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# Inflatable Liens and Like Phenomena Converting Unsecured Obligations Into Secured Debt Under U.C.C. Article 9 and the Bankrupcty Code

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# INFLATABLE LIENS AND LIKE PHENOMENA: CONVERTING UNSECURED OBLIGATIONS INTO SECURED DEBT UNDER U.C.C. ARTICLE 9 AND THE BANKRUPTCY CODE

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Under Article 9 of the Uniform Commercial Code, a security agreement can cover what might be called "after-secured obligations"—claims not secured by a security interest until after the interest attaches.[1] For instance, the 1962 version of Article 9 sanctioned coverage of "future advances," an undefined term apparently referring to new value given by the secured party after the original advance covered by the security agreement. The 1972 amendments to Article 9 added a series of priority rules to deal with such advances. Future advances, however, represent only one type of after-secured obligation.

Article 9 security agreements, as well as real property mortgages,[2] can cover obligations converted from unsecured to secured status after the original security interest provided for in the agreement has attached. For example, agreements containing broadly-drafted "dragnet clauses," providing that collateral secures all current and future indebtedness between the parties,[3] may reach claims the secured party acquired by assignment after the parties executed

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1 One commentator has used the term "floating debt" to describe "claims which [a secured party] acquired after the execution of a security agreement." Justice, *Secured Transactions—What Floats Can Be Sunk*, 24 VILL. L. REV. 867, 896 (1979). Because it is difficult to see how such debt "floats," the phrase "after-secured obligations" seems preferable.

2 This article deals primarily with security interests in personal property governed by Article 9 of the U.C.C. The issues discussed, however, often arise in connection with real property mortgages, *see* cases cited *infra* notes 49, 59, & 62 and accompanying text, and much of the Article 9 analysis contained herein also applies to mortgages.

3 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 35.2 at 917-18 (1965); Justice, *supra* note 1, at 897.

the security agreement. Such an agreement gives rise to what might be called an "inflatable lien"—a security interest that permits the secured party to expand the amount of secured indebtedness by taking assignments of claims against the debtor.[4]

Armed with such a clause, an oversecured creditor may appropriate the debtor's equity in collateral by asserting rights the debtor did not intend to convey. Because Article 9 dates priority in many situations from the time a financing statement is filed,[5] such a creditor may "squeeze out" third parties who have obtained an interest in the property. In some cases the priority Article 9 apparently affords after-secured obligations is unjustified, and the power to "squeeze out" other claimants to the collateral encourages abusive behavior. These problems are exacerbated where the debtor has become insolvent. The bankruptcy laws designed to control opportunistic behavior by secured creditors often depend on non-bankruptcy priority rules. Thus Article 9's failure to deal sensibly with after-secured obligations may permit an oversecured party to purchase unsecured claims against a bankrupt at a discount, reaping windfall profits at the expense of the debtor's other creditors.

In attacking such abuses, courts and commentators have issued broad condemnations that threaten legitimate transactions. Inflatable liens and similar devices permitting unsecured debt to be converted into secured obligations under a preexisting security agreement can serve legitimate purposes. The ability to "convert" certain unsecured claims can reduce the costs of secured lending by creating flexibility to meet the bewildering variety of circumstances requiring such financing. It is unwise, therefore, to declare all conversion arrangements unenforceable. Applicable doctrine should distinguish between abusive and nonabusive uses of these devices and afford the latter appropriate protection. Without such a distinction, the law thwarts desirable developments in secured financing techniques and defeats the reasonable expectations of parties who have employed conversion arrangements in good faith.

A policy-oriented approach to after-secured obligations, such as that proposed in the Appendix, can protect proper uses of conversion devices while discouraging abusive behavior. To guard against oppression of the debtor who did not intend to give a secured party the power to convert, any reform must condition enforceability of

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4 "Inflatable liens" should be distinguished from "floating liens," which are security interests covering after-acquired collateral. The distinctive feature of a floating lien is the collateral; the distinctive feature of an inflatable lien is the obligation secured. An inflatable lien can attach to any kind of permitted collateral, whether or not "after-acquired." The U.C.C. generally permits floating liens, U.C.C. § 9-204(1) (1977), but no provision in Article 9 specifically deals with inflatable liens.

5 *E.g.*, U.C.C. §§ 9-312(5), (7), 9-313(4) (1977).

conversion arrangements on the debtor's actual assent thereto. To protect third parties, the priority rules applicable to converted debt must distinguish obligations arising from new value advanced in reliance on the conversion agreement, which are the functional equivalents of direct future advances and deserve equivalent priority, from "nonreliance" claims. Affording the latter retroactive priority under the rules applicable to future advances merely opens the door to manipulation and abuse by secured creditors. A state law priority scheme that made the suggested distinction would remove most obstacles to the proper regulation of conversion arrangements under federal bankruptcy law.

## I

## THE PROBLEM: INFLATABLE LIENS AND VARIANTS

### A. Inflatable Liens

Consider the following situation ("Hypothetical A"):[6] in 1984, Lender advances $50,000 to Debtor, secured by a security interest in equipment worth $100,000. Lender immediately files a financing statement. The security agreement contains a dragnet clause providing that the collateral secures "all debts owing by Debtor to Lender now existing or hereafter arising, including all debts owed by Debtor to others that Lender has obtained or will obtain by assignment or otherwise."[7] In 1985, Bank lends Debtor $10,000 secured by a junior security interest in the equipment, and Bank immediately perfects by filing. On May 15, 1986, Tortvictim, who had obtained a $20,000 judgment against debtor, levies on the equipment. Debtor becomes insolvent in June, 1986. On August 15, 1986, Creditor, who had previously lent Debtor $50,000 on an unsecured basis, responds to rumors about Debtor's financial condition by assiguing its claim to Lender in exchange for $5,000. On August 28, Debtor files a voluntary petition under Chapter 7 of the Bankruptcy Code.[8] The value of the equipment remains $100,000. Lender submits a $100,000 claim, arguing that the entire amount is a first-priority secured claim under Section 506 of the Bankruptcy Code.[9]

Lender will assert that its security interest in Debtor's equipment covers both the original advance and the claim obtained from

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6 Hypothetical A is a somewhat more elaborate version of a situation suggested in Shanor, *A New Deal for Secured Creditors in Bankruptcy*, 28 EMORY L.J. 587, 607 (1979).

7 This language is adapted from a clause in the security agreement at issue in *In re E.A. Fretz Co.*, 565 F.2d 366 (5th Cir. 1978) (discussed *infra* text accompanying notes 75-88).

8 11 U.S.C. §§ 701-76 (1982 & Supp. III 1985).

9 *Id.* § 506 (1982).

Creditor. In addition, Lender will argue that it has priority over both Bank and Tortvictim as to its entire $100,000 claim under the provisions of Article 9. If these arguments succeed and if nothing in the Bankruptcy Code prevents the result, Lender will have contrived a windfall profit of $45,000 at the expense of Bank and Tortvictim (who will be left with mere unsecured claims[10]) and Debtor's other unsecured creditors (whose recovery will no longer include the $20,000 in "excess" collateral value). The success of Lender's maneuver would, among other things, circumvent established bankruptcy principles: if on August 15 Debtor had merely granted Lender a new security interest to cover the claim acquired from Creditor, the transaction would be voidable as a preference under section 547 of the Bankruptcy Code.[11]

Two aspects of Lender's maneuver deserve particular attention. First, Lender's attempt to bring unsecured claims purchased from third parties within an existing security agreement is not normal commercial practice. Thus, one could question whether Lender and Debtor actually contemplated this possibility when they executed the security agreement. Furthermore, Lender did not have a reasonable expectation based on business usage that the priority of its security interest extended to a claim assigned to Lender after the liens of Bank and Tortvictim had attached, or that a bankruptcy court would recognize the validity of the interest securing the assigned claim. Thus, the burden should be on Lender to justify its behavior and the claimed consequences.

Second, the success of Lender's maneuver would radically alter the distribution of Debtor's estate. Assume, for example, that Debtor had no assets other than the collateral and a total of $150,000 in unsecured liabilities in addition to the $50,000 obligation assigned to Lender. Had Creditor not assigned its claim, Lender would receive $50,000 in satisfaction of its original secured claim, Bank would receive full payment of its $10,000 claim, Tortvictim's $20,000 judgment would be satisfied, and the remaining $20,000 of assets would be distributed pro rata among $200,000 in unsecured claims, for a recovery of ten cents on the dollar for the unsecured claimants.[12] If Lender's maneuver succeeds, however,

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10 Under section 506(a) of the Bankruptcy Code, *id.*, "An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is an unsecured claim to the extent that the value of such creditor's interest [in the estate's interest in such property] . . . is less than the amount of such allowed claim." Because Lender's claim would exhaust the value of the collateral and thereby render the liens of Bank and Tortvictim valueless, Lender's success would make the claims of Bank and Tortvictim "unsecured" within the meaning of the Bankruptcy Code.

11 11 U.S.C. § 547 (1982 & Supp. III 1985).

12 The same distribution would result if Creditor assigned its claim to Lender but

Lender will receive full payment of its $100,000 secured claim, leaving nothing for the unsecured creditors (who would now include Bank and Tortvictim).

The question is whether this departure from the norm can be justified. In certain circumstances, Article 9 grants future advance lenders priority over intervening interests in the collateral in order to facilitate secured future advance lending. Bankruptcy law recognizes the rights of secured parties in order to preserve the system of secured financing. These purposes do not justify giving Lender priority over Bank and Tortvictim as to the claim acquired from Creditor, nor do they justify treating that claim as secured in bankruptcy, because the claim assigned to Lender does not represent credit extended to Debtor in reliance on a security interest in the collateral.

Despite these objections, Lender's maneuver may succeed under current law. If the dragnet clause creating Lender's inflatable lien is clear enough, courts may enforce it even if Debtor never actually intended to grant an inflatable lien. If Lender has such a lien, furthermore, it can reasonably argue that Article 9 gives it priority over other parties whose interest in the collateral arose before the assignment of Creditor's claim. These priority arguments, in turn, may shield Lender's maneuver from the avoiding powers of

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Lender's security agreement did not reach claims acquired by assignment. Lender would have a $50,000 secured claim that would be paid in full and a $50,000 unsecured claim that, like the other unsecured claims, would be paid at ten cents on the dollar ($5,000) after the claims of Bank and Tortvictim had been satisfied. Creditor would have already received $5,000, but this would not affect the distribution in bankruptcy. Bankruptcy law ignores the transaction between Lender and Creditor for purposes of distribution. Thus, the bankruptcy distribution would not be changed if Lender had paid more or less than $5,000 for Creditor's claim: the amount paid merely reflects the value that Creditor and Lender placed on the claim.

If Lender had made a future advance of $5,000 to be used by Debtor to settle Creditor's claim, Lender would have a $55,000 secured claim. The $15,000 in collateral remaining after Bank and Tortvictim were paid would be distributed among $150,000 in unsecured claims, again permitting payment at ten cents on the dollar. Debtor's payment to Creditor could not be avoided as a preference because it did not permit Creditor to recover more than it would have in a Chapter 7 liquidation of Debtor. (Specifically, Creditor received $5,000, the same amount it would have received on its $50,000 claim in a liquidation proceeding.) Thus, the payment would not satisfy § 547(b)(5) of the Bankruptcy Code. 11 U.S.C. § 547(b)(5) (1982).

If Debtor had settled Creditor's claim for an amount greater than $5,000 within the preference period established by § 547(b)(4) of the Bankruptcy Code, 11 U.S.C. § 547(b)(4) (1982 & Supp. III 1985), preference law would operate to restore the distribution to unsecured creditors. Hence, if Creditor and Debtor had settled for $10,000 (borrowed as a future advance from Lender), Lender would have a $60,000 secured claim, leaving only $10,000 (after Bank and Tortvictim are paid) to be distributed to Creditors with $150,000 in unsecured claims. The $10,000 payment to Creditor, however, could be recovered as a preference if Debtor was insolvent at the time of the payment, producing $20,000 to be distributed among $200,000 in unsecured claims (including Creditor's $50,000 claim revived by the preference recovery) for a recovery, once again, of ten cents on the dollar.

Debtor's bankruptcy trustee. If the trustee attempts to avoid the lien securing the assigned claim as a preference, for instance, Lender can plausibly argne that the elements required for avoidance are not present.[13]

Lender's arguments can be overcome by a careful, policy-oriented interpretation of current law. The response to abuses of inflatable liens and similar arrangements, however, must also protect similar but legitimate transactions. Consider the facts of *Shaw v. Walter E. Heller & Co.*[14] Some 16 months before the debtor, Bemporad Carpet Mills, declared bankruptcy, Heller granted it a $430,000 line of credit.[15] The credit line was guaranteed by a subsidiary of debtor and secured by duly perfected security interests in real property and equipment of Bemporad and the subsidiary. The security deeds providing for these interests contained broad dragnet clauses reaching "any . . . indebtedness of whatever kind or character, whether otherwise secured or not, that may be owing by Grantor to Grantee."[16] Heller also factored most of Bemporad's accounts receivable. The factoring agreement provided that Heller could charge against factored receivables "[a]ny amounts owing by you to us for merchandise purchased from any conceru factored or financed by us."[17]

When its financial condition worsened and suppliers balked at shipping on credit, Bemporad turned to Heller for assistance. Four of Bemporad's suppliers also factored their receivables with Heller, and Heller found a simple solution: it agreed to purchase the suppliers' receivables arising from shipments to Bemporad. Heller was aware of Bemporad's difficulties[18] and assumed that its security interests secured payment of the assigned claims.[19] The District Court held that the receivables Heller purchased were secured and

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13 Section 547 of the Bankruptcy Code requires that the transfer be made during a specified period before bankruptcy and on account of an "antecedent" debt. 11 U.S.C. § 547(b) (1982 & Supp. III 1985). Because preference law looks to priority over lien creditors to determine when a transfer occurs, *see id.* § 547(e), Lender can argue that these requirements are not met. *See infra* text accompanying notes 151-62.

14 258 F. Supp. 394 (N.D. Ga. 1966), *rev'd on other grounds,* 385 F.2d 353 (5th Cir. 1967), *cert. denied,* 390 U.S. 1003 (1968). *See infra* note 20.

15 Actually, Heller granted debtor the line of credit 16 months before Bemporad's *second* bankruptcy filing. In fact, the arrangements described in the text were part of a reorganization plan executed in connection with prior bankruptcy proceedings. 258 F. Supp. at 396-98.

16 *Id.* at 396 n.1.

17 *Id.* at 396 n.2.

18 *See id.* at 400.

19 "The purchase of supplier's invoices . . . was a continuing business decision made by Heller, based on its entire 'security' position . . . ." *Id.* at 398. A fifth supplier was not a factoring client of Heller, and Heller induced it to ship by guaranteeing the account rather than by purchasing receivables. Heller assumed its security interest covered reimbursement claims against debtor for any amounts paid under this guarantee.

that the transactions did not give rise to voidable preferences, even though Heller purchased some receivables during the preference period.[20]

Heller's use of its inflatable lien to convert the suppliers' unsecured claims into secured obligations was a critical element in a legitimate attempt to rescue Bemporad. Heller might have loaned Bemporad the cash needed to pay suppliers, but that would have required Heller to police disbursement of the proceeds. Alternatively, Heller might have taken title to the goods ordered from suppliers in order to resell them to Bemporad. Taking title would have put Heller in the business of brokering supplies, exposing it to potentially unpleasant tax and corporate law consequences, and would have required costly and meaningless paperwork. The quickest and cheapest solution was to purchase the suppliers' receivables.[21]

It is perfectly clear that both Bemporad and Heller understood that Heller's security interest would cover claims assigned by the suppliers.[22] Furthermore, the suppliers would not have shipped on credit had Heller not agreed to purchase the resulting receivables.[23] Heller would not have agreed to purchase the receivables if it did not believe they were covered by its security interest. Thus the assigned receivables in *Heller* represented value given to the debtor in reliance on Heller's security interest, equivalent to future advances by Heller to permit Bemporad to pay suppliers in cash.[24] Protecting

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The court said that the arrangements with the fifth supplier "were handled in almost the same fashion as the other suppliers." *Id.* at 403.

20 *Id.* at 404. On appeal, the trustee did not attack the assignments of supplier accounts to Heller and the court did not address any issues raised by these assignments. Shaw v. Walter E. Heller & Co., 385 F.2d 353, 356 (5th Cir. 1967), *cert. denied* 390 U.S. 1003 (1968). The Fifth Circuit found, however, that the transfer of certain accounts receivable to Heller during the preference period could be avoided. 385 F.2d at 357-58. The Fifth Circuit opinion thus exemplifies the preference attack on floating liens under the 1898 Bankruptcy Act, Ch. 541, 30 Stat. 544 (1898) (repealed 1978) an issue that the new Bankruptcy Code addresses in 11 U.S.C. § 547(c)(5), (e)(3) (1982 & Supp. III 1985); *see* authorities cited *infra* note 163.

21 For an example of another legitimate use of an inflatable lien, see Lamoille County Sav. Bank & Trust Co. v. Belden, 90 Vt. 535, 98 A. 1002 (1916) (discussed in Strong Hardware Co. v. Gonyow, 105 Vt. 415, 418, 168 A. 547, 548 (1933)).

22 When Bemporad and Heller arranged for the secured line of credit they intended $100,000 "to be available for commitments and payments by Heller to Bemporad's suppliers to induce them to ship raw materials to Bemporad." 258 F. Supp. at 396. The factoring agreement between Bemporad and Heller specifically covered claims against Bemporad that were factored by and assigned to Heller. *See supra* text accompanying note 17.

23 258 F. Supp. at 402.

24 Indeed, the district court found tbat the arrangement amounted to a cash sale by the suppliers that was financed by Heller. 258 F. Supp. at 402. In determining whether future advances are secured by a mortgage, several courts have looked to whether the mortgagee relied on the mortgage in making the advance. *See, e.g.*, Union Bank v. Wendland, 54 Cal. App. 3d 393, 126 Cal. Rptr. 549 (1976); Wright v. Lincoln County

Heller's expectation that the purchased claims were secured and affording Heller the same priority it would have if it had made future advances directly to Bemporad appears quite proper.[25]

B. Negotiable Liens

Proposals to curb abuses of inflatable liens while preserving legitimate transactions must also deal with other arrangements designed to convert unsecured debt into secured obligations under an existing security interest. Consider the following situation ("Hypothetical B"): On January 1, 1978, Debtor and Financier execute a security agreement covering Debtor's equipment. The secured obligations include "all debts now existing or hereafter arising owing by Debtor to Financier or to any assignee of the security interest provided for herein." Financier lends Debtor $50,000, approximately 80% of the value of Debtor's equipment, and perfects its security interest by filing. By September 1, 1980, Debtor has reduced Financier's claim to $5,000, but Debtor has become insolvent. Furthermore, Debtor has granted a junior security interest in the collateral to another creditor and a judgment holder has levied on the equipment. Debtor owes Manufacturer $45,000 on open account. On October 31, 1980, Financier assigns its security interest and its remaining claim against Debtor to Manufacturer in exchange for $10,000 in cash. On December 5, 1980, Debtor files a bankruptcy petition. The equipment is sold for $50,000 and Manufacturer claims the assigned security interest gives it priority in all proceeds.

According to the dragnet clause in Financier's security agreement, the security interest covers pre-existing debts owed to an assignee of the security interest. Such a security interest might be called a "negotiable lien." As Hypothetical B illustrates, negotiable liens are subject to abuses similar to those possible with inflatable liens. Financier's attempt to exploit its excess collateral value resem-

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Bank, 62 Tenn. App. 560, 465 S.W.2d 877 (1970); Second Nat'l Bank v. Boyle, 155 Ohio St. 482, 99 N.E.2d 474 (1951).

25 Transactions in which assigned debt does not arise from value given in reliance on the security interest can also be legitimate. Consider the following: Debtor guarantees obligations of its subsidiary. Debtor gives the obligee a security interest to secure that guarantee and all other "gnarantee obligations." Before this arrangement was contemplated, Debtor had gnaranteed other obligations its subsidiary owed to a subsidiary of the obligee. When Debtor executes the security agreement covering the later guarantee, it understands that the security interest will secure the earlier guarantee if the guaranteed obligation is assigued to the secured party. Suppose the secured party takes such an assignment and both Debtor and its subsidiary default. Debtor has in effect agreed that the earlier guarantee would be secured. The secured party's reasonable expectation that the earlier guarantee is secured by the security interest deserves protection, even though the secured party's subsidiary did not rely on the security interest when extending the credit covered by the earlier guarantee.

bles Lender's attempt in Hypothetical A to exploit its oversecured position and similarly offends bankruptcy principles. For example, if Manufacturer took a new security interest to secure its $45,000 claim, the transaction would run afoul of preference law. Moreover, the legal issues raised by negotiable liens—the enforceability of the arrangement, the priority rules applicable to claims held by the assignee of the security interest, and the applicability of the bankruptcy trustee's avoiding powers—parallel those raised by inflatable liens, and the resolution of these issues under current law is just as difficult.

Negotiable liens, like inflatable liens, can also be used in perfectly legitimate transactions. An entity not party to a security agreement may be willing to lend funds to a debtor only if it enjoys the priority of another's security interest. If it is impractical to delay the loan until after assignment of the security interest, the parties could accomplish the transaction indirectly: the third party could take a security interest in the rights of the secured party against the debtor, then funnel the loan through the secured party to the debtor. Using a negotiable lien in such a situation merely eliminates the costs of taking and perfecting an extra security interest and policing the original secured party's distribution of loan proceeds.

### C. Other Variants

The transaction in *In re Wilco Forest Machinery, Inc.*[26] illustrates yet another variation on conversion arrangements. The Eaton Corporation[27] provided financing to the debtor. Obligations arising from the financing arrangement were allocated to two accounts: (1) "current accounts payable," representing inventory Eaton sold debtor on open account, and (2) "debenture notes payable," secured by a duly perfected security interest in all debtor's inventory, accounts receivable, and bank accounts. The financing agreements required debtor to transfer all current accounts not paid at the end of a month to the debenture notes account and to issue corresponding debentures to Eaton. Eaton did not strictly enforce this requirement until debtor developed a severe cash shortage,[28] whereupon Eaton forced debtor to transfer $617,630 from the current to the debenture account and to issue corresponding debentures.[29] Less

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26 491 F.2d 1041 (5th Cir. 1974).

27 The case also involved several subsidiaries of Eaton Corporation. I refer to the parent and subsidiaries collectively as "Eaton."

28 The court held that Eaton should have known debtor was insolvent 10 months before this development. 491 F.2d at 1044.

29 The procedure was as follows: Eaton held $900,000 in debentures, which were convertible into common stock of debtor at Eaton's option. Eaton converted sufficient debentures to gain majority control of debtor, then replaced all but one of debtor's

than three months later, debtor filed for bankruptcy under the Bankruptcy Act of 1898.[30] The Fifth Circuit held that Eaton's security interest covered the claims transferred to the debenture account and upheld the transfer against the trustee's argument that it gave rise to a preference voidable under the 1898 Act.[31]

The security agreement in *Wilco* permitted Eaton to convert previously unsecured obligations into secured claims, just as unsecured debt is converted in Hypotheticals A and B.[32] In *Wilco*, however, there is little doubt that the debtor understood and assented to the conversion feature of the arrangement, and Eaton probably relied on its power to convert when it agreed to ship goods to Wilco on credit. The arrangement, however, obscured the fact that the secured obligations included not just the debenture notes account but also, in practical effect, Eaton's open account claims. This could easily have misled third parties who extended credit to Wilco on the strength of the debtor's apparent equity in the collateral. Indeed, the odd structure of the financing arrangement may reflect a deliberate attempt to make it appear that Wilco retained substantial unencumbered assets. Given Eaton's power to transfer the large amount of overdue open account indebtedness into the secured debenture notes account, however, no unencumbered assets actually existed.[33]

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directors with its own representatives. The new Board raised the limit on debtor's debenture indebtedness, transferred the current account into the debenture account, and issued new debentures. *Id.* at 1044. The control Eaton exercised via the convertible debentures probably would make Eaton an "insider" of debtor under the Bankruptcy Code. 11 U.S.C. § 101(28)(B)(iii) (Supp. III 1985). Thus, under the current Bankruptcy Code's preference provision, Eaton would be subject to a one year preference period. 11 U.S.C. § 547(b)(4)(B) (Supp. III 1985).

30 Bankruptcy Act of 1898, Ch. 541, 30 Stat. 544 (1898) (repealed 1978).

31 491 F.2d at 1045-47. Approximately one month after the conversion of current accounts into debenture accounts, Eaton foreclosed on the collateral covered by its security interest, which comprised almost all debtor's assets. The trustee sought to recover the assets seized to satisfy the converted current accounts on the basis of the preference provision in the 1898 Act, but the Fifth Circuit rejected the argument. Most of the opinion discusses whether Eaton's financing statement was sufficient and whether the Board of Directors appointed by Eaton, *see supra* note 29, had the power to raise debtor's ceiling on debentures. 491 F.2d at 1045-46. It is not clear whether the court understood the issues raised by the conversion of the current accounts. In any event, citing *In re King-Porter Co.*, 446 F.2d 722 (5th Cir. 1971) (discussed *infra* text accompanying notes 166-74), the court held that the lien securing the converted accounts was transferred for preference purposes when Eaton perfected by filing—a date well outside the preference period. 491 F.2d at 1046-47.

32 Unlike the secured claimant in Hypothetical A, however, Eaton presumably paid full value for its claims by shipping goods on credit to the debtor.

33 *Wilco* illustrates that parties can use conversion arrangements to disguise the extent to which assets are encumbered even if the convertible obligations are the functional equivalent of future advances, that is, even if they represent new value given in reliance on the security interest. In *Wilco* the sale of inventory to the debtor on credit (which gave rise to the unsecured open account indebtedness) represented new value

Although article 9 relies primarily on filing to provide third parties with information, financing statements need reveal nothing about the amount or nature of the secured obligations.[34] U.C.C. section 9-208 creates a procedure by which third parties can, with the debtor's cooperation, obtain from a secured party a statement of the outstanding indebtedness secured by collateral.[35] Section 9-208, however, requires only that the secured party approve or correct a statement of "the aggregate amount of unpaid indebtedness as of a specified date."[36] Assuming that this phrase refers only to secured indebtedness, section 9-208 would probably not have required Eaton to reveal that it could convert Wilco's existing obligations into secured debt.

Fraudulent transfer law, which permits avoidance of transactions accomplished with actual intent to hinder, delay, or defraud creditors, and principles of equitable estoppel may be sufficient to handle the abuse of conversion arrangements illustrated by *Wilco*.[37] Given that third parties cannot reasonably rely on a section 9-208 statement of indebtedness because the debtor's equity in the collateral may disappear if the secured party makes future advances,[38] section 9-208 may not be the appropriate vehicle to address this abuse. Nevertheless, section 9-208 establishes a procedure for obtaining reliable information pertaining to the debtor's equity in collateral, subject to the possibility that future advances will consume that equity. Such future advances, unlike credit already extended and later converted into secured indebtedness, enhance the debtor's assets available to other creditors.[39] It would therefore make sense to interpret or amend section 9-208 to require secured parties to

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and may very well have been made in reliance on the power to transfer overdue obligations into the secured account.

34 U.C.C. § 9-402(1) provides:

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

U.C.C. § 9-402(1) (1977).

35 *Id.* § 9-208 (1977).

36 *Id.* § 9-208(1) (1977).

37 *See* 1A P. COOGAN, W. HOGAN, D. VAGTS & J. MCDONNELL, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 6C.07(3)(b), at 6C-115 to 18 (1985) [hereinafter SECURED TRANSACTIONS].

38 *See infra* Parts III & IV (discussing priority of future advances). The minimal protection afforded by a § 9-208 statement of indebtedness combined with the unwieldy procedure for obtaining it may explain why the provision remains ambiguous. *See* 1A SECURED TRANSACTIONS, *supra* note 37, § 6C.07(3)(b), at 6C-113 to 23; Justice, *supra* note 1, at 883-86.

39 *Cf. infra* text accompanying note 121 (discussing Professor Gilmore's compensation rationale for the priority of future advances).

reveal existing unsecured indebtedness that can be converted into secured obligations under a security interest. Failure to make this disclosure should prevent the secured party from claiming priority over a relying creditor with respect to the unreported obligations.

To appreciate the scope of potential problems with conversion arrangements, consider a final illustration ("Hypothetical C"): Suppose the security agreement in Hypothetical A did not cover obligations Lender acquired by assignment. After Creditor assigns its claim to Lender but before Debtor files for bankruptcy, Debtor and Lender amend their security agreement to cover the assigned obligation. Nothing in Article 9 addresses the effect of adding to the secured obligations by amending the security agreement. If the amendment is enforceable Lender can easily argne that its priority over competing claimants relates back to the time it filed a financing statement. If successful, this argnment would prevent Debtor's bankruptcy trustee from using preference law to foil Lender's maneuver.[40] In short, the abuse illustrated by Hypothetical A can occur whenever an oversecured creditor has enough leverage to induce a financially battered debtor to amend a security agreement.

## II
## ENFORCEABILITY OF CONVERSION ARRANGEMENTS

### A. Early Dragnet Clause Cases

Whether inflatable liens and other conversion devices are enforceable under current law is a question intimately connected with judicial decisions dealing with the dragnet clauses typically found in security agreements creating such arrangements.[41] Long before Ar-

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40 *See infra* Part V(A) (discussing application of preference law to converted indebtedness).

41 Although the dragnet clause in Hypothetical A specifically covers debt acquired by assignment, that will not always be the case. *See, e.g.*, Berger v. Fuller, 180 Ark. 372, 373, 21 S.W.2d 419, 420 (1929) (dragnet clause covering " 'any indebtedness of whatsoever sort or nature that may be due from mortgagors to mortgagee at the time of foreclosing this mortgage' "). Compare the following form dragnet clause: "This mortgage is given to secure the payment of a promissory note (describe in detail), and also the payment of any additional sums and interest thereon now or hereafter due or owing from mortgagor to mortgagee." G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW 772 (1979) [hereinafter REAL ESTATE FINANCE]. The wording of some dragnet clauses appears to exclude assigned debt. *See, e.g.*, Cotton v. First Nat'l Bank, 228 Ala. 311, 314, 153 So. 225, 228 (1934) (clause covering " 'any additional amounts *furnished me [mortgagor]* by the mortgagee on any account and at any time before the debt herein is fully paid, in money or otherwise' " (emphasis added by court)).

Many cases dealing with dragnet clauses in real estate mortgages, including several involving inflatable liens, are discussed in Annotation, *Debts Included in Provision of Mortgage Purporting to Cover Unspecified Future or Existing Debts ("Dragnet" Clause)*, 172 A.L.R. 1079 (1948) [hereinafter Annotation, *Debts*] and Annotation, *Debts Included in Provision of*

ticle 9 was proposed, dragnet clauses[42] had provoked judicial hostility. The typical dispute arose when a mortgagor defaulted on some original obligation to the mortgagee which was unrelated to the loan or credit that occasioned the mortgage (the "primary obligation").[43] When the mortgagee attempted to foreclose on the basis of a broad dragnet clause, the mortgagor would argne that he never intended to give security for the defaulted obligation.

In most cases, the mortgagor probably did not understand the potential reach of the security agreement. The dragnet clause most likely was boilerplate appearing on a printed form agreement or copied from a form book, and was probably included without discussion by the parties.[44] One court labelled mortgages containing dragnet clauses " '[a]naconda mortgages' . . . as by their broad and general terms they enwrap the unsuspecting debtor in the folds of indebtedness embraced and secured in the mortgage which he did not contemplate."[45] Seeking to avoid harsh results, a number of courts adopted a policy of construing dragnet clauses strictly against the mortgagee. Several adopted the following formula:

> The "other indebtedness" secured by a mortgage may be either antecedent or subsequent. Where it is antecedent, it must be identified in clear terms, and where it is subsequent, it must be of the same class as the primary obligation secured by the instrument and so related to it that the consent of the debtor to its inclusion may be inferred.[46]

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*Mortgage Purporting to Cover All Future and Existing Debts (Dragnet Clause)—Modern Status*, 3 A.L.R.4th 690 (1981).

42 For other discussions of judicial treatment of dragnet clauses, *see* 2 G. GILMORE, *supra* note 3, § 35.5, at 932-33; Justice, *supra* note 1, at 903-15; Note, *Future Advances Financing Under the Uniform Commercial Code: Curbing the Abuses of the Dragnet Clause*, 34 U. PITT. L. REV. 691, 692-93 (1973).

43 For example, in Beavers v. LeSueur, 188 Ga. 393, 3 S.E.2d 667 (1939), plaintiff attempted to foreclose on a security deed given by defendant (a lawyer) to secure a note for $1,650 and "any and all other indebtedness which the grantor herein may now owe, or may hereafter owe to grantee." *Id.* at 402, 3 S.E.2d at 673. Plaintiff sought to satisfy not only the $1,650 note but also a claim for $1,882.35 based on defendant's negligent representation of plaintiff in unrelated litigation. The court held that the security deed did not cover the malpractice claim. *Id.* at 403-04, 3 S.E.2d at 674.

44 REAL ESTATE FINANCE, *supra* note 41, at 772.

45 Berger v. Fuller, 180 Ark. 372, 377, 21 S.W.2d 419, 421 (1929).

46 National Bank v. Blankenship, 177 F. Supp. 667, 673 (E.D. Ark. 1959) (applying Arkansas law), *aff'd sub nom.* National Bank v. General Mills, Inc., 283 F.2d 574 (8th Cir. 1960). Courts viewed the formula as a rule of construction purportedly aiding discovery of the parties' intent. *See, e.g., id.* at 672-73; John Miller Supply Co. v. Western State Bank, 55 Wis. 2d 385, 392-94, 199 N.W.2d 161, 164-65 (1972); Capocasa v. First Nat'l Bank, 36 Wis. 2d 714, 719-25, 154 N.W.2d 271, 274-77 (1967). The formula is phrased, however, as a substantive rule containing positive requirements—antecedent indebtedness *must* be identified in clear terms, subsequent indebtedness "*must* be of the same class . . . and so related." National Bank v. Blankenship, 177 F. Supp. 667, 673 (E.D. Ark. 1959), *aff'd sub. nom.* National Bank v. General Mills, Inc., 283 F.2d 574 (8th Cir.

When disputes involving inflatable liens arose, many courts adopted a similar approach. In *Poulter v. Weatherford Hardware Co.*,[47] for instance, Poulter gave Weatherford a chattel mortgage to secure seven specified promissory notes and "any other amount I may now owe, or hereafter owe, as if the same were specifically described herein."[48] Weatherford later purchased a third party's judgment against Poulter and attempted to foreclose the chattel mortgage to satisfy the judgment. The Texas appeals court held that the judgment was not secured, stating that the reach of dragnet clauses is confined to "debts of the general kind of that specifically secured."[49]

Even jurisdictions that took a strict approach to construing dragnet clauses, however, sometimes held that claims assigned to the secured party were covered by a sufficiently broad provision. In *Lamoille County Savings Bank & Trust Co. v. Belden*,[50] for instance, the Vermont Supreme Court held that a defeasance clause covering "all further sums we or either of us [the mortgagors] now owe it [the mortgagee] or may become owing it in any way" secured a mortgagor's note assigned to the mortgagee after the mortgage was executed.[51] Seventeen years later, in *Strong Hardware Co. v. Gonyow*,[52] the same court held that a mortgage containing a dragnet clause covering "all other indebtedness of [mortgagors] to the said mortgagees, their heirs and assigns, heretofore or hereafter contracted, and represented by promissory notes or otherwise" did not cover a note that the mortgagee's assignee acquired by assignment.[53] The court did not overrule *Lamoille*, but distinguished it based on differences in the dragnet clauses' language and because the mortgagee

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1960). In any event, it was often applied without genuine inquiry into the parties' intent. Justice, *supra* note 1, at 897-98, 905; *see* Note, *supra* note 42, at 696-97.

47 166 S.W. 364 (Tex. Ct. App. 1914).

48 *Id.* at 364.

49 *Id.* Other pre-Article 9 cases held that a consensual lien on real property did not cover obligations obtained by assignment after the lien arose. Crutchfield v. Johnson & Latimer, 243 Ala. 73, 8 So. 2d 412 (1942); Berger v. Fuller, 180 Ark. 372, 21 S.W.2d 419 (1929); Lightle v. Rotenberry, 166 Ark. 337, 266 S.W. 297 (1924); Walker v. Whitmore, 165 Ark. 276, 262 S.W. 678 (1924); Martin v. Holbrooks, 55 Ark. 569, 18 S.W. 1046 (1892); Provident Mut. Bldg. & Loan Ass'n v. Shaffer, 2 Cal. App. 216, 83 P. 274 (1905); First Nat'l Bank v. Combs, 208 Ky. 763, 271 S.W. 1077 (1925); Lashbrooks v. Hatheway, 52 Mich. 124, 17 N.W. 723 (1883). Recent cases are in accord. Thorp Sales Corp. v. Dolese Bros., 453 F. Supp. 196 (W.D. Okla. 1978) (personal property); *Ex parte* Chandler, 477 So. 2d 360 (Ala. 1985) (real property); Pongetti v. Banker's Trust Sav. & Loan Ass'n, 368 So. 2d 819 (Miss. 1979) (real property); Hudson v. Bank of Leakesville, 249 So. 2d 371 (Miss. 1971) (real property); Wood v. Parker Square State Bank, 400 S.W.2d 898 (Tex. 1966) (real property).

50 90 Vt. 535, 98 A. 1002 (1916).

51 *Id.* at 537, 98 A. at 1003-04.

52 105 Vt. 415, 168 A. 547 (1933).

53 *Id.* at 417, 168 A. at 547.

in the earlier case acquired the note in the normal course of business.[54] The *Gonyow* court felt itself free to "adopt the law" of cases in other jurisdictions hostile to conversion arrangements.[55]

At least one jurisdiction rejected the strict construction principle. In *Rose City Foods, Inc. v. Bank of Thomas County*,[56] the Supreme Court of Georgia held that open account indebtedness assigned to a bank was secured by bills of sale for motor vehicles that the account debtor executed before the assignment. Each bill of sale recited that it secured a specific loan by the bank and "any and all other indebtedness now due by me [debtor] to said bank or hereafter incurred by me, whether directly or indirectly, as principal, endorser, guarantor, or otherwise."[57] The court noted that "it is a well established principle of law in this State that a grantor may convey property, real or personal, for the purpose of securing a present, past, or future indebtedness."[58] The language of the bills of sale, which the court construed to reach assigned obligations, was a "matter of private contract" which "courts should always guard with jealous care" and "give . . . full effect when it is possible to do so."[59] As a result of *Rose City* and similar cases,[60] the Georgia legislature amended the state mortgage statute to restrict the reach of dragnet clauses to "debts or obligations arising . . . between the original parties to the security instrument."[61]

A few cases involving what this article labels negotiable liens have also appeared. In most instances, courts relied on the dragnet clause doctrines explored above and construed mortgages not to reach claims held by an assignee of the mortgage if the claims predated the assignment.[62]

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54 *Id.* at 418, 168 A. at 548.

55 *Id.* at 419, 168 A. at 548.

56 207 Ga. 477, 62 S.E.2d 145 (1950).

57 *Id.* at 478, 62 S.E.2d at 146.

58 *Id.* at 481, 62 S.E.2d at 148.

59 *Id.* For other cases holding that a consensual lien covered obligations obtained by assignment after the lien arose, see Nix v. Hopper, 18 Ala. App. 240, 90 So. 35 (1921) (personal property); Collins v. Gregg, 109 Iowa 506, 80 N.W. 562 (1899) (real and personal property); First Nat'l Bank v. Byard, 26 N.J. Eq. 255 (1875) (real property); Lamoille County Sav. Bank & Trust Co. v. Belden, 90 Vt. 535, 98 A. 1002 (1916) (real property).

60 *E.g.*, Vidalia Prod. Credit Ass'n v. Durrence, 94 Ga. App. 368, 94 S.E.2d 609 (1956) (deed covering all liability to grantee and assigns secured judgment against grantor obtained by third party who later took assignment of deed and thereby gained priority over junior mortgagee whose interest arose before judgment or assignment).

61 GA. CODE ANN. § 44-14-1(b) (1981). In Poole v. Smith, 226 Ga. 259, 174 S.E.2d 430 (1970), the Georiga Supreme Court held that the statute did not apply to a security deed executed before the law became effective.

62 Berger v. Fuller, 180 Ark. 372, 21 S.W.2d 419 (1929) (claims held by assignee of mortgage at time of assignment were not secured by mortgage); Americus Finance Co. v. Wilson, 189 Ga. 635, 7 S.E.2d 259 (1939) (security deed covering all indebtedness

B. Dragnet Clause Cases Following the Adoption of Article 9

The extent to which the principles of early dragnet clause cases survive under Article 9 is in dispute. Professor Gilmore, one of the drafters of Article 9, cited with approval cases that refused to apply dragnet clauses to debt unrelated "to the financing transaction which the mortgage was given to secure."[63] Some courts have followed Gilmore's lead and required a showing of "relatedness" between the primary obligation and the debt in question;[64] other courts have not.[65] The only Article 9 provision that addresses what obligations may be secured is section 9-204(3), which validates coverage of "future advances or other value."[66] The only limitation expressed in the Code is that the obligation must be "covered by a

owing to grantee or assigns by joint grantors did not cover note given by one grantor to third party who obtained security deed by assignment); Moss v. Hipp, 387 S.W.2d 656 (Tex. 1965) (chattel mortgage, purporting to secure indebtedness owing to holder of mortgage, did not secure claim of third party who obtained assignment of chattel mortgage). *Contra* Vidalia Prod. Credit Ass'n v. Durrence, 94 Ga. App. 368, 94 S.E.2d 609 (1956) (security deed covering all liability to grantee and assigns secured judgment against grantor obtained by third party who later took assignment of deed and thereby gained priority over junior mortgagee whose interest arose before judgment or assignment).

63 2 G. GILMORE, *supra* note 3, § 35.2, at 917-18. Professor Gilmore specifically addressed inflatable and negotiable lien situations. *Id.* § 35.2, at 918. He quoted with approval the formulation set out at *supra* text accompanying note 46. *Id.* § 35.2, at 920-21.

64 Marine Nat'l Bank v. Airco, Inc., 389 F. Supp. 231 (W.D. Pa. 1975); *In re* Midas Coin Co., 264 F. Supp. 193 (E.D. Mo. 1967), *aff'd sub. nom.* Zuke v. St. John's Community Bank, 387 F.2d 118 (8th Cir. 1968); Community Bank v. Jones, 278 Or. 647, 566 P.2d 470 (1977); John Miller Supply Co. v. Western State Bank, 55 Wis. 2d 385, 199 N.W.2d 161 (1972). *See* Justice, *supra* note 1, at 906-11.

65 Kimbell Foods, Inc. v. Republic Nat'l Bank, 557 F.2d 491 (5th Cir. 1977), *aff'd sub nom.* United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979); *In re* Public Leasing Corp., 488 F.2d 1369 (10th Cir. 1973); *In re* Riss Tanning Corp., 468 F.2d 1211 (2d Cir. 1972); Chrysler Credit Corp. v. Community Banking Co., 35 Conn. Supp. 73, 395 A.2d 727 (Super. Ct. 1978); South County Sand & Gravel Co. v. Bituminous Pavers Co., 106 R.I. 178, 256 A.2d 514 (1969). *See* Justice, *supra* note 1, at 906-11; *see also* Labovitz, *The Future of the Future Advancements Clause*, 66 J. COM. BANK LENDING 37 (1983). For recent discussions of the tests for determining whether after-secured obligations (in these cases, future advances) are covered by a security agreement, see *In re* Continental Resources Corp., 43 Bankr. 658, 661-63 (W.D. Ok. 1984) (real property mortgage), *aff'd*, 799 F.2d 622 (10th Cir. 1986); *In re* Bates, 35 Bankr. 475, 477-79 (M.D. Tenn. 1983) (Article 9 security interest).

66 U.C.C. § 9-204(3) (1977). Nothing in the U.C.C. prohibits negotiable liens. Indeed, Article 9 clearly contemplates that security interests can be assigned. *See* U.C.C. § 9-302(2) (1977) ("If a secured party assigns a perfected security interest, no filing under this Article is required in order to continue the perfected status of the security interest against creditors of and transferees from the original debtor."); U.C.C. § 9-405(2) (1977) (secured party who assigns its security interest has option to file notice of assignment, although such notice is not required); *see also* B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 2.16, at 2-77 to -78 (1980). No Article 9 provision, however, addresses what obligations may be covered by a security interest that has been assigned.

security agreement."[67]

The general policy of Article 9 is that "[e]xcept for procedure on default, freedom of contract prevails between the immediate parties to the security transaction."[68] Thus, the doctrines of pre-Article 9 cases may indeed survive to the extent that the pre-Article 9 doctrines clarify the parties' intent. To the extent they contain limitations on the parties' freedom to contract not explicitly adopted in Article 9, however, pre-Article 9 principles do not survive.[69] Under this approach, an Article 9 security agreement can cover any after-secured obligations the parties intend.

A clause in a security agreement that could be construed to cover assigned debt or obligations owed to an assignee of the security interest, however, should not be sufficient to establish an inflatable or negotiable lien. If part of a form agreement or inserted without meaningful discussion, the clause says little about the parties' actual intent. Given the exotic nature of inflatable and negotiable liens, courts should require specific indications that the parties meant to create such an arrangement.

Even such evidence would not necessarily mean that the parties intended to secure all obligations obtained by assignment or debts owed to an assignee of the security interest. For instance, a debtor who assented to an inflatable lien may not have contemplated the possibility that the creditor would acquire claims after the primary obligation was repaid.[70] Construing the security agreement to cover such claims would subject the debtor to substantial hardship. A secured party could prevent debtor from clearing title to collateral under U.C.C. section 9-404(1)[71] simply by purchasing debt from

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67 U.C.C. § 9-204(3) (1977); *see id.* comment 5.

68 U.C.C. § 9-101 comment (1977); *see* U.C.C. § 9-201 (1977) ("Except as otherwise provided by this Act a security agreement is effective according to its terms between the parties . . . .").

69 *See* Justice, *supra* note 1, at 904. As an absolute prohibition on coverage of "antecedent" debts not specifically mentioned in the security agreement and "subsequent" debts not "of the same class as the primary obligation," the formula quoted at *supra* text accompanying note 46 should be rejected. Indeed, it is difficult to imagine how the "same class" requirement would apply to debt acquired by assignment. If both the primary obligation and the assigned debt arose from loans to the debtor, does not the assigned claim satisfy this requirement? What if the assigned debt arose from a loan given under a different security interest? What if the primary obligation itself was originally unsecured and had been obtained by assignment before the security agreement was executed?

On the other hand, the formula highlights factors relevant in determining the proper scope of a dragnet clause. Used in this fashion—as a genuine rule of construction to resolve ambignities—the formula has some value.

70 Dragnet clause cases not involving assigned debt suggest this possibility. *See* cases collected in Annotation, *Debts*, *supra* note 41, at 1088-91.

71 U.C.C. § 9-404(1) (1977) (procedure for noting discharge of secured obligations and termination of financing arrangements).

third parties. In other situations, however, the arrangement between the parties may require that the security agreement reach claims acquired after satisfaction of the primary debt.

Judges must approach agreements that appear to create inflatable or negotiable liens realistically. A court cannot find the parties' intent as to situations they did not anticipate. It can only determine what the parties would have done had they foreseen the situation that developed. In this respect, security agreements involving inflatable or negotiable liens are no different from other contracts. As a general guide, a court should find that a particular debt is secured when such a finding is consistent with the legitimate purposes of the security agreement as contemplated by the parties at the time they executed the agreement.[72] The doctrine of unconscionability embodies this approach, and commentators have urged its application to inflatable liens.[73]

Enforcing inflatable or negotiable liens only where the debtor and secured party have actually agreed to such an arrangement will protect the parties to a security agreement. Conversion arrangements, however, can also have an enormous impact on the rights of the debtor's other creditors. The effect on third party creditors exists whether or not the debtor and secured party understood and agreed to the conversion feature. Debtor's knowing assent to the inflatable lien in Hypothetical A, for instance, would not improve the outlook for Bank, Tortvictim, or Debtor's other creditors, nor would it justify protecting Lender at their expense. The priority rules in Article 9, in combination with the Bankruptcy Code's avoidance provisions, are desigued to protect third parties against abuse of security interests. It is to the Article 9 priority rules, therefore, that the discussion must turn.

## III
## PRIORITY UNDER ARTICLE 9: CONVERTED CLAIMS AND CONFLICTING SECURITY INTERESTS

### A. Priority Under the 1962 Version of U.C.C. Section 9-312

The priority rules in U.C.C. Article 9 appear to assume that after-secured obligations will represent credit extended in reliance on a security interest. The drafters of Article 9 did not anticipate the phenomenon of non-reliance after-secured indebtedness. This failure makes it difficult to reach sensible results in priority contests

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72 *Cf.* Note, *supra* note 42, at 696-98 (suggesting similar test for determining scope of dragnet clauses).

73 Justice, *supra* note 1, at 905-06; *see* 2 G. GILMORE, *supra* note 3, § 35.2 at 919-20.

between security interests with a conversion feature and junior interests in the same collateral.

To illustrate, return to Hypothetical A and consider the results of a priority contest between Lender and Bank under the 1962 version of Article 9. Assuming Debtor in fact assented to Lender's inflatable lien, Lender clearly prevails over Bank. Questions of priority between conflicting security interests in the same collateral are governed by section 9-312. Because none of the rules stated in the 1962 version of section 9-312(1) through (4) apply to this situation, the "residuary" rule in section 9-312(5) governs. Section 9-312(5)(a) gives priority to the first secured party to file or perfect.[74] Because Lender and Bank perfected by filing, Lender wins as to both the original and the acquired claims because it filed first.

The Fifth Circuit missed an opportunity to explore this issue in *In re E.A. Fretz Co.*,[75] a dispute arising under the 1898 Bankruptcy Act. Revlon took a security interest in Fretz's equipment and inventory. The security agreements purported to reach debts acquired "by assignment or otherwise."[76] After Revlon perfected by filing, Republic National Bank took a security interest in Fretz's inventory and perfected by filing. Approximately one year later, Fretz filed for bankruptcy. At that time, Fretz had outstanding obligations to both Revlon and Republic secured by their respective security interests. Fretz was also indebted to two Revlon subsidiaries. Shortly after Fretz's bankruptcy petition, the two subsidiaries assigned their claims to Revlon.[77] The bankruptcy judge decided that Revlon's security interest, which was senior to Republic's lien, secured the assigned claims, leaving no collateral for Republic.[78] The district court affirmed.[79]

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74 The 1962 version of § 9-312(5) provides:

> In all cases not governed by other rules stated in this section . . . , priority between conflicting security interests in the same collateral shall be determined as follows:
>
> (a) in the order of filing if both are perfected by filing, regardless of which security interest attached first under Section 9-204(1) and whether it attached before or after filing . . . .

U.C.C. § 9-312 (1962).

75 565 F.2d 366 (5th Cir. 1978) (applying Texas law); *see also* Justice, *supra* note 1 (discussing case at length).

76 565 F.2d at 368 n.2.

77 *Id.* *See infra* note 147 for observations on whether the post-petition conversion of unsecured claims into secured obligations violates the automatic stay provided for in § 362 of the Bankruptcy Code, 11 U.S.C. § 362 (1982).

78 The inventory was sold for approximately $106,000. At the time of the petition, Fretz owed Revlon and a more senior lien holder (whose claim was thereafter assigned to Revlon) approximately $31,000. The claims assigned to Revlon by its subsidiaries totalled approximately $193,000. Republic's claim was for approximately $23,000. 565 F.2d at 369.

79 *Id.*

The Fifth Circuit reversed in a haze of confusion over "the bizarre facts of this case."[80] Most of the opinion discusses whether a financing statement filed under Revlon's name could perfect a security interest in favor of its subsidiaries. The subsidiaries, however, did not claim a security interest. Indeed, they did not even assert the assigned claims in the bankruptcy proceedings because Revlon had taken over the claims. The court clearly misperceived the issue and, consequently, the applicable law.[81]

When the court of appeals tried to address the argnment that Revlon itself had a security interest that covered claims assigned to it, its opinion degenerated into mere invective.

> Neither the Bankruptcy Judge nor Revlon has explained to our satisfaction precisely how (by abracadabra, sleight of hand, baptism or otherwise?) this perfected secured status arose. Mystical, magical miracles are rare, even in Texas. The naked conclusion that the indebtedness of the Revlon subs was secured by their parent's security interest does not hold water; it simply avoids the real question of how the transmutation could have occurred within the terms of the UCC.[82]

The court noted "the potential for inequality, and, indeed collusion or fraud" (which it labelled "enormous") under these circumstances.[83] It quoted a passage from *Collier on Bankruptcy* that described the bankruptcy policy favoring equality in distributing a debtor's assets.[84] Finally, the court held that Revlon's security interest did not cover the assigned claims and that Republic had priority after Revlon's senior claims—which did not include those assigned by its subsidiaries—were satisfied.[85]

What permitted the magical transformation that so mystified the court, of course, was Revlon's inflatable lien. Once that is recognized,[86] the case becomes a simple priority contest between Repub-

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80 *Id.* at 367.

81 The opinion also threatened to confuse the law governing security interests perfected in the name of an agent or trustee representing others with claims against the debtor. Justice, *supra* note 1, at 872-96. *Cf.* B. CLARK, *supra* note 66, ¶ 2.9[2], at 2-37 to 38.

82 565 F.2d at 374 n.23.

83 *Id.* at 374.

84 *Id.* at 374-75 (quoting 3 COLLIER ON BANKRUPTCY ¶ 60.01, at 743 (14th ed. 1977)).

85 *Id.* at 375.

86 Fretz must have known that the security agreements with Revlon would cover claims assigned by Revlon subsidiaries. The security agreements stated that they covered debtor's obligations to Revlon *and* present or future affiliates, as well as obligations Revlon (or present or future affiliates) might obtain by assignment. *Id.* at 368 n.2; *see* B. CLARK, *supra* note 66, ¶ 2.11[2], at 2-56 to 57. Thus, Revlon's inflatable lien would probably pass muster under the principles described *supra* text accompanying notes 68-73. The circumstances in which an Article 9 security interest can secure debts not due to

lic and Revlon. Revlon arguably should have prevailed because, under the 1962 version of Article 9,[87] the first to file (Revlon) has priority.[88] Similarly, under the 1962 version of Article 9 the claims converted from unsecured to secured status in Hypotheticals A, B, and C would also arguably have priority from the time of filing over conflicting security interests in the collateral.

### B. Priority under the 1972 Version of U.C.C. Section 9-312

Determining the priority of a converted obligation as against an intervening security interest is more complicated under the 1972 version of Article 9. The 1972 amendments added a provision specifying the priority of claims based on future advances where there are conflicting security interests in collateral. New section 9-312(7)[89] provides that future advances made while a security interest is perfected by filing or by possession of the collateral (or pursuant to a commitment made "before or while the security interest is so perfected"[90]) have priority under the rules in section 9-312(5).[91] Thus, under the 1972 version of Article 9, a future advance lender has priority as to advances made while the security interest is per-

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the secured party (for example, Revlon's subsidiaries' claims before they were assigned to Revlon) is beyond the scope of this article.

87 The parties in *Fretz* agreed that the 1962 version of Article 9, which was in effect at the time the security agreements in question were executed, governed the dispute. 565 F.2d at 368 & n.3.

88 *See* Justice, *supra* note 1, at 918. The Fifth Circuit's reference to the bankruptcy policy favoring equality of distribution, 565 F.2d at 374, must be taken with a very large grain of salt. The court did not hold that the general creditors should share the collateral Revlon claimed; it held that the collateral should be used to satisfy the claim of a single creditor—Republic. If Fretz's bankruptcy trustee could have avoided the lien securing the claims assigned to Revlon under the 1898 Bankruptcy Act, Republic would have had to prove its priority over the avoided lien to keep the assets from the general creditors. Carlson & Shupack, *Judicial Lien Priorities under Article 9 of the Uniform Commercial Code: Part I*, 5 CARDOZO L. REV. 287, 364 n.323 (1984). The same would be true under the current Bankrnptcy Code, which preserves avoided transfers "for the benefit of the estate." 11 U.S.C. § 551 (1982).

The application of various bankruptcy avoidance provisions to inflatable liens is explored *infra* Part V.

89 The 1972 version of § 9-312(7) provides:

> If future advances are made while a security interest is perfected by filing or the taking of possession, the security interest has the same priority for the purposes of subsection (5) with respect to the future advances as it does with respect to the first advance. If a commitment is made before or while the security interest is so perfected, the security interest has the same priority with respect to advances made pursuant thereto. In other cases a perfected security interest has priority from the date the advance is made.

U.C.C. § 9-312(7) (1972). The 1977 amendments added the phrase "or under Section 8-321 on securities" after "taking of possession" in the first sentence. *Id.* (1977).

90 *Id.* (1972).

91 *Id.* § 9-312(5) (1977).

fected in the specified manner if he was the first to file or perfect. If an advance is made while the security interest is not so perfected, priority dates from the time the advance is made.[92]

The obvious question is whether converted obligations come within the term "future advance." If converted claims are not deemed future advances governed by section 9-312(7), the results under the 1972 Code are the same as under the 1962 Code. The 1972 residuary rule in section 9-312(5) is indistinguishable from the 1962 version of section 9-312(5) for purposes of this discussion. The 1972 version would give Lender priority over Bank in Hypothetical A because Lender was the first to file.

If converted obligations are treated as future advances governed by section 9-312(7), the results are unclear. On facts like Hypothetical A, for instance, when was the advance "made"? At the time Creditor assigned its claim to Lender?[93] At the time Creditor made its unsecured loan? If the former, a literal application of section 9-312(7) would give Lender priority because the assignment occurred while Lender had a security interest perfected by filing and Lender filed first. Under this interpretation, a senior inflatable lien has priority over an intervening junior lien with respect to assigned debts as long as the assignment occurred while the inflatable lien was perfected as specified in the first sentence of section 9-312(7). If the assignment had occurred when the inflatable lien was not so perfected, Lender's priority would date from the time of assignment under the last sentence of section 9-312(7). In that case, Lender would be subordinate to Bank as to the assigned claim.

If the advance is deemed made when Creditor granted the unsecured loan, the priority situation is even more curious. If Creditor made the unsecured loan after Lender filed its financing statement, Lender appears to have priority under the first sentence of section 9-312(7). If Creditor made the loan before Lender filed, the last sentence of section 9-312(7) dates priority from "the date the advance is made" (that is, the date the unsecured loan was made). Thus, Lender still appears to have priority. Indeed, in the last situation Lender argnably has priority even if Bank filed first, as long as

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92 *Id.* § 9-312(7) (1972).

93 Although the term "future advance" is not defined in Article 9, a respectable definition might be "value given after the security interest attaches." Taking a security interest for an antecedent claim constitutes giving value. *Id.* § 1-201(44)(b) (1977). Thus, Lender in Hypothetical A "gave value" when it acquired Creditor's claim. This would be true even if the assignment had been gratuitous. Because Lender gave this value after the security interest attached, it could be considered a "future advance." Similarly, the secured parties in Hypotheticals B and C gave value and hence argnably made future advances when they converted previously unsecured claims into secured indebtedness.

Creditor made its loan before Bank filed.[94]

1. *Future Advance Rules and Reliance Obligations*

Does it make sense to give Lender priority over Bank? In certain circumstances, the 1972 version of section 9-312 grants retroactive priority for future advances representing new value given by a secured party. Such priority, of course, may "squeeze out" a junior party; that is, later advances by the senior party may consume the debtor's equity in the collateral. If the senior interest is perfected by the methods mentioned in the first sentence of section 9-312(7), however, a junior party is on notice of this risk.[95] The junior party will either eliminate the risk (for example, by obtaining a subordination agreement or by paying off the senior party and terminating his priority) or adjust the terms of his credit to compensate for it.[96] Retroactive priority for advances made by senior interest holders thus imposes costs on lending by junior parties, but these costs are presumably more than offset by a reduction in transaction costs accompanying senior party lending.[97] The rationale for the priority afforded future advances, therefore, is that it reduces the costs associated with secured lending.[98]

If assigned claims or other converted obligations represent credit extended in reliance on the security interest (for example, the obligations assigned in *Heller*[99]), and if the security interest was perfected by the methods listed in the first sentence of section 9-312(7) when the credit was extended, the converted obligations deserve the

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94 This result reflects a more general problem in the drafting of § 9-312(7). Unless the priority rule in the last sentence of § 9-312(7) is limited to advances made after a financing statement has been filed or the security interest has been perfected in some manner (a qualification that the subsection does not express), the results are bizarre. For instance, suppose a secured party makes an uncommitted future advance while a security interest is unperfected, but the secured party later perfects by filing. Because the secured party did not make the advance either pursuant to commitment or while the security interest was perfected, it is clear that neither of the first two sentences of § 9-312(7) governs the situation. Rather, the last sentence of the section appears to apply because the security interest is now perfected. If so, priority would date from the time the advance was made, even if a conflicting security interest was perfected before the advance lender filed. That, clearly, was not the intent of the drafters. The situation belongs in § 9-312(5) so that priority would date from the time of filing or perfection.

95 U.C.C. § 9-312 comment 7 (1977); *see* 2 G. GILMORE, *supra* note 3, § 35.4, at 928. If a junior secured party will not necessarily have notice of a perfected senior interest (for example, if the senior interest is temporarily perfected without filing or possession), the priority in the first sentence of § 9-312(7) does not apply. *See* U.C.C. § 9-312 comment 7 (1977).

96 Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1178-82 (1979).

97 *Id.* at 1180.

98 *See id.*; Justice, *supra* note 1, at 918-20; Comment, *Priority of Future Advances Lending Under the Uniform Commercial Code*, 35 U. CHI. L. REV. 128, 139-50 (1967).

99 *See supra* notes 14-25 and accompanying text.

same priority as future advances made directly by the secured party. Priority eliminates the need to check the record and obtain subordination agreements from other lien holders each time new credit is extended. Perfection by the specified methods gives junior parties notice of the senior interest and permits junior parties to protect themselves. Presumably the costs avoided by senior interest-holders more than offset the costs imposed on junior parties.

2. *Nonreliance Obligations*

What is the proper treatment of converted obligations that do not represent credit extended in reliance on the security interest? Article 9 clearly contemplates that security agreements can cover "nonreliance" obligations when the obligations represent value given before the security agreement is executed. U.C.C. section 1-201(44)(b) defines "value" to include taking security for a pre-existing debt[100] and thus assures that a security interest covering such obligations can attach and be perfected. Given the decision to permit Article 9 agreements to include nonreliance obligations among "original" secured indebtedness, it makes sense to permit after-secured nonreliance obligations. Conversion arrangements that reach such obligations allow the parties to secure pre-existing debt without the time and expense of executing a new security agreement and filing a new financing statement.

To secure these advantages, however, it is unnecessary to treat converted nonreliance obligations as future advances with priority from the time of filing. Because non-reliance converted indebtedness does not represent secured credit, the transaction costs associated with that credit are unaffected by priority. Retroactive priority merely gives the secured party an incentive to convert unsecured claims and reap a windfall. A junior party aware of this possibility would not lend at secured terms. Thus, granting a secured party priority from the time of filing in these situations would impose costs on lending by junior parties not offset by savings to senior parties. The best solution is to date priority from the time nonreliance obligations are converted.[101] That date approximates the time priority would commence had the parties created and perfected a new security interest.[102] This approach captures the advantages of

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100 U.C.C. § 1-201(44)(b) (1977). Thus when a security agreement covers pre-existing claims, the "agreement" and "value" requirements for attachment in U.C.C. § 9-203(1)(a), (c) (1977) tend to collapse: when there is an agreement giving the secured party security for the pre-existing claims, the secured party has given value.

101 *Cf.* Jackson & Kronman, *supra* note 96, at 1181-82 (arguing that U.C.C. "notice-filing" system should be replaced by "transactional filing system" when collateral consists of "large, stable assets").

102 The secured party might argue that a new agreement covering pre-existing obli-

conversion arrangements covering nonreliance obligations without unjustifiably prejudicing third parties.[103]

### 3. *The Inadequacies of the 1972 Version of U.C.C. Section 9-312*

The treatment of future advances in U.C.C. section 9-312(7) suggests that in priority contests between conflicting security interests one should distinguish converted claims that represent new value given to the debtor in reliance on the security agreement from other converted obligations. The former deserve as much protection as "true" future advances;[104] the latter do not and should only have priority from the time of the conversion.

The current version of section 9-312 does not distinguish between reliance and nonreliance obligations. It is clear, however, that the provision dealing with future advances (section 9-312(7)) was drafted with genuine future advances in mind. Thus section 9-312(7) should apply to converted claims only if they represent new value given in reliance on the security agreement. Construing the term "advance" to reach only such claims and deeming such advances "made" when the converted claim first arose would yield proper results for reliance obligations. In *Heller*, for instance, where retroactive priority was necessary to induce extensions of new credit, the secured party could claim priority with respect to the assigned claims over security interests perfected after Heller's filing.

Under the current version of Article 9, however, the priority of nonreliance converted claims excluded from the term "advance" ap-

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gations can be covered by a previous filing and the security interest would have priority over interests arising after the filing. This priority, however, appears to represent an oversight by the Article 9 drafters. There is no good reason to date priority from the time of a previous filing in this situation, assuming the pre-existing obligations do not represent new value given in reliance on the filing. This problem may lie behind cases like Coin-o-Matic Serv. Co. v. Rhode Island Hosp. Trust Co., 3 U.C.C. Rep. Serv. (Callaghan) 1112 (R.I. Super. Ct. 1966), which held that the "first-to-file" rule in § 9-312(5)(a) does not apply to certain future advances. The debtor executed a security agreement with a car dealership that filed a financing statement. The agreement was assigned to Rhode Island Hospital Trust Company. The Trust Company then advanced funds to debtor, who executed a new agreement. Because the original agreement did not provide for future advances, the court held that the original filing did not give the Trust Company priority over an intervening security interest. The Code does not require that a security agreement expressly provide for future advances, and *Coin-o-Matic* has rightly been criticized because it does not reflect the Code's policy of encouraging lending by senior secured parties. *E.g.*, J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 25-4, at 1038-40 (2d ed. 1980). If the new agreement between debtor and the Trust Company had covered pre-existing unsecured claims (compare Hypothetical C), however, the decision might be appealing.

103 *Cf.* Justice, *supra* note 1, at 918 (to the extent priority is intended to promote lending to debtors, priority for assigned debt is "unappealing" because debtor gets no benefit from the assignment).

104 *But see supra* text accompanying notes 32-39.

pears to be governed by the first-to-file-or-perfect rule in section 9-312(5)(a). The priority afforded by this rule is unjustified and leads to abuses. In Hypothetical A, for instance, section 9-312(5) would give Lender priority over Bank. An extremely enlightened court might be persuaded not to grant retroactive priority in such a situation on the principle that a rnle should not apply where application would violate its purpose. Such an approach, however, flies directly in the face of the language of section 9-312(5), which states that the provision applies "[i]n all cases not governed by other rules stated in this section."[105] The best solution, therefore, is to amend section 9-312.

## IV
## PRIORITY UNDER ARTICLE 9: CONVERTED CLAIMS AND LIEN CREDITORS

The failure of Article 9 to distinguish obligations representing new value advanced in reliance on a security interest from other secured obligations also infects the priority rules applicable to contests between secured parties and creditors who have obtained judicial liens on the collateral.[106] The ability to convert obligations under an existing security interest may permit an oversecured party to "squeeze out" lien creditors who have executed on the collateral. Where the converted debt is a nonreliance obligation, the power to squeeze out judicial lienors cannot be justified.

### A. "Multiple" vs. "Unitary" Security Interests under the 1962 Version of U.C.C. Article 9

Consider a priority contest between Lender and Tortvictim in Hypothetical A. Under the 1962 version of Article 9, Lender's priority as to the claim acquired from Creditor is entirely unclear.[107] The 1962 version does not specifically address the priority of any after-secured obligations, including future advances. This gap has led to competing theories and results where a judgment creditor levies on property before a secured party makes an advance but after the secured party perfects an interest in the property.

One view, championed by Peter Coogan,[108] has been called the

105 U.C.C. § 9-312(5) (1977).

106 The priority rules applicable to inflatable lien/lien creditor contests are particularly significant for their impact on the treatment of inflatable liens in bankruptcy. *See infra* Part V.

107 Lender has priority as to its original claim under U.C.C. § 9-301(1)(b) (1962).

108 Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien,"* 72 HARV. L. REV. 838 (1959).

"multiple theory."[109] Proponents of this view point to the requirement that value be given before a security interest can attach.[110] The "value" requirement, they argue, suggests that a future advance is secured by a security interest distinct and separate from the interest securing the original advance.[111] The separate security interest securing a future advance does not attach to the collateral until the advance or a commitment for the advance—the "value"—is given.[112] Under the 1962 Code, a lien creditor has priority over a security interest that is not perfected at the time he becomes a lien creditor.[113] Because a security interest cannot be perfected until it has attached,[114] a lien creditor, according to the multiple view, has priority over the separate security interest securing an uncommitted advance made after the judicial lien arose.[115]

The opposing view has been called the "unitary theory,"[116] and its chief spokesman was Grant Gilmore.[117] Under this view, a security interest is accordion-like: it expands to cover future advances.[118] As soon as the creditor has given some value and the other requirements for attachment have been met, a unitary security interest attaches.[119] The unitary security interest thereafter absorbs future advances. According to this view, a unitary security interest that meets all the requirements for attachment and perfection before a judgment creditor levies on the collateral gives the secured party priority even as to advances made after a judgment creditor has levied.[120]

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109 Schroeder & Carlson, *Future Nonadvance Obligations under Article 9 of the UCC: Legitimate Priority or Unwarranted Squeeze-Out?*, 102 BANKING L.J. 412, 413, 418-20 (1985).

110 U.C.C. § 9-204(1) (1962); *id.* § 9-203(1)(b) (1972).

111 Coogan, *supra* note 108, at 867-68; Coogan, *Intangibles as Collateral Under the Uniform Commercial Code*, 77 HARV. L. REV. 997, 1019-20 (1964) [hereinafter *Intangibles as Collateral*]; Coogan & Gordon, *The Effect of the Uniform Commercial Code upon Receivables Financing—Some Answers and Some Unresolved Problems*, 76 HARV. L. REV. 1529, 1546-51 (1963); *see also* Schroeder & Carlson, *supra* note 109, at 418-20; Comment, *supra* note 98, at 137-39.

112 *E.g.*, 2 G. GILMORE, *supra* note 3, § 35.6, at 935-36, § 35.7, at 941; *Intangibles As Collateral*, *supra* note 111, at 1028; Coogan, *supra* note 108, at 868 n.108.

113 U.C.C. § 9-301(1)(b) (1962).

114 *Id.* § 9-303(1) (1977) (unchanged from 1962 version).

115 *E.g.*, 2 G. GILMORE, *supra* note 3, § 35.6, at 935-36; Comment, *supra* note 98, at 135-37.

116 Schroeder & Carlson, *supra* note 109, at 418-20.

117 *See* 2 G. GILMORE, *supra* note 3, § 35.6, at 937-39.

118 "Disbursements either create a security interest which is like one big cloud that mushrooms as further advances are made; or they create security interests incapable of growth, so that the advances generate a separate security interest—cloud—for each advance . . . ." Comment, *supra* note 98, at 135.

119 *E.g.*, 2 G. GILMORE, *supra* note 3, § 35.6, at 937-39; Comment, *supra* note 98, at 135-37.

120 *E.g.*, 2 G. GILMORE, *supra* note 3, § 35.6, at 937-39; Comment, *supra* note 98, at 136-37.

The unitary theory permits secured parties to squeeze lien creditors by making subsequent advances. A lien creditor, unlike a junior secured party, cannot adjust his credit terms to eliminate this risk. Professor Gilmore justified the priority afforded by the unitary theory on the grounds that future advances induced by the priority rule enhance the debtor's estate and thus increase the lien creditor's chance of recovering on his claim.[121] In other words, the advance compensates the lien creditor for being squeezed, and priority encourages advances by eliminating the cost of checking the records each time an advance is contemplated.

### B. Applying the Unitary and Multiple Theories to Converted Claims under the 1962 Version of Article 9

Under the 1962 version of Article 9, priority between secured parties and lien creditors as to claims converted after the judicial lien attached depends on resolving the unitary/multiple debate. If the unitary theory is applied to Hypothetical A,[122] for instance, Lender's original security interest can expand to absorb the debt Lender acquired from Creditor. Because Lender did everything required to perfect its "unitary" security interest in 1983, Tortvictim took subject to the assigned claim that the perfected security interest later absorbed.[123] Under the unitary theory, converted claims secured by a security interest that attached and was perfected before a lien creditor levied have priority no matter when the conversion occurred.

Under the multiple theory, the converted claims are secured by a separate security interest that does not attach and cannot be perfected until the necessary value is given. When was that? There are two possibilities. First, value was given under section 1-201(44)(b) when the secured party acquired security for the converted claim—that is, at the time of conversion. Thus, in Hypothetical A, Lender gave value when it acquired Creditor's claim.[124] If this is the value that permits attachment, Tortvictim has priority under section 9-301(1)(b) because the separate security interest securing the acquired claim was not perfected until after Tortvictim levied.

Second, value was given when the subsequently converted

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121 *See* 2 G. GILMORE, *supra* note 3, § 35.6, at 939; Schroeder & Carlson, *supra* note 109, at 420, 423-24.

122 *See supra* text accompanying notes 6-9.

123 *See* U.C.C. § 9-301(1)(b) (1962); Justice, *supra* note 1, at 918.

124 A previous commentator apparently assumed (but did not examine) this view. *See* Justice, *supra* note 1, at 918. As explained at *supra* note 93, § 1-201(44)(b) provides that a person who acquires security for a pre-existing claim thereby gives value. Because the assignment converted Creditor's claim into a secured obligation, Lender gave value by taking the assignment (even if the assignment had been gratuitous).

claim first arose. Section 9-203(1)(b) does not state that the value necessary for attachment must be given by the secured party.[125] Thus, in Hypothetical A, Creditor's loan to Debtor may satisfy the value requirement.[126] Under this view, priority depends on when Creditor made the loan. If the loan was made before August 10, Tortvictim's claim is subordinate because all the requirements for attachment and perfection of the separate security interest occurred before Tortvictim levied.[127] If Creditor's loan was made after August 10, however, Tortvictim has priority because the value necessary for the separate security interest to attach[128] was not given until after the levy.

It is clear that Creditor in Hypothetical A did not lend in reliance on Lender's inflatable lien. The priority the unitary approach affords was therefore not instrumental in making compensatory assets available to Tortvictim. Professor Gilmore's rationale for the unitary theory does not justify giving Lender priority. Permitting Lender to squeeze Tortvictim merely creates opportunities for abuse. Tortvictim deserves priority, yet only the first approach under the multiple theory[129] always yields this result.

In *Heller*,[130] however, the suppliers relied on the inflatable lien when they shipped goods to Bemporad on an unsecured basis. In this case Professor Gilmore's argument for the "unitary" approach applies. Without priority, Heller would not have agreed to purchase the suppliers' accounts and the suppliers would not have given new value. Because the suppliers' shipments enhanced Bemporad's estate, Bemporad's lien creditors would be compensated and could justifiably be squeezed. Only the unitary theory always yields this result.

In short, neither the unitary nor the multiple view distinguishes between converted obligations representing value given in reliance on a security interest and non-reliance converted debt. Thus to achieve proper results, one must adopt different views depending on the circumstances.

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125 U.C.C. § 9-203(1)(b) (1977) (requiring that "value has been given").

126 *Id.* § 1-201(44)(a) (1977) ("value" includes "the extension of immediately available credit").

127 The security agreement was executed in 1983, *id.* § 9-203(1)(a), Creditor gave value before the levy, *id.* § 9-203(1)(b), Debtor had rights in the collateral in 1983, *id.* § 9-203(1)(c), and Lender filed in 1983, *id.* §§ 9-303(1), 9-302(1).

128 *Id.* § 9-203(1)(b).

129 *See supra* text accompanying note 124.

130 Shaw v. Walter E. Heller & Co., 258 F. Supp. 394 (N.D. Ga. 1966), *rev'd on other grounds*, 385 F.2d 353 (5th Cir. 1967), *cert. denied*, 390 U.S. 1003 (1968) (discussed *supra* notes 14-25 and accompanying text).

### C. Converted Claims and Lien Creditors under the 1972 Version of Article 9

One commentator described the "multiple" vs. "unitary" approach to the priority of future advances under the 1962 version of Article 9 as an exercise in "Heraclitian metaphysics."[131] The 1972 amendments attempt to side-step the debate.[132] Rather than declaring whether the security interest securing a future advance is multiple or unitary,[133] the drafters added a compromise priority rule. Under the new version of section 9-301(4), a party with a perfected security interest has priority over a levying creditor for advances made before or within 45 days after the levy and for all advances made without knowledge of the levy (or pursuant to a commitment made without such knowledge). The lien creditor has priority over all other advances.

Treating converted obligations as "advances" governed by section 9-301(4) is justified in situations like *Heller*. Because the arrangements in that case generated more assets for Bemporad's judgment creditors to reach, Heller should enjoy the same priority it would have had if it had made advances to permit Bemporad to pay suppliers in cash.[134] Section 9-301(4) yields unacceptable results

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131 Comment, *supra* note 98, at 134.

132 1A SECURED TRANSACTIONS, *supra* note 37, § 7.07(6), at 7A-58.

133 Professor Carlson and his co-authors assert that the 1972 amendments adopt the multiple view. Carlson & Shupack, *supra* note 88, at 347 n.255; Schroeder & Carlson, *supra* note 109, at 418. They argue that a lien creditor has priority with respect to interest charges, collection costs, collateral preservation expenses, and similar items covered by a senior security interest, unless such charges mature or accrue before the lien creditor levies. Those items, it is argued, constitute "nonadvance value"—that is, value not within the term "advance"—and thus are subordinate under U.C.C. § 9-301(4) to a lien creditor who levies before the charges accrue or mature. Carlson & Shupack, *supra* note 88, at 352-59; Schroeder & Carlson, *supra* note 109, at 422-24. "Nonadvance value," however, is not value at all; rather, it is part of the original secured obligation. The time when interest and expenses accrue or mature should be irrelevant for priority purposes. *See* Dick Warner Cargo Handling Corp. v. Aetna Business Credit, Inc., 746 F.2d 126 (2d Cir. 1984).

134 There are, however, interpretative difficulties. For instance, if the converted obligations in *Heller* are treated as advances governed by § 9-301(4), when were the advances "made"? At the time the suppliers gave new value by shipping (or committing to ship) goods on credit—that is, at the time the converted obligations arose—rather than the time the "conversion" occurred is the best answer. Once the suppliers gave or committed new value to Bemporad, they could not take back the value or commitment even if they acquired knowledge of a judicial lien before the obligation was converted. Thus, as soon as the suppliers shipped or committed to ship on credit, the debtor's lien creditors received "compensation." *But see* Justice, *supra* note 1, at 919 (assuming that, under § 9-301(4), advance would be deemed "made" when conversion occurred).

In a situation like *Heller*, whose knowledge of intervening judicial liens is relevant for § 9-301(4) purposes? Because the limited priority given advances made with knowledge of an intervening judicial lien is desigued to avoid conscious manipulation by the secured party, Heller's knowledge, rather than that of the suppliers, should control.

So interpreted, § 9-301(4) yields acceptable results whenever converted obligations

when applied to non-reliance converted debt, however. In Hypothetical A, for instance, Lender should not be permitted to squeeze judicial lienors whose interests attached before Creditor's claim was converted. Creditor's loan was not induced by a priority security interest,[135] and Tortvictim received no "compensation." Giving Lender priority for obligations converted after Tortvictim levied only creates opportunities for abuse, yet that is the result under section 9-301(4). The sensible approach is to date priority from the time of conversion, because Lender would enjoy such priority if, on the date of the assignment, it had created and perfected a new security interest covering the claim assigned by Creditor.

One commentator has argued that converted obligations do not represent advances and that section 9-301(4) subordinates such obligations to a lien creditor.[136] Because section 9-301(4) provides that a lien creditor takes subject to a security interest "*only* to the extent it secures advances," the argument runs, a lien creditor must have priority over "nonadvance" converted debt.[137] This approach would favor Tortvictim over Lender in Hypothetical A. The argument, however, would also give Tortvictim priority if Lender had acquired Creditor's claim *before* Tortvictim levied because assigued debt is not an advance and a lien creditor is subordinate "*only*" to advances.[138] Because this approach would subordinate converted debt to a lien creditor even if conversion occurred years before the lien creditor levied, a bankruptcy trustee of the debtor could always avoid the lien securing the assigued claims under section 544(a) of the Bankruptcy Code.[139] In other words, this approach yields ab-

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represent new value advanced to the debtor in reliance on the security interest. Under this approach, Heller would have priority over all judicial liens that arose up to 45 days before the suppliers' shipments or commitments. In addition, Heller would have priority over all judicial liens of which it was ignorant when the suppliers shipped or committed to ship.

135 This is true even if Debtor actually agreed to permit the kind of "conversion" that occurred in Hypothetical A. Meaningful assent by the debtor to "conversion" arrangements, of course, is a prerequisite to reaching priority questions. *See supra* text accompanying notes 69-73.

136 *See* Justice, *supra* note 1, at 919-20.

137 *Id.*

138 *Cf. Dick Warner Cargo*, 746 F.2d at 133-34 (rejecting literal reading of § 9-301(4) because it would give lien creditor priority over everything that is not an "advance" no matter when "nonadvances" occurred).

139 11 U.S.C. § 544(a) (Supp. III 1985). *See infra* note 147. Furthermore, unless a distinction between reliance and nonreliance converted debt is drawn, any levying creditor would have priority over the assigned claims in *Heller*, and Heller's security interest would be vulnerable to the bankruptcy trustee's powers under 11 U.S.C. § 544(a). This problem could be solved by construing the term "advance" in U.C.C. § 9-301(4) to include converted claims representing new value given in reliance on the inflatable lien. *See supra* Part III, penultimate paragraph.

surd results, and reflects a misreading of the statute.[140]

To achieve proper results, courts should construe the term "advances" in section 9-301(4) to include converted obligations only if they represent new value advanced in reliance on the security interest (for example, the suppliers' claims in *Heller*[141]) and hold section 9-301(4) inapplicable to other converted claims. This interpretation leaves priority between nonreliance converted obligations and judicial liens ambiguous under the 1972 amendments to Article 9 and leads back to the unitary/multiple debate. The multiple view, if interpreted so that the separate security interest securing non-reliance claims does not attach until conversion occurs, yields proper results,[142] although its application is absurdly complicated and may be inconsistent with the drafting of the 1972 amendments.[143]

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140 Justice argues that U.C.C. § 9-204(3) distinguishes between an "advance" and "other value." By failing to mention other value, he argues, § 9-301(4) subordinates it to lien creditors. Justice, *supra* note 1, at 919-20. *Cf.* Carlson & Shupack, *supra* note 88, at 353-56 (reasoning that interest payments constitute value, but not future advances).

The drafting history of the Code reveals what the drafters meant by "other value" in § 9-204(3). In the 1952 version of the Code, this provision (numbered 9-204(5) until 1972) said simply that a security agreement could cover "future advances." 15 UNIFORM COMMERCIAL CODE DRAFTS 216 (E. Kelly comp. 1984). The second paragraph of comment 8 to § 9-204 stated that "advance" meant only a loan of money and that a security agreement could not cover future sales of goods on credit. *Id.* at 220. The New York legislature criticized this limitation when it studied the U.C.C. in 1954-56. It suggested that language be added to clarify that an Article 9 security agreement could also cover future sales of goods on credit. 2 N.Y. LAW REVISION COMM'N, REPORT FOR 1954, LEGISLATIVE DOC. No. 65, 1021 (1954); 3 N.Y. LAW REVISION COMM'N, REPORT FOR 1955, LEGISLATIVE DOC. No. 65, 2051 (1955); N.Y. LAW REVISION COMM'N, REPORT FOR 1956, LEGISLATIVE DOC. No. 65, 470 (1956). In response, the U.C.C. drafters added the "other value" language and dropped the second paragraph of comment 8 to § 9-204. 20 UNIFORM COMMERCIAL CODE DRAFTS, *supra*, at 155, 158.

If the drafters of § 9-301(4) intended to subordinate "other value" to lien creditors, they must have intended to subordinate all credit that did not take the form of money advances, an idea not even hinted at in the comments. In fact, Justice himself rejects that result, although apparently unaware of the drafting history behind "other value." Justice, *supra* note 1, at 919.

In short, the drafters of § 9-301(4) did not intend to distinguish between advances and other value and did not intend to subordinate the latter to lien creditors. *See Dick Warner Cargo*, 746 F.2d at 133-34.

141 This interpretation of "advance" should also apply under U.C.C. § 9-307(3) (1977) (governing contests between non-ordinary-course buyers and secured parties).

142 In Hypothetical A, for instance, this interpretation gives Tortvictim priority over Lender. Because the assigned claim does not represent new value given in reliance on Lender's security interest, it is not an "advance" governed by § 9-301(4). The separate security interest securing the assigned claim did not attach and could not be perfected until conversion occurred. Because conversion occurred after Tortvictim levied, Lender is subordinate to Tortvictim as to the assigned claim under § 9-301(1)(b).

143 The drafters of the 1972 amendments appear to have conceived of security interests in unitary terms. Section 9-301(4), for instance, begins as follows: "A person who becomes a lien creditor while a security interest is perfected takes subject to the security interest . . . ." U.C.C. § 9-301(4) (1977). The second reference to "security interest" must, because of the definite article ("*the* security interest"), refer back to the first refer-

The drafters of section 9-301(4) did not anticipate the possibility that a security interest could cover previously unsecured claims converted into secured obligations after the security interest attached. Indeed, the intellectual contortions required to apply any of the Article 9 priority rules to converted debt demonstrates that neither the 1962 nor the 1972 versions deal adequately with inflatable liens and related phenomena. The consequences of this failure are bad enough when a dispute arises between competing claimants to collateral; the confusion is compounded when the debtor enters bankruptcy proceedings.

## V

## CONVERTED DEBT AND BANKRUPTCY

Hypotheticals A, B, and C represent unjustifiable attempts by secured parties to exploit an oversecured position at the expense of an insolvent debtor's general creditors. A trustee in bankruptcy should be able to use his avoiding powers under the Bankruptcy Code[144] to prevent such abuse. Transactions like those in *Heller*, on the other hand, are not abusive and should not be subject to avoidance. Unfortunately, the failure of both state law and the Bankruptcy Code to anticipate the phenomenon of converted debt makes it diffi-

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ence—a security interest that is perfected when the judgment lien arises. Thus, § 9-301(4) appears to give priority only if the security interest securing a subsequent advance is perfected when the intervening judgment lien arises. Under the multiple theory, that situation is rare. The separate security interest securing an advance cannot be perfected under the multiple view until the advance is made, unless the advance is made pursuant to a previous commitment. Section 9-301(1)(b) in the 1972 Code gives lien creditors priority over unperfected security interests without exception. Thus, if one adopts the metaphysics of the multiple view, a voluntary future advance made within 45 days after a levy or made without knowledge of the levy would, because of § 9-301(1)(b), be subordinate despite § 9-301(4). The last clause of § 9-301(4), however, suggests that the drafters intended the provision to give priority to uncommitted advances.

Furthermore, § 9-301(4) refers to a security interest's having priority to the extent that "it secures advances." The idea of one security interest securing multiple "advances" contradicts the multiple theory, unless the advances are all made pursuant to the same commitment. In addition, the drafters phrased § 9-301(4) as if it cuts back on priority that the secured party would otherwise have. (A lien creditor is subordinate "*only* to the extent.") Section 9-301(4) is a limitation on the priority of secured parties only under the unitary theory: Under the multiple theory, § 9-301(4) expands rather than constricts that priority. In short, the only way to make sense of § 9-301(4) is to adopt a unitary conception of security interests.

There is other evidence of the unitary concept in the 1972 amendments. Section 9-307(3), for instance, also contemplates a single security interest securing a series of voluntary future advances. In addition, commenting on changes in § 9-312, the drafters addressed the unfairness of squeezing out lien creditors "by permitting later enlargement of the security interest by an additional advance." U.C.C. § 9-312, Reasons for 1972 Change, § 5. The security interest posited by the multiple theory cannot be "enlarged" by an advance unless the advance is "committed" at the time of the original credit; only a unitary security interest can be "enlarged" by a voluntary advance.

144 11 U.S.C. §§ 544-45, 547-49, 553(b) (1982 & Supp. III 1985).

cult, although not impossible, to regulate abuses while preserving legitimate transactions.

### A. Bankruptcy Preference Provisions and Converted Debt

In Hypotheticals A, B and C, the secured parties attempted to convert debt shortly before the debtor declared bankruptcy. The timing suggests that the preference provision (section 547) of the Bankruptcy Code,[145] which permits the trustee to avoid certain eve-of-bankruptcy transfers,[146] may play a critical role in the proper regulation of converted indebtedness in bankruptcy.[147] A situation like

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145 *Id.* § 547.

146 To recover a preference under § 547 of the Bankruptcy Code, the trustee must establish that there has been a "transfer of an interest of the debtor in property" with the following attributes: (1) the transfer must be "to or for the benefit of a creditor"; (2) the transfer must be "for or on account of an antecedent debt owed by the debtor before the transfer was made"; (3) the transfer must occur when the debtor is insolvent (the debtor is presumed insolvent during the 90 days preceding the bankruptcy petition under § 547(f)); (4) the transfer must occur within 90 days of the bankruptcy petition, or within one year of the petition if the creditor is an "insider" (as defined in § 101(28)); (5) the transfer must make the creditor better off than he would have been if the transfer had not occurred and the creditor had asserted the antecedent debt in liquidation proceedings for the debtor. 11 U.S.C. § 547(b)(1)-(5) (1982 & Supp. III 1985).

147 This discussion focuses on the application of preference and fraudulent transfer law to conversion of unsecured obligations into secured debt before bankruptcy proceedings intervene. The trustee's other avoiding powers are normally unavailing in such situations. For instance, the transactions in Hypothetical A are not vulnerable under § 544(a), which permits the trustee to avoid a transfer if a creditor who had obtained a judicial lien on the debtor's property on the date of the bankruptcy petition would have priority over the transferee. 11 U.S.C. § 544(a)(1) (Supp. III 1985). As long as the parties actually agreed to permit conversion, Lender in Hypothetical A should have priority over a lien creditor who did not levy until the date of Debtor's bankruptcy petition. *See supra* text accompanying notes 141-43. The trustee could use § 544(b) to avoid the conversion in Hypothetical A only if he could locate an actual unsecured claimant who would have priority over Lender. 11 U.S.C. § 544(b) (1982). Unless assignment of the claim to Lender constituted a fraudulent conveyance under state law, *see infra* text accompanying notes 182-96, it is unlikely that the trustee could find such a claimant.

Where conversion does not occur until after the bankruptcy petition is filed, as was the case in *Fretz*, *see supra* text accompanying notes 75-78, § 544(a) might come into play. If obligations converted post-petition do not represent new value given in reliance on the security interest, priority over judicial lien creditors should not begin until conversion, *see supra* text accompanying note 135, and the trustee could avoid the conversion under his hypothetical lien creditor powers. Indeed, the attempt to convert such obligations post-petition might violate § 362(a)(4) of the Bankruptcy Code, which extends the automatic stay to "any act to create, perfect, or enforce any lien against property of the estate." 11 U.S.C. § 362(a)(4) (1982). If the obligations converted post-petition represent new value extended pre-petition in reliance on the security interest, however, the conversion should not be vulnerable under § 544(a). In this circumstance, the converted debt should have priority over judicial liens that arose after the giving of new value. *See supra* text accompanying notes 134 & 141. Furthermore, the post-petition conversion of such obligations should not violate the automatic stay, which does not apply to perfection of a lien if perfection gives the lien-holder retroactive priority over pre-perfection claimants to the collateral. 11 U.S.C. §§ 362(b)(3), 546(b) (Supp. III 1985).

Hypothetical A has, in fact, all the indicia of a preference.[148] Lender is a creditor of Debtor who has made a "last minute grab"[149] of rights in Debtor's assets. Unless the "grab" is avoided, a portion of Debtor's value will be diverted from the pool available to Debtor's unsecured creditors and used for the benefit of one claimant. The result thus disturbs the "equality of distribution" that section 547 was designed to promote.[150] Indeed, an attempt by Lender to achieve directly the substance of the transaction in Hypothetical A by procuring a new security interest within the preference period to secure the claim acquired from Creditor would constitute a classic voidable preference.

The difficulty in using preference law to prevent Lender's maneuver is that section 547 requires transfer of an interest in Debtor's property (specifically, the security interest securing the claim assigned to Lender[151]) during the statutory period.[152] Under section 547(e), the time at which a security interest is transferred is determined by the temporal relationship between attachment (the time a security interest "takes effect between the transferor and the transferee"[153]) and perfection against a lien creditor of the debtor.[154] Unfortunately, as has been demonstrated, the times at which the security interest securing the claim assigned to Lender in Hypothetical A attached and was perfected against lien creditors of Debtor are unclear.[155]

Under both the 1962 and 1972 versions of Article 9, the secur-

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148 *See* Carlson & Shupack, *supra* note 88, at 364; Justice, *supra* note 1, at 920-28; Shanor, *supra* note 6, at 603-10.

149 Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 760 (1984).

150 *See* 4 COLLIER ON BANKRUPTCY ¶ 547.03 (15th ed. 1986); Carlson & Shupack, *supra* note 88, at 364.

151 11 U.S.C. § 101(48) (Supp. III 1985) (defining "transfer" to include taking security interest in collateral).

152 Under § 547(b)(4) the statutory period is 90 days prior to the bankruptcy petition, assuming Lender was not an "insider" of Debtor. 11 U.S.C. § 547(b)(4) (1982 & Supp. III 1985).

153 *Id.* § 547(e)(2)(A) (1982 & Supp. III 1985). Under the 1972 version of Article 9, a security interest becomes "enforceable against the debtor" when it attaches. U.C.C. § 9-203(2) (1972).

154 Under § 547(e)(1)(B) of the Bankruptcy Code, a transfer of an interest in personal property is perfected for preference purposes "when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee." 11 U.S.C. § 547(e)(1)(B) (1982). If the transfer is perfected at or within 10 days of the time it takes effect, the transfer is made when it takes effect. *Id.* § 547(e)(2)(A). If the transfer is perfected more than 10 days after it takes effect and not after the bankruptcy proceeding commences, the transfer is made when perfected. *Id.* § 547(e)(2)(B). If the transfer is perfected after the later of commencement and 10 days following the time it takes effect, the transfer is made "immediately before the date of the filing of the petition." *Id.* § 547(e)(2)(C) (Supp. III 1985). In any event, a transfer cannot be made before the debtor acquires rights in the property transferred. *Id.* § 547(e)(3) (1982).

155 *See supra* Part IV.

ity interest securing the assigned claim in Hypothetical A should be deemed transferred for preference purposes at the time of assignment. In other words, the claim should be treated as secured by a separate security interest (as posited by the multiple theory) which did not attach and could not be perfected against lien creditors of Debtor until Lender gave value by receiving security for Creditor's pre-existing claim.[156] Under section 547(e)(2)(A), this separate security interest would be deemed transferred for preference purposes on August 15, 1986,[157] within the 90-day preference period. Because an antecedent debt (the debt originally due Creditor) gave rise to the transfer and the other elements of section 547(b) appear to be satisfied,[158] the trustee could avoid the lien securing the assigned claim. Lender would be relegated to a $50,000 unsecured claim.[159]

Assigned claims in situations like *Heller*,[160] in contrast, do not violate preference law policies and should be treated as future advances. Where the 1972 version of Article 9 applies, construing the term "advance" in U.C.C. section 9-301(4) to include converted obligations if, but only if, they represent new value given in reliance on the security interest would solve this problem. Under this approach,

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156 *See* U.C.C. § 1-201(44)(b) (1977); *supra* text accompanying notes 124 & 143. Some jurisdictions may have adopted the unitary approach in priority contests involving future advances. *E.g.*, Friedlander v. Adelphi Mfg., 5 U.C.C. Rep. Serv. (Callaghan) 7 (N.Y. Sup. Ct. 1968). Only extreme loyalty to metaphysical consistency, however, would prevent courts in such jurisdictions from making an exception and adopting the multiple approach for situations such as Hypothetical A. Indeed, Professor Gilmore himself, the leading spokesman for the unitary view, was extremely hostile to abuses involving converted obligations. *See* 2 G. GILMORE, *supra* note 3, § 35.2, at 918.

157 In other words, the separate security interest both attached and was perfected against lien creditors when Creditor assigned its claim to Lender—on August 15. The transfer would be deemed made on that date under the Bankruptcy Code, 11 U.S.C. § 547(e)(2)(A) (1982).

158 *See supra* note 146. The transfer was to a creditor (Lender), Debtor was insolvent on the date of the transfer, and the transfer of the security interest permitted Lender to receive more than if the transfer had not been made (assuming that unsecured creditors of Debtor would receive less than full payment in a Chapter 7 liquidation).

159 One must make certain fine distinctions in handling assigned claims in bankruptcy. If Lender's actions in Hypothetical A were properly characterized as, in effect, an advance of $5,000 to Debtor used to settle Creditor's claim, Lender should properly receive a $5,000 additional secured claim rather than a $50,000 unsecured claim. The different treatment will matter if the amount paid for the claim differs from the amount the claim will fetch if treated as an unsecured claim in bankruptcy. The amount a secured party pays for a claim should be treated as a secured advance only if the secured party and debtor agreed that the secured party would settle a claim on behalf of debtor—that is, if the secured party intended to make an indirect loan to debtor rather than to acquire the claim of the third party creditor. Lender in Hypothetical A asserted the full amount of Creditor's claim in bankruptcy, undermining the suggestion that Lender in effect loaned Debtor $5,000 to extinguish Creditor's claim.

160 258 F. Supp. 394 (N.D. Ga. 1966), *rev'd on other grounds*, 385 F.2d 353 (5th Cir. 1967), *cert. denied*, 390 U.S. 1003 (1968); *see supra* notes 14-25 and accompanying text.

the security interest securing the assigned claims in *Heller* would be deemed transferred for preference purposes no later than the time the claims arose.[161] Thus, the "antecedent debt" requirement of section 547 would protect the transactions from preference attack. Where the 1962 version of Article 9 remains applicable, similar results can be achieved under either the unitary or multiple theories.[162]

### B. Complications: Inventory and Receivables Collateral

Although the solution requires a complex result-oriented reading of Article 9 priority rules, current preference law can prevent abuses of converted indebtedness while preserving legitimate transactions where the collateral is equipment (as in Hypotheticals A, B and C). Where the security interest covers inventory or receivables, however, further difficulties arise. Section 547(c)(5) of the Bankruptcy Code, which regulates floating liens for preference purposes, provides that the trustee cannot avoid the transfer of a perfected security interest in inventory or receivables unless the secured party has improved its position.[163] Prohibited improvement occurs only if

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161 The security interest securing such "advances" (which should be deemed "made" when the suppliers gave or committed to give new value by extending credit to Bemporad) would have priority over a judicial lien under U.C.C. § 9-301(4) if the judicial lien arose less than 45 days before the advances. The security interest would thus be perfected under 11 U.S.C. § 547(e)(1)(B) (1982) 45 days before the suppliers extended credit. The security interest securing the advances attached under the unitary view when Heller's security interest in the collateral first attached; under the appropriate interpretation of the multiple view, *see supra* text accompanying note 125, it attached when the suppliers shipped (or agreed to ship) on credit. In either case, the security interest would be transferred under the timing rules of § 547(e)(2) no later than the time the suppliers extended (or committed to extend) credit.

162 Under the unitary view, the security interest securing the assigned claims both attached and was perfected against lien creditors when Heller first acquired a perfected security interest in the collateral—well before the suppliers' claims arose. Under the multiple view, the value that permits the separate security interest securing the suppliers' claims to attach (and be perfected against lien creditors) should be deemed given when the suppliers extended (or committed to extend) credit to Bemporad. *See supra* text accompanying note 125. Thus, the security interest securing the suppliers' claims would be transferred under the timing rules in § 547(e)(2) at the same time the claims arose. Under either approach, the transfer of the security interest would not meet the antecedent debt requirement.

163 11 U.S.C. § 547(c)(5) (Supp. III 1985). Many commentators have discussed the background and operation of § 547(c)(5). *E.g.*, Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 790-801 (1985); Countryman, *Bankruptcy Preferences—Current Law and Proposed Changes*, 11 U.C.C. L.J. 95, 103-04 (1978); Hogan, *Games Lawyers Play with the Bankruptcy Preference Challenge to Accounts and Inventory Financing*, 53 CORNELL L. REV. 553 (1968); Kaye, *Preferences Under the New Bankruptcy Code*, 54 AM. BANKR. L.J. 197, 207-11 (1980); Shanor, *supra* note 6, at 603-10; Young, *Preferences Under the Bankruptcy Reform Act of 1978*, 54 AM. BANKR. L.J. 221, 232-36 (1980); Note, *Avoidance of Preferential Transfers Under the Bankruptcy Reform Act of 1978*, 65 IOWA L. REV. 209, 241-57 (1979).

the amount by which the secured indebtedness exceeds the value of the collateral (the "unsecured deficiency") at the beginning of the preference period (or, if later, the date new value was first given under the security agreement) is greater than the unsecured deficiency at the time of the bankruptcy petition.

Suppose the collateral in Hypothetical A was inventory rather than equipment. Lender had no unsecured deficiency (indeed, it was over-secured) at the beginning of the preference period. Thus Lender could not improve its position within the meaning of section 547(c)(5). Literally applied, the exception appears to shield the security interest securing the claim acquired by Lender from preference attack.[164]

The solution is to limit the application of section 547(c)(5) to those situations for which it was designed—transfers of security interests in after-acquired collateral caused by the debtor acquiring rights in such collateral during the preference period. The exception should not apply to transfers arising from the conversion of previously unsecured obligations into secured debt because the results would undermine the purposes of preference law. "The problem with this argument," notes one commentator, "is that the statutory language does not support it."[165]

The failure of section 547 to solve the problem of obligations converted to secured debt on the eve of bankruptcy is surprising because its drafters declared their intention to overrule a case which permitted such conversion. In *In re King-Porter Co.*,[166] debtor entered into a security agreement with the Mills Morris Company, an inventory supplier. The collateral was debtor's current and after-acquired inventory. The secured obligations included "any existing and future indebtedness" to Mills Morris.[167] Mills Morris began to ship appliances to debtor on credit and perfected by filing on February 25. On April 25, Mills Morris took an assignment of open-account claims for 112 air conditioners debtor had purchased from Kelvinator on March 28.[168] Mills Morris repossessed all but 11 of the air conditioners on May 31. On June 5, debtor filed for bankruptcy.[169]

The district court held that the assignment to Mills Morris gave

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164 *See* Shanor, *supra* note 6, at 607-08.

165 *Id.* at 608 n.80.

166 446 F.2d 722 (5th Cir. 1971).

167 *Id.* at 725.

168 The assignment was part of a distributorship agreement between Mills Morris and Kelvinator. Mills Morris purchased the claims from Kelvinator for face value on July 2. *Id.* at 725-26.

169 *Id.* at 726.

rise to a preference under the Bankruptcy Act of 1898.[170] The Fifth Circuit reversed, holding that the security interest securing the claims assigned to Mills Morris was transferred when Mills Morris perfected by filing on February 25.[171] Because the assigned claims did not arise until March 28, the court reasoned, the transfer was not on account of an antecedent debt.[172]

The Fifth Circuit clearly confused the situation in *King-Porter* with cases involving the validity of floating liens in bankruptcy—a controversy that was still raging at the time.[173] Although Mills Morris' security interest covered collateral acquired by the debtor during the preference period, that was not its objectionable feature. By acquiring Kelvinator's unsecured claim, Mills Morris converted it into a secured obligation on the eve of bankruptcy. If debtor had given Kelvinator a security interest on April 25, the situation would clearly involve a preference. In its zeal to shield floating liens from preference attack, the *King-Porter* court failed to notice this aspect of the transaction.

Several commentators[174] criticized *King-Porter*, and the drafters of the Bankruptcy Code attempted to overrule the case. The Senate Report on the Bankruptcy Reform Act of 1978 states that section 547(e)(3), "in combination with subsection (b)(2) [requiring that a transfer be "for or on account of an antecedent debt owed by the debtor before such transfer was made"], overrules *In re King-Porter Co.*"[175]

The provisions cited in the Senate Report, however, do not defeat the *King Porter* analysis. Section 547(e)(3) provides that a security interest cannot be transferred until the debtor has rights in the collateral.[176] In *King-Porter*, however, the debtor received rights in the 112 air conditioners at the same time the debt to Kelvinator arose. Thus, the antecedent debt requirement would be unsatisfied on such facts despite section 547(e)(3).[177] Under current law, even

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170 *Id.* at 727. The district court also held that the creation of a security interest to secure the assigned claims was a fraudulent transfer. *Id.*

171 *Id.* at 730.

172 *Id.* at 732-33. Compare the results in *In re* Wilco Forest Machinery, Inc., 491 F.2d 1041 (5th Cir. 1974), described *supra* text accompanying notes 26-31.

173 For accounts of this controversy, see sources cited *supra* note 163.

174 In the 1972 edition of their treatise, Professors White and Summers described the *King-Porter* holding as follows: "A party . . . can convert what would have been a preferential security transfer if made to him into a non-preferential transfer merely by assigning his own claim to another party who has a security interest in assets of the common debtor . . . ." J. WHITE & R. SUMMERS, *supra* note 102, § 24-5, at 883 (1972); *see also* Kennedy, *Secured Transactions*, 27 BUS. LAW. 755, 769-70 (1972).

175 S. REP. No. 989, 95th Cong., 2d Sess. 89, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5875.

176 11 U.S.C. 547(e)(3) (1982).

177 *See* Justice, *supra* note 1, at 925-26.

if debtor acquired new collateral after the Kelvinator claim arose, the exception in section 547(c)(5) might have shielded the transaction.[178] At any rate, section 547(e)(3) will not help in a situation like Hypothetical A, where the inflatable lien does not cover after-acquired property.[179] Furthermore, the Senate Report's statement that the antecedent debt requirement in section 547(b)(2) helps to overrule *King-Porter* is misleading. The current wording of section 547(b)(2) does nothing to solve the problems raised by Hypothetical A and *King-Porter*.[180] In short, the attempt to overrule *King Porter* in section 547 was unsuccessful.[181]

C. Fraudulent Conveyance Law

Given the shortcoming of current preference law, trustees might turn to fraudulent conveyance law to deal with converted obligations. Unfortunately, neither the fraudulent transfer provision of the Bankruptcy Code[182] nor state fraudulent conveyance law[183] appears adequate for this purpose. For instance, assuming that the transaction which originally gave rise to Creditor's claim in Hypothetical A did not constitute a fraudulent conveyance, the trustee's only recourse is to attack the transfer of the security interest to Lender.[184] That transfer is probably not avoidable under section

178 *See supra* text accompanying notes 163-65.

179 *See* Justice, *supra* note 1, at 926.

180 In *King-Porter* the inflatable lien holder (Mills Morris) purchased Kelvinator's claim by assuming liability for debts owed to Kelvinator. 446 F.2d at 725. The Fifth Circuit strongly implied that the security interest securing the assigned claim should be deemed transferred on account of Mills Morris's assumption of liability rather than by virtue of the pre-existing debt owed to Kelvinator. The court ruled that Mills Morris's assumption of liability constituted "value" to the debtor. *Id.* Compare the value analysis under the multiple theory, *supra* note 124 and accompanying text. The Bankruptcy Code drafters may have felt that the language of § 547(b)(2) overruled the Fifth Circuit's value analysis in *King-Porter*.

181 *See* Justice, *supra* note 1, at 925. This failure is particularly surprising given the drafters' successful handling of analogous situations in the context of setoff. *See* 11 U.S.C. § 553(a)(2) (1982); *see also* Justice, *supra* note 1, at 930; Shanor, *supra* note 6, at 608 n.80.

182 11 U.S.C.A. § 548 (West Supp. 1987).

183 If there were an unsecured creditor of the debtor who could avoid a transfer under state fraudulent conveyance law, the trustee could invoke the state law. 11 U.S.C. § 544(b) (1982) (trustee succeeds to powers of actual unsecured creditors of debtor).

184 Fraudulent transfer law often has a limited "reach back" period. For example, under § 548(a) of the Bankruptcy Code, the transfer must occur within one year of the petition date. *Id.* § 548(a) (1982 & Supp. III 1985). Under the new Uniform Fraudulent Transfer Act, which at the time of writing has been adopted in eight states, 7A U.L.A. 40 (Supp. 1987), the reach back period varies from one to four years. UNIF. FRAUDULENT TRANSFER ACT § 9 (1984). Because the time a transfer occurs under these laws is determined by reference to priority over others holding an interest in the transferred property, 11 U.S.C. § 548(d)(1) (Supp. III 1985); UNIF. FRAUDULENT TRANSFER ACT § 6, issues similar to those raised by the timing rules in the preference provision have to be resolved. *See supra* text accompanying notes 151-62.

548(a)(2) of the Bankruptcy Code[185] or equivalent state laws, which permit avoidance of some transfers made for less than equivalent value in exchange,[186] because a transfer that gives security for an antecedent debt is usually deemed made for fair consideration.[187]

Several commentators[188] have suggested that the transfer of a security interest to secure converted obligations in a situation like Hypothetical A offends the principles of *Dean v. Davis*[189] and thus is voidable under section 548(a)(1) of the Bankruptcy Code as a transfer made "with actual intent to hinder, delay, or defraud"[190] creditors. In *Dean* the Supreme Court held that a security interest given to permit the debtor to make a preferential payment was a fraudulent conveyance.[191] Section 548(a)(1) and *Dean*, however, require that the *debtor* possess the requisite fraudulent intent.[192] In situations like Hypothetical A, however, only the secured party intends to exploit its oversecured position. Furthermore, section 548(a)(1)[193] and *Dean*[194] require proof of debtor's subjective intent, an ex-

185 11 U.S.C.A. § 548(a)(2) (West Supp. 1987).

186 *See id.* § 548(a)(2); UNIF. FRAUDULENT TRANSFER ACT §§ 4(a)(2), 5(a); UNIF. FRAUDULENT CONVEYANCE ACT §§ 4-6 (1918). In addition, the transferor must at the time of the transfer have been insolvent (or rendered insolvent thereby), too thinly capitalized for anticipated business, or intending to incur debts beyond his ability to pay. *See* 11 U.S.C. § 548(a)(2) (1982 & Supp. III 1985); UNIF. FRAUDULENT TRANSFER ACT §§ 4(a)(2), 5(a); UNIF. FRAUDULENT CONVEYANCE ACT §§ 4-6.

187 *See* 11 U.S.C. § 548(d)(2)(A) (Supp. III 1985) ("value" includes "securing of a present or antecedent debt of the debtor"); UNIF. FRAUDULENT TRANSFER ACT § 3(a) ("Value is given for a transfer . . . if, in exchange for the transfer . . . an antecedent debt is secured . . . ."); UNIF. FRAUDULENT CONVEYANCE ACT § 3(b) (fair consideration is given when transfer "is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small"); *see also* cases cited in 4 COLLIER ON BANKRUPTCY, *supra* note 150, ¶ 548.09, at 548-99 n.2. The "good faith" requirement for "fair consideration" under the Uniform Fraudulent Conveyance Act might open a line of attack against maneuvers such as Lender's where the trustee could invoke this statute.

At least one court has held that giving security for an unsecured claim against an insolvent debtor involves a transfer for less than fair consideration, because the value of the claim secured is less than the value of the security. Inland Security Co. v. Estate of Kirshner, 382 F. Supp. 338 (W.D. Mo. 1974). Commentators have attacked the use of fraudulent conveyance law to recover transfers made on account of antecedent debts, however, because such use blurs the distinction between preference and fraudulent conveyance principles and undermines the limitations on the former. *See* D. BAIRD & T. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 265-66 (1985); Jackson, *supra* note 149, at 783-86.

188 *See* Kennedy, *supra* note 174, at 770; *see also* Carlson & Shupack, *supra* note 88, at 364 n.323; Justice, *supra* note 1, at 928.

189 242 U.S. 438 (1917).

190 11 U.S.C. § 548(a)(1) (Supp. III 1985).

191 242 U.S. at 444-45.

192 *See* 4 COLLIER ON BANKRUPTCY, *supra* note 150, ¶ 548.02[4]-[5]. Indeed, the *Dean* doctrine may require that both debtor and the secured party share an impermissible purpose. *Id.* ¶ 548.02[4], at 548-35 to -36; Justice, *supra* note 1, at 894.

193 11 U.S.C. § 548(a)(1) (Supp. III 1985).

194 242 U.S. at 445.

tremely difficult burden to meet.[195] Finally, the legislative history indicating that section 547 was intended to overrule *King-Porter* suggests that the Bankruptcy Code drafters intended preference law to goveru pre-bankruptcy attempts to convert debt. Consequently, section 547 may pre-empt fraudulent conveyance law in this area.[196]

Preference law represents the best vehicle for regulating converted indebtedness when the debtor has entered bankruptcy proceedings. Under current law, however, defensible results can be achieved only with difficulty. With the exception of the problems caused by section 547(c)(5), however, the difficulties can be attributed to the inadequate treatment of converted obligations under state law. Reforming Article 9 of the U.C.C. would eliminate many of the problems in using preference law to prevent abuses of converted obligations.

## VI
## PROPOSED AMENDMENTS

Courts dealing with converted debt have focused on whether, as a matter of contract law, the security agreement gave the secured party the power to convert. This is appropriate in most cases, and courts have succeeded in preventing attempts by overreaching creditors to take advantage of inconspicuous and incomprehensible draguet-clause language that informed debtors would likely have resisted.

Even where debtors have knowingly agreed to allow conversion, however, courts have tended to avoid thorny priority questions by construing the security agreement not to permit conversion. In *In re E.A. Fretz Co.*,[197] for instance, the dragnet clause in a security agreement between two sizeable and, presumably, sophisticated business entities specifically covered claims acquired by assignment.[198] Indeed, the agreement plainly stated that the collateral secured claims of Revlon subsidiaries.[199] In short, as a contractual matter, the security agreement clearly covered claims that Revlon subsidiaries assigned to the parent company. Nevertheless, the Fifth Circuit concluded that Revlon did not have a valid lien secur-

195 Justice, *supra* note 1, at 894-95.

196 *Cf.* Jackson, *supra* note 149, at 779-80 ("The essence of fraudulent conveyance law, therefore, is to prevent manipulative activities by the debtor. If the activity in question is, at best, a manipulation by a *creditor* vis-a-vis other creditors, then it should succumb, if at all, to a preference-type rationale rather than a fraudulent-conveyance-type rationale.").

197 565 F.2d 366 (5th Cir. 1978).

198 *Id.* at 368 n.2; *see supra* text accompanying note 76.

199 *See supra* note 86.

ing the assigned claims.[200] The holding can only be seen as an attempt to avoid the difficult bankruptcy and priority issues facing the court.

Existing case law dealing with inflatable liens and similar conversion devices is generally hostile to their operation. This raises the possibility, realized in *Fretz*, that courts will refuse to enforce the power to convert even when such a ruling is inappropriate. It also means that the complex priority questions raised by conversion arrangements remain unexplored. It is extraordinarily difficult to construe current Article 9 priority rules to yield justifiable results for converted debt.[201] Without the aid of a well-reasoned body of case law, it may be impossible.

The obvious solution is to amend the law goveruing secured transactions to account for the phenomena of converted obligations. My suggested amendments to Article 9 are set forth in an Appendix. The proposed amendments can be classified under four headings. First (and least important), section 9-203(1)(b) is amended to reflect the unitary concept of a security interest. This clarification merely provides a stable framework for drafting. I have chosen the unitary view because it is consistent with the language of current sections 9-301(4) and 9-307(3).[202]

Second, the proposed amendments permit the use of inflatable liens and variants in certain circumstances. Under the proposed revisions to section 9-204(3), a security agreement can cover future advances and other "after-secured obligations," a term defined to include any obligation not secured when the security interest attached.[203] The term thus includes "true" future advances, as well as assigned debt and similar claims. In the latter case, however, the parties must "clearly intend"[204] the obligations to be covered. The adverb requires a court to look realistically at the parties' intent and to discount form language cast in legalese incomprehensible to most debtors. The definition of "after-secured obligation" excludes inflatable liens and negotiable liens in consumer transactions. The devices are easily abused in this context, and consumer transactions seldom require the flexibility they provide.

Third, the amendments attack the priority problems explored in this article. Changes to section 9-301(4) give a lien creditor priority over obligations not "secured by the security interest" (a newly

200 565 F.2d at 375.

201 *See supra* Parts III and IV.

202 *See supra* note 143. The amendment to § 9-203(1)(b) is sufficiently subtle to warrant a comment explaining its function.

203 See the proposed additions to U.C.C. § 9-101 in the Appendix.

204 *Id.*

defined phrase[205]) when he becomes a lien creditor, unless the obligations represent "advances" made under the circumstances described in the current version of section 9-301(4).[206] Amendments to section 9-307(3) make similar changes in the priority rules applicable between secured parties and non-ordinary-course buyers. The amendments define "advance" as "new value" (a term in current sections 9-108 and 9-312(2)) given to or for the benefit of the debtor after the security interest attaches and in reliance on the security interest.[207] To avoid needless litigation, classic future advances (obligations secured when they arise and representing new value given by the secured party) are presumed to satisfy the reliance requirement.

Under these proposed amendments, Lender in Hypothetical A would be subordinate to Tortvictim as to the claim assigned by Creditor. The changes would also make Lender's maneuver vulnerable to avoidance under section 547 of the Bankruptcy Code. The amendments, however, would give the secured party in *Heller* priority over lien creditors who levied after the assigning suppliers extended credit to the debtor and thus would insulate Heller's security interest from avoidance as a preference.

Section 9-312(7) is completely rewritten. Advances, including converted claims that meet the definition of an advance, are subject to the priority rules governing competing security interests in the current version of section 9-312(7). The amendments date priority for after-secured obligations not constituting advances from the time they become "secured by the security interest" or from the time they receive priority under the rules in section 9-312(5), whichever is later.[208] The proposal includes amendments to section 9-313(4) to conform priority in fixtures.

Fourth, the proposal includes amendments to section 9-208 designed to control the use of conversion arrangements to disguise the extent to which a debtor's assets are encumbered.[209] Preventing this abuse does not require abandoning conversion arrangements, which can offer the flexibility needed to accomplish perfectly legitimate transactions (as in *Heller*). The proposed amendments to section 9-208 require the secured party, upon the debtor's request, to

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205 *Id.*

206 If converted debt meets the proposed definition of advance, *id.*, the advance should be deemed made when the obligation arose rather than when it was converted. A comment to this effect would be appropriate.

207 *Id.*

208 This change would also correct the problem that arises under current § 9-312(7) when a "true" advance is made before the security interest is perfected in any way. *See supra* note 94.

209 *See supra* text accompanying notes 32-39.

issue account statements describing all existing obligations that are or will be secured by the security interest. This reporting obligation protects third parties who might otherwise be misled.[210]

The notice rules in the proposed revisions to 9-208 are important. Problems caused by inadequate disclosure of secured obligations cannot be lightly dismissed. The experience in Georgia, where the courts liberally enforced conversion arrangements in real property mortgages until stopped by the legislature,[211] is instructive:

> The rule recognizing the tacking on of other indebtedness by special provision in the contract has for many years in this State been a thorn in the side of title attorneys and title companies, giving rise to the contention that the holder of a lien junior to an instrument authorizing the tacking on of subsequent indebtedness places the junior lien holder in the unfortunate position of not knowing what obligations and priorities are his. This adversely affects the opportunity of a debtor obtaining junior loans from another than the first lien holder and places him at the mercy of the holder of the first lien where additional credit is necessary. It also places at a disadvantage an investor in junior liens.[212]

The liberal future advance rules in Article 9, however, already create the problems noted by the court. The drafters of Article 9 decided that the advantages of encouraging future advance lending by senior parties outweighed the risks and inconvenience to junior parties.[213] As long as third parties can obtain information about existing obligations that can be converted into secured debt, which is possible under the proposed revisions to section 9-208, conversion arrangements do not pose any special problems.

The proposed amendments to Article 9 will not solve all disputes over conversion arrangements. The problems discussed herein often arise in connection with real estate mortgages; thus, amendments to state mortgage statutes are also necessary to ensure proper treatment of conversion arrangements. The proposed amendments to Article 9 might serve as a model, to be modified in

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210 Section 9-208 has many failings beyond those suggested by the problems considered herein. See SECURED TRANSACTIONS, *supra* note 37, § 6C.07[3][b], at 6C-113 to 23; Justice, *supra* note 1, at 883-86. The proposed amendments to § 9-208 adopt the current version's terminology and approach, which may well be inadequate, but the reform of which is beyond the scope of this article. The proposed amendments require that the secured party disclose unmatured and contingent claims, which may address some of the concerns expressed about such obligations. *See supra* note 133.

211 *See supra* text accompanying notes 56-61.

212 Vidalia Prod. Credit Ass'n v. Durrence, 94 Ga. App. 368, 371, 94 S.E.2d 609, 611 (1956). *Cf.* Jackson & Kronman, *supra* note 96, at 1178-82.

213 *See* U.C.C. § 9-312(7) comment 7 (1972); 2 G. GILMORE, *supra* note 3, § 35.8, at 942.

light of the varying approaches and terminology in state mortgage laws.

## CONCLUSION

Analysis of the issues raised by inflatable liens and like phenomena reveals significant gaps in U.C.C. Article 9's "comprehensive scheme for the regulation of security interests in personal property and fixtures."[214] The consequences have been confusion over converted obligations and, in certain cases, injustice. More disturbingly, the unsettled state of current law encourages the abuse of conversion arrangements in the future. The potential for abuse is greatest when the debtor has become insolvent, because the failure of state law to deal adequately with conversion arrangements undermines provisions of federal bankruptcy law designed to regulate security interests in this critical area.

Although the current Article 9 scheme has survived despite its imperfections and can be made to yield proper results in some situations, amending Article 9 as proposed in the Appendix would ensure a rational and predictable approach to converted obligations. Inflatable liens and similar arrangements have appeared with frequency sufficient to reveal their utility and their potential for abuse. Both aspects deserve a legislative response.

214 U.C.C. § 9-101 comment (1972).

## APPENDIX

*Proposed Amendments to Article 9*

Add the following new definitions to § 9-105(1):

(o)*An "advance" is new value given to or for the benefit of the debtor in reliance upon a security interest after such security interest has attached. New value given by the secured party is presumed to be given in reliance upon a security interest if the resulting obligation is secured by the security interest when the new value is given.*

(p)*"After-secured obligation" means any enforceable obligation that is not secured by the security interest involved at the time the security interest attaches. Except to the extent the collateral is consumer goods, after-secured obligations may include obligations assigned to the secured party after the security interest attached and pre-existing obligations to a party who was assigned the security interest.*

(q)*An obligation or indebtedness is "secured by the security interest" when and to the extent that the obligation has arisen and is covered by an effective security agreement creating or providing for such security interest, provided that there has been no period thereafter when such obligation was not covered by such a security agreement.*

Amend § 9-203(1)(b) to read as follows:

(b)*some* value has been given; and

Amend § 9-204(3) to read as follows:

(3) Obligations covered by a security agreement may include *(1) future advances, whether or not such advances are given pursuant to commitment (subsection (1) of Section 9-105), and (2) if the parties clearly so intend, other after-secured obligations.*

Replace the first sentence of § 9-208(1) with the following:

*(1) A debtor may sign a statement of obligations with a request that the statement be approved or corrected and returned to the debtor. The statement of obligations shall indicate what the debtor believes to be (1) the aggregate amount of unpaid indebtedness as of a specified date, and (2) any other obligations existing as of the specified date (including unliquidated, contingent or unmatured obligations) which are or will be secured by the security interest.*

Amend § 9-208(2) as follows:

—Add the following sentence after the first sentence:

*If the secured party complies and the request included a statement of obligations, the secured party may claim a security interest against persons who reasonably relied on the statement of obligations (as corrected in the response) only with respect to (1) the indebtedness and other obligations indicated on the statement as corrected in the response, and (2) advances made after the date specified in the request.*

—Replace the portion of the third sentence that follows the semicolon with the following:

and if the debtor has properly included in his request a good faith

statement of *obligations, the secured party may claim a security interest against persons misled by his failure to comply only with respect to (1) the indebtedness and other obligations indicated on the statement and (2) advances made after the date specified in the request; and if the debtor has properly included in his request a list of the collateral the secured party may claim a security interest against persons misled by his failure to comply only with respect to collateral indicated in the statement.*

Amend § 9-301(4) to read as follows:

(4) A person who becomes a lien creditor while a security interest is perfected takes subject to the security interest only to the extent that it secures

*(a) obligations secured by the security interest before he becomes a lien creditor; and*

*(b) advances made within 45 days after he becomes a lien creditor or made without knowledge of the lien or pursuant to a commitment entered into without knowledge of the lien.*

Amend § 9-307(3) to read as follows:

(3) A buyer other than a buyer in ordinary course of business (subsection (1) of this section) takes free of a security interest to the extent that it secures *obligations not secured by the security interest at the time of the purchase, except for advances made at or within 45 days after the purchase and before the secured party acquires knowledge of the purchase, and advances made pursuant to a commitment entered into without knowledge of the purchase and before the expiration of the 45 days period.*

Amend § 9-312(7) to read as follows:

*(7) The priority of a security interest securing after-secured obligations as against a conflicting security interest in the same collateral shall be determined by the following rules:*

(a) *To the extent the security interest secures advances made while the security interest was perfected by filing, the taking of possession, or under Section 8-321 on securities, the priority of such security interest is governed by subsection (5).*

(b) *To the extent the security interest secures advances made pursuant to a commitment given before or while the security interest is perfected by filing, the taking of possession, or under Section 8-321 on securities, the priority of such security interest is governed by subsection (5).*

(c) *In all other cases, the security interest has priority from the time the after-secured obligation is secured by the security interest or the time the security interest would have priority under the rules in subsection (5), whichever is later.*

Amend § 9-313(4) to read as follows:

(4) A perfected security interest in fixtures has priority over the conflicting interest of an encumbrancer or owner of the real estate *to the extent that*

(a) [unchanged]

(b) the security interest is perfected by a fixture filing before the interest of the encumbrancer or owner is of record, *the security interest secures obligations secured by the security interest before the interest of the encumbrancer or owner is of record or advances made thereafter,* the security interest has priority over any conflicting interest of a predecessor in title of the encumbrancer or owner, and the debtor has an interest of record in the real estate or is in possession of the real estate; or

(c) the fixtures are readily removable factory or office machines or readily removable replacements of domestic appliances which are consumer goods, *the security interest secures obligations secured by the security interest before the goods become fixtures or advances made thereafter,* and before the goods become fixtures the security interest is perfected by any method permitted by this Article; or

(d) the conflicting interest is a lien on the real estate obtained by legal or equitable proceedings after the security interest was perfected by any method permitted by this Article, *and the security interest secures obligations secured by the security interest before the lien was obtained or advances made thereafter.*