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A FUNDAMENTAL FLAW WITH UNCITRAL'S APPROACH TO CROSS-BORDER SECURED TRANSACTIONS: THE FAILURE TO ADDRESS CREDITOR DUE DILIGENCE ISSUES

JOHN J. CHUNG[*]

INTRODUCTION

Developed economies recognize the need for the use of collateral to reduce the risk of non-payment of loans. A security interest in collateral provides the secured lender with a source of repayment beyond the borrower's mere promise to repay.[1] Unlike an unsecured loan in which the obligation to repay is supported by only the borrower's promise, a secured loan is supported by the borrower's promise plus collateral. Thus, a secured loan reduces the risk of non-payment to the lender. This paper will focus on security interests in collateral in the form of personal property. In the United States, such security interests are governed by Article 9 of the UCC.[2] The development of Article 9 in the 1950's addressed the problems faced by commercial businesses and lawyers in dealing with the differing laws of 50 states.

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[1] The definition of "security interest" in the Uniform Commercial Code (sometimes referred to as the "UCC" or the "Code") is found in Article 1 of the Code at U.C.C. § 1-201(a)(35), which provides in pertinent part: "'Security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation." U.C.C. § 1-201(a)(35) (2011). Unless otherwise indicated, all citations to the Code in this paper are to the 2011 version of the UCC found in Selected Commercial Statutes (Carol L. Chomsky et al. eds., West 2011).

"A security interest, of course, gives the secured creditor higher priority in reaching those assets to satisfy the debt than would be the case if the creditor simply were entitled to share the assets with all of the debtor's creditors." With this "first shot" at the assets of the debtor, it becomes possible for the debt to be paid in full, even if the debtor becomes insolvent. The grant of a security interest decreases the creditor's risk of loss and, accordingly, allows the creditor to enter into the credit transaction at an interest rate low enough for the transaction to be profitable to the debtor. Thus, by reducing the insolvency risk, the security interest facilitates the transaction." Neil B. Cohen, *Harmonizing the Law Governing Secured Credit: The Next Frontier*, 33 TEX. INT'L L.J. 173, 176 (1998).

To provide a simple illustration, suppose a consumer purchases an automobile with a loan from a bank. As any consumer knows, the automobile will be collateral for the loan. Suppose the purchaser loses her job and is unable to pay any of her debts. Because the bank has a security interest in the automobile, it has the right to take possession of the car, sell it, and apply the proceeds of the sale to its loan. Thus, the bank may be repaid even if all the consumer's other debts remain unpaid.

[2] Section 9-109(a) of the Code provides in pertinent part: "[T]his article applies to: (1) a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract." U.C.C. § 9-109(a). Comment 1 to section 9-101 provides in pertinent part: "[Article 9] provides a comprehensive scheme for the regulation of security interests in personal property and fixtures." *Id.* at § 9-101 cmt. 1.

The definition of "security interest" in section 1-201(b)(35) is incorporated in Article 9. *See id.* at § 9-102 cmt. 1 ("Note that the definition of 'security interest' is found in Section 1-201, not in this Article, and has been revised.").

Article 9 contains the definitions of "security agreement" and "secured party." A "security agreement" is "an agreement that creates or provides for a security interest." *Id.* at § 9-102(a)(73). A "secured party" includes "a person in whose favor a security interest is created or provided for under a security agreement . . . ." *Id.* at § 9-102(a)(72).

The UCC solved a massive transaction cost problem by unifying 50 laws into one uniform code, and no doubt played a material role in the post-World War II prosperity in the U.S.

Seeking to emulate the success of Article 9, various international organizations have attempted to develop a harmonized or more uniform approach to international secured transactions. One such organization is the United Nations Commission on International Trade Law ("UNCITRAL").[3] UNCITRAL has developed a Legislative Guide on Secured Transactions (the "Legislative Guide").[4] According to the Legislative Guide, its objectives are:

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[3] UNCITRAL describes itself this way:

> The United Nations Commission on International Trade Law (UNCITRAL), established by the United Nations General Assembly by its resolution 2205 (XXI) of 17 December 1966 (see annex I), plays an important role in developing that framework in pursuance of its mandate to further the progressive harmonization and modernization of the law of international trade by preparing and promoting the use and adoption of legislative and non-legislative instruments in a number of key areas of commercial law. Those areas include dispute resolution, international contract practices, transport, insolvency, electronic commerce, international payments, secured transactions, procurement and sale of goods. These instruments are negotiated through an international process involving a variety of participants, including member States of UNCITRAL, which represent different legal traditions and levels of economic development; non-member States; intergovernmental organizations; and non-governmental organizations. Thus, these texts are widely acceptable as offering solutions appropriate to different legal traditions and to countries at different stages of economic development. In the years since its establishment, UNCITRAL has been recognized as the core legal body of the United Nations system in the field of international trade law.

U.N. Comm'n on Int'l Trade Law, *The UNCITRAL Guide, Basic facts about the United Nations Commission on International Trade Law* 1 (2010), *available at* http://www.uncitral.org/pdf/english/texts/general/06-50941_Ebook.pdf.

[4] U.N. Comm'n on Int'l Trade Law, *UNCITRAL Legislative Guide on Secured Transactions*, (2010) (the "Legislative Guide"), *available at* http://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670_Ebook-Guide_09-04-10English.pdf. The Legislative Guide is intended to apply to secured transactions in the form of "contractually created rights in moveable assets that secure the payment or other performance of an obligation." *Id.* at 61.

According to one supporter of the Legislative Guide:

> The Guide follows a modern approach to secured transactions that can be described as an integrated and functional approach, relying on a public registry that provides notice to third parties and is reflected in several national and international texts on security interests in movable assets. In this way, the Guide becomes the basic text to be referred to in the modernization and harmonization efforts relating to secured transactions law.

Spiros V. Bazinas, *The UNCITRAL Legislative Guide on Secured Transactions—Key Objectives and Fundamental Policies*, 42 #2 UCC L.J. 123, 126–127 (2010).

> In addition, it was decided that the Working Group would not examine a number of legislative policies that States might enact to limit the availability of consensual secured credit in the name of social solidarity or other public policies. The operating assumption of the Guide is that these are all decisions States might take, but that

(a) To promote low-cost credit by enhancing the availability of secured credit;
(b) To allow debtors to use the full value inherent in their assets to support credit;
(c) To enable parties to obtain security rights in a simple and efficient manner;
(d) To provide for equal treatment of diverse sources of credit and of diverse forms of secured transactions;
(e) To validate non-possessory security rights in all types of assets;
(f) To enhance certainty and transparency by providing for registration of a notice of a security right in a general security rights registry;
(g) To establish clear and predictable priority rules;
(h) To facilitate efficient enforcement of a secured creditor's rights;
(i) To allow parties maximum flexibility to negotiate the terms of their security agreement;
(j) To balance the interests of all persons affected by a secured transaction; and
(k) To harmonize secured transactions laws, including conflict-of-laws rules relating to secured transactions.[5]

> exactly how would be driven by very specific considerations of national policy. The foundational purpose of the Guide is to make recommendations to States about how to achieve an efficient, effective and internally equitable regime of consensual secured transactions. The various key objectives of the Guide are, consequently, cast with this overarching goal in mind.

Id. at 134.

[5] Legislative Guide, *supra* note 4, at 462.

UNCITRAL generates four types of work product: (1) Conventions; (2) Model Laws; (3) Legislative Guides; and (4) Model Rules. *See* Edward S. Cohen, *Normative Modeling for Global Economic Governance: The Case of the United Nations Commission on International Trade Law (UNCITRAL)*, 36 BROOK. J. INT'L L. 567, 578–579 (2011). Legislative Guides are designed to:

> [A]id states in the development or reform of a particular area of commercial law. These are less specific and structured than Model Laws; they are developed either to aid in the interpretation of a model law or to address an area where it proves too difficult to resolve the distinction between national legal systems into a common structure. In addition, Legislative Guides are at times used by other international and regional institutions (especially lending banks and agencies) as part of the conditions for aid to specific states.

Id. at 579.

The final procedural stage behind the development of the Legislative Guide is as follows:

> At its thirty-ninth session, in 2006, the Commission considered and approved in principle the substance of the recommendations of the Guide. The final negotiations were held during the fortieth session of UNCITRAL, held in Vienna from 25 June to 12 July 2007 (first part), and from 10 to 14 December 2007 (second part), and the Guide

Commentators have offered numerous reasons to justify this international attempt to harmonize secured transactions laws. They include: (1) the uncertainty and transactions costs imposed on lenders in determining and attempting to comply with differing and conflicting laws; (2) the inability of some national regimes to deal with international transactions; (3) the need to modernize and facilitate international commerce; (4) the need to reduce transaction costs and risks created by non-uniform laws; and (5) providing a neutral choice of law.[6] As summarized by one commentator:

> The differences between secured credit regimes, in terms of both substantive principles and their procedural effectuation, create uncertainty and transaction costs that lower the expected value of a transaction to the creditor. Once again, these differences likely result in higher interest rates and, in some cases, foregone transactions.[7]

Such goals have driven attempts such as the Legislative Guide to harmonize secured transactions laws across national borders.

The asserted need for harmonization has been underscored by the disparities in national laws.

> First, there are wide differences in philosophy and legal culture concerning the extent to which security should be recognized at all and the conditions necessary for the validity of a security interest.

> was adopted by consensus on 14 December 2007. Subsequently, the General Assembly adopted resolution 63/121 of 11 December 2008. In this resolution, the General Assembly expressed its appreciation to UNCITRAL for the completion and adoption of the Guide, requested the Secretary-General to broadly disseminate the Guide, and recommended to States both the Guide and the United Nations Convention on the Assignment of Receivables in International Trade (the "Receivables Convention"), the principles of which are also reflected in the Guide.

See Bazinas, *supra* note 4, at 133–34 (footnotes omitted).

[6] *See* Sandeep Gopalan, *The Creation of International Commercial Law: Sovereignty Felled*, 5 SAN DIEGO INT'L L.J. 267, 278–89 (2004).

[7] Cohen, *supra* note 1, at 176. In another article, Professor Cohen specified four concerns:

> (1) [I]n an international transaction, there is substantial uncertainty as to which jurisdiction's law will govern various aspects of a secured transaction; (2) the cost of acquiring knowledge of the laws of the jurisdiction that will govern the transaction can often be high; (3) the jurisdiction that will govern the transaction may have laws that are uncertain, adding an element of risk to the transaction; and (4) the governing jurisdiction may have laws that do not effectively promote secured credit.

Neil B. Cohen, *Internationalizing the Law of Secured Credit: Perspectives from the U.S. Experience*, 20 U. PA. J. INT'L ECON. L. 423, 432 (1999) (footnote omitted).

> Common law jurisdictions, which are generally sympathetic to the concepts of party autonomy and self-help, have a liberal attitude towards security. This attitude allows security interests to be taken with a minimum of formality over both present and future assets to secure existing and future indebtedness. In addition, they allow universal security rather than require specific security. By contrast, civil law jurisdictions have been more cautious in their approach to nonpossessory security and have been anxious about the 'false wealth' which such practices are perceived as permitting. So in these jurisdictions, one finds, in varying degrees, requirements of specificity or individualization of collateral, the need for a new post-acquisition act of transfer to give in rem effects to security in after-acquired property, requirements of notice to the debtor as a condition of the *validity* (not merely priority) of an assignment of debts, and restrictions on self-help remedies such as possession and sale of the collateral.[8]

Proponents of international harmonization have admired America's experience with the UCC and have drawn explicit parallels between the current state of commercial law in the international realm to America's situation before the development of the Uniform Commercial Code.[9] The varying laws of the individual American states governed secured transactions and subjected lenders to the risk of non-uniform laws. The lack of uniformity posed obstacles to national commerce. Article 9 addressed and solved these problems and has established itself as an unqualified success.[10] For this reason, international lawyers have looked to Article 9 for guidance and inspiration in their attempts to achieve similar results on a global scale, and the Legislative Guide was heavily influenced by Article 9.[11]

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[8] Roy Goode, *Security in Cross-Border Transactions*, 33 TEX. INT'L L.J. 47, 48 (1998).

A possessory security interest is one in which the creditor maintains possession of the collateral. A non-possessory security interest is one in which the borrower maintains possession. Thus, the security interest in an automobile is a non-possessory security interest.

[9] *See, e.g.*, Cohen, *supra* note 7, at 435.

[10] Indeed, Article 9 has been described as the "jewel" of the Uniform Commercial Code. Donald J. Rapson, *Default and Enforcement of Security Interests under Revised Article 9*, 74 CHI.-KENT L. REV. 893, 893 (1999). The original enacted version of Article 9 was largely the product of Professor Grant Gilmore's draftsmanship. *See* GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY x–xi (1965) (discussing Professor Gilmore's involvement in drafting Article 9).

A large part of Article 9's success is undoubtedly due, in large part, to the fact that it is comprehensive. Gilmore described it as "all-embracing, all-devouring; it covers everything." *Id.* at 295. This paper explains how lender due diligence is included in Article 9's comprehensive scope.

[11] "The [Legislative] Guide recommends a functional approach to secured transactions, which was originally taken in Article 9 of the American Uniform Commercial Code." Bazinas, *supra* note 4, at 128.

A Canadian commentator also noted the heavy influence of Article 9 on the drafting of the Legislative Guide.

> In fact, however, the Guide by and large adopted the basic principles of modernization instantiated by Article 9: (a) a unitary, functional approach to scope; (b) nonpossessory

The original version of Article 9 was largely drafted in the 1950's and resulted in the Official Text of 1966.[12] By 1968, it had been enacted in all states, except for Louisiana (which adopted it later).[13] An entirely new version of Article 9 was promulgated in 1998, and by July 1, 2001, all of the states had adopted the revised Article 9 (although four states delayed its effective date).[14]

The proponents of international efforts such as the Legislative Guide find encouragement in America's adoption of the Uniform Commercial Code, and view their efforts as the initial steps to accomplishing the global equivalent of a uniform

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> security over present and future property; (c) an extended concept of proceeds; (d) a notice-filing registry system; (e) non-judicial enforcement; (f) equal protection for acquisition financing whether offered by sellers or lenders; and (g) special rules governing third-party effectiveness, priority, and enforcement of certain intangible assets, including receivables, bank accounts, independent guarantees, negotiable instruments, and negotiable documents.

Roderick A. Macdonald, *Three Metaphors of Norm Migration in International Context*, 34 BROOK. J. INT'L L. 603, 641 (2009) (footnote omitted).

[12] *See* JAMES BROOK, PROBLEMS AND CASES ON SECURED TRANSACTIONS 18 (2008) (noting drafting and redrafting occurred predominately in 1950s).

[13] *See id.*

[14] *See id.* Revised Article 9 became effective simultaneously on 1 July 2001 in forty-six states, and since 1 January 2002, has been in effect in all states.

> This is remarkable in at least three respects: (1) Article 9 has been enacted with almost perfect uniformity (such local tinkering as has occurred has been minor and at the margins, generally adding some narrow exclusions from the scope of Article 9's coverage); thus, national uniformity has essentially been achieved despite this body of law being enacted by the states rather than by Congress; (2) in the past, several years passed before all the states had enacted the various revised articles or other uniform laws, while in this case, the entire enactment process has been accomplished within three legislative sessions; and (3) an agreed deferred uniform effective date has been successfully used for the first time in the history of uniform laws in the US, thereby dramatically lessening the cost of change in the law.

Harry Sigman, *Security in Movables in the United States – Uniform Commercial Code Article 9: a basis for comparison, in* SECURITY RIGHTS IN MOVABLE PROPERTY IN EUROPEAN PRIVATE LAW 54, 63 (Eva-Maria Kieninger ed., 2004).

Comment 1 of section 9-101 explains the relationship between the revised Article 9 and former Article 9.

> This Article supersedes former Uniform Commercial Code (UCC) Article 9. As did its predecessor, it provides a comprehensive scheme for the regulation of security interests in personal property and fixtures. For the most part this Article follows the general approach and retains much of the terminology of former Article 9. In addition to describing many aspects of the operation and interpretation of this Article, these Comments explain the material changes that this Article makes to former Article 9. Former Article 9 superseded the wide variety of pre-UCC security devices. Unlike the Comments to former Article 9, however, these Comments dwell very little on the pre-UCC state of the law. For that reason, the Comments to former Article 9 will remain of substantial historical value and interest. They also will remain useful in understanding the background and general conceptual approach of this Article.

U.C.C. § 9-101 cmt. 1 (2011).

code.[15] The thesis of this paper, however, is that efforts such as the Legislative Guide lack a crucial feature of the Uniform Commercial Code. This paper contends that the success of Article 9 of the Uniform Commercial is the result, in large part, of its role in guiding the due diligence efforts of lenders in determining whether to make a loan or not. In effect, Article 9 says to lenders: If you conduct due diligence, as guided by Article 9, you will have assurance that you have a valid security interest with the priority you seek. The Legislative Guide does little, if anything, to address due diligence issues. Because it does not do so, it cannot have the force and vitality of Article 9. For this reason, this paper contends that the Legislative Guide is a pale imitation, at best, of Article 9, and cannot achieve what Article 9 has achieved. This paper further questions whether the Legislative Guide is necessary at all, because the international capital markets have devised powerful means to enable banks to engage in cross-border secured lending without the need for such empty efforts as the Legislative Guide.

Part I of this paper addresses how Article 9 is, in effect, a "how to" guide for lenders to conduct their due diligence before making a loan. It also discusses the history of the Uniform Commercial Code to explain how "due diligence" requirements became embedded in the Code. The fact that lenders' due diligence practices are inseparable from the function and requirements of Article 9 is not an accident; it was part of the original design. Part II of this paper provides several illustrations of how particular sections of Article 9 guide due diligence, and demonstrates that any secured lender operating under Article 9 must necessarily comply with the due diligence procedures in order to receive full protection. Part III explains how the Legislative Guide is fundamentally flawed because it does not provide guidance on how to perform due diligence. Unlike Article 9, the Legislative Guide does not reflect or embody how actual lenders conduct their due diligence. Indeed, it does not address the matter in any obvious way, and that is why it has little use. Part IV examines the explosive growth of multi-bank lending across borders, which has enabled borrowers and lenders in different countries to enter into loan transactions, all without the need for anything like the Legislative Guide. The banking world has not stood still waiting for technocrats to devise impotent guides to encourage lending. The banking world has moved forward and continues to move forward to make secured credit globally available. All of this has occurred without the assistance of the Legislative Guide or any other, similar effort. Thus, this raises the issue as to whether the Legislative Guide serves any material purpose. Part V concludes this paper.

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[15] *Cf.* Bazinas, *supra* note 4 ("The [Legislative] Guide recommends a functional approach to secured transactions, which was originally taken in Article 9 of the American Uniform Commercial Code") (footnote omitted).

I. ARTICLE 9 AS A "HOW TO" GUIDE ON LENDER DUE DILIGENCE

Loans may be divided into two categories: unsecured and secured. With unsecured loans, lenders loan money in exchange for the borrower's mere promise to repay. With secured loans, lenders loan money in exchange for the borrower's promise plus a security interest in certain collateral.[16] Generally, any kind of property may be used as collateral. Real property, whether residential or commercial, is a common type of collateral. Personal property, whether tangible or intangible, is also a common type of collateral. The creation of a security interest in personal property is governed by Article 9 of the Uniform Commercial Code.[17]

Article 9 of the Uniform Commercial Code has been a great success in facilitating the loan process.[18] A major reason for its success is that it tells lenders how to perform their due diligence before making a secured loan.[19] Before making any loan, a lender must ask itself, among other things, "will I be repaid?" and "what

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[16] The legal framework for governing secured transactions must contain the following elements.

> To support secured credit effectively, a legal regime must address three distinct issues. First, the regime must determine how a debtor and creditor may create *inter se* an enforceable agreement that certain property of the debtor will serve as collateral for the debtor's obligation. Not only must the necessity of such formalities as signed writings be addressed, but also such issues as the ability of debtors to encumber disparate items of property in a single grant of a security interest and the ability to encumber anticipatorily property not yet owned by the debtor.
>
> Second, a secured credit regime must set out the ground rules for enforcement of the secured party's interest after default by the debtor. For example, how may the secured party obtain physical possession of the collateral (if it is tangible) or control of the collateral (if it is not tangible)? May self-help be utilized, or must the secured party resort to the courts? What limits exist on the methods by which the secured party reduces the collateral to money and applies that money to the debtor's obligation?
>
> Third, and perhaps most important, a secured credit regime must delineate the rights of the secured party as against other claimants of the collateral. A security interest that is enforceable against the debtor, but is subordinate to the rights of another secured creditor or of a lien creditor, has much less economic value than an interest that is superior to those competing rights. Both moral and economic value judgments are required to determine the rules that establish priority among competing claimants.

Cohen, *supra* note 7, at 430–31 (footnotes omitted).

[17] U.C.C. § 9-109(a); *see id.* at § 9-101 cmt. 1.

[18] *See* Rapson, *supra* note 10, at 893 ("Article 9 has been rightfully lauded as the 'jewel' of the Uniform Commercial Code").

[19] The U.C.C. defines due diligence outside of Article 9:

> An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless the communication is part of the individual's regular duties or the individual has reason to know of the transaction, and that the transaction would be materially affected by the information.

U.C.C. § 1-202(f).

is the risk the loan will not be repaid?" The process by which the lender determines the answer to such questions is called "due diligence."[20] All lenders must perform due diligence with respect to the borrower himself, herself, or itself. Basically, the lender must determine if the borrower is willing and able to repay the loan. Some borrowers seek loans on a fraudulent basis and have no willingness to repay. Other borrowers have the best intentions to repay but are unable to do so. That is why the borrower must be willing *and* able.[21] For unsecured lenders, the due diligence process usually ends here.

For secured lenders, though, the due diligence process continues. The secured lender must conduct due diligence into the collateral that has been offered to support the loan. In order to conduct due diligence regarding the collateral, the secured lender must ask (at a minimum) the following series of questions: (1) Does the collateral exist? Fraudulent borrowers have been known to offer collateral that does not exist.[22] (2) Does the borrower have the right to grant a security interest in the collateral? Fraudulent borrowers have been known to offer a security interest in property they do not own.[23] (3) Does the value of the collateral support the loan amount? No lender wants to loan $1 million in exchange for a security interest in collateral that is only worth $100.[24] (4) Is the collateral encumbered by any liens or liabilities? A lender needs to know if any other party has a right to the collateral.[25] In the U.S., one of the essential requirements of creditor due diligence is that the creditor check the U.C.C. filings of the appropriate state to determine if there is a prior security interest.[26]

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[20] *See* Pauline Stevens, *The Intersection of Film Finance and Revised Article 9: A Mystery*, 9 UCLA ENT. L. REV. 211, 219 (2002) (discussing how due diligence under U.C.C. Article 9 involves locating collateral and determining priority of interests through searching records in offices where security interests are filed).

[21] *See* Marshall E. Tracht, *Renegotiation and Secured Credit: Explaining the Equity of Redemption*, 52 VAND. L. REV. 599, 622 (1999) (explaining lenders' insistence on protecting their interests).

[22] *Cf.* Bank of Saipan v. CNG Fin. Corp., 380 F.3d 836, 844 n. 7 (5th Cir. 2004) (noting there was no fraud since fictitious credit card accounts proposed as collateral were disclosed as non-existent).

[23] *See In re* Hendry, 77 B.R. 85, 90–91 (Bankr. S.D. Miss. 1987) (holding debtor's misrepresentation of cattle as collateral, which he did not own, defrauded creditors).

[24] *Cf. In re* Anand, 210 B.R. 456, 458–59 (Bankr. N.D. Ill. 1997) *aff'd sub nom.* Anand v. Nat'l Republic Bank of Chi., 239 B.R. 511 (N.D. Ill. 1999) (explaining that in exchanging assets, courts compare values of what debtors give to creditors against what debtors receive from creditors).

[25] *Cf.* Bland v. Farmworker Creditors, 308 B.R. 109, 116 (S.D. Ga. 2003) (explaining unsecured creditors' best chance for repayment on their claims comes from unencumbered assets).

[26] *See, e.g.*, Bayer Corp. v. MascoTech, Inc. (*In re* AutoStyle Plastics, Inc.), 269 F.3d 726, 743 (6th Cir. 2001) (discussing that financing statement put party on notice); United States v. Scottsbluff Nat'l Bank & Trust Co. (*In re* Great Western Sugar), 902 F.2d 351, 353 n. 1 (5th Cir. 1990) ("The [creditor] could have avoided this suit by checking the liens of the [debtors] to determine whether other liens on the sugar beets existed"); *In re* Moon Thai & Japanese, Inc., 448 B.R. 576, 578–579 (Bankr. S.D. Fla. 2011) (emphasizing counsels' mistake of failing to check U.C.C. filings); *In re* SMTC Mfg. of Tex., 421 B.R. 251, 314 (Bankr. W.D. Tex. 2009) (stating due diligence would have revealed debtor's bank loan and lenders' security interests); *In re* Mgmt. by Innovation, Inc., 321 B.R. 742, 745–46 (Bankr. M.D. Fla. 2005) (remarking that lease at issue sufficiently explained what collateral was encumbered by which security interests and stating that creditors are obligated to read lease in its entirety); Dyer v. Honea, 557 S.E.2d 20, 26 (Ga. Ct. App. 2001) (rejecting fraud claim for lack of due diligence); Kubota Tractor Corp. v. Citizens & S. Nat'l Bank, 403 S.E.2d 218, 223 (Ga. Ct. App. 1991) (acknowledging filed financing statements reasonably put third

One way to think of Article 9 is as a "how to" guide for lenders that tells the lender how to conduct due diligence into the legal rights surrounding the collateral. What I mean by this is that Article 9 does not tell the lender how to conduct due diligence into the value of the collateral (that is for appraisers and other valuation experts).[27] However, it does tell the lender how to conduct due diligence into the legal rights. Specifically, Article 9 tells the lender how to determine whether the collateral is encumbered by legal or equitable rights.[28]

The crucial role of due diligence in Article 9 is explained by the way in which the Uniform Commercial Code was drafted. The drafters of the Code looked to the actual practices of business parties and drafted it to reflect and incorporate existing practice.[29] The Code was not the imposition of a set of rules imposed by legal technocrats on businesses without regard to whether the law had any resemblance to actual business practice.[30] It was the other way around. Actual business practice drove the drafting of the Code. Professors Gillette and Walt described the drafting of the Code this way:

> The UCC was originally promulgated under the auspices of the American Law Institute and the National Conference of Commissioners on Uniform State Laws in the 1940s in order to bring a greater level of certainty and predictability to an increasingly national commercial system. The UCC was intended to deal not only with sales, but with a range of transactions involving commercial parties, from the use of negotiable instruments to secured transactions. The entire project was headed by Professor Karl Llewellyn of the Columbia Law School. Much of the UCC . . . reveals Llewellyn's commitment to Legal Realism and to his desire to allow commercial parties to dictate the proper scope and doctrine of the law that was to govern their practices. Llewellyn assumed that these parties were in a better position than judges or legislators to determine socially desirable commercial arrangements. Thus, in many ways the UCC seeks primarily to

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parties on notice); Citizens State Bank v. Peoples Bank, 475 N.E.2d 324, 331 (Ind. Ct. App. 1985) (noting due diligence is performed if records are searched before attempting to create security interests); Excel Bank v. Nat'l Bank of Kan. City, 290 S.W.3d 801, 808 (Mo. Ct. App. 2009) ("The present version of the UCC equates due diligence in this fact pattern with checking for perfected security interests") (footnote omitted); Stoeckinger v. Presidential Fin. Corp., 948 A.2d 828, 833 (Pa. Super. Ct. 2008) (remarking non-performance of due diligence resulted in mistakenly accepting receivables encumbered by security interests).

[27] *See In re* Okla. City Broad. Co., 112 B.R. 425, 430 (Bankr. W.D. Okla. 1990) (accepting appraiser's opinion regarding liquidation value of debtor's collateral).

[28] *Cf. In re* Alcon Demolition, Inc., 204 B.R. 440, 447 (Bankr. N.J. 1997) (discussing security interest creation).

[29] *See* Bazak Int'l Corp. v. Tarrant Apparel Grp., 378 F. Supp. 2d 377, 384 (S.D.N.Y. 2005) (stating U.C.C. drafters endeavored to create rules according to business norms and practices).

[30] *See* Christopher J.S. Termini, *Return on Political Investment: The Puzzle of Ex Ante Investment in Articles 3 and 4 of the U.C.C.*, 92 VA. L. REV. 1023, 1029–30 (2006) (noting influence of private lawyers and general counsel for financial institutions in creating U.C.C.).

> give state sanction to private rules developed by merchants . . . . Llewellyn believed that the courts that would inevitably be required to interpret these provisions should do so by reference to the practices of the trade under investigation, rather than by the imposition of some external standard of appropriate commercial conduct.[31]

Lenders, of course, conducted due diligence in making loan decisions before the UCC was developed, and the drafters of the Code were guided by the actual practices of lenders.[32]

Article 9 reflects Llewellyn's approach to the entirety of the UCC. One commentator at the time of Article 9's creation wrote:

> Among the chief advantages of the Code are its structure and approach. For one thing, instead of relying on *a priori* concepts, the draftsmen sought to probe the expectations of the business community, an effort facilitated by the length of time available for preparing the Code. And, having found those expectations, the draftsmen tried to express them in words that make sense to businessmen (and consequently perhaps make nonsense to attorneys). To the codifiers it seemed that a financier should be enabled to tell rapidly what his rights would be under a projected loan; under current law by the time those rights are ascertained the loan may well have fallen through.[33]

As Gilmore himself stated:

> In a sense the unified structure of personal property security law had already been built: all that remained was to knock down the scaffolding which had been a temporary necessity during

[31] CLAYTON P. GILLETTE & STEVEN D. WALT, SALES LAW: DOMESTIC AND INTERNATIONAL 1–2 (2d ed. 2009). Karl Llewellyn was the Chief Reporter of the Code, and appointed Grant Gilmore to serve as a reporter for Article 9. 2 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 290 n. 2 (1965). Llewellyn appointed Gilmore to this task because Gilmore shared Llewellyn's view of the appropriate approach to the drafting of the uniform code. *Id.*

[32] GILLETTE, *supra* note 31, at 2 (remarking drafters of UCC generally relied on commercial parties within trade to establish legal standards of conduct).

[33] Robinson O. Everett, *Securing Security*, 16 LAW & CONTEMP. PROBS. 49, 51 (1951). A more recent commentator observed: "In Article 9 the commercial reasonableness standard exemplifies the UCC's policy of incorporating commercial practices." Michael Korybut, *Article 9's Incorporation Strategy and Novel, New Markets for Collateral: A Theory of Non-Adoption*, 55 BUFF. L. REV. 137, 142 (2007) (footnote omitted).

> construction. Article 9 is not so much a new start or fresh approach as it is a reflection of work long since accomplished.[34]

Interestingly enough, the phrase "due diligence" does not appear in any of the sections of Article 9. It is mentioned only in Comment 2, Example 3 to section 9-316.[35] Yet, the codification of the due diligence process lies at the heart of Article 9.[36] Even though the phrase may not appear in the text of the Code, lawyers and the courts certainly see its presence.[37]

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[34] GILMORE, *supra* note 31, at 290 (footnote omitted). Article 9 "was designed to allow all known forms of security transactions to continue to be carried on without substantial change." *Id.* at 299. In a later article, Gilmore added these further observations:

> I talked yesterday about the patterns and techniques of inventory and receivables financing which came into use between 1900 and 1950. In drafting article 9, there was no great problem in dealing with those transactions: all that had to be done was to simplify the legal framework so that businessmen and bankers could go on doing what they were already doing to everyone's satisfaction.

Grant Gilmore, *Article 9: What It Does Not Do for the Future*, 26 LA. L. REV. 300, 300 (1966).

Professors White and Summers described the development of Article 9 in a bit more colorful language with their allusion to Greek myth:

> Although Article 9 was the most innovative of the original Code articles, it did not spring full grown from the forehead of Grant Gilmore, Allison Dunham, or even Karl Llewellyn. The drafters drew heavily on a large body of separate pre-Code personal property security law.

JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 1148 (6th ed. 2010).

[35] U.C.C. § 9-316 cmt. 2 (2011). The phrase "due diligence" is not a defined term under Article 9, and it is not a defined term under the general definitions in Article 1 of the Code. However, it is mentioned in section 1-202, which provides for the meaning of "notice" and "knowledge." *Id.* at § 1-202. Subsection (f) provides in pertinent part:

> An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless the communication is part of the individual's regular duties or the individual has reason to know of the transaction, and that the transaction would be materially affected by the information.

Id. at § 1-202(f).

[36] Article 9 is designed to "push secured parties to do what due diligence and good business practice would dictate anyway: confirm the debtor-supplied information by examining public records to be sure they know who the debtor is, what its status is, whether there are peculiarities in its articles, etc." Harry C. Sigman, *Twenty Questions About Filing Under Revised Article 9: The Rules of the Game Under New Part 5*, 74 CHI.-KENT L. REV. 861, 867 (1999).

As reflected in one of the comments, Article 9 is expressly designed to force due diligence procedures on creditors.

> This section adopts the system of "notice filing." What is required to be filed is not, as under pre-UCC chattel mortgage and conditional sales acts, the security agreement

The courts are fully aware that due diligence requirements are embedded in the Code, and the fundamental role of due diligence starts with the nature of the security agreement itself. The Seventh Circuit explicitly recognized the role of the security agreement in the lender's due diligence process.

> A security agreement is a special kind of contract for which an important audience is third parties who need to know how much collateral has become encumbered. A potential creditor's decision whether to provide credit . . . is contingent on the creditor's understanding of the extent of pre-existing security interests. An unclear statement of that extent should be avoided at all costs: if the creditor reads it reasonably, but too narrowly, when extending credit, it will be out of luck when the debtor defaults. If the potential creditor on the other hand takes a more conservative position and, fearful of the ambiguity, decides not to extend credit, the party seeking that credit is penalized in its access to capital by

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> itself, but only a simple record providing a limited amount of information (financing statement) . . . .
>
> The notice itself indicates merely that a person may have a security interest in the collateral indicated. *Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs*. Section 9-210 provides a statutory procedure under which the secured party, at the debtor's request, may be required to make disclosure. However, in many cases, information may be forthcoming without the need to resort to the formalities of that section.

U.C.C. § 9-502 cmt. 2 (emphasis added).

[37] One commercial lawyer discussed the crucial role of due diligence as required by Article 9.

> Not only will these changes simplify the process of perfecting security interests by filing under Revised Article 9, but after the transition to Revised Article 9 is effective, due diligence practices and the process of determining the relative priority of security interests perfected by filing will be streamlined. To the extent that filing multiple financing statements was necessary to perfect a security interest under Old Article 9, due diligence was required to ascertain the location of collateral and priority of interests could be determined only by searching the records in each of the relevant filing offices. Since Revised Article 9 limits the number of offices where filings can be made to perfect a security interest, once the transition to Revised Article 9 is complete, the scope of due diligence and the number of searches that will have to be conducted by secured parties will be more limited than under Old Article 9.
>
> The fact that perfecting security interests in, and performing due diligence regarding, many types of assets has been simplified by Revised Article 9 will reduce the actual out-of-pocket costs and time associated with documenting secured transactions. Anyone hoping to finance a film with secured loans could benefit directly from this simple change in the law, but this modest change will not have its maximum impact unless other changes find their way into the law.

Stevens, *supra* note 20, at 219–20 (footnotes omitted) ("Revised Article 9 has reduced the cost of perfecting many security interests by streamlining the procedures for perfecting security interests in (and conducting due diligence searches regarding) most types of personal property . . . ."). *Id.* at 240.

> the shoddy work of its prior creditor—another result to be avoided.[38]

In other words, one of the key purposes of the security agreement is to enable later creditors to perform due diligence. It is a document designed to be read by third parties, not just the parties to the contract.[39]

The concept of due diligence is also embedded in section 9-203 and the Code sections governing perfection. Section 9-203 governs the attachment of a security interest.[40] In lay terms, the "attachment" of a security interest is basically the creation of one. For this reason, 9-203 may be the most important section of Article 9 because without attachment, the rest of Article 9 dealing with priority and enforcement becomes, for the most part, moot.[41] That is why section 9-203 is at the foundational core of Article 9.

"Perfection" is one of the other crucial concepts in Article 9.[42] "Perfection" may be thought of this way. The entire reason why a lender wants collateral is to enable it to have the right to take and sell a piece of property to raise cash to repay all, or at least part, of the loan in the event the borrower breaches its promise to repay. In most circumstances, the lender wants to ensure that it has the exclusive right to the collateral, and that no one else has a right to take the collateral.[43] In other words, the lender wants to be in the position where it and it alone has the right to take the collateral, and no other lender will be able to take the collateral ahead of it. Thus,

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[38] Shelby Cnty. State Bank v. Van Dienst Supply Co., 303 F.3d 832, 839 (7th Cir. 2002).

[39] *See id.* (noting importance of security agreements to third parties).

[40] U.C.C. section 9-203(a) provides: "A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral, unless an agreement expressly postpones the time of attachment." U.C.C. § 9-203(a).

With respect to section 9-203(b), this paper will focus on section 9-203(b)(1), (2), (3) and (3)(A) and (3)(B). These sections provide:

> (b) Except as otherwise provided in subsections (c) through (i), a security interest is enforceable against the debtor and third parties with respect to the collateral only if: (1) value has been given; (2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and (3) one of the following conditions is met: (A) the debtor has authenticated a security agreement that provides a description of the collateral . . . [or] (B) the collateral is not a certificated security and is in the possession of the secured party under Section 9-313 pursuant to the debtor's security agreement.

Id. at § 9-203(b).

To translate section 9-203(b) into simplified, plain English, a security interest attaches (comes into existence) if (1) a lender makes a loan, (2) the debtor grants a security interest in an item of collateral to the lender, and (3) either the debtor signs a written security agreement describing the collateral or hands over possession of the collateral to the lender pursuant to a written or oral security agreement.

[41] WILLIAM D. HAWKLAND ET AL., UNIFORM COMMERCIAL CODE SERIES (Frederick H. Miller ed., 2012) (describing importance and inseparable nature of enforceability and attachment).

[42] *See* Claire Moore Dickerson, *New Article 8 of the Uniform Commercial Code: Are Certificated Shares Subject to a Perfected Security Interest if Held in Escrow?*, 17 HOFSTRA L. REV. 407, 419 (1989) (describing critical importance of attachment and perfection of security interest).

[43] *See, e.g.*, Kimbell Foods, Inc. v. Republic Nat. Bank of Dall., 557 F.2d 491, 503 (5th Cir. 1977) (asserting perfection protects secured creditor against later-filed claims of other creditors).

when a lender takes a security interest in collateral, it wants to tell the entire world that it has a security interest and warn all others that it is first when it comes to taking the collateral in the event of default.[44] Equally important, a lender wants to know if another lender preceded it and has already taken a security interest.[45] Because if there is a prior security interest, the subsequent lender faces the risk of not having any value in the collateral after the earlier secured creditor has exercised its enforcement rights.[46] Therefore, lenders want the ability to tell the entire world that it has taken a security in collateral, and they want to know if anyone else has already taken a security interest.

Article 9 provides the means for a lender to notify the world that it has taken a security interest in collateral. The process of notifying the world is called "perfection."[47] Once a security interest attaches, lenders then want to perfect the security interest. By perfecting the security interest, the lender tells the world that it has a security interest and therefore has priority (as a general matter) over any subsequent lender who also takes a security interest in the same collateral.[48]

Article 9 provides for several different methods of perfection (the proper way to perfect depends on the type of collateral involved). One way to perfect a security interest is by filing a financing statement (usually with the office of the Secretary of

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[44] *See* Van Dusen Acceptance Corp. v. Gough, 466 F.2d 51, 52 (9th Cir. 1972) (affirming statutory purpose of perfection requirement is to give notice to future creditors).

[45] *See id.*

[46] *See Kimbell*, 557 F.2d at 503 (affirming that earlier secured creditor with perfected interest has priority over subsequent creditors); *see also* Justin M. Vogel, Note, *Perfecting Security Interests In Unregistered Copyrights: Preemption of the Federal Copyright Act and How Filing In Accordance With Article 9 Leads to the Creation of a Bankruptcy "Force Play"*, 10 AM. BANKR. INST. L. REV. 463, 466 (2002) (explaining first creditor to perfect security interest obtains first priority and all other secured creditors are estopped from perfecting interest in same property).

[47] *See* U.C.C. § 9-301 (2011).

[48] The general priority rules are set forth in U.C.C. sections 9-317(a), 9-322(a). Section 9-322(a) provides:

> Except as otherwise provided in this section, priority among conflicting security interests and agricultural liens in the same collateral is determined according to the following rules: (1) Conflicting perfected security interests and agricultural liens rank according to priority in time of filing or perfection. Priority dates from the earlier of the time a filing covering the collateral is first made or the security interest or agricultural lien is first perfected, if there is no period thereafter when there is neither filing nor perfection. (2) A perfected security interest or agricultural lien has priority over a conflicting unperfected security interest or agricultural lien. (3) The first security interest or agricultural lien to attach or become effective has priority if conflicting security interests and agricultural liens are unperfected.

Id. at § 9-322(a).

It is important to note that these rules are general and subject to exceptions. *See, e.g., id.* at § 9-324 (discussing priority of purchase money security interests).

State in the appropriate state).[49] A lender may also perfect a security interest in tangible property by taking possession of the collateral.[50]

In sum, the concept and importance of perfection is inseparable from lender due diligence. Indeed, one of the crucial goals of due diligence is for a lender to determine if a prior creditor has perfected a security interest in the collateral that has been proposed for a loan.[51] The concept and mechanics of due diligence exist for the purpose of enabling creditors to conduct due diligence, and due diligence would be fruitless without perfection.[52]

II. EXAMPLES OF ARTICLE 9'S DUE DILIGENCE REQUIREMENTS

The due diligence requirements embedded in section 9-203 and the rules regarding perfection demonstrate Article 9's role as a "how to" guide. To keep matters simple, without affecting the substance of the thesis, I will focus on section 9-203(b)(3)(A) and (B). Under subparagraphs 3(A) and 3(B), there are basically two ways of creating a security interest. Under subparagraph 3(A), a security interest attaches when the borrower authenticates a written security agreement (and when the other requirements of section 9-203(b) are satisfied).[53] Under subparagraph 3(B), a security attaches when the lender takes possession of the collateral (and when the other requirements of section 9-203(b) are satisfied).[54] Subparagraph 3(B) does not require a written security agreement; the security agreement may be oral.[55]

The following hypothetical illustrates these points. Suppose Dan Debtor owns one Monet painting valued at $10 million and wishes to borrow $9 million. First Bank is willing to make the loan, and the parties agree that the painting will be the collateral for the loan. In one scenario, the requirements of section 9-203(b)(1) and (2) are met, and the parties sign a written security agreement. The painting remains on display in Dan Debtor's home. In a second scenario, the requirements of section 9-203(b)(1) and (2) are met, but there is no writing to document the transaction; First Bank simply takes possession of the painting and places it in its vault. In both scenarios, First Bank's security interest in the painting has attached.

[49] *See id.* at § 9-501 cmt. 2; *see also* LINDA J. RUSCH & STEPHEN L. SEPINUCK, PROBLEMS AND MATERIALS ON SECURED TRANSACTIONS 220-21 (2d ed. 2010).

[50] Article 9 provides four methods of perfection: (1) filing an initial financing statement; (2) possession of the collateral by the secured creditor; (3) "control" of certain types of collateral; and (4) automatic perfection for certain types of transactions. *See* BROOK, *supra* note 12, at 18.

[51] *See* Kenneth B. Axe, *Creation, Perfection and Enforcement of Security Interests in Intellectual Property Under Revised Article 9 of the Uniform Commercial Code*, 119 BANKING L.J. 62, 70–72 (2002) (examining lender due diligence in searching for prior security interests in collateral).

[52] *See* Mottaz v. Keidel (*In re* Keidel), 613 F.2d 172, 174 (7th Cir. 1980) ("Under the Uniform Commercial Code, the rule, which is intended to reward diligence in perfection, applies even when the competing creditor has knowledge of the unperfected security interest").

[53] U.C.C. § 9-203(b)(3)(A).

[54] *Id.* at § 9-203(b)(3)(B).

[55] *See id.* (noting perfection occurs when goods are possessed by secured party).

Now, First Bank wants to perfect its security interest. In the first scenario where Dan Debtor has retained possession of the painting, the only way for the bank to perfect its security interest is by filing an initial financing statement in the Secretary of State's office in the state of Dan Debtor's principal residence (which the bank dutifully does).[56] In the second scenario where the painting has been placed in the bank's vault, the bank does not need to do anything further to perfect. Taking possession of the collateral constitutes perfection of the bank's security interest pursuant to section 9-313.[57]

A further elaboration of this hypothetical provides the basis to explain how Article 9 acts as a "how to" guide in conducting due diligence. Suppose a year later (and the painting is still valued at $10 million), Dan Debtor goes to Second Bank, seeks to borrow $9 million, and offers his Monet as collateral. Second Bank is willing to make the loan, but wants to make sure that it and it alone will have a security interest in the painting. In order to ensure this, it must conduct its due diligence.

All banks know that proper due diligence in these circumstances requires a search of the UCC filings in the appropriate state.[58] In the first scenario where First Bank has filed an initial financing statement, Second Bank's search of the records will reveal the existence of First Bank's prior security interest. In this situation, Article 9's rules regarding perfection have worked to protect both First and Second Bank. They have protected First Bank by enabling it to tell the world that it is first in line with respect to the painting. They have also protected Second Bank because the notice mechanism of perfection has revealed that it will not have the first right to collateral. With this knowledge, Second Bank will decline to make a loan it would otherwise regret.

What about the second scenario where First Bank has possession of the painting? Second Bank's search of the UCC records will reveal no filing by First Bank. At this point, would it be prudent for Second Bank to make the loan and take a security interest in the painting because of the absence of a filing in the UCC records? The clear answer is "no." Because Article 9 permits perfection of a security interest through possession (even in the absence of any tangible writings to memorialize the transaction), Article 9 says in effect: In order to conduct thorough and proper due diligence, the lender should determine the location of the collateral

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[56] For individuals (human beings), the initial financing statement must be filed in the state where the individual's principal residence is located. *See id.* at § 9-301 (providing "while a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection"); *see also id.* at § 9-307(b)(1) (codifying "[a] debtor who is an individual is located at the individual's principal residence").

[57] "Except as otherwise provided in subsection (b), a secured party may perfect a security interest in tangible negotiable documents, goods, instruments, money, or tangible chattel paper by taking possession of the collateral." *Id.* at § 9-313(a).

[58] *See* Pascack Cmty. Bank v. Universal Funding, LLP, 16 A.3d 1097, 1107 (N.J. Super. Ct. 2011) (remarking "a commercially reasonable lien search is 'a search of the records of the [relevant state or county] filing office, under the debtor's correct name, using the filing office's standard search logic'") (internal citation omitted).

and inspect it.[59] Therefore, Second Bank must tell Dan Debtor that it wants to see the painting. When Dan Debtor tells Second Bank that the painting is available for inspection in First Bank's vault, this bit of information serves as notice to Second Bank that First Bank may have a security interest in the painting, and that Second Bank needs to inquire into First Bank's relationship to the painting. Second Bank would thus need to contact First Bank and ask why the painting is located in First Bank's vault. When Second Bank is informed that the painting is in the vault because First Bank has a security interest in it, the due diligence process will have worked to protect Second Bank from making a regrettable loan. Hence, even though there is no section in Article 9 that says anything like "lenders must determine the location of the collateral and ask to inspect it in order to learn of other encumbrances on the collateral," an understanding of how Article 9 works reveals that it is indeed a "how to" guide for conducting due diligence.

The "how to" guide becomes more complicated when proceeds are involved. For example, suppose Jeans Store, Inc. ("JSI") operates a store selling high fashion jeans. It finances the purchase of its expensive inventory through a line of credit from Finance Corp., which is secured by the jeans themselves. Finance Corp. perfects its security interest by filing an initial financing statement in the proper state, and the financing statement indicates that the collateral consists of "all jeans now owned or hereafter acquired." JSI is located next door to a luxury high rise building in which Dan Debtor lives. Dan Debtor picks out ten highly fashionable jeans in JSI and offers the owner a Vermeer painting in exchange for the jeans. Both Dan Debtor and the owner agree that this barter exchange is mutually beneficial for both, and the exchange is made. Finance Corp. has no knowledge of this exchange. The owner of JSI then proudly displays the painting in her showroom.

In order to expand her successful business, JSI applies for a $5 million loan at Third Bank and offers the Vermeer painting as collateral. Third Bank begins its due diligence. It asks to inspect the collateral, and one of its employees confirms that it is on display in the JSI showroom. The bank's appraiser confirms the $8 million value of the painting. The bank then conducts a search of the UCC filings in the proper state and sees Finance Corp.'s filing under the name Jeans Store, Inc. However, the filing indicates that Finance Corp.'s collateral consists of "jeans"; there is no indication that the painting is part of the collateral.

Thus, Third Bank has confirmed that JSI has possession of the painting and that the UCC records show no filing indicating the painting as any creditor's collateral. Does this mean that Third Bank can make the loan with assurance that it will have priority in the painting in the event of default? The answer is no.

The answer is no because Article 9 requires further due diligence by Third Bank. Even though Finance Corp.'s filing does not indicate a security interest in any painting, Finance Corp. has a perfected security interest in the painting. The

[59] *See* U.C.C. § 9-203(b).

reason is because the painting constitutes "proceeds" of the jeans.[60] Under section 9-315(a)(2), Finance Corp.'s security interest in the jeans (including the jeans transferred to Dan Debtor) continued in and attached to the painting.[61] Furthermore, Finance Corp.'s security interest in the painting is perfected by virtue of its initial financing statement which indicates the collateral as "all jeans now owned or hereafter acquired." In other words, Finance Corp.'s security interest in the painting is perfected even though its initial financing statement says nothing about a painting. This is correct because of section 9-315(d).[62] In plain English, Finance Corp.'s security interest in the painting attached and remained perfected beyond 21 days after JSI acquired the painting because (A) Finance Corp. filed an initial financing statement covering the original collateral, the jeans; and (B) the painting is collateral (in this case, the painting is considered to be JSI's "equipment") in which a security interest may be properly perfected by filing in the office in which the financing statement has been filed.[63] In other words, Finance Corp. could perfect its security interest in the painting (or equipment) in the same office in which it filed the financing statement for the jeans; and (C) the painting was not acquired with cash proceeds; it was acquired in a barter exchange for jeans.

The meaning of all this for due diligence is that any bank considering the making of a loan with the Vermeer as collateral, must ask how and under what circumstances did JSI acquire the painting. It is not enough to confirm possession and check the UCC records. By conducting due diligence into how JSI acquired the painting, Third Bank will learn that JSI acquired the painting in exchange for jeans and it will see that Finance Corp.'s initial financing statement indicating "jeans" also

[60] "Proceeds" are defined to include "whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral." *Id.* at § 9-102(a)(64).

[61] Section § 9-315(a)(2) provides: "(a) Except as otherwise provided in this article and in Section 2-403(2): . . . (2) a security interest attaches to any identifiable proceeds of collateral." *Id.* at § 9-315(a)(2).

[62] Section § 9-315(d) provides: "A perfected security interest in proceeds becomes unperfected on the 21st day after the security interest attaches to the proceeds unless: (1) the following conditions are satisfied: (A) a filed financing statement covers the original collateral; (B) the proceeds are collateral in which a security interest may be perfected by filing in the office in which the financing statement has been filed; and (C) the proceeds are not acquired with cash proceeds." *Id.* at § 9-315(d).

[63] "Equipment" is defined to mean "goods other than inventory, farm products, or consumer goods." *Id.* at § 9-102(a)(33). "'Goods' means all things that are moveable when a security interest attaches." *Id.* at § 9-102(a)(44). "This Article also retains the four mutually-exclusive 'types' of collateral that consist of goods: 'consumer goods,' 'equipment,' 'farm products,' and 'inventory.' . . . The classes of goods are mutually exclusive. For example, the same property cannot simultaneously be both equipment and inventory." *Id.* at § 9-102 cmt. 4.a.

The term "equipment" is designed as a catch-all for any good that does not fall into one of the other categories of goods. *Id.* ("goods are 'equipment' if they do not fall into another category"). Classification of goods depends on the primary use of the goods by the debtor. *See* Coop. Fin. Ass'n, v. B & J Cattle Co., 937 P.2d 915, 918 (Colo. App. 1997) (explaining classification of goods is question of fact).

So, in the hypothetical, the jeans are inventory. *See* U.C.C. § 9-102(a)(48)(B) (inventory includes goods "held by a person for sale"). And the painting is "equipment."

acts to perfect Finance Corp.'s security interest in the painting. Commercial lenders know this is what Article 9 requires in the way of due diligence.[64]

The complexity and thoroughness of the rules regarding due diligence are further exemplified in section 9-315(d) once again. Section 9-315(d) begins by providing "A perfected security interest in proceeds becomes unperfected on the 21st day after the security interest attaches to the proceeds unless" one of three exceptions is met.[65] For purposes of this discussion, only the first exception will be addressed. To paraphrase (in part), a perfected security interest in proceeds becomes unperfected on the 21st day after which it attaches to the proceeds unless:

> (1) the following conditions are satisfied: (A) a filed financing statement covers the original collateral; (B) the proceeds are collateral in which a security interest may be perfected by filing in the office in which the financing statement has been filed; and (C) the proceeds are not acquired with cash proceeds.[66]

It is (C) on which I would like to focus. Why does the security interest in proceeds become unperfected on the 21st day if the proceeds are acquired with cash proceeds? As in the example discussed above, if the jeans store owner barters jeans for a painting, the security interest in the jeans (the proceeds) remains perfected for the effective term of the initial financing statement (which is five years, assuming the financing statement has the full term remaining).[67]

However, if the jeans store owner sells jeans for cash (which are cash proceeds) and then uses those cash proceeds to buy a painting (which is proceeds of proceeds), the security interest in the painting lapses on the 21st day after attachment.[68] In other words, the use of cash results in a dramatic effect on the security interest.

So why does the presence of cash in the transaction make such a difference? The only plausible explanation lies in due diligence considerations. In the event of a barter exchange (jeans for painting), a subsequent lender that is offered the painting as collateral may and should ask how the painting was acquired. The buyer should be able to produce a document memorializing the exchange, and this document will require the lender to conduct due diligence into prior security interests in the painting.[69] Even if there is no documentation, the truthful answer

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[64] This hypothetical demonstrates that the only parties who should engage in secured lending on personal property are those with a deep knowledge of Article 9. Secured lending is not designed to be a casual transaction for laymen. The same also applies to secured lending on real property.

[65] U.C.C. § 9-315(d) (codifying three exceptions where perfected security interest does not become unperfected).

[66] *Id.*

[67] *See id.* at § 9-515(a).

[68] Proceeds of proceeds are proceeds. *Id.* at § 9-102 cmt. 13.c.

[69] *See, e.g.*, ELDON H. REILEY, SECURITY INTERESTS IN PERSONAL PROPERTY § 6:11 (2012) (explaining that secured party must be able to trace proceeds back to collateral and positing that tracing is easy where proceeds are anything other than cash).

that the painting was acquired in a barter exchange for jeans should prompt the lender to conduct due diligence into the prior owner of the painting and the existence of prior security interests.

However, the situation is different if cash is used. If the lender asks for documentation for the purchase of the painting, the bill of sale will show that it was paid in full with cash. At that point, the lender may ask "where did you get the cash?" However, cash is fungible. How can the lender know if the cash is directly traceable to jeans (and therefore proceeds) or whether the cash is traceable to some other source (in which case it is not proceeds)? The sources of cash are difficult to trace and too easy to cover up. The Article 9 drafters apparently were aware of this nature of cash and took it into account in setting the guidelines for due diligence requirements.[70]

These hypotheticals illustrate that due diligence is inextricably embedded in Article 9. Article 9 exists (to a large extent) to serve as a structure to enable due diligence. In some instances, the necessary due diligence rules are simple. In others, the rules are highly complex. That is part of the beauty of Article 9. It anticipates a wide myriad of due diligence issues.

III. THE LEGISLATIVE GUIDE'S FAILURE TO ADDRESS LENDER DUE DILIGENCE ISSUES

The fundamental flaw with international attempts to harmonize secured transactions law is that their approach is the opposite of the history of the Uniform Commercial Code. Instead of looking to and incorporating a "bottoms up" approach of allowing actual business practices to inform the lawmaking, attempts such as the Legislative Guide are "top down" inventions by a select technocratic group attempting to impose its view on commerce.[71] The problem with this approach was recognized by another commentator.

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[70] *See id.* (describing difficulties of tracing cash proceeds).

[71] Professor Stephan described the UNCITRAL process in the following way: "What these bodies seem to represent, in other words, is a fairly complete realization of the technocratic ideal of lawmaking." Paul B. Stephan, *The Futility of Unification and Harmonization in International Commercial Law*, 39 VA. J. INT'L L. 743, 756 (1999).

He goes on to state:

> The project of unifying substantive international commercial law necessarily depends on a technocratic legal process. I have raised at least a reasonable suspicion that this process has its own political economy with predictable and unattractive implications for what it produces. International unification instruments display a strong tendency either to compromise legal certainty or to advance the agendas of interest groups. In either case they offer no obvious gains as compared to rules produced through the national legislative process.

Id. at 788.

> More generally, in accounts of modernization, it is now time to give up claims to universalism in favor of more differentiated analyses and prescriptions for particular times and particular places. We need to locate our evaluations of commercial law reform within a better understanding of how local entrepreneurial networks and credit institutions function on the ground.[72]

That should be the key question: How do local lenders conduct their due diligence in deciding whether to extend credit? It seems that the proponents of the Legislative Guide have overlooked or ignored how actual lenders conduct business, and have instead engaged in an effort to impose a legalistically contrived structure on lenders.

How can any attempt to harmonize or unify varying laws succeed when the actual due diligence practices vary so widely because of the wide divergence in laws? The differences in law are fundamental. In some countries, there is no system for giving, or requiring, notice of a security interest.[73] In some countries, it is not possible to grant a security interest in an item of collateral to more than one creditor.[74] Not all countries permit a security interest in after-acquired property.[75]

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[72] Macdonald, *supra* note 11, at 650.

[73] *See* Bazinas, *supra* note 4, at 139 (footnotes omitted).

> In many jurisdictions, there are no public notice systems with respect to security rights in movable assets. This means that a potential secured creditor has to rely on representations of a potential debtor or on its own independent search to find out whether an asset offered by a debtor as collateral for credit is encumbered by another security right, and, if so, to whom the security right has been granted. In other jurisdictions, the security agreement itself has to be vetted by a public official before it can be registered. The absence of any registration system or the existence of a document registration system often results in delays and costs. In addition, in the case of a document registration system, the confidentiality of a transaction may also be violated even if public access to the registry is limited (which of course will also limit the usefulness of the registry).

Id.

[74] *See id.* at 140.

> As already mentioned, in jurisdictions in which transfer- and retention-of-title devices form the main non-possessory security rights, it is not possible for a debtor to give more than one security right to a secured creditor or, in other words, to use the full value of its assets (although, in some jurisdictions, the buyer in a retention-of-title sale may use its expectancy right as collateral for credit). Once more than one security right may be created in an asset so that the debtor may be able to use all the value of its assets to obtain credit, the question of priority arises (that is which secured creditor will be paid first, if the debtor defaults and the asset's value is not enough to satisfy all secured obligations). A security right will have little value if the secured creditor cannot determine its order of priority before extending credit.

Id.

[75] *See id.* at 148.

Such differences present the possibility that a security interest in collateral created under the law of one country may not be recognized under the law of another country if the collateral crosses a national border.[76]

A lender that conducts business solely within its home borders will probably not be familiar with the proper way to conduct due diligence in another country if the laws of the other country vary in a material way, and there is nothing in the Legislative Guide to guide that lender if that is the situation.[77] Because the Legislative Guide provides no guidance on such due diligence obstacles, its value is questionable. Does this mean that cross-border lending has been restricted or is suffering from a lack of capital? The following section addresses this question, and the answer is a definite "no."

IV. THE EXPLOSIVE GROWTH IN CROSS-BORDER LENDING WITHOUT THE NEED FOR THE LEGISLATIVE GUIDE

Proponents of the Legislative Guide claim that a harmonization of secured transactions law will lead to increases in the amount of credit available to borrowers, and therefore spur economic activity. A notable proponent asserts:

> The differences between secured credit regimes, in terms of both substantive principles and their procedural effectuation, create uncertainty and transaction costs that lower the expected value of a transaction to the creditor. Once again, *these differences likely result in higher interest rates and, in some cases, foregone transactions*. Indeed, the problem may even be worse, because secured credit law is designed to operate largely without court supervision.[78]

Another proponent expressly claims that the Legislative Guide "is likely to result in an increase of the amount of credit available."[79]

> Many States with traditional pledge-based systems only permit grantors to create security rights in existing assets that they own at the time of the creation of a security right. They are not able to grant a security right in assets not yet in existence or that they have not yet acquired at the time of the conclusion of the secured transaction. The concern is to protect debtors from over-commitment of their assets, in particular their future assets, to secured creditors.

Id.

[76] *See id.* at 145–46 (indicating security right in movable asset created in one state may not be recognized under law of state where asset was moved).

[77] *Cf.* Lucinda A. Low, *When Your Client Needs an Agent Overseas*, 4 BUS. L. TODAY 45 (1995) (reminding lawyers to perform due diligence on foreign repsentatives who will serve their interests in international transactions).

[78] Cohen, *supra* note 1, at 176 (emphasis added).

[79] Bazinas, *supra* note 4, at 135.

Such concerns about the amount of internationally available credit have been raised since (at least) the 1970's. In that decade, UNCITRAL retained Professor Ulrich Drobnig of the Max Planck-Institute to prepare a study on the legal principles governing security interests in a variety of legal systems around the world.[80] The purpose was to determine the possibility of harmonizing such laws.[81]

> The study, published in 1977, comprehensively examined the law of nineteen nations, noting the similarities and differences among them in their treatment of basic legal issues in secured credit. Not surprisingly, the differences were great. More important for present purposes, though, the Drobnig report also contained assessments to 'help to consider the necessity or desirability of framing rules in this field on an international level, especially for the international movement of goods subject to security interests.'[82]

For those in favor of harmonization, the report was bleak. Drobnig wrote:

> It would seem that international legislation in the form of a convention providing uniform rules of substantive and conflicts law is not appropriate in this case. As against international sales or international transportation or the international circulation of negotiable instruments, transnational incidence of security interests is as yet relatively moderate. It would probably be difficult to obtain sufficient government support for an international conference dealing with the relatively technical topic of security interests; and even if the text of an international instrument could be agreed upon, national parliaments would probably be slow and perhaps even reluctant to ratify such a text.[83]

> Under the Guide, the central premise of a secured credit regime lies in the fact that the security against the risk of debtor default is likely to result in an increase of the amount of credit available and in a decrease of its cost. In an international context, secured credit becomes even more important as new risks are added. Movable assets cross national borders and rights created in the assets in one jurisdiction may not be recognized in another jurisdiction. In addition, the assets may become subject to rights of third parties in the new jurisdiction.

Id.

[80] Cohen, *supra* note 7, at 432.

[81] *See id.* at 432–33.

[82] *Id.* at 433 (footnotes omitted).

[83] *Report of the Secretary-General: study on security interests*, [1977] 8 Y.B. Int'l Trade L. 171, 218, U.N. Doc. A/CN.9/SER.A/1977.

Drobnig went on to add, "[m]ere recommendations, even if emanating from an international organization of the highest repute, will not command sufficient moral or other support for adoption by any sizeable number of States."[84]

Given that the secured transactions laws around the world have not been harmonized (much less unified),[85] one might conclude that the world economy has suffered and is suffering from a lack of available credit, and that international lending activity has been curtailed. One might further conclude that the world economy is hobbled by a situation where borrowers are desperate to borrow and lenders desperate to lend, with their goals frustrated by the absence of a harmonized law of secured transactions. Thus, proponents of the Legislative Guide assert that it is necessary to promote global lending activities.[86] These assertions beg a few simple questions: What is the proof that the amount of internationally available credit is less in the absence of efforts such as the Legislative Guide? In other words, what is the proof that the absence of harmonization or uniformity in secured transactions laws is the cause of a reduced amount of money to lend? Have borrowers around the world suffered from a lack of availability of credit since the 1970's?

If there is, indeed, proof that the global economy has suffered from a lack of international credit, then the proponents of the Legislative Guide would have a strong argument that harmonization is needed, perhaps essential to global economic growth. If, however, international bankers have been able to increase international lending (despite the absence of a harmonized or unified law), then the question is raised whether something like the Legislative Guide is necessary in the first place.

History provides the answer. There has been no shortage of internationally available credit.[87]

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[84] *Id.*

[85] *See* Cohen, *supra* note 1, at 188 (advocating for global harmonization while acknowledging lack of unification).

[86] *See id.* at 177 (illustrating that harmonization would decrease risks and costs of international transactions).

[87] In fact, the opposite appears to be true. The cause of the financial crisis that erupted in 2008 was the easy international availability of too much credit. In discussing the crisis, one commentator wrote:

> But why did banks generously dish out mortgages when they must have known that their loans might become burdens once the cycle turned? In the past they would have found themselves with bad loans on their books and thus would likely have exercised some foresight when giving them out, insisting on good credit ratings of their customers. But financial innovation ("securitization") meant that they did not need to keep questionable loans on their books; instead, they could bundle them up and sell them on the international financial market. This massively increased the global potential for the creation of credit, and was even more attractive since no capital requirements applied to intermediation through markets. Risk could be better diversified, lowering the need to hold capital against it, further increasing the potential for credit creation. International trading of the resulting securities led to their passing on to customers in European states (most of which have relatively high savings ratios), and with them spread the risks from US mortgage loans.

ANDREAS BUSCH, BANKING REGULATION AND GLOBALIZATION 251–52 (Oxford Univ. Press 2009).

In contrast to unsupported assertions that national differences in secured transactions law have hindered or impaired borrowers and lenders, this paper contends that it is more instructive to examine the developments in the international capital markets since Drobnig's report. Such an examination reveals that bankers have not stood still, waiting for UNCITRAL to unify or harmonize national laws. The opposite has occurred. There has been an expansion in international lending because bankers have invented new mechanisms to facilitate it, with or without a UN-sponsored harmonization of law.[88] The proof of the growth in cross-border lending is demonstrated by the following fact: From 1977 to 1996, the market size of international loans increased from $34.2 billion to $349.7 billion.[89]

In simple terms, securitization is the process by which a lender bundles and converts a pool of loans into securities which can then be sold to institutional investors. For example, a lender (or a transferee) with hundreds of mortgage loans secured by houses in the U.S. may securitize the loans by placing them into a special purpose entity, which then issues securities to investors. The investors' return is derived from the monthly payments on the mortgages by the hundreds of individual borrowers. Any pool of similar loans may be securitized. *See, e.g.*, STEVEN L. SCHWARCZ ET AL., SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS 8–16 (LexisNexis 2004) (providing example of securitization of automobile loans).

> Securitization has been described as the financing or refinancing of income-yielding assets (receivables) by repackaging them together with suitable enhancements into tradeable securities with the securities being both secured on the assets and serviced from the cashflows which they yield. In the context of banks, it involves the pooling of loans or other assets such as derivatives and using such pools to raise money from investors who thereby become entitled to receive the loan proceeds. This popular method of financing is, as such, based on or backed by previously existing financial assets such as loans; and this accounts for the designation of 'asset-backed securities'. Virtually all the banks and the major investment dealers are active in creating new securitization products and issues. Securitization is attractive to the banks, borrowers, and investors alike because they all derive distinct advantages. For the banks, securitization means that receivables are turned into cash thereby improving liquidity. Furthermore, this improves their capital adequacy position because the securitized assets are written off the books of accounts, resulting in the requirement that there be less equity. The investors' primary attractions are the opportunity to acquire a safe and liquid investment in diversified assets, which provides predictable cashflows and low default rates. The instruments are also liquid and transferable. The arrangement also normally results in borrowers paying lower interest rates.

AGASHA MUGASHA, THE LAW OF MULTI-BANK FINANCING, SYNDICATED LOANS AND THE SECONDARY LOAN MARKET 55 (Oxford Univ. Press 2007) (footnotes omitted).

[88] *See* MUGASHA, *supra* note 87, at 3 (explaining innovative phenomena of multi-bank financing and syndicated loans which have helped to increase international transactions).

[89] *See* HAL S. SCOTT, INTERNATIONAL FINANCE, TRANSACTIONS, POLICY, AND REGULATION 12 (17th ed. 2010).

> The cross-border aspect of finance can arise from the fact that the activity of the provider and the user of funds may be located in two different countries. A lender can market and transfer funds to a borrower in another country, or the borrower can seek and attain funds from the lender in the lender's country.

Id. at 1.

The growth in the market size of international loans has been accompanied (not surprisingly) by growth in the international banking system.

Much of this growth is the result of increased use of multi-bank loans, loans where more than one bank participates in the funding of the loan.

> Multi-bank financing occurs when a number of banks act in concert to extend credit to a borrower. The combination of the banks is usually highly coordinated, but in some cases the banks act in loose associations that are linked only by the simultaneous extension of credit to a borrower. The two main phases of multi-bank financing are the syndicated loan and secondary loan practices . . . . Viewed together, the two phases of multi-bank financing comprise a group of related credit-and-risk transfer techniques that permit the participants in the financial markets to manage their credit and risk more precisely.[90]

One common form of such a loan is called a syndicated loan.

> A syndicated loan is one where two or more banks join together to lend to a single borrower on the basis of a single set of lending documents, of which the primary document is usually called a 'loan agreement', 'credit agreement,' 'facility agreement', or 'loan facility agreement.' All the banks execute the one agreement and there is privity of contract between the borrower and each of the banks. Legally, each of the banks has a separate contract with the borrower even though, for convenience, the separate contracts are printed in one document. Any security taken for the loan is for the common benefit of all the banks. They own proportionate interests in it even though for convenience it may be held or monitored by only one of them, often the agent bank; or an independent entity, often a trustee, for the benefit of all.[91]

> The international banking system has been growing in importance as compared [to] the world economy. Although the trend growth rates in total foreign claims, foreign currency claims, and cross-border claims slowed during the 2008-2009 financial crisis, the broader historical trend growth is clear . . . . For example, total foreign claims have steadily increased as a share of world GDP from below 60 percent in 2002 to nearly 80 percent by the end of 2009, despite a pullback during the financial crisis. Likewise, cross-border bank assets grew at an average annualized rate in the high teens before falling somewhat during the financial crisis.

Id. at 208.

[90] MUGASHA, *supra* note 87, at 2.

[91] *Id.* at 22 (footnotes omitted).

> The early syndicated loans were simple structures assembled exclusively or nearly so among banks. The transactions are no longer simple and they are no longer exclusive to banks. Nowadays other types of financial institutions are actively involved and include

Mugasha continues:

> The syndication arrangement offers several economic benefits to the lead bank, agent, and participants. Its very existence enormously increases the capacity of the banks to accommodate their borrowers' needs. For example, a bank may not have the capacity to make a loan it wishes to make because of the sheer size of the required loan. It may still be able to lend part of the loan, however, if it forms a syndicate of lenders. For the participant, the invitation to join in a syndicated loan gives it the opportunity to lend funds that would otherwise be idle.[92]

One form of an international syndicated loan is called a eurocurrency syndication.

> Eurocurrency loans are made by a syndicate of banks. The lead manager deals with the borrower and other participants about the terms. It elicits the participation of other banks and may assume an underwriting risk, i.e., commit to lend a fixed amount whether or not other participants can be obtained. Other managing banks may share responsibilities with the lead manager. They may have regional responsibilities in a large international loan. 'Participants' are simply the banks that provide funds. The agent bank deals with the ongoing administration of the loan, communicating between the borrower and the participants. It coordinates the disbursements to the borrower, the calculation of interest due, and the distribution of the payments from the borrower to the participants.[93]

In addition to the development of the syndicated loan, sophisticated lenders injected even more liquidity into the international capital markets by developing a secondary market for syndicated loans.

> Secondary loan market practices are those where the original syndicate member passes to another party an interest in its loan, or engages in any subsequent transaction in relation to the loan interest. Through this market, the syndicate member/lender or investor is able to sell the whole or part of a loan to other lenders or investors, or may engage in other transactions in relation to the

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> collateralized loan obligations (CLOs), hedge funds, pension funds, and insurance companies to mention but a few.

Id. at 6 (footnote omitted).

[92] *Id.* at 88.

[93] SCOTT, *supra* note 89, at 599.

> same loan. Any lender or investor is also able to buy or acquire interests in other loans to supplement its existing portfolio. The traders, investors, and lenders who acquire interests in the secondary market provide capital, thereby performing an important function of adding liquidity in the overall loan market. The continuous development of this market means that trading or other dealing in syndicated loans is now a common feature of the financial markets. Borrowers have increasingly accepted that their loans will be assigned or transferred, and increasingly the loans are acquired as investments by institutional investors and a vast array of financial institutions.[94]

Given this explosive growth in international loan activity, proponents of the Legislative Guide should ask: How has this been accomplished in the absence of harmonized or uniform laws? If the absence of harmonization or unification is such a barrier to international lending, how have bankers been able to overcome this obstacle?

An examination of actual banking practice demonstrates that the use of loan mechanisms such as syndicated loans has addressed and solved the due diligence problem created by differing national laws.[95] The problem sought to be addressed by the Legislative Guide is that differing national laws discourage lenders from making cross-border loans because of the transaction costs and difficulties created by inconsistent and conflicting laws.[96] Syndications solve this problem by virtue of the fact that the lead bank takes on the responsibility of determining how to comply with the laws governing creation and perfection of the security interest, and the other banks that participate in the loan rely on the lead bank's work.[97] There is no need for all the banks to work out the security interest issues.

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[94] MUGASHA, *supra* note 87, at 36.

> The secondary loan market has existed since the 1980's (even though not necessarily under that label), and has evolved from occasional transactions negotiated and sold on an ad hoc basis to commoditized transactions sold on the basis of standard documents.

Id.

[95] *See* Yener Altunbas et al., *Large Debt Financing Syndicated Loans Versus Corporate Bonds* 7 (European Central Bank, Working Paper No. 1028, 2009), *available at* http://www.ecb.int/pub/pdf/scpwps/ecbwp1028.pdf (highlighting bank process of delegating screening and monitoring of syndicates to agent banks which, in turn, become specialized in specific geographical areas, making harmonization of differing national laws unnecessary).

[96] *See, e.g.*, Sandeep Gopalan, *The Creation of International Commercial Law: Sovereignty Felled?*, 5 SAN DIEGO INT'L L.J. 267, 279–80 (2004) (discussing how differences in contract laws of European Union Member States imposes additional transaction costs, thereby deterring international deals).

[97] *See* MUGASHA, *supra* note 87, at 43 ("The typical participation agreement leans heavily in favor of lead bank control of the underlying loan.").

> The participants may have widely varying powers in relation to the underlying loan. On the one hand, they may have very limited powers right from inception whereby they may not have the information or the means to verify the information supplied by the lead bank. This situation may subsist for the entire duration of the participation relationship in which the participants have very little access to information regarding the borrower and no active role to play in the underlying loan.[98]

Because of syndication, banks can therefore specialize in the due diligence requirements of individual countries. Thus, one bank can develop an expertise in the secured transactions law and due diligence requirements of (say) Poland, and serve as the lead bank for a syndicated loan where the controlling law is the law of Poland. This lead bank can then offer other banks around the world the opportunity to participate in the loan, and the other banks may take advantage of the lead bank's expertise in Polish law to make a loan to a Polish borrower, even though the other banks may have no knowledge of Polish law. This phenomenon was noted in a working paper issued by the European Central Bank.

> For this reason, the logic of banks as designated monitors of depositors . . . would also apply to the syndicated loan market, where banks (or uninformed lenders) participating in the syndication delegate most of the screening and monitoring to an agent bank (or informed lender) . . . . Therefore, certain lead banks could obtain lending specialisation in specific sectors or geographical areas and act as delegated monitors of participating banks.[99]

Instead of waiting for guidance from technocrats up high, it appears that banks have resorted to the basic business concept of division of labor. Banks have successfully created loan mechanisms that obviate the need for every bank to be an expert in every national due diligence process.[100] The cost of due diligence associated with complying with a particular national law regarding secured transactions is borne by one bank, and others are able to participate in the loan by relying on the work of the lead bank. These developments in international banking have emerged since the Drobnig report from the 1970's and have occurred without (or despite) the assistance of efforts such as the Legislative Guide.[101] So, what is the value-added proposition of the Legislative Guide?

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[98] *Id.*

[99] Altunbas et. al., *supra* note 95, at 7.

[100] *See, e.g.*, MUGASHA, *supra* note 87, at 2 (listing loan mechanisms such as syndicated loan, sub-participation, loan participation, loan trading, credit derivatives, and collateralized debt obligations).

[101] *See id.* at 36 (stating that secondary loan market has existed since 1980s and has continuously evolved so that syndicated loans are now common in financial markets).

CONCLUSION

By their own admission, the proponents of the Legislative Guide seek to emulate the success of Article 9 and view the Legislative Guide as Article 9's global equivalent.[102] However, the starting points of their respective drafting were located at polar opposites. Article 9 was drafted to incorporate and mirror actual, commercial practices.[103] The Legislative Guide was drafted with no obvious reference to actual, commercial practices. For this reason, the Legislative Guide lacks one of the crucial features of Article 9; it is unable to serve as a "how to" guide on lender due diligence. In this regard, the Legislative Guide misses the mark entirely on what lenders need in order to lend across borders. Lenders do not need a technocratic Legislative Guide in order to make loans. Lenders need reasonable certainty that their loans will be repaid. Reasonable certainty is provided by due diligence. Instead of relying on organizations such as UNCITRAL to spur lending activity, lenders (as one would predict) have relied on their own ingenuity to solve the due diligence problems, and they have done so through means such as international syndicated loans.[104]

In sum, the Legislative Guide is not the global equivalent of Article 9. Article 9 addresses and provides solutions to the lenders' due diligence concerns. It is uncertain what the Legislative Guide would accomplish, especially in light of the fact that the markets have provided their own solution to the problems created by differing national laws. Thus, this paper concludes with one final question: What does the Legislative Guide provide that the international capital markets have not already accomplished?

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[102] *See* Macdonald, *supra* note 11, at 641 (noting Legislative Guide's working group mostly adopted basic principles of modernization represented by Article 9).

[103] *See* Everett, *supra* note 33, at 51 (explaining Article 9's draftsmen and codifiers adopted functional approach which tapped into business community's expectations and vernacular).

[104] *See* MUGASHA, *supra* note 87, at 3 (remarking that in last decade, major syndicated loan market participants themselves have been developing common terminology, standard practices, and documents that are increasingly being used by industry leaders).