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Note: Tracing Cash Proceeds in Insolvency Proceedings under revised article 9

Introduction

In early 1990, the National Conference of Commissioners on Uniform State Laws ("NCCUSL"), the American Law Institute ("ALI") and the Permanent Editorial Board for the Uniform Commercial Code ("PEB") established a committee to study whether Article 9 needed revision. [1] In 1992, the PEB issued its report ("PEB Report"), stating that while Article 9 was conceptually sound, the system of commercial transactions would still benefit from a comprehensive revision. [2] This need for revision was due to the unparalleled growth and modernization in the secured credit markets since the promulgation of the 1972 revisions. [3] The PEB attributes this growth to the many hundreds of decisions applying Article 9, the volumes of commentaries discussing Article 9, as well as a new codification of bankruptcy law. [4] In response to these many changes in commercial and secured transactions, the new proposed Article 9 offers extensive revisions. Many view these changes as largely successful in remedying certain omissions and misinterpretations and adapting the law to the realities of modern commercial and financial transactions.

This note will address those changes which deal with proceeds. More specifically, this note will discuss the effect of insolvency proceedings, both under Current Article 9 and under Revised Article 9, on cash proceeds which have been commingled by the debtor. Current section 9−306(4)(d) provides an overly technical and complicated formula for calculating an interest in cash proceeds in the event of insolvency. This artificial formula was intended to replace the general principles of tracing with a more workable method. Despite this goal, many problems have resulted which have caused some severe and harsh consequences to creditors who believed that they had fully perfected security interests in collateral and their proceeds. To combat these problems and many others, the Revised Article 9 was created. Basically, it deleted the artificial formula and in its place, called for the utilization of equitable tracing principles. One of these equitable tracing principles, the lowest intermediate balance rule ("LIBR"), has become the most prevalent form of tracing commingled funds and is specifically referenced in Revised Article 9. This note will consider whether or not Revised Article 9 handles the problems of current section 9−306(4)(d). It will also provide an analysis of the various common−law tracing rules so as to give secured creditors insight into how courts have and will deal with cash proceeds when a debtor commences insolvency proceedings.

I.Current U.C.C. Section 9−306(4)

A. Section 9−306 in General

Section 9−306 is the current Code section which deals with proceeds and secured creditor's rights on disposition of collateral. [5] Basically, subsections (1), (2) and (3) allow a secured party, in non−insolvency situations, to maintain a perfected security interest in identifiable proceeds and reclaim them if necessary. [6] Outside of bankruptcy, the creditor typically has a claim to all identifiable proceeds, even where they have been commingled with non−proceeds. This provision is not any different from pre−Code law, when a secured party was allowed to reclaim proceeds or their equivalent if he or she could identify them through some form of tracing. [7] While subsections (1), (2) and (3) appear to be clear and unambiguous on their faces, it is subsection (4) which has been the subject of great debate within the legal community.

Section 9−306(4) is a special provision for dealing with proceeds where the debtor is subject to "insolvency proceedings." [8] It is divided into four subsections which cover two broad categories of proceeds. One category

includes proceeds which are identifiable and have not been commingled with any other proceeds, collateral or accounts of the debtor. [9] The second category covers proceeds which have been commingled by the debtor and are thus not immediately identifiable. [10] Within these two broad categories, the Code further differentiates between cash and non−cash proceeds. Without question, causing the greatest amount of controversy is section 9−306(4)(d) because it suggests a technical rule for reaching commingled cash proceeds which is markedly different from the tracing required pre−insolvency. Section 9−306(4) provides:

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 only in the following proceeds:

a. in identifiable non−cash proceeds and in separate deposit accounts containing only proceeds;

b. in identifiable cash proceeds in the form of money which is neither commingled with other money nor deposited in a deposit 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 deposit account prior to the insolvency proceedings; and

d. in all cash and deposit accounts of the debtor, in which proceeds have been commingled with other funds, 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 among of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings less the sum of (I) the payments to the secured party on account of cash proceeds received by the debtor during such period and (II) the cash proceeds received by the debtor during such period to which the secured party is entitled under paragraphs (a) through (c). [11]

A. History and Policies Behind Section 9−306(4)(d)

The overall purpose of section 9−306(4) is to substitute specific rules of identification for general principles of tracing in the event of insolvency proceedings. [12] While similarly intending to substitute specific tracing rules, subdivision (d) has several distinct purposes. The main purpose is to replace the general principles of tracing with new rules of identification when dealing with insolvency proceedings. [13] The second purpose is to eliminate the expense, nuisance and difficulty of tracing funds which have been commingled by the debtor. [14] A third purpose is to limit the secured creditors' interest to the amount of cash proceeds received by the debtor within ten days before the commencement of insolvency proceedings. [15] Basically, section 9−306(4)(d) has the effect of sharply cutting back the secured party's rights when insolvency proceedings are initiated by or against the debtor. [16]

There have been several earlier statutes which have contributed to current section 9−306(4)(d). One major contributor was the Uniform Trust Receipts Act (UTRA). [17] This statute specifically provided that the trustee account to the entruster for the proceeds of any disposition. Additionally, UTRA created a rule which forced the trustee to account for proceeds received within ten days of "bankruptcy or judicial insolvency proceedings," much like the current U.C.C. rule. Another early contributor to the Code was the Restatement (Second) of Trusts section 202. [18] Though the Restatement dealt with the enforcement of constructive trusts and equitable liens when there has been a wrongful disposition by a trustee, several courts and commentators found it easy to analogize deposited proceeds to trust funds. [19] Because the Uniform Commercial Code did not provide a means of identifying cash proceeds, courts applied the equitable tracing rules provided by section 202 to conclude that cash proceeds were identifiable to the extent that they remained in the commingled account. [20] This rule, known today as the LIBR, is the most common equitable tracing rule used by courts throughout the nation and is discussed extensively in Part II.

B. Understanding Section 9−306(4)(d)

In order to fully understand the application of section 9−306(4), it is necessary to analyze the individual terms within the section. Generally speaking, most of the terms within section 9−306 have specific meanings and applications as defined both by the Code and by the many courts which have interpreted them.

The impact of section 9−306(4) is much broader than bankruptcy situations. Insolvency proceedings include "any assignment for the benefit of creditors or other proceedings intended to liquidate or rehabilitate the estate of the person involved." [21] Thus, not only federal bankruptcy, but any state insolvency proceeding will be included within the terms of section 9−306(4). [22] In Maxl Sales Co. v. Critiques, Inc., [23] a Kansas court was called upon to determine whether section 9−306(4)(d) applied in Critiques bankruptcy case. Upon Critiques default of two security agreements, a state receiver conducted a public sale of existing inventory and deposited the funds in an account which contained funds generated from the sale of different inventory. [24] Prior to the establishment of priorities and the distribution of the proceeds from the sale, the debtor filed for bankruptcy. [25] Maxl Sales sought reclamation of the funds and argued that the default provisions of the Code applied rather than the proceeds provision of section 9−306(4)(d). [26] The Court of Appeals rejected this claim and correctly concluded that the institution of bankruptcy proceedings caused the provisions of section 9−306(4)(d) to apply. [27] Thus, Maxl Sales was denied any and all claims to proceeds because it failed to properly show what amounts, if any, were received by the debtor within ten days of bankruptcy.

Once an insolvency proceeding has been instituted, before a secured party can make any claim to proceeds, section 9−306(4) requires that the secured party must have a perfected security interest in proceeds. Acquiring an interest in collateral and/or proceeds is accomplished through a security agreement and by the filing of a financing statement in the appropriate state or county office. [28] To determine if the secured party has a perfected interest in the proceeds, one would analyze the interest under section 9−306(1), (2) or (3). Section (1) defines proceeds to include "whatever is received upon the sale, exchange, collection, or other disposition of collateral or proceeds." [29] The significance of the term is that a security interest generally continues in identifiable proceeds, including cash, notwithstanding the sale, exchange or other disposition of the collateral, as provided by paragraph (2). [30] Section (3) provides for the lapse of a perfected security interest in proceeds unless one of four situations are met. [31] Depending upon the original collateral and security interest granted, one will be able to determine, based on these subsections, whether or not the interest in proceeds remains perfected.

After the secured party has established his or her perfected security interest in the proceeds, two inquiries will determine which paragraph of section 9−306(4) will be used to ascertain whether the perfected security interest will continue in those proceeds. If the proceeds are non−cash, non−bankruptcy rules will govern, thus preventing the application of the technical rules of paragraph (d). [32] If, on the other hand, the proceeds are cash, the applicable paragraph will depend upon whether the proceeds have been commingled. Cash proceeds not commingled or kept in a separate deposit account are undisturbed by the commencement of insolvency proceedings. [33] Thus, similar to non−cash proceeds, the same tracing rules allowed prior to bankruptcy are applicable. Only cash proceeds which have been commingled are subject to the technical tracing rule of section 9−306(4)(d).

A key component of section 9−306(4)(a), (b) and (c) with respect to non−cash and uncommingled cash proceeds is that the proceeds be "identifiable" in order for the security interest to be valid. [34] The U.C.C. does not define "identifiable proceeds." Therefore, courts have been forced to borrow from trust law and utilize the "tracing concept" to fill the gaps left by the U.C.C. [35] These trust principles have been applied throughout Article 9 via section 1−103, which allows for the principles of law and equity to supplement the provisions of the U.C.C. [36] A key issue which arose was whether funds could be identifiable after they have been commingled in the debtor's deposit account. Professor Gilmore saw no merit in applying common law tracing principles to determine whether cash proceeds were still identifiable after commingling. [37] He believed that cash proceeds ceased to be identifiable once they were deposited in a general bank account. [38] Most courts addressing the same issue have disagreed with Professor Gilmore and have concluded that commingling of cash proceeds with other money of the debtor does not automatically cause the proceeds to be unidentifiable. [39] Today, it is clear that where there has been no insolvency proceeding, the commingling of proceeds is not fatal to tracing the security interest. [40]

C. Application of Section 9−306(4)(d) to Commingled Cash Proceeds

Upon the institution of insolvency proceedings and after the secured party has established his or her perfected security interest in the commingled cash proceeds, the technical tracing formula section 9−306(4)(d) applies. [41] It gives the secured creditor a perfected security interest "in all cash and deposit accounts of the debtor in which proceeds have been commingled with other funds," but limits this interest "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." [42] Section

9−306(4)(d) places three further restrictions on the interest, reducing the amount by "the sum of (I) the payments to the secured party on account of cash proceeds received by the debtor during such period and (II) the cash proceeds received by the debtor during such period to which the secured party is entitled under paragraphs (a) through (c)." [43] This interest is also limited by any right of set−off. [44] The application of section 9−306(4)(d) requires four things. First, it is necessary to identify the cash and deposit accounts subject to the secured party's claim. They must contain commingled proceeds or other funds. Second, calculation of the ten−day limit must be performed. Third, calculation of a reduction of the limit to take into account payments received by the secured party during the ten−day period plus cash proceeds received by the debtor to which the secured party is entitled under subsections (a) through (c). Fourth, there must be a determination as to whether a right of setoff makes all or part of the fund unavailable.

At this point, it is extremely important to note that section 9−306(4)(d) only governs a creditor's interest in commingled proceeds up to and including the instant of commencement of insolvency proceedings. [45] This means that a creditor will lose his or her interest in funds which have been commingled prior to the ten−day period. [46] Most courts also agree that section 9−306(4)(d) will not apply to cases in which funds have been commingled after the filing of insolvency proceedings. [47] In In re Hugo, [48] the Michigan court was confronted with this issue when debtor farmer's filed for bankruptcy after defaulting on two mortgages secured by a perfected interest in debtor's crops. After filing, the debtor was given permission to use the proceeds from the sale of the previous years unencumbered crops to operate the business and grow the new crop. [49] When the crop was harvested and sold, the proceeds were deposited into the general operating account of the debtor and commingled with other funds. [50] The court found that the absence of any language in section 9−306(4)(d) suggesting it was intended to apply to post−petition commingling to be significant and therefore the court held it inapplicable. [51]

1. Identification

The absence of a specific identifiability requirement in section 9−306(4)(d) like that of paragraph's (a), (b) and (c) has caused some controversy. An early view as to the meaning of section 9−306(4)(d) was taken by the Ninth Circuit in In re Gibson Products of Arizona. [52] That court found that a secured party's interest in funds was not limited to those funds generated from the sale of its collateral, but extended to the entire commingled account. [53] The court took the position that section 9−306(4)(d) expressly extended a perfected security interest to the entire amount of cash proceeds deposited or received by the debtor within 10 days before bankruptcy. [54] Thus, the creditor's interest was not limited to the amount that was identifiable as proceeds from the creditor's original collateral. Under this construction, the secured creditor had a security interest in funds that are not the secured creditor's proceeds. [55]

Most courts disagree with the In re Gibson Products court and do not give a security interest in the entire amount received or deposited. [56] Rather, these courts interpret the phrase "any cash proceeds received by the debtor" in section 9−306(4)(d)(ii) to limit a secured party's interest to those proceeds actually received or deposited from the disposition of that creditor's own collateral within 10 days of insolvency proceedings. [57] Eldon Reiley also sought to determine what the phrase "any cash proceeds received by the debtor" meant? [58] He found that it was susceptible to three interpretations: 1) all cash proceeds from collateral held by all secured parties; 2) all cash proceeds from collateral held by this secured party whether or not deposited in deposit accounts or commingled in a fund; and 3) all cash proceeds from collateral held by this secured party but only to the extent deposited in the account in question or commingled in the fund in question. [59] Mr. Reiley concluded that the second interpretation made the most sense such that only proceeds from the secured creditor's collateral were referenced. [60] In addition, some courts have interpreted section 9−306(4)(d) with reference to section 9−306(2), which explicitly requires proof that the proceeds be identified as from the disposition of the original collateral, and have concluded that there are identification limitations. [61]

Courts agree with Mr. Reiley and have interpreted the phrase to mean cash proceeds of the secured lender's collateral and not cash proceeds of all receipts by the debtor from any source. [62] Additionally, courts have imposed a burden on the secured party to prove the amount of funds actually received by the debtor within the 10 days before the commencement of insolvency proceedings. [63] Creditors have been required to submit detailed documentary evidence or testimony proving that an account contained only proceeds, or establishing the amount of proceeds the debtor received in the ten days preceding the bankruptcy filing. [64] The debtor may not hide this information from the secured party. If the secured party is unable to prove the actual amount of funds received by the debtor within that 10−day period, the secured party loses any entitlement to the commingled proceeds. [65]

Though the court in In re Gibson Products allowed an interest in the entire commingled account, the court did find that any interest in proceeds in excess of that which could be traced was subject to the trustee's power to avoid as a preference. [66] Since the secured party failed to trace its proceeds, it was denied any right to amounts over and above that which was received from the sale of its collateral. Thus, the outcome was the same as those where the secured party was not awarded an interest in the entire account. Furthermore, since its practically impossible for a secured party to trace proceeds which are not a product of its collateral, it appears the result will almost always be the same. It is merely arrived at in a different manner.

2. Calculation of Ten−day Limit and Reduction

As discussed earlier, an interest in commingled cash proceeds received more than ten days before bankruptcy is destroyed by section 9−306(4)(d). [67] Additionally, the ten−day limit will not apply to cash proceeds commingled after the commencement of insolvency proceedings. [68] The cash proceeds must arise out of the secured creditor's own collateral and be received within that ten−day period before commencement. In order to compute the ten−day period, it is the date that the petition is filed which is considered the commencement date of the insolvency proceeding. [69] In order to appreciate the complexity and harshness of this rule, it is important for the reader to follow through a specific example of how the calculations work.

a.Example 1 [70]

Cris Creditor (CC) had a security interest in all of the Dennis Debtor's (DD) inventory and accounts receivables ("collateral") to secure an indebtedness of $2 million. DD filed for bankruptcy on November 10, 2000. On the petition date, DD had:

(i) a general operating account containing $800,000;

(ii) a separate account opened in order to deposit proceeds of collateral ("collateral account") containing $400,000;

(iii) $50,000 in undeposited checks received in payment of accounts receivable; and

(iv) $20,000 in money.

Of the $800,000 in the operating account, $700,000 would be considered identifiable cash proceeds of the collateral if CC could use tracing rules.

Eight days prior to the filing of the bankruptcy petition, DD received $400,000 in cash proceeds of collateral and paid $50,000 to CC. Of the $200,000 received as of the petition date:

(i) $100,000 of it had been deposited into the collateral account;

(ii) $240,000 of it had been deposited into the operating account;

(iii) $50,000 of it was held by DD in undeposited checks; and

(iv) $10,000 of it was held by DD in money that had been commingled with nonproceed money.

To what extent does CC have a security interest in the proceeds? Two things are clear. CC would have a security interest in the entire $400,000 in the collateral account pursuant to section 9−306(4)(a). That amount was in a separate deposit account set up to receive proceeds of the collateral and only contained proceeds of the collateral. CC also has an interest in the $50,000 in undeposited checks as provided by section 9−306(4)(c). With respect to the commingled cash proceeds, further calculations are necessary.

Pursuant to section 9−306(4)(d), CC's security interest in the $800,000 remaining in the operating account and the $10,000 in commingled cash would of course be subject to set−off. For our purposes, we will assume that no right of

set−off exists. The first step involves calculating the ten−day limit. The maximum amount of any interest CC may have is capped at $400,000, since this is the amount of proceeds received by DD during the ten days prior to the filing. The next step involves calculating any reductions in that $200,000. The $400,000 amount would be reduced by:

1) the amount of proceeds paid to CC during the ten days prior to filing ($100,000);

2) the amount of cash proceeds in the collateral account received by DD during the ten days before bankruptcy, which CC is entitled to received under section 9−306(4)(a) ($100,000);

3) the amount of money received by DD during the ten days before bankruptcy, which CC is entitled to receive under section 9−306(4)(b) ($0); and

4) any undeposited checks received DD during the ten days before bankruptcy, which CC is entitled to receive under section 9−306(4)(c) ($50,000).

This gives CC an interest in $150,000 of the commingled cash proceeds in the operating account and money, for a total amount of $600,000 ($150,000 from commingled cash proceeds + $400,000 from separate deposit account + $50,000 from undeposited checks).

To further demonstrate the harsh results which secured creditors face through the application of section 9−306(4)(d), lets look deeper into the numbers provided by this example. Based on the limitations, CC would have a security interest in only $150,000 of the total $810,000 in commingled cash proceeds contained in the operating account and money. Similarly, out of the total available cash and undeposited checks in the amount of $1,330,000, CC would have a security interest in cash proceeds of its collateral totaling only $600,000.

To best exemplify this harsh result, its necessary to contrast it with the interest CC would have received had DD not filed for bankruptcy. Without a filing, the general nonbankruptcy provisions of section 9−306(2) would apply, giving CC the ability to use the common law rules of tracing. This would give him a security interest in the amount of $1,160,000. This total consists of $400,000 from the collateral account; $50,000 from undeposited checks; $10,000 from traceable commingled cash held by DD; and $700,000 from traceable commingled cash in the operating account. Thus, the mere filing for bankruptcy by DD, causing the limitations and restrictions contained in section 9−306(4)(d) to apply, acted to reduce CC's security interest by about 50%, or $560,000.

3. Set−off

The uses, application and effect of the right to setoff go well beyond the scope of this article. For our purposes, it is necessary to understand the general theory behind the right. In general, a bank has a right under its loan documents and/or under state law, upon default by the depositor, to set−off against a general deposit account belonging to the depositor. [71] This involves using the deposit account of the debtor to pay off the unpaid loans or overdrafts of the debtor. [72] Section 9−306(4)(d)(i) specifically provides for the right of setoff as a reduction in the security interest a creditor has in the event of insolvency proceedings. Perhaps the most important factor in determining whether a right to setoff exists is whether the bank had knowledge of a third party's interest in the funds deposited in the bank. [73] The majority rule is that a bank that has neither actual nor constructive knowledge of a third party's interest in a deposit is entitled to set off the funds against a debt owed it by the depositor. [74] Essentially, issues with respect to setoff involve the determination of priority between the bank and the secured creditor. [75] It also involves the determination of the effect of different state laws. [76] As a whole, setoff can comprise its own note. The key here is for the reader to understand what the right to setoff is, and that it exists under section 9−306(4)(d).

E. Problems with Current 9−306(4)(d)

Several problems have plagued the use and application of section 9−306(4)(d) to cash proceeds. The section has been described as harsh and over−technical, and has been thought to conflict with provisions of the Bankruptcy Code. Overall, one could say that the problems have outweighed the section's usefulness. Obviously, since it has been deleted from the revised Article 9, those responsible for addressing the problems deemed it necessary to completely

delete section 9−306(4)(d) from new revised Article 9. In order to address some of the major problems, each of the following subsections will relate to the ensuing hypothetical example. The calculations truly help to understand the many problems that section 9−306(4)(d) is said to have caused.

1. Example 2 [77]

CC has a perfected security interest in all of DD's equipment. Randy Creditor (RC) has a perfected security interest in all of DD's inventory. Five days before bankruptcy, DD had a distress sale of equipment which generated total proceeds of $20,000 in cash and checks. Of that amount, $10,000 was deposited in DD's general operating account. The other $10,000 was represented by a $2,000 check in DD's cash drawer, and the balance was unaccounted for. Eight days prior to bankruptcy, DD sold inventory for $16,000 cash which was all deposited in his general operating account. At bankruptcy, the balance in DD's general operating account was $40,000.

RC is entitled to his full $16,000 which was deposited in the general account. All proceeds were received and commingled within the ten−day period. Additionally, there are no reductions based on the facts since there were no payments or other amounts which he is entitled to under paragraphs (a) through (c).

CC's proceeds total $20,000, of which only $10,000 were commingled in the general operating account. Since there is enough funds in the account to cover both CC and RC, CC's interest should be the full $20,000, whether or not that full amount was deposited in the account. This amount will be reduced by any payments actually received or payments which he is entitled to under paragraphs (a) through (c). Therefore, the $2,000 check would reduce his entitlement to $18,000 since the check is recoverable under paragraph (c).

2. Controversy with Bankruptcy Law − Preferences and Statutory Liens

One of the major problems with section 9−306(4)(d) is that some courts and commentators see a conflict with certain provisions of the Bankruptcy Code. [78] Specifically, these problems occur due to the possibility that the artificial tracing formula of section 9−306(4)(d) creates an illegal preference and/or illegal statutory lien. A statutory lien is defined as a "lien arising solely by force of statute on specified circumstances or conditions, . . . but shall not include any lien provided by or dependent upon an agreement to give security, whether or not such lien is also provided by or is also dependent upon statute and whether or not the agreement or lien is made fully effective by statute." [79] Bankruptcy Code section 545 prevents statutory liens to the extent that such lien first becomes effective when an insolvency proceeding is commenced. [80]

With respect to the above example, it would appear that CC is benefited through a lien which arose by force of a statute, namely section 9−306(4)(d). Addressing this issue, one court found the exception "but shall not include any lien provided by or dependent upon an agreement to give security" to be key language in deciding the issue. [81] The major difficulty of applying this section is that one could say that CC's interest arose both by operation of statute (as to $8,000) and by operation of the security agreement (as to $10,000). Clearly, CC's interest may not have existed without both the statute and the agreement operating to give him a security interest in proceeds. Thus, it would be inaccurate to describe the interest as a lien arising "solely" by force of statute. While it is arguable that any amounts received through operation of section 9−306(4)(d) result in an illegal statutory lien, the preferable position is that there has been no violation. [82]

A preference is also proscribed by the Bankruptcy Code. Section 547 allows the trustee to avoid any transfer of an interest in property:

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made

(A) on or within 90 days before the date of filing of the petition; and

(5) that enables such creditor to receive more than such creditor would receive if

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title. [83]

Does CC's interest in $18,000 result in a voidable preference? Most would agree that the $18,000 claim is, in part at least, a transfer under section 547. CC can not trace the entire $20,000 disposition into the general account. Rather, he is able to specifically trace only $10,000 of the proceeds from disposition of his collateral. As to the $8,000 which can not be traced, it would appear that it is a transfer for an antecedent debt and should be tested under section 547 to determine if that amount is a voidable preference. The In re Gibson Products court found any excess over and above that which could be traced by the creditor to be avoidable by the trustee as a preference. [84] Others believe the proper analysis is based on the improved position test, and that the validity of a proceeds claim should depend upon the extent to which section 9−306(4)(d) increased or decreased the creditor's security. [85] If this is the proper test, than CC's claim is not an avoidable preference since the claim is $2,000 less than the actual amount received by the debtor. Irrespective of a conclusive answer regarding the conflict, the mere fact that there is a possible conflict has created much confusion and uncertainty with calculating the proceeds claim under section 9−306(4)(d).

1. Harshness of the Rule

Many commentators believe the effect of section 9−306(4)(d) to be extremely severe because it sharply cuts back the secured creditor's rights. [86] As discussed above, the Maxl Sales case clearly shows the extreme result, which all creditors face, of losing the entire interest in proceeds upon the commencement of insolvency proceedings. [87] Whether or not a creditor is able to trace his or her proceeds, section 9−306(4)(d) limits the interest to those proceeds received within the ten−day period. Therefore, unlike Maxl Sales, the creditor may be able to recover something, but it won't be nearly as much as the proceeds actually recovered through the disposition of the encumbered collateral. In the example above, CC will likely only recover $18,000, thus $2,000 below that which was actually proceeds of his collateral. Though this may not seem like a large amount to most, it is still a reduction in the interest. If either RC or CC had their collateral disposed of before the ten−day period, both would have lost their entire interest. That would be quite an oppressive result. This ten−day rule gives a debtor who is contemplating bankruptcy the ability to commingle before or during the ten−day period, in order to limit or completely defeat, the perfected interest of his or her creditor.

F. Strategies

This possible harsh effect of section 9−306(4)(d) tends to encourage creditors to police their proceeds or risk losing them. [88] All of the tracing problems and potential for different interpretations of section 9−306(4)(d) can be avoided by requiring the debtor to segregate proceeds in a separate deposit account, [89] thus preventing commingling. [90] In In re Cooper, [91] the court found that "separate" deposit accounts should be limited to those accounts specifically created and used for the deposit of proceeds of secured collateral. [92] Most courts agree with In re Cooper court's finding. This implies that accounts which, at one time or another, contained commingled funds could not be considered a "separate" deposit account. [93] By requiring segregation, the creditor would avoid the application of section 9−306(4)(d) and impose the application of section 9−306(4)(a) instead.

G. Summary and Key Points

At this point, it would be helpful to summarize the major points behind section 9−306(4)(d). The first major point is that for non−cash proceeds, nonbankruptcy rules for tracing will apply. Second, cash proceeds which have not been commingled are undisturbed by the commencement of insolvency proceedings, and thus the same tracing rules apply as those prior to bankruptcy. Third, once cash proceeds are commingled, the complicated tracing formula which limits the secured creditor's ability to continue its security interest applies, whether or not the proceeds could be identified.

Fourth, an interest in commingled cash proceeds received more than ten days before bankruptcy is destroyed by section 9−306(4)(d).

I.Revised Article 9

A. New Broader Definition of Proceeds

Like current Article 9, Revised Article 9 seeks to facilitate lending by allowing a security interest to attach to collateral and continue in identifiable proceeds of that collateral. With respect to proceeds, the definition has been expanded dramatically. Under Revised Article 9, "proceeds" means the following property:

A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;

B) whatever is collected on, or distributed on account of, collateral;

C) rights arising out of collateral;

D) to the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or

E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral. [94]

This definition is much broader than its current counterpart. The PEB felt that the concepts of "sale, exchange, collection or other disposition" found in the current definition was not broad enough to embrace certain kinds of property which a creditor could have a security interest in, such as stock splits and warranty or tort claims. [95] Additionally, the PEB believed that the definition should make clear that "proceeds" extended to "any proceeds to the extent the debtor acquired rights in the property," and that it wasn't limited to property in the possession of or control of the debtor. [96] By including "collections" and "distributions," Revised Article 9 proceeds include rent payments under personal property leases, payments on instruments and payments on investment property. Because the broader definition classifies more property as proceeds, the PEB felt that it would serve to eliminate the need for expansive drafting of security agreements. [97] Other advantages cited by the PEB included the savings of negotiation costs, the inhibiting of abuse and overreaching by secured parties, and the rescuing of secured parties from careless omissions. [98]

A. Deletion of Current Section 9−306(4)

As discussed in great detail throughout most of this note, many commentators found the special rules for commingled cash proceeds when dealing with insolvency proceedings to be harsh, complicated and unworkable. Based on the problems and confusion associated with current section 9−306(4)(d), the PEB recommended that subsection (4) be deleted in its entirety. [99] This recommendation was grounded on three major considerations. First, it was enormously unclear how subsection (4) was to be construed and applied. [100] Second, even when properly construed, the PEB found subsection (4) to reflect unsound policy. [101] Finally, the PEB determined that the subsection's effectiveness was questionable in proceedings under the Bankruptcy Code, although they found it to be effective under state insolvency proceedings. [102]

In addition, the PEB found the absence of a consensus as to the purpose and effect of paragraph (d) to be important in its determination to delete the paragraph altogether. It concluded that there was no reason for the establishment of different rules which provide either a limited or a more expansive reach in insolvency than those provided outside such proceedings. [103] Furthermore, the PEB doubted whether the Bankruptcy Code would even give effect to an application of paragraph (d) when it resulted in a more expansive reach by the creditor. [104]

B. Revised Section 9−315

Revised section 9−315 is the new version of section 9−306 which deals with a secured party's rights on disposition of collateral and proceeds. Like its predecessor, rev. section 9−315 provides for the continuation of a security interest upon disposition of collateral and attachment of the security interest to any identifiable proceeds of the encumbered collateral. Though similar, rev. section 9−315 has some major differences which were intended to address certain drawbacks of current section 9−306. Perhaps the most telling difference is the revised version's lack of complicated rules or formulas for dealing with proceeds upon the institution of insolvency proceedings. Just as recommended by the PEB, the drafters of the revised version intentionally omitted the substance of current section 9−306(4) and provided for its deletion through its Official Comments. [105] Comment 8 to rev. section 9−315 provides:

Insolvency Proceedings; Returned and Repossessed Goods. This Article deletes former Section 9−306(4), which dealt with proceeds in insolvency proceedings. Except as otherwise provided by the Bankruptcy Code, the debtor's entering into bankruptcy does not affect a secured party's right to proceeds. [106]

Revised section 9−315(b) is the subsection which deals with commingled proceeds. It provides:

[When commingled proceeds identifiable.] Proceeds that are commingled with other property are identifiable proceeds:

1) if the proceeds are goods, to the extent provided by Section 9−336; and

2) if the proceeds are not goods, to the extent that the secured party identifies the proceeds by a method of tracing, including application of equitable principles, that is permitted under law other than this article with respect to commingled property of the type involved. [107]

Two important points are evident from the language of rev. section 9−315. First, it comports with the majority view that commingled proceeds can be identified through some form of tracing, thus directly refuting Professor Gilmore's belief that commingled proceeds ceased to be identifiable. [108] Second, it provides that a security interest in proceeds attaches automatically, without any particular provision in the security agreement required. [109] The only requirement is that the proceeds be identifiable. This identifiability requirement is not a new concept. It has already been addressed by the many courts which have confronted commingled proceeds in non−insolvency situations. Though various methods of tracing exist, no form has been as widely used as the LIBR.

A. Tracing Rules

1. Lowest Intermediate Balance Rule (LIBR)

Ultimately, the omission of section9−306(4)(d) "means merely that [under Revised Article 9] the same tracing rules will be applied to cash proceeds when the debtor is involved in insolvency proceedings as when the debtor is not so involved." [110] As discussed earlier, courts have generally allowed secured parties to utilize common law tracing principles in order to determine "identifiable cash proceeds." [111] One of these equitable tracing principles is the LIBR. Courts utilize the LIBR for tracing proceeds in many contexts. Such contexts include the rights of a trust beneficiary in a commingled account; [112] a secured party's interest in a commingled account; [113] the liability of a guarantor for commingled funds; [114] and rights with respect to funds in a drug forfeiture case. [115] The PEB recognized this widespread use of the LIBR and commented in its report that the LIBR was the conventional wisdom outside of bankruptcy. [116] Based on this recommendation, rev. section 9−315(b)(2) expressly provides for the application of equitable tracing principles.

The LIBR arose out of a comment within section 202 of the Restatement (Second) of Trusts. Comment j provides:

Effect of withdrawals and subsequent additions. Where the trustee deposits in a single account in a bank trust funds and his individual funds, and makes withdrawals for the deposit and dissipates the money so withdrawn, and subsequently makes additional deposits of his individual funds in the account, the beneficiary cannot ordinarily enforce an equitable lien upon the deposit for a sum greater than the lowest intermediate balance of the deposit. If the amount on deposit at all times after the deposit of the trust funds equaled or exceeded the amount of trust funds

deposited, the beneficiary is entitled to a lien upon the deposit for the full amount of the trust funds deposited in the account. If after the deposit of trust funds in the account the deposit was wholly exhausted by withdrawals before subsequent deposits of the trustee's individual funds were made, the beneficiary's lien upon the deposit is extinguished, and if he is unable to trace the money withdrawn, he is relegated to a mere personal claim against the trustee, and is entitled to no priority over other creditors of the trustee. [117]

In addition to specifically supporting the use of equitable tracing principles, the Revised U.C.C goes one step further. It officially approves of the LIBR in its Official Comments to section 9−315. Official Comment 3 provides:

Secured Party's Right to Identifiable Proceeds. Under subsection (a)(2), which derives from former Section 9−306(2), a security interest attaches to any identifiable "proceeds," as defined in Section 9−102. See also Section 9− 203(f). Subsection (b) is new. It indicates when proceeds commingled with other property are identifiable proceeds and permits the use of whatever methods of tracing other law permits with respect to the type of property involved. Among the "equitable principles" whose use other law may permit is the "lowest intermediate balance rule." See Restatement (2d) Trusts section 202. [118]

The LIBR presumes that any payments made from the commingled fund were from funds other than the funds in which another had a legally recognized interest. [119] Under this rule, proceeds are protected only to the extent that there are funds in the commingled account to cover the amount of proceeds deposited. [120] It is the secured party's burden to trace those proceeds claimed to arise out of that party's collateral. [121] Once the traced proceeds are withdrawn such that the balance of the account dips below the amount of the secured creditor's interest, those proceeds are treated as lost. [122] Subsequent deposits by the debtor do not replenish the account balance unless there is a clear manifestation of intent to make restitution. [123] If the account dips below the secured creditor's interest, the creditor can bring an action to secure a lien on the account to collect any later deposits up to the deficiency of its interest. Instead of bringing such an action, a debtor can agree to earmark the next money deposited, up to the amount of the deficiency, as proceeds.

For example, if $1000 in proceeds is deposited in a bank account, it is presumed to remain there. If, however, the balance in the account subsequently dips to $500, the LIBR identifies only $500 in the account as proceeds. In Universal CIT Credit Corp. v. Farmers Bank of Portageville, the court was called upon to use equitable tracing principles when the debtor−car dealer commingled cash proceeds of the floating lienor's collateral with other working capital funds. [124] On several occasions, the bank account dipped below the amount of traceable proceeds in the account. Utilizing the LIBR, the court adjusted the security interest downward to reflect the lowest balance over those several occasions. Similarly, in C.O Funk & Son, Inc. v. Sullivan Equipment, Inc., [125] the secured party asked the court to invoke trust principles when an insolvent farm dealer commingled proceeds of the secured party's collateral in debtor's general bank account. The court found for the secured party, using the LIBR to find the commingled proceeds intact to the extent the bank account remained above secured creditor's traceable proceeds. [126]

2. Tax Tracing

In Begier v. I.R.S., [127] the petitioner Begier, trustee for American International Airlines (AIA), sought to avoid as preferential amounts paid to the IRS for trust−fund taxes during the 90−days before the bankruptcy filing. These payments came out of the general operating account as well as a separate account required by the IRS and created for the purpose of depositing taxes. The IRS claimed that the withholding and excise taxes paid were held in trust, as stated in an Internal Revenue Code (IRC) provisions. Under the IRC, whenever a person is required to collect or withhold any revenue tax, the amount of the tax collected or withheld is said to be held as a special fund in trust. [128] The Court found this provision not to impose a segregation requirement, but instead, created a trust at the moment any relevant payments were made to AIA. The court also found common−law tracing principles inapplicable because, unlike a common−law trust in which the settlor sets aside particular property as the trust res, the IRC created a trust in an abstract amount, a dollar figure not tied to any particular assets. [129] The Court utilized "reasonable assumptions" to govern the tracing of tax funds paid by AIA. In this case, the assumption was that "any voluntary pre−petition payment of trust−fund taxes out of the debtor's assets is not a transfer of the debtor's property." [130] The court also imposed a requirement that the IRS show some connection between the trust funds and the assets sought to be applied. [131] Ultimately, the Supreme Court found that the funds were not property of the estate or property of the debtor, but were instead held in trust for the IRS.

Another case addressing tax funds was In re Megafoods Stores, Inc. [132] In that case, the Texas state comptroller brought adversary proceedings against chapter 11 debtors who withheld payment of sales tax trust funds. In holding the debtor liable to the comptroller for the sales taxes plus post−petition interest, the Ninth Circuit court initially relied on the Begier decision. The court found that Begier required the IRS to show some connection between the IRC trust and the assets sought to be applied to the debtor's trust−fund tax obligations, and that this meant tracing. [133] After imposing this tracing requirement, the court had to determine how such tracing would be accomplished. Instead of using the "reasonable assumptions" method of tracing as in Begier, the Megafoods court chose to apply the LIBR, following a Texas Supreme Court decision which utilized the LIBR to trace tax funds in a commingled bank account. [134]

Based on decisions interpreting and examining Begier, it is likely that common law tracing and identification principles can be applied in the tax context. [135] In re Megafoods is just one example of taxes being traced through the LIBR. Additionally, courts have been reluctant to extend Begier past the narrow scope of its holding. [136] Since it was decided, courts have continued to apply the LIBR rather than the reasonable assumptions standard in cases involving trusts other than income tax withholdings. [137] Based on the distinguishing features of Begier and its strict tax−based reasoning, it is safe to say that inventory and equipment lenders will not have to worry about the "reasonable assumptions" method of tracing.

3. FIFO/LIFO

The 'first−in, first−out' ("FIFO") and 'last−in, last out' ("LIFO") rules are inventory valuation methods used mostly in accounting. FIFO is a method which assumes that the first goods purchased or produced are the first to be sold. LIFO, on the other hand, assumes that the last goods purchased or produced are the first to be sold. These methods can be employed to come to a conclusion as to the traceability of cash proceeds. For example, FIFO would assume that the first funds deposited in a commingled account would also be the first funds withdrawn or paid out of that account. In In re California Trade Technical Schools, Inc., [138] the Ninth Circuit utilized FIFO in order to determine whether an account contained funds from another account which contained funds deposited in violation of the preferential transfer rule. The court looked at the Bankruptcy Code provisions which prevent preferential transfers and fraudulent conveyances and found their intent was to discourage last minute transfers from debtors. [139] Based on that intent, the court determined that a FIFO rule would best serve that purpose. [140] FIFO presumes that funds wrongfully transferred to an account at the eleventh hour remain there until all of the funds previously in the account have been expended. The rule thereby makes it more difficult for a debtor to dissipate funds owed to his creditors by commingling those funds with other money.

FIFO has been applied in other contexts as well. Two NY courts have used FIFO to distribute assets from a decedent's estate. [141] An Iowa court found, under either Iowa or Minnesota law, that FIFO could be used to determine the extent of a creditor's purchase money lien upon entering into a new loan transaction. [142] Here we are concerned with tracing cash proceeds. As In re California Trade makes apparent, FIFO can be used to trace proceeds in a commingled account. [143] It can have a similar effect to that of the LIBR by preventing a debtor who is contemplating bankruptcy from completely destroying a security interest by commingling cash proceeds just prior to filing. LIFO would not be helpful to such creditors because that method would presume that the last funds deposited are the first to be paid out. The fact is, FIFO is not a strict accounting method and can be applied in the right scenario.

A. Conflicting Security Interests: A Pro−Rata Approach

An important issue arises when there are two creditors who each claim an interest in an account which is believed to contain proceeds. Revised Article 9 does not provide any rules for determining how to allocate cash proceeds between two competing creditors who both claim an interest in a commingled account. With respect to commingled goods, rev. section 9−336 provides that a security interest does not exist in commingled goods, but that a security interest may attach to a product or mass that results when goods become commingled. [144] More importantly, rev. section 9−336 specifically addresses the possibility of conflicting security interests in a product or mass. It provides that the security interests would rank equally in proportion to value of the collateral at the time it became commingled goods. [145]

Despite the absence of clear language like that of rev. section 9−336, several courts have put the onus upon themselves to create a similar pro−rata rule for allotting cash proceeds between creditors. [146] In employing this approach, a court may consider identifiable proceeds as a pro−rata share of the commingled account, the share being determined by the percentage of collateral owned by the secured creditor before the proceeds were commingled. In Ford Motor Credit Co. v. Troy Bank & Trust Co., [147] a secured creditor brought suit against a second secured creditor to recover proceeds of collateral which had been distributed to the second secured creditor by the bankruptcy court. In addressing the rights of each creditor under current section 9−306(4)(d), the court commented on the lack clarity with respect to competing security interests under current Article 9. [148] After determining that each creditor had a perfected interest in different collateral, and that priority rules only resolve disputes between interests in the same collateral, the court found that a pro−rata distribution would be the fairest division. [149] In order to enter the proper judgment, each creditor had to first, determine how much it was entitled to under current section 9−306(4)(d); and second, pro−rate the account between themselves. It would be that pro−rated share of the account which each creditor could recover.

In In re Halmar Distributors, Inc., [150] the court found a pro−rata approach to be a viable form of tracing where a purchase−money creditor sued to determine its competing rights against a bank who allegedly committed conversion. The court found the pro−rata approach to be "universally accepted in . . . other jurisdictions . . ." [151] After identification and tracing, the court awarded the plaintiff approximately 10% of the commingled account. Similarly, in Bombadier Capital, [152] proceeds in debtor's checking account were found to be subject to two separate security interests. After finding that the bank had converted funds in the commingled account through wrongful set−off, the court ultimately determined that the proper measure of creditor's damages was through application of the LIBR on a pro−rata basis. The court felt that awarding the creditor anything more than its pro−rata share would result in a windfall. Whatever the reasoning behind the absence of specific language under the Revised Article 9 to deal with conflicting interests in cash proceeds, it is my belief that the pro−rata approach will become the rule applied more often. Cases such as Bombadier Capital, which utilized the LIBR and pro−rata distribution, will become the precedent for dealing with a competing security interest in commingled accounts.

B. Deposit Accounts under Revised Article 9

Another interesting change under Revised Article 9 has to do with deposit accounts. Revised section 9−109(d)(13) now allows a security interest in deposit accounts as original collateral, except in consumer transactions. Revised Article 9 has expanded the definition of "deposit accounts" to mean a "demand, time, savings, passbook, or similar account maintained with a bank. The term does not include investment property or accounts evidenced by an instrument." [153] Additionally, deposit accounts have been added to the definition of cash proceeds under Revised Article 9. [154] In order for a secured creditor to perfect a security interest in a deposit account under Revised Article 9, it can be done only by control. [155]

This broad definition of deposit accounts and this new ability to perfect an interest in a deposit account will help creditors in several ways. The most important benefit of perfecting an interest in a deposit account is that it will allow the secured creditor to avoid having to identify the proceeds in a deposit account by a method of tracing. Rather, the secured party need only obtain a security interest in the deposit account directly. If that is not possible, as with current Article 9, the creditor could provide for only proceeds of the collateral to be deposited into a deposit account, thus making the proceeds easily traceable and identifiable. Overall, the ability to acquire a perfected interest in a deposit account serves to save the time and money associated with tracing, including attorney's fees and court costs.

Other benefits of this new interest in deposit accounts relate to priority. One feature is that a security interest in a deposit account perfected by "control" has priority over a conflicting security interest held by a secured party that does not have control. [156] This means that such an interest has priority over a perfected security interest in funds in such deposit account as identifiable cash proceeds. Furthermore, a secured party who later perfects an interest by control of a deposit account can obtain priority over a secured party with a first−filed financing statement covering collateral. [157]

With respect to a banks' conflicting security interest, the bank with which the deposit account is maintained has a special priority such that its interest has priority over any conflicting security interests held by another secured party. [158] A secured party who takes a security interest in the deposit account as original collateral can protect itself in one of two ways. First, it can take "control" of the deposit account by becoming the bank's customer. This is done by having

the deposit account in the secured creditors own name and operates to subordinate the bank's security interest. [159] Alternatively, the bank can specifically agree to subordinate its security interest in the deposit account to the security interest of such secured party. [160] Either of these two ways will put the secured creditor in a much better position.

C. Impact of Revised Article 9

With respect to cash proceeds, the most important change associated with Revised Article 9 is the deletion of the insolvency−tracing rule of current section 9−306(4)(d). This deletion will likely result in better results for creditors. Instead of being limited to those funds commingled within ten days of insolvency, all a secured creditor has to do is trace his funds through one of the common law methods of tracing allowed under rev. section 9−315. In most cases, the court will utilize the LIBR method of tracing. By deleting this ten−day rule, debtors will be unable to destroy a secured creditor's interest by commingling in the days before the ten−day period begins. Additionally, this interest won't be reduced by any payments made, cash found in a desk drawer, or checks found lying around the office.

Additionally, the broader definitions of proceeds, cash proceeds and the inclusion of deposit accounts as a form of collateral will serve to aid secured creditors. By allowing a perfected security interest in deposit accounts, coupled with the benefits of priority, secured creditors can be protected from the rigors and disadvantages associated with tracing. As with the current section, the best way to avoid any of the tracing problems is for the creditor to require that the debtor designate a separate account solely for the deposit of proceeds.

Conclusion

Revised Article 9 will bring about significant changes for many involved in asset−based lending, inventory financing and equipment leasing. Some will aid the lender, some will aid the borrower, and some will have a detrimental effect on both parties. Either way, practicing attorneys, judges, professors and law students must be prepared for the sweeping revisions that will affect the secured lending industry. A significant portion of these changes will affect the way lenders and borrowers address the threat of insolvency. Unfortunately for many, not so unfortunate for those of us who plan to practice in the field of bankruptcy, bankruptcy is a factor which looms over every transaction.

For many years, the U.C.C. addressed commingled cash proceeds in a different manner than other types of proceeds once insolvency proceedings were instituted. Based on the desire for uniformity and clarity, a formula was created to help calculate the amount of proceeds attributable to the secured creditor's collateral. The purpose was to prevent the need for the time−consuming and expensive tracing methods utilized in equity. After much debate, uncertainty, and significant losses by many creditors, Revised Article 9 will do away with the over−technical and complicated way of identifying cash proceeds which have been commingled. In its place, Revised Article 9 substitutes the common law methods of tracing which courts have been using for some time. In most cases, the LIBR will be used. If there is a conflict as to the proceeds held in a commingled account, it's likely that a pro−rata approach will by applied along with the LIBR to determine each creditors share of the proceeds. What is perfectly clear once the Revised Article 9 takes effect, is that the technical insolvency−tracing rule of current section 9−306(4)(d) is gone. At least until the next revision.

Harris J. Diamond

FOOTNOTES:

[1] Permanent Editorial Board for the Uniform Commercial Code, PEB Study Group Uniform Commercial Code Article 9 Report (1992), Section 1 at 1 (hereinafter "PEB Report"). Back To Text

[2] See id. at 6. Back To Text

[3] See id. at 2. Back To Text

[4] See id. at 2. Back To Text

[5] See U.C.C. § 9−306 (1972). Back To Text

[6] See Id. Section 9−306 provides:

(1) "Proceeds" includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds. Insurance payable by reason of loss or damage to the collateral is proceeds, except to the extent that it is payable to a person other than a party to the security agreement. Any payments or distributions made with respect to investment property collateral are proceeds. Money, checks, deposit accounts and the like are "cash proceeds." All other proceeds are "noncash proceeds."

(2) Except where this article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition 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 20 days after receipt of the proceeds by the debtor unless:

(a) A filed financing statement covers the original collateral and the proceeds are collateral in which a security interest may be perfected by filing in the office or offices where the financing statement has been filed and, if the proceeds are acquired with cash proceeds, the description of collateral in the financing statement indicates the types of property constituting the proceeds; or

(b) A filed financing statement covers the original collateral and the proceeds are identifiable cash proceeds; or

(c) The original collateral was investment property and the proceeds are identifiable cash proceeds; or

(d) The security interest in the proceeds is perfected before the expiration of the 20−day period.

Id. Except as provided in this section, a security interest in proceeds can be perfected only by the methods or under the circumstances permitted in this article for original collateral of the same type. Back To Text

[7] See U.C.C. § 9−306 Official Comment 2(a) (1972). See also In re Hugo, 58 B.R. 903, 909 (Bankr. E.D. Mich. 1985) (illustrating necessity of tracing crop proceeds in order to determine if security interest has been maintained); In re Potter, 46 B.R. 536, 538 (Bankr. E.D. Tenn. 1985) (holding security interest in milk of debtors' cows continued in identifiable proceeds). Back To Text

[8] See U.C.C. § 9−306(4) (1972). Back To Text

[9] See § 9−306 (a−c). Back To Text

[10] See § 9−306(d). Back To Text

[11] Id. Back To Text

[12] See U.C.C. § 9−306 Official Comment 2(a); see also Barkley Clark, The Law of Secured Transactions Under the Uniform Commercial Code ¶ 14.6(5) at 14−16 (1980) (stating 9−306(4) was intended to make rights exclusive such that a secured party could not claim proceeds under 9−306(4) and additional rights based on tracing principles). Back To Text

[13] See Maxl Sales Co. v. Critiques, Inc., 796 F.2d 1293, 1300 (10th Cir. 1986) (holding 9−306(4)(d) is substitution for, and limitation upon, right to trace proceeds in commingled funds); Quinn v. Montrose State Bank (In re Intermountain Porta Storage, Inc.), 74 B.R. 1011, 1014 (D. Colo. 1987) (finding § 9−306(4)(d) operates to replace, not just to supplement traditional common−law rules of tracing); First Nat'l Bank of Amarillo v. Martin (In re Martin), 48 B.R.

317, 320 (N.D. Texas 1985) (holding § 9−306(4) eliminates common law doctrine of tracing). Back To Text

[14] See Arizona Wholesale Supply, Co. v. Itule (In re Gibson Prod. of Ariz.), 543 F.2d 652, 655 (9th Cir. 1975); see also In re Intermountain Porta Storage, 74 B.R. at 1014 (stating traditional rules of tracing should be replaced by more definite and workable procedure); Maxl Sales Co., 796 F.2d at 1300 (finding drafters believed hard and fast rules of identification were preferable to imprecise and time consuming tracing theories). Back To Text

[15] See U.C.C. § 9−306 Official Comment 2(a). Official Comment 2(a) provides:

"Paragraph 4(d) limits the security interest in proceeds not within these rules to an amount of the debtor's cash and deposit accounts not greater than cash proceeds received within ten days of insolvency proceedings less the cash proceeds during this period already paid over and less the amounts for which the security interest is recognized under paragraphs 4(a) through (c)").

Id.; see also In re Gibson Prod. of Ariz., 543 F.2d at 655 (holding purpose of § 9−306(4)(d) was to give secured creditors quantifiable security interest); Sacramento Mansion, Ltd. v. Sacramento Savings & Loan Assoc. (In re Sacramento Mansion, Ltd.), 117 B.R. 592, 608 (Bankr. D. Colo. 1990) (holding same); In re Martin, 48 B.R. at 320 (holding same). Back To Text

[16] See 2 Gilmore, Security Interests in Personal Property, § 45.9 at 1340 (Grant Gilmore, et al. eds., 2d ed. 1965) (stating "[t]he intent was to . . . limit the grasp of secured creditors to the amount received during the last ten days before insolvency proceedings, which, the draftsmen assumed, would usually be less than the same creditor could trace if he had a grip on the entire balance deposited over an unlimited time"); In re Gibson Prod. of Ariz., 543 F.2d at 655 (citing same); In re Critiques, 29 B.R. 941, 946 (Bankr. D. Kan. 1983) (citing same); In re Cooper, 2 B.R. 188, 196−97 (Bankr. S.D. Tex. 1980) (citing same). Back To Text

[17] See Ray D. Henson, Secured Transactions Under the Uniform Commercial Code § 6−7 at 220 (2d ed. 1979) (stating "the progenitor of section 9−306(4)(d) was section 10(b) of the Uniform Trust Receipts Act"); 2 Gilmore, Security Interests in Personal Property, § 45.9 at 1341 (Grant Gilmore, et al. eds., 2d ed. 1965) (finding it "obvious" that UTRA section 10(b) was the direct ancestor of section 9−306(4)(d)). UTRA Section 10(b) provided:

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 buy 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; . . .

Uniform Trust Receipts Act § 10(b) (1933). Section 10(b) was intended to create an enforceable security interest or lien on proceeds. Unfortunately however, the Section concluded with a statement that it gave a "priority," which the Bankruptcy Act later eliminated. This conflict was eventually resolved in the courts and lead to the redrafting of section 9−306(4) to state the interest in terms of a perfected security interest rather than a priority.

Professor Gilmore correctly analyzed the similarities between section 10(b) and section 9−306(4)(d) in that both were triggered by insolvency proceedings; both measured the claim by the proceeds received within 10 days preceding the commencement of insolvency proceedings; and both dispensed with the requirements of tracing or identification. On the other hand, Professor Gilmore determined that section 10(b) went well beyond what section 9−306(4)(d) provided because section 10(b) included all proceeds, cash and non−cash, in its calculation. He found that section 10(b) did not call for a deduction of the amount of proceeds actually paid to the secured party like section 9−306(4)(d) provided. Furthermore, Professor Gilmore found that a claim under section 10(b) would be good against any unencumbered

assets which the trustee might have, which was vastly different from section 9−306(4)(d), which limited the claim to the balance in the debtor's checking account. Despite the significant differences between the two provisions, Professor Gilmore, like many others subsequent, found section 10(b) to be the main contributor to section 9−306(4)(d). Back To Text

[18] Restatement (Second) of Trusts § 202 (1959). Section 202 provides:

(1) Where the trustee by wrongful disposition of trust property acquires other property, the beneficiary is entitled at his option either to enforce a constructive trust of the property so acquired or to enforce an equitable lien upon it to secure his claim against the trustee for damages for breach of trust, as long as the product of the trust property is held by the trustee and can be traced.

Id. The Restatement rule was itself drawn from a series of English cases from the nineteenth century. While the common law of the United States was fragmented at the time, the states generally followed the rough principles of fictional tracing developed by the English common law cases. Professor Barnes believed that to understand tracing in the modern commercial law of the U.C.C., one was required to first understand the English common law antecedents. See Richard L. Barnes, Tracing Commingled Proceeds: The Metamorphosis of Equity Principles into U.C.C. Doctrine, 51 U. Pitt. L. Rev. 281, 292 (1990). Back To Text

[19] See Brown & Williamson Tobacco Corp. v. First Nat'l Bank of Blue Island, 504 F.2d 998, 1002 (7th Cir. 1974) (finding proceeds, based on analogous case of fund impressed with trust, could be traced into fund of commingled money). See supra note 18; Laura B. Bartell, The Lease of Money in Bankruptcy: Time for Consistency? 16 Bankr. Dev. J. 267, 323−25 (2000) (discussing equitable tracing of proceeds as applied through U.C.C.). Back To Text

[20] See, e.g., Security State Bank v. Firstar Bank Milwaukee, N.A., 965 F. Supp. 1237, 1244−46 (N.D. Iowa 1997) (tracing proceeds from the sale of cattle); Sony Corp. v. Bank One, N.A., 85 F.3d 131, 138−39 (4th Cir. 1996) (applying tracing rule to proceeds from the sale of video tapes); Harley−Davidson Motor Co. v. Bank of New England−Old Colony, N.A., 897 F.2d 611, 620 (1st Cir. 1990) (utilizing tracing rules to identify proceeds from the sale of motorcycles). Back To Text

[21] U.C.C. § 1−201(22) (1972). Back To Text

[22] See Maxl Sales Co. v. Critiques, Inc., 796 F.2d 1293 (10th Cir. 1986); see also In re Litamar, Inc., 157 B.R. 828, 832 (Bankr. N.D. Ohio 1993) (holding 9−306(4) applied in debtor's converted bankruptcy case from chapter 11 to chapter 7); In re Charter First Mortgage, Inc., 56 B.R. 838, 849 (Bankr. Or. 1985) (finding statutory language indicated intent of drafters was to include within its terms receiverships instituted under state law). Back To Text

[23] 796 F.2d 1243 (10th Cir. 1986). Back To Text

[24] See id. at 1300. Back To Text

[25] See id. Back To Text

[26] See id. Back To Text

[27] See id. Back To Text

[28] An extensive review and analysis of the perfection rules and procedures is beyond the scope of this article. Along with the revisions in the area of proceeds, Revised Article 9 has provided new rules for perfection which are intended to make perfection easier. For an introduction to the Revised Article 9 perfection rules, see generally Marcus Salitore, Maintaining Perfection: Practitioners Must Act Soon to Preserve Interests Under the U.C.C. Revised Article 9, 31 Tex. Tech L. Rev. 1043 (2000); John J. Eikenburg, Jr., Filing Provisions of Revised Article 9, 53 SMU L. Rev. 1627 (2000); Charles Cheatham, Changes in Filing Procedures Under Revised Article 9, 25 Okla. City U. L. Rev. 235 (2000). Back To Text

[29] U.C.C. § 9−306(1). Back To Text

[30] U.C.C. § 9−306(2). Back To Text

[31] U.C.C. § 9−306(3). Back To Text

[32] See U.C.C. § 9−306(4)(a). See also In re Pelton, 171 B.R. 641, 648 (Bankr. W.D. Wisc. 1994) (finding security interest continued in account receivables since they were considered non−cash proceeds). See generally, Reiley Guidebook to Security Interests in Personal Property § 7.06 (Eldon H. Reiley et al. eds., 2d ed. 1986) (discussing treatment of cash and non−cash proceeds in bankruptcy). Back To Text

[33] See U.C.C. § 9−306(4)(b) and (c). See also In re Quaker Distributors, Inc., 189 B.R. 63 (Bankr. E.D. Pa. 1995) (finding secured creditor's interest in proceeds which are segregated and identifiable to be equivalent to like interest of its counterpart in non−insolvency situation); In re Hugo, 58 B.R. 903, 905 (Bankr. E.D. Mich. 1985) (stating cash proceeds in separate deposit accounts and money or checks not deposited or commingled prior to insolvency survive insolvency); In re Gibson Prod. of Ariz., 543 F.2d 652, 656 (9th Cir. 1975) (stating that uncommingled cash proceeds would give secured party perfected security interest under section 9−306(4)(b), just like in pre− Code days, without any limitations imposed by § 9−306(4)(d)). Back To Text

[34] See id. Back To Text

[35] See, e.g., In re Intermountain Porta Storage, Inc., 74 B.R. 1011, 1016 (D. Colo. 1987) (utilizing trust law's LIBR); Cessna Fin. Corp. v. Millard Aviation, Inc. (In re Turner), 13 B.R. 15, 22 (Bankr. D. Neb. 1981) (using same); Sony Corp., 85 F.3d 131, 138−39 (4th Cir. 1996) (utilizing same); see also Restatement (Second) of Trusts § 202 (1959). See generally Barkley Clark, The Law of Secured Transactions Under the Uniform Commercial Code ¶ 6.5 at 6−37. Back To Text

[36] U.C.C. § 1−103 (1972). See also 1 Barkley Clark, The Law of Secured Transactions Under the Uniform Commercial Code ¶ 3.14 at 3−213 (Revised ed. 1999) (declaring section 1−103 to be most heavily litigated section in entire U.C.C.). See generally, R. Hillman et al., Common Law and Equity Under the U.C.C. (1985) (discussing use of equitable principles throughout U.C.C.). Back To Text

[37] 2 Gilmore, § 27.4 at 735 –736. Back To Text

[38] Id. Back To Text

[39] See In re Patio & Porch Systems, Inc., 194 B.R. 569 (Bankr. D. Md. 1996) (holding commingled proceeds of creditor's collateral does not prevent proceeds from being "identifiable" under Maryland Commercial Code); In re Southern Equipment Sales Co., 24 B.R. 788, 795−96 (Bankr. D. N.J. 1982) (holding that commingling of funds is not determinative as to whether proceeds of inventory are "identifiable" within purview of New Jersey law); Conagra, Inc. v. Farmers State Bank, 237 Mich. App. 109 (1999) (finding cash proceeds do not lose their identity as proceeds of collateral merely because they have been commingled). Back To Text

[40] See Cositt v. First Am. State Bank (In re Fort Dodge Creamery Co.), 121 B.R. 831, 836 (Bankr. N.D. Iowa 1990). Back To Text

[41] See In re Martin, 48 B.R. 317, 321 (N.D. Texas 1985) (finding it well−established that if proceeds are commingled prior to insolvency proceedings, section 9−306(4)(d) limits extent to which a creditor retains a security interest); see supra notes 9−15 and accompanying text. Back To Text

[42] See U.C.C. § 9−306(4)(d). Back To Text

[43] See U.C.C. § 9−306(4)(d)(ii). Back To Text

[44] See U.C.C. § 9−306(4)(d)(i). Back To Text

[45] In re Hugo, 58 B.R. 903, 905 (Bankr. E.D. Mich. 1985); see also In re Patio & Porch Systems, Inc., 194 B.R. at 575 (citing In re Hugo); In re Bumper Sales, Inc., 907 F.2d 1430, 1438 (4th Cir. 1990) (agreeing with In re Hugo). Back To Text

[46] See In re Cooper, 2 B.R. at 196 (finding creditor had no security interest in deposits which occurred 17 days before bankruptcy filing); Campbell v. Small Business Admin. (In re Jameson's Foods, Inc.), 35 B.R. 433, 438 (Bankr. D. S.C. 1983) (holding creditor had no interest in funds deposited two months prior to commencement). See generally J. White & R. Summers, Uniform Commercial Code, § 24−11 at 345−46 (3d ed. 1988). Back To Text

[47] In re Patio & Porch Systems, Inc., 194 B.R. at 569, 575 (Bankr. D. Md. 1996) (finding 9−306(4)(d) inapplicable since the case only involved the receipt of proceeds post−petition); In re Fort Dodge Creamery Co., 121 B.R. 831, 836 (Bankr. N.D. Iowa 1990) (dealing with liquidation of collateral and commingling after commencement of bankrutpcy); In re Turner, 13 B.R. 15, 22 (Bankr. D. Neb. 1981) (finding trustee failed to prove that debtor took possession of airplane prior to bankruptcy filing). Back To Text

[48] 58 B.R. 903 (Bankr. E.D. Mich. 1985). Back To Text

[49] See id. at 907. Back To Text

[50] See id. at 907. Back To Text

[51] See id. at 907. The court went on to state "[l]ike many issues in bankruptcy law, property rights under § 9−306 are determined at the inception of insolvency proceedings. Subsequent events in the insolvency proceeding do not affect these vested rights." Id. Back To Text

[52] 543 F.2d 652, 655 (9th Cir. 1975). Back To Text

[53] See id. at 656. Back To Text

[54] See id. at 656. Back To Text

[55] See also In re Charter First Mortgage, Inc., 56 B.R. at 838, 849 (Bankr. Or. 1985) (criticizing but nevertheless following the reasoning of In re Gibson Prod. of Ariz.). Back To Text

[56] See Fitzpatrick v. Philco Finance Corp., 491 F.2d 1288, 1292 (7th Cir. 1974) (rev'd on other grounds) (finding phrase "any cash proceeds" in subsection (ii) to mean cash proceeds from the sale of collateral in which creditor had security interest); see also In re Triple A Coal Co., 55 B.R. 806, 811 (Bankr. S.D. Ohio 1985) (finding creditor could not claim security interest in total funds deposited); In re Guaranteed Muffler Supply Co., 5 B.R. 236, 238 (Bankr. N.D. Ga. 1980) (finding In re Gibson Prod. of Ariz. court misinterpreted language and logic of section 9−306(4)(d)). Back To Text

[57] See supra note 51. Back To Text

[58] Reiley Guidebook to Security Interests in Personal Property § 7.06[1] (Eldon H. Reiley et al. eds., 2d ed. 1986). Back To Text

[59] See id. Back To Text

[60] See id. Back To Text

[61] In re Highland Park Assocs. Ltd. Partnership I, 130 B.R. 55, 59 (Bankr. N.D. Ill. 1991) (finding identification requirement of section 9−306(2) to be applicable to section 9−306(4)); In re Guaranteed Muffler Supply Co., 5 B.R. at

238 (holding secured creditor could not claim proceeds unless it's shown to have been collected upon disposition of property in which creditor had perfected lien). Back To Text

[62] See Maxl Sales Co. v. Critiques, Inc., 796 F.2d 1293, 1300−01 (10th Cir. 1986) (holding creditor failed to show what amounts were deposited from sales of its own collateral); see also In re Highland Park Assocs. Ltd. P'ship I, 130 B.R. at 59 (finding creditor must trace proceeds of specific collateral into account); In re Mark Twain Marine Indus., Inc., 115 B.R. 948, 954 (Bankr. N.D. Ill. 1990) (finding same). Back To Text

[63] See General Electric Co. v. Halmar Distrib., Inc. (In re Halmar Distrib., Inc.), 232 B.R. 18, 24 (Bankr. D. Mass. 1999) (finding burden of identifying proceeds from sale of its collateral to be on secured party); In re Litamar, Inc., 157 B.R. 828, 832 (Bankr. N.D. Ohio 1993) (finding creditor had burden of showing, by clear and convincing evidence, amount of cash proceeds received by debtor attributable to sale of collateral during ten−day pre−insolvency period); C.O. Funk & Sons, Inc. v. Sullivan Equip. Inc., 431 N.E.2d 370, 372 (Ill. App. Ct. 1982) (holding secured party must establish that proceeds "arose directly from the sale or other disposition of the collateral and that these alleged proceeds cannot have arisen from any other source"). Back To Text

[64] Stoumbos v. Kilimnik, 988 F.2d 949, 958 (9th Cir. 1992) (finding mere self−serving testimony to be inadequate to satisfy creditor's burden); In re Mark Twain Marine Indus., Inc., 115 B.R. 948, 953 (Bankr. N.D. Ill. 1990) (holding creditor failed to meet burden by not providing evidence of what remittances deposited into the account were for); U.S. v. Barsotti Brothers Bakery (In re Barsotti Bros. Bakery, Inc.), 80 B.R. 745, 748 (Bankr. W.D. Pa. 1987) (finding same). Back To Text

[65] See In re Oriental Rug Warehouse Club, 205 B.R. 407, 413 (Bankr. D. Minn. 1997) (finding secured party failed to satisfy burden of tracing); In re Barsotti Bros. Bakery, Inc., 80 B.R. at 748 (finding same); Maxl Sales, 796 F.2d at 1301 (finding no evidence of amounts received within ten days before institution of insolvency proceedings). Back To Text

[66] See In re Gibson, 543 F.2d 652, 656 (9th Cir. 1975). Back To Text

[67] See Maxl Sales Co. v. Critiques, Inc., 796 F.2d at 1301; see also In re Quaker Distributors, Inc., 189 B.R. at 71 (holding secured creditor loses its security interest in proceeds which are commingled before ten−day period); Feltman v. BankAtlantic, 182 B.R. 589, 594 (Bankr. S.D. Fla. 1995) (finding section 9−306(4)(d) to be inapplicable to funds paid long before ten−day period). Back To Text

[68] See supra notes 39−45. Back To Text

[69] See In re Barsotti Bros. Bakery, Inc., 80 B.R. at 748 (holding date of filing of involuntary petition was date of institution of insolvency proceedings for purposes of U.C.C.); see also In re Litamar, Inc., 157 B.R. 828, 833 (Bankr. N.D. Ohio 1993) (leaving undecided whether ten−day period would be computed from date of filing of chapter 11 or date of conversion to chapter 7); In re Charter First Mortgage, Inc., 56 B.R. 838, 850 (Bankr. Or. 1985) (finding, although state receivership was appointed earlier, date of bankruptcy proceeding should be date used for purposes of section 9−306(4)). Back To Text

[70] This example is based upon one created in an article published by John Grecco. Though nearly all of the information has been changed, it would be unfortunate not to attribute the main thrust of the example to Mr. Grecco. See John Grecco, Secured Creditor Beware: Postpetition Security Interest in Cash Proceeds May be Wiped Out by U.C.C. Article 9, Bankruptcy Strategist, September 1998, at 4. Back To Text

[71] See generally, George T. Lewis, Resolving Priority Disputes Under 9−306 of the Uniform Commercial Code, 27 Tenn. B.J. 14 (1991). Mr. Lewis intelligently discusses the persistent problems arising when banks attempt to setoff amounts owed to the bank. More specifically, the article addresses the problems of continuing overdrafts. Citing several cases and his own examples, the article demonstrates the harsh results which banks face when they allow overdrafts and pay themselves back out of funds subsequently deposited. The problem with this practice is that on many occasions, the money deposited is proceeds of collateral secured by an inventory or equipment lender. The

lender has almost no way of knowing that the debtor is writing overdrafts and that the bank is paying itself back out of the proceeds of the lender's collateral. The bank, on the other hand, likely knows that the deposits are proceeds of collateral, but won't encounter a claim by a lender until the depositor files for bankruptcy, which could be months after the setoff. Back To Text

[72] See, e.g., General Motors Acceptance Co. v. Lincoln Nat'l Bank, 18 S.W.3d 337, 340 (Ky. 2000) (finding bank liable to creditor for conversion since creditor's security interest in identifiable proceeds of its collateral took priority over bank's right to apply those proceeds as setoff); Textron Financial Co. v. Firstar Bank Wisconsin, 217 Wis.2d 582, 591 (1998) (holding bank's right to keep set−off was defeated by security interest in the same funds, whether or not bank had knowledge that set−off violated security interest). See generally, David B. Harrison, Annotation, Effect Of UCC Article 9 Upon Conflict, as to Funds in Debtor's Bank Account, Between Secured Creditor and Bank Claiming Right of Setoff, 3 A.L.R.4th 998 (1981). Back To Text

[73] See In re Triple A Coal Co., 55 B.R. 806, 812 (Bankr. S.D. Ohio 1985) (precluding bank from setting off against debtor's general deposit account where bank knew funds were proceeds subject to perfected security interest); see also Westerly Community Credit Union v. Indus. Nat'l Bank, 240 A.2d 586, 591 (R.I. 1968) (absent actual or constructive notice on part of bank that deposited funds belonged to third person, bank had right to set off debts owed to it by depositor); Cooper v. Nevada Bank of Commerce, 403 P.2d 198, 199−200 (Nev. 1965) (bank with neither actual knowledge nor knowledge of facts sufficient to put it upon inquiry concerning third person's interest in deposited funds may apply deposit to individual debt of depositor). Back To Text

[74] See supra note 71. Back To Text

[75] See Citizens Nat'l Bank v Mid−States Dev. Co., 177 Ind. App. 548, 557 (1978) (discussing effect of section 9−201, which is to give the secured party priority upon debtor's default, and finding bank's claim of setoff, where bank was unsecured general creditor, to be subordinated to secured party's security interest). Back To Text

[76] See generally, Stephen L. Sepinuck, The Problems With Setoff: A Proposed Legislative Solution, 30 Wm. & Mary L. Rev. 51, 73 (1988) (discussing major problems with effect of various state laws and setoff). Back To Text

[77] This example is based upon one contained within Reiley Guidebook to Security Interests in Personal Property § 7.06[1] (Eldon H. Reiley et al. eds., 2d ed. 1986). The specific names and numbers have been changed for the purposes of this article. Back To Text

[78] See In re Gibson Prod. of Ariz., 543 F.2d 652, 655 (9th Cir. 1975) (finding security interest in excess proceeds in account to be illegal preference); but see In re Guaranteed Muffler Supply Co., 5 B.R. 236, 238 (Bankr. N.D. Ga. 1980) (finding absolutely no conflict between section 9−306(4)(d) and old Bankruptcy Act). Back To Text

[79] 11 U.S.C. § 101(53) (2000). Back To Text

[80] See 11 U.S.C. § 545(1)(B) (2000). Back To Text

[81] General Motors Acceptance Corp. v. Taft (In re Dexter Buick−GMC Truck Co.), 2 B.R. 242, 246 (Bankr. D. R.I. 1980) (finding agreement between the plaintiff and debtor clearly establishes a security interest and not statutory lien). Back To Text

[82] See id. at 246. See generally, 2 Gilmore, § 27.4 at 735 –736; 3 Norton Bankruptcy Law & Practice 2d. § 57:25 at 109−115 (William L. Norton, Jr. et al. eds., 2d ed. 1991) . Back To Text

[83] 11 U.S.C. § 547 (2000). Back To Text

[84] See In re Gibson Prod. of Ariz., 543 F.2d 652, 655 (9th Cir. 1975) . Back To Text

[85] See generally, 3 Norton, § 57:25 at 109−115. Back To Text

[86] See 2 Gilmore, § 45.9 at 1338. Back To Text

[87] See supra notes 22 − 26. Back To Text

[88] See Duncan, The Law and Practice of Secured Transactions: Working with Article 9 § 2.05[3](c) at 2−55 (stating "the prudent secured party should avoid having to rely on these rules by insisting, when practicable, that the debtor maintain a separate deposit account for holding cash proceeds). Back To Text

[89] See U.C.C. § 9−105(1)(e). The term "deposit account" is defined as "a demand, time, savings, passbook or like account maintained with a bank, savings and loan association, credit union or like organization, other than an account evidenced by a certificate of deposit." Id. Back To Text

[90] See In re Quaker Distributors, Inc., 189 B.R. 63, 71 (Bankr. E.D. Pa. 1995) (finding, section 9−306(4)(a), pre−petition security interest extended to proceeds which were segregated in separate account). Back To Text

[91] 2 B.R. 188, 196 (Bankr. S.D. Tx. 1980). Back To Text

[92] See In re Cooper, 2 B.R. at 196; see also In re Barsotti Bros. Bakery, 80 B.R. 745, 747 (Bankr. W.D. Pa. 1987) (citing In re Cooper); In re Martin, 48 B.R. 317, 321 (N.D. Texas 1985) (quoting from In re Cooper). Back To Text

[93] See In re Martin, 48 B.R. at 321 (finding that framers of U.C.C. intended to create limitation on type of account, containing only proceeds, which would fall within application of subsection 9−306(d)(1)). Back To Text

[94] Rev. U.C.C. § 9−102(a)(64) (1998). Back To Text

[95] PEB Report, Recommendation (A)(2), Section 15 at 106. Back To Text

[96] PEB Report, Recommendation (A)(3), Section 15 at 106. The PEB questioned the wisdom of limiting proceeds to what is "received by the debtor." They found it difficult to rationalize why, for example, "a security interest in identifiable collections on accounts collateral should not exist merely because the collections received are received by an escrow agent or paid into court." The PEB also found that the limitation to what is "received" implies physical possession or receipt, and that this concept conflicted with the reality that intangibles could be proceeds of collateral. Ultimately, the PEB recommended that that concept of acquisition of rights be substituted for the receipt concept. Back To Text

[97] See id. at 107. Back To Text

[98] See id. at 107. Back To Text

[99] See PEB Report, Recommendation (G) and Comments, Section 15 at 122. Back To Text

[100] See id. at 122. Back To Text

[101] See id. at 122. Back To Text

[102] See id. at 122. Back To Text

[103] See id. at 123. Back To Text

[104] See id. at 123. Back To Text

[105] See rev. U.C.C. § 9−315 Comment 8 (1998). Back To Text

[106] See id. Back To Text

[107] Rev. U.C.C. § 9−315(b) (1998). Back To Text

[108] See supra notes 35−38. Back To Text

[109] See rev. U.C.C. § 9−315(a)(2) (1998). Back To Text

[110] Reiley, Security Interests in Personal Property § 6.12 at 6−21 (Gordon H. Reiley et al. eds., 3d ed. 2000) (finding it no longer necessary to discuss what the original language of 9−306(4)(d) meant or whether it was valid) Back To Text

[111] See supra notes 33−38. Back To Text

[112] See In re Columbia Gas Sys., Inc., 997 F.2d 1039, 1063 (3d Cir. 1993). Back To Text

[113] See, e.g., General Motors Acceptance Corp. v. Norstar Bank, N.A., 532 N.Y.S.2d 685 (N.Y. Sup. Ct. 1988) (adopting and citing 13 jurisdictions adopting LIBR method of tracing); see also Universal C.I.T., 358 F.Supp. at 325 (utilizing LIBR); Harley−Davidson Motor Co. v. Bank of New Eng.−Old Colony, 897 F.2d 611, 622 (1st Cir. 1990) (utilizing same). Back To Text

[114] See First Wis. Fin. Corp. v. Yamaguchi, 812 F.2d 370, 375 (7th Cir. 1987). Back To Text

[115] See United States v. Banco Cafetero Pan., 797 F.2d 1154, 1159 (2d Cir. 1986). Back To Text

[116] See PEB Report, Section 15 at 124 (also finding old paragraph (d) to be penalty for secured party's failure to police proceeds). Back To Text

[117] Restatement (Second) of Trusts § 202 Comment j. The following are three illustrations which are provided after Comment j. Though each is rather simple, they are very helpful in understanding the effect of the LIBR. Illustration 20, 21 and 22 provide:

20. A is trustee for B of $1000. He deposits this money together with $1000 of his own in a bank. He draws out $1500 and dissipates it. He later deposits $1000 of his own in the account. B is entitled to a lien on the account for $500, the lowest intermediate balance.

21. A is trustee for B of $1000. He deposits this money together with $1000 of his own in a bank. He draws out the whole $2000 and dissipates it. He later deposits $500 of his own. B is not entitled to a lien on the account.

22. A is trustee for B of $1000. He deposits this money together with $1000 of his own in a bank. He draws out various amounts and makes further deposits of money of his own. The amount on deposit in the account is at no time less than $1000. B is entitled to a lien on the account for $1000. Id. Back To Text

[118] Rev. U.C.C. § 9−315 Comment 3 (1998). Back To Text

[119] See Universal C.I.T. Credit Corp. v. Farmers Bank of Portageville, 358 F. Supp. 317, 326 (E.D. Mo. 1973); see also Meyer v. Norwest Bank Iowa, N.A., 112 F.3d 946, 951 (8th Cir. 1997) (finding LIBR assumes traced proceeds are last funds withdrawn from contested account); Sony Corp., 85 F.3d 131, 138 (4th Cir. 1996) (stating LIBR "assumes that the debtor spends his own money out of the account before he spends the funds encumbered by the security interest"). Back To Text

[120] See C.O. Funk & Sons, 421 N.E.2d at 372; see also In re Dameron, 155 F.3d 718, 724 (4th Cir. 1998) (finding if amount on deposit in commingled account had at all times equaled or exceeded amount of trust, trust's funds would be returned in full amount); In re Oriental Rug Warehouse Club, 205 B.R. 407, 411 (Bankr. D. Minn. 1997) (finding presumption that proceeds remained in commingled account as long as account balance was equal to or exceeded amount of proceeds). Back To Text

[121] See In re Oriental Rug Warehouse Club, 205 B.R. at 411 (emphasizing that secured party has burden to trace his proceeds); Frumenti v. Chrysler Credit Corp., 22 Cal. Rptr. 2d 37, 41 (Cal. App. 1993) (finding same); C.O. Funk & Sons, 421 N.E.2d at 372 (finding same); but see In re Parker Steel Co., 149 B.R. 834 (Bankr. N.D. Ohio 1992) (refusing to extend interest to deposit account because burden not met). Back To Text

[122] Frumenti, 22 Cal. Rptr.2d at 41 (finding secured party lost interest in proceeds in deposit account when balance reduced to zero); Security State Bank, 965 F. Supp. 1237, 1245 (N.D. Iowa 1997) (stating that once traced proceeds are withdrawn, they are treated as lost); C.O. Funk & Sons, 431 N.E.2d at 372 (finding, if balance of account dips below amount of deposited proceeds, prior security interest in identifiable proceeds abates accordingly). Back To Text

[123] See Universal C.I.T., 358 F. Supp. at 326 (finding lack of intent to make restitution); but see In re Dameron, 155 F.3d at 724 (stating "in no case is the trust permitted to be replenished by deposits made subsequent to the lowest intermediate balance"). Back To Text

[124] Universal C.I.T., 358 F. Supp. at 326−27. See generally, 1 Clark, The Law of Secured Transactions Under the Uniform Commercial Code ¶ 310.03 at 10−53 (discussing commingled proceeds and various applications of LIBR). Back To Text

[125] C.O. Funk & Sons, 421 N.E.2d at 372. Back To Text

[126] See id. at 372. Back To Text

[127] 496 U.S. 53 (1990). Back To Text

[128] 26 U.S.C. § 7501. Back To Text

[129] 496 U.S. at 62. Back To Text

[130] Id. at 67. But see In re Ruggeri Electrical Contracting, Inc., 214 B.R. 481, 489 (E.D. Mich. 1997) (finding transfer by debtor was not voluntary, and therefore not within the purview of Begier). Back To Text

[131] 496 U.S. at 66. Back To Text

[132] 163 F.3d 1063, 1066 (9th Cir. 1998). Back To Text

[133] Id. at 1068. Back To Text

[134] See In re Al Copeland Enterprises, Inc., 133 B.R. 837 (Bankr. W.D. Tex. 1991) (finding debtor liable to state for sales taxes which were identified and traced into concentration account). Back To Text

[135] See In re Carozzella & Richardson, 255 B.R. 267, 276 (Bankr. D. Conn. 2000) (finding that Begier did not "implicitly reject" common−law tracing rules for preference cases); In re Flying Boat, Inc., 245 B.R. 241, 253 (Bankr. N.D. Tex. 1999) (noting that Begier expressly states that its ruling is not a mandate and that other methods of tracing may be reasonable). Back To Text

[136] See In re Wellington Foods, Inc., 165 B.R. 719, 728 (Bankr. S.D. Ga. 1994) (finding voluntary pre−petition payment to be necessary requirement for applying "reasonable assumption" standard); In re Plummer, 174 B.R. 284, 287 (Bankr. C.D. Cal. 1992) (finding Begier inapplicable where debtor had failed to designate payments as trust fund payments); see also In re Antweil, 154 B.R. 982, 987 (Bankr. D. N.M. 1993) (rejecting Begier analysis and finding that it only deals with unique type of situation where trust created for the benefit of IRS). Back To Text

[137] See In re Flying Boat, Inc., 245 B.R. at 252 (refusing to apply "reasonable assumptions" analysis and applying LIBR to trace user fees collected by debtor−aircraft operator in connection with ticket sales which were owed to U.S. Department of Agriculture and Immigration Naturalization Service); In re Columbia Gas Sys. Inc., 997 F.2d 1039,

1064 (3d Cir. 1993) (applying LIBR to collected customer refunds and surcharges). Back To Text

[138] 923 F.2d 641, 649−50 (9th Cir. 1991). Back To Text

[139] Id. Back To Text

[140] Id. Back To Text

[141] See Estate of Agioritis, 52 A.D.2d 128 (1st Dept. 1976); Estate of Spinelli, 384 N.Y.S.2d 665 (N.Y. Surr. Ct. 1976); but see Chase Manhattan Bank, N.A. v. Traditional Investments Corp., 1995 WL 72410, *3 (S.D.N.Y. 1995) (applying LIFO where depositors were fraudulently induced into depositing funds such that depositor's receive their money in inverse order of times of their respective payments into fund). Back To Text

[142] In re Wilbert D. Hassebroek, 136 B.R. 527, 531 (Bankr. N.D. Iowa 1991) (citing J. White & R. Summers, Uniform Commercial Code, 333−334 for promoting FIFO method of allocating payments to debt). Back To Text

[143] 923 F.2d 641, 650 (9th Cir. 1991). See also Taxel v. Surnow (In re San Diego Realty Exch., Inc.), 1994 WL 161646, *3 (9th Cir. (Cal.) 1994) (utilizing FIFO to trace alleged trust funds in commingled accounts); but see Farmers and Merch. Nat'l Bank v. Sooner Coop., Inc., 766 P.2d 325, 329 (Okl. 1988) (finding artificial tracing methods such as LIBR and FIFO to apply only when deposited proceeds have completely lost their identity; here, the proceeds were actually traceable). Back To Text

[144] See Rev. U.C.C. § 9−336(b) (1998). Back To Text

[145] Rev. U.C.C. § 9−336(f)(2). Back To Text

[146] See Bombardier Capital, Inc. v. Key Bank of Maine, 639 A.2d 1065 (Me. 1994) (recognizing that two secured creditors interests required prorating account balance); Mid−States Sales Co., Inc. v. Mountain Empire Dairymen's Assoc., Inc., 741 P.2d 342 (Colo. Ct. App. 1987) (finding secured creditor which had security interest in fifty−two percent of debtor's inventory had fifty−two percent interest in total proceeds); In re Koch, 54 B.R. 26 (Bankr. W.D. Wis. 1985) (finding debtor's bank account should be divided pro−rata between two secured creditors). Back To Text

[147] 76 B.R. 836, 839 (M.D. Ala. 1986). Back To Text

[148] Id. at 838. Back To Text

[149] Id. at 839. Back To Text

[150] 232 B.R. at 25−26. Back To Text

[151] 232 B.R. at 26 (quoting from General Motors Acceptance Corp. v. Norstar Bank, N.A., 532 N.Y.S.2d 686 (N.Y. Sup. Ct. 1988)). Back To Text

[152] 639 A.2d at 1067−68. Back To Text

[153] Rev. U.C.C. § 9−102(1)(29) (1998). Back To Text

[154] Under rev. § 9−102(a)(9), cash proceeds now include "money, checks, deposit accounts or the like." Back To Text

[155] Revised § 9−104 provides the requirements for control. It provides:

(a) [Requirements for control.] A secured party has control of a deposit account if:

(1) the secured party is the bank with which the deposit account is maintained;

(2) the debtor, secured party, and bank have agreed in an authenticated

record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the account without further consent by the debtor; or

(3) the secured party becomes the bank's customer with respect to the deposit account.

(b) [Debtor's right to direct disposition.] A secured party that has satisfied subsection (a) has control, even if the debtor retains the right to direct the disposition of funds from the deposit account.

Id. Back To Text

[156] See Rev. U.C.C. § 9−327(1) (1998). Back To Text

[157] See Rev. § 9−322(a) (stating general priority rules among conflicting security interests. . . in same collateral is determined according to certain rules; one rule refers to "other provisions of this part" which includes § 9−327 which deals with priority in deposit accounts). Back To Text

[158] See Rev. U.C.C. § 9−327(3) (1998). Back To Text

[159] See Rev. U.C.C. § 9−927(4) (1998). Back To Text

[160] See Rev. U.C.C. § 9−339 (1998) ("This article does not preclude subordination by agreement by a person entitled to priority."). Back To Text