After-Acquired Property Security Interests in Bankruptcy: A Substitution of Collateral Defense of the U.C.C.

Few provisions of the Uniform Commercial Code1 have sparked so much controversy as Article Nine's "floating lien" on after-acquired property.2 The most intensive criticism has come from the bankruptcy bar, which views the after-acquired property lien as a major threat to the rights of general creditors in bankruptcy.3 The "floating lien" arises from Section 9-204(3) of the Code, which permits a lender and his debtor to agree to secure a debt by property all or part of which is acquired after the debt is incurred.4 The use of the Code "floating lien," however, has been limited by a widespread feeling that it conflicts with the Bankruptcy Act's prohibition against preferential transfers. Any security device by which a debtor can tie up all of his assets, present and future, is seen as a danger to the interests of general creditors.5 In practice, however, a debtor has long been able to encumber future property by the use of one or more recognized security devices.6

Inventory financing, for example, may be accomplished by supplemental chattel mortgages on additions to inventory as part of a scheme of revolving credit whereby the debtor continually repays the old debt and the creditor continually extends new credit, receiving a new lien in return.7 This technique encounters no difficulties under the Bankruptcy Act. The bankruptcy bar, however, has argued that

1. Hereinafter cited as U.C.C.
3. See Gordon and Sutkowski, supra note 2.
4. U.C.C. § 9-204(3): "... [A] security agreement may provide that collateral, whenever acquired, shall secure all obligations covered by the security agreement." See Comments 2 and 3 to this Section.
6. E.g., trust receipt, conditional sale, factor's lien, field warehousing.
7. A common arrangement is for the debtor to hold receipts from sales of inventory in an express trust for the benefit of the lender, who will make further advances from such funds against the acquisition of new inventory if it is made subject to his security interest by the execution and filing of supplemental chattel mortgages. The practical disadvantages of such a scheme are obvious in the cases where inventory is subject to rapid turnover.
using Section 9-204(3) to achieve precisely the same result involves a
transfer for an antecedent debt which, if made within four months
of bankruptcy, is made a voidable preference by Section 60 of the
Bankruptcy Act.\(^8\)

A. The Conflict

The ultimate test of any security device is its ability to resist attack
by a trustee in bankruptcy.\(^9\) The less certain its validity, the less de-
sirable it will appear to a lender.\(^10\) Lenders can be expected to avoid
the Code's "floating lien" on after-acquired property so long as there
exists any substantial probability that a bankruptcy court will find it a
preferential transfer voidable under Section 60.\(^11\)

Section 60 is a statutory reversal of the common law rule which
permitted an insolvent debtor to make transfers to select creditors,
even though these transfers deprived remaining creditors of any share
in the debtor's estate.\(^12\) Under Section 60, an insolvent debtor's crea-
tion of a lien on his property within four months of bankruptcy for
other than contemporaneous consideration will constitute a prefer-
tential transfer if the transferee knew or had reason to know the debtor
was insolvent. Such transfers are voidable by the trustee, who may thus
pad the cushion of assets available for the pro rata satisfaction of un-
secured general creditors.\(^13\) Section 60 thereby seeks to ensure that
all creditors of the same class will share equally in the debtor's mis-

9. I P. COOGAN, HOGAN & VAGTS, SECURED TRANSACTIONS UNDER THE UNIFORM COMMER-
CIAL CODE § 9.01 (1967) [hereinafter cited as COOGAN, HOGAN & VAGTS].
10. Although creditors frequently will rely upon devices subject to upset, they will only
do so if they can exact a toll commensurate with the risk involved. If the uncertainty is
too great, the premium demanded may be so high as to preclude the use of otherwise attrac-
tive financing devices.
11. See 1 COOGAN, HOGAN & VAGTS §§ 2.07, 7.12[8], where counsel for lenders are advised
to avoid the risk of eventual challenge in bankruptcy by framing security interests in future
property along traditional lines (e.g., in the case of inventory by incorporation of familiar
trust receipt limitations).
12. See 3 COLLIER, BANKRUPTCY ¶ 60.02[1] (14th ed. 1966) [hereinafter cited as COLLIER].
13. Section 60(a) defines a preference as a transfer of the debtor's property to a creditor
"[1] for or on account of an antecedent debt, [2] made or suffered by such debtor while
insolvent [5] and within four months before the filing by or against him of the petition
initiating a proceeding under this Act, [4] the effect of which transfer will be to enable
such creditor to obtain a greater percentage of his debt than some other creditor of the
same class." Bankruptcy Act § 60a, 11 U.S.C. § 96(a)(1) (1964). If a transfer meets these four
criteria and, in addition, [5] "the creditor receiving it or to be benefited thereby or his
agent acting with reference thereto has, at the time when the transfer is made, reasonable
cause to believe that the debtor is insolvent," then such transfer may be avoided as prefer-
tential by the trustee. Bankruptcy Act § 60b, 11 U.S.C. § 96(b) (1964). There is no question
that the creation of a security interest is included within the meaning of "transfer" as
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fortune. For the remainder of this note, it will be assumed that we are talking of transfers made by an insolvent debtor to a knowing transferee.

The time at which the transfer is completed is crucial. The trustee can reach a Code after-acquired property interest only if the transfer can be said to occur within the four-month period before bankruptcy and if there is no new value given by the creditor. Because Section 60a(2) of the Bankruptcy Act provides that a transfer of personal property will be deemed made when perfected under state law against subsequent judicial lien creditors, the determination of when a transfer has taken place is, at least in this sense, a question of state law. Whenever a transfer involves the creation of a security interest in personal property, the time when the transfer transpires is determined by Article Nine in the great majority of states.

Article Nine provides that a security interest is perfected (1) when all of the applicable steps required for perfection have been taken and (2) when it has attached. The first requirement presents no difficulties. The most common after-acquired property agreements involve the financing of inventories or accounts receivable. In either case, the "steps required for perfection" are completed upon the filing of a financing statement describing the collateral and providing for the extension of the lien to after-acquired property.

Unfortunately, the question of when a security interest "attaches" invites excursions into metaphysics. Section 9-204(1) provides that a security interest "attaches" when there is agreement that it shall attach and value is given and the debtor has rights in the collateral. The debtor's rights

14. See 3 Collier ¶ 60.01.
15. The further requirement that the transfer was "to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class" will be deemed present whenever all of the other enumerated elements of a voidable preference exist. See generally 3 Collier ¶¶ 60.34, 60.35.
16. Transfers perfected before the four-month period and transfers occurring within the four-month period but given for new value are beyond the trustee's reach. See 3 Collier ¶¶ 60.19, 60.32.
18. 3 Collier ¶ 60.39[2].
19. As of July 1, 1967, the U.C.C. had been enacted and become law in 45 states. Arizona, Idaho, Mississippi and South Carolina have effective dates in 1968, leaving only Louisiana, which has no present plans for adoption of the Code. 3 U.C.C. Rep. Release 12 (Feb. 1, 1967).
21. The balance of this Note is confined to the specific problems of future inventory and accounts receivable financing under the Code. Much of what is said may apply as well to "other kinds of collateral, but no attempt is made to deal comprehensively with the whole spectrum of after-acquired property problems which may arise under Article Nine.
22. See U.C.C. § 9-402.
future inventory or accounts receivable normally are not in existence at the time of the financing agreement; the security interest in after-acquired property thus cannot attach (and hence cannot be perfected) until the debtor acquires rights in that property. Therefore, when the debtor acquires rights in any collateral subject to an after-acquired property agreement within four months of bankruptcy, the uncritical answer is that he has perfected—i.e., has made—a transfer during that critical period, thereby creating a preference voidable under Section 60.

This apparent delay in the perfection of an after-acquired property security interest creates a conflict between the secured lender and the bankruptcy trustee. Take the hypothetical case in which, on January 1, L (Lender) advances $50,000 to D (Debtor) upon D's agreement to give L a security interest in both his present stock and future acquisitions of inventory. A financing statement describing the collateral subject to L's security interest is filed for record on the same day. Ten months later D goes into bankruptcy with $30,000 of inventory, all of which was acquired by D in the four months prior to bankruptcy. L will claim the entire $30,000 on the authority of the after-acquired property provision of his January 1 lien. The trustee in bankruptcy, however, will argue that since D's debt was incurred on January 1, all of the additions to inventory during the four months prior to bankruptcy must be deemed transfers to L for an antecedent debt, creating preferences voidable by him under Section 60.

The Code draftsmen perceived this threat to the Code's after-acquired property lien. They attempted to escape the trustee's reach by providing in Section 9-108 of the Code that ordinary-course transfers of after-acquired collateral should be deemed made for new value. Since transfers within the critical four-month period for new value are not voidable preferences, the after-acquired property security interest would be beyond the trustee's reach. But the propriety of this escape hatch is questionable. The definition of antecedent debt

23. Where a secured party makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value which is to be secured in whole or in part by after-acquired property his security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given. U.C.C. § 9-108. Comment 1 to this Section makes it clear that the framers had Section 60 in mind when they drafted Section 9-108: "This rule is of importance principally in insolvency proceedings under the federal Bankruptcy Act or state statutes which make certain transfers for antecedent debt voidable as preferences."

24. As a leading commentator notes, Section 9-108 has "sometimes been considered as
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in the Bankruptcy Act appears to be purely a matter of federal law, not to be superseded by state "fictional" definitions. Nothing in Section 9-108, the "§ 60 bulls" argue, can alter the fact that the original giving of value came long before our debtor acquired any interest in the stock of inventory he held at bankruptcy.

Even if Section 9-108 is ultimately rejected by bankruptcy courts unwilling to let state law defeat the policy of the federal bankruptcy law by Pickwickian definitions, there are at least two alternative arguments for validating at least some "floating liens" in bankruptcy: the early perfection theory, and the substitution of collateral analysis. The first and simpler of the two, although accepted by at least two lower courts, is unacceptable because it relies on verbal conceptualism to immunize all after-acquired property interests from the Bankruptcy Act's prohibition against preferential transfers. The second, by contrast, examines various fact situations involving the "floating lien." Instead of anointing all "floating liens" with the oil of Article Nine, it rejects those antithetical to the policy of the Bankruptcy Act, thereby mediating between the uncritical approach of the Code and the exaggerated fears of the bankruptcy bar.

B. Early Perfection and Early Transfer

Under the Code, once the lender has given value and has filed a financing statement, his security interest will be perfected automatically when the debtor acquires rights in the collateral. This means that there is no time between the filing of the financing statement and the debtor's acquisition of rights in the collateral during which a general creditor could have asserted rights in the property superior to those of the Code lender. Code supporters have fastened upon automatic perfection to argue that for purposes of Section 60, a Code after-acquired property interest should be considered fully perfected at the time of the filing of the original financing statement since it is from then on invulnerable to any subsequent judicial lien creditor.

an almost laughably naive attempt to perpetrate a fraud on the Bankruptcy Act." 2

25. See Gordon, supra note 2, at 57-58; Riemer, Bankruptcy-Preference-Conflict between Section 9-108 of U.C.C. & Sec. 60(a) of Bankruptcy Act, 79 Com. L.J. 63, 65-67 (1965); 3 COLIER ¶ 60.51A [7.2].
26. Gilmore's appellation. 2 GILMORE § 45.6, at 1309.
28. See, e.g., Friedman, supra note 2, at 215-19.

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They reason that since the bankruptcy trustee's status under Section 60 is that of a hypothetical judicial lien creditor, any security interest sufficiently perfected to preclude subsequent general creditors from asserting a claim superior to that of the Code lender should likewise be insulated from attack by the trustee in bankruptcy. This is equivalent to saying that the transfer, for bankruptcy purposes, is perfected at the time of the original financing agreement. Like Section 9-108, this argument would make the Code after-acquired property interest always immune in bankruptcy. While the result is the same, however, the tactical approaches differ. Section 9-108 would admit that a transfer has been "made" within the four-month period, but would attempt to make it by definition for "new value." The early perfection argument, on the other hand, attempts to show that no transfer has been "made" during the four-month period, thereby neatly avoiding the difficulty of arguing that "new value" has passed when the only extension of credit occurred months previously.

Unhappily, this "early perfection" argument, to be successful, must overcome Section 9-204's requirement that "a security interest cannot attach until . . . the debtor has rights in the collateral." The early perfectionist must argue, in the face of this section, that an interest may be perfected before any new property to which the interest could attach has been transferred to the debtor.

The apparent barrier of Section 9-204 is attacked through the metaphysics of "attaches"—it is hypothesized that the original transaction between lender and debtor amounts to an actual present transfer of the entire inventory (or accounts receivable) of the debtor, existing and future, as a single "entity." One of the most elaborate versions of the entity theory describes the original transaction as a transfer of "an existing property right of 'potential' existence. It is a present contingent property res. The existence of the debtor's business furnishes the present property out of which the future contingency can arise."

30. See 3 COLIER § 60.38[2], at 949.
31. It is difficult to see how a security interest could arise in property before the debtor has any right in it. See U.C.C. § 9-303, Comment 1: "The term 'attach' is used in this Article to describe the point at which property becomes subject to a security interest [emphasis added]." Read in tandem with U.C.C. § 9-204, § 9-303 must thus be taken to mean that no property is subject to a security interest until the debtor acquires rights in it. See also U.C.C. § 2-105(2) relating to the sale of goods: "Goods must be both existing and identified before any interest in them can pass."
32. Friedman, supra note 2, at 219.
33. Id. at 224. This language is from Friedman's proposed Official Comment to the revision of § 9-108 he recommends. But see Sutkowski, supra note 2, at 102-103.
But the early perfection *cum* entity theory is primarily an attempt to exorcise the objections of the bankruptcy bar by attaching new names to familiar objects. Article Nine might have provided unequivocally that the transfer of property under an after-acquired property security interest occurs at the time at which there is agreement, value is given, and the financing statement is filed. Section 60a(2), after all, does leave to state law the determination of when a transfer is perfected.34 Unfortunately, Article Nine makes no provision for the attachment of an after-acquired property security interest before the time at which “the debtor has rights in the collateral.” The entity theorist must make the linguistically embarrassing argument that the phrase “the debtor has rights in the collateral” creates a present transfer of property in which the debtor has no present interest simply by virtue of the fact that both present and future property may be described by one collective noun—“inventory.”35

Moreover, the early perfectionists are contradicted by the very existence of Section 9-108. If the Code’s draftsmen had considered the lender’s interest “perfected” at the time of filing and thus insulated from attack by the trustee under Section 60, why did they add the present value provisions of Section 9-108?36 At least one early perfectionist has called Section 9-108 self-defeating and a major tactical blunder which only “directs judicial attention to a problem which . . . does not exist.”37 A blunder it may be, but the fact that Section 9-108 is there suggests that the draftsmen had no confidence that the early perfection theory could be relied upon in bankruptcy.

The early perfectionist-entity argument avoids rather than meets the claim that the Code “floating lien” legitimates transactions contrary to the policy of the Bankruptcy Act. Some of the possible arrangements for security in after-acquired collateral validated by the early perfection theory are shown below to exemplify exactly the kinds of estate-depleting transfers Congress sought to prohibit in Section 60.38 Ingenious or ingenuous verbal formulae rationalizing the present

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34. Notes 17-18 and p. 141 *supra.*
35. The entity theory, in other words, depends upon a showing that Article Nine intended to make the after-acquired property security interest secure against a hypothetical judicial lien creditor from the moment the security interest came into existence. The Article Nine provision governing the attachment of a security interest—§ 9-204(f)—prevents us from making such an assertion about the hypothetical judicial lien creditor. Therefore the trustee in bankruptcy may argue that the transfer of after-acquired property cannot be said to have been perfected until some time after the security interest was first created.
36. Note 23 *supra.*
37. Friedman, *supra* note 2, at 220.
38. See text of Section E following note 65 *infra.*
property status of rights in future property ought not to overcome a trustee who demonstrates that the disputed transfers are in direct conflict with the Congressional intent to prevent preferential depletion of a bankrupt's estate within four months of bankruptcy.\(^{20}\)

C. The Substitution of Collateral Theory

It has long been held that a mere substitution or exchange of property is not preferential except to the extent that the value of the creditor's interest in the substituted property exceeds the value of the creditor's interest in the original property.\(^{40}\) A typical case of non-preferential substitution occurs when a debtor and a creditor agree that Blackacre, rather than Whiteacre, shall be security for an outstanding mortgage, and Blackacre is worth no more than or less than Whiteacre. Such a transfer, although relating to an antecedent debt, is not considered a transfer for an antecedent debt because it results in no depletion of the debtor's estate.\(^{41}\)

Some Code proponents have suggested that the Article Nine “floating lien” can be defended in bankruptcy on a substituted collateral rationale.\(^{42}\) Insofar as inventory or accounts receivable at the time of bankruptcy represent substitutes for earlier collateral in which the lender had a fully perfected interest, no preference, it is argued, results by giving effect to the lien.\(^{43}\)

This theory has been challenged on the grounds that prior case law requires that the exchange of security be simultaneous or that the lender police his security interest by acquiring rights in new collateral before releasing his interest in old collateral.\(^{44}\) Simultaneity will often be lacking under the Code where the debtor is given complete freedom over the collateral and may dispose of it free of the lender's interest long before new inventory or accounts are acquired to take its place. The cases establishing the simultaneous substitution rule, however, came well before the Code and therefore are unreliable prece-

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\(^{20}\) See Gordon, supra note 2, at 70-71; Note, Bankruptcy—Preferences—After-Acquired Property Provisions of the U.C.C. Held Inapplicable in Bankruptcy Proceedings as Conflicting with Section 60a of the Bankruptcy Act, 42 N.Y.U.L. Rev. 150, 157 (1967).

\(^{40}\) See 3 COLLIER ¶ 60.20 (“Diminution or Depletion of the Estate Is Essential”), and cases cited.

\(^{41}\) See 3 COLLIER ¶ 60.21, and cases cited.


\(^{43}\) Note that the substitution of collateral theory accepts that additions to inventory or accounts are transfers by the debtor within the critical four month period; it merely denies that they are preferential transfers.

\(^{44}\) Gordon, supra note 2, at 62; Sutkowski, supra note 2, at 101.
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dents for cases arising under the Code's automatically-perfected lien on after-acquired property.

Often cited for the simultaneous substitution rule is In re Lambert & Braceland Co., where the court held an accounts receivable financing arrangement voidable by the trustee where the debtor had the "privilege" of substituting accounts of equal value for those originally assigned as security. Although the precise grounds of the decision are less than clear, the court was concerned with the debtor's almost unlimited freedom over collateral, in violation of the rule in Benedict v. Ratner, and especially troubled by the fact that the arrangement amounted to a secret lien against the property.

But to the extent that the rationale for the simultaneous substitution rule is an extension of the dominion rule of Benedict v. Ratner, no objection on such grounds can be raised against the Article Nine security interest in after-acquired property. Benedict v. Ratner involved only a disputed point of state law regarding fraudulent transfers in circumstances where the debtor was given the power to terminate the lender's interest at any time. Section 9-205 of the Code now affirms as a matter of state law the validity of a security interest where the debtor has unrestricted control over the collateral. Nor can a secret lien objection be raised to inventory or accounts receivable financing under the Code, for an Article Nine security interest in after-acquired property is perfected only on filing, when it becomes a matter of public record.

But the Lambert & Braceland court also stressed that once accounts subject to the lender's lien were collected, the lender had no control

45. 29 F.2d 758 (E.D. Pa. 1928).
46. In practice, the debtor would collect outstanding accounts as they came due during the month, would deposit the proceeds in a general account and would then, at the end of the month, furnish the lender with a schedule of new accounts of approximately equal value. None of the obligors was ever notified of any of the assignments and no entries were made upon the books of the company to segregate the accounts assigned.
47. 268 U.S. 353 (1925). The trustee was allowed to recover as a fraudulent transfer amounts paid to a lender within four months of bankruptcy under a prior assignment of present and future accounts receivable. Construing New York cases, the Supreme Court decided that as a matter of New York law, where "unrestricted dominion over the proceeds is reserved to the mortgagor... the mortgage is void." Id. at 364.
48. See U.C.C. § 9-205, Comment 1. Under § 9-205, 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... or to collect or compromise accounts, contract rights or chattel paper... 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... And note that apart from the question of preference, the Bankruptcy Act leaves all questions regarding the construction, validity and operation of security arrangements and other transfers of property to state law. See 3 Collier ¶ 60.13, and cases cited.
49. See U.C.C. § 9-302.
over what new accounts became subject to the lien; which accounts, if any, to be brought within the lien were completely within the debtor’s disposition. Whatever the merits of this latter concern on the facts of Lambert & Braceland, this is not a problem under the Code. The Code gives no such freedom of choice to the debtor; all inventory or all accounts receivable acquired within the terms of the security agreement are brought automatically within the lender’s lien by operation of law at the moment of their acquisition. Once the debtor has granted a security interest in after-acquired property, he can do nothing to avoid the attachment of the lien as he acquires future property. The Code debtor, however great his dominion over collateral, has no real power to avoid the lender’s interest in after-acquired property which could pass to a trustee in bankruptcy. He can, of course, let his inventory run down and go out of business. But he cannot remain in business and avoid the attachment of the creditor’s security interest. Moreover, if the debtor does simply liquidate, there is no preference to the inventory creditor. Rather, the inventory creditor who does not insist upon any power to police the substitution of collateral and instead accepts an after-acquired property security interest under the Code is the only creditor who stands to lose. If the debtor liquidates his inventory or accounts receivable, this will redound to the benefit of the general creditors since funds which otherwise would have been locked up in secured assets thereby become available for their satisfaction.

Imputation of a simultaneity requirement into the Section 60 law of preferential transfers would be justified only if it served to block evasions of the policy of the Bankruptcy Act. But if non-simultaneity and non-policing will make the secured creditor no better off, and possibly worse off, than he would be with policing and simultaneity, no interests except those of complicating the process of inventory financing can be served by a simultaneity requirement. Policing in-

50. 29 F.2d at 759. The lender’s interest in the accounts actually submitted did not arise until receipt by him of each month’s new list.
51. U.C.C. §§ 9-204 and 9-303 together provide for the automatic perfection of an otherwise complete security interest in property on acquisition by the debtor. Cf. Friedman, supra note 2, at 215, 219.
52. See In re Pusey, Maynes, Breish Co., 122 F.2d 606, 608 (3d Cir. 1941) (also often cited for the simultaneity rule), where the court explained: “Perhaps a more practical approach to the reason for the rule is simply that the debtor’s power of control to end the lien is one which passes to an attacking creditor or to a trustee in bankruptcy, as the case may be.”
53. Assuming that the inventory creditor is unable to assert a good claim to proceeds under the tracing provisions of U.C.C. § 9-306(4).
54. It should be noted, however, that there is nothing in the Code to prevent the lender from requiring that the security agreement contain some or all of the usual policing provisions designed to protect his interest in the collateral. Few cases, in fact, are envisioned where a lender would allow his debtor the unrestricted freedom over collateral possible.
creases the costs to the secured creditor and the debtor without providing any additional safeguards for the general creditor, the intended beneficiary of Section 60. Therefore, removal of the state law requirements of simultaneity and policing does not demand their reintroduction through interpretation of the Bankruptcy Act in order to protect the interests of general creditors.

D. Two Theories in Search of a Sponsor: The Judicial Response

There are only two reported cases dealing with the U.C.C.'s "floating lien" on after-acquired property—both decided earlier this year in federal district courts. Both opinions drew heavily upon the verbal distinctions necessary to support the early perfectionists' defense of the Code.

In the first of these, Rosenberg v. Rudnick,

the creditor claiming under the Code prevailed over the trustee in bankruptcy, District Judge Ford relied on the early perfection and entity theory to hold that the creditor's security interest in the debtor's inventory was perfected at the time the creditor gave value and took the security interest in inventory. The trustee's contention that the security interest could not have attached until the debtor acquired some interest in the items making up his inventory was brushed aside: "In applying § 60... inventory subjected to a security interest should be viewed as a single entity and not as a mere conglomeration of individual items each subject to a separate lien."

Judge Ford turned to Section 9-108 to reinforce his decision, holding that since almost all states had adopted the Code, the "new value" definition of that section "should be regarded as generally accepted and in accord with current business practice and understanding and hence applied in bankruptcy." Alternatively, the intent of the Code to make such a transfer non-preferential should be respected: "[t]he Code's provisions as to perfection and attachment of security interests should not be interpreted to produce a different result." Rosenberg therefore depends either on the entity fiction or upon the bald propo-

under the Code. What is to be emphasized is that the Code leaves such arrangements to the discretion of the parties who, it is hoped, will be able to tailor their arrangement to fit their own special needs and not always with a wary eye on the Bankruptcy Act. See Spivack, The Impact of Article 9 of the UCC on Creditors' Rights in Bankruptcy, 32 Tex. L.Q. 183, 192-94 (1969); Henson, "Proceeds" under the U.C.C., supra note 2, at 237-38.

56. Id. at 639.
57. Id.
58. Id.
sition that if enough states insist that a transfer is for "new value," any transfer, whenever protected, may be insulated from the trustee.

The second decision came in late August, when the District Court of Oregon reversed the referee's opinion in In re Portland Newspaper Publishing Co. and upheld a Code "floating lien" on accounts receivable. The referee had ruled that Section 9-108 was insufficient to overcome the conclusion that the attachment of the creditor's security interest to accounts acquired by the debtor within four months of bankruptcy constituted a transfer for an antecedent debt.

Judge Solomon treated the appeal as involving two questions: Was there a transfer during the four-month period? And, if so, was this a transfer for an antecedent debt? He answered the first question in the negative by adopting Judge Ford's entity argument from Rosenberg: the transfer "was made when the security agreement was executed and not when each item of inventory was acquired by the debtor." Had he followed Rosenberg strictly, he need have gone no further; for a transfer made prior to the four-month period is beyond the trustee's reach under Section 60.

Judge Solomon, however, went on to consider whether or not the transfer, if deemed made during the four months prior to bankruptcy, could be considered a transfer for an antecedent debt. He admitted that Section 9-108 would deny that a transfer for an antecedent debt had been made, but felt it necessary—even in the face of widespread state acceptance of the Code—to decide whether or not the facts before him presented a conflict between Section 9-108 and the policy of the Bankruptcy Act. "Without a clear-cut conflict," he stated, Section 9-108 "should not be held to contravene Section 60." Because during the four months prior to bankruptcy accounts of $397,860 were replaced by new accounts of $395,085, Judge Solomon found that the "floating lien" on the newspaper's accounts receivable had not violated Section 60's opposition to any creditor improving his position over other creditors of the same class shortly before bankruptcy. Adherence to Section 9-108 did not result in a diminution of the bankrupt's estate "because the creditor is only receiving a substitution of

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62. Id. at 72,021.
63. Id. at 72,022.
64. Id.
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security. There is no preference when new accounts are substituted for released old ones."

E. Substitution of Collateral in Practice

The metaphysical word-shuffling involved in the debates over the early perfection and attachment of security interests makes the substitution of collateral rationale a much more satisfactory argument with which to challenge the trustee in bankruptcy. If it is accepted that nothing in the pre-Code simultaneity cases precludes the application of the substitution of collateral doctrine to the Code “floating lien” on after-acquired property, a way is open to harmonize the conflicting claims of the Code lender and the bankruptcy trustee in a manner which does full justice to the policy of Section 60 without emasculating Article Nine.

But even the substitution of collateral rationale, as set forth by Judge Solomon in the Portland Newspaper decision, may be interpreted in a manner which may frustrate the policy of the Bankruptcy Act. Some of the possible transactions permitted by Section 9-108 might be characterized as substitution of collateral cases, but are nevertheless in direct conflict with Section 60’s policy of preventing preferential diminution of the debtor’s estate during the four months prior to bankruptcy. Proponents of both sides in the debate over the Article Nine security interest in after-acquired property have tended to over-generalize, paying too little attention to actual cases likely to arise under Article Nine. Even under a substitution of collateral theory, only some of the possible sequences of events under standard inventory or accounts receivable financing arrangements are consistent with the Bankruptcy Act. Consider the following possible situations over the life of an inventory financing agreement, temporarily ignoring any fluctuation during the intervals between the discrete points in time identified in the table on page 152.

Cases 1 & 2: Inventory at Bankruptcy Equals or Is Less Than Original Stock-in-Trade. Cases 1 and 2 represent typical situations in which loans are secured by a presently existing stock of inventory the dollar value of which remains constant or declines up to the time of bankruptcy. These transactions appear to involve no preference under Section 60. The actual items of inventory subject to the security interest at the time of bankruptcy may all have been acquired by the

65. Id.
HYPOTHETICAL AFTER-ACQUIRED INVENTORY FINANCING ARRANGEMENTS UNDER ARTICLE NINE

<table>
<thead>
<tr>
<th>Case</th>
<th>$T_1$ inventory level</th>
<th>$T_2$ inventory level</th>
<th>$T_3$ inventory level</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10 months before bankruptcy, when financing agreement signed</td>
<td>4 months plus 1 day before bankruptcy</td>
<td>at time of filing for bankruptcy</td>
</tr>
<tr>
<td>Case 1</td>
<td>$50,000</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Case 2</td>
<td>50,000</td>
<td>50,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Case 3</td>
<td>0</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Case 4</td>
<td>0</td>
<td>0</td>
<td>50,000</td>
</tr>
<tr>
<td>Case 5</td>
<td>25,000</td>
<td>25,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Case 6</td>
<td>50,000</td>
<td>30,000</td>
<td>40,000</td>
</tr>
</tbody>
</table>

N.B. Value of loan by creditor in all cases = $50,000.

debtor during the four months prior to bankruptcy. However, an exchange or substitution of security of equal value involves no depletion of the debtor’s estate and therefore is of no prejudice to general creditors. Here, the secured creditor is no better off at $T_3$ (and in Case 2, less well off) than he was at $T_2$ when he had an entirely perfected interest in then-existing inventory equal to or greater in value than the interest he seeks to assert at the time of bankruptcy.

Cases 1 and 2, where the overall value of inventory remains constant or declines over time, therefore fit precisely within the terms of the substitution rationale. If, as argued in the preceding section, there is nothing to preclude the application of the substitution doctrine to an Article Nine security interest, a court should enforce the lender’s interest in these cases against the trustee in bankruptcy.

Case 3: Inventory Acquired After Signing of Financing Agreement—But More Than Four Months Prior to Bankruptcy. Cases 1 and 2 involved the classic inventory financing arrangement, where the lender advances money on the strength of a stock of presently-existing inventory. The Code, however, would also permit a lender to advance money to be secured by property to be acquired entirely in the future. Case 3 presents the problem of a loan unsecured by any collateral when made, but secured at $T_2$, four months and one day prior to bankruptcy, by a perfected interest in inventory of $50,000. Obviously it cannot be argued that inventory at $T_2$ is a replacement or substitute for inventory at the time of the agreement, $T_1$. But this argument is unnecessary: the lender’s interest at $T_2$ is fully perfected at that time and beyond the reach of a trustee under Section 60. The

66. See note 4 supra; U.C.C. § 9-204, Comment 4.
substitution argument need only be made for inventory replaced within the critical four months period preceding bankruptcy. In Case 3, the values of the inventory at T2 and T3 are identical. The substitution rationale which validated the lender’s interest in Cases 1 and 2 should be equally applicable to Case 3.

**Case 4: Inventory Acquired After Signing of Financing Agreement and Within Four Months of Bankruptcy.** A very different problem is presented by Case 4. Here, the entire security claimed by the lender was acquired by the debtor within the four months preceding bankruptcy. On these facts, the substitution theory must be unavailing. Because no collateral existed at T2, the lender never had a perfected security interest in any inventory for which the inventory acquired within four months of bankruptcy may be considered a substitute. Even here, Section 9-108 would validate the lender’s interest against the trustee in bankruptcy. It states explicitly that any advance secured in whole or in part by after-acquired property shall be deemed to be taken for new value and not as security for an antecedent debt. Case 4 exemplifies the worst fears of the bankruptcy bar, and is within Section 60’s condemnation of depletions of the debtor’s estate on the eve of bankruptcy. Section 9-108 overreaches itself in seeking to affirm the security interest of our Case 4 lender against the trustee in bankruptcy.

**Case 5: Where Inventory Value Rises During the Four Months Preceding Bankruptcy.** Case 5, in which existing inventory increases by $25,000 between T2 and T3, is really a variant of Case 4. Any interest asserted in this increment by the secured creditor cannot be considered to stem from the replacement of collateral under a perfected interest in inventory antedating the critical four-month period. The substitution of collateral rationale must be inapplicable to the $25,000 increment, and the lender’s interest in inventory must be rejected to the extent that the value of inventory at bankruptcy exceeds its value at T2.

**Case 6: Where Inventory Value Falls Before, and Rises During, the Four Months Preceding Bankruptcy.** In Case 6 the value of the inventory collateral falls from T1 to T2, and then rises again during the four months between T2 and T3. If the value of inventory at T1 governs the extent of the lender’s interest in the inventory at bankruptcy, then all $40,000 of inventory at T3 will be subject to the lender’s lien; if the value at T2 governs, only $30,000 will be within the lien.
The lender will argue that the inventory value at $T_1$ should control. He will claim that it is in the nature of inventory to fluctuate, although the average flow over the long run is constant. It is thus unfair to limit the value of his lien to inventory at $T_2$: the entire period may be viewed as one of continuous substitution of collateral, beginning with an original value of $50,000, and ending with a final value of $40,000.

The trouble with the lender's argument, however, is that the substitution theory is irrelevant to transactions occurring outside the period four months before bankruptcy. Case 3 demonstrated that an advance against zero collateral will be secured in bankruptcy to the extent of the value of a perfected security interest in inventory at $T_2$. This is so not because the interest at $T_2$ represents new inventory substituted for prior collateral, but simply because the inventory interest at $T_2$ is the result of transfers to the lender perfected before the four-month period and thus not subject to the trustee's power of avoidance under Section 60. Section 60 makes no attempt to catch transfers outside the four-month period; it focuses entirely upon that period, the only period in which the substitution theory is relevant.

In Case 6 the value of inventory rose by $10,000 between $T_2$ and $T_3$. That increment is not a substitute for an interest perfected at the onset of the four-month period and, under the reasoning of Case 5, results in a $10,000 depletion of the debtor's estate within four months of bankruptcy. The lender's interest at bankruptcy must be limited to $30,000, the value perfected at $T_2$.

Although it may appear arbitrary to limit the value of the lender's lien to the value of inventory existing on a single day ($T_2$), it is no more arbitrary than the voidability of any transfer, otherwise impeccable, which occurs one day into the four-month period. The Bankruptcy Act is an exercise in statutory line-drawing; all such endeavors are likely to involve seemingly arbitrary results at the margin.

Our analysis has hitherto ignored the fluctuations in the value of inventory occurring between $T_2$ and $T_3$. We have implicitly assumed that the trend line of inventory value between $T_2$ and $T_3$ is constant or steadily increasing or decreasing. But this analysis does not exhaust all possible cases. Some may still argue that fluctuations in the level of collateral during the four-month period must result in a preference voidable under Section 60. If the creditor at the time of bankruptcy has a larger secured interest than he had three months earlier, the argument runs, he must have received a preference during the four-
month period if the other criteria for a preferential transfer are met.\textsuperscript{67}

To pose an extreme example, suppose the debtor at \(T_2\) has $50,000 of inventory, which declines steadily until two days before \(T_3\) to $5,000. The next day, he acquires $45,000 of inventory, and the following day he goes into bankruptcy. Looking solely at \(T_2\) and \(T_3\), this appears no different from Case 1 and we might conclude that the creditor is secured at bankruptcy to $50,000 worth of inventory collateral. But the pattern of events between \(T_2\) and \(T_3\) prima facie appears to be an effort to prefer the inventory creditor in anticipation of bankruptcy.

Blanket objections to the Code’s “floating lien” based on such fluctuations elevate form above substance. Such objections are but an attempt to sneak the rejected requirement of simultaneous substitution back into the bankruptcy law. If the secured creditor were to police so that receipts from inventory sales are not released to the debtor’s control until new collateral is provided, the value of his security interest (the sum of unreleased receipts and inventory) presumably would remain constant. As argued above,\textsuperscript{68} the most that policing can accomplish for the creditor is to ensure that he has the same security for his loan at \(T_3\) that he had at \(T_2\).

But we have also shown that the Code after-acquired property agreement may at the most provide for the secured creditor at \(T_3\) a secured interest equal to that which he had at \(T_2\). The “floating lien” therefore can never place the creditor in a better position than that in which he would have been had the requirement of policing existed. To reject the “floating lien” because of fluctuations of collateral between \(T_2\) and \(T_3\) would have the same effect as introduction of an explicit policing requirement, which is required by neither the Code nor the Bankruptcy Act.\textsuperscript{69} The general creditors may easily protect

\textsuperscript{67} See note 13 supra.

\textsuperscript{68} See p. 148 supra.

\textsuperscript{69} In the so-called “net result” cases, the Supreme Court, followed by several lower federal courts, has held that no Section 60 preference results from payments by a debtor to a supplier of goods, even where such payments are not contemporaneous with delivery, if they are part of a bona fide system of open account on running credit, and there is no net diminution of the debtor’s estate within the four-month period taken as a whole. See Jaquith v. Alden, 189 U.S. 78 (1903); In re Fred Stern & Co., 54 F.2d 478 (2d Cir. 1931); In re Stewart, 233 F. Supp. 89 (D. Ore. 1964). The “net result” rule, taken alone, may be a shaky basis for the Article Nine “floating lien,” for it has been limited by several courts to situations in which the good faith of the creditor in the debtor’s solvency is clear. See Cooper Petroleum Co. v. Hart, No. 24,124 (5th Cir., June 29, 1957); Campanella v. Liebowitz, 103 F.2d 292 (3d Cir. 1939); COLEMAN ¶ 60.23. On the other hand, the argument that short-term credit sales during the four-month period may operate to enrich rather than diminish the debtor’s estate applies equally well to the Code “floating lien.” Inventory is inherently subject to fluctuation, and so long as the creditor’s security interest at \(T_3\) is equal to or less
themselves by keeping one eye upon the past level of the debtor’s property subject to an after-acquired property security interest. Because the secured creditor can obtain at $T_3$ no larger an interest than that secured at $T_2$, the general creditor will always know the maximum secured interest which the secured creditor can assert against the general creditor in any bankruptcy occurring at any time within the next four months.\textsuperscript{70}

The statutory provision against fraud on the Bankruptcy Act will limit the possibility of deliberate manipulations by the debtor. Section 67d(2)(d) of the Act\textsuperscript{71} makes fraudulent all transfers made within one year of bankruptcy with “actual intent . . . to hinder, delay or defraud either existing or future creditors.” It is true that “mere preferences” without clear intent to delay or defraud other creditors are not swept within this clause.\textsuperscript{72} But if the debtor led a general creditor to believe that he would not re-expand his inventory to its value at $T_2$, and did in fact expand it, Section 67d(2)(d) could apply.

It may be felt, however, that leaving the debtor free to increase the amount of his assets subject to an Article Nine after-acquired property interest at any time, for any reason, during the four months prior to bankruptcy, is too great an invitation to play fast and loose. If some further restriction is deemed necessary, a more discriminating tool than Section 67 with its requirement of actual intent may be fashioned out of relevant sections of the Bankruptcy Act and Article Nine. Section 70e of the Act\textsuperscript{73} confers upon the trustee in bankruptcy whatever powers, under either federal or state law, any creditor may have had to avoid any fraudulent or otherwise voidable transfer. Section 9-108 of the Code provides that a creditor’s security interest in after-acquired property is deemed taken for new value “if the debtor acquires his rights in such collateral . . . in the ordinary course of his business . . .”

than his interest secured at $T_2$, there is no diminution of the debtor’s estate during the critical period.

\textsuperscript{70} We have argued that the interest secured by the creditor is measured by his original loan to the debtor, or the amount secured at $T_2$ if less than the loan. The maximum level of the collateral subject to the security interest at any time up to four months in the past represents the maximum risk the general creditor runs of having the debtor’s property placed beyond his reach. If the highest level of inventory during the past four months was $40,000 two months earlier, the maximum risk faced by the general creditor over the next four months will be the assertion against him of a secured interest in inventory of $40,000, even if the creditor had a security interest of, say, $50,000. If bankruptcy occurs either earlier or later than two months in the future, a lesser amount of inventory will be beyond the general creditor’s reach.


\textsuperscript{72} 4 COLLIER ¶ 67.37, at 372-73 and cases cited nn.25-26.

\textsuperscript{73} 11 U.S.C. § 110(e) (1964).
Although the ordinary-course-of-business rule has most often appeared in the context of litigation over what kind of property acquired by debtors is within the terms of after-acquired property agreements, its appearance in Section 9-108—patently written with one eye upon the Bankruptcy Act—may give it a double edge. Not only does the section delimit the creditor's security interest if there is default in the absence of insolvency, but also it indicates the extent beyond which the Code framers were unprepared to go in seeking to protect the Code "floating lien" holder from the reach of the trustee in bankruptcy.

Comment One to the official text of Section 9-108 states that the ordinary-course-of-business rule was intended to provide "other creditors the possibility, under the law of preferences, of subjecting to their claims windfall or uncontemplated acquisitions shortly before bankruptcy." This Comment is not free from ambiguity, but it does indicate that other creditors were to have a state law remedy against abuses of the after-acquired property security interest. Because it is a state law provision for the benefit of general creditors, this part of Section 9-108 should be available to the trustee in bankruptcy under Section 70e. It permits him to discriminate between transfers which do and do not involve attempts to give special treatment to particular creditors just prior to bankruptcy. Although Section 9-108 should not validate security interests which conflict with the policy of the Bankruptcy Act, there is no reason why it should not operate to restrict, as a matter of state law, the enforcement of particular security interests. Satisfaction of Section 9-108 should be treated as a necessary but not sufficient condition for an after-acquired property security interest to stand up to the trustee in bankruptcy.

Section 60 thus is not in irreconcilable conflict with Section 9-108. Many transactions legitimated by Section 9-108 do not violate Section 60's prohibition of estate-depleting transfers within four months of bankruptcy. On the other hand, Article Nine enthusiasts chary of any

74. See U.C.C. § 9-108, Comment 1: "This rule is of importance principally in insolvency proceedings under the federal Bankruptcy Act or state statutes which make certain transfers for antecedent debt voidable as preferences."

75. "Windfall" and "uncontemplated" are undefined, as is the time period described by "shortly before bankruptcy."

76. Alternatively, power to set aside a transfer under the ordinary course of business test of § 9-108 may come to the trustee through § 70c, 11 U.S.C. § 107(c) (1964), which gives the trustee as of the date of bankruptcy the rights and powers of a hypothetical creditor who obtained a judgment against the bankrupt upon the date of bankruptcy.

effort to delimit the reach of the Code's "floating lien" must remember that Section 60 does set limits to state law. The limitations upon the "floating lien" set forth above should allay the worst fears of the bankruptcy bar; moreover, they are capable of rational, predictable administration by referees and courts in bankruptcy.