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"Add on" Clauses in Equipment Purchase Money Financing: Too Much of a Good Thing

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"ADD ON" CLAUSES IN EQUIPMENT PURCHASE MONEY FINANCING: TOO MUCH OF A GOOD THING

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*"Our nature hardly allows us to have enough of anything without having too much."***

INTRODUCTION

MANY creditors who either lend money or extend credit on a secured basis do so with one objective in mind—to gain priority over competing creditors. The rules of priority under the Uniform Commercial Code (Code),[1] which are straightforward in resolving disputes between a secured and an unsecured creditor,[2] become more complex when two secured creditors both claim an interest in the same collateral. The Code normally ranks secured creditors on a "first-in-time, first-in-right" basis.[3] If one of the secured creditors claims a purchase money security interest,[4] however, the "first-in-time" rule of priority is reversed; a "second-in-time" purchase money security interest will normally outrank a competing "first-in-time" security interest.[5] Those who regularly finance the sale of equipment may wish to rely on this "second-in-time" rule to achieve priority. If they wish to do so, equipment lenders must demonstrate that their security interests are in fact purchase money

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1. Unless otherwise noted, all citations to the Uniform Commercial Code are to the 1978 Official Text. Except with respect to securities, the 1978 Official Text does not vary from the 1972 Official Text.

2. Secured creditors take priority over unsecured creditors unless the unsecured creditor has become a lien creditor. If the unsecured creditor has become a lien creditor, only secured creditors whose security interests were perfected before the lien attached take priority. *See* U.C.C. §§ 9-201, -301(1)(b).

3. The Code provides that "[c]onflicting security interests rank according to priority in time of filing or perfection." *Id.* § 9-312(5)(a).

4. "A security interest is a 'purchase money security interest' to the extent that it is (a) taken or retained by the seller of the collateral to secure all or part of its price; or (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used." *Id.* § 9-107.

5. *Id.* § 9-312(3), (4). In a dispute between two perfected purchase money interests, priority is to be determined on a "first in time" basis "pursuant to subdivision (5) of section 9-312 of the Uniform Commercial Code." National Cash Register Co. v. Mishkin's 125th St., Inc., 65 Misc. 2d 386, 389-90, 317 N.Y.S.2d 436, 440 (Civ. Ct. 1970).

security interests. To meet this burden successfully, the language of the security agreement is all important. The Code limits the permissible scope of purchase money security interests, and the language of the security agreement must be drafted with these limits in mind. Unfortunately, equipment lenders often include in their security agreements "add on" or "cross collateral" clauses that may exceed these limits. This Article examines the effects of these clauses on the purchase money status and priority of equipment lenders.[6]

To understand what an "add on" clause is, a precise knowledge of the Code's definition of a purchase money security interest is required. The Code recognizes two kinds of purchase money security interests, the seller-buyer purchase money security interest in section 9-107(a) and the financier-buyer purchase money security interest in section 9-107(b).[7] With respect to the section 9-107(a) seller-buyer purchase money security interest, an equipment seller wishing to achieve purchase money status must retain an interest in the equipment sold "to secure all or part of its price."[8] The transaction may be viewed as having two sides. On the collateral side, the collateral must be the equipment sold and nothing more. On the debt side, the debt must be all or part of the purchase price of the equipment sold and nothing more. An "add on" clause is created when this simple structure is altered through the addition of either more collateral than the piece of equipment sold on the collateral side or more debt than the price of the equipment sold on the debt side. Similarly, with respect to the section 9-107(b) financier-buyer purchase money security interest, the equipment financier must take a security interest in the equipment purchased to secure the amount of money "in fact . . . used"[9] for the purchase. If the financier "adds on" more collateral than the equipment purchased or more debt than the amount in fact used for the purchase, an "add on" arrangement is created.

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6. This Article will discuss "add on" clauses only with respect to equipment financing. Consumer and inventory financing often involve either the application of non-Code law or specialized problems. Much of the analysis, of course, will be helpful with respect to "add on" clause problems in these other areas, but the purpose of this Article is to focus the analysis on the least diffuse set of problems.

7. A third type of purchase money security interest also exists under the Code. A seller may retain a purchase money security interest in goods sold under U.C.C. § 9-107(a). A finance company may then advance money to the seller, taking back an assignment of the seller's chattel paper as security for the advance. The finance company would thus inherit the seller's purchase money status. *Id.* § 9-107, Official Comment 1. *See also id.* § 9-302(2) & Official Comments to this section. Because the finance company's purchase money status is derived from the seller's § 9-107(a) purchase money status, this type of purchase money security interest is treated as a variant of the seller-buyer purchase money security interest.

8. *Id.* § 9-107(a).

9. *Id.* § 9-107(b).

With few exceptions, courts have treated "add on" arrangements harshly.[10] They have reasoned that if a secured creditor wishes to avail himself of the benefits of purchase money status, he has the burden of following the explicit instructions of section 9-107.[11] Deviation from these instructions will result in denial of purchase money status and the benefits of this status.[12] In some jurisdictions, the mere presence of "add on" language in a security agreement destroys the purchase money character of a transaction.[13] Without a valid purchase money security interest, the equipment lender cannot claim priority over "first-in-time" creditors. Even when the courts adopt a more lenient attitude towards "add on" clauses,[14] their presence may still result in a loss of purchase money priority if the equipment lender fails to demonstrate which portion of the debt is purchase money debt.[15]

The use of "add on" clauses poses serious risks for the equipment lender and justifies a detailed treatment of the subject. To simplify the analysis, "add on" clauses will be divided into three general categories: (1) "debt add on" clauses, in which, on the debt side of the transaction, more debt is added than the price of the equipment sold, (2) "collateral add on" clauses, in which, on the collateral side of the transaction, more collateral is added than the equipment sold, and (3) "debt collateral add on" clauses, in which, on both sides of the transaction, more debt and more collateral are added. Part I of this Article will analyze the use of these "add on" clauses by section 9-107(a) purchase money *sellers* of equipment. It will be shown that the Code sanctions the use of certain "debt add on" clauses if the debt added is related either to the sale of equipment or to the preservation of the equipment as collateral. The Code adopts a less liberal attitude towards "collateral add on" clauses, however, permitting only "proceeds" of the equipment to be added on as additional purchase money collateral. The consequences of including either an impermissible "debt add on" clause or an impermissible "collateral add on" clause in the security agreement will be discussed with the sugges-

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10. *See* Roberts Furniture Co. v. Pierce (*In re* Manuel), 507 F.2d 990 (5th Cir. 1975); W.S. Badcock Corp. v. Banks (*In re* Norrell), 426 F. Supp. 435 (M.D. Ga. 1977); *In re* Simpson, 4 U.C.C. Rep. Serv. 243 (W.D. Mich. 1966).

11. *In re* Simpson, 4 U.C.C. Rep. Serv. 243, 248 (W.D. Mich. 1966).

12. The benefits of purchase money status include not only a priority advantage, but also automatic perfection without the need for filing for certain types of collateral. U.C.C. § 9-302(1)(d) (automatic perfection for consumer goods). Deprivation of purchase money status would mean that "there was no automatic perfection." *In re* Simpson, 4 U.C.C. Rep. Serv. 243, 248 (W.D. Mich. 1966).

13. *See In re* Simpson, 4 U.C.C. Rep. Serv. 243, 248 (W.D. Mich. 1966).

14. *See* Kawasho Int'l (U.S.A.), Inc. v. Alper (*In re* Mid-Atlantic Flange Co.), 26 U.C.C. Rep. Serv. 203, 208 (E.D. Pa. 1979).

15. *See* notes 89-92 *infra* and accompanying text.

tion that, despite some opposing case law, impermissible "add on" clauses should not entirely destroy an equipment seller's purchase money status. Finally, Part I will analyze "debt collateral add on" clauses, demonstrating that, although complex in form, this type of "add on" clause is essentially a combination of an impermissible "debt add on" clause and an impermissible "collateral add on" clause. If viewed in this fashion, its use should not necessarily result in an equipment seller's total loss of purchase money status, but should require that his purchase money status be carefully tailored so as to be kept within acceptable limits. It will be suggested, however, that the potential benefits of using "debt collateral add on" clauses do not outweigh the risk that a court may not perform the tailoring necessary to save the equipment seller's purchase money status. In Part II of this Article, the analysis will be extended to the section 9-107(b) purchase money *financier* of equipment. When the conclusions reached in Part I with respect to the *seller* of equipment equally apply to the *financier* of equipment, the analysis will not be repeated. In certain situations, however, the specific language of section 9-107(b) will require that these conclusions be modified or qualified. Only these situations will be discussed.

I. The Purchase Money Seller Of Equipment

A. *"Debt Add On" Clauses*

Creditor X has a perfected security interest in debtor B's existing equipment and after-acquired equipment.[16] B requires a new computer for his monthly billings and decides to buy one from equipment seller S. In the security agreement, S retains an interest in the computer to secure the outstanding balance due on its purchase price. Under section 9-107(a) of the Code, S has a purchase money security interest in the computer, and if he files within prescribed time limits, he will also have priority in the computer over creditor X.[17] S, however, might either consciously or unconsciously include a "debt add on" clause in the security agreement by retaining an interest in the computer to secure something more than the balance due on the price. This "debt add on" clause might be drafted in one of five ways.

16. U.C.C. § 9-204(1) states that "a security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral."

17. A purchase money security interest in equipment is perfected by filing. *See id.* § 9-302. It has "priority over a conflicting security interest in the same collateral . . . [if] perfected at the time the debtor receives possession of the collateral or within ten days thereafter." *Id.* § 9-312(4).

1. "Debt Add On" Clauses—Amounts Expended at the Time of Sale for Charges Related to the Sale

At the time of purchase, an equipment seller normally adds certain sales related charges to the list price of the computer. These may include one or more of the following items: sales taxes; incidental charges for services provided by the seller, such as charges for delivery and installation of the computer or for extended warranty coverage; finance charges; insurance costs, such as the cost of credit life or health and accident insurance or the cost of insurance against loss or damage to the computer; and Code filing fees. If in the security agreement the equipment seller retains an interest in the equipment to secure not only its list price but also one or more of these additional charges, would a "debt add on" problem be created? The court in *Kawasho International (U.S.A.), Inc. v. Alper (In re Mid-Atlantic Flange Co.)*[18] seemed to say "yes." In distinguishing a group of prior cases involving "add on" clauses, the court in *Kawasho* suggested that in one of these cases a seller did create an "add on" clause by retaining an interest in the collateral sold to secure its list price and attendant finance charges.[19] If the addition of finance charges to list price constitutes an "add on" clause, it may be logically assumed that the addition of other sales related charges to list price would similarly constitute an "add on" clause, thus placing the purchase money nature of the security interest in jeopardy. If the term "price" in section 9-107(a) is interpreted as "list price," the *Kawasho* view is correct. The addition of a further charge to the list price would necessarily result in a "debt add on" clause. If, however, the term "price" in section 9-107(a) is defined more broadly as "credit price," no "debt add on" problem arises. The term "credit price" normally includes the list price, other additional charges paid by a *cash* buyer of the item, such as sales taxes and the cost of delivery and installation, and other charges paid by a *credit* buyer, such as the finance charge, insurance premiums, and filing fees. Therefore, if "price" means "credit price," and "credit price" already includes all of these additional cash and credit charges, by retaining an interest in the equipment to secure any of these amounts, the equipment seller would not be adding on anything to the equipment "price." This interpretation of "price" in section 9-107(a) as "credit price" is supported by the text of the Code, by purchase money policy considerations, and finally, by pre-Code law.

a. *Definition of Price in Section 9-107(a)*

The drafters of the Code did not define the term "price" either in section 9-107 or in the definitional sections of Articles 1 or 9. Simi-

18. 26 U.C.C. Rep. Serv. 203 (E.D. Pa. 1979).
19. *Id.* at 208.

larly, no precise definition is indicated in the Official Comments to section 9-107. Consequently, the meaning of the term must be gleaned from evidence contained elsewhere in Article 9. Sections 9-505(1) and 9-507(1), in treating consumer credit security interests, explicitly use the term "cash price" instead of "price."[20] The use of the modifier "cash" with "price" indicates that the term "price" alone has a broader scope than the term "cash price." If "price" includes "cash price" plus "something more," it is necessary, first, to define the core concept of "cash price," and, second, to define the boundaries of the "something more."

A reasonable reading of the term "cash price" should encompass those charges routinely present in an all cash sale uncomplicated by financing. Because sales taxes are mandated by governmental authority and because delivery, installation, or extended warranty charges would exist whether or not the sale were financed, the term "cash price" could easily be read to include these items. Arguments drawn from the area of consumer finance buttress this interpretation. First, when used in consumer finance, the term "cash price" typically includes sales taxes and sales related charges for delivery and installation.[21] Second, if sales taxes and these other charges were not included in "cash price," there would be a disparity in the amount of the section 9-507(1) consumer penalty depending on whether the transaction were a purchase money sale under section 9-107(a) or a purchase money loan under section 9-107(b). Assume that the purchase price of consumer goods is $100, the sales tax is $8, and the delivery cost is $12. If, under section 9-107(b), a *financier* advances the money to purchase the consumer goods, the seller would necessarily collect the sales tax and charge the delivery costs. The principal amount of the advance would have to be $120 to cover these costs. If a penalty is then imposed upon the financier for some violation of Article 9, section 9-507(1) requires that the penalty be 10% of the "principal amount of the debt" or $12, plus the credit service charge. If, however, under section 9-107(a), a seller sells the same goods on credit and the section 9-507(1) penalty is imposed on him, the penalty must be 10% of the "cash price" plus the time price differential. If the sales tax and delivery charges are not included in the cash

20. Both sections are concerned with consumer financing. U.C.C. § 9-505(1) deals with the right to strict foreclosure on consumer collateral, and § 9-507(1) deals with the computation of the penalty for violation of Article 9 with respect to consumer debtors.

21. *See* Uniform Consumer Credit Code § 1.301(9) (1974), *reprinted in* 2 J. Fonseca, Handling Consumer Credit Cases § 17:2, at 46 (2d ed. 1980). Although the definition of "cash price" does not specifically list a charge for extended warranty coverage, it would be included within the definition because it is a service "related to the sale." *Id.*, *reprinted in* 2 J. Fonseca, Handling Consumer Credit Cases § 17:2, at 46 (2d ed. 1980). The specific charges listed in the definition are only illustrative, not exhaustive.

price, the penalty would be only $10 plus the time price differential instead of $12 plus the time price differential. Parity between the penalty imposed on a purchase money seller and a purchase money financier requires that the "cash price" include, at a minimum, sales taxes and charges for services provided by the seller, such as delivery and installation costs and the cost of extended warranty coverage.[22]

Even if "cash price" is read to include amounts paid in every cash sale, the term cannot be read to include costs involved only in credit sales. These amounts, however, including first, the finance charge, and second, the filing fees and costs of insurance, may be subsumed under a reasonable reading of the "something more" included in the broader definition of price in section 9-107(a).

i. The Finance Charge

The credit price of an item always exceeds its cash price, and the difference is referred to as the "time price differential."[23] A purchase money seller routinely retains an interest in collateral to secure both the cash price and this added "time price differential," naturally assuming that his purchase money security interest includes both amounts. In light of this routine practice, if the drafters of the Code had intended to restrict purchase money debt to the cash price alone, one would have expected Article 9 to contain a clear and unambiguous statement to this effect. There is no such statement in the Article. Furthermore, section 9-507(1) seems to imply the opposite. Under this section, both the cash price and the "time price differential" must be considered in the calculation of the statutory penalty imposed on sellers of consumer goods who violate the provisions of Article 9.[24] Most credit sellers of consumer goods are purchase money sellers, who normally retain an interest in collateral to secure the cash price of goods and the time price differential. When section 9-507(1) directs that both these amounts be used to compute the penalty, there is the strong inference that purchase money debt includes, at a minimum, the cash price and the time price differential. If this is a fair inference from section 9-507(1), then the term "price"

22. This same line of reasoning with respect to U.C.C. § 9-507(1) has been applied to the question of down payments in the calculation of consumer penalties. J. White & R. Summers, Handbook of the Law Under the Uniform Commercial Code § 26-14, at 1126 n.160 (2d ed. 1980).

23. The time price differential is not limited by state usury laws. Hogg v. Ruffner, 66 U.S. (1 Black) 115, 119 (1861); Lundstrom v. Radio Corp. of Am., 17 Utah 2d 114, 119, 405 P.2d 339, 342 (1965); Annot., 14 A.L.R.3d 1065, 1077 & n.16 (1967).

24. U.C.C. § 9-507(1).

in section 9-107(a) should be construed broadly to include the cash price and the "time price differential," that is, the finance charge.[25]

ii. Insurance Premiums and Filing Fees

As a condition for the extension of credit, an equipment seller customarily requires the purchase of insurance against loss or damage to the collateral. Less commonly, he might prefer credit life or health and accident insurance to guarantee a fund from which the debt can be repaid. If the buyer does not pay the necessary insurance premium directly, the equipment seller may pay the premium and add the cost to the debt secured by the collateral. Similarly, the equipment seller must file a financing statement to perfect his security interest.[26] Because, this filing fee is minimal,[27] the buyer may pay the fee to the seller at the time of sale.[28] If the payment is not made, the seller may add this cost to the secured debt. Including these additional charges for insurance and filing[29] in the "price" of the equipment for the purposes of section 9-107(a) may be challanged as a form of "debt add on" clause.

From the perspective of the equipment seller, these costs are an integral part of a credit sale and, therefore, logically includable in the "price." If the buyer does not pay these costs, the equipment seller will routinely add them to the debt secured by the collateral. Theoretically, of course, this secured debt is divisible into discrete components: list price, cost of delivery, the finance charge, the insurance premium, and the filing fee. But because all these costs were incurred at the time of the sale and all directly facilitated the sale, the equipment seller would scoff at such "metaphysics." Acknowledging this pragmatic approach, section 1-102(1) states that the Code

25. It should be recognized, however, that in the Uniform Consumer Credit Code the term "finance charges" does include certain amounts beyond the "time price differential." Uniform Consumer Credit Code § 1.301(20)(a)(ii)(iv) (1974), *reprinted in* 2 J. Fonseca, Handling Consumer Credit Cases § 17:2, at 49-50 (2d ed. 1980). For the sake of convenience, however, the term "finance charge" will be used as the equivalent of the term "time price differential."

26. A purchase money security interest in equipment is not automatically perfected. *See* U.C.C. § 9-302(1)(d).

27. In New York, for example, the filing fee is normally $2. N.Y. U.C.C. § 9-403(5) (McKinney Supp. 1980).

28. For a form of consumer retail installment contract in which the filing fees are required to be paid at the time of the execution of the contract, see L. Denonn, Secured Transactions Under the UCC 267-68 (1970).

29. In the context of consumer financing, these charges are called "additional charges" and are excluded from the definition of finance charges and the time price differential. *See* Uniform Consumer Credit Code §§ 1.301(20)(b)(ii), 2.501(1)(a), (b), (2)(a), (b), *reprinted in* 2 J. Fonseca, Handling Consumer Credit Cases § 17:2, at 49-50, 84-85 (2d ed. 1980).

"should be liberally construed and applied to promote its underlying purposes and policies."[30] One of these policies is "to simplify, clarify and modernize the law governing commercial transactions";[31] another is "to permit the continued expansion of commerical practices through custom, usage and agreement of the parties."[32] Including in the "price" of an item sold all credit costs that were incurred at the time of sale and directly facilitated the sale would further both of these policies. It is the simplest solution and the solution that comports most readily with general business practice and understanding. Therefore, unless Article 9 contains strong evidence to the contrary, the term "price" in section 9-107(a) should be defined to encompass all incidental credit costs incurred at the time of the sale, including the finance charge, the insurance premium, and the filing fee.

Unfortunately, Article 9 is ambivalent on the question whether filing fees and insurance premiums are included in the section 9-107(a) term "price." On the one hand, section 9-306(1) seems to support at least the inclusion of insurance premiums in the "price" of an item.[33] It provides that any insurance benefits payable by reason of loss of or damage to the collateral normally constitute "proceeds." As will be shown in the subsequent analysis, the "proceeds" of equipment can be included in purchase money collateral along with the original equipment.[34] If purchase money collateral includes *both* the original equipment and its "proceeds," the "price" of the purchase money collateral should be interpreted to include *both* the price of the original equipment and the price of the "proceeds." The price of the "proceeds" in this case is the insurance premium. On the other hand, section 9-507(1) supports an argument against the inclusion of insurance and filing costs in the section 9-107(a) definition of "price." If these costs constituted part of the "price," why are they omitted from the computation of the statutory penalty imposed on purchase money sellers of consumer goods? The penalty is based on the the cash price and the "time price differential,"[35] and the standard definition of the "time price differential" does not include insurance and filing costs.[36] There is a plausible, although not totally convincing, explanation for the omission. The debt secured in most sales of consumer goods will be small, and consequently, the seller may not require insurance against loss or damage to the collateral. As for the filing fee, in a purchase money sale of consumer goods, the seller normally does not

30. U.C.C. § 1-102(1).
31. *Id.* § 1-102(2)(a).
32. *Id.* § 1-102(2)(b).
33. *Id.* § 9-306(1) (definition of proceeds).
34. *See* notes 106-11 *infra* and accompanying text.
35. U.C.C. § 9-507(1).
36. *See* note 29 *supra*.

need to file a financing statement to perfect his security interest.[37] Consequently, in the typical sale of consumer goods, there will be no filing fee. As a result, the drafters of the Code may have decided to base the penalty only on those amounts always present in a consumer sale,[38] rather than on amounts that may or may not be present. In light of Article 9's obvious ambivalence, the simplest, most practical solution is to include in the "price" of the equipment sold any insurance premiums or filing costs incurred at the time of the sale.

In progressive steps, it has been shown that the section 9-107(a) definition of "price" includes the cash price, the finance charge, and other incidental credit costs incurred at the time of the sale. Thus, "price" should be broadly defined as "credit price."

b. *The Policy Behind Purchase Money Priority*

Broadly defining "price" as "credit price" is further supported by the Code's policy of entitling purchase money lenders to priority over competing secured creditors.[39] The purchase money priority rule encourages the acquisition of new assets by the debtor. Assume B completely mortgages his existing equipment and after-acquired equipment to creditor X. Wishing to purchase a new computer, B may approach creditor X for an additional loan. If creditor X refuses, B must approach equipment seller S and ask if he will sell the computer on time. Without a purchase money priority rule, S will realize that if he sells the computer to B on credit, he would take a second interest in the computer because creditor X already has the first interest under his after-acquired property clause.[40] Thus, S may be discouraged from making the sale. The priority given by the Code to purchase money sellers, however, permits seller S to take the first interest in the computer.[41] It is illogical for the Code, on the one hand, to encourage the making of the sale by entitling the seller to purchase money priority, but on the other hand, not to permit the purchase money priority to include all sales related charges. The seller must add the sales tax and the cost of installation to the list price of any equipment sold. Similarly, the seller will charge the debtor all the costs of financing the sale. If the seller is not given purchase money priority in the equipment to secure *all* of these amounts,

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37. In most instances a "purchase money security interest in consumer goods" can be perfected without filing. U.C.C. § 9-302(1)(d).

38. These amounts are the "time price differential" and the "cash price." *Id.* § 9-507(1).

39. The Code priority rules for competing security interests are set out in *id.* § 9-312(3), (4).

40. *Id.* §§ 9-204(1), -312(5), (6).

41. *Id.* § 9-312(4).

the sale will be discouraged rather than encouraged, and the Code policy of purchase money priority will be undermined.

c. *Pre-Code Law*

Pre-Code law, both common and statutory, provides additional support for reading "price" in section 9-107(a) as "credit price." These pre-Code analogies, however, must be cautiously applied because they frequently may prove too much.

Under the common law of conditional sales, the lineal ancestor of seller-buyer purchase money security interests,[42] expenses connected with or incidental to the sale could be included in the secured obligation without transforming a conditional sale into a chattel mortgage.[43] Although the majority rule permitted even debts unrelated to the sale to be secured by the item sold,[44] both the majority and the minority views agreed that, at a minimum, the inclusion of incidental sales costs within the amount of the debt secured did not destroy a conditional sale.[45]

Similarly, the Uniform Conditional Sales Act included amounts incidental to the sale in the secured obligation.[46] The Uniform Conditional Sales Act defined a conditional sale as "any contract for the sale of goods under which possession is delivered to the buyer and the property in the goods is to vest in the buyer at a subsequent time upon the payment of part or all of the price, or upon the performance of any other condition."[47] In construing this language, the court in

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42. A conditional sale may be strictly defined as "a purchase money security transaction, subject in most states to statute, in which title to the goods was retained by the seller or his assignee until the full purchase price had been paid, usually in periodic installments. . . . Many types of 'conditions' may be attached to the sale of goods." 1 G. Gilmore, Security Interests in Personal Property § 3.7, at 81 (1965).

43. *See* Braden v. Bucyrus-Erie Co. (*In re* Halferty), 136 F.2d 640, 643 (7th Cir. 1943); Cloud Oak Flooring Co. v. J.A. Riggs Tractor Co., 223 Ark. 447, 449, 266 S.W.2d 284, 286 (1954); Annot., 148 A.L.R. 346 (1944). For a thorough discussion of the chattel mortgage, see 1 G. Gilmore, *supra* note 42, §§ 2.1, 2.2, at 24-27.

44. *See* Braden v. Bucyrus-Erie Co. (*In re* Halferty), 136 F.2d 640, 641-42 (7th Cir. 1943) (subsequent indebtedness); Southern Hardware & Supply Co. v. Clark, 201 F. 1, 2-3 (5th Cir. 1912) (same); *In re* C.J. Gelatt & Son, 24 F.2d 215, 215 (M.D. Pa. 1928) (same); Cloud Oak Flooring Co. v. J.A. Riggs Tractor Co., 223 Ark. 447, 449, 266 S.W.2d 284, 286 (1954) (equipment repair); Annot., 148 A.L.R. 346, 350-53 (1944). In contrast, some courts have held that the indebtedness must be related to the sale. *See* Bucyrus-Erie Co. v. Casey, 61 F.2d 473, 474 (3d Cir. 1932); Ittleson v. Hagan, 245 Mich. 56, 57, 222 N.W. 145, 145 (1928); 1 G. Gilmore, *supra* note 42, § 3.3, at 71.

45. *See* 1 G. Gilmore, *supra* note 42, § 3.3, at 71.

46. Uniform Conditional Sales Act § 1, *reprinted in* I. Mariash, A Treatise on the Law of Sales, app. C, at 808 (1930); *see* Glenn, *The Conditional Sale at Common Law and as a Statutory Security*, 25 Va. L. Rev. 559, 573 (1939).

47. Uniform Conditional Sales Act § 1, *reprinted in* I. Mariash, A Treatise on the Law of Sales, app. C., at 808 (1930). *See also* Uniform Sales Act § 20. The Uniform

Bucyrus-Erie Co. v. Casey ruled that amounts beyond the purchase price that were incidental to the sale could be validly secured by the conditional sale contract.[48]

Pre-Code common law and statutory analogies clearly support an expansive reading of conditional sale debt and thus, indirectly, an expansive reading of "price" in section 9-107(a). A degree of caution and discrimination, however, is necessary in the application of these analogies. According to the majority view, conditional sale debt, unlike Code purchase money debt, could include debt totally unrelated to the sale transaction.[49] Because conditional sale debt was so broadly defined, one does not find in these pre-Code cases a precise analysis of which costs are included in the purchase price and which costs are not. Courts that adopted the minority view, however, did limit conditional sale debt to the purchase price and costs incidental to the sale.[50] This position is more consonant with the language of section 9-107(a). But even courts that applied this more restrictive definition of conditional sale debt may have been unconsciously influenced by the majority view. Certain costs that were not truly incidental to the sale were occasionally found to be within the scope of conditional sale debt.[51] Furthermore, the policy questions at issue in the pre-Code cases were often quite different from those presented by Code purchase money priority cases. After-acquired property clauses were not widely recognized before the adoption of the Code.[52] Consequently, pre-Code courts rarely confronted a priority dispute that pitted a conditional vendor of collateral against an earlier creditor who had bargained for an interest in the same collateral. A typical pre-Code dispute involved a conditional vendor against a trustee in bankruptcy,

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Sales Act permitted the seller to reserve the right to possession until "certain conditions" were fulfilled. In construing this language, the court in Braden v. Bucyrus-Erie Co. (*In re* Halferty), 136 F.2d 640 (7th Cir. 1943), stated that "[i]t is clear from this language that the seller may impose as many conditions as he desires. He is not confined solely to the condition of payment of the purchase price, nor in fact at all unless the contract so states, for that condition is not specifically mentioned in the section." *Id.* at 644.

48. 61 F.2d 473, 474 (3d Cir. 1932). The *Bucyrus* court, of course, read the Conditional Sales Act quite narrowly. *See* note 44 *supra* and accompanying text.

49. *See* note 44 *supra* and accompanying text.

50. *See* Bucyrus-Erie Co. v. Casey, 61 F.2d 473 (3d Cir. 1932); Ittleson v. Hagan, 245 Mich. 56, 222 N.W. 145 (1928); 1 G. Gilmore, *supra* note 42, § 3.3, at 71; Annot., 148 A.L.R. 346, 348 (1944).

51. In Bucyrus-Erie Co. v. Casey, 61 F.2d 473 (3d Cir. 1932), the court included the cost of repairs as part of the conditional sale debt. *Id.* at 474. Professor Gilmore suggests that the *Bucyrus* court may have gone beyond its own logic by including these unrelated costs within the scope of the conditional sale debt. *See* 1 G. Gilmore, *supra* note 42, § 3.3, at 71.

52. U.C.C. § 9-204, Official Comment 2.

the representative of the unsecured creditors.[53] These unsecured creditors had not bargained for an interest in the collateral, which now the trustee as their representative claims from the conditional vendor. In this situation, to favor the conditional vendor, a court may have been more willing to permit a certain latitude in the definition of conditional sale debt. But in a dispute between two secured creditors when both had bargained for an interest in the same collateral, a court might have demonstrated less partiality to the conditional vendor. If these priority disputes had been regularly presented, the pre-Code scope of conditional sale debt might have been significantly narrowed. Therefore, the broad reading of conditional sale debt in the pre-Code context may not be a totally persuasive argument for an equally broad reading of the purchase money "price" in the modern Code context.

2. "Debt Add On" Clauses—Post Sale Amounts Expended to Preserve the Value of the Collateral or to Protect the Equipment Seller's Interest in the Collateral

Assume creditor X has a perfected security interest in B's equipment and after-acquired equipment. Subsequently, equipment seller S sells a computer to B on time and retains an interest in the computer to secure the outstanding balance due on its price and any future amounts that S may spend either to preserve its value or to protect his interest in the computer. The security agreement, however, clearly provides that B has the responsibility to pay all taxes and insurance premiums and to keep the computer free of any liens. Unfortunately, soon after S perfects his security interest, B fails to pay personal property taxes due on the computer, fails to make a required payment necessary to keep the computer insured against damage, and permits an artisan's lien to attach to the computer. To preserve the value of the computer as collateral, S pays these expenses. If B then defaults in his loan payments to both X and S, would S's purchase money priority in the computer cover these additional payments? Clearly, these post-sale payments cannot be considered part of the "price" of the computer. Although these payments are technically "add ons" to the price, the Code nonetheless permits their inclusion in purchase money debt. Therefore, without affecting his purchase money priority, an equipment seller may retain an interest in the equipment to secure not only its price but also any additional expenses incurred either to preserve its value or to protect his interest

53. Braden v. Bucyrus-Erie Co. (*In re* Halferty), 136 F.2d 640 (7th Cir. 1943); Peter Smith & Sons Grocery Co. v. Daily (*In re* Ames), 289 F. 208 (6th Cir. 1923); Southern Hardware & Supply Co. v. Clark, 201 F. 1 (5th Cir. 1912).

in it. To demonstrate how the Code sanctions the use of this form of "debt add on" clause, section 9-207 must be considered.

a. *Section 9-207 of the Code*

Section 9-207(2) provides that "[u]nless otherwise agreed, when collateral is in the secured party's possession," reasonable expenses incurred in the preservation of the collateral become part of the debt secured by the collateral.[54] It is important to note that these expenses *automatically* become part of the secured debt unless the security agreement specifically states otherwise.[55] Section 9-207(2), however, includes these expenses in secured debt only when the secured party is in physical possession of the collateral, which is rare in the normal sale of equipment. But there is no reason to assume that the drafters intended to include these payments in secured debt when the secured party was in possession, but not include them in secured debt when the secured party was not in possession. Professor Gilmore, one of the drafters of Article 9, observes that

> [c]ustomarily security agreements provide that the debtor shall in the first instance pay the insurance premiums and the taxes and that, if he does not do so, the secured party may pay them and add the payments so made to the secured obligation. Even in the absence of an express term in the agreement, there is no reason to doubt that the secured party could so act to protect his interest in the collateral. Provided that advances made, directly or indirectly, are covered by the security agreement, they will be included in the secured obligation.[56]

If these payments to preserve either the value of the collateral or the secured party's interest in the collateral automatically become part of the secured debt, it must be determined whether they also automatically become part of purchase money debt. Two alternate views are possible. First, although these payments do become part of the secured debt, the secured debt must be subdivided into two components: the purchase money component—the price of the equipment—and the non-purchase money component—the amount of these payments "added on" to the equipment price. Second, because the Code *automatically* includes these payments in secured debt, these payments should *automatically* assume the character of the secured debt. If the secured debt is purchase money debt, these

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54. The Code specifically includes under "reasonable expenses . . . incurred in the custody, preservation, use or operation of the collateral . . . chargeable to the debtor and . . . secured by the collateral" amounts paid for insurance and taxes. U.C.C. § 9-207(2)(a).

55. *Id.*

56. 2 G. Gilmore, *supra* note 42, § 43.5, at 1199 (footnote omitted).

payments should become part of that purchase money debt. Policy arguments support the adoption of this latter view.

b. *The Policy Behind Purchase Money Priority*

By preferring purchase money sellers of equipment over other secured creditors with after-acquired property interests, the Code seeks to encourage sales of needed equipment to buyers.[57] Including in purchase money debt payments either to preserve the value of collateral or to protect the seller's interest in the collateral furthers this policy. These costs, like the finance charge and the costs of filing, are directly incidental to a secured transaction. Unless the equipment seller knows that he can subsequently expend money to protect the value of the collateral without sacrificing his priority rights, he will be less willing to enter into the sale. All payments that directly facilitate the credit aspects of the transaction, whether paid at the time of the sale or subsequent to the sale, should be included in purchase money debt.

c. *Pre-Code Law*

In construing the common law of conditional sales, the court in *Peter Smith & Sons Grocery Co. v. Daily (In re Ames)*,[58] found that a clause that added to the purchase price of the goods the cost of "taxes, insurance, or other costs or charges necessary to protect or preserve the property" did not destroy the conditional sale nature of the transaction.[59] The most helpful pre-Code analogy, however, is not one drawn from the law of conditional sales, but rather one drawn from the law of future advances. Under the common law, a lender who advanced money on a secured basis received priority in the collateral for the amount actually loaned.[60] If *voluntary* advances were made at a later point in time, some courts held that the priority of these future voluntary advances did not "relate back" to the priority of the first loan.[61] The two advances were treated as separate transactions, and the lender did not have priority for the voluntary advance over parties whose security interests or liens arose between the first loan and this later voluntary advance.[62] Amounts expended after the loan for taxes, insurance premiums, and the like, however, were not future voluntary advances, although they could reasonably

57. *See* U.C.C. § 9-312(4); notes 39-41 *supra* and accompanying text.
58. 289 F. 208 (6th Cir. 1923).
59. *Id.* at 209-11 & n.1.
60. On the question of the common law of future advances, see 2 G. Gilmore, *supra* note 42, § 35.4.
61. *Id.* § 35.4, at 927.
62. *Id.* § 35.4, at 928.

be so classified.[63] These expenses were considered so essential and so closely related to the protection of the secured party that they merited the same priority status as the initial loan itself.[64]

The Code, policy considerations, and pre-Code case law support the notion that payments to preserve the value of the collateral or to protect the equipment seller's interest in the collateral should be treated as purchase money debt. In essence, although these expenses do not constitute part of the "price" of equipment sold, they are still includable within the seller's purchase money priority. Under the Code, a clause in the security agreement that adds these expenses to the "price" and includes both amounts in the secured debt is thus a permissible form of "debt add on" clause.

3. "Debt Add On" Clauses—Post Sale Amounts Expended to Collect the Secured Debt

The security agreement may provide that the seller retains an interest in the equipment to secure the outstanding balance due on its price and any expenses that he may incur at some future time to collect the secured debt. The two primary types of these expenses are repossession costs and any attorney's fees incurred to collect the debt. Although it does not technically include these expenses in purchase money debt, for all practical purposes, the Code treats them as if they were part of purchase money debt.

a. *Section 9-504*

Section 9-504 controls the disposition of the proceeds when collateral has been repossessed and sold. The proceeds are distributed first to pay expenses of repossession and reasonable attorney's fees[65] and only second to discharge the indebtedness secured.[66] By listing attorney's fees and expenses of repossession separately, the section makes it clear that they are not included in the secured debt.[67] Consequently, it is impossible to include these payments as a part of the secured debt—and thus part of the purchase money debt—as was done with payments to preserve the value of the collateral discussed in the immediately preceding section.[68]

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63. *Id.* § 35.4, at 929.

64. *Id.*

65. U.C.C. § 9-504(1)(a). Unlike the expenses of repossession, the payment of reasonable attorney's fees must be provided for in the security agreement.

66. *Id.* § 9-504(1)(b).

67. *But see* Wilson Leasing Co. v. Seaway Pharmacal Corp., 53 Mich. App. 359, 220 N.W.2d 83 (1974). The court held that "when [the] contract provides for reasonable attorneys' fees pursuant to UCC 9-504(1) (a), the amount of the attorneys' fees is an element of the principal debt." *Id.* at 367, 220 N.W.2d at 87 (footnote omitted).

68. *See* notes 54-65 *supra* and accompanying text.

The question whether they are actually included in purchase money debt, however, is immaterial because section 9-504 treats these payments more favorably than the purchase money debt.[69] If purchase money collateral is repossessed, the proceeds of any sale must be used to repay the expenses of repossession and attorney's fees before the purchase money debt itself is repaid. The obvious syllogism emerges:

> (1) Because he has priority, a purchase money seller of equipment must be repaid the price of the equipment before payment to other secured creditors with an interest in the same equipment.
> (2) But the Code requires that the purchase money seller be repaid the expenses of repossessing the equipment and attorney's fees before being repaid the price of the equipment.
> (3) Therefore, the Code gives the purchase money seller priority over other creditors for the expenses of repossession and attorney's fees as well as for the price of the equipment.

Thus, the expenses of repossession and attorney's fees, although technically not included in purchase money debt, should be treated as if included in purchase money debt for the purposes of priority.

b. *The Policy Behind Purchase Money*

The treatment of repossession expenses and attorney's fees as part of the purchase money debt is sensible in light of the policy behind purchase money priority. If a seller anticipates that expenses incurred to collect a debt that is given priority will not themselves be given the same priority, he may be less willing to sell the equipment. Thus, payments to collect the debt and repossess the collateral should be viewed as part and parcel of the overall secured transaction and given the same priority as the finance charge or other credit charges.

4. "Debt Add On" Clauses—Debt Unrelated to the Equipment Sale

The security agreement may include a clause that the equipment sold by the secured party to the debtor is subject to the secured party's " 'security interest therein for the payment of all monies now or hereafter owed to [the secured party by the debtor] whether under this security agreement or otherwise.' "[70] The express terms of this security agreement provide that the equipment secures not only its price, but also any past or future amounts advanced by the

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69. U.C.C. § 9-504(1)(a), (b).

70. For an example of similar language in a security agreement, see Kawasho Int'l (U.S.A.), Inc. v. Alper (*In re* Mid-Atlantic Flange Co.), 26 U.C.C. Rep. Serv. 203, 204-05 (E.D. Pa. 1979) (emphasis deleted).

seller that are totally unrelated to the sale. Under the majority view of pre-Code conditional sales law, the securing of past or future unrelated debt did not destroy a conditional sale contract.[71] Title to the goods could be retained in the seller to secure either the payment of the price of the goods or the performance of another condition—that condition could be the payment of past or future unrelated debts.[72] The Code, however, has changed prior law in this regard. A purchase money security interest can validly secure only the price of the goods sold and additional amounts spent either to preserve the collateral or collect the secured debt; it cannot secure debt totally unrelated to the sale transaction. Consequently, language in the security agreement that attempts to secure such unrelated debt constitutes an impermissible "debt add on" clause.

If such a "debt add on" clause were included in the security agreement, however, what effect should this clause have on the seller's purchase money status and ultimately his purchase money priority? At least three alternative views are possible: (1) whether or not the equipment seller actually makes additional loans, the mere presence of the noxious "debt add on" clause in the security agreement destroys his purchase money security interest *in toto*; (2) despite the presence of the noxious clause in the security agreement, only the actual making of additional loans destroys the purchase money security interest *in toto*; and (3) the actual making of loans does not destroy the purchase money security interest *in toto* but only *pro tanto*. The secured debt must be split into its two parts, a purchase money part constituting so much of the debt as represents the price of the computer and a non-purchase money part constituting the "add on" debt.

The first of these alternatives appears to be the least supportable in the Code and in the case law. In *Kawasho*,[73] the court was presented squarely with a situation in which the security agreement contained a noxious "debt add on" clause but no additional loans had in fact been made by the seller of the inventory collateral. The *Kawasho* court stated that "we cannot conclude that the presence of the 'add-on' clause . . . alone can prevent the security interest" from being considered a purchase money security interest.[74] The court in *In re Simpson*,[75] however, presented the contrary view. Although *Simpson*

71. *See* 1 G. Gilmore, *supra* note 42, § 3.3, at 71; notes 42-47 *supra* and accompanying text.

72. *See* 1 G. Gilmore, *supra* note 42, § 3.3, at 71.

73. Kawasho Int'l (U.S.A.), Inc. v. Alper (*In re* Mid-Atlantic Flange Co.), 26 U.C.C. Rep. Serv. 203 (E.D. Pa. 1979).

74. *Id.* at 208 (citation omitted).

75. 4 U.C.C. Rep. Serv. 243 (W.D. Mich. 1966). See *In re* Simpson, 4 U.C.C. Rep. Serv. 250 (W.D. Mich. 1966) for a subsequent adjudication in this bankruptcy case.

may be distinguished because extra debt was in fact created, dictum strongly implied that the mere inclusion of a "debt add on" clause completely destroys a purchase money security interest.[76] In support of its position, the *Simpson* court relied on both the language of Official Comment 2 to section 9-107[77] and the policy need for purchase money security interests to be free from "complicated and ambiguous impedimenta."[78] Whatever the implications of Official Comment 2 with respect to section 9-107(b) purchase money security interests, there is no indication that the Comment was intended to refer to section 9-107(a) purchase money security interests. As for the need for simplicity in drafting purchase money security agreements, the *Simpson* court totally disregarded the "to the extent" preamble to section 9-107(a). This language implies that a secured obligation may have both a purchase money part and a non-purchase money part.[79]

If *Kawasho* is correct in holding that the mere presence of "debt add on" language does not destroy the purchase money character of the security agreement,[80] what if debt beyond the price of the equipment is in fact created? On this question, *Simpson* seems the case most in point.[81] In *Simpson*, there was a "debt add on" clause in the security agreement and additional debt beyond the price had in fact been created.[82] The *Simpson* court argued that the inclusion of this extra debt as part of purchase money debt destroyed the purchase money security interest.[83] Thus, the purchase money seller's priority

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76. 4 U.C.C. Rep. Serv. at 246-48.

77. *Id.* at 246.

78. *Id.* at 248. The court set out U.C.C. § 9-107, Official Comment 2 in toto. " 'When a purchase money interest is claimed by a secured party who is not a seller, he must of course have given present consideration. This section therefore provides that the purchase money party must be one who gives value "by making advances or incurring an obligation": the quoted language excludes from the purchase money category any security interest taken as security for or in satisfaction of a pre-existing claim or antecedent debt.' " 4 U.C.C. Rep. Serv. at 246 (citation omitted).

79. U.C.C. § 9-107(a).

80. Kawasho Int'l (U.S.A.), Inc. v. Alper (*In re* Mid-Atlantic Flange Co.), 26 U.C.C. Rep. Serv. 203, 208 (E.D. Pa. 1979).

81. 4 U.C.C. Rep. Serv. at 243.

82. *Id.* at 244-45.

83. *Id.* at 248. In *Simpson*, the issue presented was whether there was perfection of a valid purchase money security interest in farm equipment. The 1962 Official Text of the U.C.C., § 9-302(1)(c), permitted automatic perfection of purchase money security interests in farm equipment whose purchase price did not exceed $2,500. If, however, the "add on debt" destroyed the purchase money character of the security agreement, there could not have been automatic perfection. Although the *Simpson* court ruled that the "add on debt" did destroy the purchase money character of the sale, the seller did in fact take possession of the collateral and thus perfected his security interest in an alternate way. The discussion of the requirements of a purchase money security interest was thus irrelevant to the ultimate holding of the case and hence dictum. *Id.* at 244-48.

is lost *in toto* not merely *pro tanto* because, by adding on unrelated debt to the price, the seller never created a valid purchase money security interest in the first place.[84] The more recent *Kawasho* decision holds out the hope that the *Simpson* interpretation may ultimately be rejected. The *Kawasho* court stated that

> [s]ince there were, however, no sales previous to the signing of the security agreement, and no extensions of credit . . . to the bankrupt other than as part of a conditional sale, we leave for another day the question of whether such extensions of credit would totally prohibit the characterization of the security agreement as a purchase money security agreement, or whether they would merely limit the purchase money character of the security interest to that portion of the debt secured which is taken or retained to secure the purchase price of the collateral.[85]

The third alternative, and the one perhaps suggested in the preceding *Kawasho* dictum is to permit so much of the debt as represents the price of the equipment to receive purchase money priority and so much of the debt as represents "add on" debt not to receive purchase money priority. Because the third alternative gives meaning to the "to the extent" preamble in section 9-107(a), it seems to be the preferable approach. Thus, even if one were to reject the arguments to include in purchase money debt: (1) the finance charge, filing fees and insurance premiums,[86] (2) post sale payments to preserve the value of the collateral,[87] or (3) post sale expenditures incurred to collect the secured debt,[88] the "debt add on" arrangement thus created should not destroy the purchase money security interest *in toto,* but only *pro tanto*.

If courts adopt this third alternative and permit the "add on debt" to be separated from the purchase money debt, it would still be necessary for the equipment seller to demonstrate precisely how much purchase money debt is outstanding at any given time. For example, assume S sells B a computer for $1,200 and retains an interest in the computer to secure its price and any future loans to B. Before B makes any payment on the price of the computer, S lends B $1,600. S consolidates the $1,200 unpaid purchase price and the $1,600 loan into one debt of $2,800. B makes a $300 payment on this consolidated debt and then defaults. S's priority over an earlier secured party with an after-acquired property clause should be limited

84. *Id.* at 247-48.

85. Kawasho Int'l (U.S.A.), Inc. v. Alper (*In re* Mid-Atlantic Flange Co.), 26 U.C.C. Rep. Serv. 203, 209 (E.D. Pa. 1979).

86. *See* pt. I(A)(1) *supra*.

87. *See* pt. I(A)(2) *supra*.

88. *See* pt. I(A)(3) *supra*.

to the purchase money debt. S must show how much of the $2,500 debt outstanding is purchase money debt, and how much is not purchase money debt. The burden of tracing the funds is on S.

To meet this burden, the equipment seller must include in the security agreement an allocation formula that would enable him at any given time to show how much of the consolidated debt is purchase money debt and how much is not. One simple allocation formula applies all payments made to the first debt until that debt is fully paid, and then to the second debt until that debt is fully paid.[89] In the hypothetical, the $300 payment would be applied to the amount outstanding on the computer because that was the first debt created. Thus, S could readily compute the amount of the purchase debt still outstanding simply by checking the amount paid by B. Another method of allocating payments will be to apply *each* payment pro rata to *each* debt; the amount of each payment allocated to each debt would be the proportion of the payment that the original amount of each debt bore to the entire indebtedness.[90] The original price of the computer in the hypothetical is $1,200 and the loan is $1,600. Since $1,200 is 6/14ths of the total consolidated debt of $2,800, each payment should be allocated 6/14ths to the purchase money debt and 8/14ths to the non-purchase money debt. This allocation formula has been challenged on unconscionability grounds in the area of consumer finance because it permits a seller to retain an interest in purchase money collateral until every dollar of non-purchase debt is fully discharged.[91] It may be permissible, however, in the less protected atmosphere of equipment financing.[92]

Thus, if an equipment seller retains an interest in the equipment to secure its price and debt totally unrelated to its price, he should not lose his purchase money status entirely as long as he includes an apportionment formula in the security agreement. He should have first priority in the collateral for the amount of the purchase money debt owed. A "first in time" creditor with an after-acquired property interest would then have second priority in the equipment for the full amount of his debt. Only after the "first in time" creditor is fully paid

89. For an example of this type of allocation formula, see Goodyear Tire & Rubber Co. v. Staley (*In re* Staley), 426 F. Supp. 437, 437-38 (M.D. Ga. 1977).

90. For an example of this type of allocation formula, see *In re* Brouse, 6 U.C.C. Rep. Serv. 471, 474 (W.D. Mich. 1969).

91. *See* Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965); *In re* Jackson, 9 U.C.C. Rep. Serv. 1152, 1157-58 (W.D. Mo. 1971). *But see In re* Brouse, 6 U.C.C. Rep. Serv. 471 (W.D. Mich. 1969).

92. Perhaps *In re* United Thrift Stores, Inc., 242 F. Supp. 714 (D.N.J. 1965), *aff'd sub nom.* Redisco, Inc. v. United Thrift Stores, Inc. (*In re* United Thrift Stores, Inc.), 363 F.2d 11 (3d Cir. 1966), lends some support to this view. In a case of inventory financing, an apportionment of each payment pro rata to each piece of appliance collateral seemed to pass without objection.

will the equipment seller be able to claim the non-purchase money part of his debt.

Although this result is consistent with logic and the text of section 9-107(a), the prudent equipment seller must realize that a court could adopt the view of *In Re Simpson*[93] and deny purchase money status whenever unrelated debt is added to the "price."[94] The purchase money seller may wish to structure his transaction so as to avoid this potential problem. Although it would increase his transactional costs, the seller could enter into two separate secured transactions with the buyer. In the first security agreement, the seller could retain an interest in the equipment to secure its price, and in the second, he could retain an interest in the equipment to secure the separate debt. This division of the debt into two parts—a purchase money and non-purchase money part—each covered by a separate security agreement, should immunize the equipment seller from a *Simpson* attack.[95] *Simpson* dealt with *one* security interest, which encompassed both purchase money and non-purchase money debt,[96] not *two* security interests, one of which is purchase money with no "add on" of unrelated debt and the other of which is non-purchase money with no "add on" of purchase money debt. If structured in this fashion, the equipment seller should clearly achieve priority over an after-acquired property creditor for the purchase money part, but not, of course, for the non-purchase money part.

5. "Debt Add On" Clauses—Subsequent Renewal or Refinancing of the Purchase Money Debt

In the security agreement, equipment seller S may retain an interest in the computer to secure the outstanding balance due on its price and any subsequent refinancing or modification of this unpaid price.[97] Assume the equipment seller and the buyer initially agree on a payment schedule whereby the buyer will pay the balance due on the price over five years. After the sale, however, they decide to lengthen the payment schedule to eight years. The extension of the payment schedule results in the buyer paying a larger credit price for the computer because the credit price of the computer payable over eight years will be more than its credit price payable over five years. This incremental amount can be viewed as a species of "add on"

93. 4 U.C.C. Rep. Serv. 243 (W.D. Mich. 1966).
94. *See* notes 81-84 *supra* and accompanying text.
95. 4 U.C.C. Rep. Serv. at 243.
96. *Id.* at 244.
97. *See* Spector United Employees Credit Union v. Smith, 28 U.C.C. Rep. Serv. 310, 310-11 (N.C. Ct. App. 1980).

debt. Closer analysis, however, reveals that the "price" of the computer has merely been adjusted to meet changing circumstances; the *amount* of the "price" has been increased, but no additional debt has been added to the "price." The Code does not require that the "price" be the credit price agreed to at the time of the sale. Secton 2-305(1) permits a seller and buyer to "conclude a contract for sale even though the price is not settled."[98] The price can be agreed to at a later time. Therefore, as long as the amended security agreement readjusts the "price" of the equipment, no "debt add on" problem should be created.[99]

The equipment seller, however, must be aware that the execution of a renewal or extension agreement might lead to a different set of problems threatening, not his purchase money security interest, but rather his purchase money priority. Under section 9-312(4), purchase money status does not guarantee purchase money priority. Priority requires that the seller perfect his purchase money security interest by filing either before the debtor receives possession of the collateral or within ten days thereafter.[100] If the renewal agreement is viewed as the discharge of the original security agreement and the execution of a new security agreement in its place, the seller's purchase money priority is arguably threatened. The new security interest could not be perfected until the renewal agreement that created it was signed. When the renewal agreement was signed, presumably the debtor already had been in possession of the collateral for more than ten days.[101] The seller, therefore, has failed to perfect his new security interest in the equipment within the time period prescribed in section 9-312(4) and as a consequence must be denied purchase money priority.[102] This unfortunate result can be avoided by careful drafting of any modification of the original security agreement. The modification must be characterized as a mere amendment of the first agreement and not as an entirely new agreement. The courts will generally accept the parties' characterization of the nature of an agreement.[103]

98. U.C.C. § 2-305(1).

99. In this regard, see *In re* Robertson, 6 U.C.C. Rep. Serv. 266 (E.D. Tenn. 1969), in which the court pointed out that § 9-107(a) permits a seller to take a purchase money security interest in collateral after its sale as long as the debt secured is the price of the collateral sold. *Id.* at 269-70.

100. U.C.C. § 9-312(4). If the financing statement is not filed, the purchase money security interest becomes unperfected ten days after the debtor receives the collateral. Barth Bros. v. Billings, 68 Wis. 2d 80, 90, 227 N.W.2d 673, 679 (1975).

101. The seller undoubtedly transferred possession of the equipment to the buyer at the time of the original purchase money transaction.

102. For a discussion of this problem, see 1B P. Coogan, W. Hogan & D. Vagts, Secured Transactions Under the UCC § 19.02(1)(c), at 1973 (1980).

103. Whether a renewal agreement merely extends or renews the original debt depends on the intention of the parties. *See* Mid-Eastern Elec., Inc. v. First Nat'l

B. *"Collateral Add On" Clauses*

If under section 9-107(a) purchase money debt encompasses only the price of the equipment sold and nothing more, purchase money collateral may logically be limited to the equipment sold and nothing more. Therefore, when equipment seller S sells B a computer and retains a security interest in the computer and other assets of B's to secure the price of the computer, a "collateral add on" clause would result. The collateral securing the price of the computer is no longer simply the computer; it is the computer *and* the other assets. The equipment seller might draft a "collateral add on" clause in one of four ways.

1. "Collateral Add On" Clauses—The Equipment Sold Plus Derivative Collateral

The security agreement may provide that the creditor retains an interest in the equipment and in any additional collateral that is derived from the equipment. "Derivative collateral" is the collateral that results from the disposition or processing of the original piece of collateral. The two main forms of derivative collateral are "proceeds"—what is received upon the disposition of the collateral[104]—and "products"—what is left after the original collateral is processed or manufactured into something else.[105]

a. *Proceeds Collateral*

Section 9-306(1) defines "proceeds" as "whatever is received upon the sale, exchange, collection or other disposition of collateral."[106] The equipment seller may retain a security interest in the equipment sold and its proceeds to secure its price. By making the proceeds, as well as the equipment sold, serve as collateral, a "collateral add on" arrangement seems to be created. Three distinct forms of "proceeds

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Bank, 455 F.2d 141, 145 (4th Cir. 1970); Spector United Employees Credit Union v. Smith, 28 U.C.C. Rep. Serv. 310, 313-14 (N.C. Ct. App. 1980). The intent of the parties, however, must be made clear in the appropriate documents.

104. U.C.C. § 9-306(1). Inferentially, the Code may recognize a third form of "derivative" collateral—an "increase." *See* U.C.C. § 9-207(2)(c). But as Professor Gilmore has remarked, it is unlikely that machine equipment will reproduce itself. 2 G. Gilmore, *supra* note 42, § 42.8, at 1153-54.

105. U.C.C. § 9-315(1). For an example of a secured party who claimed a nonpurchase money security interest in all derivative, accessional, and substitute collateral, see Martin Marietta Corp. v. New Jersey Nat'l Bank, 27 U.C.C. Rep. Serv. 1153 (3d Cir. 1979). This language is fairly standard in an after-acquired property clause. In essence, when a purchase money lender tries to "add on" additional derivative, accessional, or substitute collateral, he is attempting to create a type of after-acquired property interest through a purchase money security interest.

106. U.C.C. § 9-306(1).

add on" clauses must be considered: (1) when the security agreement mentions proceeds as additional collateral, but the equipment is not in fact resold, and thus no proceeds are ever generated, (2) when the security agreement mentions proceeds as additional collateral and the equipment is resold with the authorization of the original seller, and (3) when the security agreement mentions proceeds as additional collateral and the equipment is resold without the authorization of the original seller.

In the first situation, because the equipment is not resold, no proceeds are ever generated. This seems analogous to the situation previously discussed in which language in the security agreement covered "add on" debt, but no such "add on" debt was in fact created. The *Kawasho* holding that the mere presence of "add on" language does not affect a purchase money security interest should control here as well.[107] In the second situation, the equipment is resold *with the authorization of the seller* and proceeds are generated. Section 9-306(2) of the Code provides that when the sale is authorized, the seller loses his security interest in the equipment, but receives in exchange a security interest in the "identifiable proceeds" of the sale. This is a one-for-one substitution of collateral, rather than a true "collateral add on." Only the third situation, when the equipment is sold *without the authorization of the seller*, represents a true "collateral add on" arrangement. Under section 9-306(2), when the sale is unauthorized, the seller retains his security interest in the equipment and additionally receives a security interest in the "identifiable proceeds" of the sale. Under these circumstances, however, the Code automatically permits proceeds to be added to the equipment sold and allows both to serve as purchase money collateral. Thus, a seller's purchase money security interest and priority in equipment will continue in the identifiable proceeds of that equipment. This conclusion requires a two step analysis. First, section 9-203(3) states that a security agreement gives the seller the right to proceeds. Section 9-306(2) then states that when collateral is resold without the original seller's authorization, a security interest continues in the original collateral and in any identifiable proceeds received from a disposition of the collateral. The Code clearly permits a security interest in equipment to continue *automatically* in the identifiable proceeds of that equipment. Because it is *automatic*, the security agreement need not contain a specific clause identifying the proceeds as additional collateral. Second, these Code sections apply to all security interests, and a purchase money security interest is simply one subcategory of secur-

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107. *See* Kawasho Int'l (U.S.A.), Inc. v. Alper (*In re* Mid-Atlantic Flange, Co.), 26 U.C.C. Rep. Serv. 203, 208 (E.D. Pa. 1979); notes 73-79 *supra* and accompanying text.

ity interest. It therefore is reasonable to conclude that a purchase money security interest should also continue automatically in the identifiable proceeds. In the case of equipment collateral, this conclusion is buttressed by the purchase money priority rule of section 9-312(4), which states that a purchase money security interest in collateral other than inventory has priority in the original collateral *or its proceeds* if the security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter.[108]

b. *Products Collateral*

A "product" is what results from the processing of goods in such a way that the original identity of the goods is lost in the finished product.[109] Therefore, a seller might retain a security interest in raw materials sold and in any product of these raw materials to secure the price of the raw materials. To the extent that the finished product represents more value than the raw materials, the seller has "added on" to purchase money collateral more than he sold—the raw materials. It is highly unlikely that equipment will be so processed by the debtor that the original equipment loses its identity in a new finished product. As a consequence, the seller of equipment will seldom be in a position to claim a purchase money interest in both the equipment sold and in any products of that equipment. Because it is so unlikely to occur, the "collateral add on" problems created by taking a purchase money security interest in equipment and products of that equipment will not be discussed.[110]

2. "Collateral Add On" Clauses—The Equipment Sold Plus Substitute Collateral

In the security agreement, the equipment seller may retain a security interest in the equipment and any replacements of that equipment to secure the price of the equipment. This form of clause does not present the classic "collateral add on" problem. If the original equipment sold is replaced by another piece of equipment, there has not been an "add on" of collateral but rather a one-for-one substitution of collateral. The replacement becomes the only collateral; the original equipment no longer stands as collateral. A replacement clause in the security agreement, however, may still create difficulties for the equipment seller regarding his purchase money status.

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108. *See* note 100 *supra* and accompanying text.

109. *See* U.C.C. § 9-315(1)(a).

110. For a brief discussion of these problems in the context of U.C.C. § 9-107(b) inventory financing, see Jackson & Kronman, *A Plea For the Financing Buyer*, 85 Yale L.J. 1, 28-29 (1975).

a. *Replacements Provided by the Seller*

A seller may reserve in the security agreement the right to replace non-conforming equipment with conforming equipment[111] and make the conforming equipment serve as purchase money collateral. This situation should not involve the seller in section 9-107(a) difficulties. The equipment sold is in reality meant to be the conforming equipment; the seller thus retains a purchase money security interest in the conforming equipment to secure its price. The non-conforming equipment will undoubtedly be returned to the seller; therefore, no "collateral add on" problem should arise.

b. *Replacements That Are Essentially Proceeds*

If the buyer trades or exchanges the original equipment for other equipment, the Code would characterize the replacement equipment as "proceeds."[112] It has been demonstrated that an equipment seller's purchase money security interest and priority continue in identifiable proceeds and thus should continue in this identifiable proceeds replacement.[113] A more difficult problem would arise, however, if the debtor, instead of trading the original equipment for the replacement, first sells the original equipment and then with the

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111. The Code defines "conforming" as "in accordance with the obligations under the contract." U.C.C. § 2-106(2).

112. The replacement equipment would be specifically characterized as "non-cash proceeds." *Id.* § 9-306(1).

113. California has added a non-uniform paragraph to U.C.C. § 9-102. This paragraph numbered (4) reads: "[n]otwithstanding anything to the contrary in this division, no nonpossessory security interest, other than a purchase money security interest, may be given or taken in or to the inventory of a retail merchant held for sale, except in or to inventory consisting of durable goods having a unit retail value of at least five hundred dollars ($500) or motor vehicles, house trailers, trailers, semitrailers, farm and construction machinery and repair parts thereof, or aircraft. . . . The phrase 'purchase money security interest' as used in this subdivision does not extend to any after-acquired property other than the initial property sold by a secured party or taken by a lender as security as provided in section 9107. . . . " Cal. Com. Code § 9102(4) (West Supp. 1981). This prohibition against purchase money security interests in after-acquired inventory property has been interpreted to prohibit a purchase money security interest in replacements of inventory. *See* Raleigh Indus. of Am. v. Tassone, 74 Cal. App. 3d 692, 141 Cal. Rptr. 641 (1977). *But see* Holzman v. L.H.J. Enterprises, Inc., 476 F.2d 949 (9th Cir. 1973), *cert. denied*, 414 U.S. 1135 (1974) (permitting purchase money security interests in replacements under an older version of this paragraph). The California provision only relates to replacements of inventory collateral—not to replacements of equipment collateral. Because a purchase money financier of inventory does not usually receive priority in proceeds of inventory under U.C.C. § 9-312(3), stating that a purchase money security interest cannot exist in replacement inventory collateral is consistent with the priority rules for inventory. It would not necessarily be consistent, however, with the U.C.C. § 9-312(4) priority rules for equipment.

money received from the sale buys the replacement equipment. The replacement equipment would be the proceeds of cash proceeds, but the Code defines proceeds in section 9-306(1) to include proceeds of proceeds. Presumably, the equipment seller could justify his purchase money priority in the replacement equipment if the cash proceeds with which it was purchased is identifiable as the cash proceeds received from the sale of the original piece of equipment. This requires a traceable linkage between the original equipment sold and the replacement equipment purchased.

c. *Replacements That Are Equipment Already Owned by the Buyer*

In an unusual situation, the buyer of equipment might be given the right in the security agreement to substitute his other equipment as equivalent collateral in lieu of the original equipment purchased from the seller. If the buyer exercises this option, the seller runs the risk of losing purchase money status. The substitute equipment might not be characterized as "proceeds." Although the term "exchange" is not defined in section 9-306(1), the original equipment does not appear to have been "exchanged" so that the substitute equipment could be treated as "proceeds." "Exchange," of course, could be read to include a substitution of equipment by *one* party, but the juxtaposition of the term with the terms "sale" and "other disposition" may imply a trade of equipment with *another* party. If the replacement or substitute collateral does not constitute "proceeds," section 9-107(a) requires that purchase money collateral be limited to goods sold by the seller. If the secured party has agreed to release his security interest in the original equipment sold upon the substitution of other collateral already owned by the buyer, he could not claim a purchase money security interest in either the original equipment or the replacement. Under these circumstances, the equipment seller has the task of convincing a court that, even though not "proceeds," the replacement collateral substituted by the buyer should be treated as the equivalent of proceeds.

3. "Collateral Add On" Clauses—The Equipment Sold Plus Accessional Collateral

In the security agreement, equipment seller S may retain an interest in the computer and in any other collateral that is installed in, affixed to, or in some way joined with the equipment. Such collateral is called "accessional" collateral.[114] The main categories of "accessional" collateral are fixtures, accessions, and additions. A treatment of fixtures is beyond the scope of this Article, and the discussion will

114. *See* U.C.C. § 9-314.

therefore be limited to "accessions" and "additions."[115] "Accessions" are goods that are installed in or affixed to other goods so that the resulting combination is an integral whole.[116] "Additions," a term not used in the Code, are goods joined with other goods, but not in such a way that they become "accessions."[117] The Code does not indicate the degree to which goods must be affixed to other goods to constitute an "accession,"[118] and therefore, it is difficult to draw a bright line between an "accession" and an "addition." A precise distinction is unnecessary, however, because the "collateral add on" problems are identical with respect to "accessions" and "additions."

a. *Accessions*

Assume creditor X has a perfected security interest in debtor's equipment and after-acquired equipment. Equipment seller S now sells a new computer to the debtor, retaining an interest in the computer and any accessions as security for the unpaid purchase price. The debtor subsequently makes improvements in the computer by adding to it other pieces of equipment so that the added pieces become "accessions." These "accessions," however, are already owned by the debtor and hence are already subject to creditor X's after-acquired security interest in the debtor's equipment. Does S's purchase money security interest in the computer carry over to these "accessions," giving S priority over X in both the equipment sold and the "accessions?"

By claiming an interest in any accessions, S, of course, is attempting to "add on" more collateral to his original equipment collateral. The Code, however, does not entitle an equipment seller either to a purchase money interest in or priority in "accessions" to the original collateral. First, section 9-107(a) states that a seller can have a purchase money interest only in collateral that he sells to the buyer.[119]

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115. For the Code's treatment of security interests in fixtures, see *id.* § 9-313.

116. *See id.* § 9-314.

117. Not all "additions" to goods are "accessions." *See* Jacklitch v. Redstone Fed. Credit Union, 615 F.2d 679, 680-81 (5th Cir. 1980).

118. *See* Mixon v. Georgia Bank, 28 U.C.C. Rep. Serv. 827 (Ga. Ct. App. 1980).

119. Of course if the "accessions" had also been sold to the debtor by the equipment seller, the seller could retain a purchase money security interest in them to secure payment of their price. In *In re* Merrill, 9 U.C.C. Rep. Serv. 755 (D. Neb. 1971), the seller sold a mobile home and household appliances located in the home, retaining a security interest in the mobile home and appliances to secure the price of the mobile home. Although the court did not discuss whether the appliances were "accessions" or "additions," it is important to note that they were sold by the seller to the buyer. Because the price of the mobile home included the price of the appliances, the seller could retain a purchase money security interest in them to secure the price of the home. Apportionment, however, could have become an issue had it been raised.

Because the equipment seller did not sell the accessions to the buyer, the very definition of a purchase money security interest seems to rule out the inclusion of these accessions in purchase money collateral.[120] The equipment seller would have a purchase money security interest in the equipment, but only an ordinary security interest in the accessions. Second, although the Code provides that a security interest in original collateral automatically continues in proceeds,[121] it does not state that a security interest in original collateral automatically continues in accessions. Consequently, there is no textual basis in the Code for the argument that a purchase money security interest in equipment sold to a buyer may continue as a purchase money security interest in accessions that were not sold to the buyer. Finally, unlike its treatment of proceeds of equipment, the Code does not state that a purchase money security interest in equipment receives priority in accessions as well. Indeed, section 9-314(1) states the contrary.[122] Because the security interest of creditor X attached to the accessions before they were affixed to the equipment, section 9-314(1) would grant creditor X priority in the accessions over any interest claimed by equipment seller S.[123]

b. *Additions*

If the Code does not permit a purchase money seller to "add on" accessions to equipment, clearly the same analysis would preclude the purchase money seller from attempting to add on as extra collateral any "additions" to equipment. The seller of the equipment would also not be the seller of the "additions" to that equipment;[124] the "additions" could therefore not secure payment of their price. Similarly, the Code does not state that a security interest—much less a purchase money security interest—automatically continues in "additions" to collateral.

4. "Collateral Add On" Clauses—Additional Property Already Owned by the Debtor and Not Sold by the Seller

In a purchase money transaction under section 9-107(a), the collateral securing the debt consists of the item sold and, when

120. *See* U.C.C. § 9-107.

121. *Id.* § 9-306(1), (2).

122. The Code provides that "[a] security interest in goods which attaches before they are installed in or affixed to other goods takes priority as to the goods installed or affixed (called in this section 'accessions') over the claims of all persons to the whole except as stated in subsection (3) and subject to Section 9-315(1)." *Id.* § 9-314(1).

123. *See id.*

124. For a security agreement in which the secured party sought a security interest in "additions" attached to collateral, see Jacklitch v. Redstone Fed. Credit Union, 615 F.2d 679, 680 (5th Cir. 1980).

appropriate, its proceeds. If equipment seller S sells B a computer, S may retain an interest in the computer and its proceeds to secure the unpaid balance of its price. If the equipment will rapidly depreciate in value, however, S may ask B to provide additional collateral to secure the purchase price of the computer. As a consequence, B may grant S a security interest in other assets *that he already owns* to secure the debt. Under these circumstances, a "collateral add on" situation would be created; seller S has a security interest in the equipment and in the additional assets to secure the equipment purchase price.

Although the pre-Code law of conditional sales generally sanctioned the use of these "collateral add on" clauses,[125] the Code adopts a more restrictive attitude toward them. Under the Code, they should be treated in the same manner as unrelated "debt add on" clauses.[126] If purchase money debt should include the price of the equipment sold plus additional amounts expended to preserve the collateral or to collect the debt,[127] but nothing more, purchase money collateral should include the equipment sold and its proceeds, but nothing more. This limitation comports with the policy underlying purchase money priority. Because the "add on" collateral does not constitute new assets, the acquisition of which was financed by the equipment seller, there is no reason to give the seller priority in these "add on" assets.

What effect should the attempted inclusion of this "add on" collateral have on the equipment seller's purchase money status? If the security agreement contains a "collateral add on" clause, the presence of the clause should not completely destroy the purchase money character of the transaction. The "to the extent" preamble to section 9-107(a) requires a division of the collateral into two parts—the purchase money collateral, the equipment sold, and the non-purchase money collateral, the other assets.[128] The equipment seller would then have the burden of demonstrating which collateral is the purchase money collateral and which collateral is not. In this case, the equipment seller should be able to meet this tracing burden whether or not an apportionment formula is included in the security agreement.[129] Fungibility problems aside, when purchase money col-

125. *See* L. Jones, The Law of Chattel Mortgages and Conditional Sales § 1228 (6th ed. 1908).

126. *See* pt. I(A)(4) *supra*.

127. *See* pt. I(A) *supra*.

128. A purchase money security interest cannot exist in collateral not sold by the seller. *See* Raleigh Indus. of Am., Inc. v. Tassone, 74 Cal. App. 3d 692, 699, 141 Cal. Rptr. 641, 645 (1977).

129. In contrast, the equipment seller must have an apportionment formula to segregate purchase money debt from non-purchase money debt. *See* notes 89-92 *supra* and accompanying text.

lateral and non-purchase money collateral both secure the price debt, each piece of collateral will presumably maintain its separate identity and thus can easily be pinpointed. In practical terms, assume that creditor X has a perfected security interest in B's equipment and after-acquired equipment. Equipment seller S then sells B a computer and takes a security interest in the computer and in other equipment assets already owned by B to secure the price of the computer. B defaults on his payments to both X and S. S would have priority only in the computer because it is purchase money collateral; he should have no difficulty in separating the computer from his non-purchase money collateral.[130]

This result is consistent with logic and the text of section 9-107(a). The danger remains, however, that a court may adopt the *In re Simpson* approach and claim that one security interest cannot cover purchase money and non-purchase money collateral.[131] The equipment seller may thus wish to adopt a more expensive but more conservative course—the course previously suggested to deal with the problem of "debt add on" clauses.[132] He could enter into two separate secured transactions with the buyer. In the first security agreement, he could retain an interest in the equipment sold to secure its price, and in the second security agreement, he could retain an interest in the other collateral to secure the price of the equipment sold.[133] There appears to be little objection to securing the same debt with different collateral in separate transactions.

C. *"Debt Collateral Add On" Clauses*

The "debt collateral add on" clause constitutes the most complicated type of "add on" clause. Combining features of both "debt add on" and "collateral add on" clauses, it appears most commonly in the multiple sale context. The seller sells several pieces of equipment to a buyer, securing the combined prices of all the equipment with each

130. In Burlington Nat'l Bank v. Strauss, 50 Wis. 2d 270, 184 N.W.2d 122 (1971), a seller sold cattle to a debtor, retaining a security interest in the cattle sold to secure their price. Subsequently, the seller took a chattel mortgage on a grinder mixer as additional collateral to secure the price of the cattle. It should be recognized, however, that the original conditional sale contract for the cattle did not include the mixer as collateral, but a subsequent chattel mortgage added on the mixer as additional collateral. Although it did not discuss the issue in terms of the "add on" problem, the court correctly ruled that the seller had priority over an after-acquired property secured party in the cattle but not in the mixer. *Id.* at 276-77, 184 N.W.2d at 125.

131. 4 U.C.C. Rep. Serv. 243, 246 (W.D. Mich. 1966); notes 75-79 *supra* and accompanying text.

132. *See* notes 93-96 *supra* and accompanying text.

133. *See* Burlington Nat'l Bank v. Strauss, 50 Wis. 2d 270, 184 N.W.2d 122 (1971).

piece of equipment.[134] For example, creditor X has a perfected security interest in B's existing equipment and after-acquired equipment. Equipment seller S now sells a computer to B for $1,500. In the security agreement, S retains an interest in the computer to secure its price and the price of any other equipment that S either has sold or will sell to B.[135] S then sells a lathe to B for $500. The second security agreement involving the lathe contains "add on" language identical with that in the first security agreement. In addition, it combines the price of the computer and the price of the lathe into a consolidated balance of $2,000 and requires B to make one monthly payment of $200 on this consolidated balance. Each monthly payment is to be fully applied first to the first item purchased until that item is paid off, and then to the second item purchased, until that item is paid off. A careful analysis reveals that equipment seller S has retained an interest in the computer to secure its price and the price of the lathe, "debt add on," and, alternatively, the price of the computer is secured by the computer and by the lathe, "collateral add on." The same "add on" situation exists with respect to the lathe. S has retained an interest in the lathe to secure its price and the price of the computer, "debt add on," and the price of the lathe is secured by the lathe and by the computer, "collateral add on." Thus, the "debt collateral add on" clause consists of an impermissible "debt add on" clause combined with an impermissible "collateral add on" clause.

If, after his first monthly payment of $200, B defaults on his payments both to S and X, X will claim priority in the computer and lathe on the theory that the "debt collateral add on" clause destroys S's purchase money status entirely.[136] S may counter with the argument that the "debt collateral add on" clause results in a security interest that is part purchase money and part non-purchase money.[137] He will claim purchase money priority over X only for the purchase money part. As a theoretical proposition, S has a strong

134. *See In re* Jackson, 9 U.C.C. Rep. Serv. 1152 (W.D. Mo. 1971). Although most cases involve situations in which the seller sold debtor various pieces of collateral at different times, Roberts Furniture Co. v. Pierce (*In re* Manuel), 507 F.2d 990 (5th Cir. 1975), W.S. Badcock Corp. v. Banks (*In re* Norrell), 426 F. Supp. 435 (M.D. Ga. 1977), Goodyear Tire & Rubber Co. v. Staley (*In re* Staley), 426 F. Supp. 437 (M.D. Ga. 1977), the sale of different pieces of collateral in the same contract on the same day may also occur. *See, e.g.*, American Nat'l Bank of Jacksonville v. International Harvester Credit Corp., 11 U.C.C. Rep. Serv. 682, 684 (Fla. Dist. Ct. App. 1972).

135. If no other equipment has been or will be sold, the original equipment secures only its price, and the mere presence of "add on" language in a security agreement should not affect the equipment seller's purchase money status. *See* notes 73-79 *supra* and accompanying text.

136. *See In re* Simpson, 4 U.C.C. Rep. Serv. 243, 248 (W.D. Mich. 1966).

137. *See* notes 86-92, 128-30 *supra* and accompanying text.

argument. The equipment seller could contend that the "to the extent" preamble to section 9-107 must be applied in this situation. S should retain a purchase money security interest in the computer only to the extent that the computer secures its price, and an ordinary security interest in the computer to the extent that it secures more than its price, the price of the lathe. S could demonstrate the amounts still outstanding on the price of the computer and the price of the lathe because he has had the foresight to include an apportionment formula in the security agreement. After B's $200 payment, $1,300 remains outstanding on the price of the computer and $500 remains outstanding on the price of the lathe. By combining the "to the extent" preamble and the apportionment formula, S can claim a purchase money security interest in the *computer* to the extent that it secures the amount due on its price. The purchase money debt includes the price of the computer but excludes the price of the lathe. Alternatively, the purchase money collateral is only the computer and not the lathe. Through the apportionment formula, S can precisely demonstrate how much of the price of the computer is outstanding and that this is the amount secured by the computer for the purposes of section 9-107. The same reasoning can be applied to the lathe. He would argue, therefore, that he should have purchase money priority over X *pro tanto* in both the computer and the lathe.

The argument, although complex, is clearly defensible. Yet, even if one were willing to accept each of the steps of the argument, what has S gained by including the "debt collateral add on" clause in the security agreement? The equipment seller has a purchase money security interest in the computer to secure its outstanding price of $1,300 and a purchase money security interest in the lathe to secure its outstanding price of $500. Presumably, by including a "debt collateral add on" clause, S wants more. He wants the computer and the lathe to secure both their own price and the price of the other piece of equipment. The "debt collateral add on" clause, however, cannot expand S's purchase money security interest in either the computer or the lathe; therefore, the clause cannot enlarge his priority rights over creditor X. The only apparent benefit gained by including the clause is that, in addition to his purchase money security interests in the equipment, S has an ordinary security interest in the computer to secure the price of the lathe and an ordinary security interest in the lathe to secure the price of the computer. In practical terms, this is a minimal benefit. Assume that equipment seller S repossesses the computer and lathe and sells both pieces to pay off the debt. Assume also that he receives $1,500 for the computer and $300 for the lathe. The outstanding amount due on the computer was $1,300, and S has purchase money priority in the computer only for this amount. He has purchase money priority in the lathe for $500, but only $300 was realized on the sale. S would like to apply the extra $200 received from the sale of the computer to discharge the $200 remaining on the price of the lathe. Unfortunately, he has only an ordinary security interest in the computer to secure any amounts in excess of $1,300. An after-acquired creditor has priority over all later creditors with regular security interests.[138] Equipment seller S has no right to the extra $200 realized on the sale of the computer until creditor X has been fully repaid the amount of his loan. In essence, then, the equipment seller gains very little by including the "debt collateral add on" clause in the security agreement. In this instance, S only gains a junior interest in the extra $200 received from the sale of the computer to secure an amount still due on the lathe.

The benefits of this small gain must be weighed against the risks inherent in the use of a "debt collateral add on" clause. First, the equipment seller may forget to include an apportionment formula or include one that may be attacked on unconscionability grounds.[139] He cannot maintain his purchase money status even *pro tanto* without a valid and enforceable apportionment formula in the security agreement. Second, a court may be reluctant to read the "to the extent" preamble in the manner suggested by this Article. A review of "debt collateral add on" cases demonstrates the seriousness of this latter risk.

The leading case involving a "debt collateral add on" clause is *Roberts Furniture Co. v. Pierce (In re Manuel).*[140] On December 7, 1972, the debtor Manuel purchased furniture from the seller and signed a security agreement, the exact wording of which is not reported in the opinion.[141] On February 13, 1973, Manuel made an additional purchase of a television set from the seller. The purchase money security agreement signed on February 13th referred to the unpaid balance on the furniture and consolidated that balance with the unpaid balance on the television set. The February 13th security agreement also contained the following language: "[g]oods may secure all present and future liabilities, debts and obligations of whatever nature of BUYER to SELLER or its assigns."[142] This language created the "debt collateral add on" problem. On the debt side, the furniture secured its price *and* something more than its price; it secured all future liabilities, in this case the price of the later purchased television set. On the collateral side, the price of the television set, a present liability, was secured by "goods," presumably the television set itself *and* something more, the earlier purchased furniture. Relying on his assumed purchase money security interest in consumer goods, the seller did not file a financing statement to perfect his

138. *See* U.C.C. §§ 9-204(1), -312(5), (6).
139. *See* notes 91-92 *supra* and accompanying text.
140. 507 F.2d 990 (5th Cir. 1975).
141. A security agreement of some form was signed. *Id.* at 991.
142. *Id.* at 992.

security interest.[143] Manuel subsequently filed a voluntary petition in bankruptcy. When the seller sought reclamation of both items from the trustee in bankruptcy, the bankruptcy judge permitted reclamation of the television set, finding that the seller did have a perfected purchase money security interest in that item, but refused reclamation of the furniture. The District Court not only upheld the bankruptcy judge's ruling as to the furniture, it would have also denied reclamation of the television set had the issue been preserved on cross-appeal. The Circuit Court, in turn, upheld the denial of reclamation of the furniture, but expressed no opinion as to the television set.[144] The Circuit Court reasoned that, because the February 13th agreement made the furniture purchased on December 7th collateral for its price and for all future liabilities, a valid purchase money security interest did not attach because the furniture secured its price and something more than its price, the price of the television set.[145]

If the court had accepted the "to the extent" preamble, it could have found that the seller had a purchase money security interest in the furniture to the extent that it secured its price. The court might then have required the seller to demonstrate how much of the price of the furniture was outstanding; this would have required the seller to utilize an apportionment formula in the security agreement. The court noted the absence of such a formula, but the basis of its holding was that the furniture secured more than its price, not that the seller could not demonstrate how much of this price was still outstanding.[146] By so holding, the court inferentially refused to apply the "to the extent" preamble.[147]

That a court's decision on whether to apply the "to the extent" preamble may not be clearly articulated is further illustrated by the inconsistent decisions in *W.S. Badcock Corp. v. Banks (In re Norrell)*[148] and *In re Brouse*.[149] In *Norrell*, the security agreement made each item sold secure its price and the price of any subsequent purchase. The security agreement, however, did not contain an

143. *Id.* at 991. A purchase money security interest in consumer goods is automatically perfected in most states under U.C.C. § 9-302(1)(d). Kansas, to cite but one state, however, has not included this subsection in its version of the Code. Kan. Stat. Ann. § 84-9-302 (Supp. 1980).

144. 507 F.2d at 994.

145. *Id.* at 992-93. In *In re* Jackson, 9 U.C.C. Rep Serv. 1152, 1157 (W.D. Mo. 1971), the court stated that a purchase money security interest existed in an item purchased, but as soon as other items were purchased and the first item was made to stand as security for the prices of these later purchased items, the purchase money security interest was lost.

146. 507 F.2d at 993.

147. U.C.C. § 9-107.

148. 426 F. Supp. 435 (M.D. Ga. 1977).

149. 6 U.C.C. Rep. Serv. 471 (W.D. Mich. 1969).

apportionment formula.[150] The debtor purchased two items, and their purchase prices were consolidated into one outstanding balance. State retail installment legislation, however, provided that payments on revolving accounts were to be applied first to the goods first purchased. The *Norrell* court found that even if this statutory apportionment formula were read into the security agreement, a valid purchase money security interest in the first item purchased would not have been created. The security agreement *by its own terms* had made the first item purchased secure more than its price. The statutory apportionment formula, the court reasoned, could not alter how the parties chose to draft the security agreement. Despite the statutory apportionment formula, the first item purchased still secured its own price and the price of the second item purchased. The *Norrell* court thus seemed unwilling to apply the "to the extent" language of section 9-107 in conjunction with the statutory apportionment formula. If it had, a purchase money security interest in the first item purchased would have been permitted to the extent that it secured payment of the amount outstanding on its price and this amount outstanding could have been shown through the apportionment formula.

The *Brouse* court,[151] however, reached a different conclusion on similar facts. In *Brouse*, the seller sold the buyer various items and consolidated the balance owed on these items. It appears that each item sold secured its price and the price of every other item, and the security agreement lacked any apportionment formula.[152] Although the court found that no purchase money security interest attached to a stereo purchased in 1965 because the stereo secured its price plus the price of future purchases, it did find that a purchase money security interest attached to a cupboard purchased in 1966. The court justified its disparate treatment of the two purchases by noting the enactment of retail installment legislation in 1966 after the stereo had been purchased, but before the cupboard had been purchased.[153] This legislation required payments to be allocated to each item in the same ratio as the original sale price of each item bore to the total of all purchases. As previously noted in the *Norrell*[154] analysis, even if this formula were read into the security agreement, it would not have corrected the debt and collateral "add on" problems created by the language of the security agreement—unless the court also accepted the "to the extent" language of section 9-107. Inferentially, by upholding the purchase money security interest in the cupboard, the

150. 426 F. Supp. at 436.
151. *In re* Brouse, 6 U.C.C. Rep. Serv. 471 (W.D. Mich. 1969).
152. *Id.* at 471-72.
153. *Id.* at 474-75.
154. W.S. Badcock Corp. v. Banks (*In re* Norrell), 426 F. Supp. 435 (M.D. Ga. 1977).

Brouse court seems to have accepted using the apportionment formula and the "to the extent" language in combination.[155]

From a reading of the leading cases, the prudent seller must realize that certain courts have been harsh in dealing with "debt collateral add on" clauses, and he should use this type of clause only after careful deliberation. If he analyzes why he wishes to include the clause, he may discover that he can accomplish his objective by other, less dangerous, means. The equipment seller who wants the convenience of a single monthly payment for the total debt owed him by the buyer may achieve this objective without using a "debt collateral add on" clause. For example, the security agreement in *In re Staley*[156] provided that

> [debtor] hereby grant[s] to [secured party] a security interest in each item of merchandise purchased or hereafter purchased under this Agreement, and [secured party] shall retain such security interest in each item of merchandise until it is paid for in full. Accordingly . . . installment payments will be applied as follows: In the case of items purchased on different dates, the item first purchased shall be deemed paid for first; in the case of items purchased on the same date, the lowest priced item shall be deemed paid for first.[157]

This security agreement grants the seller a security interest in each item sold only to secure its price and, therefore, avoids any "debt add on" problem. No "collateral add on" problem is created because the price of each item is secured only by that item. The security agreement, however, does permit the purchase prices of all the items sold to be consolidated, and it correctly provides an allocation formula to apportion payments. Use of the *Staley* form of security agreement poses only minimal risks for the secured party.[158] The only problem that might arise is a challenge to the type of apportionment formula used. The "first bought, first paid for" model used in *Staley* appears immune from unconscionability attack. Apportionment formulas that apply each payment pro rata to each debt have been successfully attacked on unconscionability grounds in the context of consumer finance, but even these formulas may be acceptable in the less protected atmosphere of equipment financing.[159]

155. *In re* Brouse, 6 U.C.C. Rep. Serv. 471, 475-76 (W.D. Mich. 1969).

156. Goodyear Tire & Rubber Co. v. Staley (*In re* Staley), 426 F. Supp. 437 (M.D. Ga. 1977).

157. *Id.* at 437.

158. In Firestone Stores v. Henderson, 27 Ohio Misc. 160, 269 N.E.2d 75 (Mun. Ct. 1971), the secured party required the debtor to sign a new retail installment contract (security agreement) for *each* purchase. Each item purchased secured only its price. The prices of the items were apparently not consolidated. Thus, there was neither an "add on" problem nor a tracing problem.

159. *See* notes 90-92 *supra* and accompanying text.

The equipment seller who desires the added protection of having each piece of equipment secure the price of each other piece must then face the ultimate question whether this added protection is worth the risk. If he decides that the added protection is worth jeopardizing his purchase money status entirely, he should consider ways to minimize his risk. The use of multiple security agreements may be effective. The seller and buyer can sign a security agreement similar to the *Staley*[160] model in which each piece of equipment secures only its price. The prices of each item could then be consolidated, and one monthly payment required. The seller and buyer could then sign another security agreement making all the equipment also stand as security for the total consolidated debt. A court may be more willing to accept the seller's contention that, under the first security agreement, he retains purchase money interests in each item of equipment, and under the second security agreement, he retains non-purchase money interests in the same items.

II. THE PURCHASE MONEY FINANCIER OF EQUIPMENT

In Part II of the Article, the focus of the analysis will shift from the seller-buyer purchase money security interest under section 9-107(a) to the financier-buyer purchase money security interest under section 9-107(b). Because the precise language of section 9-107(b) is critical to the analysis, the section is set forth in its entirety.

> A security interest is a "purchase money security interest" to the extent that it is
>
> . . . .
>
> (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.[161]

In the financier-buyer purchase money transaction the financier does not sell the collateral directly to the buyer, but rather finances its purchase from a third party seller. For example, if B wishes to buy a computer from equipment seller S, he may approach financier F to provide the financing for the purchase. F will customarily advance the price of the computer directly to S and take a security interest in this equipment to secure the loan. The equipment actually purchased with the advance constitutes the purchase money collateral, and the amount advanced that was "in fact . . . used" to acquire

160. Goodyear Tire & Rubber Co. v. Staley (*In re* Staley), 426 F. Supp. 437, 437 (M.D. Ga. 1977).

161. U.C.C. § 9-107(b). For a discussion of this paragraph, see 2 G. Gilmore, *supra* note 42, § 29.2, at 781-84; McLaughlin, *Qualifying as a Third-Party Purchase Money Financier: The Hurdles to Be Cleared, the Advantages to Be Gained*, 13 U.C.C.L.J. 225 (1981).

rights in the equipment is the purchase money debt. If this simple structure is altered by the addition of either more collateral than the equipment purchased on the collateral side, or more debt than the amount in fact used to acquire rights in the equipment on the debt side, an "add on" arrangement would be created.

The analysis developed in Part I of this Article with respect to "add on" clauses and the section 9-107(a) equipment seller will more often than not be directly applicable to the section 9-107(b) equipment financier. There are certain situations, however, when the particular language of section 9-107(b) may make the conclusions reached with respect to equipment sellers more doubtful with respect to equipment financiers. The discussion in Part II will focus primarily on these situations.

A. *"Debt Add On" Clauses*

1. "Debt Add On" Clauses—Amounts Expended at the Time of Sale for Charges Related to the Sale

It was previously shown that certain incidental sales related charges should be included in "the price" of the equipment sold and constitute purchase money debt.[162] Because the language of section 9-107(b) does not use the term "price," these incidental charges, if they are to be included in purchase money debt, must be considered part of an advance made by the equipment financier that was "in fact . . . used" to acquire rights in the equipment.

In Part I, these incidental charges were divided into two groups. One group included sales taxes and charges for delivery and installation of the collateral and for extended warranty coverage. These charges are paid by a buyer in an all cash sale; they are part of the "cash price" of the equipment and thus part of the purchase money "price" for the purposes of section 9-107(a). The equipment financier under section 9-107(b) should also be able to include them in purchase money debt. S, who sells the computer, will charge B for these costs, and F will be required to advance S funds sufficient to cover these costs to enable B "to acquire rights" in the computer. If F makes out his check to the order of S and B jointly, he will be able to show that his advance was *in fact* used to acquire rights in the computer.[163]

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162. *See* pt. I(A)(1).

163. *See* J. White & R. Summers, *supra* note 22, § 25-5, at 1045. *But see* Rockland Credit Union, Inc. v. Gauthier Motors, Inc., 5 U.C.C. Rep. Serv. 637 (Mass. App. 1967) (an advance was apparently made to the debtor, but a purchase money security interest under § 9-107(b) was still upheld). In Fedders Financial Corp. v. Chiarelli Bros., 221 Pa. Super. 224, 229, 289 A.2d 169, 172 (1972), a financier

The second group of incidental charges included the finance charge, filing fees and various insurance premium charges that a credit buyer would incur to finance the purchase. In the case of seller-buyer purchase money security interests, these charges were also included under the section 9-107(a) definition of "price." The language of section 9-107(b), however, makes it more difficult for the financier-creditor to justify including these charges as part of purchase money debt.[164] Because the problems are different with respect to the finance charge and filing fees and insurance premiums, each merits separate discussion.

a. *The Finance Charge*

To include the finance charge as section 9-107(b) purchase money debt, it must be justified first as an "advance" and then as an advance "in fact used to acquire rights in collateral." As to whether the finance charge constitutes an "advance" by the financier, it must be recognized that the financier does not directly pay the finance charge to anyone on the buyer's behalf. He advances the seller the purchase price of the equipment, thereby lending the buyer that amount of money. The buyer must then repay the financier the principal amount of the advance plus the finance or interest charge. Although the word "advance" in section 9-107(b) appears to connote an advance *of money*, it need not be interpreted so narrowly. The financier could be viewed as having "advanced" the finance charge to the buyer, not in the form of money, but rather in the form of a credit. Even if the "advance" hurdle is surmounted, can this "credit advance" be viewed as having in fact been used to acquire rights in collateral? It is hard to fit the "credit advance" covering the finance charge within this language because the "advance" covering the finance charge is not directly involved in the *buyer's acquisition of rights* in equipment from the *seller*.

Although the language of section 9-107(b) presents analytical difficulties, it can still reasonably be interpreted to include the finance charge in purchase money debt. Section 9-107(b) does not expressly exclude the finance charge from purchase money debt. Although this is a plausible inference from the "in fact so used" language of the section, it is not the only plausible inference. The drafters of the Code wished to limit purchase money debt to advances actually used to acquire collateral, but they must have understood that the finan-

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advanced the buyer money directly, but the court still found a § 9-107(b) purchase money security interest to exist. There was, however, definite evidence in this case that constructed a chain of evidence between the money advanced and the collateral purchased.

164. *See* McLaughlin, *supra* note 161, at 233-35.

cier's advance "so used" would be repaid with a finance charge added to it. Thus, in emphasizing the nature of the purchase money advance, the drafters did not intend to imply that the finance charge was to be treated differently from the underlying advance. Two other sections of Article 9 lend support to this conclusion.

Section 9-107 deals with *purchase* money security interests, and the very wording of the section indicates that this type of security interest requires a "purchase." The Code defines a "purchase" in Article 1 as a "taking by sale."[165] In the context of Article 9, a sale will always be a credit sale, and credit sale necessarily involves a finance charge. A *purchase* money security interest should secure the full amount needed for the credit sale; the finance charge, therefore, should be included within the purchase money debt secured by the collateral.

Section 9-507(1) provides for the computation of the statutory penalty imposed on secured parties who violate their Article 9 obligations toward consumer debtors. This penalty is computed by dividing the secured debt into its cash and credit components and then adding 10% of the former to the entire amount of the latter.[166] The section inferentially recognizes that a secured debt is always composed of both cash and credit elements. There is no reason to assume that the drafters intended a *purchase* money debt to exclude the credit element.[167]

b. *Filing Fees and Insurance Premiums*

In the typical situation, if the buyer does not pay the filing fees and the required insurance premiums at the time the security interest attaches to the collateral, the financier will pay these costs and add them to the secured debt owed him by the buyer. In terms of

165. U.C.C. § 1-201(32).

166. *Id.* § 9-507(1).

167. In Mechanicks Nat'l Bank v. Parker, 109 N.H. 87, 242 A.2d 69 (1968), a § 9-107(b) financier bank advanced $1,800 to a debtor to buy a car. The debtor then gave the bank an installment note for $2,080.44—which obviously included finance charges. The court ruled that the bank had a purchase money security interest in the proceeds of the sale of the collateral to secure the remaining indebtedness—presumably the amount left to be paid on the full $2,080.44. *Id.* at 88-89, 242 A.2d at 70-71. In Union Nat'l Bank v. Northwest Marine, Inc., 27 U.C.C. Rep. Serv. 563 (Pa. C.P. 1979), it is clear that the secured debt included finance charges as well as the principal amount of the financier's loan. Although the court ultimately ruled that the financier did not have an automatically perfected purchase money security interest in consumer goods, the court did not suggest or even refer to the problem because the finance charges were included in purhase money debt. The court found that the collateral in question—a yacht—was not consumer goods, and thus, the financier's purchase money security interest had to be perfected by filing. *Id.* at 567-68.

the language of section 9-107(b), the financier will have given value by "making advances" on the buyer's behalf. This advance, however, will not be made to the *seller*, but to the *insurance company and the filing officer*. Section 9-107(b) *also* requires that the advance actually be used to "acquire rights in collateral." It is difficult to fit advances used to pay the costs of filing and insurance directly within the scope of this language. The amounts advanced to pay these costs were used, not "to *acquire* rights" in collateral, but to *protect and preserve* the financier's rights in the collateral. To include these additional credit charges in section 9-107(b) purchase money debt, an equipment financier should rely on the Code's general principles and policies embodied in section 1-102. There is no rational basis for treating these incidental costs of credit differently from the finance charge. They generally become part of the secured debt when the debtor does not pay them directly.[168] Common sense and general business understanding argue for their inclusion in section 9-107(b) purchase money debt. Thus, section 9-107(b) can be interpreted to include the finance charge and insurance and filing costs in purchase money debt.

The policy behind purchase money priority and pre-Code law support including advances covering filing fees, insurance premiums and the finance charge in section 9-107(b) purchase money debt as they supported including these amounts in section 9-107(a) purchase money debt.[169] Similarly, nothing in the Code indicates that the drafters intended to treat the section 9-107(a) financing seller more favorably than the section 9-107(b) financier with respect to these costs. The inclusion of these costs in section 9-107(a) purchase money debt, but not in section 9-107(b) purchase money debt, would have that effect.

2. "Debt Add On" Clauses—Post Sale Expenses

Part I of this Article demonstrated that post sale expenses paid either to preserve the value of the collateral or to collect the secured debt are includable in purchase money debt even though not part of the "price." This conclusion was based mainly on sections of the Code other than section 9-107(a). With respect to post sale expenses paid to preserve the value of the collateral, the analysis depended on

168. See the retail installment contract in L. Denonn, *supra* note 28, at 267-69. In this retail installment contract, charges for insurance are made part of the principal balance due from the debtor and thus one of the debtor's obligations, the payment of which is secured by an interest in the collateral. The filing fees in this form contract must be paid at the time of the execution of the agreement. Thus, they are not made part of the outstanding obligations of the debtor, secured by the collateral. If not paid by the debtor at the time of the signing of the security agreement, filing fees would be added to the payment obligation still due from the debtor, the performance of which would be secured by the collateral. *Id.*

169. *See* notes 39-41 *supra* and accompanying text.

section 9-207.[170] Section 9-207 could also justify the "add on" of such post sale expenses to the purchase money advance under section 9-107(b). It should be recognized, however, that the explicit "in fact so used" language of section 9-107(b) might make judicial acceptance of the suggested reasoning more speculative. With respect to post sale expenses paid to collect the secured debt, the section 9-504 analysis offered in Part I appears sufficiently compelling to warrant treating amounts expended to collect the secured debt as part of purchase money debt under section 9-107(b).[171]

3. "Debt Add On" Clauses—Debt Unrelated to the Equipment Sale

The explicit requirement of section 9-107(b) that a purchase money advance actually be used to acquire rights in collateral bars including debt unrelated to the equipment sale as part of purchase money debt. Thus, if financier F advanced $10,000 to S to cover the purchase of a computer by B and then advanced B and extra $5,000 to prepare his plant to receive the computer, securing both advances with the equipment purchased, F would have a purchase money security interest in the computer to secure his $10,000 advance, but only an ordinary security interest in the computer to secure the $5,000 advance.[172] This result assumes, of course, that a court would accept the "to the extent" preamble of section 9-107 and permit division of the debt into its purchase money and non-purchase money components. If a court were not so disposed, the addition of the non-purchase money debt might destroy the purchase money transaction *in toto*.

Financier-creditor F, however, might attempt to justify including the $5,000 advance in purchase money debt by arguing that section 9-107(b) permits purchase money debt to encompass amounts spent to *enable* the debtor to acquire rights in collateral, as well as amounts actually used to acquire rights in collateral. The financier would argue that the antecedent of "in fact so used" in section 9-107(b) is the phrase " 'to enable' the debtor to acquire rights in . . . collateral" rather than "to acquire rights in collateral."[173] Thus, if an advance is used to *enable* B to purchase the computer, it can be treated as

170. *See* notes 54-56 *supra* and accompanying text.

171. *See* notes 65-68 *supra* and accompanying text.

172. In Meyer v. General Am. Corp., 22 U.C.C. Rep. Serv. 525 (Utah 1977), a financier loaned debtor $12,000 "for the purpose of providing operating capital for their mining operation and to purchase [equipment]." *Id.* at 526. Although dictum, the Utah Supreme Court found that the financier had a purchase money security interest in the equipment to secure the full $12,000. *Id.* at 531. The court, however, did not divide the debt into its two components. The opinion seems wrong in this regard.

173. *See* McLaughlin, *supra* note 161, at 227-28.

purchase money debt. The $5,000 advance was "so used"; it *enabled* B to prepare his plant to receive the computer, and without this preparation, there would have been no purchase. If accepted, this line of reasoning could justify almost any advance to the debtor as a purchase money advance. For example, an advance to cover the debtor's general expenses could be causally linked to the equipment purchase. Without the advance, the debtor would be required to use his own funds to pay the expenses and, as a result, would be less able to buy the equipment. The scope of section 9-107(b) is not so sweeping. Unless the advance is used directly to acquire rights in the equipment, it cannot be justified as a purchase money advance.

4. "Debt Add On" Clauses—Subsequent Renewals or Refinancings of the Purchase Money Debt

The peculiarities of language in section 9-107(b) can create "add on" problems for an equipment financier who amends a security agreement to lengthen the original schedule of repayments. As was previously demonstrated, the resultant increase in the finance charge should not create "add on" problems for the section 9-107(a) purchase money seller.[174] The same cannot be said for the section 9-107(b) purchase money financier, however.

To constitute purchase money debt under section 9-107(b), any increase in the finance charge must both enable the debtor to acquire rights in collateral and in fact be used to acquire those rights in collateral. A degree of ingenuity is required to justify the increase in the finance charge as an enabling advance. Obviously, the debtor acquired rights in the collateral prior to the increase in the finance charge. The language of section 9-107(b), however, appears to be directed at the character of the underlying advance, rather than at the character of the attendant credit charges. The section requires that the principal amount of the underlying advance enable the debtor to acquire rights in collateral. Once the underlying advance meets this test, any credit charges required by the financier should also be treated as purchase money debt.[175] Similarly, because the increase in the finance charge is treated as part of the purchase money "price" of an item, it would be illogical to include it in purchase money debt for the purposes of section 9-107(a), but not for the purpose of section 9-107(b).

An argument is also available to counter the "in fact so used" objection. If the original finance charge can be included as part of

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174. *See* notes 97-103 *supra* and accompanying text.

175. Professor Gilmore has argued for a more flexible definition of the enabling requirement that might permit even post sale loans by the financier to meet this requirement. *See* 2 G. Gilmore, *supra* note 42, § 29.2, at 782.

purchase money debt despite the "in fact so used" language,[176] then any subsequent increase in the finance charge should receive similar purchase money treatment. The increase in the finance charge remains linked to the underlying purchase money advance.

B. *"Collateral Add On" and "Debt Collateral Add On" Clauses*

As to "collateral add on"[177] and "debt collateral add on"[178] clauses the conclusions reached with respect to the equipment seller under section 9-107(a) remain valid for the equipment financier under section 9-107(b). To the extent that the language of section 9-107(b) complicates the analysis of *purchase money debt,* however, it will also complicate the analysis of "debt collateral add on" clauses.

Conclusion

An analysis of the effect of "add on" clauses on the purchase money priority rights of equipment sellers and financiers is facilitated by dividing these clauses into three categories: "debt add on" clauses, "collateral add on" clauses, and "debt collateral add on" clauses. Without affecting purchase money priority the Code permits *debt* to be added to the price of the equipment sold if the debt is sales related or incurred either to preserve the value of the collateral or to collect the secured debt. Debt totally unrelated to the sale transaction cannot be permissibly added to the price without affecting purchase money rights. In these cases, however, the Code may permit the secured debt to be divided into its purchase money and nonpurchase money components. With respect to "collateral add on" clauses, the Code permits the addition of "proceeds" as extra purchase money *collateral,* but precludes the addition of "accessions," "additions," or collateral already owned by the debtor. "Debt collateral add on" clauses are impermissible, although a defensible argument can be advanced that these clauses should not result in a total loss of purchase money priority. Equipment lenders, however, should only use these "debt collateral add on" clauses with great caution. The reason for the caution is clear. The salvage of even partial purchase money status requires a court to perform a rather intricate division of the secured debt into its two components; some courts may refuse to do this. Moreover, the equipment lender can achieve most advantages of the "debt collateral add on" clause by less dangerous means.

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176. *See* note 169 *supra* and accompanying text.
177. *See* pt. I(B) *supra.*
178. *See* pt. I(C) *supra.*

The importance of the meticulous analysis of "add on" clauses cannot be overemphasized. An equipment lender who ignores the difficulties caused by "add on" clauses may find himself stripped of purchase money priority. In an effort to gain a little extra advantage, he may discover, much to his chagrin, that he has sacrificed his primary advantage—namely, purchase money priority. In this case, too much of a good thing can result in nothing at all.