February, 1988

The Rights of Creditors Under Article 2A

Steven L. Harris, *Chicago-Kent College of Law*
THE RIGHTS OF CREDITORS UNDER ARTICLE 2A

Steven L. Harris*

I. INTRODUCTION

Article 2A of the Uniform Commercial Code¹ affects not only the rights of the lessor and the lessee of personal property but also the rights of third parties. Part 3 of Article 2A explicitly addresses the rights of a wide variety of third-party transferees from the lessor and lessee, including those of buyers, sublessees, judicial lien creditors, holders of artisan’s liens, encumbrancers of real estate, and Article 9 secured parties.² This article analyzes the effects of Article 2A on two of the most common types of third-party claimants: Article 9 secured parties and holders of judicial liens. Specifically, this article considers the effects of Article 2A on the creation and nonbankruptcy enforcement of security interests and judicial liens by creditors of the lessor and lessee. It also considers the Article’s effects on the relative rights of one party to the lease and of the other party’s creditors.

This article examines three transactions in detail: the lease of goods that the lessor previously has encumbered with a security interest; the grant of a security interest in a lessor’s rights under an existing lease; and the suffering of a judicial lien on a lessee’s rights under a lease. In the interest of brevity, the discussion of other transactions (the creation of a security interest in a lessee’s rights under a lease and the sufferance of a judicial lien on a les-

---

* Professor, University of Illinois College of Law. This article benefited from the comments and suggestions of Douglas G. Baird, Ronald DeKoven, John F. Dolan, Homer Kripke, Fred H. Miller, Charles W. Mooney, Jr., Donald J. Rapson, Howard Ruda, and Harry C. Sigman.

¹ All references to sections of and Official Comments to Article 2A are to the 1987 Official Text. Unless otherwise indicated, all references to sections of and Comments to other Articles of the Uniform Commercial Code (“Code”) are to the 1978 Official Text.

² See U.C.C. § 2A-305 (buyers and sublessees); U.C.C. § 2A-306 (holders of artisan’s liens); U.C.C. § 2A-307 (judicial lien creditors and secured parties); U.C.C. § 2A-309 (encumbrancers of real estate); see also U.C.C. § 2A-304 (subsequent lessees from the lessor); U.C.C. § 2A-308 (special rights of creditors).
sor's rights under a lease) is less complete and relies considerably on references to the extensive discussions of the three major transactions. For each transaction, this article assumes that the lease in question is a longer-term commercial lease.\(^3\) Although this article does not address directly the rights of other third-party claimants, many of the observations it makes concerning secured parties and judicial lien creditors also apply to the rights of other third parties.\(^4\)

The provisions of Article 2A that govern the rights of secured parties and judicial lien creditors are found primarily in two sections, sections 2A-303 and 2A-307.\(^5\) Section 2A-303, which applies

3. Article 2A applies to any transaction, regardless of form, that creates a lease. U.C.C. § 2A-102. "'Lease' means a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, or retention or creation of a security interest is not a lease." U.C.C. § 2A-103(1)(j). Because Article 2A does not apply to transactions that create what sections 9-102(2) and 1-207(37) refer to as a lease "intended as security," this article does not discuss those transactions. (The Official Text of Article 2A includes a conforming amendment to section 1-201(37) that, inter alia, deletes the term "intended as security"; however, the term remains in section 9-102.)

Some of the third-party issues that this article addresses are unlikely to arise in connection with short-term leases. The lessee's rights under a short-term lease are unlikely to serve as collateral, and a creditor of the lessee is unlikely to acquire a judicial lien on the lessee's rights during the brief lease term. Even those issues that do arise are unlikely to become serious problems when the lease is for a short term; the expiration of the lease will terminate one of the competing claims to the goods, and any potential conflict will disappear.

For a discussion of the application of Article 2A to leases in which the lessee is a consumer, see Miller, Leases With Consumers Under Uniform Commercial Code Article 2A, 39 Ala. L. Rev. 957 (1988).

4. For example, sections 2A-304(1) and 2A-305(1) are expressly subject to the provisions of section 2A-303, which this article discusses in detail.

5. Section 2A-303 provides in part as follows:

   (1) Any interest of a party under a lease contract and the lessor's residual interest in the goods may be transferred unless

   (a) the transfer is voluntary and the lease contract prohibits the transfer; or

   (b) the transfer materially changes the duty of or materially increases the burden or risk imposed on the other party to the lease contract, and within a reasonable time after notice of the transfer the other party demands that the transferee comply with subsection (2) and the transferee fails to comply.

   (2) Within a reasonable time after demand pursuant to subsection (1)(b), the transferee shall:

   (a) cure or provide adequate assurance that he [or she] will promptly cure any default other than the one arising from the transfer;

   (b) compensate or provide adequate assurance that he [or she] will promptly compensate the other party to the lease contract and any other person holding an interest in the lease contract, except the party whose interest is being transferred, for any loss to that party resulting from the transfer;
not only to transfers to creditors but to transfers generally, regulates the ability of parties to a lease to alienate their rights under the lease and the lessor’s ability to alienate its residual interest. Section 2A-307 contains priority rules that specifically address the

(c) provide adequate assurance of future due performance under the lease contract; and
(d) assume the lease contract.

Section 2A-307 provides in part as follows:
(1) Except as otherwise provided in Section 2A-306, a creditor of a lessee takes subject to the lease contract.
(2) Except as otherwise provided in subsections (3) and (4) of this section and in Sections 2A-306 and 2A-308, a creditor of a lessor takes subject to the lease contract:
(a) unless the creditor holds a lien that attached to the goods before the lease contract became enforceable, or
(b) unless the creditor holds a security interest in the goods that under the Article on Secured Transactions (Article 9) would have priority over any other security interest in the goods perfected by a filing covering the goods and made at the time the lease contract became enforceable, whether or not any other security interest existed.

With the exception of a few references to problems that arise from the lessee’s failure to take possession of leased goods, this article does not address issues covered by section 2A-308. These include sale-leaseback transactions and transactions that are fraudulent or voidable under non-Code law.

6. Article 2A refers to the bundle of rights that the lease contract affords the lessor as the “lessor’s leasehold interest.” See U.C.C. § 2A-103(1)(m) (definition of “leasing interest”). Typically, those rights encompass the right to receive the lessee’s performance under the lease, including the right to receive rents, and the right to enforce the lessee’s obligations upon the lessee’s default. Similarly, Article 2A refers to the bundle of rights that the lease contract affords the lessee, including the right to use the goods during the lease term, as the “lessee’s leasehold interest.”

The lease contract not only affords rights to the lessor and the lessee but also imposes upon each of them various performance obligations. These obligations are included in the party’s “leasehold interest.” The transfer of this aspect of a leasehold interest is a delegation of duties to which section 2A-303 applies. The creation of a security interest or judicial lien ordinarily implicates only the “rights” aspect of a leasehold interest and not the “duties” aspect. Consequently, this article does not address the application of section 2A-303 to delegation of duties. Some consequences of the failure of the section to distinguish between the assignment of rights and the delegation of duties are discussed infra in the text accompanying notes 134-44 and 151-57.

7. When the owner leases goods, he parts with the right to use the goods during the term of the lease but retains the right to use or dispose of the goods at the conclusion of the lease. Following current usage, Article 2A refers to this interest of the lessor in the goods “after expiration, termination, or cancellation of the lease contract” as the “lessor’s residual interest.” U.C.C. § 2A-103(1)(q). That interest is a property right that can be transferred separately from or together with other rights of the lessor. The lessor’s residual interest has been referred to also as the lessor’s “reversionary interest.” See, e.g., Boss, Lease Chattel Paper: Unitary Treatment of a “Special” Kind of Commercial Specialty, 1983 Duke L.J. 69.
relative rights of one party to the lease and of the other party's creditors.

Assessing the effects of those provisions requires first that one ascertain the existing law. Current law is uncertain with respect to personal property leases and, to a lesser extent, with respect to the rights of creditors. The uncertainty surrounding the law of personal property leases was the principal motivation for the promulgation of Article 2A. But with the exception of the controversy surrounding whether a lessor should be required to file a financing statement as a prerequisite to enforcing its rights against third parties, third-party rights have not been considered to be among the most significant issues that a uniform statute on personal property leasing would address. Perhaps as a consequence, the applicability of Article 2A to the transactions under discussion and, when the Article does apply, the manner in which it applies are not always clear.

When the meaning of a statutory provision is in doubt, this article considers the different possible meanings and suggests a construction that accords with the principles and policies of the Code. Those principles and policies include "permit[ting] the continued expansion of commercial practices through custom, usage and agreement of the parties." Given the diverse structure of leasing transactions, it is doubtful that a single statutory framework could apply to all personal property leases unless it left the

---


9. Journal articles discussing the need for a uniform statute typically do not address third-party rights other than in the context of filing. See, e.g., Ayer, Further Thoughts on Lease and Sale, 1983 ARIZ. ST. L.J. 341; Boss, Leases and Sales: Ne'er or Where Shall the Twain Meet, 1983 ARIZ. ST. L.J. 357; Mooney, supra note 8. But see Leary, The Procrustean Bed of Finance Leasing, 56 N.Y.U. L. REV. 1061, 1088-89 (1981). Nor did the Study Committee of the National Conference of Commissioners on Uniform State Law address third-party issues other than filing and waiver of defense clauses in its report recommending the establishment of a committee to draft a uniform law on personal property leasing. In a similar vein, the Official Comment to section 2A-101 lists ten issues "critical to codification," of which only filing relates to third-party rights. The paucity of reported cases on third-party issues may explain the relative lack of emphasis on these issues during the drafting process. Although the issues that this article explores were not considered to be among the most significant, they were considered by the drafting committee from the outset of its work.


11. U.C.C. § 1-102(2)(b).
parties free to vary the effects of the statute by agreement. The Code generally affords the parties that freedom.\textsuperscript{12} If they find a provision of Article 2A to be undesirable, the parties to the longer-term, commercial leases that this article examines usually are free to "contract out."

Although the freedom to contract out of Article 2A's provisions may ameliorate the adverse consequences of an inappropriate statutory provision, it does not render the substance of the statute irrelevant. Like those of Article 2, many provisions of Article 2A fill gaps the parties may have left in their agreement. To the extent that Article 2A dictates results that are consistent with those that generally would obtain as a result of face-to-face bargaining, the Article serves to maximize the value of the lease contract to the parties. In addition, the Article may reduce the costs attendant to leasing transactions by relieving the parties of the need to negotiate those points and set them out in the lease contract. On the other hand, statutory rules that parties routinely change by contract undermine the gap-filling function of a statute. To the extent that Article 2A contains rules of that kind, it will make many leasing transactions comparatively more costly, not only for those who would have found it unnecessary to negotiate over the point had the statute reflected the result they desired but also for those who do not contract out of its provisions—for example, because they are uninformed or because the cost of contracting out exceeds the benefit to be gained. Of course, when a provision of Article 2A cannot be varied by agreement, the substance of the provision is particularly important.

Any analysis of specific transactions must be considered not only in the context of freedom of contract but also in the context of the general principles governing transfers of interests in personal property. Ordinarily, a person can convey no greater rights than he has. This principle, which this article refers to as \textit{nemo}

\textsuperscript{12} Section 1-102(3) provides:
The effect of provisions of [the Code] may be varied by agreement, except as otherwise provided in [the Code] and except that the obligations of good faith, diligence, reasonableness and care prescribed by [the Code] may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable.
dat, 13 pervades the Code 14 and applies as well to judicial liens. 15 Were the rule otherwise, a person would be able to convey rights that he did not have; that is, the person would be able to deprive another person of his rights. Nemo dat underlies the vast array of "first in time, first in right" rules relating to the transfer of personal and real property. The effect of those rules is that the person who takes rights second in time can take only those rights that remain after the first taker has taken his rights. Were the rules reversed to be "second in time, first in right," then the second taker would take not only the rights of the transferor but also the rights of the first taker.

By generally precluding one person (the transferor) from divesting another (the first transferee) of his rights, the law may increase the value of property rights. 16 Nevertheless, the nemo dat principle is far from ironclad; the law often enables a person to convey greater rights to personal property than the person has. 17 A considerable number of the exceptions to nemo dat arise when the application of the principle may increase the total costs associated with the transfer of private property. For example, when first transferees routinely would agree to relinquish their rights to cer-

---

13. This is a shorthand version of a Latin maxim, which often appears as nemo dat quod non habet (one cannot give what one does not have). For a brief history of the principle, see 1 G. Gilmore, Security INTERESTS IN PERSONAL PROPERTY 229 n.1 (1965).

14. See, e.g., U.C.C. § 3-306 (transferee without rights of a holder in due course takes subject to all claims and defenses); U.C.C. § 6-110(1) (purchaser takes subject to title defects arising from transferor's noncompliance with Article 6). The Code also reflects the principle that the transferee of property acquires all rights that the transferor had. See, e.g., U.C.C. § 2-403(1) (first sentence) (purchaser of goods); U.C.C. § 3-201(1) (transferee of negotiable instrument); U.C.C. § 7-504(1) (transferee of document of title). Nemo dat is a "necessary corollary" of this principle. Dolan, The U.C.C. Framework: Conveyancing Principles and Property Interests, 59 B.U.L. Rev. 811, 812 (1979).

15. See, e.g., Carolina Power & Light Co. v. Uranex, 451 F. Supp. 1044, 1054 (N.D. Cal. 1977) (applying California law) ("creditor may attach only his debtor's actual interest in property that the debtor holds"); see also G. Glenn, The RIGHTS AND REMEDIES OF CREDITORS RESPECTING THEIR DEBTOR'S PROPERTY § 25, at 23 (1915) ("The creditor is entitled to realize on whatever property the debtor may himself be able to realize on. In other words, whatever the debtor can lawfully alienate, that in turn the creditor can reach.").

16. See, e.g., Jackson & Kronman, Secured Financing and Priorities Among Creditors, 88 YALE L.J. 1143, 1162-64 (1979) (rule of "first in time, first in right" is required to capture special efficiencies that secured financing makes possible); Weinberg, Sales Law, Economics, and the Negotiability of Goods, 9 J. LEGAL STUD. 569 (1980) (suggesting that nemo dat may be economically efficient as applied to the sale of stolen goods).

17. For examples of these situations in the Code, see Dolan, supra note 14, at 815-16 & nn. 26, 27, 29, 35-37.
tain subsequent transferees, the law may provide that result in lieu of requiring the parties to reach agreement in each case.18 Or when first transferees can reduce total costs by publicizing or otherwise protecting their rights, subsequent transferees may take the rights of those who fail to provide the requisite publicity.19 Because those to whom the law affords greater rights than their transferors often are good faith purchasers for value, the exceptions to nemo dat often are termed "good faith purchase" rules.20 This article's analysis of the provisions of Article 2A that affect the rights of secured parties and judicial lien creditors concludes that, in most cases, one can construe those provisions to reach the result that the parties likely would have reached had they bargained over it. This article also suggests that a few rules in Article 2A were poorly chosen and are likely to increase the costs inherent in leasing transactions. Perhaps the most important of those rules is contained in section 2A-303(1)(b). The rule of that section is particularly troublesome not only because it may not command the result that parties generally would have reached through face-to-face bargaining but also because it violates nemo dat without any apparent justification and because the parties may not be able to change its effect by contract.21

In the majority of cases, as to which Article 2A provides appropriate gap-filling rules, the Article makes a valuable contribution to commercial law. Even in those cases, however, the value of the contribution is not as great as it could be. In part, Article 2A's usefulness is diminished because certain rules affecting the rights of Article 9 secured parties appear only in Article 2A, where, undoubtedly, some will overlook them. Statutory provisions

18. Section 9-307(1), which provides that certain buyers in ordinary course of business take free of certain security interests may be an example of such a case. See Baird & Jackson, Possession and Ownership: An Examination of the Scope of Article 9, 35 Stan. L. Rev. 175, 210 (1983); cf. Dolan, supra note 14, at 815-16 (rules enabling transferee to receive interests greater than those of his transferor reflect concern for protecting the expectations of parties to regular transactions).

19. For example, by enabling potential transferees to rely on the absence of public notice of an existing security interest as an indication that particular personal property is not so encumbered, the Article 9 priority rules generally reduce the cost of transactions in personal property. See Baird & Jackson, supra note 18, at 179-90.

20. See Dolan, supra note 14, at 813-16.

21. See infra Part III.
that are peculiar to secured parties belong instead in Article 9. At
the very least, Article 9 should have been amended to refer to the
relevant provisions in Article 2A, particularly when the results
under Article 2A may differ from those that otherwise would ob-
tain under Article 9. More generally, some provisions of Article
2A suffer from a lack of clarity that may impair the value of the
Article. Some, if not many, parties will be uneasy relying upon a
court’s ability to draw the appropriate meaning from ambiguous
statutory language and will incur the costs of articulating their in-
tentions in the lease contract. A primary goal of this article is to
help clarify the meaning of Article 2A and so minimize the need
for parties to incorporate its provisions in their lease contracts.

II. THE RIGHTS OF SECURED CREDITORS OF A LESSOR

This Part of the article analyzes the rights of secured creditors
of a lessor of personal property in two distinct situations: when the
lessee leases goods in which a secured party already holds a secur-
ity interest, and when a secured party takes a security interest
from the lessor after goods have been leased.

22. These provisions include the rule in section 2A-303(1)(a), which permits the par-
ties to the lease to make the lessor’s right to receive rents inalienable, and the priority rules
in subsections (2)(b), (3), and (4) of section 2A-307. One reason why these provisions affect-

23. The 1977 relocation to Article 8 of Code provisions regulating the attachment and
perfection of security interests in investment securities was accompanied by the addition of
appropriate cross-references in Article 9. See, e.g., U.C.C. §§ 9-203(1), 9-302(1)(f). Unlike
the 1977 revisions, however, the 1987 revisions, which include Article 2A, do not amend
Article 9 to direct the lawyer’s attention to provisions in other Articles that may affect the
rights of his client. Indeed, even though the 1987 revisions include a conforming amendment
extending the coverage of section 9-113 to include security interests arising under Article
2A, the references to that section in Article 9 were not modified to reflect the amendment.
See U.C.C. § 9-203(1) (referring to security interests “arising under the Article on Sales”); U.C.C.
§ 9-302(1)(f) (same). Nevertheless, after Article 2A becomes effective, references to
section 9-113 should be read to refer to the section as amended. See U.C.C. § 9-113 com-
ment (1987 Official Text).

Article 2A rules that supersede Article 9 rules are discussed in the text accompanying
notes 63-69 infra.
A. When a Lessor Leases Goods in Which a Secured Party Already Holds a Security Interest

1. How existing law resolves competing claims to the goods—Perhaps because it was drafted at a time when personal property leasing was not a significant part of the economy, Article 9 contains only a few provisions specifically addressed to leasing transactions. As a consequence, under existing law the rights of a secured party with a security interest in goods that the debtor subsequently leases are somewhat uncertain. To determine whether and to what extent the security interest survives the creation of the lessee’s leasehold interest, one first must distinguish between the lessor’s residual interest, which the lessor retains, and the right to use the goods during the lease term, which the lessor transfers to the lessee. That the security interest in the residual interest survives is beyond dispute. The lease of the goods to the lessee does not affect that aspect of the secured party’s collateral. The lessee has bargained for the use of the property only during the lease term and acquires no interest in the residual interest, which remains subject to the security interest. Any other result would enable a debtor to deprive a secured party of its entire security interest by transferring only some of the debtor’s rights in the collateral.

A more difficult question is whether the lessee’s rights under the lease are subordinate to the security interest. That is, if the lessor defaults on its obligations to the secured party, may the secured party enforce its security interest against the lessee in

24. Inasmuch as only one jurisdiction has adopted the new Article to date, “existing law” refers to the pre-Article 2A Code.

25. The following sections of Article 9 refer explicitly to lease transactions: U.C.C. § 9-103(3) (perfection in multiple state transactions); U.C.C. § 9-105(1)(b) (definition of “chattel paper”); § 9-109(4) (definition of “inventory”); U.C.C. § 9-206(1) (agreements not to assert defenses); U.C.C. § 9-408 (precautionary filing for true leases); see also U.C.C. § 9-104(j) (excluding transfer of lease of real estate); U.C.C. § 9-105(1)(i) (definition of “instrument”); U.C.C. § 9-106 (definition of “account”); U.C.C. § 9-504(1) (disposition of collateral). For some indications of the growth of the leasing industry since the Code was drafted, see Boss, supra note 7, at 71 n.11.

26. See U.C.C. § 2-403(1) (first sentence) (purchaser of a limited interest acquires rights only to the extent of the interest purchased). This result would obtain whether or not the security interest is perfected.
accordance with Part 5 of Article 9. Generally, the purchaser of goods acquires no greater rights than its transferor had. In Article 9, this general rule appears in section 9-306(2): "Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise . . . ." Thus, in the absence of a statutory exception or an authorization by the secured party, Article 9 follows nemo dat and provides that the security interest continues in the goods, even if the debtor leases them to a lessee.

Article 9 contains no statutory exception to the general rule in section 9-306(2) as regards lessees. The Article does, however, enable certain buyers of goods to take free of security interests, even if the security interests are perfected. For example, the good-faith-purchase rule of section 9-307(1) enables a buyer of inventory in ordinary course of business to take free of most security interests, even those that are perfected. The creditor that is secured by goods that the debtor is in the business of selling expects, or at least hopes, that the debtor will sell the goods in its ordinary course of business because those sales enable the debtor to con-

27. Part 5 of Article 9 permits a secured party, upon the debtor's default, to repossess the goods, sell them, and apply the net proceeds of the sale towards the satisfaction of the secured debt. See U.C.C. §§ 9-503, 9-504.

28. See U.C.C. § 2-403(1) (first sentence); see also supra notes 13-20 and accompanying text.


30. This discussion assumes that a lease of goods is an "other disposition" to which section 9-306(2) applies. Authority to the contrary is criticized infra notes 75-82 and accompanying text. Even if a lease is not an "other disposition," the security interest should be preserved by using a fortiori reasoning (if a security interest survives a sale of all the debtor's rights, surely it survives something less than that) or by reference to sections 9-201 and 2-403(1) (first sentence).

31. The following discussion generally applies to both perfected and unperfected security interests.

32. U.C.C. § 9-307(1). Although the section does not specifically mention inventory, the definition of "buyer in ordinary course" in section 1-201(9) requires that the buyer buy from a person in the business of selling goods of that kind, thus suggesting that the goods are held for sale and therefore are inventory. (Section 9-307(1) excludes farm products, which also are sold by a person in the business of selling goods of that kind.) See U.C.C. § 9-109(4) (definition of "inventory"); U.C.C. § 9-109(3) (definition of "farm products"). Section 9-307(1) enables a buyer to take free only of security interests created by "his seller." It applies whether or not the buyer knew of the security interest (but not if the buyer knew that the sale violated the security interest) and even if the security interest was perfected.
continue in business and repay the secured debt. A buyer in ordinary course would assume that, because those who take security interests in inventory understand that the goods will be sold, a secured party would neither object to ordinary course sales nor refuse to release its security interest in goods that are sold. Section 9-307(1) protects the reasonable expectations of the ordinary course buyer. In doing so, it commands a result that is consistent with the agreement that the secured party and ordinary course buyer most likely would have reached through face-to-face bargaining.

Because a lessee is not a buyer, a lessee—even one that leases in ordinary course from a lessor in the business of leasing goods of that kind—will not fall under the protection of section 9-307(1). Nevertheless, one can argue that the policy underlying the buyer-protection provisions of section 9-307(1) should be applied by analogy to protect an ordinary course lessee. As is the case when the collateral is sold, had the secured party and the lessee in ordinary course bargained with each other, in all likelihood they would have agreed that the lessee would take its leasehold interest free of the security interest; otherwise, the lessee would refuse to lease the goods, and the secured party would have one less source for repayment of the secured debt.

Even if one does not analogize an ordinary course lessee of inventory to a buyer in ordinary course, the Code affords a means of enabling the ordinary course lessee to take free of a perfected security interest. Section 9-306(2) provides that a security interest does not continue if the secured party authorizes the disposition of

33. Some debtors typically retain a security interest in inventory that they sell. The buyer often agrees to pay interest on his debt at a rate higher than that paid by the seller-debtor to the inventory lender. The ability to share in the higher interest rate may provide an additional reason why the inventory lender hopes the inventory will be sold.

34. See Baird & Jackson, supra note 18, at 210.

35. Section 1-102(1) mandates that the Code “shall be liberally construed and applied to promote its underlying purposes and policies.” The Official Comment explains that “[t]he text of each section should be read in the light of the purpose and policy of the rule or principle in question, [and] also of the [Code] as a whole, and the application of the language should be construed narrowly or broadly, as the case may be, in conformity with the purposes and policies involved.” Courts often have applied Code provisions to lease transactions by analogizing them to sales. See, e.g., Mooney, supra note 8, at 1618-20 and cases cited therein.

36. Indeed, anecdotal evidence suggests that professional lenders who are secured by inventory held for lease assume that their security interest is subordinate to the rights of an ordinary course lessee. Some lenders provide for this result in the security agreement. See infra note 38 and accompanying text.
the collateral in the security agreement or otherwise.\textsuperscript{37} When the collateral is the debtor's equipment, the secured party is most unlikely to authorize the debtor to lease the equipment free of the security interest. However, when the collateral is inventory that the debtor is in the business of leasing, then the security agreement may explicitly authorize the debtor to hold the goods for lease.\textsuperscript{38} Even if the security agreement is silent on that point, a court may infer the secured party's authorization for ordinary course leases from the secured party's conduct, including the fact that the secured party, without objecting, knowingly permitted the debtor to offer the goods for lease.\textsuperscript{39} Alternatively, under appropriate circumstances, a court might hold that the secured party has waived its security interest as against the lessee.\textsuperscript{40} In either of these ways, a court could enable an ordinary course lessee of inventory to take its leasehold interest free of the security interest, thereby giving effect to the reasonable expectations of both the lessee and the secured party.

Although the application of section 9-307(1) by analogy and the application of section 9-306(2) provide alternative routes toward the same result, the two sections do not operate in an identical manner. In addition to relieving secured parties and buyers of the costs attendant to negotiating a purchase free of the security interest, section 9-307(1) relieves courts of the burden of conducting case-by-case examinations of facts in order to determine whether the secured party has waived its security interest as against the lessee. In doing so, section 9-307(1) may afford the buyer in ordinary course greater protection than does section 9-306(2) because it enables the buyer in ordinary course to take free...

\textsuperscript{37} U.C.C. § 9-306(2). Notwithstanding two cases to the contrary, discussed \textit{infra} note 81, the text assumes that the lease of goods is a "disposition."


\textsuperscript{39} For cases in which courts have found an implied authorization of the disposition of collateral, see R. HILLMAN, J. MCDONNELL & S. NICKLES, COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE ¶ 22.02[1][b][i] & n.104 (1985 & Supp. 1987). If the debtor is in the business of selling, but not leasing, goods of that kind, the analogy to section 9-307(1) nevertheless may be appropriate, as long as the security interest continues in the debtor's rights under the lease.

\textsuperscript{40} See generally id. ¶ 22.02[1][b][ii]. See also Muir v. Jefferson Credit Corp., 108 N.J. Super. 586, 262 A.2d 33 (1970) (secured party estopped from asserting perfected security interest).
of a security interest even if the secured party specifically has prohibited the debtor from selling the goods.\textsuperscript{41} Whether the law should protect the ordinary course lessee in every case, not just in those cases in which the facts support an implied authorization or a waiver, is a question over which reasonable people may differ.\textsuperscript{42}

Just as one appropriately may analogize the ordinary course lessee of inventory to a buyer in ordinary course, one appropriately may analogize other lessees to other buyers. Consider first the lease of goods encumbered by an unperfected security interest. By analogy to section 9-301(1)(c), the lessee, even of goods other than inventory, would take priority over the unperfected security interest if the lessee takes delivery and gives value without knowledge of the security interest and before it is perfected. Other lessees, including those who know of the security interest when they take delivery of the goods, would take subject to the security interest.

Suppose instead that a financing statement covering the goods has been filed, but the debtor has yet to enter into a security agreement. The debtor then leases the goods to the lessee. Thereafter, the debtor and secured party named in the financing statement enter into a security agreement covering the leased goods. The lessee should take free of the security interest, as would a buyer. Until a security interest has attached, it is unenforceable against the world.\textsuperscript{43} A buyer of goods as to which no security interest has attached takes unencumbered goods, even if a financing statement was filed before the purchase.\textsuperscript{44} After the debtor has sold the goods, the debtor lacks rights in the collateral and ordina-

\textsuperscript{41} Unlike other buyers in ordinary course of business, a buyer of farm products in ordinary course does not take free of a security interest created by his seller. U.C.C. § 9-307(1). Some courts have enabled ordinary course buyers of farm products to take free of security interests under section 9-306(2), even when the security agreement expressly prohibited the debtor from selling the collateral. See cases cited in B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 8.4[3][b] (1980 & Cum. Supp. No. 3 1987); see also R. HILLMAN, J. MC DONnell & S. NICKLES, supra note 39, ¶ 22.02[1][b][iii]-[iv].

\textsuperscript{42} Another distinction between section 9-306(2) and section 9-307(1) is that the former may apply to all lessees, whereas the latter applies, if at all, only to lessees in ordinary course of business.

\textsuperscript{43} U.C.C. § 9-203(1).

\textsuperscript{44} See U.C.C. § 2-403(1) (first sentence).
rily cannot thereafter grant an enforceable security interest in them.\textsuperscript{45}

A similar analysis, based on \textit{nemo dat}, would enable the lessee to take free of the security interest. The secured party had no security interest in the goods until the security agreement was signed, and so the lessee would acquire an unencumbered leasehold interest. The secured party acquired no greater rights to the goods than the debtor had, and when its security interest attached, the debtor no longer enjoyed the right to use the goods during the lease term. That right belonged to the lessee, and the lessor would be unable to convey it to the secured party.\textsuperscript{46}

2. \textit{How Article 2A resolves competing claims to the goods}\textemdashArticle 2A contains provisions that directly address the relative rights of Article 9 secured parties and lessees of collateral from the debtor. Like Article 9, Article 2A reflects both the \textit{nemo dat} and good-faith-purchase principles. But unlike Article 9, Article 2A lacks a general first-in-time rule.\textsuperscript{47} Instead, it contains several provisions, each of which regulates the relative rights of a different pair of competing claimants.\textsuperscript{48} As a result, the extent to

\textsuperscript{45} See U.C.C. § 9-203(1)(c). A less satisfying analysis would start with section 9-301(1)(c), which enables a buyer to take free of an unperfected security interest if he gives value and takes delivery of the goods without knowledge of the security interest and before it is perfected. That section apparently was designed to govern the rights of the holder of an attached but unperfected (usually, unfiled) security interest and not the rights of a person who has filed a financing statement but who did not acquire a security interest until after the rights of the buyer attached. Nevertheless, some may wish to apply the section to the conflict under discussion, either directly or by a fortiori reasoning. A direct application would consider an unattached security interest as to which a financing statement has been filed to be an \textquote*{unperfected security interest.} Cf. U.C.C. § 9-303(1) (\textquote*{[a] security interest is perfected when it has attached and when all of the applicable steps required for perfection have been taken.}). Under a fortiori reasoning, any buyer who prevails over the holder of an attached but unperfected security interest ought to prevail over a person who holds no security interest at all. When the putative secured party has done nothing more than file a financing statement, no security interest exists, so a buyer ordinarily will take delivery without knowledge of the security interest and take free of any security interest.


\textsuperscript{47} Actually, Article 9 contains two general \textit{nemo dat} rules: section 9-203(1)(c) (security interest does not attach unless the debtor has rights in the collateral) and section 9-306(2) (security interest ordinarily survives disposition of the collateral). See also U.C.C. § 2-403(1) (\textit{nemo dat} rule applying to all purchasers of goods).

\textsuperscript{48} The failure of the drafters to include a basic \textit{nemo dat} rule modeled after the first sentence of section 2-403(1)\textemdash\textit{i.e.}, that a lessee acquires all rights that the lessor had or had power to convey\textemdashis particularly puzzling given the drafters' general adherence to the \textquote*{gag rule}: the provisions of Article 2 would be followed unless they were so bad that they caused
which Article 2A follows *nemo dat* sometimes is unclear.\footnote{49} Although one is tempted to resolve doubtful cases by analogizing to Article 9's treatment of buyers, those analogies should be drawn with great care. For reasons that are neither readily apparent nor explained in the Official Comments, the drafters decided to treat lessees like buyers in some cases but not in others.

(a) *Lessees in ordinary course of business*—Part II(A)(1) of this article, which discusses existing law, suggests that courts may analogize certain lessees to buyers in ordinary course. Article 2A draws that analogy in section 2A-307(3). The section provides that 
"[a] lessee in ordinary course of business takes the leasehold interest free of a security interest in the goods created by the lessor even though the security interest is perfected and the lessee knows of its existence."\footnote{50} This provision, which derives from section 9-307(1),\footnote{51} subordinates the secured party's rights in the goods to those of the lessee in ordinary course of business in all cases, not only when the facts support a finding of a waiver or implied authorization.\footnote{52} Section 2A-307(3) does not affect a security interest in the lessor's residual interest, inasmuch as the lessee in ordinary course takes only the "leasehold interest" free of the security interest.\footnote{53}

---

one to gag. The drafters did borrow from section 2-403(1) with respect to the rights of particular claimants. See U.C.C. § 2A-304(1) (first sentence) (subsequent lessees from a lessor under an existing lease contract); U.C.C. § 2A-305(1) (first sentence) (buyers and subsequent lessees from a lessee under an existing lease contract).

49. For example, in the absence of a general *nemo dat* rule, section 2A-301, which provides that ordinarily a lease contract is enforceable and effective according to its terms against creditors, could be read to override *nemo dat*. Notwithstanding the breadth of its language, section 2A-301 should not be read as a priority rule under which the lessee ordinarily wins. Failure to construe the section consistently with *nemo dat* would enable the thief of goods to convey to a lessee an effective leasehold interest in them at the expense of the true owner, a result that the drafters surely did not contemplate.


51. Section 2A-307(3) differs from section 9-307(1) primarily in that the former contains no exception for farm products. Other differences appear to be adjustments for differences between leases and sales or to be matters of style.

52. By defining a "lessee in ordinary course of business" to include one who leases goods from a person who is in the business of selling, but is not in the business of leasing, goods of that kind, Article 2A resolves an issue that is uncertain under existing law. Whether the resolution comports with the reasonable expectations of both the secured party and the lessee is dubious.

53. "Leasehold interest" means, in this context, "the interest of the ... lessee under a lease contract." U.C.C. § 2A-103(1)(m). "'Lease contract' means the total obligation that results from the lease agreement as affected by Article 2A and any other applicable rules of
The central element in the definition of "lessee in ordinary course of business" is the leasing of goods "from a person in the business of selling or leasing goods of that kind."\(^{54}\) That element encompasses the vast proportion of lessees under both operating and finance leases.\(^{55}\) A commercial lessee that leases from a person in the business of selling or leasing goods of the kind leased also can be expected to qualify as a "lessee in ordinary course of business" in all other respects: to lease in ordinary course, in good faith, and without knowledge that the lease is in violation of the rights of a third party in the goods.\(^{56}\) Thus, most commercial lessees will be "lessees in ordinary course of business."

(b) Lessees not in ordinary course of business—Given the propensity of Article 2A to treat lessees in a manner analogous to buyers, the establishment of the category of "lessee in ordinary course" and the rule of section 2A-307(3) comes as no surprise.\(^{57}\)

\(^{54}\) "Lessee in ordinary course of business" means a person who in good faith and without knowledge that the lease to him [or her] is in violation of the ownership rights or security interest or leasehold interest of a third party in the goods leases in ordinary course from a person in the business of selling or leasing goods of that kind but does not include a pawnbroker.

U.C.C. § 2A-103(1)(o). The definition differs from the definition of buyer in ordinary course of business, U.C.C. § 1-201(9), in that it refers to the "leasehold interest" of a third party. The definition goes on to explain what "leasing" means, in a manner similar to Article 1's explanation of "buying." Compare U.C.C. § 2A-103(1)(o) with U.C.C. § 1-201(9).

55. In commercial cases, the primary exceptions are likely to be short-term arrangements whereby the lessee borrows equipment from a competitor or other person that uses the goods in its business. Because of their short term, those leases are unlikely to give rise to priority disputes of any significance.

56. When the lessee is a "merchant," U.C.C. § 2-104(1), "good faith" means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade. See U.C.C. §§ 2A-103(3), 2-103(1)(b). In this regard, Article 2A departs from the prevailing view that "good faith" under section 1-201(9) means "honesty in fact," even when the buyer is a merchant. See, e.g., Sherrock v. Commercial Credit Corp., 290 A.2d 648 (Del. 1972) (to be a buyer in ordinary course, one must buy in "good faith" within the meaning of section 1-201(19)). With respect to all lessees, "knowledge" means actual knowledge. See U.C.C. § 1-201(25).

57. This article suggests that analogizing lessees to buyers is an appropriate approach to resolving the competing claims of the lessee's secured party and the lessee. For an argu-
The analogy does not hold, however, in section 2A-307(2)(b), which governs the relative rights of the lessor’s secured party and the non-ordinary course lessee. Rather than analogize the lessee to a buyer, the section analogizes the lessee to a secured party. More specifically, section 2A-307(2)(b) resolves the competing claims of the lessor’s secured party and the non-ordinary course lessee by reference to the Code’s resolution of the competing claims of the lessor’s secured party and the holder of a hypothetical security interest in the goods. Unless the actual security interest would have priority over “any other security interest in the goods perfected by a filing covering the goods and made at the time the lease contract became enforceable,” the lessor’s secured party takes subject to the lease contract. 58

The use of a hypothetical creditor in section 2A-307(2)(b) was inspired by the “strong-arm” clause of the Bankruptcy Code, which gives a bankruptcy trustee the rights and powers of a hypothetical judicial lien creditor. 59 The Bankruptcy Code uses a hypothetical creditor not to resolve disputes between competing interests (as the Official Comment to section 2A-307 suggests) but rather to define one person’s rights in terms of another person’s. In the conflict under discussion, both the lessor’s secured party and the lessee’s rights are defined except with respect to their relationship to one another. Article 2A would have been clearer had it defined that relationship directly rather than by resort to a hypothetical secured party.

A good deal of the difficulty of section 2A-307(2)(b) arises from choosing among the many potential hypothetical secured parties. For example, if one chooses a purchase money secured party, then the lessor’s secured party often will take subject to the lease, even though the lessee acquired its rights after the security interest attached and was perfected. 60 For this reason, the Official

59. See U.C.C. § 2A-307 comment. The hypothetical creditor in the “strong-arm” clause is one who extends credit to the debtor at the time of the commencement of the case and who obtains a judicial lien at that time and with respect to that credit. See 11 U.S.C. § 544(a)(1) (Supp. IV 1986).
60. Assume that the lessor’s secured party has a security agreement covering all goods now owned by the lessor and all goods that the lessor acquires in the future. After the secured party files a proper financing statement, the lessor acquires goods subject to a
Comment indicates that "the hypothetical secured creditor is not the holder of a purchase money security interest entitled to special priority." Although the Comment suggests otherwise, one probably would not reach this conclusion in the absence of an extra-statutory explanation.

Even if one follows the Comment and determines the priority of the hypothetical security interest under section 9-312(5), the formulation may yield results that are difficult to explain. Suppose the debtor leases goods to the lessee after a financing statement covering the goods has been filed but before the parties enter into a security agreement. Under existing law, a lessee, like a buyer, would take free of any security interest that attached subsequently. But because section 9-312(5) awards priority to the security interest that is filed first, the hypothetical-security-interest test of section 2A-307(2)(b) would award priority to the secured party, even though that party acquired its rights in the goods after the lessee acquired its rights. Nothing in the Comments to Article 2A explains why the drafters rejected nemo dat and decided that a lessee should fare worse than a buyer under otherwise identical circumstances.

purchase money security interest retained by the seller. The seller, as a purchase money secured party, would be able to take priority over the security interest in after-acquired goods by complying with section 9-312(3) or 9-312(4), depending on the type of collateral. If, however, the lessor's secured party is itself a purchase money secured party, then the relative priority of its security interest and that of another purchase money secured party is uncertain. See B. CLARK, supra note 41, at ¶ 3.9[5] (discussing various resolutions of the problem).


62. The Official Comment cites two reasons for not using a purchase money security interest as the hypothetical security interest. First, "the facts and circumstances relating to the security interest described in Section 2A-307(2)(b) would not create a purchase money security interest as defined in Section 9-107." Section 2A-307(2)(b) refers to "any other security interest in the goods perfected by a filing covering the goods and made at the time the lease contract became enforceable." Nothing about a purchase money security interest is inconsistent with that description. Second, the Official Comment goes on to suggest that "assuming arguendo that it did create a purchase money security interest, the facts and circumstances relating to the security interest described in Section 2A-307(2)(b) would not create a special priority under the provisions of Section 9-312(3) or (4)." Again, the security interest described in section 2A-307(2)(b) is not inconsistent with one that is entitled to purchase-money priority.

63. See supra notes 43-46 and accompanying text.

64. The drafters may have awarded priority to the secured party because it was the first to publicize its interest. But section 2A-307(2)(b) does not fully address problems associated with ostensible ownership. The section dates the lessee's priority from a secret
In some cases—for example, when the security interest is unperfected—section 2A-307(2)(b) treats the lessee better than the buyer. Because an unperfected security interest would not have priority over another security interest in the goods perfected by a filing made at the time the lease contract became enforceable, the unperfected secured party takes subject to the lease contract. This result obtains even if the lessee fails to take delivery before the security interest is perfected, or if the security agreement explicitly prohibits the debtor from leasing the goods and the lessee knows of the prohibition at the time it takes delivery. In contrast, a buyer takes free of an unperfected security interest only if he takes delivery and gives value without knowledge of the security interest and before it is perfected. Regardless of one's opinion of the proper roles of possession and knowledge in fashioning Code priorities, there appears to be no reason to distinguish between buyers and lessees for these purposes, as Article 2A has done.

---

event—the time the lease contract becomes enforceable—thereby preserving an ostensible ownership problem that may arise with respect to buyers. But see infra note 66.

Section 2A-307(4) may provide some solace to the lessee whose rights are subordinate to a security interest. See infra notes 70-74 and accompanying text.

65. See U.C.C. §§ 9-301(1)(a), 9-312(5).

66. The secured party may be able treat the lease contract as void if the lessor remains in possession and if retention of possession by the lessor is fraudulent against the secured party under a statute or rule of law. See U.C.C. § 2A-308(1). Retention of possession in good faith and current course of trade by the lessor for a commercially reasonable time after the lease contract becomes enforceable is not fraudulent. Id.; cf. U.C.C. § 2-402(2) (similar rule with respect to retention of possession by seller).

67. Section 9-311 provides that "[t]he debtor's rights in collateral may be voluntarily or involuntarily transferred (by way of sale, creation of a security interest, attachment, levy, garnishment or other judicial process) notwithstanding a provision in the security agreement prohibiting any transfer or making the transfer constitute a default." Presumably the parenthetical list is intended to be exemplary and not exhaustive; if so, the section would apply to transfers by way of lease.

68. See U.C.C. § 9-301(1)(c). Although section 9-301(1)(c) applies by its terms only to "a transferee in bulk or other buyer not in ordinary course of business," it should be applied to protect buyers in ordinary course who do not qualify for the protection of section 9-307(1). See Harris, The Interaction of Articles 6 and 9 of the Uniform Commercial Code: A Study in Conveyancing, Priorities, and Code Interpretation, 39 VAND. L. REV. 179, 245 & n.248 (1986). Although section 9-301(1)(c) "subordinate[s]" the unperfected security interest to the rights of certain buyers, in that context subordination should be read as termination. See Carlson, Death and Subordination Under Article 9 of the Uniform Commercial Code: Senior Buyers and Senior Lien Creditors, 5 CARDozo L. REV. 547, 547-63 (1984); Harris, supra, at 203 n.108. Aircraft Trading & Servs., Inc. v. Braniff, Inc., 819 F.2d 1227 (2d Cir.), cert. denied, 108 S. Ct. 163 (1987), which holds to the contrary, is wrong.

69. Indeed, the problem is exacerbated with leases because of the poorly reasoned case law holding that the lessor's right to receive rents is not the proceeds of the collateral. See
But treating lessees like buyers is not a panacea, as the problem of future advances demonstrates. Consider the problem first in the context of the sale of collateral to a buyer who takes subject to the security interest. At the time of the purchase, the amount of the secured debt (say, 10,000 dollars) is less than the value of the collateral (say, 15,000 dollars). After the purchase, the secured party extends additional credit (say, 3,000 dollars) secured by the collateral. The debtor defaults, the secured party repossesses the collateral and sells it for a net sale price of 14,000 dollars. The amount in excess of the secured debt (1,000 dollars) belongs to the owner of the collateral (the buyer).\textsuperscript{70} Of the remaining 13,000 dollars, at least 10,000 dollars goes to the secured party, because the buyer bought subject to the security interest. What about the remaining 3,000 dollars? The buyer argues that the secured party should not be able to recover advances made to the debtor-seller from property that the buyer owned at the time of the advances. Section 9-307(3) takes into account that the buyer should have discovered the perfected security interest before buying and that the secured party is not likely to discover immediately that the debtor has sold the collateral. The section permits the secured party to recover from the collateral post-purchase advances except those made after the secured party acquires knowledge of the purchase, or more than 45 days after the purchase, whichever first occurs, unless the advance is made pursuant to a commitment entered into without knowledge of the purchase and before expiration of the 45-day period.\textsuperscript{71}

\textit{infra} note 81. That narrow reading of the proceeds rule supports limiting the classes of lessees that take free of an unperfected security interest to those having the characteristics of buyers who qualify under section 9-301(1)(c).


\textsuperscript{70} \textit{See} U.C.C. § 9-504(2).

\textsuperscript{71} U.C.C. § 9-307(3).
With the sole exception that it applies to lessees rather than to buyers, section 2A-307(4) follows section 9-307(3) almost verbatim. Primarily because of the difference between ownership rights and leasehold interests, the section is considerably more difficult to apply than its Article 9 forerunner. Unlike the buyer, who is deprived of the entire value of the goods by the enforcement of a security interest in them, the lessee is deprived only of his leasehold interest. Thus, in applying section 9-307(3), one need not evaluate the buyer’s interest. The buyer is entitled to the full value of the collateral, less the amount of (a) pre-purchase secured debt and (b) those future advances as to which the buyer takes subject under section 9-307(3). In contrast, an evaluation of the lessee’s leasehold interest becomes necessary under section 2A-307(4) if the proceeds of the secured party’s foreclosure sale exceed the amount of the secured debt.

Assume the facts of the previous example but substitute a lessee for the buyer. Assume further that the lessee takes free of the 3,000 dollar future advance. Upon the debtor-lesser’s default, the secured party can repossess the collateral and sell the goods. The first 10,000 dollars of the 14,000 dollars of proceeds can be applied toward the satisfaction of the secured debt. Who receives the balance? Surely section 2A-307(4) does not mean that the lessee recovers the entire balance, regardless of the size of the proceeds and the value of the leasehold interest. Rather the section must mean that the lessee is entitled to an unspecified portion of the proceeds as compensation for the loss of its leasehold interest and that any portion remaining is to be applied toward the 3,000 dollar future advance. Read in this manner, the section in effect awards to the lessee a lien on the proceeds of a repossession sale. Article 2A contains no explicit guide for evaluating the size of this lien. As between themselves, the lessor and lessee presumably could determine this issue in the lease contract; however, their agreement should not bind the secured party, as to whom the lease

72. There are other differences, but they stem from the fact that the provision in Article 2A applies to leases (e.g., the reference to “lease” rather than to “purchase”) or they are intended to clarify (e.g., “unless the future advances are made” rather than “unless made”). Section 2A-307(4) does not address any of the problems associated with section 9-307(3). It does not explain what is meant by a “future advance”; its applicability to security interests not created by the lessor is uncertain; and the 45 days starts to run from a secret event—“the purchase” in section 9-307(3) and “after the lease contract becomes enforceable” in section 2A-307(4).
contract itself may be wrongful.\textsuperscript{73} Although courts are unlikely to construe section 2A-307(4) with frequency, the foregoing suggests that some rules that work well when applied to buyers may be problematic when applied to lessees.\textsuperscript{74}

3. \textit{Security interests in the lessor's right to receive rents}—One issue that has arisen under existing law, and which Article 2A does not address, is the right of the secured party to rents owed by a lessee under a lease of collateral. Here, again, a consideration of the rights of buyers is helpful. When the debtor sells collateral, the secured party automatically acquires a security interest in the proceeds of the sale without the need to take any further action.\textsuperscript{75} Indeed, one rationale underlying the buyer in ordinary course rule of section 9-307(1) is that the secured party that loses its collateral to the buyer acquires an interest in the proceeds as substitute collateral.\textsuperscript{76} When goods are sold on open credit, the proceeds of the sale constitute an account.\textsuperscript{77} When goods are sold on secured credit, the proceeds of the sale are the buyer's promise to pay and the security interest created by the buyer; if the promise to pay and the security interest securing the promise are in writing, then the writing constitutes chattel paper\textsuperscript{78} and the bundle of rights it evidences is subject to the security interest.

One would think that when goods are leased, a similar result would obtain. The lessor acquires the right to receive performance

\textsuperscript{73} Cf. U.C.C. § 9-311 (contemplating restrictions on transfer of debtor's rights in collateral).

\textsuperscript{74} Even if the secured party does not make a future advance, a similar problem of evaluating the lessee's leasehold interest arises in the rare event of a surplus. The sales proceeds represent the value of the use of the goods from the date of sale until the end of the useful life of the goods. The secured party's portion should come first from the lessor's residual value and then from the remaining value of the goods. If the secured debt is less than the net sales proceeds, then the surplus should be divided between the lessor and lessee, with the lessee receiving the value of its leasehold interest and the lessor receiving the value of the residual interest less the amount paid to the secured party. Inasmuch as the secured party has been paid in full, the parties to the lease presumably could determine their relative rights by contract. See U.C.C. § 1-102(3).

\textsuperscript{75} This right to proceeds is granted by section 9-306(2), which reflects the bargain that the parties would have reached had they incurred the costs of negotiating that particular term.

Section 9-306(2) speaks only to attachment. Because of the possible prejudice to third parties of a secret security interest in the proceeds, a secured party may be required to take further action to perfect its security interest in proceeds. See U.C.C. § 9-306(3).

\textsuperscript{76} See United States v. Handy & Harman, 750 F.2d 777, 782 (9th Cir. 1984).

\textsuperscript{77} See U.C.C. § 9-106 (definition of "account").

\textsuperscript{78} See U.C.C. § 9-105(1)(b) (definition of "chattel paper").
of the lessee's obligations under the lease, including the obligation to pay rent; that right, together with the lease of specific goods, constitutes chattel paper; and the lessor's bundle of rights is subject to the security interest. Presumably, any secured party that consents to the lease of goods free of its security interest would require that it receive a security interest in the lessee's right to receive the rentals generated by the lease. A fair reading of section 9-306 gives this result: a security interest continues in any identifiable proceeds, which are defined to include "whatever is received upon the sale, exchange, collection or other disposition of collateral." Unfortunately, some of the cases that discuss this issue hold that the rents owing to the lessor under a lease of goods that serve as collateral do not constitute the secured party's proceeds. If one were to follow those cases, the rule in section 2A-307(3) would result in the secured party's being unable to resort either to goods that have been leased or to the lessor's right to receive rentals, unless the secured party specifically bargained for a security interest in either the lease or the rentals.

79. See id. The text assumes the lease is written. Cf. U.C.C. § 2A-201(1)(b) (statute of frauds). If it is not, then the lessee's obligation to pay rent would be an account. See U.C.C. § 9-106.


Interestingly, both bankruptcy courts purported to distinguish the opinion in Feldman v. Philadelphia National Bank, 408 F. Supp. 24 (E.D. Pa. 1976), on the ground that the secured party there took not only a security interest in the goods (an aircraft) but also a separate assignment of the lease. Although the Feldman court observed that the lease payments were proceeds of the lease, it intimated in its discussion of the issue that the lease was itself the proceeds of the aircraft, id. at 38, and explicitly concluded that "the duly recorded and perfected Aircraft Security Agreement effectively granted to [secured party] a perfected security interest in the proceeds of the Aircraft, including lease payments," id. at 41.

Section 9-504(1), which provides that "[a] secured party after default may sell, lease or otherwise dispose" of the collateral, also supports the view that a lease of collateral is a "disposition."

82. See Cleary Bros., 9 Bankr. at 41 ("[t]he way to create a security interest in rent under the U.C.C. is to assign the lease or to give a security interest in the lease.").
Article 2A did not create this problem. It arises even under existing law, under which the lessee in ordinary course may be protected either under section 9-306(2) or by analogy to section 9-307(1). The drafters of Article 2A left this problem unresolved, perhaps because they were not charged with the task of fleshing out Article 9's incomplete treatment of leasing issues. Accordingly, courts should not conclude from the failure of Article 2A to address the proceeds issue that the drafters approve the few cases that inappropriately prevent a secured party from enforcing its security interest against either the goods or the lessee's obligation to pay for their use. Instead, when construing section 9-306(1), courts should treat the lease of collateral as a "disposition" and should treat the lessor-debtor's rights under the lease, including the right to receive rentals, as "proceeds." The fact that Article 2A affords lessees in ordinary course rights analogous to those of buyers in ordinary course supports this construction. Nevertheless, rather than rely on a court to construe section 9-306 properly, a secured party may wish to bargain for a security interest not only in the goods but also in the debtor's rights under any future lease of the goods.

Even if the right to receive rentals from the lease of its collateral is considered to be the "proceeds" of the collateral, and even if the debtor agrees to grant a security interest in the rental stream, Article 2A threatens the ability of a secured party to acquire a valid security interest in rentals arising from the lease of its collateral. Section 2A-303(1)(a) provides that a lessor's leasehold interest, which includes the right to receive rentals, may not be transferred voluntarily if the lease contract prohibits the transfer. 83 One could construe the section to mean that a contractual prohibition against the creation of a security interest in the leasehold interest invalidates any security interest in the leasehold interest that the secured party otherwise would acquire as proceeds of the goods. The section should not be read to command that result either when the lessee's rights are subordinate to the security interest, 84 or when the lessee takes free of the security interest. 85

83. For a detailed discussion of section 2A-303(1)(a), see infra notes 94-115 and accompanying text.
85. See U.C.C. § 2A-307(3).
In the former case, to bind the secured party by a prohibition in the lease effectively would subordinate the secured party to the lessee. In the latter, when the lessee is a lessee in ordinary course, enforcing the prohibition against the secured party would prevent that party from enforcing its security interest against a substantial portion of the value of the goods and against the rental stream. A bargain of that kind, which is not the likely result of face-to-face bargaining, should not be imposed upon the secured party without its consent. Moreover, the group of lessees seeking to limit the alienability of the lessor's leasehold interest is likely to be smaller than the group of secured parties seeking to protect their security interests in the leasehold interest as proceeds. Thus, the costs of requiring lessees to come forward and obtain the secured party's consent to a prohibition against alienation is likely to be less than the costs of requiring those secured parties that wish to protect their security interests to insure that the lessor does not agree to a prohibition with one or more of the lessees. Accordingly, courts should not extend the effect of a contractual prohibition against assignment of the lessor's right to prevent a security interest in the rents from attaching under section 9-306(1). 86

Even in the absence of a prohibition in the lease contract, section 2A-303(1)(b) may affect adversely the secured party's claim to the lessor's rights under the lease. Under that section, transfers that materially change the duty of, or materially increase the burden or risk imposed on, the other party to the lease contract are not effective if "within a reasonable time after notice of the trans-

86. The prohibition should be effective against a secured party that extends value against the lease, as opposed to the goods. That secured party for the most part can protect itself by examining the lease prior to extending value. But see infra note 115. A secured party that takes its security interest under an after-acquired chattel paper clause probably should be treated in the same way. Cf. U.C.C. § 9-108 (security interest in after-acquired property deemed to be taken for new value).

An alternative, but less desirable, means of reaching the proper result would be for a court to hold that a lessee under a lease contract that prohibits the lessor from creating a security interest in its right to receive rents is not a lessee in ordinary course of business unless the lessee leases under circumstances when secured parties routinely agree both to give up any claim to the rental stream and to permit lessees to take free of their security interests. Although this approach may comport with the reasonable expectations of secured parties, it is likely to disappoint the reasonable expectations of lessees.

A lease might also prohibit the assignment of the lessor's residual interest. Notwithstanding section 2A-301, which makes a lease contract effective according to its terms against creditors, a prohibition of this kind should not be effective against a preexisting security interest in the goods. Section 2A-307(2)(b) is consistent with that result.
fer the other party demands that the transferee comply with [section 2A-303(2)] and the transferee fails to comply."87 Section 2A-303(2) requires, among other things, that the transferee provide adequate assurance of future due performance under the lease and assume the lease contract.88 Part II(B)(1)(b) of this article questions the wisdom of applying section 2A-303(1)(b) to the creation of a security interest and suggests a reading of the section that reduces some of its undesirable effects. Suffice it to say here that the section should have no application when the lease contract is subordinate to the security interest, and the applicability of the section should be as restricted as possible when the lessee takes free of the security interest.

The foreclosure of a security interest raises related, unresolved issues under Article 2A. Although a foreclosure sale by a secured party arguably constitutes a "transfer" to which section 2A-303(1)(b) could apply,89 the buyer at the sale ought not be compelled to comply with section 2A-303(2) and, inter alia, assume the lessor's obligations under the lease. The secured party has no way to prevent the debtor from granting an effective leasehold interest,90 and the debtor should not be able to limit the secured party's ability to foreclose upon its collateral by leasing the collateral. When the lessee's leasehold interest is subordinate to the security interest,91 to require the purchaser from the secured party to perform under the lease effectively would subordinate the security interest to the lease.92 But when the lessee takes free of the security interest, as in section 2A-307(3), the appropriate result is not so clear.

87. U.C.C. § 2A-303(1)(b). For more detailed discussions of the operation of sections 2A-303(1)(b) and 2A-303(2), see infra Part II.B.1.b and Part III.
88. See U.C.C. § 2A-303(2)(c) & (d).
90. See U.C.C. § 9-311; supra note 67.
92. Although Article 9 does not address this issue directly, it is not inconsistent with the approach suggested by this article. A sale of collateral discharges not only the security interest under which it is made but also "any security interest or lien subordinate thereto." U.C.C. § 9-504(4). For these purposes, leases are not distinguishable from security interests and liens.
B. When a Secured Party Takes a Security Interest After the Lessor-Debtor Has Leased Goods to a Lessee

Having considered what happens to a security interest in goods that the debtor subsequently leases, this article next turns to a consideration of the relative rights of the lessor’s secured party and a lessee when they acquire their rights in the opposite order—that is, when the lessor purports to create a security interest after the goods have been leased to the lessee. As was the case in Part II(A), sound analysis requires one to distinguish between the two different aspects of the lessor’s interest: the lessor’s right to receive performance from the lessee according to the terms of the lease and the lessor’s right to the property following the end of the lease term. This Part of the article considers those two aspects seriatim.

1. Taking a security interest in the lessor’s rights under the lease—Lessor often use their rights under a lease as a source of financing. These rights include a right to receive the lessee’s performance, including payment of the rent, and a right upon the lessee’s default to enforce the lessee’s obligations against the lessee and against the goods. When these rights are evidenced by a writing and are assigned either outright or as security, the transaction is subject to Article 9 and the property transferred constitutes chattel paper.93

(a) Contractual prohibitions against the creation of a security interest—Under Article 9, the effect of a lease prohibition on the assignment of the lessor’s rights under the lease is unclear. Section 9-318 addresses the rights of an assignee of accounts, chattel paper, and general intangibles.94 Each of the first three subsections of that section refers to the “account debtor,” and so specifically applies to all three types of collateral.95 Indeed, the 1972 amendment to section 9-318(3), which replaced “account” with “amount due or to become due,” reflects an intention to cover

93. U.C.C. § 9-105(1)(b). Section 9-102(1)(b) provides that Article 9 applies to any sale of chattel paper, but section 9-104(f) excludes sales of chattel paper that generally are not commercial financing transactions. The lessor may create a security interest in its residual interest along with one in its leasehold interest. “Chattel paper” does not include the residual interest. See In re Leasing Consultants, Inc., 486 F.2d 367 (2d Cir. 1973); see also infra note 183 and accompanying text.
94. Section 9-106 defines “account” and “general intangibles.”
95. See U.C.C. § 9-105(1)(a) (definition of “account debtor”).
all three types of collateral in that subsection.96 Prior to the 1972 amendments to Article 9, subsection (4) rendered ineffective any contract term that prohibited a party from assigning an account or contract right but was silent concerning a similar term with respect to chattel paper and general intangibles.97 Although the drafters may have always intended that subsection (4) include the two omitted categories of obligations on which there is an account debtor,98 the 1972 amendment added only general intangibles. The continuing omission of chattel paper appears to be unintentional,99 but some uncertainty remains concerning the effect of a prohibition against the assignment of a lessor’s rights under a lease.100


98. “There is surely nothing in the Article [9] to suggest that the contrary rule was being deliberately adopted for the classes of intangibles not specifically referred to.” 1 G. Gilmore, supra note 13, at 392.

99. “It is clear to me that the last sentence of 9-318(4) omitted chattel paper by inadvertence.” Letter from Homer Kripke to Steven L. Harris 3 (Dec. 16, 1987) [hereinafter Kripke Letter]. Professor Kripke was the Associate Reporter of the Review Committee for Article 9, which recommended the 1972 amendments to the Article.

100. I have been unable to find any case that considers the applicability of section 9-318(4) to chattel paper, perhaps because lessors often are reluctant to make their leasehold interests nonassignable. In fact, lessors often contemplate assigning their leases and specifically indicate that fact in the lease. See, e.g., Leasing Serv. Corp. v. River City Constr., Inc., 743 F.2d 871, 875 (11th Cir. 1984) (lessee of crane acknowledges intended assignment of lease to specific assignee); Feldman v. Philadelphia Nat’l Bank, 408 F. Supp. 24, 27 (E.D. Pa. 1976) (aircraft lease assignable without lessee’s consent). Grant Gilmore observed, “The apparent restriction of the rule [of section 9-318(4)] to accounts and contract rights presumably reflects the fact that no-assignment clauses have caused the greatest amount of trouble in this area; the draftsmen were more anxious to hunt down the existing beasts than to bother with hypothetical dragons.” 1 G. Gilmore, supra note 13, at 392.

One can construct several statutory arguments supporting the free assignability of the lessor’s rights under a lease contract. Those rights consist of a right to payment and a limited interest in goods. Prohibitions on an assignment of a right to payment that is not coupled with an interest in goods are ineffective under section 9-318(4). In all likelihood, the Code also would render ineffective a prohibition on alienating an interest in goods. See U.C.C. § 2-403(1) (first sentence); cf. 1 American Law of Property § 3.68, at 304, 306-07 (A. Casner ed. 1952 & Supp. 1977) [hereinafter American Property] (assignment or sublease of leasehold interest by lessee of real property is effective until lessor terminates lease). Since, notwithstanding a prohibition in the lease, the lessor would be able to assign effectively each
Section 2A-303(1)(a) resolves that uncertainty. It provides that “[a]ny interest of a party under a lease contract . . . may be transferred unless . . . the transfer is voluntary and the lease contract prohibits the transfer.” Reading the converse of the sentence, the lessor’s leasehold interest, including its right to receive rents, may not be transferred if the transfer is voluntary and the lease contract prohibits the transfer. What does it mean to say that the leasehold interest may not be transferred? One possible meaning is that the transfer constitutes a breach of the lease but nevertheless is effective to convey rights. A second is that the transfer is effective between the immediate parties (the lessor and the secured party) but has no effect on the lessee. Thus, if the lessor defaults on its secured obligation, the transferee may not en-

aspect of its rights, taken separately, the lessor should be permitted to assign the bundle of rights taken together.

Another approach would analogize the lessor’s rights under a lease to the seller’s rights under a long-term supply contract. The Code’s policy on the assignability of the seller’s rights is not altogether clear, but the Code appears to favor assignability even when the contract purports to make the rights nonassignable. Section 2-210(2) permits the parties to prohibit the seller from assigning his rights, but section 9-318(4) invalidates any such agreement. Rather than reconcile the apparent conflict, a Comment to section 2-210 contains the following incorrect statement: “The assignment of a ‘contract right’ [a right to payment not yet earned by performance] . . . is not covered by this subsection [2].” U.C.C. § 2-210 comment 3. Perhaps the Comment was intended to refer only to the second sentence of section 2-210(2), which makes a right arising out of the assignor’s due performance of his entire obligation—that is, an “account” and not a “contract right” under pre-1972 Article 9—assignable despite agreement otherwise. That reading corrects the Comment but does nothing to resolve the apparent conflict between sections 2-210(2) and 9-318(4). To resolve the conflict in favor of nonassignability, one could argue that the specific provisions of section 9-318(4) override the general provisions of section 2-210(2), or one could rely on section 9-201.

The argument that a contractual prohibition against assignment binds third parties is straightforward. Had the drafters wished to invalidate contractual prohibitions against the transfer of chattel paper, section 9-318(4) would cover chattel paper explicitly. But see Kripke Letter, supra note 99, at 3.

102. Although used in various Articles of the Code, the word “transfer” is not defined. Nevertheless, the provisions relating to “transfer” in section 2A-303 clearly include the creation of a security interest and the suffering of a judicial lien. See U.C.C. § 2A-303 comment; cf. U.C.C. § 9-311 (“debtor’s rights in collateral may be voluntarily or involuntarily transferred (by way of sale, creation of a security interest, attachment, levy, garnishment or other judicial process)’’); U.C.C. § 1-201(9) (“buying” does not include “a transfer . . . as security’’); U.C.C. § 6-103(1) (excepting “transfers . . . made to give security” from Article 6); see also 11 U.S.C. § 101(50) (Supp. IV 1986) (Bankruptcy Code definition of “transfer”).
force its security interest against the lessee.\textsuperscript{104} The third possible meaning, and the one that the drafters tell me that they intended, is that the transfer is ineffective and that the secured party acquires no interest in the lessor's rights under the lease.\textsuperscript{105}

The drafters apparently thought that section 2A-303(1)(a), which validates prohibitions against the transfer of chattel paper, conflicts with section 9-318(4), which may invalidate them. The Comment to section 2A-303 suggests that any conflict be resolved in favor of enforcing the contractual prohibition on transfer.\textsuperscript{106} The Code itself can be read fairly to support that resolution of any conflict. One can construe section 9-318(4) literally and conclude that it is inapplicable to chattel paper. Alternatively, one can conclude from section 2A-301, under which a lease contract is "effective and enforceable according to its terms . . . against creditors of the parties,"\textsuperscript{107} that a lease contract stating that the lessor lacks the power to convey its leasehold interest would be effective against the lessor's secured party.\textsuperscript{108} Inasmuch as Article 9 contains a similar provision making the security agreement "effective according to its terms . . . against creditors,"\textsuperscript{109} a person might respond that the

\begin{itemize}
\item \textsuperscript{104} This result obtained under the Assignment of Claims Act of 1940, 31 U.S.C. § 203 (1976) (revised and recodified in 11 U.S.C. § 3727 (1982)). The Act provided that "all transfers and assignments made of any claim upon the United States . . . shall be absolutely null and void," unless they conform to the statutory requirements. \textit{Id.} Nevertheless, courts have held that although nonconforming assignments are not binding upon the United States, they are effective between the parties. \textit{See, e.g.,} Sterling Nat'l Bank & Trust Co. v. Bornstein (\textit{In re Metric Metals Int'l}, Inc.), 20 Bankr. 633, 636 (S.D.N.Y. 1981); General Cable Co. v. Altek Sys., Inc. (\textit{In re Altek Sys., Inc.}), 14 Bankr. 144, 149 (Bankr. N.D. Ill. 1981).

\item \textsuperscript{105} Other parts of the Code are consistent with that reading. First, the caption to section 2A-303 refers to the "alienability" of a party's interest under a lease contract, thereby implying that a prohibition against assignment makes the interest inalienable. (Section captions are part of the Code. \textit{See U.C.C. § 1-109.} Second, section 2-210(2), upon which portions of section 2A-303 are based, provides that, under certain circumstances, rights of the parties to a contract for the sale of goods "can be assigned." That section has been construed to mean that when rights cannot be assigned, the purported assignee acquires no rights. \textit{See E. FARNsworth, CONTRACTS} § 11.4, at 760 (1982). \textit{Compare U.C.C. § 2-210(2) with U.C.C. § 2A-303(6) (under some circumstances rights "can be assigned" despite agreement otherwise). Third, section 9-318(4), which makes contract terms that prohibit certain assignments "ineffective," suggests the same result. An effective prohibition would be one that prevents the assignee from acquiring an interest in the rights purportedly assigned to him.

\item \textsuperscript{106} "Section 9-318(4) should be interpreted to allow the rule of this section to control with respect to transfers of leases." \textit{U.C.C. § 2A-303 comment.}

\item \textsuperscript{107} \textit{U.C.C. § 2A-301.}

\item \textsuperscript{108} A secured party is a "creditor" under the Code. \textit{U.C.C. § 1-201(12).}

\item \textsuperscript{109} \textit{U.C.C. § 9-201.}
\end{itemize}
two Articles conflict. In fact they do not. The Article 9 validating provision is explicitly made subject to exceptions "as otherwise provided by this Act,"110 whereas the Article 2A provision is subject only to exceptions "in this Article."111 The validating provision of Article 2A can be read as an exception to the general effectiveness of security interests.112

Although the decision to distinguish between accounts that have not been earned by performance and lease chattel paper is open to question,113 the drafters apparently did intend to enable the parties to chattel paper to make the paper nontransferable. As a practical matter, however, section 2A-303(1)(a) may make little difference. Agreements by a lessor restricting the transferability of its rights under a lease are not likely to be common.114 A financer of chattel paper who is unwilling to bear the risk that its collateral is nontransferable generally will be able to prevent it by scrutinizing the lease contract to be sure that it contains no prohibition against transfer.115 Inasmuch as prudent chattel paper financers already review the leases against which they extend credit, the

110. Id.
111. U.C.C. § 2A-301. Section 2A-301 differs from section 9-201 in ways other than the scope of its "except" clause and its use of leasing terminology instead of secured transactions terminology. Under the latter, the security agreement is "effective . . . against creditors," whereas under the former, the "lease contract is effective and enforceable . . . against creditors of the parties" (emphasis added). The additional language probably was intended to clarify the meaning of section 9-201. Section 2A-301 contains no counterpart of the second sentence of section 9-201, which states that nothing in Article 9 affects the application or applicability of regulations or other statutes governing usury, small loans, retail installment sales, or the like. Section 2A-104 addresses these issues to a limited extent.
112. The first sentence of section 2-403(1) cannot protect the secured party, as it does under current law, because section 2A-301 overrides it. Section 2A-301 should not always be read to be as broad as it seems. See supra note 49.
113. Section 2-210(2) may be construed to eliminate the distinction with respect to accounts arising from the sale of goods. See supra note 105.
114. Restrictions on transfers of the residual interest are likely to be more common. See infra text accompanying and following notes 192-94.
115. To some extent, even a secured party that examines a lease contract before extending credit against it runs the risk that the transfer will be invalid under section 2A-303(1)(a). The lessor and lessee may have prohibited the transfer in another document, such as a master lease, side agreement, or amendment to the lease, that constitutes part of the "lease contract." See U.C.C. § 2A-103(1)(l) (definition of "lease contract"); U.C.C. § 2A-202 (admissibility of parol and extrinsic evidence). In transactions of considerable magnitude, therefore, a secured party may find it prudent, prior to giving value to the lessor, to obtain the lessee's written consent to the transfer and the lessee's acknowledgement that the particular writings known to the secured party constitute the entire lease contract.
incremental burden of searching for restrictions on transferability is likely to be small.

Moreover, section 2A-303(7) minimizes the burden on a potential assignee by requiring that the language of prohibition be in writing, specific, and conspicuous.116 Determining whether a prohibition on transfer is sufficiently specific may be problematic. A prohibition to the effect that the lessor shall not transfer "the equipment" probably does not specifically prohibit the transfer of the lessor's leasehold interest; however, a prohibition to the effect that the lessor shall not transfer its "leasehold interest" or its "rights under the lease" probably does.

Section 2-210(3) contains a rule for construing prohibitions against the transfer of a party's rights under a contract for the sale of goods: "Unless the circumstances indicate the contrary a prohibition of assignment of 'the contract' is to be construed as barring only the delegation to the assignee of the assignor's performance."117 The effect of section 2-210(3) is to construe ambiguous prohibitions against transfer in a manner that promotes free alienability of rights. Although section 2A-303 follows section 2-210 closely in many respects, it does not contain a provision tracking section 2-210(3). Were Article 2A to contain a similar provision, then a lease contract that prohibited the transfer of "the lease" or of the lessor's "leasehold interest" ordinarily would not affect the creation of a security interest.118 The closest analogue to section 2-210(3) is section 2A-303(7), which does not command the same result.119

A term or clause is conspicuous when it is so written that a reasonable person against whom it is to operate ought to have noticed it. A printed heading in capitals . . . is conspicuous. Language in the body of a form is "conspicuous" if it is in larger or other contrasting type or color. Whether a term or clause is "conspicuous" or not is for decision by the court.

117. U.C.C. § 1-201(10). Interestingly, subsection (7) itself is not as conspicuous as it might be.

118. More precisely, the prohibition would affect only the creation of a security interest in the lessor's duties under the lease contract, which are not used as collateral, and not in the lessor's rights.

119. Given the "gag rule," supra note 48, the drafters' failure to follow section 2-210(3) is surprising. It may reflect a general insensitivity to the distinction between assignments of rights and delegations of duties. See infra text accompanying and following note 134. Or it may reflect a concern that the lessor and lessee be placed in identical positions. Generally, a lessee is more likely to be concerned about the delegation of the lessor's duties than about the assignment of the lessor's rights. On the other hand, a prohibition against
Section 2A-303(6) contains another limitation on the ability of the parties to a lease to prohibit the transfer of the lessor's leasehold interest. It provides that "a right arising out of the assignor's due performance of his [or her] entire obligation can be assigned despite agreement otherwise."\textsuperscript{120} Modeled on section 2-210(2), this subsection permits assignment of rights to payment under circumstances in which the obligor ordinarily is not entitled to return performance and so has little if any risk that the assignment will impair his chance of receiving return performance.\textsuperscript{121} In the usual case, when the lessor has partially performed with respect to a lease (e.g., by affording the lessee the unimpaired use of the goods for a portion of the lease term), the lessor's right to payment cannot be assigned contrary to a term in the lease. An assignment would be effective only when the lessor has performed fully.

One may argue that a different result should obtain in the case of a "finance lease" that is not a "consumer lease."\textsuperscript{122} Section 2A-407 provides that upon the lessee's acceptance of the goods, the lessee's promises under a commercial finance lease contract be-

---

\textsuperscript{120} U.C.C. § 2A-303(6). The section also provides that "[a] right to damages for default with respect to the whole lease contract . . . can be assigned despite agreement otherwise." \textit{Id}. These rights rarely are taken as collateral.

\textsuperscript{121} Apparently that is the meaning of Comment 3 to section 2-210: "In such cases no question of delegation of any performance is involved."

\textsuperscript{122} "Finance lease" means a lease in which (i) the lessor does not select, manufacture or supply the goods, (ii) the lessor acquires the goods or the right to possession and use of the goods in connection with the lease, and (iii) either the lessee receives a copy of the contract evidencing the lessor's purchase of the goods on or before signing the lease contract, or the lessee's approval of the contract evidencing the lessor's purchase of the goods is a condition to effectiveness of the lease contract.

U.C.C. § 2A-103(1)(g).

"Consumer lease" means a lease that a lessor regularly engaged in the business of leasing or selling makes to a lessee, except an organization, who takes under the lease primarily for a personal, family, or household purpose, if the total payments to be made under the lease contract, excluding payments for options to renew or buy, do not exceed $25,000.

U.C.C. § 2A-103(1)(e).
come irrevocable and independent.\textsuperscript{123} Arguably, prohibitions against assignment of the lessor's rights under a commercial finance lease become ineffective upon the lessee's acceptance of the goods, since at that time the lessee becomes unconditionally obligated to perform. This argument overlooks the fact that even though the lessee becomes unconditionally obligated to perform, the lessor is not excused from performing its duties under the lease contract.\textsuperscript{124} In other words, the finance lessor's right to receive the lessee's performance does not necessarily "aris[e] out of [its] due performance of [its] entire obligation."\textsuperscript{125} and so may not be the subject of an Article 9 security interest in the face of a prohibition in the lease contract. When the lessee is entitled to performance from the lessor, the fact that the lessee's obligations are unconditional should not invalidate the lessor's agreement not to assign its rights under the lease. Lessees are not indifferent between receiving performance from lessors and suing to recover damages for nonperformance.

In many cases, particularly when the lease is a finance lease, the only obligation of the lessor may be to uphold its warranty of quiet enjoyment.\textsuperscript{126} In those cases, one may argue that a lease provision that prohibits the transfer of the lessor's rights under the lease should not be enforced. In construing section 2A-303(6), courts should consider the reason underlying the rule: to promote the free alienability of the lessor's rights when the transfer ordinarily cannot be expected to increase the lessee's risk of not receiving future performance from the lessor.\textsuperscript{127} In some cases, the argument goes, the risks to the lessee from the creation of a security interest in the rental stream do not justify enforcing the prohibition.

The foregoing argument overlooks that section 2A-303(1)(b) invalidates transfers that materially increase the lessee's risks.\textsuperscript{128}

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{123} U.C.C. § 2A-407(1).
\item \textsuperscript{124} Section 2A-407 requires "the lessee to perform even if the lessor's performance after the lessee's acceptance is not in accordance with the lease contract; the lessee may, however, have and pursue a cause of action against the lessor." U.C.C. § 2A-407 comment.
\item \textsuperscript{125} U.C.C. § 2A-303(6).
\item \textsuperscript{126} See U.C.C. § 2A-211(1).
\item \textsuperscript{127} See U.C.C. § 1-102(2) & comment 1 (Code should be construed narrowly or broadly in conformity with purposes and policies involved); U.C.C. § 2-210 comment 3 (contractual prohibitions on assignment of rights are ineffective when there is no question of delegation of performance).
\item \textsuperscript{128} Section 2A-303(1)(b) is discussed \textit{infra} in Part II.B.1.b. and Part III.
\end{enumerate}
\end{footnotesize}
Section 2A-303(1)(a) enables the lessee to avoid the difficult questions of fact inherent in the application of subsection (1)(b) by, in effect, agreeing with the lessor that any assignment of the lessor’s rights materially and adversely affects the lessee. Section 2A-303(6) prevents the parties from enforcing that agreement only in cases in which a transfer is most unlikely to give rise to adverse consequences. But rather than validate the transfer in those cases, the section leaves open the possibility that the lessee may invalidate it under section 2A-303(1)(b). Expansion of the rule of subsection (6) on a case-by-case basis undercuts the parties’ ability to dispense with the fact-specific analysis required by subsection (1)(b). It should not be undertaken lightly.

(b) Statutory limitations on the ability to create a security interest—Even when the parties have not agreed to prohibit the lessor from creating a security interest in its rights under the lease, section 2A-303(1)(b) may limit the ability of the lessor to do so. That section provides that the lessor’s leasehold interest may not be transferred if

the transfer materially changes the duty of or materially increases the burden or risk imposed on the other party to the lease contract, and within a reasonable time after notice of the transfer the other party demands that the transferee comply with subsection (2) and the transferee fails to comply.¹³⁰

A likely concern of a lessee is that the grant of a security interest in the lessor’s right to receive rentals increases its risk that the lessor will not continue to perform under the lease. For example, the lessor may have less incentive to comply with its obligations to maintain and repair the goods if its right to receive rentals has been assigned, particularly if the rentals are paid directly to the secured party.¹³¹ Unfortunately, whether section 2A-303(1)(b) covers that concern is unclear.

¹²⁹. A lessee may believe that the creation of a security interest in the lessor’s rights under the lease may affect the lessee adversely even when the lessor’s only obligation is to uphold its warranty of quiet enjoyment. If the lessor defaults on its secured obligation, a person other than the lessor will have the right to enforce the lease against the lessee. The lessee may not wish to take the risk that the person enforcing the lease will act with the same concern for the lessee as would the lessor.

¹³⁰. U.C.C. § 2A-303(1)(b). Section 2A-303(2) is set forth supra note 5.

¹³¹. “When so agreed . . . the secured party is entitled to notify an account debtor . . . to make payment to him . . .” U.C.C. § 9-502(1). The account debtor (here, lessee) becomes obligated to pay the secured party upon receipt of notification that the rentals have been
Section 2A-303(1)(b) derives from the first sentence of section 2-210(2), which provides that

Unless otherwise agreed all rights of either seller or buyer can be assigned except where the assignment would materially change the duty of the other party, or increase materially the burden or risk imposed on him by his contract, or impair materially his chance of obtaining return performance.\textsuperscript{132}

In addition to making minor changes in wording, section 2A-303(1)(b) does not contain the last clause of that sentence. One could argue that the decision to delete this clause was intended to yield the result that impairment of the lessee's chance of obtaining return performance does not constitute an event that triggers section 2A-303(1)(b). That argument should be rejected for two reasons. First, its acceptance would reduce dramatically the scope of section 2A-303 for no apparent reason. Second, one of the assurances contemplated by section 2A-303(2) is specifically directed toward reducing the risk that a transfer will impair materially the chance of obtaining return performance.\textsuperscript{133} Accordingly, a transfer that materially impairs the chance of obtaining return performance should be considered one that "materially increases the . . . risk imposed" and should trigger section 2A-303(1)(b).

Section 2A-303(1)(b) departs from its source in an even more significant way. Section 2-210 follows the important common law distinction between an assignment of rights and a delegation of duties.\textsuperscript{134} Whereas subsection (1) speaks to a party's ability to delegate its duty to perform, subsection (2), upon which section 2A-303(1)(b) is modeled, concerns only the assignment of a party's right to receive performance from the other party under the contract. In contrast, section 2A-303(1)(b) addresses not only a lessor's

\textsuperscript{132} U.C.C. § 2-210(2); cf. Restatement (Second) of Contracts § 317(2)(a) (1981) (adding as a triggering event a material reduction in the value of the contract).

\textsuperscript{133} See U.C.C. § 2A-303(2)(c) (transferee shall provide adequate assurance of future due performance under the lease).

\textsuperscript{134} "[I]t is vital to distinguish the assignment of rights from the delegation of performance of duties." E. Farnsworth, supra note 105, at 746 (emphasis deleted).
assignment of its right to receive the lessee’s performance under the lease but also the delegation of its duties under the lease and the transfer of its residual interest.

The surprising failure to distinguish between an assignment of rights and a delegation of duties has its most undesirable consequence in section 2A-303(2).\(^{135}\) That section is designed to alleviate any material harm that the transfer of the lessor’s leasehold interest may impose upon the lessee. In order to comply with section 2A-303(2), the secured party must, among other things,

compensate or provide adequate assurance that [it] will promptly compensate the other party to the lease contract [here, the lessee] and any other person holding an interest in the lease contract, except the party whose interest is being transferred [here, the lessor], for any loss to that party resulting from the transfer.\(^{136}\)

The meaning of this subsection is unclear. Bankruptcy Code section 365(b)(1)(B), from which section 2A-303(2) derives, requires compensation for “any actual pecuniary loss . . . resulting from such default.”\(^{137}\) For an example of loss resulting from a default, consider the following: the lessor defaults on its obligation to maintain the goods in accordance with the lease contract, and as a consequence the goods cause injury to the lessee’s other property. Unless section 2A-303(2)(b) contains a simple drafting error, whereby the word “default” was replaced by “transfer,” the transferee of the lessor’s rights under the lease would be obligated under section 2A-303(2) to cure the default (i.e., provide the agreed-upon maintenance) but would not be obliged to compensate the lessee for any loss suffered as a consequence of the default. Instead, to acquire any rights, the transferee would be obligated to compensate the lessee for any loss resulting from the transfer. Perhaps this means that when the transfer materially changes the duty of the lessee or increases its burden, the transferee must compensate the lessee for the costs of the change in its duty and the

---

135. The failure to draw the distinction is surprising both because the distinction is a long-standing one that aids analysis greatly, see Corbin, Assignment of Contract Rights, 74 U. PA. L. Rev. 207, 216-18 (1926), and because the drafting committee followed the “gag rule,” see supra note 48.
increase in its burden.\textsuperscript{138} To give effect to this subsection, one must evaluate these prospective costs. Differences in appraisals of the amount necessary to compensate the lessee are likely to be the rule, and a secured party will have no way to be certain that it has complied with the lessee’s demand.\textsuperscript{139}

In addition to providing adequate assurance of future performance and compensating the lessee for any injury caused by the creation of the security interest, the secured party must provide an additional source from which the lessee can recover for past or future failures of the lessor-debtor to perform its obligations under the lease. Section 2A-303(2) specifically requires the transferee to “cure or provide adequate assurance that he [or she] will promptly cure any default other than one arising from the transfer”\textsuperscript{140} and “assume the lease contract.”\textsuperscript{141}

These requirements make little sense when applied to the grant of a security interest in the lessor’s rights under a lease. The lessee has bargained only for performance from the lessor, and creation of a security interest in the lessor’s rights does not excuse the lessor from its performance obligations. No reason exists for requiring a person who wishes to take a security interest in the lessor’s right to receive rents also to undertake affirmative obliga-

\textsuperscript{138} In section 2A-303(2), the drafters seem to have focused on assuring that the non-transferring party receives both past and future performance, \textit{i.e.}, that the transfer does not affect adversely the nontransferring party’s rights. \textit{See} U.C.C. \textsection 2A-303(2)(a) (cure of past defaults); U.C.C. \textsection 2A-303(2)(c) (assurance of future performance); U.C.C. \textsection 2A-303(2)(d) (assumption of the lease). If the section is to be read as also preventing the nontransferring party from suffering increased burdens as a consequence of the transfer, one must do so through subsection (2)(b).

\textsuperscript{139} \textit{Compare} 11 U.S.C. \textsection 365 (Supp. IV 1986) \textit{with} U.C.C. \textsection 2A-303(2). Under the former the amount necessary to compensate the injured party is readily determinable. First, the loss already has occurred at the time of compensation. Second, the loss must be an “actual pecuniary” one, thereby greatly facilitating assessment of the amount of compensation necessary. Under Article 2A, compensation must be given for a prospective loss that may be speculative and not out-of-pocket.

The result under section 2A-303(2) is analogous to the result that obtains with respect to an assignment of a seller’s right to receive payment for goods sold or to be sold. Section 2-210(2) invalidates assignments of accounts when the assignment would materially change the duty of the other party or materially increase the burden imposed upon him by the contract. Nothing in section 9-318(4), which addresses only contractual prohibitions on transfer, changes this result. Thus a secured party faces the risk, albeit a small one, that a purported security interest in the seller’s right to receive payment will be held to be ineffective.

\textsuperscript{140} U.C.C. \textsection 2A-303(2)(a).

\textsuperscript{141} U.C.C. \textsection 2A-303(2)(d).
tions to the lessee. Article 2A addresses itself elsewhere to concerns that the lessee may have concerning the lessor’s future performance. If the lessee believes that the grant of a security interest in the lessor’s interest affords the lessee reasonable grounds for insecurity with respect to the lessor’s future performance, then the lessee is entitled to demand assurances from the lessor and suspend any performance for which the lessee has not already received the agreed return. 142 If the lessor does not provide adequate assurance of performance within a reasonable time not to exceed thirty days, then the lessor has repudiated the lease and the lessee acquires rights under section 2A-402. 143 These protections are sufficient. Absent the lessor’s agreement, the lessee should not be entitled to prevent the lessor from borrowing against its interest except on terms that require the secured party to become a surety for the lessor.

Accordingly, section 2A-303(1)(b) should be construed to enable a secured party to take an enforceable security interest in the lessor’s rights under a lease without having to cure defaults or assume the lessor’s obligations. The provisions of Article 2A should be read in a fashion that promotes the purposes and policies behind them. 144 The purpose of sections 2A-303(1)(b) and 2A-303(2) is to enable the lessor to transfer its rights while protecting the interests of the lessee. If the lessor and the secured party take steps prior to the attachment of the security interest to ensure that the transfer neither changes materially the lessee’s duty nor increases materially its burden or risk, then the lessee would not be entitled to hold the transaction hostage by insisting on compliance with subsection (2). The fact that the lessor and transferee take those steps later, in response to the lessee’s demand for compliance with subsection (2), should make no difference. In other words, the quantum of protection afforded the lessee should not depend on whether the protection precedes the transfer or follows the lessee’s demand.

To reach this result, courts should construe section 2A-303(2) as a sufficient but not a necessary response to a demand for assurances. If a transferee complies, the transfer is effective even if it

142. U.C.C. § 2A-401(2).
143. See U.C.C. § 2A-401(3).
144. U.C.C. § 1-102(2) & comment 1.
adversely affects the lessee. If for some other reason the lessee’s
duty is not materially changed and its burden and risk are not ma-
terially increased, then any event that may have triggered section
2A-303(1)(b) has been undone and any need to comply with sub-
section (2) obviated.

Construing section 2A-303(1)(b) in the manner suggested in
the previous paragraph does not solve all the difficulties that the
section raises. Almost invariably time will elapse between the pur-
ported creation of the security interest and the lessee’s receipt of
notice of the transfer, between the lessee’s receipt of notice and a
demand for compliance with section 2A-303(2), and between the
secured party’s receipt of the demand and its compliance with the
demand. What is the status of the transfer at any point during this
process? For example, suppose the lessee has received notice but a
reasonable time for a demand has not yet elapsed? Suppose the
secured party has received a demand but a reasonable time for
compliance has not yet elapsed? Is the transfer valid or invalid
during the interim? If it is valid but should become invalid there-
after because the secured party fails to comply with subsection (2),
is the invalidity prospective only, or is it retrospective?146

These uncertainties, among others, reduce the value of the
transfer to the secured party and, consequently, reduce the aliena-
bility of the lessor’s rights. To a considerable extent, however, the
parties can take steps to eliminate them. One useful step would be
for the putative secured party to notify the lessee of the transfer.
The lessee’s reasonable time to demand compliance with section
2A-303(2) starts not at the time of the transfer but upon notice of
the transfer. By giving notice of the transfer, the secured party can
limit the time during which the lessee may seek to invalidate it.
(Of course, notice to the lessee may trigger a demand for compli-
ance that otherwise never would have been made.) Giving notice
does not eliminate all uncertainty, however. Even if the secured
party itself notifies the lessee of the transfer, the secured party
may not be sure whether the lessee’s demand for compliance has
followed within a “reasonable time.”146 And if the secured party

145. These undesirable consequences would not arise if section 2A-303(1) did not in-
validate the transfer but rather afforded the lessee a remedy for breach of the lease contract
or provided that the transfer was not binding against the lessee.

146. Compare section 2A-401(3), which requires a party to respond to a demand for
adequate assurance of due performance “within a reasonable time, not to exceed 30 days
attempts to comply with subsection (2), it may be uncertain whether it has done so successfully. 147 Accordingly, the secured party may be well-advised not only to notify the lessee but also to obtain the lessee’s consent to the transfer.

With proper planning, a lessor can obviate the need for a putative secured party to obtain the lessee’s consent to the creation of a security interest. A lease provision that purports to make effective a transfer of the lessor’s leasehold interest even if the transfer materially and adversely affects the lessee would be consistent with the Code’s principles of free alienability and freedom of contract. 148 If the provision is properly drafted, the transfer should be effective, at least in the commercial context. 149

Despite the ability of parties to contract around the uncertainties inherent in section 2A-303(1)(b), the desirability of the rule is dubious. A statutory gap-filler should be consistent with the bargain that most likely would have been reached through face-to-face bargaining. Otherwise the statute increases costs instead of reducing them. The transactions in which face-to-face bargaining would result in restricting the lessor’s ability to transfer its leasehold interest probably are far less common than those that would permit

after receipt of a demand.” The notice of transfer may seek to limit the time by which the lessee must make a demand for assurances. Whether the effort will be availing depends on non-Code law. Cf. U.C.C. § 1-102(3) (generally permitting parties to determine by agreement the standards by which the performance of an obligation of reasonableness is to be measured).

147. A declaratory judgment of the effectiveness of the transfer is unlikely to be available within any reasonable time.

Section 2A-307(2) is modeled upon section 365 of the Bankruptcy Code, 11 U.S.C. § 365(b) (Supp. IV 1986). Unlike the situations governed by section 2A-303(2), however, the bankruptcy court is readily available to determine whether the requirements of section 365 have been complied with. See id. § 365(a) (requiring court approval for assumption of unexpired leases); see also Fed. R. Bankr. P. 6006, 9014 (governing proceedings to assume an unexpired lease).

148. See supra note 14 (free alienability); U.C.C. § 1-102(3) (freedom of contract); see also U.C.C. § 2A-303 comment (“restrictions [on transfer] are not generally favored in law”).

149. See U.C.C. § 1-102(3). Because section 2A-303(1)(b) is a gap-filler, it should be applied only when the parties have not reached an express agreement concerning the ability of the lessor to transfer its rights. Thus, if the lease contract contains specific restrictions on transfer by the lessor, section 2A-303(1)(b) should not supplement them. Inclusio unis est exclusio alterius. Similarly, a general consent to assignment should be sufficient to cover transfers covered by section 2A-303(1)(b). Nevertheless, a cautious lessor might include in addition the lessee’s acknowledgement that any assignment of the lessor’s leasehold interest would neither materially change the lessee’s duty nor materially increase the burden or risk imposed on the lessee.
free alienability. If that is the case, then the statutory gap-filler should permit the lessor to transfer its leasehold interest in the absence of an explicit agreement to the contrary. Section 2A-303(1)(a) accomplishes this result; section 2A-303(1)(b) undermines it. Even if leases containing restrictions on transferability would be more common than those permitting free alienation, the gap-filler should reflect the restrictions to which the parties would have agreed. A lease contract that restricts the lessor's ability to transfer its leasehold interest is most unlikely to be crafted along the lines of section 2A-303(1)(b). A statutory provision that required the lessee's consent as a prerequisite to the alienability of the lessor's leasehold interest would more closely reflect at least some contractual restrictions and would be considerably easier to administer than section 2A-303(1)(b).

(c) Preventing an unwanted delegation of duties—This article observed above that sections 2A-303(1)(b) and 2A-303(2)(d) inappropriately link certain assignments of rights with a delegation of duties. Section 2A-303(4) does likewise. That section, which derives from section 2-210(4), provides that ordinarily the assignee's acceptance of an assignment of "all my rights" or of "the lease" constitutes a promise by the assignee to perform the assignor's duties; but when the language of, or the circumstances surrounding, the assignment indicate the contrary, the assignment does not constitute a delegation of duties. An example of language or circumstances indicating the contrary is "as in an assignment for security." When a security interest is created by virtue of an assignment for collateral purposes, for example, when the lessor grants a security interest in its rights under the lease, no delegation should be assumed. A security interest also can arise when there is an outright sale of chattel paper. In those cases, should

150. Even in the absence of Article 2A, it is not uncommon for a lessor that contemplates assigning its rights under a lease contract to include in the lease contract a provision setting forth its intention to assign and acknowledging the lessee's consent to the anticipated assignment. See, e.g., Leasing Serv. Corp. v. River City Constr., Inc., 743 F.2d 871, 875 (11th Cir. 1984) (lessee of crane acknowledges intended assignment of lease to specific assignee). (A consent to assignment often is accompanied by a provision pursuant to which the lessee agrees not to assert against the assignee any defenses it may have against the lessor. These clauses are discussed infra notes 161-65 and accompanying text.) When the lessor undertakes few obligations to the lessee, as in many finance leases, the lessee is unlikely to bargain for a restriction on the lessor's ability to alienate its leasehold interest.
152. See U.C.C. § 1-201(37) (definition of "security interest"); U.C.C. § 9-102(1)(b).
the assignee be deemed to promise to perform the lessor's obligations merely because it accepted the assignment of the lessor's rights? The Official Comment to section 2A-303 recognizes this problem but affords no solution. It merely observes that (a) "commercial assignments," which substitute the assignee for the assignor as to the rights and duties, differ from "financing assignments," which substitute the assignee for the assignor only as to rights, and (b) not every sale of chattel paper is a commercial assignment to which section 2A-303(4) applies.\(^{153}\) The Comment then reiterates that whether a buyer of a lease is the holder of a commercial assignment or financing assignment should be determined by the language of the assignment or its circumstances.\(^{154}\)

Article 9 also distinguishes among types of assignments of chattel paper. Section 9-104(f) "excludes from the Article certain transfers of [chattel paper] which, by their nature, have nothing to do with commercial financing transactions."\(^{155}\) Those transactions that section 9-104 excludes from Article 9 cannot fairly be said to be "for security" within the meaning of section 2A-303(4); conversely, if the transaction is within Article 9, it is a financing transaction and is "for security."\(^{156}\) But that begs the question. Section 9-104(f) excludes from Article 9 a transfer of a right to payment under a contract to an assignee who is also to do the performance under the contract. In other words, if the assignment is coupled with a delegation of duties, the transaction is excluded ipso facto from Article 9. The real question is, has there been a delegation? One wishes the Comment were more helpful. The buyer of a lease can protect itself by stipulating in the agreement for transfer that it is not assuming any of the lessor's obligations under the lease. As written, the statute may be a trap for the unwary. It probably should give the opposite rule, at least with respect to the lessor's assignment of "all my rights" under the lease: in the absence of an affirmative assumption of duties, the assignee assumes none of the assignor's obligations.\(^{157}\)

\(^{153}\) U.C.C. § 2A-303 comment.

\(^{154}\) Id.

\(^{155}\) U.C.C. § 9-104 comment 6.

\(^{156}\) Nevertheless, an assignment that is not "for security" is not necessarily accompanied by a delegation of duties.

\(^{157}\) Construing an assignment of "all my rights" to mean both an assignment of
(d) **Enforcement of a security interest**—The secured party not only wishes to be certain that it has taken an effective security interest without having assumed the lessor's duties under the lease, but it also wishes to be free to enforce its security interest upon the lessor-debtor's default. One method of enforcement is to notify the lessee to make payment directly to the secured party.\(^{168}\) One reason that the debtor-lessee may be in default is that the lessee has refused to perform on the ground that it has a defense to its obligations under the lease. Security interests in chattel paper, like security interests generally, ordinarily are governed by *nemo dat*; a secured party acquires no greater rights than its debtor has. Article 9 provides that the assignee of chattel paper (i.e., the secured party) ordinarily takes its rights in lease chattel paper subject to (a) all the terms of the lease and any defense or claim arising from it and (b) any other defense or claim of the lessee against the lessor which accrues before the lessee receives notification of the assignment.\(^{159}\) Section 2A-307(2), which provides that "a creditor of the lessor takes subject to the lease contract," apparently applies only to a security interest in the goods, not to a security interest in the lessor's rights under the lease contract. Accordingly, it does not affect this result.\(^{160}\)

Notwithstanding its general adherence to *nemo dat*, Article 9 authorizes the parties to agree that the lessor can convey to the secured party greater rights than the lessor has. Under section 9-206, an enforceable agreement not to assert defenses against an assignee "is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense."\(^{161}\)

\(^{158}\) U.C.C. § 9-502(1).

\(^{159}\) U.C.C. § 9-318(1)(a) & (b). Obviously, the secured party's rights may vary depending on when the lessee receives notification of the assignment.

\(^{160}\) By its caption, section 2A-307(2) is limited to "priority of liens . . . on, security interests in, and other claims to goods." The two exceptions to subsection (2)—the artisans' liens in section 2A-307 and the lessor-in-possession rules of section 2A-308—apply to interests in the goods and not to interests in the lessor's rights under the lease. The exceptions to the general rule in sections 2A-307(2)(a) and 2A-307(2)(b) both refer to creditors with rights in the goods, and section 2A-307(3) refers to a security interest in the goods.

\(^{161}\) U.C.C. § 9-206(1). The rule of section 9-318(1) does not apply when "an account debtor has made an enforceable agreement not to assert defenses or claims arising out of a
Article 2A does not affect this rule. What are the rights of a secured party who has acted in bad faith or who has notice of a claim or defense? At least one court has distinguished a waiver of defense clause under section 9-206(1) from a “hell or high water” clause and held that the assignee of a lease of personal property could enforce the latter clause even if the assignee acted in bad faith or had notice of defenses. Others have not drawn this dubious distinction and have treated these clauses as equivalents. To clarify the analysis, one must distinguish between two different clauses—one in which the lessee agrees not to assert claims or defenses against an assignee, and one in which the lessee agrees not to assert claims or defenses against the lessor. Section 9-206(1) governs the former and affords good-faith-purchase protection only to those assignees who take in good faith, for value, and without notice of claims or defenses. Assuming that the law permits the lessor to enforce the latter clause and prohibits the lessee from raising any defenses against the lessor, the nemo dat principle,

sale as provided in Section 9-206.” U.C.C. § 9-318(1) (emphasis added). Although section 9-318(1), which sets forth the rights of assignees against account debtors, makes no reference to leases, section 9-206 applies to leases as well as sales. The omission of leases from section 9-318(1) was inadvertent, and courts should apply the section to leases as well as to sales. See 2 G. Gilmore, supra note 13, at 1093-95; U.C.C. § 2A-303 comment.

162. A person who has not given value cannot acquire a security interest. U.C.C. § 9-203(1)(b).

163. West Virginia v. Hassett (In re O.P.M. Leasing Serv., Inc.), 21 Bankr. 993 (Bankr. S.D.N.Y. 1982) (alternate holding). The “hell or high water” clause provided that the lessee’s “obligation to pay directly to such assignee the amounts due from Lessee under any Equipment Schedule (whether as rent or otherwise) shall be absolutely unconditional and shall be payable whether or not any Equipment Schedule is terminated by operation of law, any act of the parties, or otherwise.” Id. at 1006. Other courts have followed West Virginia v. Hassett but have not considered whether the assignee acted in good faith and without notice. See, e.g., Philadelphia Sav. Fund Soc'y v. Deseret Management Corp., 632 F. Supp. 129, 135-38 (E.D. Pa. 1985).

164. U.C.C. § 9-206(1); see, e.g., Equico Lessors, Inc. v. Rockville Reminder, Inc., 4 Conn. App. 102, 492 A.2d 528 (1985); cf. United Counties Trust Co. v. Mac Lum, Inc., 643 F.2d 1140, 1142 (5th Cir. 1981) (Georgia common law permits assignee of lease to benefit from lessee’s agreement not to assert defenses even if assignee takes with notice of a defense; id. at 1146 (Clark, J., dissenting) (same).

165. Clauses of this kind have met with mixed receptions from the judiciary. Compare Stewart v. United States Leasing Corp., 702 S.W.2d 288 (Tex. Ct. App. 1985) (relying in part on lease provisions expressly providing that lessee was responsible for arranging delivery and that the obligation to pay rent was not affected by claims against the vendor of the equipment, and enabling lessor to recover from lessee even though equipment never was delivered to lessee) with Tri-Continental Leasing Corp. v. Law Office of Richard W. Burns, 710 S.W.2d 604 (Tex. Ct. App. 1985) (affirming judgment for lessee based on trial court’s
as codified in section 9-318(1), would enable the lessor's secured party to take free of defenses.

Article 2A contains a "self-executing" provision that, according to the Official Comment, "extends the benefits of the classic 'hell or high water' clause to a finance lease that is not a consumer lease." Section 2A-407(1) provides that, in nonconsumer finance leases, "the lessee's promises under the lease contract become irrevocable and independent upon the lessee's acceptance of the goods." The effect of that provision is to include as part of every nonconsumer finance lease contract an agreement by the lessee not to assert defenses against the lessor. Given the limited obligations of the lessor under a finance lease, in many cases, the lessee will have no defenses against the lessor. To that extent, section 2A-407(1) is unremarkable. In some cases, however, the lessee may have a claim or defense against the finance lessor. Even so, section 2A-407(1) requires the lessee to perform while it pursues its action against the lessor. Under traditional nemo dat principles, any assignee of the lessor's rights, including a secured party, likewise would be free to enforce the lessee's obligation to perform under the lease, notwithstanding any failure of the lessor or other party to perform its obligations to the lessee. Section 2A-407(2) yields this result.

findings that lease provisions disclaiming warranties, obligating the lessee to pay rent even if the equipment was unsatisfactory, and affording the lessee a remedy only against vendor were unconscionable, and affirming judgment for lessee).

166. U.C.C. § 2A-407 comment. The definitions of "finance lease" and "consumer lease," found in subsections (1)(g) and (1)(e) of section 2A-103, are quoted supra note 122.


168. The lessor under a finance lease makes no implied warranty of merchantability or of fitness for a particular purpose. See U.C.C. §§ 2A-212(1), 2A-213.

169. What is remarkable is that Article 2A has clarified that a finance lessor has performed by doing what it undertook to do (i.e., provide the financing) and is entitled to be paid even though the goods are nonconforming. Article 2A has obviated the need to provide an excusable clause in the lease, whereby the lessee is entitled to remedies against the supplier. See U.C.C. § 2A-209(1); see also supra note 165.


171. Section 2A-407 does not address leases that are consumer leases or leases that are not finance leases. As to these leases, see Miller, supra note 3, at 969-70.

Section 2A-407 does not override the obligation of good faith that every contract or duty within the Code imposes. See U.C.C. § 2A-407 comment; U.C.C. § 1-203 (obligation of good faith); U.C.C. § 2-103(1)(b) (definition of "good faith" in the case of a merchant). A finance lessor that fails to act in good faith may lose the benefit of section 2A-407's statutory "hell or high water" clause, and the lessor's assignee would have to qualify under section 9-206 in order to take free of the lessee's defenses.
An alternative to collecting payment from the lessee is for the secured party to sell the chattel paper collateral. One might characterize the foreclosure sale of the chattel paper as a "transfer" of the lessor's leasehold interest within the meaning of section 2A-303(1)(b). If so, then the attempted transfer to the buyer at the foreclosure sale would not be effective if it materially increased the lessee's risk or burden or materially changed its duty, unless the buyer complied with the requirements of section 2A-303(2). Because a buyer at a foreclosure sale may never be certain whether the lessee would assert the ineffectiveness of the purported transfer, requiring the buyer to comply with section 2A-303(2) may reduce the market for the collateral.

There are several approaches to resolving this difficulty. Perhaps the simplest is to treat the foreclosure sale as a transfer. Arguably, the number of cases in which a transfer of that kind would trigger section 2A-303(1)(b) is likely to be negligible, and a lessee rarely would have the incentive to challenge the sale. If chattel paper financiers agree with this assessment of the risk, any increase in the cost of chattel paper financing is likely to be small. An alternative approach is to treat the original transfer of the security interest as including the potential sale of the chattel paper upon the debtor-lesser's default. Although this approach obviates any need for the buyer to comply with section 2A-303(2), it requires that the potential effects of a foreclosure sale on the lessee be evaluated at the time of the creation of the security interest. An evaluation of this kind is difficult at best.

Parties seeking certainty can solve this potential problem by contract. Leases commonly contain a clause in which the lessee consents to the assignment of the lessor's rights. Courts should construe a clause of this kind to include a consent to the sale of the

172. U.C.C. § 9-504(1).
173. With respect to the creation of a security interest in the lessor's leasehold interest, this article suggested above that courts should construe section 2A-303(1)(b) to require only that the lessee is not materially and adversely affected by the transfer; courts should not require the secured party to assume the lease contract. See supra text following note 144. If a foreclosure sale is considered a "transfer" for purposes of section 2A-303(1)(b), then courts should construe the section the same way as applied to the buyer at the foreclosure sale.
174. To the extent that chattel paper financiers exaggerate the risk, section 2A-303(1)(b) may have the unintended effect of increasing costs to lessees rather than protecting them from increased costs.
leasser's rights upon foreclosure by the assignee. To minimize its risk, a secured party might insist on a consent clause that explicitly permits the assignee to sell the chattel paper if the lessor defaults on the secured obligation and acknowledges that a foreclosure sale will neither materially change the lessee's duty nor materially increase its burden or risk.

(e) Competing creditors of the lessor—The secured party's concerns do not end with acquiring a valid and readily enforceable security interest. The secured party also wishes to assure that its security interest takes priority over competing creditors of the lessor. To be assured priority, the secured party must perfect its security interest.\textsuperscript{175} When the secured party takes an interest in only the rights to the lessee's performance and the right to retake the goods on the lessee's default, the secured party may perfect as to chattel paper. That is, the secured party may file a financing statement naming the lessor as debtor and showing the collateral to be chattel paper,\textsuperscript{176} or the secured party may take possession of the lease.\textsuperscript{177} The latter method of perfection affords greater protection to the secured party, and secured parties are well-advised to take possession of any chattel paper collateral.\textsuperscript{178} Article 2A does not address this issue.

2. Taking a security interest in the lessor's residual interest—

(a) Under existing law—Secured parties that take chattel paper as collateral often take in addition a security interest in the lessor's residual interest in the goods. Section 2-403(1) makes clear that the secured party, as a purchaser, acquires a security interest in whatever title the lessor had or had power to convey.\textsuperscript{179} To effec-

\textsuperscript{175} Unperfected secured interests are subordinate to perfected security interests and to judicial liens and may be cut off by certain buyers. \textit{See} U.C.C. \textsection\textsection 9-301(1), 9-312(5).

\textsuperscript{176} U.C.C. \textsection 9-304(1).

\textsuperscript{177} U.C.C. \textsection 9-305.

\textsuperscript{178} \textit{See} U.C.C. \textsection 9-308 (good-faith-purchase rule enabling certain purchasers of chattel paper who take possession of the paper to take priority over prior perfected security interests in the paper). Section 9-306(3) may afford certain protections to one who has perfected by filing. If the lessee's payments are considered proceeds of the chattel paper, then a security interest in them becomes unperfected after ten days unless a filed financing statement covers the collateral. \textit{See} U.C.C. \textsection 9-306(3)(b). Prudence dictates both filing a financing statement and taking possession of the lease.

\textsuperscript{179} U.C.C. \textsection 2-403(1) (first sentence); \textit{see} U.C.C. \textsection 1-201(29) (definition of "purchase"); \textit{see also} Iola State Bank v. Bolan, 679 P.2d 720, 727 (1984) & cases cited therein. As the purchaser of a limited interest, a secured party acquires rights only to the
tuate the transfer of a security interest in the residual interest, the secured party must comply with the attachment requirements of section 9-203(1): a signed security agreement describing the collateral, the giving of value, and the debtor (lessor) having rights in the collateral.180 In the event that the transfer of the lessor’s residual interest violates a prohibition against transfer that is contained in the lease, the security interest in the residual interest will be effective, but the lessor will be liable to the lessee for breach of the lease contract.181

The requirement for attachment most likely to create difficulties is the description of the collateral. For purposes of Article 9, “any description of personal property . . . is sufficient whether or not it is specific if it reasonably identifies what is described.”182 Does a secured party that takes a security interest in “the lease” acquire a security interest only in the debtor-lesser’s right to receive the lessee’s performance, or does it acquire a security interest in the residual interest as well? Generally, an assignment of “the lease” does not encompass a right to the lessor’s residual interest, but an assignment of the goods includes the lessor’s rights under the lease.183 The best practice is to specify both the rights arising

extent of the interest purchased, which is a security interest. See U.C.C. § 2-403(1) (first sentence).

Some commentators have argued and some courts have held that a secured party should not be considered a “purchaser” for purposes of the Code’s good-faith-purchase rules. See, e.g., National Bank v. West Tex. Wholesale Supply Co. (In re McBee), 714 F.2d 1316, 1330 (5th Cir. 1983) (acknowledging that “purchaser” may include a secured party, but holding that the term as used in section 6-110 does not); McDonnell, The Floating Lienor as Good Faith Purchaser, 50 S. Cal. L. Rev. 429 (1977) (recommendng that a secured party not be afforded good-faith-purchase treatment under § 2-403(1) unless it relies to its detriment on particular after-acquired property).

180. U.C.C. § 9-203(1). Because the goods would be in the possession of the lessee, possession of the collateral by the secured party, which may serve as an alternative to a written security agreement, would be highly unlikely.

181. See U.C.C. § 2-403(1) (first sentence); cf. 1 American Property, supra note 100, § 3.58, at 304, 306-07 (assignment or sublease of leasehold interest by lessee of real property is effective until lessor terminates lease).

182. U.C.C. § 9-110.

183. See Boss, supra note 7, at 75-76. The famous Leasing Consultants case, which held that a secured party that takes a security interest in both the lessor’s residual interest in the goods and in the lessor’s right to receive the lessee’s performance under the lease must perfect separately as to each, had no need to address this issue. The security agreement there described the collateral as “the lease(s) and the property leased.” In re Leasing Consultants, Inc., 486 F.2d 367, 369 (2d Cir. 1973).
under a specific lease, properly described, and the lessor's residual interest in the goods, if a security interest in both is desired.184

(b) Under Article 2A—Article 2A renders effective a contractual prohibition against the transfer of the lessor's residual interest.185 Unlike a prohibition against transfer of the lessor's rights under the lease, the prohibition need not be specific or conspicuous.186 In this way, Article 2A distinguishes the lessor from other owners of limited interests in goods, who have the power to transfer their interests in the goods voluntarily.

At first blush, the policy underlying this distinction is difficult to discern. The Code generally adopts a principle of free alienability.187 More specifically, in an analogous situation, the Code permits the owner of goods (Article 9 debtor) effectively to transfer his rights in them notwithstanding that a written agreement between him and another party having an interest in the goods (secured party) prohibits the transfer.188 Just as the transfer of the collateral by an Article 9 debtor may pose a risk to the secured party,189 so the transfer of the lessor's residual interest may pose some risk to the lessee.190 The nature of these risks arguably does not justify a difference in treatment. Nor, arguably, is the magnitude of the risk to the lessee ever great. When the lessee acquires its leasehold interest before the security interest attaches, the security interest is subject to the lease contract, and the lessee does not face the risk that the secured party will cause the lease to be

184. Section 2A-303(4) speaks to this issue but does not answer the question. Following section 2-210, it provides that an assignment of "the lease" or of "all my rights under the lease" is an assignment of rights, as opposed to a delegation of duties. When attachment is concerned, however, the problem is not usually whether any duties have been assigned but rather determining which rights have been transferred.


186. See U.C.C. § 2A-303(7). Presumably the prohibition must be in writing. Because the lessor's residual interest does not arise from the lease contract, courts should not construe a prohibition against transfer of "the lease," of "all the lessor's rights under the lease," or of "the lessor's obligations under the lease," to include a prohibition against transfer of the lessor's residual interest.


188. U.C.C. § 9-311. Section 9-311 overrules pre-Code law to the contrary. See U.C.C. § 9-311 comment 2.

189. No longer facing the risk of repossession, the debtor's incentive to pay the secured debt is reduced.

190. For example, the lessor may have undertaken to repair and maintain the leased goods. If the lessor no longer has an interest in the goods, the lessor's incentive to provide adequate repair and maintenance may be reduced.
terminated. These arguments ultimately are unpersuasive. In some cases, the identity of the owner of the goods may be of utmost importance to the lessee. For example, whether an aircraft can be operated legally in the United States generally depends on whether it is eligible for registration; eligibility for registration turns in part on the identity of the owner. Although the creation of a security interest in the lessor-owner’s residual interest does not change the ownership of the aircraft, sale of the residual interest upon the lessor’s default will do so. To avoid any interruption in its ability to use the aircraft, the lessee may bargain for a term in the lease contract that prohibits any transfer of the lessor’s residual interest or conditions the validity of the transfer on the lessee’s prior written consent. Similarly, one can imagine a lease that requires the lessee to return the goods to a place that the lessor directs at the end of the lease term. Creation of a security interest in the residual interest and its subsequent sale upon the lessor’s default to, say, a Taiwanese buyer might create a significant burden to the lessee. Accordingly, section 2A-303(1)(a)’s policy validating contractual restrictions on the transferability of the lessor’s residual interest is a justifiable departure from the Code’s general principle of free alienability.

The same cannot be said concerning section 2A-303(1)(b). The observations concerning the operation of section 2A-303(1)(b) in the context of chattel paper generally are applicable to security interests in the lessor’s residual interest and need not be repeated at length. Although a well-drafted lease can prevent most of the potential problems, two points are worthy of mention. First, section 2A-303(1)(b) is poorly suited to its gap-filling function because

191. See U.C.C. § 2A-307(2)(b). But see supra notes 63-64 and accompanying text. The same result obtains under Article 9. A secured party ordinarily takes whatever rights its debtor had or had power to convey. See U.C.C. § 2-403(1) (first sentence). If the collateral consists of goods that the debtor has leased to a lessee, the secured party’s rights are subordinate to those of the lessee. See supra note 46 and accompanying text.


193. See id. § 1401(b).

194. Because lessors in leases of this kind often have no assets other than their interests in the lease, a damage remedy may be insufficient to compensate the lessee for the loss of use. Secured parties typically are involved in transactions of this kind from the outset, so there is little risk that a secured party will not discover a restriction on transfer of the lessor’s residual interest. Cf. supra note 115 (discussing that risk).

195. Those observations are set forth supra Part II.B.1.b. Further discussion is found infra Part III.
its rule does not reflect the likely agreement of the parties. Second, neither the secured party nor any buyer at a foreclosure sale (if a foreclosure sale is deemed a “transfer”) should be required to cure defaults or assume the lease in order to comply with the requirements of section 2A-303(2). As observed above, this section makes the mistake of applying provisions similar to those of Bankruptcy Code section 365, which was designed to affect assignments of rights coupled with delegations of duties, to transfers of rights that are unaccompanied by a delegation of duties. Borrowing from the Bankruptcy Code is particularly inappropriate when the subject of the transfer is the lessor’s residual interest. That interest is not at all analogous to the transfer of rights under an executory contract or unexpired lease.

(c) Competing creditors of the lessor—One final issue is worthy of mention: the proper method of perfecting a security interest in the lessor’s residual interest when the secured party also has taken a security interest in the lessor’s rights under the lease (chattel paper). Given the Second Circuit’s holding in In re Leasing Consultants, a prudent lessor will perfect a security interest in the lessor’s residual interest (i.e., in the goods) separately from a security interest in the lessor’s rights under the lease (i.e., chattel paper).196

III. THE RIGHTS OF LIEN CREDITORS OF A LESSEE

This Part of the article concerns the rights of a judicial lien creditor of the lessee of personal property when the creditor acquires its lien on goods that the lessee holds under a lease contract.197

The non-Code law of each state determines whether the lessee’s rights under a lease may be reached by judicial process and, if so, the specific requirements for acquiring a lien. The Code generally has little to say about the acquisition and enforcement of

196. The court in In re Leasing Consultants, Inc., 486 F.2d 367 (2d Cir. 1973), held that a secured party must perfect its security interest in a lessor’s residual interest separately from its security interest in the lessor’s rights under the lease.

197. Unlike security interests, judicial liens do not usually reach after-acquired property. Accordingly, this article does not discuss the rights of a lien creditor whose lien arose prior to the lessee’s acquisition of a leasehold interest.
judicial liens. Article 2A for the most part wisely leaves these matters outside the Code. It does, however, contain some provisions that affect the rights of judicial lien creditors. Chief among them is section 2A-303(1)(b), which renders invalid an involuntary transfer of the lessee's leasehold interest if the transfer materially changes the duty of or materially increases the burden or risk imposed on the other party and the transferee fails to comply with a timely demand for adequate assurance of future performance under the lease.

Although nothing in the Code defines the term "transfer;" the suffering of a lien appears to be a "transfer" within the meaning of section 2A-303(1)(b). That section applies to involuntary as well as voluntary transfers, and the vast proportion of involuntary transfers are the consequence of the exercise of judicial process. The federal Bankruptcy Code defines "transfer" to include the suffering of a lien, and it is highly unlikely that the drafters of Article 2A intended that the meaning of the term in that Article would differ dramatically from the meaning of the term in the other major commercial statute. The lien creditor, not the sheriff or other

198. But see U.C.C. § 8-317 (creditors' rights with respect to investment securities); U.C.C. § 9-301(1)(b) (relative priority of an Article 9 security interest and a judicial lien); U.C.C. § 2-402 (rights of a buyer of goods as against the creditors of the seller); see also U.C.C. § 2-702 (1962 Official Text) (addressing relative rights of reclaiming seller and judicial lien creditor).

199. Section 2A-303(1) can be read to affect the availability of judicial liens. By stating affirmatively that "[a]ny interest of a party under a lease contract . . . may be transferred unless," the section can be read to override a statute that excludes a leasehold interest from the types of property that are subject to creditor process. Conversely, when non-Code law limits enforcement of a judgment to property that is transferable, e.g., Cal. Civ. Proc. Code § 695.030(a) (West 1987), a prohibition against transfer of a leasehold interest might be construed to make the leasehold interest nontransferable within the meaning of the non-Code law. That the drafters actually intended either reading is dubious. But cf. infra notes 222-24 and accompanying text (section 2A-303(1) may have been designed to benefit unsecured creditors).

200. Sections 2A-303(1)(b) and 2A-303(2) are set forth supra note 5.

201. One other common type of involuntary transfer is the transfer that results from the filing of a bankruptcy petition. See 11 U.S.C. § 541(a) (1982 & Supp. IV 1986). As to those transfers, any conditions imposed by section 2A-303 would be irrelevant. See id. § 541(c)(1) (Supp. IV 1986). A second common type of involuntary transfer is the transfer on foreclosure by a secured party. Surely the drafters did not include provisions that are limited in application to foreclosure sales.

202. See id. § 101(50) (Supp. IV 1986) ("'transfer' means every mode . . . voluntary or involuntary, of disposing of or parting with property or an interest in property . . . ."); see also, e.g., Rocky Mountain Ethanol Sys., Inc. v. Mann, Inc. (In re Rocky Mountain Ethanol Sys., Inc.), 21 Bankr. 707, 709 (Bankr. D.N.M. 1981).
officer under whose name any bill of sale will be issued, should be considered the transferee of the transfer. Otherwise, the requirements of section 2A-303(2) are unlikely ever to be met. In addition to the suffering of the lien, the foreclosure of the lien, for example, by a sheriff's sale, arguably constitutes a "transfer" within the meaning of section 2A-303. If so, it is likely to be a transfer that would trigger section 2A-303(1)(b).\footnote{203}

Applying section 2A-303(1)(b) to both the suffering of the lien and the foreclosure sale seems unnecessary. For several reasons Article 2A will work better if the two transfers are treated as a single transfer to the buyer at the sale. Absent bankruptcy, the sale of the lessee's rights under the lease is the inevitable consequence of the suffering of a judicial lien. Little purpose is served by requiring the lien creditor to provide the assurances required by subsection (2) when the ultimate purchaser at a sale may be some other person. If the lien creditor buys at its own sale, as often occurs, the creditor is free to provide adequate assurances before the sale. Even if the lien creditor would be required to comply with subsection (2), the creditor would have a reasonable time in which to do so. In many cases, the sale would be consummated before the reasonable time elapsed. Indeed, the pendency of the sale should be taken into account when determining what is reasonable.\footnote{204}

A consideration of the application of section 2A-303(1)(b) to the situation under discussion reveals another consequence of the general failure of section 2A-303 to reflect the distinction between an assignment of rights and a delegation of duties.\footnote{205} By analogy to section 2-210(1), upon which section 2A-303 was modeled, and under the Restatement (Second) of Contracts, a lessor that had a substantial interest in having the original lessee perform could re-

\footnote{203. For example, possession of the leased goods by a person other than the lessee may increase materially the risk of their rapid depreciation and the risk of a significant diminution of their residual value. Similarly, if the other person were to use the goods in a distant location, any burden to the lessor of maintaining and repairing the goods may increase materially.}

\footnote{204. The approach suggested in the preceding paragraph is not without its difficulties. Because the lessor does not know whether the purported transfer ultimately will be effective until the transferee has had a reasonable time to comply with section 2A-303(2), the suggested approach has the undesirable effect of increasing the period during which the lessor is in limbo.}

\footnote{205. Other consequences are discussed supra Parts II.B.1.b and II.B.1.c.}
fuse performance from a delegate.\textsuperscript{206} In contrast, one party’s substantial interest in having the original promisor perform is not grounds for refusing performance from a transferee under section 2A-303, nor is it even among the stated circumstances that give rise to the right to demand and receive assurances. One possibility is that the drafters concluded that the interest of a party to a lease contract in having the original promisor perform is never so substantial as to require the delegate to comply with section 2A-303(2). A more likely explanation for the exclusion of that circumstance is that the drafters believed it was included by other language in section 2A-303(1)(b). Courts construing section 2A-303(1)(b) should take the lessor’s interest in receiving performance from the original lessee into account when determining whether the lessor has received adequate assurance of future due performance under section 2A-303(2).

As observed above, section 2A-303(1)(b) reflects an effort to maintain the alienability of rights under a lease without imposing unacceptable risks or burdens on the other party to the lease contract. This article criticized that section on the ground that those lessees that are concerned about who receives their rental payments are likely to bargain for a contractual prohibition of the transfer, whereas the costs attendant to enabling other lessees to prevent the transfer as a matter of law are not justified. When section 2A-303(1)(b) applies to a voluntary transfer, the ability of the parties to contract around the section mitigates the section’s undesirable consequences. Section 2A-303(1)(a) validates only prohibitions against voluntary transfers; as a result, the parties to a lease cannot effectively prohibit involuntary transfers. The astonishing consequence is that Article 2A may saddle a lessor with a lessee with which the lessor otherwise would refuse to deal.

Suppose that the lessee has defaulted not only on its obligation to the lien creditor but also on its obligation to pay rent under the lease contract. Upon foreclosure of a judicial lien on the lessee’s leasehold interest, the buyer at the sale acquires the

\textsuperscript{206} "A party may perform his duty through a delegate unless otherwise agreed or unless the other party has a substantial interest in having his original promisor perform or control the acts required by the contract." U.C.C. § 2-210(1); accord Restatement (Second) of Contracts § 318(2) (1981). The Bankruptcy Code respects nonbankruptcy restrictions on delegation of duties that are imposed by law, but not those that are imposed solely by contract. See 11 U.S.C. § 365(f)(3) (1982).
lessee’s right to use the goods under the same terms that the lessee could use them. 207 Thus the lessor would be free to cancel the lease, or otherwise exercise its remedies, for nonpayment of rent. 208 The buyer may tender the past due rent in an effort to persuade the lessor not to cancel the lease. But if the lease contract does not entitle the lessee to cure its default, the lessor would be free to refuse the buyer’s tender. Section 2A-303(2)(a) changes this result by permitting the transferee to cure or provide adequate assurance that he will promptly cure any default other than one arising from the transfer. In other words, this section gives the transferee greater rights than the transferor had and deprives the lessor of its rights without its consent, in violation of nemo dat. 209

Section 365 of the Bankruptcy Code, from which section 2A-303(2) is derived, gives rise to the same problem. 210 The primary justification for imposing a different lease contract upon the lessor when the lessee is in bankruptcy is that, because the lessee’s assets are insufficient to pay its debts, the value of the property available to be applied toward satisfaction of the lessee’s debts should be

---

207. The same result obtains under Article 9. “When collateral is disposed of by a secured party after default, the disposition transfers to a purchaser for value all of the debtor's rights therein . . . .” U.C.C. § 9-504(4).
209. In contrast to section 2A-303(2)(a), section 2A-303(2)(d) actually may improve the lessor’s position. It requires that the transferee assume the lease contract and thereby obligate itself to perform. In effect, the section requires that the transferee become a surety for the original lessee, even though the lessor did not bargain for that suretyship obligation. Query whether the transferee has a right to reimbursement from the lessee.

As is the case when the lessor’s rights are transferred, section 2A-303(2) imperfectly accomplishes its goal when the lessee transfers its rights under the lease. The section requires the transferee (here, the buyer at the foreclosure sale) to provide adequate assurance of future due performance under the lease contract. U.C.C. § 2A-303(2)(c). Although section 2A-303(2) provides that the assurances must be provided by the transferee, adequate assurances provided by another person on behalf of the transferee should constitute compliance with the section. As discussed supra notes 136-39, the requirement in section 2A-303(2)(b) that the transferee compensate or provide adequate assurance that he will promptly compensate the lessor for any loss resulting from the transfer is more problematic. One possibility is to read the requirement broadly enough to require compensation for any increased burden imposed on the lessor by the transfer. That reading presents difficult problems of valuation, inasmuch as it requires evaluating future burdens. An alternative reading is to limit the compensation to losses that are incurred immediately upon transfer. That reading is perhaps less desirable, because it may permit transfers that impose considerably greater burdens on the other party without compensating that party for the increase.

210. 11 U.S.C. § 365 (1982 & Supp. IV 1986). This section permits the lessee's bankruptcy trustee to cure past defaults even when no assignment of the lease is contemplated. See id. § 365(b)(1).
Consider the case of a lease at below-market rent as to which the lessee is in default. Rather than permit the lessor to cancel the lease and relet the property, the Bankruptcy Code enables the creditors as a group to reap the benefits of that valuable asset by permitting otherwise incurable defaults to be cured and the lease to be assigned. Any loss to the lessor that results from depriving the lessor of its right to assert the default and cancel the lease is thought to be justified by the increase in value to the lessee’s bankruptcy estate that benefits the creditors as a group.212

Article 2A applies similar rules to all cases in which the transfer of the lessee’s rights under the lease adversely affects the lessor. Unlike section 365 of the Bankruptcy Code, section 2A-303 is not limited to cases in which the lessee is insolvent and assignment of the lease contract will redound to the benefit of the lessee’s creditors as a group.213 The reason for this radical departure from existing law is not readily apparent, and the Official Comment confuses rather than enlightens. Addressing the case in which a transfer triggers section 2A-303(1)(b), the Comment observes that “[s]ection 2-210(5) resolves this issue for sales by allowing the other party to demand assurances from the transferee (Section 2-609). Section 365 of the Bankruptcy Code, a modern version of the provisions of Section 2-609, provided a better model for resolving this issue for leases.”214 It is not clear why sections 2-210(5) and 2-609, which concern delegation of duties and assurances of future performance from the delegate, are appropriate models for transfers in which only rights are transferred. It is even less clear why Bankruptcy Code section 365, which was designed to facilitate the transfer of an asset-liability combination in cases in which the value of the asset exceeds the liability, affords a “better model” in lease transactions. Not only does Bankruptcy Code section 365 change the bargain of the parties to the lease contract, it also requires that any assumption of rights under the contract be

211. See, e.g., Fogel, Executory Contracts and Unexpired Leases in the Bankruptcy Code, 64 MINN. L. REV. 341, 349 (1980).

212. Bankruptcy Code section 365 has been criticized for its failure to respect the relative nonbankruptcy rights of competing creditors. See T. Jackson, The Logic and Limits of Bankruptcy Law 115-16 (1986).

213. When the transfer of the lessee’s rights under a below-market lease occurs as a consequence of the suffering of a judicial lien on those rights, any premium paid by the transferee typically will benefit only the lienor.

accompanied by a delegation of duties to the assignee. Even if that coupling is justifiable in the bankruptcy setting (e.g., because the debtor may be liquidating and will not survive to perform its duties), the justification outside bankruptcy is wholly lacking.

Another problem that arises from borrowing section 365 of the Bankruptcy Code is that the section has been subjected to judicial interpretation, some of which may be appropriate only when the lessee is in bankruptcy. For example, bankruptcy courts have grappled with lease provisions the effect of which is to prevent the lease from being assigned because very few persons other than the original lessee (bankruptcy debtor) are able to comply with all the terms of the lease, as bankruptcy law requires.\footnote{216} Even a bankruptcy court that acknowledges the requirement nevertheless may insist only on substantial performance by the assignee.\footnote{218} Substantial performance may translate into paying the rent while disregarding some other terms of the lease.\footnote{217}

A court that excuses the assignee from complying strictly with the terms of the lease may do so in order to effectuate the Bankruptcy Code’s policy of rendering nugatory any lease clause that purports to prohibit an assignment or to enable the lessor to cancel the lease as a consequence of an attempted assignment.\footnote{218} The extent to which Article 2A is premised upon the same policy is unclear. Section 2A-303 contains no general principle of nonassignability. Instead, as regards voluntary assignments, only when the lessor has failed to use a nontransferability clause to protect its own interests does the statute step in and provides, in essence, that so long as an assignee brings the lessor current and is likely to perform in the future, the lessee can assign its rights and delegate its duties. On the other hand, the negative pregnant in section 2A-303(1)(a), which validates prohibitions against voluntary transfers,

\begin{itemize}
\item \footnote{215} Under bankruptcy law, the trustee must assume a lease before the lease can be assigned. 11 U.S.C. § 365(f)(2)(a) (1982). A lease must be assumed \textit{cum onere}; the trustee may not assume only the favorable portions of a lease. See, e.g., LHD Realty Corp. v. Metropolitan Life Ins. Co. \textit{(In re LHD Realty Corp.)}, 20 Bankr. 717, 719 (Bankr. S.D. Ind. 1982), citing \textit{In re} Italian Cook Oil Corp., 190 F.2d 994, 997 (3d Cir. 1951). This principle derives from case law decided under the Bankruptcy Act of 1898. See \textit{2} \textit{Collier on Bankruptcy} ¶ 365.01[1] (15th ed. 1988).
\item \footnote{217} See id. (assignee permitted to disregard use restrictions). Arguably, that approach changes the contract of the lessor to an extent greater than even section 365 contemplates.
\item \footnote{218} 11 U.S.C. § 365(f) (1982).
\end{itemize}
is that when the transfer is involuntary, a provision in the lease contract prohibiting it would not prevent the transfer from being effective.

Rather than prohibiting involuntary transfers, the parties to a lease contract might attempt to achieve the same result by making the suffering of a lien an event of default, thereby affording the lessor the remedy of cancelling the lease.\textsuperscript{219} The intended result would be that the lienor, who takes subject to the lease contract, acquires rights in a leasehold interest that subsequently is cancelled.\textsuperscript{220} That is, the property subject to the lien disappears, and the lessor need neither demand nor accept compliance with section 2A-303(2). Section 2A-307(1) provides support for this reading. It states, with an exception not relevant here, that "a creditor of a lessee takes subject to the lease contract."\textsuperscript{221} One way to read sections 2A-303 and 2A-307 consistently is to use the former to determine whether the transfer is effective and to use the latter to determine what rights the transferee acquires. Following this approach, upon compliance with section 2A-303(2) the transfer would be effective, but the transferee would acquire its rights subject to the lease. That is, the lessor would be able to terminate the lease as a consequence of the transfer.

Whether the drafters actually intended that result is unclear. Section 365 of the Bankruptcy Code, from which section 2A-303(2) derives, clearly would not give effect to contract provisions of that kind.\textsuperscript{222} Although the Bankruptcy Code provides the source of the rule, it is not necessarily the best guide to its interpretation. Section 365 is concerned with maximizing the value of the bankruptcy estate at the expense of freedom of contract. Section 2A-303(1)(b) may express a similar concern for unsecured creditors. From their perspective, their debtor (the lessee) enjoys a valuable asset (the leasehold interest) that, if the suffering of a lien constitutes an event of default giving rise to a cancellation of the lease, they are unable to reach. Section 2A-303 may be intended to enable unsecured creditors to override the default provisions of the lease and


\textsuperscript{220} Another variation is an ipso facto clause, pursuant to which the lease automatically terminates upon the suffering of a lien or upon the passage of a fixed period of time after a lien has attached to the property and not been discharged.

\textsuperscript{221} U.C.C. § 2A-307(1).

remove the insulation that the asset otherwise would enjoy.\textsuperscript{223} The fact that section 2A-303(2)(a) permits the transferee to cure otherwise incurable defaults, but provides that a default "arising from the transfer" need not be cured, lends considerable support to this reading.\textsuperscript{224}

On the other hand, section 2A-303(1)(b) may be intended only as a gap-filler here, as it apparently is with respect to voluntary transfers. Section 2A-303(3), which provides that "[d]emand pursuant to subsection (1)(b) is without prejudice to the other party's [here, the lessor's] rights . . . against the party whose interest is being transferred," supports that reading. But if section 2A-303(1)(b) is designed to fill gaps, then the parties themselves should be able to avoid its effects by leaving no gap in the lease contract. For some reason, however, section 2A-303 does not permit the parties to fill the gap by expressly prohibiting the suffering of liens or other involuntary transfers. Can it be that section 2A-303(3) permits the parties to do indirectly what section 2A-303(1) prevents them from doing directly?

Even construed as a gap-filler, section 2A-303(1)(b) is problematic. It simply contains the wrong rule. Unlike transfers of the lessor's residual interest or the lessor's rights under a lease, to which section 2A-303(1)(b) also applies, lease contracts routinely prohibit the lessee from transferring its leasehold interest. Face-to-face bargaining between a lessor and lessee ordinarily would afford the lessor the right to declare a default if the lessee's leasehold interest is subjected to legal process. The lessor has a right to the

\textsuperscript{223} The problem of debtors enjoying assets that their creditors cannot reach is not new. Consider Twyne's Case, 3 Coke 80, 76 Eng. Rep. 809 (Star Ch. 1601), in which the debtor, Pierce, continued to use as his own property that he purportedly transferred to Twyne. This fact made the transfer objectionable not only because subsequent creditors might have been deceived into thinking that Pierce was a man of means, but also because had the transfer not been set aside, Pierce would have been able to enjoy rights akin to ownership of the property while insulating the property from the reach of his existing creditors, such as C, who sought to set the transfer aside.

Distinguishing between a lease prohibition that prohibits transfer and one that enables a lessor to prevent a transfer by making it an event of default and then cancelling the lease creates difficulties elsewhere. Section 2A-303(7) states that "[t]o prohibit the transfer of an interest of a party under a lease contract, the language of prohibition must be specific, by a writing, and conspicuous." A default clause accomplishes the same result as a prohibition. If a clause does not comport with the requirements of section 2A-303(7), is it effective nonetheless?

\textsuperscript{224} U.C.C. § 2A-303(2)(a).
goods at the end of the lease term and normally is concerned that the person in possession of the goods will use them so as to preserve their value. Had the drafters perceived the need for a gap-filler, they would have done well to make the transfer of the lessee's leasehold interest ineffective in the absence of a provision in the lease contract to the contrary. 225

Another interpretive problem with respect to section 2A-303(1)(b) arises when the lessor has transferred its right to the lessee's performance to a secured party. Does the secured party become a "party to the lease contract" who is entitled to give the demand for adequate assurances? A secured party whose collateral is the lessee's performance under the lease contract certainly has an interest in being assured of future due performance. Inasmuch as the transfer of the lessee's leasehold interest can prejudice that interest, the secured party should be entitled to make demand of the lessee's assignee and receive adequate assurance of future performance. 226

IV. THE RIGHTS OF SECURED CREDITORS OF A LESSEE

A lessee of goods may grant a security interest in its leasehold interest, including its right to use the leased goods, in two distinct

225. This article approved making the lessor's residual interest freely alienable in the absence of an agreement to the contrary and criticized section 2A-303(1)(b) for imposing a limitation on alienability. See supra Part II.B.2.b. The text's argument in favor of a rule limiting alienability of the lessee's leasehold interest is not inconsistent. Gap-fillers should afford the parties the result they would have reached through face-to-face bargaining. Section 2A-303 reflects the assumption that the parties ordinarily would agree that the alienability of the lessee's rights should be identical to the alienability of the lessor's. That assumption is unjustified. See, e.g., Bayer, Lease Documentation Handbook, in Equipment Leasing 1987, at 456 (suggesting that lessee's leasehold interest be nonassignable without lessor's prior consent, but that lessor's leasehold and residual interests be freely assignable); 19 Am. Jur. Legal Forms 2d Uniform Commercial Code § 253:3120, at 381 (1974) (providing form to the same effect).

226. The statute is not as clear as it might be on this point. Article 1 explains that "'Party', as distinct from 'third party', means a person who has engaged in a transaction or made an agreement within this Act." U.C.C. § 1-201(29). Although a secured party that takes the lessor's leasehold interest as security has made an agreement under the Code, the agreement is not part of the lease contract. If, however, the secured party buys the right to the lessee's performance, then a better case could be made that the secured party is a "party to the lease contract." The secured party has taken the rights of the lessor and, to that extent, is in the position of a party to the lease contract.

Whether the lessor's secured party holds its rights with recourse against the lessor should not matter, nor should the fact that the financing is done on a non-notification basis.
situations: before or after the lessee acquires its interest. This Part of the article analyzes the secured party's rights in each situation.

A. When a Secured Party Takes a Security Interest in the Lessee's Rights Under an Existing Lease Contract

1. Under existing law—Under current law, opinions differ concerning whether a lessee can create a valid security interest in its rights under a lease contract. Article 9 provides that a security interest is unenforceable against the debtor or against third parties unless the debtor has rights in the collateral.\textsuperscript{227} Although some have expressed the view that a lessee may not encumber goods owned by the lessor,\textsuperscript{228} the better view is that a lessee's leasehold interest affords the lessee sufficient rights in the goods to enable a security interest to attach.\textsuperscript{229}

The erroneous approach may derive from concern about protecting the lessor's interest from being encumbered by the lessee.\textsuperscript{230} But the creation of a security interest in a lessee's leasehold interest does not necessarily affect the lessor's rights. A secured party ordinarily takes no greater rights than the lessee has.\textsuperscript{231} To the extent that the lessee's rights are subordinate to those of the lessee—for example, if the lessor has the right to re-

\textsuperscript{227} U.C.C. § 9-203(1)(c).


\textsuperscript{229} See R. Hillman, J. McDonnell & S. Nickles, supra note 39, ¶ 18.05[1]. To perfect a security interest in the lessee's leasehold interest, one must determine what type of collateral the leasehold interest is. "Chattel paper" includes both the lessor's right to payment from the lessee and the lessee's right to enforce the lease against the goods. See U.C.C. § 9-105(1)(c). Article 9 does not contain the equivalent of chattel paper with respect to the lessee's leasehold interest. Rather, the lessee's right to use the goods appears to constitute "goods," whereas its right to receive the lessor's performance under the lease may be a "general intangible." But see Report of the Uniform Commercial Code Committee of the Business Law Section of the State Bar of California on Proposed California Commercial Code Division 10 (Article 2A) 42 n.29 (1987) [hereinafter Cal. Bar Report], reprinted in 39 Ala. L. Rev. 979, 1016 n.29 (1988) (the lessee’s leasehold interest in goods would appear to be a general intangible).

\textsuperscript{230} For example, in Towe Farms the issue facing the court was whether the lessee's secured party was liable to the lessor for conversion when the secured party caused the leased goods to be sold. Towe Farms, 528 F.Supp. at 506-07. Similarly, in Disch v. Raven Transfer & Storage Co., 17 Wash App. 73, 561 P.2d 1097 (1977), the issue was whether the lien of a warehouse with which the lessee bailed leased goods was effective against the lessor.

\textsuperscript{231} See U.C.C. § 2-403(1) (first sentence). The lessee may be able to grant a security interest in the lessor's property if, for example, the lessor authorizes or ratifies the transac-
possess the goods upon the lessee's default on its obligations under the lease—the rights of the lessee's secured party likewise will be subordinate. Although section 9-201 is written in broad enough language to suggest that a secured party always takes priority, the section is subject to the rest of the Code.\footnote{232} The first sentence of section 2-403(1) makes clear that "a purchaser of a limited interest acquires rights only to the extent of the interest purchased." Thus, the debtor-lessee's rights, from which the secured party's rights derive, are no greater than those afforded by the lease contract.

Notwithstanding some suggestions to the contrary, the third sentence of 2-403(1) does not enable the secured party to take its security interest free of the lessor's rights under the lease. That sentence enables a good faith purchaser for value to take good title when goods have been delivered to the purchaser's transferor in a voluntary transaction. Some have observed that, since the delivery of goods to a lessee is a "transaction of purchase," a literal reading of section 2-403(1) may grant to the lessee the power to give good title (i.e., title free of the lessor's interest) to a good faith purchaser for value.\footnote{233} The Official Comment to section 2-403 makes clear that the intention underlying the third sentence is to protect the good faith purchaser for value "in a number of specific situations which [were] troublesome under prior law." Section 2-403(1) sets forth those situations explicitly in subsections (a) through (d).\footnote{234} Each concerns the case in which the owner of goods voluntarily parts with possession under circumstances that the common law sometimes characterized as giving void title to the buyer (i.e., that the common law analogized to theft of the goods). The conse-

\footnote{232} Under section 9-201, a security agreement is effective according to its terms "[e]xcept as otherwise provided by this Act [i.e., the Code]." Some courts have misconstrued section 9-201 and held that a secured party always prevails over competing claimants unless Article 9 provides to the contrary. See, e.g., Citizens Nat'l Bank v. Mid-States Dev. Co., 380 N.E.2d 1243 (Ind. App. 1978) (bank's right of set-off is subordinate to security interest in deposit account).


\footnote{234} The four situations are (a) when the transferor was deceived as to the identity of the transferee; (b) when the goods were delivered in exchange for a check that is later dishonored; (c) when the parties agreed to a "cash sale"; and (d) when the delivery was procured through fraud punishable as larcenous under the criminal law. U.C.C. § 2-403(1) (third sentence).
quence of the common law rule was that even though the owner put a third party (the buyer) in possession of his goods, takers from the buyer who relied on his possession of the goods likewise acquired void title. In accordance with its general thrust of protecting good faith purchasers for value, the Code provides that those specific circumstances will be treated like voidable title cases, in which the person in possession has acquired possession through fraud and can give good title to a good faith purchaser. The common law did not analogize the lease of personal property to fraud or to theft. The last sentence of section 2-403(1) has no application to leases. 235

The effect of a provision in a lease contract that purports to prohibit the lessee from transferring its interest is less certain. 236 The likely effect is that the creation of a security interest in violation of a prohibition of that kind merely will constitute a breach of the lease but will not render the security interest ineffective. 237

235. That is not to say that a lease is not a transaction of purchase; it is not a transaction of purchase that gives the purchaser (lessee) the power of one who has voidable title. Thus Towe Farms is only half correct in its assertion that "a true lease is not a transaction of purchase and does not confer even voidable title upon the lessee." Towe Farms, 500 F. Supp. at 505.

Section 2-403(2), which enables buyers in ordinary course to take the rights of persons who entrusted goods to a seller who is a merchant, would apply to cut off the lessor’s interest in a lease; however, a secured party is not a buyer and so cannot take its security interest in the lessee’s leasehold interest free of the rights of the lessor. Cf. U.C.C. § 2A-305(2) (governing rights of buyers in ordinary course and sublessees in ordinary course from merchant lessors).

236. A somewhat different clause appeared in the lease at issue in Danning v. World Airways, Inc. (In re Holiday Airlines Corp.), 647 F.2d 977 (9th Cir. 1981), cert. denied, 464 U.S. 1146 (1982). The lease contract provided that "LESSEE shall have no right to consent to, allow, or permit any liens or encumbrances on said AIRCRAFT." Danning, 647 F.2d at 983. Without discussing the meaning or effect of that provision, Judge Sneed held that the lessee could create a security interest in its leasehold interest. In a concurring opinion, Judge Gibson reached the same result but relied on other lease provisions that required the lessee to maintain the aircraft at its own expense in holding that the lease afforded the lessee an implied right to create the security interest. In dissent, Judge Poole argued that the lessee could not create a security interest because of the prohibition in the lease and because a lessee cannot encumber his lessor’s property.

237. See U.C.C. § 2-403(1) (first sentence); cf. 1 AMERICAN PROPERTY, supra note 100, § 3.58, at 304, 306-07 (assignment or sublease of a leasehold interest by lessee of real property is effective until lessor terminates lease). Any person who acquires rights upon the lessee’s default will take those rights subject to the lessor’s rights under the lease. Thus, as long as the lease contract makes a transfer of an interest in the goods to a third party an event of default, there is little practical difference between rendering the transfer invalid and making it an event of default.
2. Under Article 2A—Section 2A-303(1) preserves the general principle that the lessee’s leasehold interest is alienable, and, following nemo dat, section 2A-307(1) subordinates the rights of the lessee’s secured party to the rights of the lessor.\(^{238}\) As discussed above, whether free alienability should be the back-up rule with respect to a lessee’s leasehold interest is dubious. A lessor’s concerns for preserving the value of its residual interest and for avoiding potential disputes with competing claimants, among other concerns, probably would prompt the lessor to restrict the lessee’s ability to transfer the lessee’s leasehold interest.\(^{239}\) When parties ordinarily would restrict alienation, there seems to be no reason to impose upon them the contrary result if they fail to do so.

Similarly, whereas Article 2A’s requirement that the prohibition of the transfer of an interest of a party under a lease contract must be specific, conspicuous, and in writing\(^{240}\) may be appropriate when the lessor’s interests are concerned, the requirement is less justifiable when the lessee’s interest is the subject of the prohibition. The Official Comment to section 2A-303 suggests that restrictions on transfers generally are not favored and that section 2A-303 “ensures that both parties knowingly impose prohibitions on transfer.”\(^{241}\) Ordinarily, the Code requires terms to be conspicuous when the party adversely affected by them would assume that the term would not be part of the contract.\(^{242}\) No such assumption is warranted in the case of leased goods, at least outside the consumer context. Commercial leases often restrict the assignability of the lessee’s rights, so that a prohibition on transfer should come as

\(^{238}\) “Except as otherwise provided in Section 2A-306 [concerning artisan’s liens], a creditor of a lessee takes subject to the lease contract.” U.C.C. § 2A-307(1).

\(^{239}\) See supra note 225 and accompanying text. Although a security interest in a lessee’s rights under the lease is not usually accompanied by the immediate transfer of possession of the goods, the lessor ordinarily will be concerned about a transfer of possession occurring after the lessee defaults on the secured obligation. See U.C.C. § 9-504(1) (upon default the secured party may sell the collateral).

\(^{240}\) U.C.C. § 2A-303(7).

\(^{241}\) U.C.C. § 2A-303 comment.

\(^{242}\) For example, Article 2 implies warranties of fitness for purpose and merchantability because the buyer reasonably assumes that the goods he buys will be fit for the purpose and merchantable. See U.C.C. §§ 2-314, 2-315. To overcome that expectation, disclaimers and modifications of those warranties must be conspicuous. See U.C.C. § 2-316(2).
no surprise to the lessee.\textsuperscript{243} The statutory conspicuousness requirement is particularly puzzling given that anti-assignment clauses have not created problems for lessees such that courts have imposed the requirement as a matter of common law. The requirement that a prohibition against transfer be conspicuous seems even more incongruous when one considers that other terms that are more important and more likely to surprise a lessee not only need not be conspicuous, but also need not be written in the lease contract at all.\textsuperscript{244}

Even if the written document were to call the attention of the lessee to a prohibition on transfer, a lessor would be unlikely to negotiate that provision away. It simply is too important. As a consequence, the net effect of subsection (7) is likely to be that sophisticated lessors will expend the sums necessary to reprint their lease forms and that unsophisticated lessors will find previously valid prohibitions on transfer to be invalid. The actual bargains of the parties are not likely to change.

One interpretive problem arising from subsection (7) is what it means for a prohibition on transfer to be "specific."\textsuperscript{245} A prohibition against permitting any liens or encumbrances "on the goods" should be held to be specific enough to prohibit the lessee from encumbering its leasehold interest in them.\textsuperscript{246} Nevertheless, a well-drafted provision will specify not only the rights, duties, and interests that may not be transferred (e.g., the lessee may not assign its rights under the lease, delegate its duties under the lease, nor transfer any interest in the goods) but also the types of transfers that are prohibited (e.g., voluntary and involuntary, including the suffering of a lien). The effect of a prohibition against transfer of "the lease" or "all the lessee's rights under the lease" is uncertain. Section 2A-303(4) indicates that, when those terms appear as part of an assignment, they are "general terms" to which that section ascribes specific meaning: an assignment of that kind is an assignment of rights and, unless the language or the circumstances


\textsuperscript{244} For example, the statutory hell or high water clause for nonconsumer finance leases. See U.C.C. § 2A-407.

\textsuperscript{245} This language probably derives from the requirements of section 2-312 concerning exclusion or modification of the warranty of title. Cf. U.C.C. § 2-316(2) (exclusion or modification of implied warranty of merchantability must mention merchantability).

\textsuperscript{246} But see supra note 236.
indicate the contrary, a delegation of duties. The statute does not indicate whether those terms would be construed in the same way (i.e., as referring to both an assignment of rights and a delegation of duties) if they appeared in a contractual prohibition on transfer. To give effect to the likely bargain of the parties, however, those “general terms” should be construed to prohibit at least an assignment of the lessee’s rights under the lease and, so construed, should be specific enough to meet the specificity requirement in section 2A-303(7).

If an attempted prohibition against transfer does not comply with the requirements of section 2A-303(7), or if the lease contract does not prohibit transfers of that kind, a purported grant of a security interest nevertheless will be ineffective if it materially changes the duty of or materially increases the burden or risk imposed on the lessor, and within a reasonable time after notice the lessor demands that the transferee comply with section 2A-303(2) and the transferee fails to comply.247 The creation of a security interest in the lessee’s leasehold interest is unlikely to bring this rule into play. The lessee will still remain in possession of the goods in most cases.248 Absent a sham transaction, in which the security interest is created just to be foreclosed, the creation of the security interest does not reduce the lessee’s incentive to comply with the terms of the lease. And as long as the lessor’s rights to reach the goods on the lessee’s default are not impaired by the granting of the security interest, which ordinarily they will not be, the lessor has no additional risk.

Although the creation of a security interest is unlikely to trigger section 2A-303(1)(b), foreclosure of the security interest by sale of the lessee’s rights under the lease may do so. This article discussed above whether to treat the foreclosure sale as a separate transfer from the creation of a judicial lien.249 The considerations

248. It is possible to perfect a security interest in the lessee’s leasehold interest by taking possession of the goods, U.C.C. § 9-305, but to do so would deprive the lessee of the use of the goods, which would hinder the lessee’s ability to generate income for the repayment of the secured debt. As a result, the secured party is likely to perfect by filing. U.C.C. § 9-302(1).

Of course, to the extent that the lessee’s leasehold interest is characterized as a general intangible, see supra note 229, then the secured party must file a financing statement to perfect; taking possession would be ineffective. U.C.C. § 9-305.
249. See supra text accompanying and following note 203.
there are applicable here as well. One additional consideration is that the parties could have prohibited a foreclosure sale by prohibiting the creation of the underlying security interest. 250 One could argue that the failure to prohibit the creation of the security interest constitutes an implied consent not only to the creation of a security interest but also to its enforcement. On the other hand, one purpose of section 2A-303(1)(b) is to afford the parties contract terms to which they likely would have agreed, had they the foresight and incurred the costs to negotiate over them. One ought not assume that a lessor would have agreed to any foreclosure sale, let alone one that materially increased its risk or burden under the lease contract. 251 Article 2A would have done better to avoid these difficulties of statutory construction and application and instead posited a rule that invalidates transfers of the lessee's leasehold interest except when the parties agree to the contrary. Instead, section 2A-303(2) enables a buyer at a foreclosure sale to reach the lessee's rights for the price of assuming the lessee's obligations under the lease. 252 If the buyer does so, then the lessor must accept future performance from a person with whom it may have chosen not to deal. 253

B. When a Person Grants a Security Interest in a Leasehold Interest That He Acquires Thereafter

Debtors often grant a security interest in property that they do not own at the time but in which they may acquire an interest


251. Of course, since the buyer at a foreclosure sale acquires "all the debtor's rights" in the collateral, U.C.C. § 9-504(4), the buyer's rights, like the lessee-debtor's, will be subject to the lease contract.

252. This article suggests that, when the transfer consists only of an assignment of rights, the transferee should be able to comply with the requirements of section 2A-303(2) without curing past defaults or assuming the lease. See supra text accompanying and following notes 140-44.

253. In addition, under one plausible interpretation of section 2A-303(2), if the lessee has defaulted in its obligations under the lease, the lessor may be precluded from asserting the default and, even if the lease contract does not entitle the lessee to cure, the lessor must accept a cure from a transferee who otherwise complies with the requirements of the section. If the lease terms are favorable, e.g., if the rent is below market, then a buyer may be willing to cure defaults and assume the lease.
in the future.254 Under section 9-203(1)(c), even though the debtor has granted the security interest, the security interest does not attach and is not enforceable against the debtor or against third parties until the debtor acquires rights in the collateral. If a debtor signs a security agreement covering existing and after-acquired equipment and thereafter acquires a leasehold interest in a particular piece of equipment, then the security interest attaches to the leasehold interest, just as it does if the security interest is created after the debtor acquires the leasehold.255 Unfortunately, as this article discusses above, section 2A-303(2) may be construed to affect a lessor’s rights adversely by creating in the lessee’s transferee a right to cure that otherwise would not be available. Although both sections 2A-304(1) and 2A-305(1) are expressly “[s]ubject to the provisions of section 2A-303,” section 2A-307(1) is not.256 One could argue that when the transferee is a creditor, the specific section (2A-307(1)) and not the general section (2A-303) applies.257 Under that analysis, the secured party takes subject only to the terms of the lease and not also subject to the requirements of section 2A-303.

The fact that section 2A-303 applies to involuntary transfers, the most common of which are effectuated through judicial process initiated by creditors, suggests that the drafters intended that section 2A-303 apply to transfers to creditors. One way to give voice to both sections is to look first to section 2A-303 to determine whether the transfer is effective. As part of making that determination, the transferee is permitted to assert rights in addition to those afforded him by the lease (e.g., to cure otherwise incurable past defaults). Once the transfer has become effective, however, section 2A-307(1) makes the transferee’s rights “subject to the lease contract.”

254. A security agreement may provide that obligations covered by the security agreement are to be secured by after-acquired collateral. See U.C.C. § 9-204(1).

255. As noted above, some disagree with this analysis and think that the lessee lacks sufficient rights in leased goods to permit a security interest to attach. See supra note 228. Those who take that position appear to be motivated by a concern that the lessee not be able to encumber the lessor’s rights. Section 2A-307(1), which makes the rights of the lessee’s secured party “subject to the lease contract,” should allay that fear.

256. The only stated exception to section 2A-307(1) is section 2A-306, which concerns the rights of certain persons with liens arising by operation of law.
257. “Where there is inescapable conflict between general and specific terms or provisions of a statute, the specific will prevail.” 2A N. Singer, STATUTES AND STATUTORY CONSTRUCTION § 46.05, at 92 (Sands 4th ed. 1984 rev. & 1987 Cum. Supp.).
When the lessor has created a security interest in the goods subject to the lease contract and the lessee has granted a security interest in its leasehold interest, an interesting issue arises concerning the relative priority of the two secured parties. Generally, the relative priority of perfected security interests is determined by the order of filing financing statements.\textsuperscript{258} When each security interest was created by a different debtor, however, this rule does not always command the correct result and therefore should not be applied. Rather, \textit{nemo datt} should be used to resolve the competing priorities.\textsuperscript{259} Quite properly, Article 2A does not address this Article 9 problem, which arises in a variety of other contexts; however, nothing in Article 2A is inconsistent with resolving the problem by applying \textit{nemo datt}.

V. THE RIGHTS OF LIEN CREDITORS OF A LESSOR

This Part of the article concerns the rights of lien creditors of the lessor of personal property when the creditor acquires its lien on goods that are the subject of a lease contract.\textsuperscript{260} As is the case when considering the rights of a lessor’s secured party, one must distinguish between the lessor’s residual interest in the goods and the lessor’s rights under the lease.

Whether the lessor’s residual interest may be reached by judicial process, and, if so, the method by which creditors may reach

\textsuperscript{258} See U.C.C. § 9-312(5). Security interests in goods that the lessor has leased or in the lessee’s leasehold interest are unlikely to be perfected by taking possession of the collateral.

\textsuperscript{259} Consider, for example, a case in which the lessor’s secured party takes a security interest in a drill press held as equipment and files on July 1 to perfect. On September 1, the debtor leases the equipment to the lessee. The lessee was a party to a security agreement that included an after-acquired property clause, and the lessee’s secured party filed a financing statement on May 1. Even though the lessee’s secured party was the first to file, its rights should be subordinate to those of the lessor’s secured party. The lessee’s rights were subordinate to those of the lessor’s secured party; accordingly, one who takes from the lessee acquires encumbered rights. For a discussion of the two-debtor problem as it arises in the context of bulk transfers, see Harris, \textit{supra} note 68, at 222-30.

\textsuperscript{260} The situation in which a lessee enters into a lease of goods after a judicial lien has attached to the goods is sufficiently rare that this article does not discuss the case at length. Under common law principles of \textit{nemo dat}, the lessee would take its leasehold interest subject to the lien. Article 2A continues that result. See U.C.C. § 2A-307(2)(a). When the lien is secret, however, application of \textit{nemo datt} may be inappropriate. See \textit{Cal. Bar Report}, \textit{supra} note 229, at 45, 39 \textit{Ala. L. Rev.} at 1018-19.
the residual interest, is a matter for state non-Code law. Article 2A apparently does not address these issues. 261

Generally speaking, the law does not afford good faith purchase rights to a lien creditor. Rather, a lien creditor acquires only the rights of its debtor. 262 Accordingly, a lien creditor takes the lessor's residual interest free from any claims of the lessee and would take whatever rights the lessor has under the lease. It would not be able to deprive the lessee of its leasehold interest. Article 2A continues this result by providing that a creditor of a lessor ordinarily takes subject to the lease contract. 263

Many of the observations above concerning the rights of lien creditors of the lessee apply equally to the rights of lien creditors of the lessor. One of the issues worthy of further elaboration is whether both the suffering of the lien and the foreclosure sale are to be considered transfers as to which section 2A-303(1)(b) might apply. In addition to the considerations discussed above, one further consideration is particularly relevant when the debtor is the lessor: for want of a buyer, no sale may occur. Recall that in order to acquire the lessor's residual interest, a buyer must not only cure any past defaults by the lessor and provide assurance of future performance, but also must assume the lease contract. 264 Even if a transfer of the lessor's residual interest carries with it the right to the lessee's performance, 265 difficulties may arise in finding a buyer who is willing to undertake the lessor's performance obligations. A lien creditor that otherwise might be willing to bid in part of its judgment against the lessor in exchange for the residual interest may not be willing to assume the lease. What happens then? 266

Once the relevant "transfer" is identified, much of what was said above concerning security interests in the residual interest is relevant here, but will not be repeated. One additional point is that section 2A-303 may place the judicial lien creditor in a better position than the Article 9 secured party. Suppose that the lease prohibits all transfers of the residual interest. A security interest in

261. But see supra note 199.
262. See supra note 15.
263. See U.C.C. § 2A-307(1). This general rule has a number of exceptions, none of which is relevant to the situation under discussion.
264. See U.C.C. § 2A-303(2).
265. See Boss, supra note 7, at 76.
266. One can resolve this problem by not requiring the transferee to cure defaults and assume the lease contract. See supra text accompanying and following notes 140-44.
the lessor's residual interest would be invalid under section 2A-303(1)(a). But because subsection (1)(a) covers only voluntary transfers, the judicial lien and foreclosure sale might be effective to convey the residual interest to the buyer.\textsuperscript{267} If, however, the lease contract contains a provision making the involuntary transfer of the lessor's residual interest an event of default, and if section 2A-303(1)(b) permits the lessee to enforce that provision against a lien creditor of the lessor, then the lien creditor will be in a position virtually identical to that of a secured party.

The discussions of security interests in the lessor's leasehold interest and of judicial liens in the lessor's residual interest make an examination of judicial liens on the lessor's leasehold interest unnecessary.

VI. CONCLUSION

Sections 2A-303 and 2A-307 generally provide useful rules for resolving competing claims to leased goods and to the rights of parties to a lease contract. In several instances, however, they fall short of the mark. The vast majority of shortcomings that this article has revealed will not present major impediments to lessors and lessees, to secured parties, or to judicial lien creditors. To some extent the sections are not as clearly written as they might be, but a gentle reading usually solves those problems. When the sections dictate a result that is not to the liking of the parties, usually they can contract around it. If enactment of Article 2A becomes widespread, the rules in Article 2A changing the results that obtain under Article 9 will become more widely known.

Some of the perceived shortcomings appear to result from a lack of sensitivity to the distinction between assignments of rights and delegations of duties. Others stem from a desire to treat lessors and lessees identically rather than to create gap-filling rules that mirror the likely contracts of the parties. Still others may derive from an overriding concern for unsecured creditors. If Article 2A is widely enacted, the coming years will afford the commercial community ample opportunity to evaluate these policy choices.

\textsuperscript{267} If the transfer did trigger section 2A-303(1)(b) and the transferee failed to comply with 2A-303(2), then the transfer would not be effective.