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The Article 9 Study Committee Report: Strong Signals and Hard Choices, (with C. Mooney, Jr.).

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THE ARTICLE 9 STUDY COMMITTEE REPORT: STRONG SIGNALS AND HARD CHOICES

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I. INTRODUCTION

In December, 1992, the PEB Study Committee ("Committee") issued its Report ("Report").[1] The Report follows more than two and

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1. PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, PEB STUDY GROUP UNIFORM COMMERCIAL CODE ARTICLE 9 REPORT (December 1, 1992) (hereinafter, REPORT). For background on the Committee, including its organization and methodology,

one-half years of work by the Committee. Its principal recommendation calls for the creation of a drafting committee ("Drafting Committee") for the revision of Article 9. In addition, the Report contains many specific recommendations for the revision of Article 9 and many other recommendations that identify problems to which the Drafting Committee[2] should give serious consideration.

Although the Report covers many areas in detail, it does not purport to be a comprehensive catalog of all issues that the Drafting Committee should consider. The purpose of the Report is two-fold. First, it will provide the Drafting Committee with background and guidance. Even as to issues on which the Study Committee reached no consensus, the Report plows much ground that will advance and facilitate the Drafting Committee's work. Second, the Report will serve as a medium for attracting responses from interested persons. As a result of this input, the Drafting Committee should be better informed about the views of those who will be affected by a revision of Article 9.

In this essay we identify and explain, by way of examples, some important themes and patterns that emerge from the Report. One of our goals is to offer some insight into the challenges that the Drafting Committee will face during the next few years.[3] Another is to encourage readers to provide feedback that will inform and guide the Drafting Committee.

II. THE RELATIONSHIP OF SECURED TO UNSECURED CREDITORS: SECURITY INTERESTS AND BANKRUPTCY POLICY

As Grant Gilmore's magnificent narrative makes clear, the history of the law governing security interests in personal property can be seen as a series of judicial and legislative battles between unsecured creditors and secured parties over the ability of the former to reach property claimed by the latter.[4] Article 9 represents what many believe to

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see REPORT at 1-16. The Committee's chair and reporters also issued an interim report. *See* William M. Burke, et al., *Interim Report on the Activities of the Article 9 Study Committee*, 46 BUS. LAW. 1883 (1991).

2. The Council of the American Law Institute ("ALI") and the Executive Committee of the National Conference on Uniform State Laws ("NCCUSL") has acted favorably upon the Report's principal recommendation and approved the formation of a drafting committee. We expect that the first full working session of the Drafting Committee will take place during the fall of 1993.

3. We anticipate that the ALI and NCCUSL will approve a revised Article 9 in 1996.

4. *See* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY chs. 1-8 (1965).

be a grand victory for secured parties. Under Article 9, debtors generally are free to secure any and all of their debts with as much or as little of their existing and after-acquired property as they wish. The Article's express validation of after-acquired property and future-advance clauses has made "all assets" financing commonplace and relatively inexpensive.[5] Often, very little remains unencumbered and available for the satisfaction of unsecured claims.

In today's economy, the centuries-old conflict between secured and unsecured creditors frequently plays itself out in bankruptcy. Under the federal Bankruptcy Code, security interests ordinarily are valid in bankruptcy; that is, secured parties ordinarily are entitled to recover their collateral or its value from the bankruptcy estate.[6] Unsecured creditors may resort to the value of the collateral only when, and to the extent that, the value exceeds the amount of the debt that the collateral secures.

A key exception to this general rule—and one of which the Committee was acutely aware—is that security interests that are unperfected when the debtor enters bankruptcy can be avoided by the bankruptcy trustee.[7] Upon avoidance of the security interest, the value of the collateral will redound to the benefit of holders of unsecured claims, including the (formerly) secured party.[8] Inasmuch as the property of a bankruptcy debtor rarely suffices to pay its debts in full, the loss of collateral in bankruptcy usually means a substantial loss to the secured party.

Even a perfected security interest is not necessarily immune from avoidance in bankruptcy. Security interests that are perfected more than ten days after they attach ordinarily can be avoided as preferences.[9] Thus, a delay in perfection that has no non-bankruptcy consequences may be fatal to a security interest if the debtor enters bankruptcy.

For many lenders, loss of a security interest in the debtor's bankruptcy is a risk that is not willingly undertaken. The debtor's potential entry into bankruptcy drives the structure and implementation of many secured transactions, even those with debtors whose financial

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5. *See* U.C.C. § 9-204(1) (security agreement may provide that obligations are to be secured by after-acquired collateral); *id.* § 9-204(3) (obligations covered by security agreement may include future advances).

6. *See, e.g.*, 11 U.S.C. § 725 (1988).

7. *See id.* § 544(a)(1)(1988); U.C.C. § 9-301(1)(b). In a Chapter 11 reorganization, the debtor in possession may exercise the avoiding powers. *See* 11 U.S.C. § 1107(a)(1988).

8. *See* 11 U.S.C. §§ 550(a), 551 (1988).

9. *See id.* § 547(b), (e).

health appears sound. Of course, the holder of an unperfected security interest may lose the value of its collateral in a variety of ways other than by avoidance of its security interest in bankruptcy. For example, the debtor may sell the collateral to a buyer who takes free of the security interest;[10] or the debtor may encumber the collateral with a competing security interest that is entitled to priority.[11] But security agreements typically contain covenants prohibiting or restricting such sales and encumbrances, and secured parties often are willing to act on the expectation that debtors will not violate the covenants.[12]

During the past dozen years, scholars have challenged and attempted to justify the favorable treatment that both bankruptcy and nonbankruptcy law afford to security interests.[13] To a considerable extent, the key to this favorable treatment is section 9-301(1)(b), which provides that an unperfected security interest is subordinate to the rights of a person who becomes a lien creditor before it is perfected. As a matter of both federal and state law, the bankruptcy trustee enjoys the rights of a lien creditor and so prevails over an unperfected security interest.[14] Section 9-301(1)(b) also is a major determinant of whether a security interest is immune from avoidance as a preference. Whether the creation of a security interest constitutes a preference turns in part on when the "transfer" of the security interest occurred.[15] Bankruptcy law determines the time of transfer of an interest in personal property and fixtures by reference to the rights of a non-bankruptcy lien creditor, *i.e.*, by reference to section 9-301(1)(b).[16]

Although it was aware of both the controversy raised in the academic literature and of the pivotal role that section 9-301(1)(b) plays

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10. *See* U.C.C. § 9-307(1).

11. *See id.* § 9-312(5).

12. A covenant against sales and encumbrances is not effective to invalidate a sale or encumbrance that occurs in violation of the covenant. *See id.* § 9-311.

13. *See, e.g.*, F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986); Thomas H. Jackson & Alan Schwartz, *Vacuum of Fact or Vacuous Theory: A Reply to Professor Kripke*, 133 U. PA. L. REV. 987 (1985); Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929 (1985); Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984); Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986); Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984).

14. *See* 11 U.S.C. § 544(a)(1); U.C.C. § 9-301(3).

15. *See* 11 U.S.C. § 547(b)(4).

16. *See id.* § 547(e).

in defining the trustee's avoidance powers, the Committee did not undertake a thorough examination of the issues surrounding the appropriate balance between secured and unsecured creditors. Rather, it acted on the premise that any revision of Article 9 should minimize the costs attendant to the granting and enforcement of security interests. Among these costs are the costs of perfecting a security interest. Making perfection easier and less costly to accomplish is likely to tilt the balance between secured and unsecured creditors: the number of unperfected security interests in bankruptcy can be expected to decline and the allocation of a debtor's property is likely to become more favorable to secured parties.

The Committee's approach to security interests in instruments affords a prime example of the Committee's approach to perfection issues. Under current law, a security interest in "instruments" can be perfected only by the secured party's taking possession of the instrument.[17] In contrast, a security interest in most rights to payment that is not embodied in instruments (*i.e.*, accounts and general intangibles) can be perfected only by filing a financing statement.[18] The Committee recommends that Article 9 be revised to permit a secured party to perfect a security interest in instruments by filing a financing statement.[19]

As the Report explains, the existing possession requirement appears to impose unnecessary costs on secured transactions in instruments.[20] First, the secured party who wishes to take a particular writing as original collateral must determine whether that writing is an "instrument" or some other type of collateral. When the writing is a negotiable instrument under Article 3, a secured party can classify the collateral by examining the writing itself. But in other cases this determination may require a factual inquiry as to whether the writing is "of a type which is in ordinary course of business transferred by delivery."[21] A secured party who chooses not to make this determination, or who is unable to reach a conclusion with the desired level of certainty, has an incentive to incur the costs of both filing and taking possession,

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17. U.C.C. § 9-304(1). Exceptions are made for (i) certificated securities, as to which §§ 8-321(2) and 8-313(1) make filing ineffective as a method of perfection; (ii) instruments that are part of chattel paper, for which both filing and taking possession are permissible means of perfection according to §§ 9-304(1) and 9-305; (iii) instruments in which a security interest is temporarily perfected under § 9-304(4) or (5); and (iv) instruments consisting of cash proceeds in which a security interest is automatically perfected under § 9-306(3)(b).

18. *See* U.C.C. § 9-302(1).

19. REPORT, *supra* note 1, at 152.

20. *See id.* at 152-54.

21. U.C.C. § 9-105(1)(i).

to pass the risk along to the debtor in the form of an increased interest rate or higher fees and charges, or to refrain from entering into the transaction at all. A secured party may have similar incentives when the collateral consists of a pool of writings, not all of which are identical in form.

Second, the possession requirement means that secured parties whose proceeds consist of instruments (*e.g.*, a note evidencing the obligation to pay an overdue account) lose perfection in those proceeds unless they take possession of them before the end of the ten-day period of automatic perfection in proceeds.[22] If a security interest in instruments could be perfected by filing, then the proceeds rules would extend the automatic-perfection period in many cases.

Third, taking possession of an instrument—whether as original collateral or as proceeds—often is more expensive than filing. The costs are particularly high when the collateral consists of a very large number of instruments (such as mortgage notes) that are to be collected and administered by the debtor-assignor.

At first blush, the option to perfect a security interest in instruments by filing may appear to conflict with existing commercial practice, in which those who purchase instruments (including those who take instruments as collateral) normally take delivery of the instruments without referring to the filing system.[23] If reducing the costs of perfection carries with it a concomitant increase in the costs of determining whether instruments are encumbered, there is little apparent advantage to the rule. The Committee's recommendations take these considerations into account. If adopted, they would have the effect of subordinating a security interest perfected by filing to the rights of holders in due course and many other subsequent purchasers (including secured parties) who take delivery of the instrument.[24] Yet a security interest perfected by a timely filing would not be avoidable by the debtor's bankruptcy trustee.

Several of the Committee's other recommendations would extend the current distinction between perfection, which enables a security interest to remain valid in bankruptcy, and priority over other competing claimants (*e.g.*, buyers and secured parties), for which perfection usually is necessary but may not be sufficient. For example, the Committee recommends that filing become a permissive means of perfecting a

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22. *See* U.C.C. § 9-306(3). If, however, the proceeds are cash proceeds (*e.g.*, a check), then taking possession is not necessary to continued perfection. *See id.*

23. Official comment 1 to § 9-304 refers to the "universal practice for the secured party to take possession of [instruments] in pledge."

24. *See* REPORT, *supra* note 1, at 154-55.

security interest in a letter of credit, but that a security interest perfected by filing be subordinated to certain subsequent security interests perfected by notification and acknowledgment.[25] Likewise, the Committee recommends revision of the rules governing security interests in investment securities, now found primarily in Article 8, to permit perfection of security interests by filing; however, any security interest so perfected would be subordinate to a variety of other competing claims, even though they arise subsequently.[26] The Committee's recommendations on security interests in intellectual property subject to federal law take the same approach. They contemplate that perfection (*i.e.*, priority over the bankruptcy trustee) be achieved either by filing in accordance with Article 9 (*i.e.*, in the UCC records) or by recording in a proposed federal tract index; however, purchasers who record in the federal tract index would take priority over certain security interests perfected only by an Article 9 filing.[27]

The adoption of other recommendations would make clear that the secured party's inability to enforce a security interest without the use of legal process is irrelevant to its perfected status and thus to its priority over the bankruptcy trustee. For example, the Committee is of the view that depositary institutions should owe no obligation to secured parties holding a perfected security interest in a deposit account unless, and then only to the extent that, the institution agrees to assume such obligations or is served with legal process concerning the deposit account.[28] The Committee generally approved a similar approach to the duties of a financial institution maintaining a securities account that is encumbered by a security interest.[29]

Another of the Committee's recommendations invites the Drafting Committee to consider extending this approach to non-assignable contracts, permits, and licenses.[30] Specifically, the Drafting Committee is invited to consider revising Article 9 to provide that prohibitions on assignment are ineffective to prevent a perfected security interest from attaching to the debtor's rights in a contract, permit, or license, and that the creation of a security interest in the debtor's rights does not *per se* create a default notwithstanding any agreement or other law to the contrary. The Drafting Committee's revision of Article 9 along these lines would have important consequences if the debtor were to

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25. *See id.* at 159-61; 161-62.

26. *See id.* at 163-65.

27. *See id.* at 50-55. We discuss the interaction of Article 9 and federal law below in part IV.

28. *See* REPORT, *supra* note 1, at 71.

29. *See id.* at 163-64.

30. *See id.* at 178-80.

enter bankruptcy. Under such a revision, a security interest could attach to property that may not be subjected to a valid security interest under current law. If the security interest is perfected in a timely manner, then the bankruptcy trustee ordinarily would be unable to avoid it. But the secured party would be able to realize on the collateral only when the trustee disposes of it in accordance with the applicable contract, permit, or license. In businesses whose most valuable asset is non-assignable (*e.g.*, rights under a franchise agreement), a change along these lines would enable the secured party, rather than the unsecured creditors, to capture a major portion of the value of the business.

As the consequences of perfection are increasingly divorced from priority and enforcement rights, one is led to the question whether perfection should be eliminated altogether as an Article 9 concept. This radical idea is not a new one; Professor Gilmore himself suggested something like it more than four decades ago.[31] The Reporters did not put this question directly to the Committee; but we are confident that, had we done so, the discussion would have been uncharacteristically short. Our confidence is based not only on the Committee's disinclination to tamper with fundamental Article 9 concepts but also on the belief that, when the filing system works properly, perfection serves at least one useful purpose: It informs those who might seek to take a security interest in particular property that the property already may be subject to an encumbrance.[32]

This justification has far less force when the competing claimant is the debtor's bankruptcy trustee. When exercising the power to avoid unperfected security interests, the bankruptcy trustee represents unsecured creditors who, unlike buyers and most secured parties, did not give value in reliance on particular assets being available for satisfaction of their claims when they came due. The Committee recognized that, as non-reliance parties, the debtor's bankruptcy trustee and unsecured creditors are situated differently from competing secured parties. Occasional suggestions were made for ways in which Article 9 might be revised to take account of these differences. These suggestions ranged from reversing the priority rule in section 9-301(1)(b) and providing that a judicial lien is junior to an unperfected security inter-

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31. *See* 1 GRANT GILMORE, *supra* note 4, at 463-65 (describing Gilmore's suggestion for scrapping public files and introducing appropriate safeguards to protect those misled by false or incomplete financial statements).

32. We discuss the Committee's recommendations concerning the filing system below in part IV.

est, to creating a separate federal filing system to establish security interests in bankruptcy cases.

The Committee did not pursue these suggestions, perhaps because of the slim likelihood that they would be enacted into law. Regardless of the merits, it is difficult to imagine that the political clout of the secured lending lobby is sufficient to prompt Congress into establishing a federal bankruptcy filing system. And even if the obverse of section 9-301(1)(b) could be enacted on the state level, Congress could restore the status quo ante by amending the Bankruptcy Code to provide directly that the bankruptcy trustee can avoid unperfected security interests.[33]

The appropriate relationship between secured and unsecured creditors may present the single most important cluster of issues that the Drafting Committee will address. We look forward to seeing how those issues are resolved.

III. SCOPE OF ARTICLE 9: DEALING WITH THE MARGIN

Article 9 generally has provided a sound set of rules governing attachment, perfection, priority, and enforcement of security interests in personal property. Accordingly, the Committee paid substantial attention to whether the scope of Article 9 should be expanded to include certain transactions and types of property currently excluded from its scope. Part III.A. of the Report covers seven scope-related topics: (i) sales of general intangibles and credit card receivables,[34] (ii) intellectual property,[35] (iii) rights under insurance policies,[36] (iv) tort claims,[37] (v) fixtures and real estate-related collateral,[38] (vi) oil, gas, and minerals-related collateral,[39] and (vii) deposit accounts.[40] The Report also

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33. The Committee itself suggested some changes to the Bankruptcy Code. Among these are the addition of an exception to the automatic stay of Bankruptcy Code § 362 to permit the filing of continuation statements during the bankruptcy case, *see* REPORT, *supra* note 1, at 137 n.10, and the extension of the 10-day period in Bankruptcy Code § 547(c)(3) to 20 days, to comport with proposed changes to §§ 9-301(2) and 9-312(4). *See* REPORT, *supra* note 1, at 103.

34. *See* REPORT, *supra* note 1, at 43-49.

35. *See id.* at 50-55. The Committee's recommendations concerning security interests in intellectual property are discussed below in part IV.

36. *See* REPORT, *supra* note 1, at 56-57.

37. *See id.* at 58-59.

38. *See id.* at 60-66.

39. *See id.* at 67.

40. *See id.* at 68-71.

deals with other areas that raise issues of Article 9's scope.[41] The Committee relied on the work of a number of outside groups and individuals in connection with its deliberations on many scope-related issues.[42]

The Committee concluded that several types of property interests that section 9-104 now excludes from the scope of Article 9 usefully might be brought within its scope. In the course of determining whether to recommend the inclusion of particular types of property within Article 9, the Committee found it necessary to distinguish among different varieties of a particular type. For example, although the Committee disagreed with the existing exclusion of *all* insurance policies and tort claims, it recognized that security interests in *some* insurance policies and tort claims probably should remain excluded.[43] In specifying which policies and claims are in and which are out of Article 9, the Drafting Committee will face difficulties and risks of unwelcome complexity not unlike those discussed below in part V.

The difficulty of drawing a line that includes *most* transactions of a particular type while excluding *some* transactions of that type became particularly apparent to the Committee in the context of sales of general intangibles for the payment of money. Article 9 currently governs outright sales of accounts and chattel paper as well as security interests in accounts and chattel paper that secure indebtedness.[44] In contrast, Article 9 does not apply to sales of general intangibles, such as rights to payment on unsecured loans,[45] although it does apply to security interests in general intangibles that secure indebtedness. The Report summarizes the problems that arise from the exclusion of sales of all general intangibles from Article 9:

> First, the transactions are governed by non-UCC law (presumably the common law dealing with the assignment of choses in action), which may be hard to find and unclear. Second, because determining whether a transaction should be characterized as a true sale or as a secured transaction often is difficult, parties must proceed based on alternative assumptions. Similarly, classifying certain types of property as accounts, chattel paper, general intangibles, or instruments may be difficult.

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41. *See id.* at 91-93 (non-UCC principles of law and equity), *id.* at 106-34 (proceeds), *id.* at 178-80 (non-assignable contracts, permits, and licenses), *id.* at 181-84 (agricultural financing), *id.* at 194-98 (financing buyers and non-lease bailments).

42. *See id.* at 13-16.

43. *See id.* at 56-59.

44. *See* U.C.C. §§ 1-201(37); *id.* § 9-102(1).

45. *See id.* § 9-106 cmt. ("right to receive payment of a loan not evidenced by an instrument or chattel paper" is a general intangible).

> Fourth, the excluded sale transactions do not receive the benefit of the repeal of the *Benedict v. Ratner* doctrine. . . . Finally, and probably most important, exclusion from Article 9 excuses assignees from compliance with the public notice (filing) requirements of Article 9.[46]

These concerns led the Committee to recommend that "Article 9 . . . be revised to include within its scope sales of general intangibles for the payment of money."[47] To implement the Committee's recommendation, the Drafting Committee must develop a statutory definition that distinguishes general intangibles "for the payment of money"[48] from other general intangibles. That may be easier said than done; the Committee noted, for example, that "[v]irtually any intangible right could . . . ripen into a right to payment by virtue of a breach or default."[49]

Once the line between general intangibles for the payment of money and other general intangibles is drawn, another problem remains. Some sales of general intangibles for the payment of money should, in the Committee's view, remain excluded from Article 9. For example, the application of Article 9 (and particularly its filing provisions) to the sale of loan participations[50] by financial institutions would be particularly "obstructive."[51] The Committee's recommendations

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46. REPORT, *supra* note 1, at 44-45 (footnotes omitted).

47. RECOMMENDATION 1.A. (1st sentence), REPORT, *supra* note 1, at 43.

48. UCC § 9-318(4) mentions, but does not define, "a general intangible for money due or to become due."

49. REPORT, *supra* note 1, at 46. No one has suggested that sales of all general intangibles (*e.g.*, outright assignments of patents) should be brought within the scope of Article 9. The Committee also took note of the possibility that a sale of a general intangible that is itself not one for the payment of money (such as the assignment of a patent) could give rise to a stream of payments (*i.e.*, royalties) that would constitute a general intangible for the payment of money. *See id.* at n.10 and accompanying text.

50. As the Report explains:

> Loan-participation transactions usually are structured as the sale of an undivided interest in the payments of principal, interest, and fees to be paid by a borrower. The seller (the "lead lender" or "originator") normally continues to pursue the collection of payments and passes on the appropriate shares of the receipts to the participants.

REPORT, *supra* note 1, at 47 n.12.

51. *Id.* at 47. The second sentence of Recommendation 1.A. reads as follows: "However, the Drafting Committee should ensure that the expanded scope does not embrace sales of receivables as to which regulation by Article 9 would be impractical or unnecessary (*e.g.*, loan participations and other loan sales by financial institutions and, possibly, sales by other classes of professional lenders)." *Id.* at 43. The Committee appreciated that existing Article 9 may be construed as covering some sales of loan participations, *i.e.*, participations in loans that are evidenced by chattel paper. It recommended that:

leave the Drafting Committee with yet another difficult line to draw. It might define the excluded transactions in terms of the nature of the loan originator/participation seller as a "regulated entity," such as a commercial bank, thrift institution, or registered broker-dealer. That approach would create the risk that the statute would become obsolete as the regulatory environment for financial institutions continues to change. Or, the Drafting Committee could identify the excluded transactions on the basis of the formal structure—*i.e.*, the sale of a participation interest. The latter approach, however, might allow form to govern substance and permit clever lawyers to remove an unacceptably wide variety of transactions from Article 9's reach.

However the Drafting Committee may approach a carve-out for loan participations and the like, it should be guided by input from interested segments of the financial-services community and those who rely on that community as a source of receivables-based financing. The drafters must avoid disruption of current practices, preserve flexibility for practices that may develop in the future, and be faithful to the emerging principles of the Article 9 revisions.[52]

IV. BEYOND THE STATUTORY TEXT: THE ARTICLE 9 FILING SYSTEM AND THE INTERACTION OF ARTICLE 9 WITH NON-UCC LAW

Commercial transactions are affected by many laws and regulations other than the UCC and by a variety of business practices and patterns.[53] Yet earlier UCC reform efforts have focused almost exclu-

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> The definition of security interest in § 1-201(37) or the scope of Article 9 specified in § 9-102(1) should be revised to provide that loan participations and other loan sales by financial institutions (and, possibly, sales by other classes of professional lenders) do not constitute the sale of chattel paper that is within the scope of Article 9.

RECOMMENDATION 21.C., REPORT, *supra* note 1, at 169.

52. It remains to be seen whether the Drafting Committee can craft a satisfactory statutory approach for including within the scope of Article 9 some, but not all, general intangibles for the payment of money. (This assumes, arguendo, that the Drafting Committee will accept the Committee's recommendations concerning general intangibles for the payment of money.) In another scope-related context, the inclusion of deposit accounts as original collateral, the Study Committee was skeptical that the Drafting Committee could exclude from Article 9's coverage a subset of "transactional" or "operating" accounts.

53. UCC § 1-103 probably is the most important UCC provision relating to non-UCC law. That section provides: "Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement

sively on the statutory text and the official comments. That approach is not surprising; the principal role of the UCC's sponsors has been the promulgation of statutory text to be presented to the states for (hopefully) unanimous adoption. Nonetheless, in several areas the Committee cast a wider net, with a view toward influencing non-UCC developments that affect secured transactions. This part of the essay addresses two of those areas: filing systems and federal laws that regulate interests in intellectual property. The Committee also considered the large volume of agriculture-related secured financing that is governed not by Article 9 but by non-UCC statutory liens. The final section of this part addresses the Committee's recommendations concerning the relationship between Article 9 and those liens.

The issues considered in this part also illustrate the enormous assistance that the Committee received from a number of groups and individuals. No doubt the Drafting Committee will require and receive similar assistance on a continuing basis.[54]

A. Article 9 Filing Systems

The provisions for giving public notice of (*i.e.*, perfecting) a nonpossessory security interest by filing a financing statement and the subordination of an unperfected security interest to lien creditors and most purchasers are central components of the Article 9 scheme. The scheme contemplates that interested third parties can search the public records to discover whether any financing statements have been filed against a debtor's name and, if so, the nature of the collateral covered by the financing statement.[55] But Article 9 has precious little to say about how information in a filing system is to be made available to interested persons. Section 9-403(4) requires a filing officer to record on a financing statement a filing number and the date and time of filing and to index a financing statement according to the debtor's name.[56] Only in an optional provision, section 9-407(2), does Article 9 require that the filing officer make information in the records available

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its provisions." Although the Committee noted in the *Report* several examples of improper judicial applications of § 1-103, the Committee recommended that "Article 9 should not be revised to address explicitly the circumstances under which non-UCC principles of law and equity should override otherwise applicable Article 9 priority rules." RECOMMENDATION 12, REPORT, *supra* note 1, at 91.

54. *See, e.g.*, RECOMMENDATION 24.D., REPORT, *supra* note 1, at 181 (encouraging Drafting Committee to work with ABA task forces concerning agricultural financing issues).

55. *See* U.C.C. § 9-402 (formal requisites of a financing statement).

56. *Id.* § 9-403(4).

to the public.[57] It seems that the drafters of Article 9 assumed that filing officers would, as a matter of course, make information concerning filings available to those who wished to search.[58]

Several years ago the Article 9 Filing System Task Force[59] undertook a study of the UCC filing systems. At the request of, and in cooperation with, the Study Committee, the task force issued a report ("Filing Report") to the Study Committee that documented and detailed a host of deficiencies in the filing systems in various jurisdictions.[60] The Filing Report demonstrates that the drafters' assumption was only partially correct. Although all UCC filing offices have procedures for searching for financing statements filed against a particular debtor's name, in many jurisdictions substantial delays occur between the time of a search request and the time that a filing officer responds; and often the responses, when received, are not current.

The Filing Report prompted the Study Committee to encourage the formation of another task force—one that would include representatives of filing offices and technical experts, as well as law practitioners and academics—to study and make concrete recommendations concerning the systemic problems in the Article 9 filing systems.[61] This task force has been organized and now is working under the sponsorship of the UCC Committee of NCCUSL. In Recommendation 11.A., the Committee urged the UCC's sponsors to address these systemic problems and to "support the ongoing efforts to improve and make more uniform the various state systems for filing . . . and conducting searches . . . ."[62] The success of the new task force and the shape of its ultimate product are difficult to predict. However, we are heartened by

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57. *Id.* § 9-407(2) (filing officer required to provide certificate concerning financing statement filings against a particular debtor); *see also id.* § 9-403 (continuation statements and filing fees for financing statements and continuation statements); *id.* § 9-404 (termination statements, duties of filing officer, and related fees); *id.* § 9-405 (assignments, duties of filing officer, and related fees); *id.* § 9-406 (releases of collateral, duties of filing officer, and related fees).

58. *See, e.g.*, U.C.C. § 9-403, cmt. 2 (discussing effect of continuation statement rules on "a person searching the files").

59. The task force was organized under the auspices of the American Bar Association Section of Business Law, Uniform Commercial Code Committee, Subcommittee on Secured Transactions.

60. REPORT OF THE UNIFORM COMMERCIAL CODE ARTICLE 9 FILING SYSTEM TASK FORCE TO THE PERMANENT EDITORIAL BOARD'S ARTICLE 9 STUDY COMMITTEE (May 1, 1991).

61. The Committee recognized that the systemic problems stem in part from political, financial, and technical considerations and that neither the Committee nor the Drafting Committee would be well-suited to address them.

62. RECOMMENDATION 11.A., REPORT, *supra* note 1, at 88.

the reluctance of the current group of UCC law reformers to shy away from goals that are more ambitious than revisions to statutory text.[63]

B. Federal Regulation of Intellectual Property

The Committee also reached beyond the UCC text and commentary by considering federal law governing intellectual property, such as copyrights, trademarks, and patents. The Committee made specific recommendations for the revision of both federal and state law as they relate to the perfection and priority of security interests in intellectual property.[64] In this connection, the Committee received valuable assistance from the Task Force on Security Interests in Intellectual Property of the ABA Section of Business Law, which submitted a report for the Committee's consideration.[65]

Given the detail and complexity of the substance of the task force's report and the Committee's recommendations, it is not feasible to discuss them here. Suffice it to note that the Committee is recommending that federal law and Article 9 be revised to the end that the perfection and priority of security interests in federally regulated intellectual property would be governed, for the most part, by state law (*i.e.*, Article 9). The Committee recommends that an exception to this general proposition be made for interests that are recorded in the federal records by identification of a specific item of intellectual property. Under this exception, those recorded interests would be perfected and would be senior to security interests that were earlier perfected by filing under Article 9 unless the secured party also had filed a "notice filing" in the federal records.

Were federal law revised to comport with the Committee's recommendations, revision of Article 9 also would be advisable. For example, section 9-104(a) excludes from Article 9 "a security interest subject to any statute of the United States, to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property."[66] That provision essentially states the obvious: Under the Supremacy Clause, federal law controls. In the Committee's view, however, section 9-104(a) should be clarified to

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63. Of course, the fact remains that numerous problems relating to filing could be addressed by changes to the text of Article 9. *See* RECOMMENDATION 11.B., REPORT, *supra* note 1, at 89 (identifying twenty-two such problems that the Drafting Committee may wish to address).

64. *See* RECOMMENDATIONS 2.A. - F., REPORT, *supra* note 1, at 50-51.

65. *See* PRELIMINARY REPORT OF THE ABA TASK FORCE ON SECURITY INTERESTS IN INTELLECTUAL PROPERTY (1992).

66. U.C.C. § 9-104(a).

make clear that state law controls except to the extent the United States Constitution requires otherwise.[67]

C. Agricultural Statutory Liens

The Committee studied a host of issues affecting agricultural financing. Two task forces of the ABA Section of Business Law, Committee on Commercial Financial Services, Subcommittee on Agricultural and Agri-Business Financing—the Article 9 Task Force and the Task Force on Statutory Liens—presented most of these issues to the Committee. These task forces prepared two reports for the Committee's consideration,[68] and task force members met with the Committee on two occasions. The Final Report of the task forces contained several important recommendations; the Committee recommended that the Drafting Committee give these recommendations serious consideration.[69]

The task forces' most novel and far-reaching recommendation concerns the burgeoning number of agricultural statutory liens. Even within a given state, the law governing these liens often differs greatly with respect to creation of the lien, priority over competing claims to property subject to the lien (including whether any public-notice step is required for priority), and methods of enforcement. Under the task forces' recommendation, which the Committee generally supported,[70] the perfection, priority, and enforcement rules of Article 9 would be extended to agricultural statutory liens.[71] If successful, this approach

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67. *See* Committee RECOMMENDATION 2.A., REPORT, *supra* note 1, at 50; *id.* at 52 n.4. The Committee also recommends clarification of § 9-302(3)(a), which excludes from the Article 9 filing requirements security interests covered by federal laws that provide for certificates of title or a special place of filing.

68. *See* REPORT ON AGRICULTURAL FINANCING UNDER ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE (1991); FINAL REPORT ON AGRICULTURAL FINANCING UNDER ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE (1992).

69. REPORT, *supra* note 1, at 181.

70. *Id.*

71. Under the recommendation, Article 9 would not affect the creation (attachment) of agricultural statutory liens or determine the property to which they attach. These issues would continue to be determined by the non-UCC law of each state.

The current Article 9 deals with statutory liens only to a very limited extent, as follows:

> When a person in the ordinary course of his business furnishes services or materials with respect to goods subject to a security interest, a lien upon goods in the possession of such person given by statute or rule of law for such materials or services takes priority over a perfected security interest unless the lien is statutory and the statute expressly provides otherwise.

U.C.C. § 9-310.

could be used to regularize the treatment of a vast array of other non-UCC liens.[72]

In recommending that the Drafting Committee consider addressing agricultural statutory liens through revisions to the text of Article 9 itself, rather than through changes to non-UCC law, the Committee's recommendation differs somewhat from the approach it favored in connection with filing systems and federal law regulating intellectual property. But the differences should not be overemphasized. Of greater significance is the fact that in each case the Committee demonstrated its willingness to confront and to deal with non-UCC law.

V. CRAFTING THE STATUTORY RULES: FINE LINES AND ROUGH JUSTICE

One of the virtues of Article 9 is that most of its provisions are readily accessible to lawyers who are familiar with its general outlines. In revising Article 9, the Drafting Committee will be expected not only to determine questions of Article 9's policy and scope, but also to embody its choices in statutory language that preserves its accessibility.

We have all heard that hard cases make bad law. This aphorism reflects two sometimes competing goals of the legal system. As a general matter, the system benefits from rules whose applicability and application are certain and that generate predictable results. Commercial law, which usually concerns financial rather than moral values, serves not only to resolve disputes after they occur but also to guide parties in planning and structuring their transactions. As a result, one often hears a clamoring for certainty from those whose conduct is governed by commercial law. This demand for certainty sometimes is so strong that it evokes another aphorism: the content of the rule is irrelevant, as long as the rule is certain.

But even in commercial law, among commercial parties, the results yielded by otherwise desirable legal rules may be seen as inappropriate or unfair in particular cases. A perception that the legal system effectuates injustice tends to undermine the respect for law. Insofar as those who draft statutes are able to foresee circumstances under which a special rule (or an exception) should substitute for the general rule, they can limit the general rule accordingly. Precision is not without its costs, however. As special rules multiply, the law becomes more complicated; with complexity comes an increased likelihood that those who rely upon the law will find it increasingly difficult to find, comprehend,

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72. *See* REPORT, *supra* note 1, at 181 (recommending that the Drafting Committee seriously consider approaching non-agricultural statutory liens in a manner similar to the approach suggested for agricultural liens).

and apply. In some cases, the cure may be worse than the disease. Suffering injustice in a limited number of cases may be preferable to confronting a bewildering array of rules in every case. And, in the extreme, a complex of rules may be so impenetrable that, ironically, litigation becomes unpredictable.

As experience under Article 9 grows, so do the cases for which its users perceive a need for special rules to govern apparently unforeseen circumstances. The Drafting Committee is likely to face a number of situations in which it must decide whether to fashion a complex statutory rule that resolves each imaginable case with something close to perfection or a simpler rule that can be expected to yield less than optimum results in a number of cases. The Study Committee experienced this tension periodically. Nowhere was the tension more evident than in the Committee's deliberations concerning the effect of a change in business structure on security interests in property acquired after the change.

The 1962 Official Text contained no provisions directly addressing the Article 9 consequences of the incorporation of a debtor-proprietorship, the merger of a debtor-corporation, or similar changes in business structure. The 1972 amendments to Article 9 addressed at least some of these problems in a new section 9-402(7). The second sentence governs changes of name and organizational structure. The third sentence governs transfers of collateral. As applied to the simplest situations—the change of a debtor's name and the sale of collateral without the secured party's authorization—the rules give clear albeit not uncontroversial answers. The application of these sections to other common but more complex facts, *e.g.*, a sole proprietor incorporates the business and transfers the inventory-collateral to the new corporation, or a corporate debtor whose inventory is subject to a security interest merges into another corporation whose inventory secures a debt to another lender, has posed considerable difficulty for commentators as well as courts.

The problems that transactions of this kind otherwise might generate often are solved by good lawyering. The attorney who advises the sole proprietor concerning incorporation should check to see whether the incorporation would violate the credit agreement with the secured party; if (as is likely) it would, then the attorney would advise the client to reach an understanding with the secured party before proceeding to incorporate. Similarly, a corporate merger is likely to constitute a default by the non-surviving corporation, if not also by the survivor. Adept attorneys for both debtors would discover this fact before the merger and take steps to insure that all necessary consents were obtained. For secured creditors of the non-survivor, these steps might include seeking to obtain from the survivor appropriate documentation,

including a security agreement and financing statement. This would set into motion the process of determining the relative rights of the parties. If Article 9 were unclear on this point (which it is), then the parties either would establish their relative priorities by agreement, agree to defer the contest without resolving it, or refuse to consummate the merger.

Reported cases suggest that these issues do arise with some frequency and that the courts have not resolved them in a consistent fashion.[73] As for the "right" answer, each side can make a case. Some observers believe that a secured party should not be deprived of a first-priority security interest in after-acquired property because its debtor incorporated or merged, particularly if the incorporation or merger violated the security agreement and transpired without the knowledge of the secured party. On the other hand, some argue that Article 9 should not impose upon the lender to the new or surviving corporation the risk that property acquired by its own debtor (other than as a result of the incorporation or merger) may be subject to security interests neither granted by nor filed against that debtor.

The Committee recommendations reflect the divergence of views on this issue.[74] One group favored a rule that would reflect the distinction that non-UCC law draws among different legal persons (*e.g.*, the sole proprietor and the corporation; the non-survivor and the survivor). This group would impose the risk that a different person continues the debtor's business on the secured party whose debtor no longer operates the business (or, in the case of a corporate merger, no longer exists). They would revise Article 9 to provide that the security agreement and financing statement do not bind and are not effective against a person who did not sign them, except to the extent that a non-UCC statute or rule of law (*e.g.*, the applicable state corporation law) provides otherwise. In many cases, a rule of this kind would require the secured party of the sole proprietor or of the non-surviving corporation to obtain a new security agreement and financing statement from the entity that continues the business.

The other group would give the secured party a grace period, during which a security interest in collateral acquired by the entity continuing the business would be perfected if it would have been perfected had the collateral been acquired by the original debtor. That is, the latter group would make a financing statement naming the original debtor (sole proprietor or non-surviving corporation) effective with re-

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73. *See, e.g., In re* Scott, 113 B.R. 516, 520-26 (Bankr. W.D. Ark. 1990) (citing cases).

74. *See* REPORT, *supra* note 1, at 143-45.

spect to collateral acquired by a successor entity within four months of the change, even if the successor had a completely different name and did not sign the statement.[75]

The arguments in favor of each position are set forth in the Report, and the Drafting Committee can be expected to debate the issue at length. If it concludes that the second view gives better results, then the Drafting Committee will confront the question whether the complications attendant to effectuating the second view override the concern for more perfect justice. Adoption of the second view would require drawing a statutory line between those business changes for which overriding the generally applicable distinction among separate legal persons might be appropriate (*e.g.*, the incorporation of a proprietorship) and those for which it would be inappropriate (*e.g.*, the sale of business assets to a competitor).

In addition, as the Report explains in greater detail, adoption of the second view would require the promulgation of special priority rules to govern competing security interests in property acquired after the change in structure. The priority rule that the Committee suggested is not a simple one: For purposes of the first-to-file-or-perfect rule of section 9-312(5), a financing statement filed against one debtor (*e.g.*, a non-surviving corporation) that becomes effective against another debtor (the survivor) would date, for purposes of determining priority against a competing secured creditor of the other debtor, not from the time of its filing against the non-survivor but from the time the survivor became bound by the non-survivor's security agreement (generally, the effective date of the merger).[76]

When confronted with the choice between drawing fine, but complex, lines and effectuating rough justice, on this issue and numerous others, the Drafting Committee does have a third option. It can eschew the task of writing rules and leave the issue to the courts, with a statutory standard or two for guidance. Our experience with recent revisions to the UCC leads us to predict with supreme confidence that the tradition of seeking at least a modest degree of certainty will continue and that the Drafting Committee will not choose this third approach.

VI. CONCLUSION

We close this paper as we began. We call on those who are interested in Article 9 to share with the Drafting Committee their reactions to the Committee's recommendations and any other views that might

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75. The original financing statement would remain effective until lapse if it is not seriously misleading with respect to the successor.

76. *See* REPORT, *supra* note 1, at 146-48.

be of assistance in the drafting process. And we remind the various constituencies of Article 9 that the immensity and range of the Article 9 revision project will demand your attention, your involvement, and, not in the least, your sense of humor.