1997

UCC Article 9 Drafting Committee Considers
October 1996 Draft

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posed revisions to Article 9. At this meeting, the Drafting Committee reviewed difficult issues relating to ascensions, low-price foreclosure sales to credit-related parties, tort claims, "realty paper," and other issues of importance to consumers and consumer lenders. In addition, this meeting featured a dramatic announcement that the Consumer Creditors Group was withdrawing from the Subcommittee on Consumer Transactions.

As usual the November 1996 meeting was chaired by William M. Burke, Chair of the Article 9 Drafting Committee. Also present were the Reporters, Professors Steven L. Harris and Charles W. Mooney, Jr. Mr. Burke convened the meeting and announced that the next two meetings would be held at the Omni Sheraton Hotel in Washington, D.C. on March 7-9, 1997, with a subsequent meeting to be held November 14-16, 1997 in Chicago and final approval of revised Article 9 expected in the summer of 1998.

II. Initial Deliberations

A. Code Structure and Organization

Professor Harris noted that the October 1996 draft is structured in a way to break the larger sections into smaller separate sections. As a result the new section members vary considerably from old Article 9, and for example old Part 5 (Remedies) has now become Part 6 in the October 1996 (February 1997) draft.

B. Bankruptcy and Other Issues

There were comments to the effect that some of the more active members of the National Bankruptcy Review Commission (NBRC) view the secured transactions market in static terms, and may not fully account for the probability that changes in the law will affect creditor behavior. Ed Smith reported on the Article 9 Drafting Committee Task Force on Bankruptcy-Related Matters, indicating that some members of the NBRC are cognizant of these issues and are aware of the economic importance of secured credit. He suggested that further dialogue and consideration of the economic impact of the proposed bankruptcy changes is needed. There was a consensus that some of the more radical proposals for bankruptcy reform are not warranted.4

Jerry Singman discussed a new proposed form UCC 3 (Financing Statement Change) and discussed other financing statement issues, including the problem of bogus filings. Neil Cohen reported on the UNCITRAL Receivables Financing Project.

C. Circular Priorities

Professor Harris discussed a memo from October 10, 1996 by the Reporters, on circular priorities. The Reporters asked for discussion as to whether these are issues that should be dealt with in the statute. Bob Zadek and Marion Benfield opined that the problems are in frequent in practice, and are being addressed by courts. There was a consensus that Article 9 does not need to be cluttered with additional rules to cover these issues, but that the flexibility should be appropriate for a PEB Commentary, which could then be integrated into the revised Article 9. Official Comments. This was informally approved.

D. Consumer Issues

Professor Benedikt then reported for the Subcommittee on Consumer Transactions. He reported that the creditor representatives had withdrawn from the Sub- committee on grounds that the proposed consumer credit revisions are effective in comparison to current Article 9. The creditor representatives were reported to have stated that they believe current Article 9 is superior to the proposed revisions. As a result the Consumer Issues Subcommittee did not have any new proposals for the Drafting Committee to consider. Ed Heser then spoke on behalf of the creditor representatives, noting that consumer lenders are not asking for anything in revised Article 9. They are not concerned with consumer protections without receiving anything in return. Mr. Heser reported that the consumer finance industry believes the consumer revisions would have a significant adverse impact on the cost and availability of consumer credit and therefore cannot support the revisions as currently proposed.

Ed Smith reported that there have been indications that the revisions to consumer credit are not being addressed by consumer protection issues. He distributed a list of some states attorneys general as an example. Ed Heser responded that this letter is less than it seems, in that some state officials apparently signed the letter as a general matter without consideration of the specifics or implications of the proposed revisions. He argued that evidence such as this letter should not be a basis for decisions by the Drafting Committee. Bob Zadek commented that the consumer issues involve social and political issues compared to the legal efficiencies involved in the commercial transaction issues. He urged that the Article 9 Drafting Committee is ill-suited to make these social and political judgments, and that efforts to do so will jeopardize the ability of the process to achieve needed consensus regarding legal efficiencies. Bill Burke noted that all of this is the result of an effort to be politically inclusive, so that every viewpoint can be represented.

He noted that the Drafting Committee must overtime with the process, and urged all parties to continue their participation.

III. Accessions

Professor Mooney then discussed a Reporters' memo of October 10, 1996 (Reporters' memo) covering accessions and commingled goods. The memo distinguishes the three categories of goods: (2) attached goods, (2) unattached goods, and (3) commingled goods. Attached goods are those attached to other goods without losing their separate identity, and which can be removed without injury to the attached goods or the whole (e.g., a radio installed in a vehicle). Incorporeal goods are similar except that they cannot be removed without serious injury to the whole (e.g., an alarm system integrated into a mobile home).

The basic rule under proposed section 9-33(b) is that no security interest in attached goods continues after their attachment to other goods will have priority over subsequent security interests in the whole (essentially preserving this priority if such attachment had not occurred). With regard to pre-attachment claims against the whole (which extend to the attached goods after attachment), proposed section 9-332 gives priority to the holder of the security interest in the attached goods, "except with respect to future advances made by the holder of a perfected security interest in the whole without knowledge of the security interest in the attached goods and before it is perfected." There was discussion over whether the element of "knowledge" should be eliminated. Professor Harris argued that the other priority rules should be applied, so that if the whole is sold to a buyer in the ordinary course that buyer would take free of the security interest in the attached goods.

The Reporters' memo raises but leaves open the question of priority when the competing security interests (in the attached goods and the whole) are perfected after the goods are attached. The three options are: (1) priority for the claim against the attached goods; (2) priority for the claim against the whole; and (3) priority for the first in time. Bob Zadek argued for a first in time rule; others argued for a rule based on the system governing real estate fixtures, but Professor Mooney noted that the practices for fixtures are quite different from personal property accessions. There was a consensus that purchase money priority should be recognized in this context. There was also agreement that detached goods should continue to be subject to the perfection and priority of a price security interest in the whole, and that attached goods automatically become subject to a security interest in the whole (although this is inherent in the Article 9 system rather than being expressed specifically). It was noted that many security agreements specifically cover attachments, accessions, and replacements, though this should be unnecessary.

Incorporated goods present more difficult issues. Bob Zadek argued that rules should be devised which do not require that the whole be treated as a sale of the whole (and possibly the right to force a sale of the whole, although there is disagreement on this). Ed Smith articulated a proposal

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5. The comments made in part by the NBRC, are part of an ongoing debate about the ramifications of the UCC Article 9, see also , "The Need for a Bankruptcy-Related Financing Statement Change," (1996).
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Based on this proportionate value approach for security interests perfected by filing, which would preclude removal of incorporated goods but would give the secured party a security interest in the whole. Gail Hillbend questioned whether this would allow the expenditure of funds to secure an interest in the whole. It was not clear whether the secured party would be able to exercise control over the goods in the absence of a security interest in the whole. The basic point is that incorporated goods cannot be secured if the secured party is not permitted to exercise control over the goods in the absence of a security interest in the whole.

Secured goods would also be subject to an assignment formula, as under current section 9-115. In effect, incorporated goods would be treated as unincorporated goods, since the secured party perfected by filing a security interest in incorporated goods would continue in the whole, but would only be perfected as to the whole in the event that the secured party would be allowed to exercise control over the whole in a similar manner. In other words, a security interest in incorporated goods would continue in the whole, but would only be perfected as to the whole in the event that the secured party would be allowed to exercise control over the whole in a similar manner.

The meeting then turned to sales of collateral at artificially low prices to the second party or a related party. Professor Mooney indicated that there was an emerging consensus in favor of stipulating that the sales price in a repurchase sale to the secured party or a related party must be commercially reasonable. Professor Mooney indicated that there was an emerging consensus in favor of stipulating that the sales price in a repurchase sale to the secured party or a related party must be commercially reasonable. Professor Mooney indicated that there was an emerging consensus in favor of stipulating that the sales price in a repurchase sale to the secured party or a related party must be commercially reasonable. Professor Mooney indicated that there was an emerging consensus in favor of stipulating that the sales price in a repurchase sale to the secured party or a related party must be commercially reasonable. Professor Mooney indicated that there was an emerging consensus in favor of stipulating that the sales price in a repurchase sale to the secured party or a related party must be commercially reasonable.

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VII. Tort Claims As Collateral

Professor Mooney briefly described Professor Harold Weinberg's Quarterly Report article on security interests in tort claims. He also referred to a letter dated May 15, 1996 from Hugh E. Reynolds, Jr. of Indiana University, regarding tort claims as collateral. This article and letter had been previously distributed to attendees. The letter focuses on the duties associated with the tort insurer. Putting aside the time for the meeting, the focus of the letter focused on Professor Weinberg's Quarterly Report article on the more fundamental issues relating to the possible expansion of Article 9 to cover tort claims. Professor Mooney began the discussion by asking, 'What is different about tort claims, and why should they not be included in Article 9?'

Jeff Turner noted that tort and contract claims are frequently involved in bankruptcy, and it is difficult if it is not impossible to separate them for purposes of Article 9. Others agreed that this fact supports the inclusion of tort claims in Article 9. There seemed to be general agreement with the analysis and conclusions in Professor Weinberg's article.

David McMahon then pointed out that consumer advocates oppose this expansion of Article 9, in response to the arguments that consumers need this expansion to facilitate their access to credit, he reminded the meeting that the consumer advocates generally do not believe that consumers need more credit.

Gail Hillebrand argued that the reasons for inclusion of tort claims are limited to commercial torts, and that the reasons do not apply to tort claims of natural persons.

Professor Mooney responded that natural persons may need access to cash during the pendency of the action, just like commercial entities. Bob Zdek also noted that there is already an active consumer credit market for loans secured by tort claims, and that these revisions would reduce the cost and uncertainty of financing. He also pointed out that these claims are already allowable, and seemed to question why the consumer would be better served by the current system of hidden and unclear rules as opposed to being under Article 9. There was a consensus that favored inclusion of tort claims in Article 9. Professor Mooney then questioned how this should be limited. There was a consensus that personal injury claims should not be excluded from Article 9, even if otherwise allowable under state law. There was also a consensus that claims specifically made insurable under other law should be excluded. Gail Hillebrand then argued for exclusion of claims that arise outside an individual's trade or business. A vote of the Drafting Committee favored this proposal.

Bob Zdekly noted the 'bubbles' of the proposal, which would be very broad (e.g., personal injury claims), and suggested that middle class consumers should not be caught in these collateral claims.

IX. Instruments Secured by Real Estate

A letter of October 1, 1996 from James A. Newell, Associate General Counsel of Freddie Mac, was presented, expressing concern over the proposed rule to allow perfection by filing as to instruments secured by a real estate mortgage. There was a discussion of "super generic" (all encompassing) collateral. Dan LaPiano questioned whether a description covering "all assets" would cover non-Article 9 collateral. Professor Harz responded that this would depend on other law; the security agreement would be valid as a contract outside of Article 9 for purposes, for example, of creating a common law pledge.

The Drafting Committee voted to preclude the use of super generic ("all assets") descriptions in the security agreement, though such descriptions would be allowed in financing statements. This preserves current law regarding security agreements. There was a consensus that use in the security agreement of broadly defined Article 9 terms (e.g., "all accounts") is permitted and desirable.

Proposed section 9-209 was then reviewed. This requires a secured party to comply with a debtor's request for an accounting within two weeks and provides a $500 statutory penalty for a failure to do so. This was approved.

X. Other Issues

A. Choice of Law (Revised Sections 9-301, 9-302, 9-306)

The differences between consumer and business choice of law are often related because of the relationships between this proposed section 9-310, discussed above, and the commentaries on the relationship between the proposed section and Section 9-327, discussed above.

The provisions were retained, with authority delegated to the Reporters to modify or remove the provision as needed in negotiations with real estate interests.

IX. Section 9-111— Sufficiency of Description

Proposed section 9-111(b) would require a description of a deposit account "by item, as all of the debtor's deposit accounts, or as an identified class of the debtor's deposit accounts." There was a discussion of "super generic" (all encompassing) collateral. Dan LaPiano queried whether a description covering "all assets" would cover non-Article 9 collateral. Professor Harz responded that this would depend on other law; the security agreement would be valid as a contract outside of Article 9 for purposes, for example, of creating a common law pledge.

B. Lien Creditors

Should the current rule at section 9-110(b) be preserved, giving the lien creditor priority over a filed but not yet perfected security interest on collateral? Proposed section 9-115(a) (and Comment 1) retains priority on account of the lien creditor over a filed security interest if the lien creditor is in good faith in possession of a good faith belief that the collateral is a fixture to be attached and disposed of.
C. Buyers in the Ordinary Course

Should the limitation at current section 9-307, confining the rule protecting buyers is the ordinary course of business to security interests created "by his seller," be re-examined or eliminated? The consensus was that the current text is satisfactory. Should the priority rules at proposed sections 9-315(c), (d), and (h) have a similar limitation? Should investment securities be added to section 9-315(b)?

The consensus on the latter question was yes.

D. Receivables and Consignments

Since "security interest" is defined in section 1-201(17) to include consignments, the rule allowing a lender-creditor to prevail over unperfected security interests will allow lien creditors to prevail over unperfected consignments. The same applies to a debtor-seller of receivables as to a buyer who fails to perfect. The debtor-seller subsequently could resell or encumber the sold receivables to a third party who would have priority if he or she was the first to perfect.

E. Future Advances

The future advances provisions have been construed in proposed section 9-330. Proposed section 9-320(a) specifies the only circumstance in which the time of the advance is relevant. No substantive change is intended from prior law, but the intent is to clarify that in any case not specified at section 9-320(a) the time of the advance does not control priority.

Proposed section 9-320(b) is derived from current section 9-301(e) and is designed to conform Article 9 to the federal Tax Liens Act. The proposal brings this and all other future advances rules into a single section at proposed section 9-320. Proposed section 9-320(c) does the same for competing buyers, replacing existing section 9-307(c).

Harry Sigman suggested a stronger statement that proposed section 9-320(a) is the exception and restating the general rule to the contrary. This seems well-advised in view of the propensity of some courts to become confused over future advances issues.

F. PMSI—Section 9-222

Should a purchase of a negotiable document of title confer purchase money priority on the purchaser? The Reporters think not (consistent with current law), but included such a provision in brackets for discussion purposes. The consensus was to delete the bracketed language.

Proposed section 9-222(b) would allow purchase money priority in inventory to carry over to chattel paper proceeds (contrary to current law).

G. Proposed Section 9-334—Priority of Security Interests in Certificate of Title Goods

If a state issues a certificate of title covering goods subject to a security interest perfected by any means in another state: (1) a buyer other than a dealer would take free of the security interest to the extent the buyer gives value and takes delivery of the goods after issuance of the certificate and without knowledge of the security interest; and (2) the security interest from the prior state would be subordinate to a conflicting security interest that attaches and is perfected after issuance of the certificate and without knowledge of the prior security interest. This carries forward the general theory that a good faith claim or interest takes for value and without notice in reliance on a certificate of title will have priority over a claim or interest perfected by other means.

H. Incorrect Financing Statement

Proposed section 9-235 provides that a filed financing statement, containing information described in proposed section 9-515(b)(5) (e.g., whether or what type of organization the debtor is) that is incorrect, is subordinate to the rights of a purchaser who relied on the incorrect information. This is intended to protect creditors parties only, though the potential extent of the rule is not completely clear. Harry Sigman argued against attempts to time-tone this rule to cover every possibility and suggested statutory clarification that this rule is intended to protect only reliance creditors. However, the Drafting Committee voted for more extensive clarification.

I. Rights of Third Parties

On page 92 of the October 1996 draft the Reporters questioned whether new choice of law rules are needed to govern third party rights. Generally the Article 9 choice of law rules govern only debtor and secured party issues. Should the Article 9 choice of law rules also apply to related third party issues, such as a contract clause that prohibits assignment of an account, chattel paper, or payment in- tangible? Neil Cohen argued that such choice of law rules should be provided in a better solution than reliance on the general choice of law rules at UCC section 1-105. Obviously the issue could have greater practical importance of law of one state prohibits a waiver of the section 9-406(b) prohibition and the law of another interested state does not.

J. Assignments and Agreements Not to Assert Defenses

Proposed section 9-403(d), subject to other consumer laws, permits an agreement between an account debtor and assignor, not to assert against any assignee, claims that the account debtor may have against the assignor, if the assignate takes in good faith and without notice. This is not enforceable with regard to the defenses asserted against a holder in due course. The Drafting Committee approved a motion by Ed Truth clarifying that this does not bar such rights under other law.

Proposed section 9-404 provides that absent or agreement not to assert defenses, the rights of an assignee are subject to the terms of the contract between the account debtor and assignor and any defense of the account debtor against the assignor which accrues before the account debtor receives notice of the assignment. This claim can only be enforced as a reduction in the amount due on the contract. This language is intended to follow the language at UCC section 3-305. Concern was expressed that proposed section 9-404(c) (carrying forward prior law) could subject an account debtor to contract changes by reason of an assignment of which the account debtor has not had notice. The Reporters agreed to consider this issue.

X. Conclusion

As the foregoing may suggest, the current Article 9 revision process is subjecting the purposes and rules of Article 9 to an unparalleled level of scholarly and practical scrutiny, as befits the premier commercial law in the world today. While the process sometimes yields disagreements and even consensus on needed reforms. While the process is not perfect, it has demonstrated superiority in many respects to other methods of rule-making and legislation. But as the process has become more open, it has also become more political. This is a less a problem with regard to commercial transaction issues, in that broad consensus is often possible regarding clear improvements in the law, but has become a serious problem with regard to consumer protection issues. The latter are inherently subject to regional and political divisions, and the extent to which these divisions can be satisfactorily resolved in this forum remains to be seen, even at this late stage in the process.

Follow up: Premises Owner’s Liability