Perfecting Article 9: A Partial Prescription for the Next Revision

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The Joint Review Committee for Article 9 of the Uniform Commercial Code recently completed its two-year effort to revise Article 9. Both the American Law Institute and the Uniform Law Commission have approved the Joint Review Committee's proposed amendments and, save for some minor work on finalizing revisions to the official comments, the Joint Review Committee's work is done.

All those involved in the project deserve significant praise. In fact, the whole process might be regarded as a model for how legislation should be drafted. The sponsors formed a committee of about a dozen of the nation's leading experts on the subject and hired as reporter (*i.e.*, draftsman) the person who co-drafted the law to be revised. The Committee solicited input from all interested constituencies, listened attentively, but maintained throughout its fidelity to a legislative product that will work and achieve the interests of the sponsors, the bar, and the public. The Committee reviewed drafts in fine detail

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and labored over every sentence, to ensure that the amendments say what is intended and create no unintended consequences. In the end, the Committee reached a unanimous consensus on its proposed amendments, a consensus that all the interested constituencies appear willing to embrace. While the final test of success still lies in the future—when state legislatures either enact or refuse to enact the proposed revisions—it is difficult to conceive of way in which the project could have been handled better.

That said, it is worth remembering that the Joint Review Committee had a limited charge. It was to consider and draft amendments to deal with only those issues raised in the June 2008 report by its predecessor, the Article 9 Review Committee.[1] If the Joint Review Committee wished to take up any other matters, it needed to seek and obtain permission to do so from its sponsors.[2] In short, the Joint Review Committee was not tasked with a major rewrite of Article 9. Nor was it to revisit policies decided during the 1990s revision process. The Joint Review Committee was instead merely to deal with matters that had presented significant interpretive problems, particularly those that had arisen in practice, generated unfortunate judicial opinions, or led to non-uniform amendments.[3]

Because of this, the proposed amendments do not address a variety of errors and problems in existing law. The Joint Review Committee should not be faulted for this. Yet nor should these errors and problems be ignored. This article is intended to identify a few of these errors and problems, and thus serve as a partial agenda for the next drafting committee.[4] In discussing each of the six identified problems, this article endeavors to explain: (i) what the proper result is under current law; and (ii) how Article 9 should be revised to either change that result or remove any uncertainty. However, one must remain cognizant of the reality that no amount of drafting will remove all questions and ambiguities,[5] and some clarifications can raise more questions than they solve. Thus, whether the changes recommended here are truly warranted is a matter for the drafters during the next revision process to evaluate in the context of whatever other changes are desired. It may well be that a slimmer,

1. *See* Article 9 Review Comm., Statutory Modification Issues List (June 24, 2008), *available at* http://www.law.gonzaga.edu/Centers%20Programs/Files/clc/Study_group_report.pdf.

2. *See* Memorandum from Edwin E. Smith to Members of the Article 9 Joint Review Comm., Advisors and Observers 2 (Sept. 8, 2008) (on file with the author).

3. *See id.* at 1.

4. This article does not question major policy decisions or long-standing rules in Article 9. Thus, for example, it does not attack on the concept of perfection by possession as something antiquated and unnecessary. Such an attack will have to await another article.

5. *See* Bayless Manning, *Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385*, 36 TAX LAW. 9 (1982).

less complex Article 9 is a better way to approach these and other interpretive problems that may arise.

I. CLARIFY THE EFFECT OF PRE-FILING AS TO RECEIVABLES THAT ARE LATER SOLD

Does pre-filing as to accounts or other receivables work if the debtor then sells them before the pre-filer's security interest purports to attach? Consider the following scenario.

> Bank One, having authority to do so, files a financing statement against Debtor covering accounts. Debtor then sells to Bank Two certain specified accounts, and Bank Two promptly files a financing statement against Debtor covering the accounts sold. Debtor later purports to grant to Bank One a security interest (either pursuant to a sale or a secured borrowing), authenticating a security agreement at the time value is given. Which bank has priority?

Under the first-to-file-or-perfect rule of section 9-322(a)(1),[6] Bank One would seem to have priority. However, this rule applies only if Bank One actually has a security interest in the accounts. Because Debtor transferred all of its rights to the accounts to Bank Two before Debtor purported to grant a security interest to Bank One, Debtor had no rights remaining that Debtor could transfer to Bank One, and thus Bank One arguably has no security interest at all. In other words, under the principle of *nemo dat qui non habet*,[7] Bank One acquired no rights to the accounts previously sold to Bank Two. This argument is supported by section 9-318(a),[8] which states that upon sale of an account or other receivable, the debtor retains no legal or equitable interest in the property sold.

Alas, the issue and analysis is a bit more complicated. All section 9-318(a) says is that the debtor retains no *rights* in the collateral. However, for a security interest to attach, the debtor need have either *rights* in the collateral or the *power* to transfer rights in the collateral.[9] Does the debtor retain such a power? Well, if Bank Two's perfection later lapsed for some reason—as it

6. U.C.C. § 9-322(a)(1) (2008).

7. BLACK'S LAW DICTIONARY 1037 (6th ed. 1990) (one cannot give what one does not have).

8. U.C.C. § 9-318(a) (2008).

9. *See* U.C.C. § 9-203(b)(2) (2008). If Debtor does retain sufficient power to grant a security interest in receivables previously sold, the statement in section 9-318(a) would not be meaningless. The statement would merely indicate that, as between Debtor and Bank Two, Debtor retains no rights to the collateral sold.

might if Bank Two had perfected by filing and the financing statement later lapsed—then Bank Two's security interest would be deemed never to have been perfected as against a purchaser for value.[10] As a result, Bank One's security interest would then attach and, apparently, be deemed retroactively to have attached. This kind of springing security interest is quite strange and arguably suggests that Debtor does indeed have some power over the accounts sold to Bank Two, perhaps even enough for the first filer's security interest to attach, even before Bank Two filer loses perfection. If so, Bank One would have priority.

Moreover, there is at least one strong policy reason for treating Bank One's filing as effective and for having Bank One win the priority battle: it avoids the need to distinguish a sale from a secured borrowing. There is no doubt that if Bank Two's security interest arises in connection with a loan secured by receivables—in contradistinction to a sale of receivables—then Debtor would retain some rights to the receivables, Bank One's security interest would attach, and Bank One's security interest would have priority over Bank Two's security interest as the first to file or perfect. If, however, Bank Two wins the priority battle if its security interest arises from a sale of receivables, then it becomes important to determine whether Bank Two's transaction with Debtor was a sale or a collateralized borrowing. That can be extremely difficult. Indeed, the difficulty in making that distinction is one reason Article 9 applies to sales of receivables.[11]

Giving priority to Bank One probably also facilitates secured transactions. Bank Two can protect itself by doing a search; something it should do anyway to check for prior perfected lenders (as opposed to merely pre-filers).[12] Upon discovering Bank One's filing, Bank Two can insist on a subordination agreement or termination statement. In other words, giving priority to Bank One probably places no new significant burden on Bank Two. If the law were to give priority to Bank Two, Bank One could protect itself by doing a search before each subsequent transaction, but that would be far more cumbersome and is precisely what Article 9's express authorization to pre-file is intended to make unnecessary.[13]

Still, there is substantial uncertainty about what the result is under current law. The issue can divide a room of Article 9 junkies and periodically

10. *See* U.C.C. § 9-515(c) (2008).

11. *See* U.C.C. § 9-109 cmt. 4 (2008).

12. Buyers of instruments and chattel paper may not need to search if they will be taking possession and therefore qualify for priority under section 9-330 or section 9-331. *See* U.C.C. §§ 9-330, 9-331 (2008). *But cf. id.* §§ 9-330 cmt. 6, 9-331 cmt. 5 (describing situations in which a search may be required for the secured party to be acting in good faith).

13. *See* U.C.C. § 9-502(d) (2008).

generates a good deal of discussion on listservs. During the recent revision process, the Joint Review Committee originally decided to address this matter by comment,[14] drafted a comment to make it clear that Bank One wins,[15] but then later abandoned any effort to deal with the issue.[16]

The next revision should resolve this issue. It may well be that having a definitive resolution to this priority question is more important than what the resolution is. Nevertheless, the better result would appear to be priority for Bank One. The following proposed statutory amendment is offered as one possible way to reach this result.

§ 9-318. NO INTEREST RETAINED IN RIGHT TO PAYMENT THAT IS SOLD; RIGHTS AND TITLE OF SELLER OF ACCOUNT OR CHATTEL PAPER WITH RESPECT TO CREDITORS AND PURCHASERS.

(a) **Seller retains no interest.** A debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold <u>but does retain the power to transfer a security interest in the account, chattel paper, payment intangible, or promissory note to a person who, before the sale, filed a financing statement identifying the seller as debtor and identifying as collateral the account, chattel paper, payment intangible, or promissory note</u>.

* * *

II. APPLICATION OF THE DOUBLE-DEBTOR PRIORITY RULE TO PROCEEDS OF COLLATERAL

The general rule governing priority among perfected security interests is in section 9-322(a)(1): the first to file or perfect has priority.[17] One of the numerous exceptions to this rule is in section 9-325.[18] This section deals with the "double-debtor problem":[19] security interest in the same item of collateral

14. *See* Stephen L. Sepinuck, Joint Article 9 Review Committee Meeting Notes for February 6-8, 2009, at 26-27, *available at* http://www.law.gonzaga.edu/Centers%20Programs/Files/clc/joint_review/Joint_Review_Committee_Notes_Feb_2009.pdf.

15. *See* Stephen L. Sepinuck, Joint Article 9 Review Committee Meeting Notes for March 6-8, 2009, at 25-26, *available at* http://www.law.gonzaga.edu/Centers%20Programs/Files/clc/joint_review/Joint_Review_Committee_Meeting_Note_2009-03.pdf.

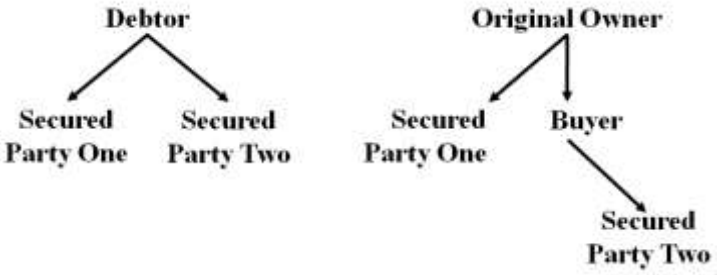
16. *See* Stephen L. Sepinuck, Joint Article 9 Review Committee Meeting Notes for September 25-26, 2009, at 3, *available at* http://www.law.gonzaga.edu/Centers%20Programs/Files/clc/Meeting_Notes_2009-09.pdf.

17. U.C.C. § 9-322(a)(1) (2008).

18. *See* U.C.C. § 9-325 (2008).

19. *See* U.C.C. § 9-325 cmt. 2 (2008).

granted by two different people in the chain of title. A simple graphic can help illustrate the issue. In most priority disputes among secured parties, the two creditors obtained their interest in the collateral from the same debtor (the diagram on the left). In the double-debtor problem (the diagram on the right), one secured party obtains a security interest from the original owner, who then sells the collateral to a buyer. The buyer takes subject to the security interest.[20] The buyer then grants a security interest to a second secured party, either in connection with a new transaction or pursuant to an after-acquired property clause in an existing security agreement.



Priority in the first situation is governed by the first-to-file-or-perfect rule of section 9-322(a)(1). If that rule were to govern the double-debtor situation, anomalous results would be reached in some cases. Consider the following scenario.

> First Bank has a security interest in an item of equipment in Owner's possession. First Bank perfected its security interest by filing a financing statement against Owner in the proper office on June 1. Months later, Owner sells that piece of equipment to Buyer, who is located in the same jurisdictions as Owner. The piece of equipment is still subject to First Bank's properly perfected security interest.[21] Prior to the sale, Buyer granted Second Bank a security interest in all of Buyer's existing and after-acquired equipment. Second Bank filed a proper financing statement against Buyer on April 1. When Buyer acquired the piece of equipment, Second Bank's security interest attached to the piece of equipment and that security interest was perfected by Second Bank's financing statement already on file. Even

20. Although in some circumstances the buyer will take free of the security interest, *see, e.g.*, U.C.C. §§ 9-317(b), (d), 9-320, 9-331, 9-337(1), 9-338(2) (2008), the general rule of Article 9 is that a buyer takes subject to a perfected security interest. *See id.* §§ 9-201(a), 9-315(a)(1).

21. *See* U.C.C. §§ 9-315(a)(1), 9-507(a) (2008).

> though First Bank's security interest in the item of equipment both attached and was perfected before Second Bank's security interest in that item, Second Bank's security interest would have priority because Second Bank filed before First Bank either filed or perfected.

Application of the first-to-file-or-perfect rule in this scenario would violate one of the fundamental principles underlying Article 9: that a person may transfer only those rights in property that a person has.[22] In other words, if Buyer takes subject to First Bank's security interest, then Second Bank, whose property rights are derived from Buyer, should also take subject to First Bank's security interest. Moreover, there would be no way for First Bank to guard against this risk if the first-to-file-or-perfect rule applied. Even if First Bank carefully searched for filings and conducted a physical inspection of the equipment to ensure no creditor was perfected first, it could not discover this problem in advance. After all, there is no way for First Bank to know in advance who the buyer will be. Put another way, the problem is not in establishing priority initially, the problem is that such priority, even if established, would be lost.

Section 9-325 deals with this through an exception to the first-to-file-or-perfect rule.[23] Unfortunately, nothing in the text of the rule makes it applicable to proceeds of the collateral. Other priority rules in Article 9 do expressly cover all or some types of proceeds.[24] The implication of this—that some Article 9 priority rules expressly cover proceeds but section 9-325 does not—is that the double-debtor priority rule does not in fact extend to proceeds of the collateral.[25] As a result, if the Buyer in the hypothetical above were to sell the piece of equipment for cash or were to trade the piece of equipment for a different item of equipment, Second Bank would have priority in the proceeds even though First Bank had priority in the original item.[26]

This result is not appropriate. All of the policies underlying section 9-325 and which justify a departure from the first-to-file-or-perfect rule apply in full force to proceeds of the original collateral. The current inapplicability of

22. *See supra* note 7 and accompanying text.

23. *See* U.C.C. § 9-322(f)(1) (2008) (indicating that the priority rules in subsection (a) are subject to the other provisions of Part 3 of Article 9).

24. *See* U.C.C. §§ 9-324(a), (b), 9-330(c), 9-322(c) (2008).

25. This implication is acknowledged in at least one other area. The priority rule of section 9-327, which deals with conflicting security interests in deposit accounts, does not expressly cover proceeds and the comments make clear that the rule in fact does not cover proceeds. *See* U.C.C. § 9-327 cmt. 5 (2008).

26. Because both security interests in the proceeds would be perfected, *see* U.C.C. § 9-315(c), (d) (2008), Second Bank would have priority because it filed before First Bank filed or perfected. *Id.* § 9-322(a)(1).

section 9-325 to proceeds is quite possibly a product of a minor oversight in drafting. The following amendment should be adequate to correct this.

§ 9-325. **PRIORITY OF SECURITY INTERESTS IN TRANSFERRED COLLATERAL.**

(a) **Subordination of security interest in transferred collateral.** Except as otherwise provided in subsection (b), a security interest created by a debtor is subordinate to a security interest in the same collateral, or its proceeds, created by another person if:

(1) the debtor acquired the collateral subject to the security interest created by the other person;

(2) the security interest created by the other person was perfected when the debtor acquired the collateral; and

(3) there is no period thereafter when the security interest is unperfected.

* * *

III. APPLICATION OF THE PRIORITY RULE IN § 9-336(f) TO PROCEEDS OF COMMINGLED GOODS

A similar issue lurks in section 9-336. That provision deals with commingled goods: goods physically united with other goods in such a way that their identity is lost.[27] The classic illustration of commingling is the combining of flour and eggs to make cakes.[28] Article 9 provides that a security interest in goods that are later commingled automatically attaches to the resulting product or mass.[29] In other words, a security interest in the flour (or in the eggs) would automatically become a security interest in the cakes. Article 9 also provides that if a security interest in an input is perfected, the resulting security interest in the product or mass is also perfected.[30]

The priority rules for commingled goods are somewhat complicated and vary depending on whether both security interests are claimed in the product or mass because of the commingling (*i.e.*, as a result of a security interest in one or more inputs that were commingled) or whether one or both security interests arise from the fact that the product or mass falls within the description of

27. *See* U.C.C. § 9-336(a) (2008); *cf. id.* § 9-102(a)(1) (defining "accessions" to mean "goods that are physically united with other goods in such a manner that the identity of the original goods is *not* lost") (emphasis added).

28. *See* U.C.C. § 9-336 cmts. 4, 5, 6 (2008).

29. U.C.C. § 9-336(c) (2008).

30. U.C.C. § 9-336(d) (2008).

collateral in the security agreement.[31] Our concern here is only with the former.

Article 9 provides that if two or more conflicting perfected security interests in commingled goods result from a security interest in one or more of the inputs, then they rank equally in proportion to the value of the inputs at the time the inputs were commingled.[32] Thus, if Secured Party One has a perfected security in flour worth $600, Secured Party Two has a perfected security interest in eggs worth $400, and the debtor commingles the flour and eggs to make cakes, the two security interests in the cakes rank equally and Secured Party One would be entitled to sixty percent of the value of the cakes and Secured Party Two would be entitled to the remaining forty percent.[33]

This rule makes perfect sense. Unfortunately, as currently phrased, the rule applies only to the product or mass itself, not to any proceeds of the product or mass.[34] In other words, if the debtor sold the cakes for cash or an account, the priority of the security interests of Secured Party One and Secured Party Two in those identifiable proceeds would apparently be determined under the first-to-file-or-perfect rule. The two security interests will have become perfected *in the proceeds* simultaneously—when the debtor sold the cake in exchange for the proceeds[35]—and so priority in the cash or account will be determined based on which secured party filed first. Such a rule is arbitrary in the sense that it is not one either secured party can easily guard against. Moreover, the policies for according the secured parties equal priority in the commingled goods, shared in proportion to the value of the inputs, also apply to the proceeds.

A reasonable argument can be made that the rule of shared priority does apply to proceeds in spite of the lack of a reference to "proceeds" in section 9-336. After all, if the priority rule applied only to the product or mass itself, it

31. *See* U.C.C. § 9-336(e), (f) (2008).

32. U.C.C. § 9-336(f)(2) (2008).

33. *See* U.C.C. § 9-336 cmt. 4, ex. 1 (2008).

34. *See supra* notes 24-25 and accompanying text, identifying other priority rules in Article 9 that expressly apply to proceeds, in contradistinction to those that do not so expressly provide.

35. Both security interests will attach to the identifiable proceeds as soon as the debtor acquires rights in the proceeds. *See* U.C.C. § 9-315(a)(2) (2008) (security interest attaches to identifiable proceeds). *See also id.* § 9-203 cmt. 2 (security interest attaches when the last of the three requirements—authenticated security agreement, value, and rights in the collateral—is satisfied). The security interests will be perfected upon attachment. *See id.* § 9-315(c), (d)(1), (2).

Although not relevant to the analysis, the two security interests *in the cakes* would also have been perfected simultaneously: upon attachment when the debtor commingled the flour and eggs to make the cakes. That is because perfection occurs automatically under section 9-336(d).

would be a remarkably narrow rule. As soon as either secured party exercised its rights to foreclose by conducting a disposition of the product or mass, the rule would no longer apply. Instead, the proceeds of the disposition, which are proceeds of the collateral, would be governed by some other priority rule. Thus, the rule of shared priority would apply only if the secured parties divvied up the product or mass itself or the debtor went into bankruptcy and for one reason or another the priorities were fixed as of the petition date.

Moreover, the comments support, somewhat obliquely, application of the rule to proceeds. The examples in the comments refer to what the secured parties will collect from the product or mass,[36] the dollar amount they would be entitled to,[37] and the amount in dollars they would receive.[38] If the priority rule extended only to the product or mass of goods, the comments would refer to the proportion of the product or mass to which the parties were entitled, not an amount of money or collections.

Nevertheless, given the uncertainty on this point, a statutory clarification would be appropriate. Such a clarification should make clear that priority in the proceeds could be affected by other things, such as holder-in-due-course status or control of a deposit account.[39] In other words, the shared priority rule of section 9-336(f) should trump the first-to-file-or-perfect rule of section 9-322(a)(1), but not the other rules in Part 3 of Article 9 that determine priority. It should not even trump the perfected-beats-unperfected rule of section 9-322(a)(2). The following change to the text should accomplish this goal.

§ 9-336. COMMINGLED GOODS.

* * *

(f) **Conflicting security interests in product or mass** If more than one security interest attaches to the product or mass under subsection (c), the following rules determine priority:

> (1) A security interest that is perfected under subsection (d) has priority over a security interest that is unperfected at the time the collateral becomes commingled goods.

36. *See* U.C.C. § 9-336 cmt. 4, ex. 2 (2008).

37. *See* U.C.C. § 9-336 cmt. 4, ex. 1, cmt. 6, ex. 5 (2008).

38. *See* U.C.C. § 9-336 cmt. 4, ex. 3, cmt. 6, ex. 5 (2008).

39. *See* U.C.C. § 9-331, 9-327 (2008); *see also id.* § 9-322(c) (identifying sections 9-327 through 9-331 as rules which trump the rules otherwise applicable to proceeds).

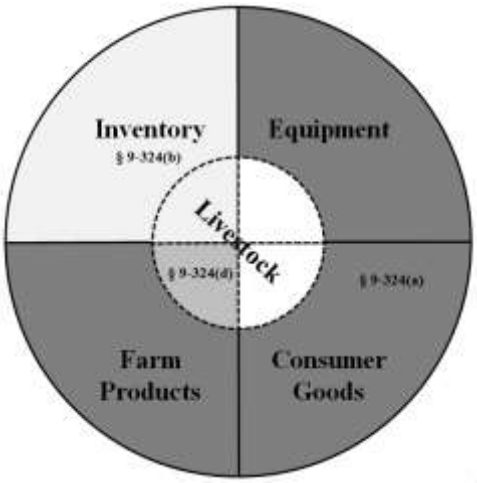
(2) If more than one security interest is perfected under subsection (d), the security interests rank equally in proportion to the value of the collateral at the time it became commingled goods.
(3) Except as otherwise provided in Section 9-322(a)(2), 9-327, 9-328, 9-329, 9-330, or 9-331, if two or more security interests rank equally in the product or mass under paragraph (2), the security interests rank equally in proceeds of the product or mass.

IV. PROVIDE FOR PMSI PRIORITY IN LIVESTOCK HELD AS EQUIPMENT OR CONSUMER GOODS

Article 9 gives special treatment to many purchase-money security interests. A purchase-money security interest ("PMSI") is a security interest in goods or software that secures either all or part of the price of the collateral or value given to enable the debtor to acquire the collateral.[40] The special treatment consists of automatic perfection if the collateral is consumer goods,[41] a twenty-day relation-back rule for perfection of a PMSI in other collateral,[42] and a heightened priority.[43] Unfortunately, there is a minor drafting glitch in section 9-324, which provides for the heightened priority.

Section 9-324 contains several, slightly different priority rules for PMSIs, each depending on the classification of the goods. Subsection (a) covers goods other than inventory and livestock. Because there are four mutually exclusive subcategories of goods—consumer goods, equipment, farm products, and inventory[44]—subsection (a) therefore applies to all farm products, equipment, and consumer goods that are not livestock. Subsection (b) covers inventory. Subsection (d) covers livestock that are farm products.[45] As the following diagram illustrates, that leaves a small omission from coverage (the unshaded areas): livestock that are not inventory or farm products.

40. U.C.C. § 9-103(a), (b) (2008).
41. *See* U.C.C. § 9-309(1) (2008).
42. *See* U.C.C. § 9-317(e) (2008).
43. *See* U.C.C. § 9-324 (2008).
44. *See* U.C.C. § 9-102(a)(23), (33), (34), (48) (2008); *see also id.* § 9-102 cmt. 4.
45. *See generally* U.C.C. § 9-324 (2008).



In other words, subsection (a) excludes all livestock but subsections (b) and (d) pick up only livestock that are farm products or inventory. A PMSI in livestock constituting consumer goods or equipment is not covered by any special priority rule. Thus, it is not possible, apparently, to get PMSI priority in a race horse, a show horse, circus animals, service animals, or pets.

There is no good reason for this gap in coverage. In fact, the official comments suggest that the gap was unintended by indicating that livestock that are not inventory or farm products are covered by subsection (a).[46] Alas, it would be difficult for a court to follow the comment when the text of the code itself is so clear. Therefore a minor amendment is in order. The following should do the trick.

§ 9-324. PRIORITY OF PURCHASE-MONEY SECURITY INTERESTS.
(a) **General rule: purchase-money priority.** Except as otherwise provided in subsection (g), a perfected purchase-money security interest in goods other than inventory or livestock that are farm products has priority over a conflicting security interest in the same goods, and, except as otherwise provided in Section 9-327, a perfected security interest in its identifiable proceeds also has priority, if the purchase-money security interest is perfected when the debtor receives possession of the collateral or within 20 days thereafter.

* * *

46. *See* U.C.C.§ 9-324 cmt. 3 (2008) (stating that subsection (a) applies to "all types of goods except inventory and farm-products livestock").

V. APPLY THE DUTY TO COLLECT IN A COMMERCIALLY REASONABLE MANNER TO A NON-RECOURSE SALE OF RECEIVABLES

Article 9 provides three main ways in which a secured party may, without judicial assistance, enforce its security interest against the collateral: disposition, acceptance, and collection.[47] A disposition is a sale, lease license or other transfer of the collateral,[48] and includes what most people think of as a foreclosure sale. Acceptance occurs when the secured party simply keeps the collateral in full or partial satisfaction of the secured obligation.[49] Collection is when the secured party obtains payment on the collateral from a personal obligation thereon.[50] In other words, collection is that act of enforcing a collateralized monetary obligation owed *to* the debtor, such as an account, instrument, chattel paper, or payment intangible.

Article 9 provides no set of instructions on how to conduct a disposition. Unlike a judicial foreclosure of real estate, which must normally be conducted pursuant to a procedure specified by statute, the method and manner of Article 9 dispositions is as varied as the types of collateral. Instead of a specified procedure and judicial oversight, Article 9 imposes a single, somewhat vague, standard: every aspect of the disposition must be "commercial reasonable."[51] This rule protects the debtor, obligors, and junior lienors.[52] If a secured party's disposition is not commercially reasonable, and the proceeds of the disposition are less than what the proceeds of a complying disposition would have been, an obligor liable for a deficiency can have the deficiency reduced.[53] Alternatively, a debtor or lien holder denied some, or all of a surplus, can be recompensed therefore. Because of its impact on the right to a deficiency or surplus, there is extensive litigation about the requirement that dispositions be commercially reasonable.[54]

47. *See* U.C.C. § 9-626 (a)(1) (2008) (referring to the rules "relating to collection, enforcement, disposition, or acceptance"). "Enforcement" probably includes repossession, *see id.* § 9-609, which does no act directly to extract value from the collateral. "Enforcement" is also used in conjunctively with the term "collection," *see id.* § 9-607, but for simplicity this article refers to collection as a separate right.

48. *See* U.C.C. § 9-610(a) (2008).

49. *See* U.C.C. § 9-620 (2008).

50. *See* U.C.C. § 9-607 (2008).

51. U.C.C. § 9-610(b) (2008).

52. *See* U.C.C. § 9-625(c)(1) (2008) (providing that the debtor, an obligor, and other lien holders may recover damages for the secured party's failure to comply with Part 6 of Article 9).

53. Indeed, after a noncomplying disposition, there is often a rebuttable presumption that no deficiency is owing. *See* U.C.C.§ 9-626 cmt. 3 (2008).

54. For cases just within the last two calendar years, see *Aviation Finance Group*,

In contrast, there is no requirement that an acceptance be commercially reasonable. This is because acceptance requires the consent of the debtor and lack of objection from anyone else who could be impacted by it.[55] Acceptance is, however, subject to the general obligation of good faith, which in the context of Article 9 requires exercise of reasonable commercial standards of fair dealing.[56] This requirement of fair dealing is apparently a lesser standard than commercial reasonableness and focuses almost exclusively on the substance of the transaction rather than its process.[57]

With respect to collection, Article 9 is a bit schizophrenic: for some secured transactions it requires that the secured party act in a commercially reasonable manner and for others it does not. Specifically, section 9-607(c) requires that the secured party act in a commercially reasonable manner only if

LLC v. Duc Housing Partners, Inc., No. CV 08-535-LMB, 2010 WL 1576841 (D. Idaho Apr. 20, 2010); *SFG Commercial Aircraft Leasing, Inc. v. N59CC, LLC*, No. 3:09 CV 101 PPS, 2010 WL 883764 (N.D. Ind. Mar. 8, 2010); *Commercial Credit Group, Inc. v. Falcon Equipment, LLC of Jax*, No. 3:09cv376-DSC, 2010 WL 144101 (W.D. N.C. Jan. 8, 2010); *Financial Federal Credit, Inc. v. Wills*, No. 8:08CV184, 2009 WL 4045136 (D. Neb. Nov. 20, 2009); *Lyon Financial Services, Inc. v. Oxford Maxillofacial Surgery, Inc.*, No. 08-5498, 2009 WL 2170999 (D. Minn. July 17, 2009); *Bremer Bank, National Ass'n v. John Hancock Life Insurance Co.*, No. 06-1534, 2009 WL 702009 (D. Minn. Mar. 13, 2009); *Atchley v. Pepperidge Farm, Inc.*, No. CV-04-0452-FVS, 2009 WL 672986 (E.D. Wash. Mar. 12, 2009); *Textron Financial Corp. v. Lentine Marine Inc.*, 630 F. Supp. 2d 1352 (S.D. Fla. 2009); *Financial Federal Credit, Inc. v. Walter B. Scott & Sons, Inc.* (*In re Walter B. Scott & Sons, Inc.*), 436 B.R. 582 (Bankr. D. Idaho 2010); Arizona Business Bank v. Leveton, No. 1 CA-CV 09-0390, 2010 WL 1998149 (Ariz. Ct. App. May 18, 2010); *USA Financial Services, LLC v. Young's Funeral Home, Inc.*, No. U607-11-102, 2010 WL 3002063 (Del. Crt. Com. Pl. June 24, 2010); *Hicklin v. Onyx Acceptance Corp.*, 970 A.2d 244 (Del. 2009); *Versey v. Citizens Trust Bank*, No. A10A2013, 2010 WL 4009662 (Ga. Ct. App. Oct. 14, 2010); *John Deere Construction & Forestry Co. v. Mark Merritt Construction, Inc.*, 678 S.E.2d 183 (Ga. Ct. App. 2009); *Okefenokee Aircraft, Inc. v. Primesouth Bank*, 676 S.E.2d 394 (Ga. Ct. App. 2009); *Grayson v. Union Federal Savings & Loan Ass'n of Crawfordsville*, 928 N.E.2d 652 (Ind. Ct. App. 2010); *Moore v. Wells Fargo Construction*, 907 N.E.2d 1038 (Ind. Ct. App. 2009); *Wells Fargo Business Credit v. Environamics Corp.*, 934 N.E.2d 283 (Mass. App. Ct. 2010); *Commercial Credit Group, Inc. v. Barber*, 682 S.E.2d 760 (N.C. Ct. App. 2009); *Regions Bank v. Trailer Source*, No. M2008-01167-COA-R3-CV, 2010 WL 2074590 (Tenn. Ct. App. May 21, 2010); *Regal Finance Co. v. Tex Star Motors, Inc.*, No 08-0148, 2010 WL 3277132 (Tex. 2010); *Wallander v. Texoma Community Credit Union*, No. 2-08-457-CV, 2009 WL 1650110 (Tex. Ct. App. June 11, 2009).

55. *See* U.C.C. § 9-620(a)(1)-(2) (2008). The debtor's consent to acceptance in full satisfaction of the debt can be manifested by the debtor's failure to object within twenty days after the secured party's proposal was sent. *Id.* § 9-620(c)(2).

56. *See* U.C.C. §§ 1-201(b)(20), 1-304 (2008); *id.* §§ 9-102(a)(43), 9-620 cmt. 11.

57. Process might matter under the standard of good faith if, for example, the secured party purposefully sent its proposal to the debtor when the debtor was out of the country and would not receive the proposal in time to object.

the secured party will have recourse against the debtor or a secondary obligor for any uncollected collateral.[58]

There are two interrelated reasons for this limitation. First, Article 9 applies both to the use of receivables to secure an obligation,[59] and to the sale of most receivables.[60] In the former transaction, the debtor will typically remain, after collection, liable for a deficiency and entitled to a surplus. In the latter transaction, the debtor will not be liable for a deficiency or entitled to a surplus. Second, the drafters apparently viewed the duty to collect in a commercially reasonable manner in a fairly narrow way. They saw it as something affecting a secured party's right to settle with the account debtor or instrument obligor.[61] For example, if an account debtor raised a spurious defense to payment, a secured party might not be acting in a commercially reasonably manner if the secured party settled a $100,000 account for $100. Of course, if neither the debtor nor any obligor had liability for a deficiency or the right to any surplus, then the secured party's unreasonable settlement could not possibly hurt them. Hence the limitation on the duty to act in a commercially reasonable manner when collecting.

Unfortunately, the drafters seem to have overlooked another way in which the secured party's collection activities could injure the debtor. If a secured party violates the Fair Debt Collection Practices Act,[62] a state-law analog, or otherwise harasses an account debtor, the account debtor might not understand that the secured party is not acting on the debtor's behalf or may regard the debtor as responsible in any event. The account debtor may then cease doing business with the debtor and may influence other commercial parties to also sever ties with the debtor. This could significantly hurt the debtor's business.[63] The obligation to act in a commercially reasonable manner when collecting collateral should apply to and prohibit such actions by the secured party. Indeed, a strong argument can be made that it already does. However, under

58. *See* U.C.C. § 9-607(c) (2008).

59. *See* U.C.C. § 9-109(a)(1) (2008). *But cf. id.* § 9-109(d)(3), (5), (6), (7).

60. *See* U.C.C. § 9-109(a)(3) (2008). *But cf. id.* § 9-109(d)(4).

61. *See* U.C.C. § 9-607 cmt. 9 (2008); *see also id.* § 9-607(a)(3) (giving secured parties the right to "exercise the rights of the debtor" with respect to the obligation of the account debtor or instrument obligor); *id.* § 9-404(a) (detailing the defenses available to an account debtor).

62. 15 U.S.C. §§ 1692-1692p (2006).

63. A debtor who has defaulted on a secured obligation may not have much of a business left, but the law should not be built upon such an certain assumption. More to the point, when the debtor sells receivables outright, the agreement expressly or implicitly allows the secured party to collect the receivables even when there is no default. *See* U.C.C. § 9-607(a) & cmt. 4 (2008). In such a case, the debtor's business may be thriving and could be seriously injured by the secured party's collection tactics.

current law the obligation is limited to collection activity in connection with a secured transaction for which the debtor or a secondary obligor remains liable for a deficiency. Such a limitation makes no sense.

In short, limiting the obligation to act in a commercially reasonable manner when collecting makes sense if the duty refers only to settling claims and compromising receivables. If, however, the duty encompasses more, such as not undermining the debtor's business reputation though illegal or unreasonable collection activity, then the duty should apply regardless of whether the debtor or a secondary obligor remains liable for a deficiency.

One might claim that tort law could deal adequately with harm to the debtor's business reputation. The trouble with relying on tort law, though, is that section 9-607(c) seems to negate the existence of a duty. Accordingly, a change to section 9-607(c) is in order. The simplest and easiest change would be to simply remove the language limiting when the duty arises:

§ 9-607. COLLECTION AND ENFORCEMENT BY SECURED PARTY.

* * *

(c) **Commercially reasonable collection and enforcement.** A secured party shall proceed in a commercially reasonable manner if the secured party~~:~~

~~(1)~~ undertakes to collect from or enforce an obligation of an account debtor or other person obligated on collateral~~; and~~

~~(2) is entitled to charge back uncollected collateral or otherwise to full or limited recourse against the debtor or a secondary obligor~~.

* * *

This change would not make the duty too broad. While it would suggest that the secured party who purchased receivables without recourse could be held accountable for settling an account for a commercially unreasonable amount, neither the debtor nor a secondary obligor could suffer any damage from the unreasonable settlement if the purchase were an outright sale of the receivables, and thus the debtor would have no cause of action. The debtor or a junior lienor could be injured if the transaction were a nonrecourse loan, but that is actually further reason for expanding the scope of the duty to act in a commercially reasonable manner when collecting. Consider the following scenario.

> Factor One acquires a security interest in Debtor's accounts in return for a $500,000 non-recourse loan. If Factor One collects more than the loan balance plus interest from the account debtors, Factor One must remit the surplus to Debtor. If Factor One collects less than the full secured obligation, neither Debtor nor anyone else is liable for a deficiency. Factor One perfects by filing a proper financing statement.

> Shortly thereafter, Factor Two acquires and perfects a security interest in Debtor's accounts. At a time when the secured obligation owed to Factor One is only $10,000, Factor One unreasonably settles a $100,000 account for $10,000.

Under current law, Factor One has no duty to act in a commercially reasonable manner when collecting. As a result, neither Debtor nor Factor Two has any claim against Factor One even though both were injured by Factor One's unreasonable actions.[64] The change proposed above to section 9-607(c) would rectify this and close what should be regarded as a loophole in the law.

VI. REMOVE THE LIMITATIONS IN § 9-102(a)(64)(D) AND (E) RELATING TO THE VALUE OF THE ORIGINAL COLLATERAL

A security interest governed by Article 9 automatically extends to identifiable proceeds of the collateral.[65] This rule protects the secured party by providing an alternative source of recovery if the original collateral is sold to a buyer who takes free of the security interest.[66] It similarly protects the secured party if the original collateral is a receivable that the debtor collects in full, and hence the receivable itself no longer exists.[67] However, the rule is not limited to situations in which the security interest in the original collateral is lost. The security interest will attach to identifiable proceeds even if the security interest in the original collateral survives the event that gives rise to the proceeds.[68] In such a situation, the value of the collateral—now consisting of the original collateral and the proceeds—may double. Of course this does not create a windfall for the secured party, because the secured party is entitled to only one satisfaction of the secured obligation. In other words, the likelihood that the secured obligation will be satisfied may rise, but the secured party will not recover more than the debt actually owed.

64. *See* Teri Dobbins Baxter, *Secured Party's Liability for Collection or Enforcement of Account Debtor's Obligation When Secured Party Has No Right of Recourse Against the Debtor*, 63 CONSUMER FIN. L. Q. REP. 225 (2009) (noting that the debtor can be harmed by the secured party's commercially unreasonable settlement of a receivable securing a nonrecourse loan).

65. U.C.C. § 9-315(a)(2) (2008); *see also id.* § 9-203(f).

66. *See* U.C.C. § 9-102(a)(64)(A) (2008) (defining "proceeds" to include whatever is received upon a sale or disposition of collateral); *see also id.* §§ 9-317(b), 9-320, 9-330, 9-331 (providing ways in which a buyer of collateral may take free of a security interest).

67. *See* U.C.C. § 9-102(a)(64)(B) (2008) (defining "proceeds" to include collections on collateral).

68. *See* U.C.C. § 9-315(a)(1)-(2) (2008) (providing that the security interest generally continues in collateral notwithstanding its sale and extends to identifiable proceeds).

The definition of proceeds in section 9-102(a)(64) is quite broad, and purposefully so.[69] It covers whatever is received upon the sale, lease, license, exchange or other disposition of the collateral. It also includes amounts collected or distributed on the collateral and rights arising out of the collateral.[70] Proceeds further includes insurance payable by reason of loss of or damage to the collateral,[71] and tort or contract claims arising out of loss of, defects in, nonconformity of, or damage to the collateral.[72] Unfortunately, each of these last two components is limited by the value of the original collateral. This limitation is unnecessary and unduly restrictive. It also raises a factual inquiry about something that may be extremely difficult to determine.

The limitation on insurance and other claims as proceeds is apparently intended to avoid treating as proceeds of collateral the portion of a claim that is really attributable to something else. Consider the following two examples.

> Manufacturer has granted Lender a security interest in certain equipment. Manufacturer has casualty insurance that provides protection against damage to property and associated loss of business. A casualty occurs and the equipment is destroyed. The casualty causes Manufacturer to lose a substantial amount of business. As a result, Manufacturer has a claim against the insurer for both the destruction of the collateralized equipment and the loss of business. The claim for destruction of the equipment is proceeds of the equipment; the claim for business losses is not.
>
> Individual granted Bank a security interest in Individual's car. Individual is injured in an accident in which the car is heavily damaged. The portion of any insurance claim or tort claim attributable to the damage to the car is proceeds of the car. The portion of any claim for damages for Individual's pain and suffering is not proceeds of the car.

All this makes perfect sense. However, the limitation need not be expressed in reference to the value of the original collateral. It could just as easily be expressed in terms of what the claim is for. A limitation expressed is such a manner would produce the same result.

Now consider another scenario.

> Printer has granted Lender a security interest in certain equipment. Printer has casualty insurance that provides for coverage for up to the

69. *See* U.C.C. § 9-102 cmt. 13 (2008) (indicating that revised Article 9 expanded the definition of "proceeds").

70. *See* U.C.C. § 9-102(a)(64)(B)-(C) (2008).

71. *See* U.C.C. § 9-102(a)(64)(E) (2008).

72. *See* U.C.C. § 9-102(a)(64)(D) (2008).

> replacement cost of the equipment. The equipment is destroyed in a covered casualty with the result that Printer has a claim against the insurer for $100,000, the amount needed to replace the destroyed equipment. Under section 9-102(a)(64)(E), the amount of the claim that constitutes proceeds of the equipment is limited to the value of the equipment prior to its destruction.

There is no good reason for the limitation to apply in this case. Unlike in the earlier scenarios, all of the insurance claims in this last scenario are attributable to the loss of the collateralized equipment. Therefore, the entire insurance claim should be proceeds. If Printer had sold the equipment for more than its real value, the whole amount paid or due from the buyer would be proceeds. The insurance claim should be treated similarly. In neither case is there any windfall to the secured party. After all, if the security interest attaches to proceeds that exceed the value of the original collateral, the secured party remains entitled to collect no more than the amount of the secured obligation.

Moreover, the limitation in current law requires the secured party to prove a fact that may be impossible to determine. Because the collateral has been destroyed, it may be difficult or impossible to appraise what it was worth before the casualty. Yet the secured party's claim to the proceeds is limited to that earlier, unknown value. In short, by providing for coverage up to the cost of replacement, the insurance contract made it unnecessary to determine the value of the property destroyed, yet Article 9 now comes in and demands that information. This is contrary to the Code's stated policy of facilitating commercial practices.[73]

There are at least two more problems with the value limitation in section 9-102(a)(64)(D) and (E). First, the limitation implies that a secured party never has the right to prosecute, directly, a claim against the tortfeasor or insurer.[74] While insurance law may have something to say about whether a secured party is a proper plaintiff, there is no reason for Article 9 to speak to this issue, let alone to prevent the secured party from having such a right. Second, the limitation would be extremely difficult to draft around in the security agreement. Certainly the security agreement could define the collateral to include all insurance claims for loss of or damage to the collateral, irrespective of the value of the collateral involved. However, that might not solve the problem. Article 9 applies to a security interest in insurance claims only if, and

73. *See* U.C.C. § 1-103(a)(2) (2008).

74. *See* City Sanitation, LLC v. Burdick (*In re* Am. Cartage, Inc.), 438 B.R. 1, 13 (D. Mass. 2010).

to the extent that, the claim is proceeds of other collateral.[75] Thus, to the extent the insurance claim is not proceeds, Article 9 does not govern the security interest. One must then look to other law to determine how to acquire, perfect, and enforce the security interest. In all likelihood, the secured party would have to get the insurer's consent, something Article 9 otherwise makes unnecessary. Moreover, priority and enforcement issues could get rather messy, with Article 9 governing the parties' rights to some portion of the insurance claim and other law governing the remainder.

Given all this, "proceeds" should be re-defined to eliminate the value limitation. The following amendments do this while also ensuring that the term will not include claims for other damage or injury.

§ 9-102. DEFINITIONS AND INDEX OF DEFINITIONS.

(a) **Article 9 definitions.** In this article:

* * *

(64) "Proceeds", except as used in Section 9-609(b), means the following property:

(A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;

(B) whatever is collected on, or distributed on account of, collateral;

(C) rights arising out of collateral;

(D) ~~to the extent of the value of collateral,~~ claims arising out of and in compensation for the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or

(E) ~~to the extent of the value of collateral and~~ to the extent payable to the debtor or the secured party, insurance payable by reason of and in compensation for the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.

* * *

75. *See* U.C.C. § 9-109(d)(8) (2008).