BYU Law Review

Volume 1976 | Issue 4 Article 10

11-1-1976

Bankruptcy Law - Secured Transactions-Bankruptcy Trustee's Power To Avoid as Preferential a Creditor's Perfected Security Interest Under U.C.C. Section 9-306(4) (d) in Excess Proceeds-Arizona Wholesale Supply Co. v. Itule (In re Gibson Products)

Bankruptcy Law—SECURED TRANSACTIONS—BANKRUPTCY TRUSTEE'S POWER TO AVOID AS PREFERENTIAL A CREDITOR'S PERFECTED SECURITY INTEREST UNDER U.C.C. SECTION 9-306(4)(d) IN EXCESS PROCEEDS—*Arizona Wholesale Supply Co. v. Itule (In re Gibson Products)*, 543 F.2d 652 (9th Cir. 1976).

Prior to 1972, petitioner, Arizona Wholesale Supply Company (Wholesale), sold various brand name appliances to Gibson Products of Arizona (Gibson) under a secured financing arrangement whereby Wholesale retained a perfected security interest in the appliances.[1] On January 13, 1972, Gibson, indebted to Wholesale for the subject inventory in the amount of $28,800, initiated Chapter XI proceedings under the Bankruptcy Act.[2] During the ten-day period immediately preceding the filing of the bankruptcy petition, Gibson deposited $19,505.27 in its bank account. Included in the deposited amount were $10 from the sale by Gibson of one of Wholesale's appliances.

Wholesale sought and obtained an order from the bankruptcy judge awarding it the entire $19,505.27 amount, based upon Uniform Commercial Code (U.C.C.) section 9-306(4).[3] The

---

1. The Uniform Commercial Code (U.C.C.), prior to amendments in 1972, required that for the perfection of a security interest in inventory (defined at U.C.C. § 9-109(4)), (1) an agreement for the security must be made, (2) the secured creditor must give value, (3) the debtor must have rights in the collateral, and (4) a financing statement must be filed. U.C.C. §§ 9-204, -302(1) (1962 version). For variations, not applied in this case, of the above requirements, see Henson, *"Proceeds" Under the Uniform Commercial Code*, 65 COLUM. L. REV. 232, 235 nn.11-13 (1965).

2. Bankruptcy Act, 11 U.S.C. §§ 1-1255 (1970).

> Chapter XI [of the Act, 11 U.S.C. §§ 701-99 (1970),] . . . provides for the proposal of an arrangement for the settlement, satisfaction, or extension of time of payment of unsecured debts. The petition under that chapter does not seek an adjudication, although such may ultimately be entered, and a liquidation and distribution of the debtor's property is not [normally] contemplated during the administration of a case under Chapter XI.

8 COLLIER ON BANKRUPTCY ¶ 1.02, at 5-6 (14th ed. J. Moore & J. King 1976).

3. Discussion herein will be limited (as was that of the Ninth Circuit) to U.C.C. § 9-306 (1962 version), rather than to the Arizona statute adopting this section of the U.C.C. (ARIZ. REV. STAT. § 44-3127 (1967). In addition, use will be made of the text of U.C.C. § 9-306 prior to the 1972 amendments thereof, since Arizona did not adopt the 1972 amendments until 1975 (effective January 1, 1976), a date long after this litigation was instituted. The Ninth Circuit correctly observed that even if applicable, the 1972 amendments did not affect the issues of the case.

In pertinent part, U.C.C. § 9-306 (1962 version) provides:

> (1) "Proceeds" includes whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of. The term also includes the account arising when the right to payment is earned under a contract right. Money, checks and the like are "cash proceeds". All other proceeds are "non-cash proceeds".

receiver in bankruptcy[4] appealed to the federal district court, which affirmed the order.[5]

The United States Court of Appeals for the Ninth Circuit agreed to referee what it recognized as the long anticipated and much debated[6] potential conflict between the "proceeds" provi-

---

(2) Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof by the debtor unless his action was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

(3) The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a perfected security interest and becomes unperfected ten days after receipt of the proceeds by the debtor unless

(a) a filed financing statement covering the original collateral also covers proceeds; or

(b) the security interest in the proceeds is perfected before the expiration of the ten day period.

(4) In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest

(a) in identifiable non-cash proceeds;

(b) in identifiable cash proceeds in the form of money which is not commingled with other money or deposited in a bank account prior to the insolvency proceedings;

(c) in identifiable cash proceeds in the form of checks and the like which are not deposited in a bank account prior to the insolvency proceedings; and

(d) in all cash and bank accounts of the debtor if other cash proceeds have been commingled or deposited in a bank account, but the perfected security interest under this paragraph (d) is

(i) subject to any right of set-off; and

(ii) limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings and commingled or deposited in a bank account prior to the insolvency proceedings less the amount of cash proceeds received by the debtor and paid over to the secured party during the ten day period.

4. It is immaterial to the issues of this case that the official appointee in bankruptcy is a receiver, rather than a trustee. 8 COLLIER ON BANKRUPTCY ¶ 6.15 (14th ed. J. Moore & J. King 1976). Professor MacLachlan has indicated that "[o]n principle it is clear enough that all transfers avoidable by a trustee in bankruptcy should be avoidable in Chapter XI proceedings, whether the estate is administered by a trustee, a receiver, or a debtor in possession." J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 342 (1956). To conform with the terminology of other provisions of the Bankruptcy Act, the text will hereinafter refer to the receiver in the instant case as a "trustee."

5. Arizona Wholesale Supply Co. v. Itule (*In re* Gibson Products), No. 1388 (D. Ariz. Oct. 24, 1975).

6. *See, e.g.*, 4A COLLIER ON BANKRUPTCY § 70.62A [4.3] (14th ed. J. Moore & J. King 1976); 2 G. GILMORE, SECURED INTERESTS IN PERSONAL PROPERTY ¶ 45.9 (1965); Countryman, *Code Security Interests in Bankruptcy*, 75 COM. L.J. 269, 275 (1970); Duesenberg, *Lien or*

sion of the Uniform Commercial Code (section 9-306) and the bankruptcy trustee's power to avoid preferences under section 60 of the Bankruptcy Act.[7] In reversing the district court's decision, the Ninth Circuit held that the operation of U.C.C. section 9-306(4)(d) created a voidable preference under section 60 of the Bankruptcy Act by transferring to the creditor a perfected security interest in the cash deposited in the debtor's account[8] that exceeded the amount of proceeds therein obtained from the creditor's collateral.

I. BACKGROUND

A. Development of the Proceeds Provision of the Code

1. Uniform Trust Receipts Act[9]

The progenitor of U.C.C. section 9-306(4) was section 10(b) of the Uniform Trust Receipts Act (U.T.R.A.).[10] In effect, that provision directed that a secured creditor was entitled to "priority" over unsecured creditors in payment from the debtor's assets in an amount equal to all proceeds (whether or not identifiable)

Priority Under Section 10, Uniform Trust Receipts Act, 2 B.C. INDUS. & COM. L. REV. 73, 78, 83-84 (1960); Epstein, *"Proceeding" Under the Uniform Commercial Code*, 30 OHIO ST. L.J. 787, 803-08 (1969); Gillombardo, *The Treatment of Uniform Commercial Code Proceeds in Bankruptcy: A Proposed Redraft of Section 9-306*, 38 U. CIN. L. REV. 1, 28-29 (1969); Hawkland, *The Proposed Amendments to Article 9 of the UCC, Part II: Proceeds*, 77 COM. L.J. 12, 18-19 (1972); Henson, *"Proceeds" Under the Uniform Commercial Code*, 65 COLUM. L. REV. 232, 248-54 (1965); Kennedy, *The Impact of the Uniform Commercial Code on Insolvency: Article 9*, 67 COM. L.J. 113, 118 (1962); Levy, *Effect of the Uniform Commercial Code Upon Bankruptcy Law and Procedure*, 60 COM. L.J. 9, 12 (1955); Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 716-17 (1967) [hereinafter cited as Marsh, *Triumph*]; Schwartz, *The Effect of the Uniform Commercial Code on Secured Financing Transactions and Bankruptcy*, 38 ST. JOHN'S L. REV. 50, 60-68 (1963); Comment, *The Commercial Code and the Bankruptcy Act; Potential Conflicts*, 53 NW. U.L. REV. 411, 412-18 (1958); Comment, *Toward Commercial Reasonableness: An Examination of Some of the Conflicts Between Article 9 of the Uniform Commercial Code and the Bankruptcy Act*, 19 SYRACUSE L. REV. 939, 941-52 (1968) [hereinafter cited as *Commercial Reasonableness*]; Marsh, Book Review, 13 U.C.L.A. L. REV. 898, 908-09 (1966).

7. 11 U.S.C. § 96 (1970).

8. U.C.C. § 9-306(4)(d)(iii) limits the perfected security interest in the cash and bank accounts of the debtor where commingling has occurred to the "cash proceeds received [and commingled] . . . within ten days before the institution of the insolvency proceedings . . . ."

9. Although the Uniform Trust Receipts Act (U.T.R.A.) was drafted in the 1920's, *see* 2 G. GILMORE, SECURED INTERESTS IN PERSONAL PROPERTY ¶ 27.2 (1965), it was not officially promulgated until 1933. *See General Comment of National Conference of Commissioners on Uniform State Laws and the American Law Institute*, UNIFORM COMMERCIAL CODE: 1972 OFFICIAL TEXT WITH COMMENTS *ix-x* (1972). The U.T.R.A., as a model act, was specifically repealed by U.C.C. § 10-102 (1962 version) and replaced by the U.C.C.

10. 2 G. GILMORE, *supra* note 6, at 1340-41.

collected by the debtor within ten days prior to either the initiation of insolvency or bankruptcy proceedings or a demand on the debtor for prompt accounting.[11] The use of the word "priority" in section 10(b) triggered an amendment in 1938 to the Bankruptcy Act whereby state-created priorities were to be held invalid in federal bankruptcy proceedings.[12] State-created *statutory liens*, however, remained valid in bankruptcy.[13] Therefore, the issue of whether an interest created by U.T.R.A. section 10(b) would endure in bankruptcy turned on whether the section created, in fact, a priority or a lien.

Only two major cases involving the survival of the U.T.R.A. section 10(b) "priority" interest in bankruptcy were ever litigated.[14] In the first case, *In re Harpeth Motors, Inc.*,[15] a federal

---

11. U.T.R.A. § 10(b) stated:

> Where, under the terms of the trust receipt transaction, the trustee has no liberty of sale or other disposition, or having liberty of sale or other disposition, is to account to the entruster for the proceeds of any disposition of the goods, documents or instruments, the entruster shall be entitled, to the extent to which and as against all classes of persons as to whom his security interest was valid at the time of disposition by the trustee, as follows:
>
> . . . .
>
> (b) to any proceeds or the value of any proceeds (whether such proceeds are identifiable or not) of the goods, documents or instruments, if said proceeds were received by the trustee within ten days prior to either application for appointment of a receiver of the trustee, or the filing of a petition in bankruptcy or judicial insolvency proceedings by or against the trustee, or demand made by the entruster for prompt accounting; and to a priority to the amount of such proceeds or value . . . .

(Quoted in Henson, *supra* note 6, at 243-44.)

12. Bankruptcy Act § 64, 52 Stat. 874 (1938), *as amended*, 11 U.S.C. § 104 (1970). The Bankruptcy Act does not expressly eliminate state priorities; however, such is a necessary result since the five-tiered scheme of distribution as set forth in § 64 of the Act is exclusive. *See, e.g.*, Epstein, *supra* note 6, at 797 n.39, *citing* Halpert v. Indus. Comm'r, 147 F.2d 375 (2d Cir. 1945). (Section 64d of the Act does, however, allow certain state-created priorities in favor of landlords' rent claims to survive in bankruptcy.)

13. J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 212 (1956). In 1966, § 67c(1)(A) was added to the Bankruptcy Act, 11 U.S.C. § 107(c)(1)(A) (1970). The section invalidates

> every *statutory lien* which first becomes effective upon the insolvency of the debtor, or upon distribution or liquidation of his property, or upon execution against his property levied at the instance of one other than the lienor.

(emphasis added) *See generally* Kennedy, *The Bankruptcy Amendments of 1966*, 1 GA. L. REV. 149 (1967).

14. Other cases have specifically avoided the issue of priority versus lien, *e.g.*, English v. Universal CIT Credit Corp., 278 F.2d 750 (5th Cir. 1960). *See also* Henson, *supra* note 6, at 244-45.

15. 135 F. Supp. 863 (M.D. Tenn. 1955). In this case the creditor held a series of trust receipts, each covering a separate automobile. Before the institution of bankruptcy pro-

district court concluded that despite the actual use of the word "priority" in section 10(b), the intent of the U.T.R.A. was to create a lien. The court found, therefore, that a lien was created and that it was valid against the trustee in bankruptcy.[16] Four years later, in *Commercial Credit Corp. v. Allen (In re Crosstown Motors, Inc.)*,[17] the Seventh Circuit, basing its opinion principally on legislative history and use of the word "priority,"[18] took a contrary view and ruled that U.T.R.A. section 10(b) was ineffective in bankruptcy, in that the interest section 10(b) attempted to produce was a state-created priority and, as such, was invalid under section 64 of the Bankruptcy Act.[19]

2. *Adoption of and changes in the U.C.C.*

Thereafter, the U.C.C. was revised in an apparent attempt to avoid the attacks leveled on U.T.R.A. section 10(b) that had resulted in a decisive split in judicial authority. To accomplish this as well as carry out, if possible, the manifest intent of U.T.R.A. section 10(b), U.C.C. section 9-306(4) was adopted, which, among other changes,[20] substituted the phrase "security interest" for "priority." Moreover, subsection (d) of U.C.C. section 9-306(4) gave a secured creditor, subject to any right of setoff, a perfected security interest in the *entire* cash amount received and commingled with proceeds from the secured property within ten days of insolvency proceedings.[21] The purpose behind this

---

ceedings, the trustee-dealer commingled the proceeds from the sale of the automobiles with other assets. The creditor filed a petition to the bankruptcy court asserting a lien upon the amount of the proceeds from the sale. *Id.* at 864-65.

16. Commentators generally have agreed with the court's reasoning. Hanna, *The Secured Creditor in Bankruptcy*, 14 RUTGERS L. REV. 471, 488-89 (1960); Note, 34 CHI.-KENT L. REV. 294 (1955); Note, 69 HARV. L. REV. 1343-45 (1956); Note, 66 YALE L.J. 922-23 (1957). *Contra*, Comment, *Bankruptcy—Uniform Trust Receipts Act Section 10(b)—Security Interest in the General Assets of the Trustee not Created*, 35 N.Y.U.L. REV. 948-49 (1960) [hereinafter cited as *Bankruptcy*].

17. 272 F.2d 224 (7th Cir. 1959), *cert. denied*, 363 U.S. 811 (1960). Here, the creditor entered into a financing agreement under which automobiles were sold to the bankrupt auto dealer. When the creditor discovered that the dealer had sold a number of cars out of trust and its subsequent demands for payment were unproductive, it filed a petition for a prior lien on the general assets of the bankrupt based on the Illinois statute adopting U.T.R.A. § 10(b).

18. *Id.* at 226.

19. Commentators have generally rejected the Seventh Circuit's reasoning. *See, e.g.*, 2 G. GILMORE, *supra* note 6, at 1342-43; Henson, *supra* note 6, at 244-46. *Contra*, *Bankruptcy*, note 16 *supra;* Note, 58 MICH. L. REV. 783-86 (1960).

20. *See* 2 G. GILMORE, *supra* note 6, at 1341-42.

21. For complete text of U.C.C. § 9-306(4)(d), see note 3 *supra*. Whereas the 1962 version of subsection (d) allows a creditor access to *"all* cash and bank accounts of the debtor" if the creditor's proceeds have been commingled in *any* of the accounts, the 1972

provision was to eliminate the expense and burden on secured creditors of tracing proceeds when funds became commingled and, in return, to limit the reach of such creditors to the amount received within the prescribed ten-day period.[22]

Prior to the instant case, the validity in bankruptcy of the perfected security interest conferred under U.C.C. section 9-306(4)(d) had never squarely been adjudicated.[23] In 1974, in *Fitzpatrick v. Philco Finance Corp.*,[24] a trustee in bankruptcy sought to recover from a secured creditor, Philco, payments made by the bankrupt to Philco during the ten-day period prior to the filing of the debtor's bankruptcy petition. The payments, in amount, were in excess of proceeds traceable to Philco's collateral received by the debtor during the same period. The Seventh Circuit avoided the impending confrontation between U.C.C. section 9-306(4)(d) and section 60 of the Bankruptcy Act by ruling solely within its interpretation of the provisions of the U.C.C. The court concluded that the phrase "any cash proceeds" employed in section 9-306(4)(d)(ii) did not refer to all receipts from any source commingled or deposited in the bank account, but rather referred to "cash proceeds," as defined in section 9-306(1). Therefore, the phrase meant "cash proceeds from the sale of collateral in which the creditor had a security interest;"[25] hence, Philco had no right to the excess proceeds. Accordingly, the overage payment was voidable as a preference and was to be surrendered to the trustee in bankruptcy.

B. Preference Provisions of the Bankruptcy Act

Under common law, in general, a debtor may by payment or other transfer lawfully prefer any one or more of its creditors over other creditors, so long as the object of the transaction is to pay or secure payment of a debt.[26] When such a transfer is related to

---

version limits access to "all cash and deposit accounts of the debtor *in which proceeds have been commingled* with other funds . . . ." (emphasis added)

22. *See, e.g.*, 2 G. GILMORE, *supra* note 6, at 1340-41; *In re* Gibson, 6 UCC REP. SERV. 1193 (W.D. Okla. 1969).

23. *See, e.g.*, 2 G. GILMORE, *supra* note 6, at 1344 n.9 (no cases before 1965); Epstein, *supra* note 6, at 807 (no cases before 1966); Fitzpatrick v. Philco Fin. Corp., 491 F.2d 1288 (7th Cir. 1974) (discussed in text accompanying notes 24 and 25 *infra*) (court's opinion implies no cases on point before 1974).

A number of cases have avoided the issue by the parties' reserving the right to proceed at a future time as to whether U.C.C. § 9-306(4)(d) was in conflict with the Bankruptcy Act. *See, e.g., In re* Security Aluminum Co., 9 UCC REP. SERV. 47 (E.D. Mich. 1971).

24. 491 F.2d 1288 (7th Cir. 1974).

25. *Id.* at 1291-92.

26. Johnson-Baillie Shoe Co. v. Bardsley, 237 F. 763 (8th Cir. 1916).

a subsequent bankruptcy, however, it likely will violate prohibitory sections of the Bankruptcy Act.[27]

Under subsections a and b of section 60 of the Bankruptcy Act certain "transfers" are deemed to be preferential and the trustee in bankruptcy is authorized to avoid the same.[28] Eight elements must coexist before a secured transaction may be set aside as a preference. The transaction must be (1) a transfer (2) of the debtor's property (3) to or for the benefit of a creditor (4) made by the debtor while insolvent (5) within four months of bankruptcy (6) on account of an antecedent debt (7) with the effect of enabling the creditor to obtain a greater percentage of its debt than some other creditor of the same class. In addition, it must be shown that (8) the creditor had reasonable cause to believe that the debtor was insolvent when the transfer was made.[29]

Since the adoption of the Bankruptcy Act in 1898, this provision has continually given significant protection to the interests of unsecured creditors (represented by the trustee) from the depletion effect such unchecked transfers would have on the bankrupt's estate.[30]

II. ARIZONA WHOLESALE SUPPLY CO. V. ITULE (IN RE GIBSON PRODUCTS)

In considering the instant case, the Ninth Circuit rejected the Seventh Circuit's reasoning in its *Fitzpatrick* decision as impermissibly bending the language and structure of section 9-306(4). The court determined to leave that section undisturbed as drafted and to apply directly, for the first time, section 60 of the Bankruptcy Act to resolve the apparent conflict.

---

27. *Id.* For provisions of the Bankruptcy Act, in addition to § 60 of the Act, that may render transfers made prior to bankruptcy invalid or voidable, see text accompanying notes 46 and 47 *infra.*

28. 11 U.S.C. § 96(a), (b) (1970).

29. *Id. See also* Henson, *supra* note 6, at 248. For a discussion of the requirement that the creditor have had reasonable cause to believe that the debtor was insolvent at the time of the transfer, see notes 36 and 37 and accompanying text *infra.*

30. Professor MacLachlan has stated:

> The law of preferences is the most significant contribution of bankruptcy to commercial law, not merely because it promotes equitable distribution in bankruptcy, but also because it weakens incentives to profit from a race of diligence and promotes sound credit practices.

J. MACLACHLAN, *supra* note 4, § 247, at 283. The original text of Bankruptcy Act § 60, 30 Stat. 562 (1898), has been amended six times: 32 Stat. 799 (1903), 36 Stat. 842 (1910), 44 Stat. 666 (1926), 52 Stat. 869 (1938), 64 Stat. 24 (1950) and 77 Stat. 14 (1963).

Referring to section 60a of the Act, the court asserted that if "a transfer . . . within four months before the filing [of bankruptcy]"[31] had occurred, all the requirements thereunder would be met to allow the trustee to avoid as a preference the interest in excess proceeds created by U.C.C. section 9-306(4)(d). Noting its own language in a previous opinion, the court observed that a " '[t]ransfer' . . . is . . . equated with the act by which priority over later creditors is achieved and not with the event which attaches the security interest to a specific account."[32] The court concluded that the act that gave Wholesale priority over other creditors in the excess proceeds was the institution of insolvency proceedings and not the filing of the financing statement, which covered only the creditor's collateral and the proceeds received therefrom. Thus, there *was* a transfer within the meaning of the Bankruptcy Act, and even though Wholesale had a perfected security interest under section 9-306(4)(d) in the entire bank account, the trustee could avoid as a preference all amounts in excess of Wholesale's cash proceeds included in the account.

III. Analysis

A. *Effect of* Gibson

In *Gibson,* a secured creditor's right under U.C.C. section 9-306(4)(d) to a perfected security interest in a debtor's entire commingled bank account[33] met its first clear judicial test in bankruptcy—and it failed.[34] What the Ninth Circuit gave in upholding the section 9-306(4) perfected security interest as prima facie valid, it felt constrained to take away by acknowledging an exception under section 60 of the Bankruptcy Act. In effect, the court merely conceded to the creditor the same rights it had in pre-U.C.C. and pre-U.T.R.A. periods—the right in bankruptcy to

31. Bankruptcy Act § 60a(1), 11 U.S.C. 96(a)(1) (1970).

32. DuBay v. Williams, 417 F.2d 1277, 1287 (9th Cir. 1969). The court also observed the applicability of Bankruptcy Act § 60a(2), 11 U.S.C. § 96(a)(2) (1970), which provides in pertinent part:

> For the purposes of . . . [§§ 60a & b], a transfer of property . . . shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee.

33. The debtor's claim on the entire account is subject to the limitations imposed by subparagraphs (i) and (ii) of U.C.C. § 9-306(4)(d).

34. "It is often said that the acid test of a security interest is in the debtor's bankruptcy." R. Henson, Secured Transactions Under the Uniform Commercial Code 156 (1973).

claim its own identifiable proceeds, commingled or otherwise.[35]

Thus, if the trustee in bankruptcy asserts that the creditor had reasonable cause to know of the debtor's insolvency at the time of the transfer,[36] and is able to prove that assertion,[37] the instant case effectively renders impotent the perfected security interest in excess proceeds created and sustained by U.T.R.A. section 10(b) and U.C.C. section 9-306(4)(d) for over forty-three years.[38]

B. Examination of the Court's Reasoning

1. Application of section 60 to resolve the conflict

The crucial factor in considering the applicability of section 60 in resolving the statutory conflict is the determination of the time of transfer: only transfers made within four months of bankruptcy are voidable under section 60 of the Act by the trustee in bankruptcy.[39] Several notable scholars have advanced the argument that there is no transfer for purposes of section 60 at the time of the institution of insolvency proceedings.[40] Moreover,

---

35. *See, e.g.*, Gillombardo, *supra* note 6, at 30-31. Comment 2(a) to U.C.C. § 9-306 (1962 version) states in pertinent part:

> Whether a debtor's sale of collateral was authorized or unauthorized, prior law generally gave the secured party a claim to the proceeds. . . . Whatever the formulation of the rule, the secured party, if he could trace the proceeds, could reclaim them . . . from the debtor or his trustee in bankruptcy.

36. This requirement is imposed by § 60b of the Bankruptcy Act. *See* text accompanying note 29 *supra*. Whether the creditor had reasonable cause to believe that the debtor was insolvent at the time of the transfer is a question of fact. If substantial evidence is produced indicating facts and circumstances at the time of transfer that would cause an ordinarily prudent businessman in the creditor's position to conclude that insolvency existed, it is strictly a question for the jury and not for the court. Actual knowledge by the creditor is not required; it is sufficient to show circumstances that would have put a person of ordinary prudence and discretion on notice. 1 BANKR. L. REP. (CCH) ¶ 5562.01 (numerous cases cited).

37. Usually when the trustee in bankruptcy seeks to avoid transfers as preferential under § 60b of the Act, the trustee is in the position of plaintiff—thus clearly having the burden of proof. *See generally* 1 BANKR. L. REP. (CCH) ¶ 5562.04. The circumstances surrounding the interest in excess proceeds under U.C.C. § 9-306(4)(d), however, often force a reversal in the identity of the parties. Many times, as in the instant case, it is the creditor who is seeking to obtain its § 9-306(4) interest from the trustee who is in "possession" of the debtor's bank account. Nevertheless, it seems logical that the burden of proof with regard to § 60b of the Act be required to remain with the defendant trustee.

38. *See* note 9 *supra*.

39. Bankruptcy Act § 60a(1), b, 11 U.S.C. § 96(a)(1), (b) (1970).

40. *See, e.g.*, 2 G. GILMORE, note 6 *supra*; Henson, *supra* note 6, at 248-52. It should be noted that Professor Gilmore was one of the two principal draftsmen of the original version (1952) of Article 9 of the U.C.C. as well as a participant in subsequent revisions. Marsh, Book Review, 13 U.C.L.A. L. REV. 898, 899 (1966).

there is no transfer after the original secured transaction has been perfected. This argument is based on the concept that the original collateral, identifiable proceeds therefrom, and section 9-306(4)(d) unidentifiable proceeds continue through time as a unit, or "entity." The "transfer" of this entity, they assert, occurs when the perfected security interest attaches to the original components (collateral) of the entity.[41] Therefore, the time of transfer of a perfected security interest in excess proceeds under U.C.C. section 9-306(4)(d) is the same as, and relates back to, the time when perfection of a security interest in the original collateral was achieved.[42] Because under this theory the "transfer" would occur at a much earlier date, a substantially greater percentage of section 9-306(4)(d) security interests would survive bankruptcy, since they would fall outside the four-month limitation.

The entity concept fails to appreciate the fact that a secured creditor's perfected interest under U.C.C. section 9-306(4)(d) in proceeds other than those from the sale of the creditor's secured property arises only upon the institution of insolvency proceedings. Prior to that moment, there is no security interest in either the "excess" proceeds or any property from which "excess" proceeds may be derived.[43] Furthermore, the theories of "automatic perfection" and "substituted collateral"[44] lend no support to the

41. This "unit" or "entity" concept has most often been advanced in the related but distinct area of the conflict between § 60 of the Bankruptcy Act and the "after-acquired" provision of the Code (U.C.C. § 9-204). *See, e.g.*, Epstein, *supra* note 6, at 804-06; Henson, *supra* note 6, at 248-52; Kennedy, *The Impact of the Uniform Commercial Code on Isolvency: Article 9*, 67 COM. L.J. 113, 118-19 (1962). *See also Commercial Reasonableness, supra* note 6, at 942-48. For a discussion of the relationship of the after-acquired Code provisions to § 60 of the Bankruptcy Act, see Friedman, *The Bankruptcy Preference Challenge to After-Acquired Property Clauses Under the Code*, 108 U. PA. L. REV. 194 (1959).

42. Henson, *supra* note 6, at 248-52.

43. With regard to "excess" proceeds, the position of a creditor prior to insolvency proceedings (and hence, prior to any claim under U.C.C. § 9-306(4)(d)) is that of a general, unsecured creditor. Thereafter, upon perfection of a security interest in "excess" proceeds under § 9-306(4)(d), the seventh requirement of Bankruptcy Act §§ 60a, b, *see* text accompanying note 29 *supra*, is satisfied in that the transfer has the effect of enabling the creditor to obtain a greater percentage of its debt than some other creditors of the same class. For a discussion of "class," see Comment, *"Class"—the Forgotten Element of Section 60(a)(1) of the Bankruptcy Act*, 11 ARIZ. L. REV. 360 (1969).

44. The theory of "automatic perfection" advances the argument that a security interest in future (after-acquired) property is perfected from the inception of the security agreement, *see* note 1 *supra*, without any further act or agreement on the part of the debtor. Thus, a security interest automatically is perfected in and attaches to any property within the contemplation of the agreement from the time the debtor acquires rights in such property. For a discussion of this concept, see *Commercial Reasonableness, supra* note 6, at 944-46. *See also* Friedman, *supra* note 41, at 207-14.

The "substituted collateral" theory is based on the concept that a creditor, upon

concept of having the time of transfer of the security interest in *excess* proceeds relate back to the time of perfecting the original collateral. In other words, since a section 9-306(4)(d) secured creditor has no right to the excess proceeds until the institution of insolvency proceedings, no "transfer" can possibly occur before that time. The Ninth Circuit recognized this fundamental distinction and, as a result, correctly applied the bankruptcy statute.[45]

Other commentators have suggested that even though section 9-306(4)(d) might escape the strictures of the preference provisions in bankruptcy, it would still be fatally vulnerable to at least one of several other sections of the Bankruptcy Act.[46] On the other hand, there also exists substantial authority supportive of the proposition that section 9-306(4)(d) cannot be held to submit to any of the Bankruptcy Act provisions.[47] In any event, it is

---

obtaining a perfected security interest in specified collateral, acquires a perfected security interest in any collateral ("proceeds" or otherwise) derived from the sale or exchange of the original collateral. Moreover, the time of perfection of the "substituted" collateral relates back to the time of perfecting the security interest in the original collateral. For a discussion of this concept, see Epstein, *supra* note 6, at 804-07; Henson, *supra* note 6, at 236-39; Kennedy, *The Impact of the Uniform Commercial Code on Insolvency: Article 9*, 67 COM. L.J. 113, 120 (1962); *Commercial Reasonableness, supra* note 6, at 947-48.

45. Several notable commentators have sustained reasoning similar to that employed by the court. *See, e.g.*, 4A COLLIER ON BANKRUPTCY § 70.62A [4.3], at 710 (14th ed. J. Moore & J. King 1976); Countryman, *supra* note 6, at 275; Duesenberg, *supra* note 6, at 78-79; Epstein, *supra* note 6, at 804-06. *See also Commercial Reasonableness, supra* note 6, at 944-48.

46. For authority indicating an invalid state-created priority under Bankruptcy Act § 64, 11 U.S.C. § 104 (1970), see Coogan & Vagts, *The Secured Creditor and the Bankruptcy Act: An Introduction*, in 1 P. COOGAN, W. HOGAN & D. VAGTS, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 9.03[3][b][iii] (1968); Gillombardo, *supra* note 6, at 28-29; Kennedy, *The Trustee in Bankruptcy Under the Uniform Commercial Code: Some Problems Suggested by Articles 2 and 9*, 14 RUTGERS L. REV. 518, 532-34 (1960). *See also* Elliott v. Bumb, 356 F.2d 749, 754-55 (9th Cir. 1966), *cert. denied*, 385 U.S. 829 (1966); Commercial Credit Corp. v. Allen (*In re* Crosstown Motors, Inc.), 272 F.2d 224 (7th Cir. 1959), *cert. denied*, 363 U.S. 811 (1960).

For authority indicating an invalid statutory lien under § 67c of the Act, 11 U.S.C. § 107(c) (1970), see Countryman, *supra* note 6, at 274; Gillombardo, *supra* note 6, at 29; Kennedy, *supra* at 532-33; Marsh, *Triumph, supra* note 6, at 715-16; Viles, *Uniform Commercial Code v. The Bankruptcy Act*, 55 KY. L.J. 636, 678 n.143 (1967).

For authority indicating invalidity under § 70c of the Act, 11 U.S.C. § 110(c) (1970), see 4A COLLIER ON BANKRUPTCY § 70.62A [4.3], at 710 (14th ed. J. Moore & J. King 1976); Kennedy, *supra* at 532-33; Marsh, *Triumph, supra* note 6, at 716; *Commercial Reasonableness, supra* note 6, at 954-55.

For authority suggesting susceptibility to § 70e of the Act, 11 U.S.C. § 110(e) (1970), see Gillombardo, *supra* note 6, at 28; Viles, *supra* at 644-49.

47. For authority indicating validity under Bankruptcy Act § 64, see 2 G. GILMORE, *supra* note 6, at 1337-40, 1342-44; Hawkland, *supra* note 6, at 18; Henson, *supra* note 6, at 244-46, 251-52. *See also In re* Harpeth Motors, Inc., 135 F. Supp. 863 (M.D. Tenn. 1955).

For authority indicating no statutory lien under § 67c of the Act, see Epstein, *supra*

sufficient to observe that even had the Ninth Circuit construed U.C.C. section 9-306(4)(d) as not creating a voidable preference under section 60, the court may have found adequate foundation to reach the same ultimate result as it did in the instant case, either by holding the Code section explicitly invalid under the Bankruptcy Act or by rendering it grossly emasculated.

2. The interplay within section 9-306(4)

After setting forth its position that a creditor could not successfully assert its claim under U.C.C. section 9-306(4)(d) to thwart the trustee's power to set that interest aside as a preference, the court hastened to add that it did not necessarily follow that a creditor would also lose that portion of the secured interest representing its own proceeds. Rather, to the extent the creditor is able to identify its own proceeds by tracing, it will be able to defeat pro tanto the trustee's assertion of a preference. In so ruling, but without specifically commenting thereon, the court struck down the result of a literal reading of the subsections within section 9-306(4).

Although upon the institution of insolvency proceedings subsection (d) affords a secured creditor a potentially larger perfected interest than theretofore enjoyed (i.e. in proceeds not derived from the creditor's collateral), subsections (b) and (c) cut in the opposite direction. Under a literal reading, the creditor, for whatever benefit may be derived from subsection (d), gives up, under subsections (b) and (c), its claim, previously recognized under sections 9-306(2) and (3), to all *identifiable* cash proceeds *commingled* prior to the insolvency proceedings. Thus, it could logically be argued in the instant case that even though the benefit derived under subsection (d) is effectively canceled by the operation of section 60 of the Bankruptcy Act, such an event has no bearing on the revival of the right to identifiable but commingled proceeds forfeited under subsections (b) and (c).[48] Therefore, the secured creditor's only hope for revival of its secured interest in identifiable proceeds under sections 9-306(2) and (3) would appear to rest on the court's determination that subsections (b),

---

note 6, at 799-801; Hawkland, *supra* note 6, at 18; Henson, *supra* note 6, at 247.

For authority suggesting no vulnerability to § 70c of the Act, see 2 G. GILMORE, *supra* note 6, at 1336; Hawkland, *supra* note 6, at 18; Henson, *supra* note 6, at 247. *See also In re* United Thrift Stores, Inc., 242 F. Supp. 714 (D.N.J. 1965).

For authority indicating validity under § 70e of the Act, see 2 G. GILMORE, *supra* note 6, at 1336; Hawkland, *supra* note 6, at 18; Henson, *supra* note 6, at 247.

48. *See* note 3 *supra* for complete text.

(c), and (d) are not severable; that is, if subsection (d) effectively falls, so must subsections (b) and (c).[49] Although the history behind section 9-306(4) tends to indicate an intent to consider the section as a whole, the court is still confronted with the awkward problem of explaining away the rule dictated by U.C.C. section 1-108,[50] requiring severability unless effect cannot be given to the remaining provisions without reference to those invalidated. Assuming the Ninth Circuit recognized this interplay, as did the Seventh Circuit in *Fitzpatrick*,[51] it should have explicitly dealt with the issue and thereby laid clear precedent for future cases.[52]

C. *Potential Relief Still Available Under* Gibson

The ultimate result in *Gibson* turned on whether there had been "a transfer [within the meaning of section 60a(2) of the Bankruptcy Act] . . . within four months before the filing . . . [of bankruptcy]."[53] However, the catalytic event under U.C.C. section 9-306(4) for securing a perfected interest in "excess" proceeds is the institution of "insolvency proceedings."[54] " 'Insolvency proceedings,' " defined at U.C.C. section 1-201(22), "includes any assignment for the benefit of creditors or other proceedings intended to liquidate or rehabilitate the estate of the person involved." Very conceivably such an event could take place (inadvertently or after careful planning) more than four months prior to the actual filing of a petition in bankruptcy. In such circumstances, and by implication from the instant case, the secured creditor would obtain a perfected security interest in all

---

49. *Cf.* Countryman, *supra* note 6, at 274-75 (advancing this same rationale when discussing the vulnerability of U.C.C. § 9-306(4)(d) to Bankruptcy Act §§ 64, 67c and 70c).

50. U.C.C. § 1-108 provides:

> If any provision or clause of this Act or application thereof to any person or circumstances is held invalid [or ineffectual], such invalidity shall not affect other provisions or applications of the Act which can be given effect without the invalid provision or application, and to this end the provisions of the Act are declared to be severable.

51. The court stated, in footnote, "In view of the extensive speculation about the potential conflict between section 9-306(4)(d) and the Bankruptcy Act, it is somewhat surprising that the trustee did not challenge Philco's right to the . . . [identifiable proceeds] paid from commingled funds." 491 F.2d at 1292 n.4.

52. In *Gibson*, the amount in question was admittedly small ($10); however, in most cases such would obviously not be the circumstance. For example, in *Fitzpatrick*, although the issue was not pleaded and, therefore, not ruled upon, in question would have been $4513.44, which represented more than 10 percent of the subject bank account. 491 F.2d at 1292. The loss of such an amount to many secured creditors would represent all that had been gained from the profit margin on thousands of dollars of other sales.

53. Bankruptcy Act § 60a(1), 11 U.S.C. § 96(a)(1) (1970).

54. For complete text of U.C.C. § 9-306(4), see note 3 *supra*.

the debtor's commingled funds, valid even against a trustee in bankruptcy. Even if such a strategy were employed at some future time, however, the perfected interest would possibly remain susceptible to defeat when confronted by the other statutory weapons within the arsenal of the Bankruptcy Act.[55]

D. The Countermove—An Amendment to the U.C.C.?

Over the past several years, specific amendments to U.C.C. section 9-306(4) have been proposed[56] to deal with the then potential conflict at issue in the instant case. Characteristic of each proposed amendment, however, has been either the retention of language that would inevitably lead to a U.C.C.-Bankruptcy Act court confrontation[57] or the elimination of the controversial interest granted under section 9-306(4)(d) and a retreat to the pre-Code rules of tracing.[58]

In light of the instant holding and the extensive authority the Bankruptcy Act itself commands under the supremacy of federal law,[59] any further amendment to the U.C.C. with the view of somehow sustaining, even in bankruptcy, the secured interest contemplated by U.T.R.A. section 10(b) and U.C.C. section 9-306(4)(d), would be futile. Any effective future amendment must necessarily be to the Bankruptcy Act itself.[60]

IV. Conclusion

Except for the previously mentioned potential relief for creditors, the three-fold message emanating from *Gibson* is clear. First, a creditor's right under section 9-306(4)(d) to a perfected security interest in commingled proceeds other than its own is almost entirely ineffective in bankruptcy.[61] Second, for a secured creditor to avoid both the limitations of U.C.C. section 9-

---

55. *See* text accompanying note 46 *supra*.

56. *See, e.g.*, Gillombardo, *supra* note 6, at 30-31; Hawkland, *supra* note 6, at 18-19.

57. Hawkland, *supra* note 6, at 18-19.

58. Gillombardo, *supra* note 6, at 30-31; note 35 *supra*.

59. 4A Collier on Bankruptcy ¶ 70.06, at 81 (14th ed. J. Moore & J. King 1976). *See also* Schwartz, *supra* note 6, at 60, 82-83.

60. *See generally* Schwartz, *supra* note 6, at 60; *Commercial Reasonableness*, *supra* note 6, at 939-41, 957.

61. *See* text accompanying notes 36 and 37 *supra*. It is, of course, possible that more than one creditor asserting a perfected security interest in "excess" proceeds under U.C.C. § 9-306(4)(d) can survive the test imposed by Bankruptcy Act § 60b. In such an event the "excess" proceeds would presumably be distributed pro rata based on the amount of the creditors' residual claims after any identifiable collateral inventory or proceeds therefrom had been recovered.

306(4)(d) and the burden of proving the identity of its own proceeds in light of an almost inevitable contest with the debtor's trustee in bankruptcy, it must prevent commingling of its proceeds, and thus follow U.C.C. section 9-306(4)(a)-(c).[62] Finally, since pragmatically many secured creditors will be unable to enforce on a day-to-day basis the segregation of their own proceeds through financing agreements, their only recourse in the face of the debtor's potential bankruptcy is to police the flow of proceeds to such a degree that they will be most able to specifically trace and identify their own cash proceeds, even after commingling.

62. *See* note 3 *supra*.