing debt amounted to new, non-purchase money advances. Appellee's Brief, at 10-13. See, Aronov, *supra* note 21, at 31-33.

Whether such factors affected the court's judgment is not known. From the opinion it appears that Borg-Warner, by the terms of the security agreement, attempted to secure all indebtedness owing to it by the debtors (both purchase money and non-purchase money) with all inventory at any time financed by Borg-Warner. *Southtrust, supra* at 1241-42. It also appears from the opinion that Borg-Warner advanced only purchase money debt. Accordingly, what appears from the published opinion is a situation in which a purchase money financier of inventory attempted to secure all purchase money obligations with all purchase money collateral in a pooling arrangement. The issue addressed by the court was directed at the efficacy of this concept. The court stated "the key issue for decision by this Court
advanced credit, on various occasions, which enabled the debtors to acquire inventory assets.\textsuperscript{229} Borg-Warner complied with the notification and perfection requirements of section 9-312(3) and obtained a perfected PMSI in the debtors’ inventory.\textsuperscript{230} The opinion gives no indication that any of the indebtedness owed to Borg-Warner was other than purchase money obligations, nor that Borg-Warner claimed as security any assets other than purchase money collateral.\textsuperscript{231} Solely as a result of Borg-Warner’s inability to match, on a one-to-one basis, the collateral to the indebtedness advanced specifically for that collateral, Southtrust, as general financier, obtained priority to collateral to which it made no contribution.\textsuperscript{232}

In comparing the diligence of the parties in protecting their respective interests, clearly Borg-Warner had done all that the Code required by informing Southtrust of its purchase money position.\textsuperscript{233} Thereafter, Borg-Warner presumably monitored its collateral and kept accounts of the outstanding balance of the credit advanced to enable the borrowers to acquire such collateral. It does not appear

\vspace{1cm}

is whether inclusion of an after-acquired property clause and a future advances clause in BWAC’s security agreements converted its purchase money security interest (PMSI) into an ordinary security interest.” \textit{Southtrust}, 760 F.2d at 1242.

The court held that “a floating lien is inconsistent with a PMSI. A PMSI requires a one-to-one relationship between the debt and the collateral.” \textit{Id.} at 1243.

The broad, categorical treatment of the facts by the Court in \textit{Southtrust} requires that any analysis of the rule established by that case must proceed from the published opinion, notwithstanding apparent factual issues raised by the parties which may have justified the result in that case for reasons other than those stated by the court.

\textsuperscript{229} \textit{Southtrust}, 760 F.2d at 1241-43.

\textsuperscript{230} \textit{Id.}

\textsuperscript{231} \textit{But see supra} note 228, regarding alleged factual discrepancies not addressed by the Court.

\textsuperscript{232} \textit{Southtrust}, 760 F.2d at 1243.

\textsuperscript{233} Obviously, if the rule set forth in \textit{Southtrust} represents the proper construction of the PMSI in inventory, Borg-Warner failed to match the outstanding debt to the collateral on a one-to-one basis. However, such tracing is required to maintain the purchase money priority when a conflict occurs. The comparative diligence principle looks to the ability of the parties, through their own actions, to avoid the resulting loss in the first place. See \textit{Summers supra} note 218, at 921. The question of comparative diligence relates to which party, through a lack of diligence, was responsible for the loss. Where lenders incur losses on secured debts, the loss is occasioned by the lack of collateral to satisfy the outstanding indebtedness at the time of default/liquidation of the debtor. With respect to a general financier’s loss in such a case, the purchase money financier has no control over the actions of the general financier in monitoring and supervising its loans to the debtor. The loss suffered by the general financier results from the general financier’s failure to diligently monitor and supervise its loans to the debtor. Any loss suffered by the purchase money financier is similarly a result of the actions and diligence exercised by the purchase money financier. Therefore, it is the case that the purchase money financier’s lack of diligence in not tracing loans and collateral on a one-to-one basis is not the cause of any loss otherwise incurred by the general financier.
from the case, or from the record, that Southtrust made any advances against the inventory claimed by Borg-Warner. In any event, Southtrust was on notice that Borg-Warner claimed a prior PMSI in the items of collateral; more importantly, Southtrust was in a position to monitor the debtor to assure that it made no advances against such collateral. Apparently Southtrust was content to allow Borg-Warner to finance the debtor’s inventory acquisitions and only when the debtors’ assets following insolvency proved insufficient to satisfy the indebtedness owing to Southtrust, did it assert priority in the assets financed by Borg-Warner by claiming that Borg-Warner had lost its purchase money priority. What appears is the classic case of the prior secured lender with an after-acquired property clause, which failed to monitor the debtor and relied instead on its prior position as the first to file. Had Southtrust exercised diligence in monitoring its debtor, it may have been possible to have avoided any loss. However, nothing Borg-Warner could have done could have avoided the collateral shortfall experienced by Southtrust. Applying the theory of comparative diligence, Borg-Warner should not have been penalized for a loss that Southtrust, through monitoring and surveillance of the debtors, was in a better position to avoid.

The related anti-windfall and unjust enrichment principles are even more significant in analyzing the proper treatment of the floating lien in the context of purchase money priority. Professor Summers sums up the anti-windfall principle: “other things being equal, one party should not realize an unearned gain at another’s expense, especially where the other is a deserving party.” The concept of purchase money priority is bottomed on this fundamental equitable conclusion. From the beginning, the drafters sought “to distinguish the security transaction where security is taken to secure some performance that resulted in a current addition to the borrower’s assets and well-being from that in which the security is taken solely to better an existing creditor’s position in relation to other existing creditors.” Such is precisely the case in Southtrust. Through advances to the debtors, Borg-Warner made “current additions to

\[234. \text{But see supra} \text{ note} 228.\]
\[235. \text{UCC} \text{ § 9-312, comment 3 (1987).} \]
\[236. \text{See supra} \text{ notes 88 and 212-215 and accompanying text.} \]
\[237. \text{Id.} \]
\[238. \text{Summers,} \text{ supra} \text{ note} 218, \text{ at} 921. \]
\[239. \text{See} \text{ Lloyd,} \text{ supra} \text{ note} 44, \text{ at} 16, 22 \text{ and} 37. \text{ “Professor Glen states that the purchase money priority “is merely another working of the principle that prevents unjust enrichment by means of another man’s money.”” Id. at} 16; \text{ see notes} 188-89, \text{ supra} \text{ and accompanying text.} \]
\[240. \text{Kelly,} \text{ Drafts, Vol.} \text{ 4, at} 286 (Comment to Tentative Draft No. 1 - Article VII (1948)). \]
\[241. \text{760 F.2d} \text{ 1241.} \]
the borrower’s assets and well being.” Southtrust clearly acquired an unwarranted windfall in the form of the assets supplied to the borrowers with Borg-Warner’s money. Application of the anti-windfall principle would have resulted in an equitable interpretation of the purchase money provisions in that case. If, as appears from the opinion, all of the debt advanced by Borg-Warner was used by the debtors to acquire inventory, then all inventory that had been acquired with such advances and which was available at the time of the debtors’ liquidation properly should have been viewed as security for such indebtedness. While Southtrust likely advanced money to the debtors for rent, payroll and other nonacquisition costs of running a business (amounts that are admittedly of value to the debtors), Southtrust did so with notice that Borg-Warner was financing acquisitions of particular inventory. Accordingly, Southtrust was not entitled to rely on such assets as security for its nonpurchase money advances. By awarding priority to Southtrust the court awarded Southtrust an unjustified windfall of additional collateral as to which Southtrust was not entitled to rely and did not make any contribution toward acquisition.

B. Normative Principles in the Interpretation of the Purchase Money Priority in Inventory

In proposing a “normative framework” for code interpretation, Professor Barnes posits a hierarchy of values and goals to be achieved by the Code and discusses the derivative rules giving effect to such values. Professor Barnes asserts that “fairness” in dealings between commercial parties is a “[f]undamental value” that the drafters intended to advance. He argues that the rules of notice contained

242. See supra note 228, regarding the discrepancy in the facts concerning the nature (purchase money or non-purchase money) of the debt owed to Borg-Warner, as appears in the briefs of the parties. However, in the reported opinion no such discrepancy appears.

243. 760 F.2d at 1241.

244. Id. at 1241-43.

245. Of course, if Southtrust also advanced funds for the acquisition of inventory it would retain priority in such inventory as it, in fact, financed. See infra note 255.

246. The fundamental values discussed by Professor Barnes are similar to certain equitable principles discussed by Professor Summers. However, Professor Barnes’ analysis proceeds from those values he views to have been motivating factors in the drafters’ construct of the Code, rather than supplemental principles left by the drafters to augment later construction of the Code. Barnes, supra note 53, at 119-122.

in Article 9 are derivative of, and constitute the means by which the drafters implemented, this fundamental value. By providing notice to the world of the state of the debtor's financial affairs, fairness between competing creditors is furthered.

Professor Barnes' article deals principally with conflicts arising between the provisions of Article 2 and Article 9. His normative construct is intended to provide a method for determining the weight to be given to the values in each Article when conflicts arise. Specifically, Professor Barnes addresses the conflict between the reclaiming seller under sections 2-702 and 2-507 and the secured party claiming the sold goods under an after-acquired property clause. His comments regarding this conflict are relevant to the conflict between the purchase money financier and the "floating lienor" under Article 9. He states:

Given the straightforward equities of a true owner who produced or used capital to acquire the goods she sold and a floating lienor who is not advancing new funds, the true owner is in a far stronger position.

To characterize the true owner's interest as creating an ostensible ownership problem is to demand that every seller, in every sales transaction, file a financing statement on the unlikely chance that some breakdown will occur [Citation to section 9-312(3) and (4)]. This seems excessive in the light of the general financier's lack of reliance. We certainly have not advanced the marketplace by making transactions more certain or more easily or cheaply concluded by requiring what will almost always be nugatory notice.

Applied to the purchase money financier, the same considerations are relevant. First, the purchase money financier supplies new value to the borrower's enterprise. Certainly the party that expends capital and other resources to enable the debtor to acquire inventory is in

---

248. Id.
249. See Id.
250. Barnes, supra note 53.
251. Id. at 173.
253. Id. at 173.
254. Id. at 174 (emphasis supplied).
255. Gilmore, supra note 21, at 1376. To the extent that the prior financier also provides advances which enable the debtor to acquire the asset, the prior financier will also be a purchase money financier and will be entitled to priority under the general priority provision of § 9-312(5). Id. This is the case since the purchase money financier cannot prove purchase money debt which is entitled to priority beyond the amount actually used by the debtor to acquire the asset. As to the balance, the prior financier retains priority under the first to file rule. See John Deere Co. v. Production Credit Ass'n of Murfreesboro, 39 UCC Rep. Serv. (Callaghan) 684 (Tenn. Ct. App., 1984).
a better position, as a matter of fairness and equity, than the party reaping the benefits of another's labor (or in this case, capital) while doing nothing.

The fundamental value of fairness is reflected through the notice provisions of section 9-312(3). Upon receipt of the purchase money notice, the prior financier acquires knowledge of the situation and the ability to protect its interest. Accordingly, as the drafters intended, the prior financier will "presumably not make" further advances against the purchase money inventory. So long as the notice provides sufficient information to enable the prior financier to reasonably identify the collateral provided by the purchase money financier, any requirement of subsequent notice is redundant. Indeed, as noted, the 1972 amendments clarified the durational effect of such notice, indicating that the drafters contemplated on-going, repeat transactions. By limiting the efficacy of on-going purchase money transactions in inventory it cannot be said that commerce has been made more certain or more easily and cheaply concluded.

C. Relational Theory and the Purchase Money Security Interest in Inventory

In a recent article, Professor Scott proposed a relational theory of secured financing in a search for an economic justification of the priority scheme of Article 9. Professor Scott concludes by noting:

All of the hypotheses that seek to explain secured financing are grounded in the belief that persistent institutional regularities rest on purposive foundations.... Frequently, insight comes only through the accreting effects of successive scholarly efforts. By building on these efforts, I have proposed a relational theory that purports to supply a coherent explanation of a dominant pattern of secured financing.

While the scholarship relating to the economic justifications for secured credit has certainly shed much light on secured credit, the

256. UCC § 9-312, comment 3 (1987).
257. As noted, supra note 94 and accompanying text, the requisite notice under § 9-312(3)(c) is effective for 5 years. Mandating "update" notices, not required by the Code, for each shipment, would impose a time consuming burden on the purchase money financier, without any offsetting benefit to the prior financier. By virtue of the original notice, the prior financier receives sufficient information to enable it to monitor the debtor and identify that inventory on which it has no right to rely.
258. See note 215 supra and accompanying text.
259. Hogan, supra note 96.
260. See supra Part III.A.1.; see also Barnes, supra note 53, at 174.
261. Scott, supra note 2.
262. Id. at 970.
263. See supra note 8.
data compiled by Professor Scott and his relational theory provide the most satisfying explanation of commercial secured credit in light of the existing reality.264

Professor Scott sets out six "properties of secured loans."265 First, the borrower generally has a particular growth prospect that is unique to the firm.266 The borrower is also positioned such that the market for financing, other than through the medium of secured credit, is unavailable.267 The nature of the growth opportunity is such that an exclusive financier must be employed and given the ability to exercise leverage and discretion in the development of the project.268 The use of the blanket lien on all assets assures this exclusivity and leverage and facilitates the financier's ability to police the borrower's development of the project.269 Finally, the borrower's size is such that sophisticated financial and investment counseling is not available to the borrower in the normal course.270 Accordingly, the secured financier is often the party that will provide such service to see that the project is developed to its fullest potential.271 The properties of firm-specific growth opportunities, the lack of alternative financing, exclusivity, requisite leverage and discretion in the secured party, the policing function and financial counseling services are derived from an impressive collection of data compiled by Professor Scott.272

Professor Scott proceeds to analyze these characteristics against the priority scheme of Article 9. The "extraordinary legal protection" accorded the floating lien under Article 9 allows the general financier to acquire exclusive control over the entire financing venture of the borrower.273 Such control is necessary in light of the general finan-

264. While I am aware that my positive view of Professor Scott's theory may be viewed as self-serving, inasmuch as his Relational Theory is consistent with the purposive interpretation of purchase money financing of inventory advocated herein, I am nonetheless impressed by the overall accuracy of Professor Scott's analysis when compared to five years of practice representing major national and regional asset based lenders.

265. Scott, supra note 2, at 936-37.
266. Id.
267. Id.
268. Scott, supra note 2 at 936-37.
269. Id.
270. Id.
271. Id. One example of such financial advice occurred in a transaction in which the author was involved. The debtor was a closely held family corporation and had never before borrowed money but instead had funded its operations through cash flow. Standard procedure by the debtor had been to pay trade payables as soon as received. The lender provided counseling and systems advice which allowed the debtor to take the fullest advantage of the grace periods afforded in the trade payables, thereby improving its cash flow and reducing the costs of borrowed money.

272. Scott, supra note 2, at 938-940 and 971-975 (Appendices).
273. Id. at 953.
cier's "investment" in the borrower's project. Professor Scott anal-
ologizes this to a prospector in search of gold. The general financier
seeks out financing opportunities. In order to develop the opportunity
in a profitable manner for the general financier (as well as for the
borrower), it is necessary to protect the general financier's proprietary
stake in the project. The information obtained by the prospecting
financier is protected, as is its ability to develop the project without
others free-riding on its efforts. The general financier also obtains
the benefits of "repeat" business with the borrower since the rela-
tional aspect of the financing makes the general financier, most
often, the cheapest provider of additional credit. Finally, the blanket
lien not only eases the monitoring burden on the general financier,
but also provides, through the default remedies, a very effective
deterrent to debtor misbehavior. Such an analysis is generally
consistent with the methods and operation of asset based lending.

So the question becomes how the exception in the Code that
gives priority to purchase money financing fits into this scheme.
Professor Scott provides two "plausible hypotheses" to explain this
apparent inconsistency. First, the drafters considered that one
providing "new money" to an enterprise is to be preferred over one
belatedly taking security to improve its position vis a vis other
creditors. The argument proceeds that existing creditors should
have little concern because the collateral for the new money is in
addition to existing collateral. While this is all true enough, Professor Scott provides further support by viewing the purchase money
priority as a "bond" against creditor misbehavior. That is, while
the floating lien provides the creditor with protection against debtor
misbehavior, there appears to be no brake against creditor misbe-

A secured lender's "excessive conservatism" derives from the
fact that, at the time the transaction is initially consummated, the
parties have in mind particular projects to be developed. Projects
may subsequently arise that the parties could not anticipate, which
borrower believes will have positive value if properly developed. If
the general financier, however, does not concur in the wisdom of
the new project, out of an abundance of caution and excessive

274. Id. at 955-957.
275. Id. at 957-959.
276. See supra notes 68-70, and accompanying text.
277. Scott, supra note 2, at 962-64.
278. Id. at 962-63.
279. See Kripke, supra note 8 at 962-64.
280. Scott, supra note 2, at 962-63.
281. Id. at 963-64.
282. Id.
conservatism, the project may go undeveloped. The purchase money priority offers the borrower a means of acquiring new, limited financing to develop the new project.

A second explanation of the purchase money priority posed by Professor Scott relates to the nature of the purchase money financier. The purchase money financier may possess particular skills, not available to the general financier, which permit the purchase money financier to monitor the purchase money collateral more cheaply and/or realize its value on default to a greater degree than the general financier. For example, a large commercial bank may have the expertise to generally monitor collateral and develop borrower projects. The purchase money financier, however, may have particular skills and economies unavailable to the bank by virtue of the purchase money financier's particular knowledge of the collateral and its markets. As a result of these particular advantages, the purchase money financier may be in a position to offer financing of particular collateral at rates below the bank.

In many cases, the purchase money financier of inventory will fit nicely into Professor Scott's Relational Theory. The purchase money financier prospects for outlets for its own products or for

283. See Scott, supra note 2, at 962. Professor Scott notes that the general financier's rate of return on its investment in the debtor's project is established at the outset of the transaction. The general financier's incentive is to limit the debtor's project development to projects which reflect the amount of risk anticipated by the financier at the inception of the relationship. Id.

284. Id. at 934-36. The possibility exists that the acquisition of inventory on a purchase money basis may be detrimental to the on-going business of the debtor, and hence of legitimate concern to the general financier. The acquisition of a new line of inventory may prove to be an unwise business decision. For example, the new line proves unpopular and sales of that type of inventory decline, perhaps with repercussions for related items of inventory. Such decline in sales may greatly increase the debtor's likelihood of default, not only to the purchase money financier, but also to the general financier. However, such a scenario can occur in the absence of any purchase money financier. As Professor Scott points out, lenders will rarely, and only under extreme circumstances, exercise the type of operational control over the debtor's business reflected in the decision to change a particular line of inventory. See, Scott, supra note 2, at 934-936. Accordingly, in most general, working capital financing arrangements the debtor retains the ability to alter lines of inventory with the same potential negative effects.

285. Id. at 963.

286. Id. Professor Scott refers to economies of scale possessed by the purchase money financier due to its specialized expertise in dealing with the financed collateral. Id.

287. Such expertise and knowledge may facilitate liquidation on default more quickly and for higher values. For example, in Southtrust, Southtrust surrendered possession of the collateral to Borg-Warner to allow Borg-Warner to liquidate the collateral because Borg-Warner "could sell the inventory back to the manufacturers and distributors [at full invoice price] under [Borg-Warner's] repurchase agreements [with such parties]." Appellee's Brief, supra note 228, at 14.
financing opportunities involving products in which it has a particular expertise. As a result of its expertise with respect to such products, it can implement more effective monitoring procedures. In addition, upon default, it can realize higher values by taking and reselling the inventory in the appropriate market. Yet, the purchase money financier also is interested in gaining exclusive control over the borrower's development of the project involving its collateral. The priority afforded the purchase money financier allows it to exercise greater control and leverage in the narrow context of its collateral. If the purchase money financier does not enjoy the benefits of the floating lien, it is likely that the project will not be fully developed if, indeed, it is developed at all.288

Given the particular nature of inventory, the floating lien is essential. This is no less true for purchase money inventory financing than for general inventory financing. Without the full benefits of the floating lien, the PMSI in inventory will be totally ineffective as a curb to creditor misbehavior or for the purpose of enabling the borrower to develop projects at the cheapest cost.

VI. APPLICATION: THE FLOATING LIEN AND THE PMSI IN INVENTORY

Having argued for a broad construction of the PMSI in inventory, it is necessary to set the parameters of the PMSI in inventory under such a construction and determine whether such a construction might have unanticipated negative consequences. In the first instance, the purchase money financier must have complied with the requirements for perfection and notice to prior parties set forth in section 9-312(3).289 Secondly, although a broader concept of "pooling" is advocated, the purchase money financier is not relieved of the obligation of proving the extent and use of the obligations secured or the necessity of identifying the pool of collateral claimed. That is, while no one-to-one correlation should be required,290 the purchase money financier still retains the ultimate burden to establish first that the obligations/indebtedness sought to be secured by the PMSI

288. See notes 273-76 supra and accompanying text.
289. See supra note 92, § 9-312(3) requires that the purchase money financier 1) perfect its security interest before the debtor receives possession of the inventory collateral (9-312(3)(a)), 2) give notice to all prior financiers who have filed a financing statement claiming an interest in the types of collateral which are claimed by the purchase money financier (9-312(3)(b)), 3) the notice must be received by the prior financier within 5 years prior to debtor's receipt of the inventory (9-312(3)(c)), and 4) the notice must inform the prior financier that the purchase money financier has or expects to acquire a PMSI in inventory describing the inventory by item or type. (9-312(3)(d)).
290. Southtrust, 760 F.2d at 1243.
are, in fact, all purchase money obligations and second that the collateral claimed as security for the purchase money obligations was in fact sold by the purchase money financier to the debtor or acquired by the debtor with purchase money obligations advanced by the purchase money financier. Once the purchase money financier has established compliance with the conditions of section 9-312(3) and the fact that purchase money collateral secures purchase money obligations, there should be no further requirement to segregate each item of collateral and relate it to specific items of outstanding indebtedness.

Assuming that the purchase money financier can establish the foregoing requirements, it remains to determine whether giving such scope to the PMSI will have adverse effects on other parties, particularly prior general financiers relying on after-acquired property clauses, which are contrary to the scheme of the Code. Although the Southtrust case can properly be called a "model commercial case" involving the conflict between the PMSI and the prior financier claiming inventory under an after-acquired property clause, a transaction involving "bulk" goods that are more or less fungible will demonstrate better the problem with a restrictive interpretation of the PMSI provisions of the Code in the context of inventory finance. Consider the hypothetical set forth earlier where Borrower commences business with a line of credit from Local Bank and later desires to acquire goods from Supplier on a purchase money basis.

The first question involves the solution to the immediate conflict between Bank and Borrower concerning the propriety of Borrower's decision to embark on the new line of auto part merchandise. The first solution that comes to mind requires Borrower completely to refinance and remove Bank from the picture. This may not be

291. See supra text following note 35 re definition of purchase money obligations. See also supra note 82.

292. That is, that all collateral as to which priority is claimed is purchase money collateral as defined in text following note 35, supra. This burden is required by the terms of § 9-107 and the common law construction of the purchase money priority under pre-Code law. Lloyd, supra note 44, at 37.

293. 760 F.2d 1240.


295. The collateral at issue in the Southtrust case was comprised of large appliances, e.g., washing machines, dryers, etc. Such items may be specifically identifiable and capable of one-to-one correlation with the purchase money advance used to acquire such inventory. See, In re Southern Vt. Supply, Inc., 58 Bankr. 887, (Bankr. D. Vt. 1986). Such a correlation may be feasible today with the use of computer facilities; but see id. at 894, where computer facilities were insufficient. Notwithstanding the possibility of such one-to-one correlation utilizing computers, Article 9 does not require such self-liquidation, and, in any event, such a self-liquidation requirement is generally impossible with certain "fungible" forms of collateral. See supra notes 177-85 and accompanying text.

296. See supra notes 30-33 and accompanying text.
desirable for Borrower for a number of reasons. Prepayment penalties may have been incorporated into the loan arrangement with Bank. Further, Borrower will be put to the expense and delay of seeking and arranging for alternate financing in connection with its general working capital needs, secured by receivables and equipment and, perhaps, other inventory. On the other hand, Bank presumably has a desirable relationship with Borrower as things stand and would like to continue the status quo. At this point it must be recalled that at the inception of the loan arrangement between Bank and Borrower, Bank could have insisted as part of the original loan arrangement, that Borrower agree to a so-called negative pledge, i.e. a covenant against incurring any additional indebtedness secured by any collateral claimed by Bank. In the absence of an effective purchase money alternative, such a covenant is effectively unnecessary since, by operation of the narrow scope given the PMSI in inventory, Borrower is effectively "locked in" to Bank, and subject to the much feared "stranglehold" on its ability to secure additional/alternative financing.  

Assuming that Bank did not protect its own interest at the time of the initiation of the loan with Borrower through the use of a negative pledge/covenant against further secured indebtedness, Borrower may have an escape by offering Supplier a PMSI in inventory provided by that Supplier. Accordingly, Borrower and Supplier enter into a purchase money arrangement whereby Supplier agrees to provide credit of up to $10,000 for the acquisition of belts and hoses manufactured by X Corporation (hereinafter "X Corp."). Each item of the proposed inventory collateral has a small value (under $25.00), and, with respect to each kind of belt or hose, is generally fungible with others of the same make and size.

Supplier duly notifies Bank that "it has or expects to acquire a PMSI in all belts and hoses manufactured by X Corp., which may be, at any time, acquired by Borrower with funds, loans or other advances provided by Supplier" and duly perfects its security interest in such collateral prior to the first shipment to the Borrower.

297. For a discussion of the problems and costs associated with a complete refinancing of the prior lender, see Scott, supra note 2, at 955 n.192 and 962-63.

298. Id. See West's Legal Forms, supra note 69, § 57.3, Form 1, Cl.2(a), Form 2 Cl.2(b), Form 6, Cl.12(d), Form 8, Cl.8(a), Form 9, Cl.2, Form 11, Cl.14(h), Form 12, Cl.9, Form 13, Cl.8(h), Form 14, Cl.7(g), Form 15, Cl.1(a), and Form 17, Cl.2(d).

299. See infra notes 308-12 and accompanying text.

300. While a negative pledge is available to the prior lender in order to establish a default by debtor, such a provision does not affect the priority which may be obtained by the purchase money financier. UCC § 9-312 (1987). Still, it is unlikely that a creditor will enter into a purchase money arrangement with knowledge that such action by the debtor will place the debtor in immediate default.

301. See supra note 298.
At this point, the purpose of the notice has been satisfied and the Bank can now eliminate this bulk of Borrower's inventory, i.e., all belts and hoses manufactured by X Corp., from its lending base.\textsuperscript{302} Presumably, the collateral as to which Bank retains priority is sufficient in Bank's judgment to adequately secure the outstanding indebtedness to Bank. As Borrower sells existing inventories, Borrower will decrease the outstanding debt to Bank in the ordinary course of business.\textsuperscript{303} Any new advances by Bank will be made only on the basis of collateral available to Bank, i.e., inventory other than belts and hoses manufactured by X Corp., receivables and equipment. It therefore appears that Bank has in no way been harmed by the presence on the scene of the Supplier.\textsuperscript{304}

Indeed, it is likely that Bank has potentially benefitted by Supplier's presence. Recall that, for any number of valid reasons, Bank was unwilling to take the additional risk of expanding the credit available to Borrower.\textsuperscript{305} Accordingly, what Bank considers to be risky credit has been made available by another party. If Bank is correct and the additional credit causes Borrower to become financially embarrassed, Bank's money is not at risk and it remains secured by the collateral (presumably sufficient in Bank's judgment), both existing and after-acquired, other than X Corp. belts and hoses. On the other hand if the new credit results in expansion of Borrower's business, then all creditors of Borrower, including Bank, benefit by the augmented estate of Borrower.

The problem in this scenario involves exactly what Borrower is capable of offering Supplier by way of security. If, as Southtrust\textsuperscript{306} would require, Supplier must be able to demonstrate a one-to-one correlation between the collateral as to which it claims a priority, and the indebtedness to be secured, the transaction cannot operate to fully protect Supplier in a commercially reasonable manner. If,
as hypothesized,\textsuperscript{307} the nature of the goods do not permit the utilization of "release prices,"\textsuperscript{308} Supplier will be required to receive frequent itemized reports of sales of the collateral from Borrower.\textsuperscript{309} Such reports must be accompanied by set payments on the debt related to the amounts of inventory reported as sold. As an initial proposition such detailed reporting is certainly burdensome. While such reporting may be required by Supplier as a matter of business monitoring, as a legal requirement it does not simplify, modernize or foster the development of commerce as intended by the Code.\textsuperscript{310}

Of greater impact to Borrower's and Supplier's relationship is the problem associated with on-going shipments. Suppose that Supplier requires monthly reports, with daily itemization of sales, and corresponding remittances as a matter of business monitoring. At a point, when, for example, sixty percent of the first shipment of goods is sold, Borrower places a new order with Supplier to replenish its inventory of X Corp. belts and hoses. Between Borrower and Supplier there now exist two groups of inventory, together with the separate debts incurred to acquire each group. Upon the sale of inventory following the second shipment, the question becomes which inventory was sold, and hence, which indebtedness was repaid. Were the sales of hoses and belts from shipment number one or shipment number two? Due to the fungible nature of the goods, it would be impossible to determine whether the goods sold were from shipment one or shipment two.

It may be suggested that an allocation formula set forth in Supplier's security agreement could provide that payments received are applied to reduce the debt related to items sold. It may be possible to convince a court that such an allocation preserves a one-to-one relationship between existing inventories and outstanding debt, but such is not a certain result.\textsuperscript{311} In any event, given the fungible nature of the collateral, the purchase money financier will be unable, at any time, to allocate payments to specific items of collateral. Furthermore, in the event that Borrower mistakenly omits sales of inventory or fraudulently reports fewer sales, the tracing problems between the two shipments and the corresponding debts become

\begin{itemize}
\item \textsuperscript{307} Id.
\item \textsuperscript{308} These are specific amounts to be paid upon the sale of discrete items of inventory, in order to reduce the outstanding debt owing to the purchase money financier incurred to acquire that specific inventory.
\item \textsuperscript{309} Reports may be daily, weekly or monthly, depending on the debtor's and financier's needs and the rapidity of debtor's inventory turnover.
\item \textsuperscript{310} UCC § 1-102(2) (1987).
\item \textsuperscript{311} If there is any discrepancy between the amount of debt outstanding and the amount of inventory left on the floor, the purchase money financier will have difficulty demonstrating what debt was paid off and what collateral was effectively released. See Lloyd, supra note 44.
\end{itemize}
virtually insurmountable. The result is a loss of all priority in all of the existing purchase money collateral. The only solution for Supplier is to ship one shipment at a time. That is, until the full indebtedness of the first shipment is satisfied and all of the original inventory is sold, Supplier cannot make a second shipment for fear of commingling.\textsuperscript{312}

As Professor Scott has demonstrated, a significant characteristic of secured lending is the relational aspect between debtor and secured party.\textsuperscript{313} The ability to exercise control over the debtor's business plan and development, the reduced amount of monitoring required where all collateral of a particular type is "tied up," and the ability to develop an on-going financing arrangement with a minimum of documentation and legal technicality allow the financier and debtor to develop the business in a commercial rather than a legal context.

Such a relational model applies as well to the purchase money financier of inventory. The financing by Supplier, by the nature of the inventory, involves a fluid asset of Borrower.\textsuperscript{314} To keep Borrower's business operating, Borrower must constantly replenish sold inventory, decrease outstanding indebtedness, and incur new obligations for new inventory. If purchase money financing of inventory is to be a realistic alternative to Borrower, it must be permitted to operate in an on-going, continuous fashion. Limiting purchase money inventory financing to a "one-shot," shipment by shipment method will make it economically burdensome, if not impossible, and generally make it so unfeasible as to cease as a workable alternative for the Borrower.

The solution is to permit Supplier to retain priority with respect to all collateral (X Corp. belts and hoses) that Supplier can identify as having been provided/financed by Supplier, as security for all indebtedness that Supplier proves was advanced to and incurred by Borrower to acquire such collateral. This "pooling" concept will allow Supplier, with a modest amount of monitoring, to maintain priority as to all collateral provided, to secure all debt provided for such acquisition. At the same time, the removal of the one-to-one correlation requirement will permit Supplier to meet this burden of tracing, but will not in any way harm Bank.

As noted, the drafters assumed that upon receipt of a notice of purchase money priority by Bank, the Bank will cease making ad-

\textsuperscript{312} Even such an arrangement may not work. If the single shipment involves numerous items, a strict view of the tracing of debt and collateral may require that the debt for the shipment be itemized in terms of the number of items contained in the shipment. If this is the case, then tracing within a shipment would also pose an insurmountable obstacle to the maintenance of priority. This is the "what unit applies" problem mentioned before. See supra note 79.

\textsuperscript{313} Scott, supra note 2, and Part V. C.

\textsuperscript{314} See supra note 83.
vances against the types of inventory collateral described in the notice (X Corp. belts and hoses). While this may appear to result in a loss of collateral to Bank, in actuality it does not. Supplier cannot "prime" Bank's interest in any existing inventory. It is only existing inventory as to which Bank relied in making advances to Borrower. The collateral with which Bank intended to secure its loans to Borrower is still very much intact. Bank will make no new advances against incoming inventory of the type claimed by Supplier and, in addition, Bank will have the benefit of accounts receivable generated upon the sale of the new inventory. Although it is likely that Bank will have an obligation to advance against these new receivables, its priority as to same is unaffected by Supplier's interest in the inventory collateral. In the context of a term loan by a general financier, the general financier has not lost any collateral as to which it was entitled (after-acquired inventory) and indeed, the general financier receives the additional collateral of receivables generated by the new inventory.

In the event that Borrower defaults and is unable to pay either lender, the presence of Supplier can only benefit the Bank. In the event that Borrower's existing assets are insufficient to satisfy the indebtedness owing to both lenders, each lender will have a portion of Borrower's assets available to it. Bank will have that collateral that would have been available to it regardless of Supplier's presence. That is, but for Supplier's presence, Borrower would not have any X Corp. belts and hoses in its inventory. This is so because Bank had refused to either finance this portion of inventory or Borrower would not have acquired the inventory as the cost of Bank's financing was excessive. If the assets other than X Corp. belts and hoses are insufficient to satisfy Bank's indebtedness, the result stems not from Supplier's participation, but from the market, Bank's miscalculation of values, lack of diligence, or other cause. At the same time, if the inventory of X Corp. auto parts is insufficient to satisfy Supplier, Supplier has no recourse to other assets until Bank has been satisfied in full. However, in the event that Supplier can be made whole by liquidating less than all of the X Corp. inventory, the excess redounds to the benefit of Bank and may be applied to satisfy Bank's indebtedness.

Under the restricted interpretation of the PMSI in inventory, the general financier receives a windfall at the unjustified expense of the purchase money financier. While it certainly is reasonable to require the purchase money financier to identify that collateral which was

315. UCC § 9-312(3) and comment 3 (1987).
316. See purpose of purchase money priority supra note 186, which was to favor the new value lender.
317. See supra note 32-34 and accompanying text.
acquired by the debtor with advances or other value provided by the purchase money financier and to prove the amount of indebtedness advanced for the purpose of acquiring such inventory, it is unreasonable to require a direct one-to-one relationship between particular items of collateral and specific amounts of outstanding indebtedness.

VII. Conclusion

From the very earliest drafts of Article 9, the drafters established the preference for new value, purchase money interests. This preference logically resulted from the common-law development of purchase money priority. The preference evolved as a matter of equity and justice following the validation of the floating lien. On the other hand, the drafters validated the floating lien, not as a matter of policy, but rather because the creative minds of lawyers had made the floating lien a fait accompli, though at excessive cost and complexity. The formulation of a unified, simpler financing system made validation of the floating lien a necessity. The contrast between the reasons for the preference given to the purchase money interest and the reasons for validation of the floating lien requires that the former be entitled to the benefits of the latter, at least in the context of inventory financing. Without the floating lien, all inventory financing is made costly, difficult and fraught with risk. Inventory financing, however, becomes workable with the floating lien. Once a creditor obtains a floating lien on the debtor’s inventory, the PMSI provides the only alternative available to the debtor to finance new lines of inventory. In that regard, the purchase money priority becomes meaningless unless it too can benefit from the floating lien. By allowing the purchase money financier to utilize the floating lien, the financier can pool all purchase money collateral as security for all purchase money obligations and provide a workable alternative for the borrower confronted with an existing financier with a blanket lien. At the same time the floating lien general financier can protect its interest and, with proper diligence, will not be prejudiced by the existence of the purchase money party. There is nothing inconsistent between the PMSI in inventory and the floating lien. Indeed, no two provisions could be more consistent and complimentary.