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Secured Transactions in Personal Property—Operation of U.C.C. 9-306(4)(d) in Bankruptcy—Secured Party's Rights to Non-Identifiable Proceeds under Code Constitutes Voidable Preference—Arizona Wholesale Supply Co. v. Itule (In re Gibson Products), 543 F.2d 652 (9th Cir. 1976)

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SECURED TRANSACTIONS IN PERSONAL PROPERTY—OPERATION OF U.C.C. § 9-306(4)(d) IN BANKRUPTCY—SECURED PARTY'S RIGHTS TO NON-IDENTIFIABLE PROCEEDS UNDER CODE CONSTITUTES VOIDABLE PREFERENCE—*Arizona Wholesale Supply Co. v. Itule (In re Gibson Products)*, 543 F.2d 652 (9th Cir. 1976).

In *Arizona Wholesale Supply Co. v. Itule (In re Gibson Products)*,¹ the Ninth Circuit held, in a case of first impression, that the operation of section 9-306(4)(d) of the Uniform Commercial Code (Code),² which

1. 543 F.2d 652 (9th Cir. 1976), *petition for cert. filed*, 45 U.S.L.W. 3602 (U.S. Jan. 1, 1977) (No. 76-1097).

2. In *Gibson Products*, the actual statute governing security interests in proceeds was ARIZ. REV. STAT. § 44-3127(D) (West 1967), as amended by ARIZ. REV. STAT. § 44-3127(D) (West. Supp. 1976). Its provisions were exactly the same as § 9-306(4) of the Code as it existed prior to the 1972 amendments. It provided:

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

- (a) in identifiable non-cash proceeds;
- (b) in identifiable cash proceeds in the form of money which is not commingled with other money or deposited in a bank account prior to the insolvency proceedings;
- (c) in identifiable cash proceeds in the form of checks and the like which are not deposited in a bank account prior to the insolvency proceedings; and
- (d) in all cash and bank accounts of the debtor, if other cash proceeds have been commingled or deposited in a bank account, but the perfected security interest under this paragraph (d) is
 - (i) subject to any right of set-off; and
 - (ii) limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings and commingled or deposited in a bank account prior to the insolvency proceedings less the amount of cash proceeds received by the debtor and paid over to the secured party during the ten day period.

U.C.C. § 9-306(4) (1968 version).

The court in *Gibson Products* used this earlier version and indicated that the 1972 amendments to the Code would not alter the result of the case. 543 F.2d at 653 n.1. This casenote will use the 1972 version of § 9-306, except where the earlier version is properly applicable. The revised section provides in pertinent part:

(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. Money, checks, deposit accounts, and the like are "cash proceeds". All other proceeds are "non-cash 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 in [sic] a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a

provides for a perfected security interest in commingled proceeds in the event of insolvency, constituted a voidable preference within the meaning of section 60 of the Bankruptcy Act.³ This has ended any utility that section 9-306(4)(d) may have had in bankruptcy proceedings in the Ninth Circuit.

I. FACTS OF THE CASE

Gibson Products of Arizona was indebted to Arizona Wholesale Supply Co. in the amount of \$28,800 for household appliances which Wholesale had sold to Gibson. Wholesale had a perfected security

perfected security interest and becomes unperfected ten 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 security interest in the proceeds is perfected before the expiration of the ten day period.

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.

(4) In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest 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 to set-off; and
 - (ii) limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings 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) of this subsection (4).

U.C.C. § 9-306 (1972 version).

The 1972 revised version attempts to clarify some of the more obvious trouble spots, without making any drastic textual changes. The new version adds the words "only in the following proceeds" to make it clear that § 9-306(4) is the exclusive remedy upon insolvency. The troublesome phrase "any cash proceeds" in § 9-306(4)(d)(ii) was retained. See text accompanying notes 31-33, 39-42 *infra*. Section 9-306(4)(d) was altered to require a showing by the secured party that at least some of his proceeds are present in *each* bank account of the debtor in which the secured party claims an interest.

3. Bankruptcy Act of 1938, § 60, 11 U.S.C. § 96 (1970).

interest in these appliances. Gibson declared bankruptcy on January 13, 1972.⁴ In the ten day period prior to the institution of these proceedings, Gibson deposited \$19,505.27 in its bank account, only ten dollars of which was shown to be derived from the sale of an appliance in which Wholesale had a perfected security interest.⁵ Wholesale claimed the entire \$19,505.27 under section 9-306(4)(d) in opposition to the claim of the trustee in bankruptcy. The Bankruptcy Court awarded judgment to Wholesale, the district court affirmed,⁶ and the trustee in bankruptcy appealed. The Court of Appeals for the Ninth Circuit reversed, holding that "the operation of U.C.C. Section 9-306(4)(d) created a voidable preference by the transfer to the creditor of a perfected security interest in the cash deposited in the debtor's account that exceeded the amount of the creditor's proceeds."⁷

II. INTRODUCING THE CONTESTANTS

A. Secured Party's Right to Proceeds in Bankruptcy

Section 9-306 governs the secured party's interest in "proceeds." Proceeds are defined as "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds."⁸ They are further broken down into cash and non-cash proceeds. The former includes money, checks, and deposit accounts; the latter includes all other proceeds.⁹ As a general rule, a perfected security interest in collateral continues in any proceeds received in exchange for the collateral.¹⁰ For example, if a finance company has a perfected security interest¹¹ in a dealer's inventory, unless there has been an agreement

4. 543 F.2d at 654. Gibson initiated bankruptcy proceedings pursuant to Chapter XI of the Bankruptcy Act. Bankruptcy Act of 1938, § 301, 11 U.S.C. § 701 (1970). Chapter XI proceedings are voluntary and are invoked by the debtor. Basically, they involve a court-supervised method whereby a debtor can achieve a composition-extension with his general creditors in order to gain financial rehabilitation. See generally 8 & 9 COLLIER ON BANKRUPTCY ¶¶ 1.01-15.04 (14th ed. J. Moore & L. King 1976) [hereinafter cited as COLLIER]. There is usually no trustee in Chapter XI proceedings. For reasons which are not explained, a trustee was appointed in *Gibson Products*.

5. 543 F.2d at 654-55.

6. *Id.* at 654.

7. *Id.*

8. U.C.C. § 9-306(1) (1972 version).

9. *Id.*

10. *Id.* § 9-306(2) (1972 version). The secured party's Code rights appear to be co-extensive with his pre-Code rights under U.C.C. § 9-306(2) & (3) (1972 version). See, e.g., *Girard Trust Comm. Exch. Bank v. Warren Lepley Ford, Inc.*, 25 Pa. D. & C.2d 395 (C.P. 1958); Countryman, *Code Security Interests in Bankruptcy*, 4 U.C.C.L.J. 35, 43-44 (1971) [hereinafter cited as Countryman].

11. This casenote will assume that a security interest has been duly perfected under

to the contrary, the company also maintains its security interest in cash, promissory notes, and trade-ins received by the dealer as a part of the sale of the goods.

Of course, the secured party has to be able to identify his proceeds.¹² This is not a difficult hurdle if, for example, a buyer trades in his old car and signs a promissory note. Problems arise when the debtor combines cash received from the sale of collateral with his other funds. When such commingling occurs, there is a division of authority over whether the secured party retains his security interest. While it has been argued that a security interest is lost once commingling occurs,¹³ the courts may permit tracing¹⁴ to assist in the identification process.¹⁵

In bankruptcy today, however, a novel concept has been introduced by section 9-306(4). Applicable only in the case of insolvency,¹⁶ whether instituted by the creditor or by the debtor, section 9-306(4) was apparently designed to eliminate the need for extensive tracing. The interest in identifiable (*i.e.*, non-commingled) cash and non-cash proceeds continues under sections 9-306(4)(a), (b), and (c). Section (4)(d), however, presents a new formula. It purports to give the secured party an interest in commingled proceeds, which may or may not have been traceable as proceeds of the collateral. This formula was designed to be the exclusive remedy of the secured party in insolvency proceedings, precluding any claim based on tracing *even if* the secured creditor can trace more than the section 9-306(4)(d) formula gives to him.¹⁷

the Code at least four months prior to the date of bankruptcy, and that any steps necessary to retain a perfected security interest in proceeds were taken. *See* U.C.C. §§ 9-302 to 9-306(3), 9-401 to 9-403 (1972 version).

12. U.C.C. § 9-306(2) (1972 version).

13. *See* G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 27.4, at 735-36 (1965) [hereinafter cited as GILMORE].

14. In most instances, "traceable" is equated with "identifiable." *See* Gillombardo, *The Treatment of Uniform Commercial Code Proceeds in Bankruptcy: A Proposed Redraft of Section 9-306*, 38 U. CIN. L. REV. 1, 8 (1969) [hereinafter cited as Gillombardo]. However, these terms are not equatable under U.C.C. § 9-306(4)(b) & (c). Under these sections, the proceeds received when collateral is disposed of must not be commingled with other funds of the debtor. *See* GILMORE, *supra* note 13, § 45.9, at 1338.

15. *See* Countryman, *supra* note 10, at 44 n.22.

16. The Code defines insolvency proceedings rather broadly as "includ[ing] any assignment for the benefit of creditors or other proceedings intended to liquidate or rehabilitate the estate of the person involved. U.C.C. § 1-201(22). Thus, bankruptcy is included.

17. *See* GILMORE, *supra* note 13, § 45.9, at 1338. In support of this position, the

To determine the interest under section 9-306(4)(d),¹⁸ the amount of cash proceeds received by the debtor during the ten days before the institution of bankruptcy must be ascertained.¹⁹ The interpretation of the phrase "any cash proceeds" in section (4)(d)(ii) is critical. It was given an expansive reading by the court in *Gibson Products*.²⁰ Once this amount is determined, there must be deducted any cash proceeds received by the debtor and paid over to the secured party during those ten days,²¹ and the amounts to which the secured party is entitled under sections (4)(a), (b), and (c).²² Finally, a depository bank's rights of set-off are deducted.²³ The remaining sum constitutes the amount of the section (4)(d) security interest in the general accounts of the debtor.²⁴ The secured party then must make an initial showing that at least a portion of his proceeds is present in each commingled account of the debtor in which he claims a section (4)(d) interest.²⁵

B. Power of Trustee to Avoid Preferential Transfers

Even a perfected security interest can be defeated by an attack from the bankruptcy trustee's arsenal.²⁶ The amount the secured party can claim in a bankruptcy proceeding under section 9-306(4)(d) depends not only on the interpretation of the (4)(d) interest, but in large part, on the section's ability to withstand the trustee's power to avoid the interest as a preferential transfer. Under section 60 of the Bankruptcy Act, the trustee must prove the elements of a voidable preference. (1) A transfer; (2) of the debtor's property; (3) where the creditor has reasonable cause to believe that the debtor is insolvent when the transfer is made; (4) for or on account of an antecedent debt;

official reasons given for the 1972 amendment to U.C.C. § 9-306(4) state that "[t]he revised subsection (4) is a clarification based on the California revision. It makes clear that the claim to cash allowed in insolvency is exclusive of any other claim based on tracing." U.C.C. § 9-306 (1972 version) (Official Reasons for 1972 Change).

18. Professor Gilmore, a drafter of the Code, has recommended a three-step formula to ascertain the sum of the secured party's interest in commingled funds in bankruptcy. See GILMORE, *supra* note 13, § 45.9, at 1338-39.

19. U.C.C. § 9-306(4)(d)(ii) (1972 version).

20. See text accompanying notes 31-33, 39-42 *infra*.

21. U.C.C. § 9-306(4)(d)(ii)(I) (1972 version).

22. *Id.* § 9-306(4)(d)(ii)(II).

23. *Id.* § 9-306(4)(d)(i).

24. For a discussion of whether the secured party's rights to proceeds prior to insolvency are equal to his rights after insolvency, see Gillombardo, *supra* note 14, at 23; GILMORE, *supra* note 13, § 45.9, at 1339.

25. U.C.C. § 9-306(4)(d) (1972 version).

26. See note 43 *infra*.

(5) within four months of bankruptcy; (6) the effect of which will enable the creditor to obtain a greater percentage of his debt than some other creditor of the same class.²⁷ The Act also provides that a transfer is "deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee."²⁸

If a security interest attaches and is perfected in collateral more than four months before bankruptcy, and the proceeds are identifiable under sections 9-306(4)(a), (b), or (c), the security interest is safe from attack by the trustee.²⁹ However, when the proceeds are commingled, the trustee might attack the interest arising under section 9-306(4)(d) on the ground that it is a voidable preference. Because the security interest does not arise until the moment insolvency proceedings are begun, the interest may be *deemed* a transfer on account of an antecedent debt at a time when the creditor probably had reason to know of the debtor's insolvency. This is the attack which proved successful in *Gibson Products*.

III. REASONING OF THE COURT

The court cited Professor Gilmore's observation that section 9-306(4)(d) was not meant to provide a windfall, but rather to "sharply [cut] back the secured party's rights when insolvency proceedings are initiated."³⁰ Section 9-306(4)(d) would lighten the secured party's tracing burden, but it would place a maximum on the sum which the secured party could claim equal to the amount of cash proceeds received in the ten day period prior to bankruptcy.

27. Bankruptcy Act of 1938, § 60, 11 U.S.C. § 96 (1970). For a more detailed consideration of each of the elements, see generally 3 COLLIER, *supra* note 4, ¶¶ 60.07-35, 60.53. In *Gibson Products*, the court did not discuss whether the knowledge requirement was met. Evidently, the court presumed that Wholesale would have reasonable cause to know of Gibson's insolvency. It has been recommended that this requirement be completely eliminated. See Comment, *Voidable Preferences: An Analysis of the Proposed Revisions of Section 60b of the Bankruptcy Act*, 1974 WIS. L. REV. 481, 482.

28. Bankruptcy Act of 1938, § 60a(2), 11 U.S.C. § 96(a)(2) (1970).

29. *Arizona Wholesale Supply Co. v. Itule (In re Gibson Products)*, 543 F.2d 652, 655 (9th Cir. 1976), *petition for cert. filed*, 45 U.S.L.W. 3602 (U.S. Jan. 1, 1977) (No. 76-1097).

30. *Id.* (quoting GILMORE, *supra* note 13, § 45.9, at 1337-38). According to the court's reading of the drafters' intent, by limiting that which secured parties could claim to an amount received during the last ten days before bankruptcy, it was assumed that they would be entitled to a lesser sum than if they could trace funds deposited over a longer period of time.

The phrase "any cash proceeds" in section 9-306(4)(d)(ii) was interpreted to mean all cash receipts from any source received by the debtor in the ten day period prior to bankruptcy.³¹ The court explicitly rejected the interpretation given in *Fitzpatrick v. Philco Finance Corp.*,³² where the Seventh Circuit interpreted the phrase in conjunction with the definition of proceeds in section 9-306(1) and limited it to "cash proceeds from the sale of collateral in which the creditor had a security interest."³³

Under the Ninth Circuit's interpretation, Wholesale would have received a windfall to the detriment of general creditors. However, this possibility was eliminated by the application of section 60 of the Bankruptcy Act. The court enumerated the various elements of a preference, including a discussion of "transfer" in section 60a(2).³⁴ The court then applied these elements to the facts. Wholesale's interest in the

31. 543 F.2d at 656.

32. 491 F.2d 1288 (7th Cir. 1974). In *Fitzpatrick*, the Seventh Circuit considered a fact situation similar to *Gibson Products*. Philco had extended a credit line of \$275,000 to the debtor, a retail appliance dealer, and taken a security interest in the appliances. During the ten days prior to the institution of bankruptcy proceedings, the debtor paid Philco \$44,766.84 from its general account. The trustee in bankruptcy proved that in those ten days \$4,513.44 had been received by the debtor as proceeds from the sale of Philco's collateral. The trustee argued that under § 9-306(4)(d), Philco's security interest in proceeds was *limited* to the proceeds received by the debtor in the ten days prior to bankruptcy—here, only the \$4,513.44. The Seventh Circuit agreed, finding that \$40,253.40 of the \$44,766.84 already paid to Philco constituted a voidable preference. *Id.* at 1292.

The court's reasoning seems patently incorrect. Section 9-306(4)(d) should not have been applied to the \$40,253.40 already paid to the secured party by the debtor. The section does not act as a limit on funds paid to the secured party in the ten day period. It merely requires that, to the extent that the proceeds were received by the debtor *and* paid over during the ten day period, they are to be deducted from the cash proceeds which the debtor received in the ten day period. In regards to the \$40,253.40 paid to Philco, the question which should have been considered was not whether § 9-306(4)(d) acted as a limit, but simply whether it constituted a voidable preference.

The trustee did not attempt to void Philco's interest in the \$4,513.44. The court noted that it was surprised at the omission of this argument given the voluminous literature on the subject of the invalidity of section 9-306(4)(d) in bankruptcy. Since the issue was not raised, the court did not consider it. *Id.* at 1292 n.4. Thus, the court in *Gibson Products* was the first to face the issue.

33. *Id.* at 1292.

34. Under an earlier Ninth Circuit ruling, the court had held that a "transfer" for purposes of § 60a(2) was "equated with the act by which priority over later creditors is achieved and not with the event which attaches the security interest to a specific account." 543 F.2d at 656 (quoting *DuBay v. Williams*, 417 F.2d 1277, 1287 (9th Cir. 1969)). In *Gibson Products*, this "act" would be the institution of bankruptcy proceedings, for it is only at that time § 9-306(4) is applicable. One noted commentator has criticized the theory of transfer in *DuBay*. See Countryman, *supra* note 10, at 53-55.

fund, and its priority over later creditors, did not arise "until (1) some part of Wholesale's proceeds were deposited with other cash in Gibson's bank account, (2) within ten days of Gibson's filing its Chapter XI petition."³⁵ A transfer for or on account of an antecedent debt has therefore occurred, because "Wholesale could not qualify for Section 9-306(4) treatment absent the antecedent debt."³⁶ Since the requisite elements were satisfied, the transfer of the excess, above Wholesale's proceeds, was declared a preference.³⁷ In order to rebut the presumption of a preference, the court required the secured party to trace his interest into the commingled funds.³⁸

IV. ANALYSIS OF THE DECISION

A. *Interpretation of "Any Cash Proceeds"*

The court interpreted the phrase "any cash proceeds" in section 9-306(4)(d)(ii) to mean all cash receipts from any source received by the debtor in the ten day period prior to bankruptcy. The court reasoned:

The statute divides "proceeds" into two categories, "identifiable" and "comingled," *i.e.*, nonidentifiable proceeds, and alters the reach of a perfected security interest, depending upon whether the proceeds are identifiable or nonidentifiable. . . . Section 9-306(4)(d) deals only with nonidentifiable cash proceeds. If the cash proceeds could be "identified," *i.e.*, had not been comingled, the secured party would have a perfected security interest in the whole fund under Section 9-306(4)(b), just as he did in pre-Code days, without any of the limitations imposed by Section 9-306(4)(d). Under the Code scheme, the secured creditor also has a perfected security interest under subsection (d) when he cannot identify his proceeds in the comingled fund, as long as he can show that some of his proceeds were among those in the comingled fund.³⁹

The court's reasoning is obscure. While the statements are valid as far as they go, it is still difficult to understand why the court believes the

35. 543 F.2d at 656-57.

36. *Id.* at 657.

37. *Id.*

38. *Id.*

39. *Id.* at 656.

definition of proceeds should vary depending on whether the proceeds are identifiable or commingled. Proceeds is a term of art, specifically defined in section 9-306(1) and limited to whatever is received when collateral is exchanged or sold. By construing the phrase to mean all cash receipts from any source, the court has given proceeds two separate meanings within the same section, without any solid justification that the drafters intended such a result.⁴⁰ Under section 9-306(1), the term proceeds is explicitly given a narrow reading, while under the Ninth Circuit's interpretation of section 9-306(4)(d), it is given an extremely broad one.

If the idea of section 9-306(4)(d) was to give secured parties an interest in all cash receipts from any source, whether or not they were actual proceeds of the creditor, the secured party would receive a benefit unavailable outside of insolvency or in pre-Code days. Section 9-306(4)(d) operates like a presumption. To the extent that a creditor can show a certain amount of his proceeds were received in the ten day period prior to insolvency, and if they are not identifiable under sections 9-306(4)(a), (b), and (c), these proceeds are presumably present in the debtor's commingled cash and bank accounts. Requiring the secured party to show that a portion of his proceeds, no matter how small an amount, are present in the commingled accounts in which he claims a section 9-306(4)(d) interest augments the validity of the "presumption." The proceeds of the secured party received in the ten day period would almost always constitute a smaller sum than the secured party could claim if he had a grasp of the commingled accounts of the debtor for an indefinite period of time.⁴¹ Under the broad interpretation, there is far greater likelihood that the secured party will receive an interest (potentially a windfall) in funds which are not derived from the sale of his collateral, a result hardly intended by the drafters of the Code. Of course, the court avoided this result by concluding that the section

40. Generally, "[i]n the absence of express restriction it may be assumed that a term is used throughout a statute in the same sense in which it is first defined." *Pampanga Sugar Mills v. Trinidad*, 279 U.S. 211, 218 (1929). There is a presumption that the words used in one part of a legislative enactment are intended to have the same meaning as the identical words used in another part of the act. *Atlantic Cleaners & Dyers, Inc. v. United States*, 286 U.S. 427, 433 (1932). This presumption yields if the words are employed in such dissimilar circumstances as to indicate they were employed with different intent. *Id.* There is absolutely no indication that any intent to construe proceeds in two different ways within the same section was present. Indeed, Professor Gilmore seems to assume that the terms "proceeds" in "any cash proceeds" means just that, as he makes no indication to the contrary. See GILMORE, *supra* note 13, § 45.9, at 1338-39.

41. 543 F.2d at 655-56 (citing GILMORE, *supra* note 13, § 45.9, at 1340).

9-306(4)(d) interest was presumptively a preference and imposing a tracing requirement. The extent of the tracing required or permitted was not discussed.⁴²

Under either interpretation the court would have reached the same result due to the requirement of tracing. To illustrate, let us assume facts similar to those in *Gibson Products*. In the ten day period prior to bankruptcy, \$19,000 is received from all sources and deposited by the debtor. Only ten dollars of this amount is shown to be proceeds of the secured party's collateral. Using the court's interpretation, the secured party would have a security interest in all \$19,000, but it would presumptively be a preference and voided by the trustee. The secured party could then trace its proceeds into the commingled accounts and claim ten dollars. If the narrower definition were adopted, the secured party would have a security interest in ten dollars, which would be presumptively a preference, but which could likewise be traced after the presumption was applied. The Ninth Circuit has thus taken a circuitous and unwarranted approach because the same result could have been achieved by adopting the narrow interpretation of "any cash proceeds."

B. *The Finding of Voidable Preference*

By finding a voidable preference, the court has aligned itself with a number of commentators who have speculated about the clash.⁴³ How-

42. In describing the function of § 9-306(4), *Gibson Products* stated that (4)(d) was intended to "eliminate the expense and nuisance of tracing." 543 F.2d at 655. However, the court later provided that "[t]o the extent a creditor is able to identify his proceeds to trace their path into the commingled funds, he will be able to defeat *pro tanto* the trustee's assertion of a preference." *Id.* at 657. This would appear to impose a more extensive tracing requirement than first recognized by *Gibson Products* or intended by the drafters of § 9-306. The comments to an earlier version of § 9-306 stated that the secured party has a security interest in cash proceeds under (4)(d) "without regard to whether or not the funds are identifiable as cash proceeds of the collateral." U.C.C. § 9-306 (1968 version) (Official Comment 2). The comments to the latest version provide that "4(a) through (c) substitute specific rules of identification for general principles of tracing" and that 4(d) acts as a limit on "the security interest in proceeds not within these rules." U.C.C. § 9-306 (1972 version) (1972 Official Comment 2). See notes 18-25, 41 *supra*, and accompanying text.

43. Several authorities have argued that the § 9-306(4)(d) interest is vulnerable as a preference. See, e.g., 4A COLLIER, *supra* note 4, ¶ 70.62A, at 710; Countryman, *supra* note 10, at 49 & n.35; Epstein, "Proceeding" Under the Uniform Commercial Code, 30 OHIO ST. L.J. 787, 803-07 (1969) [hereinafter cited as Epstein]; Gillombardo, *supra* note 14, at 29; Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 716-17 (1967) [hereinafter cited as Marsh].

Other possible areas of conflict between § 9-306(4)(d) and the Bankruptcy Act are:

(1) Bankruptcy Act of 1938, § 64, 11 U.S.C. § 104 (1970) (priorities). See, e.g., 4A

ever, theories have been developed to withstand the trustee's attack.⁴⁴ The most prominent of these are the "entity" theory and the "substitution of collateral" theory.

Under the entity theory,⁴⁵ the property which is subject to a security interest is viewed as a mass or entity which is continuously in existence. Even though the various units or portions of this mass may change in form, the identity of the property subject to the security interest is not altered. Thus, whether in the form of original collateral, proceeds of collateral, or section 9-306(4)(d) proceeds, the transfer is considered to have taken place when the perfected security interest attaches to the original portions of the mass.⁴⁶ If this occurred more than four months prior to filing bankruptcy, there can be no preference.

It is difficult to see how this theory can be successfully applied to the section 9-306(4)(d) interest, since the (4)(d) proceeds may or may not actually be part of the original mass,⁴⁷ and language in *Gibson*

COLLIER, *supra* note 4, ¶ 70.62A, at 710; Countryman, *supra* note 10, at 47-48; Epstein, *supra* at 796-99; Gillombardo, *supra* note 14, at 29; Hawkland, *The Proposed Amendments to Article 9 of the UCC, Part II: Proceeds*, 77 COM. L.J. 12, 18 (1972) [hereinafter cited as Hawkland]; Henson, "Proceeds" Under the Uniform Commercial Code, 65 COLUM. L. REV. 232, 243-45 (1965) [hereinafter cited as Henson]; Kennedy, *The Impact of the Uniform Commercial Code on Insolvency: Article 9*, 67 COM. L.J. 113, 116 (1962) [hereinafter cited as Kennedy].

(2) Bankruptcy Act of 1938, § 67(c)(1)(A), 11 U.S.C. § 107(c)(1)(A) (1970) (statutory lien). See, e.g., 4A COLLIER, *supra* note 4, ¶ 70.62A, at 710; Countryman, *supra* note 10, at 48; Epstein, *supra* at 799-801; Gillombardo, *supra* note 14, at 29; Hawkland, *supra* at 18; Henson, *supra* at 247; Kennedy, *supra* at 117; Marsh, *supra* at 715-16; Comment, *The Commercial Code and the Bankruptcy Act: Potential Conflicts*, 53 NW. U.L. REV. 411, 421-24 (1958) [hereinafter cited as *Potential Conflicts*].

(3) Bankruptcy Act of 1938, § 70(c), 11 U.S.C. § 110(c) (1970) (rights and powers of trustee). See, e.g., 4A COLLIER, *supra* note 4, ¶ 70.62A, at 710; Countryman, *supra* note 10, at 48-49; Epstein, *supra* at 801-03; Gillombardo, *supra* note 14, at 28; Hawkland, *supra* at 18-19; Henson, *supra* at 247; Kennedy, *supra* at 115-16; Marsh, *supra* at 716.

(4) Bankruptcy Act of 1938, § 70(e), 11 U.S.C. § 110(e) (1970) (validity of transfer). See, e.g., Gillombardo, *supra* note 14, at 28; Hawkland, *supra* at 18; Henson, *supra* at 247.

44. Courts and commentators have attempted to apply theories to the 9-306(4)(d) interest which have been successful in upholding after-acquired property provisions against invalidity in bankruptcy. These theories have given rise to the floating lien concept. See, e.g., *DuBay v. Williams*, 417 F.2d 1277 (9th Cir. 1969); *Grain Merchants of Ind., Inc. v. Union Bank & Sav. Co.*, 408 F.2d 209 (7th Cir.), cert. denied, 396 U.S. 827 (1969); *Rosenberg v. Rudnick*, 262 F. Supp. 635 (D. Mass. 1967); *In re White*, 283 F. Supp. 208 (S.D. Ohio 1967); Countryman, *supra* note 10, at 53-57.

45. See Henson, *supra* note 43, at 248-52.

46. See Hawkland, *supra* note 43, at 18-19; Henson, *supra* note 43, at 248-52.

47. See Epstein, *supra* note 43, at 804-05. Epstein also notes that it is questionable whether the entity theory was adopted by the Code. *Id.* at 805 n.82.

Products indicates that the interest arises anew upon initiation of insolvency proceedings.⁴⁸

The substitution of collateral theory involves the concept of original collateral being replaced by substitute collateral as proceeds: "(1) The substitution of the new security interest must be prior to or contemporaneous with the release of the old, and (2) the value of the substituted collateral may not exceed the value of that replaced—if it does, the excess is preferential."⁴⁹ If these criteria are met, the security interest will prevail against section 60 of the Bankruptcy Act, even if it occurs within four months of bankruptcy.⁵⁰ This theory may have some merit. Upon insolvency, the section 9-306(4)(d) interest arises simultaneously with the loss of interest in identifiable, *i.e.*, traceable, but commingled funds. To the extent that the section (4)(d) interest is less than or equal to the interest prior to insolvency, there has been no preferential transfer. There would be, however, a transfer, and hence a voidable preference, as to any amounts which are in excess of the secured party's interest prior to insolvency.⁵¹

In *Gibson Products* the court did not merely find a preference and void the interest completely. Because the secured party was allowed to trace his interest to defeat the presumption of a preference, the section 9-306(4)(d) interest is ultimately preferential only as to the amount in excess of the secured party's own proceeds. Though it never explicitly mentioned the substitution of collateral theory, by its tracing requirement the court has in effect employed this theory.

V. THE EFFECT ON STATE INSOLVENCY PROCEEDINGS

The interpretation in *Gibson Products* of "any cash proceeds" would have great effect on the secured party's interest in state insolvency proceedings, such as an assignment for the benefit of creditors, if the state courts were to find the Ninth Circuit's broad interpretation persuasive. Since the state insolvency proceedings have no provisions analo-

48. "[The] interest in these nonproceeds arises upon the occurrence of two events: (1) insolvency proceedings instituted by or against a debtor, and (2) commingling of some of the proceeds from his collateral with the debtor's cash on hand or with other deposits in his debtor's bank account." 543 F.2d at 655. See also Countryman, *supra* note 10, at 49, where he states: "[T]he transfer of the security interest in [nonidentifiable proceeds] to the secured creditor is not under Section 60a(2) deemed made until bankruptcy—which is, after all, exactly what Section 9-306(4)(d) says."

49. Countryman, *supra* note 10, at 44-45 (footnotes omitted).

50. *Id.* at 44.

51. See, e.g., Countryman, *supra* note 10, at 49 n.35; Epstein, *supra* note 43, at 806-07; *Potential Conflicts*, *supra* note 43, at 421 n.54.

gous to section 60 of the Bankruptcy Act,⁵² a secured party would be more likely to gain a windfall to the detriment of other creditors. The irony in this result, of course, is that the Ninth Circuit expressly intended to prevent a windfall. Hopefully, the state courts, when faced with the issue, will adopt an interpretation in accordance with the drafters' intent and with proper statutory construction.

VI. CONCLUSION

In *Gibson Products*, the Ninth Circuit addressed the long-anticipated clash between section 9-306(4)(d) of the Code and section 60 of the Bankruptcy Act. The interest arising under section 9-306(4)(d) was held to be a voidable preference to the extent that the interest exceeded the amount the secured party could trace as his proceeds. The decision ends any real usefulness that the section may have had in bankruptcy proceedings in the Ninth Circuit. The court expressly imposed a tracing requirement without specifying the extent of the requirement, while continuing to limit the secured party's maximum grasp to an amount equal to the cash proceeds received in the ten day period prior to bankruptcy. In addition, the court's interpretation of "any cash proceeds" in section 9-306(4)(d)(ii) appears to be incorrect. Since a similar interpretation in state insolvency proceedings would produce a potential windfall to the secured party, it should be rejected by state courts. Finally, *Gibson Products* illustrates the dangers of commingled accounts. Secured parties would be well-advised to include a provision in the security agreement requiring the debtor to maintain separate accounts. Further, secured parties should vigilantly police debtor's accounts if possible.

*Susan K. Knowles**

52. At common law, in the absence of statutory restrictions, a debtor can prefer one creditor over another. See, e.g., *Barnett v. Kinney*, 147 U.S. 476 (1893); *Union Bank v. Kansas City Bank*, 136 U.S. 223 (1890); *Bumb v. Bennett*, 51 Cal. 2d 294, 333 P.2d 23 (1958); CAL. CIV. CODE § 3432 (West 1970). In some states there are statutory schemes for an assignment for the benefit of creditors which prohibit the preference of one creditor over another. See, e.g., CAL. CIV. CODE § 3457 (West 1970). This definition of preference, however, is not analogous to that in the Bankruptcy Act. See text accompanying note 27 *supra*.

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