

## MEMORANDUM

TO: EDWIN E. SMITH  
STEVEN L. HARRIS

DATE: March 21, 2010

FROM: Kenneth C. Kettering

RE: Comments on the March 17, 2010 draft of  
“Amendments to Uniform Commercial Code Article 9”

The following comments are given in the order of appearance in the draft.

**p. 4. Comment 11 to 9-102 (definition of “Certificate of Title”).** This draft adds (lines 30-32) a short paragraph stating that a state’s COT statute might provide for the issuance of both a tangible and electronic record, in which case “the records taken together constitute a ‘certificate of title.’” I’m not familiar with this kind of COT statute and am not clear how it works. If a state both issues both a paper COT and an electronic record, surely one of them must prevail over the other if they are inconsistent (e.g., one notes a given security interest and the other does not). If so, shouldn’t the one that prevails be the “COT” for purposes of Article 9, contrary to what this paragraph says?

To state the point another way: isn’t it the case that one can’t properly determine precisely what should constitute the “COT” for purposes of Article 9 without knowing more about the exact status of these separate manifestations under the state COT statute?

If so, perhaps it would be better to delete this short paragraph rather than try to anticipate all possible configurations that a state COT statute might take on this point. I think that we would have to rely on courts to exercise their common sense in applying the paragraph, given the different variations a state COT law might take. If so, we wouldn’t be any worse off relying on them to exercise their common sense without the paragraph.

### **pp. 5-7. 9-104 and the related addition to Comment 3.**

Preliminarily, some technical comments. (a) However 9-104(a)(4) is worded, the parallel provision on control of commodities accounts, 9-106(b)(3) (p. 10 of the draft) should be reworded to conform to it. That hasn’t been done in the current draft. (b) In the proposed new paragraph to Comment 3 to 9-104, page 7 of the draft, (i) in line 4 the phrase “another secured party” should be replaced with “another person”, and (ii) in line 8, the phrase “acknowledging secured party” should be replaced with “acknowledging person”.

I have concerns about the proposed statutory language and comment. My overarching concern is the undesirability of wording 9-104 differently from 8-106. That, after all, was the motivation for amending 9-104 in the first place. Wording differently two provisions that should operate identically can only create confusion and invite courts to draw factitious distinctions. If a wording change is worth making in 9-104, it is worth making in 8-106 too.<sup>1</sup>

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<sup>1</sup> Conceivably there might be a concern as to whether the committee’s mandate extends to amending 8-106. The current draft already crosses that bridge, in that the proposed addition to the comments includes a comment on the interpretation of 8-106. In any case the committee’s mandate includes conforming 9-104 to 8-106, and I would think that includes tweaking 8-106 as part of the conformation.

The draft of 9-104(a)(4) makes three significant changes from the wording of 8-106(d)(3), two large and one small.

*Deletion of language covered by agency principles.* The first is deletion from 9-104(a)(4) of the language in 8-106(d)(3) that refers to a person who “has control of the security entitlement on behalf of the purchaser”, leaving only the portion of 8-106(d)(3) that refers to a person who, “having previously acquired control of the security entitlement, acknowledges that it has control on behalf of the purchaser.” I agree that, as stated in the proposed comment, the deleted language is adequately covered by the principles of agency. But then why is that language retained in 8-106(d)(3)? It is there, so it has to be given some meaning – and who knows what meaning a court might give to that language to distinguish it from the result that follows from principles of agency. I wouldn’t mind deleting the language from both provisions, but I do not see that its presence can cause any harm, so long as it is used in both. So I would propose to leave the language in both.

*Addition of language to disqualify acknowledgment by a control person if the control person is the depositary bank/securities intermediary.* The second change is the insertion into 9-104(a)(4) of language limiting the general rule that purchaser A may obtain control of a deposit account by obtaining an acknowledgment from control person B, by providing that B cannot be the depositary bank. The proposed comment states that a parallel limitation should be read into 8-106(d)(3) – that is, purchaser A cannot control a security entitlement by obtaining an acknowledgment from control person B if B is the securities intermediary.

I do not substantively object to the rule thus proposed. But the point never before came to my attention. In considering it now, I think that a court could reasonably conclude that, to the contrary, under 8-106(d)(3) a purchaser can obtain control of a security entitlement by obtaining an acknowledgment from a control person, even though that control person is the securities intermediary. I have no wish to advocate for that broader interpretation of 8-106(d)(3), however, so I will relegate the arguments for and against that interpretation to a footnote.<sup>2</sup>

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<sup>2</sup> a. The case for interpreting 8-106(d)(3) to mean that a purchaser cannot obtain control by obtaining an acknowledgment from a control person, if that control person is the securities intermediary, rests on two arguments. One is uncritical acceptance of Comment 7 to 8-106, which says that the key to the control concept is that the purchaser has the ability to grab the securities without further action by the transferor. As the Reporters’ Note to proposed 9-104(d)(4) rightly observes, awarding control on the basis of an acknowledgment by the securities intermediary doesn’t satisfy the concept of control stated in Comment 7. The second argument is merely aesthetic: it is that if control could be had by acknowledgment of the securities intermediary, that would swallow almost all the scope for activity of 8-106(d)(2) (pertaining to control via tri-party agreement between purchaser, transferor and securities intermediary).

b. The case for interpreting 8-106(d)(3) to mean that a purchaser can obtain control by obtaining an acknowledgment from a control person, even if that control person is the securities intermediary, begins with the observation that the literal language of 8-106(d)(3) certainly so provides.

Comment 7 to 8-106 can be dismissed as inapplicable to 8-106(d)(3). Comment 7 was issued in 1994, and 8-106(d)(3) was promulgated years later, as part of Revised Article 9. A court could reasonably take the position that the comment wasn’t written to apply to 8-106(d)(3) and so shouldn’t be read to apply to it.

Furthermore, analysis of the function that “control” serves reveals no strong reason why 8-106(d)(3) should be read as being limited by Comment 7. The most important function of “control”, as applied to a security entitlement, is to establish perfection. The whole point of requiring a step to be taken in order for a transfer to qualify as being perfected is to assure that there is some way for third parties to learn of the transfer, aside from trusting the transferor’s word. Whether the purchaser in a transfer has the ability to grab the securities without further action by the transferor, as per Comment 7, has nothing to do with the ability of a third party to learn of the transfer. Hence to make perfection turn on whether the purchaser has the ability to grab the securities, per

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Because that broader interpretation is plausible, I am concerned to make sure that the change proposed by the current draft won't upset existing practice under Article 8. I've circulated this draft to the chairs and vice-chairs of the ABA Investment Securities Subcommittee and the ABA UCC Committee.

If this change will not upset existing practices, I do not object to it substantively. But I do not think that this change should be made in 9-104(a)(4) without making it in 8-106(d)(3). If a comment remarking that the rule is inherent in 8-106(d)(3) is good enough to handle the point in the context of 8-106, why isn't it good enough in the context of 9-104? I wouldn't know how to answer a court if the question arose. I think that the point could reasonably be handled either by (i) amending the wording of both statutory provisions to cover the point, (ii) using the language of current 8-106(d)(3) in both statutory provisions and adding a comment to both provisions to cover the point, or (iii) passing over the point in both provisions. (We've passed over bigger issues, after all.)

*Acknowledgement must be in an authenticated record.* The third and lesser change proposed in this draft is to require the acknowledgment to be in an authenticated record. I have no objection to that change, but if it is made I would again urge that 8-106(d)(3) be conformed. Still, nonconformity on this point would be less objectionable than nonconformity on the two points discussed previously, as I think that an oral acknowledgment by a securities intermediary is more a theoretical than a practical issue.

**p. 9, Line 15 (9-615(a)(6)).** Typo: add a space before the first parenthesis in "subsection(a)(5)".

**p. 10, Lines 29-31 (9-106(b)(3)).** As noted above, the wording of 9-106(b)(3) should be conformed to whatever is settled on for 9-104(a)(4) (and, I trust, 8-106(d)(3)).

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Comment 7, is totally arbitrary and unrelated to the purpose of the perfection requirement. One might as well make perfection turn on whether the purchaser sings "Hava Nagila" upon receiving the signed security agreement. The reason why the control requirements of 8-106(d) aren't so arbitrary is because they *do* give third parties a way to learn of the transfer. For example, if purchaser P-1 obtains control of a security entitlement by means of a tri-party control agreement under 8-106(d)(2), a later potential purchaser P-2 can learn of that by asking the securities intermediary whether it has previously entered into a control agreement. (Of course the intermediary need not answer, but then P-2 does not do the deal.) Under this view it would make perfect sense to interpret 8-106(d)(3) as allowing P-1 to claim control by obtaining an acknowledgment by control party C, even if C is the securities intermediary. A potential P-2 who wants to ascertain the existence of all earlier control parties is no worse off if 8-106(d)(3) is so construed, as P-2 can simply ask the securities intermediary whether any such person exists. (That isn't even an added burden, as P-2 must deal with the securities intermediary anyway, in order to ascertain whether the securities intermediary is party to any earlier tri-party agreements per 8-106(d)(2), and to deal with the securities intermediary's own perfected interest per 8-106(e).)

If there is a functional justification for the limitation stated in Comment 7, it has nothing to do with perfection, and so must relate to some other function that "control" serves. As applied to a security entitlement, the other important function that control serves is in priority rules such as 8-510, 8-511 and 9-328. Those rules can be viewed as cousins of the traditional adverse claim cut-off rule for certificated securities, which in turn derived from the time-honored adverse claim cut-off rule for negotiable instruments. So it is natural enough to frame the rules for qualifying for priority under the cited rules in ways analogous to those traditional rules, and those traditional rules do entail conditions that are analogous to Comment 7. But that choice is merely aesthetic. If there's a *functional* reason why priority under those rules should be limited to persons who meet the limitation of Comment 7, it's not evident to me. (This is not to say that there's a good reason *not* to follow that pattern, which is why I'm satisfied with the current draft. It's merely to say that there is no real functional justification for Comment 7.)

**p. 28 et seq. (9-515A).** How is this provision going to be framed in the final amendment package? I thought that it will be a “hip-pocket amendment,” and so not part of the official text even as an optional provision (unlike the optional provisions on individual debtor name and PrMSIs).

**pp. 52-61, Part 8 (Transition): General Observations.**

I think that it would be better to cast these transition provisions as part of the session law that enacts this amendment package, rather than codifying them in the UCC. That is for several reasons.

First, the transition provisions, if codified, will remain in the codification forever. (Cf. UCC Articles 10 and 11.) Even decades from now, codifiers will not repeal transition provisions unless they can be sure that no transition issues might still linger – and with transition provisions as dense as these, nobody decades from now will be sure of that. If codified, these transition provisions will be like a Biblical curse, junking up the statute even unto the seventh generation. Accepting that consequence was far more justifiable in the case of the 1998 revision than in this revision, for the current revision is much slighter and the transition issues are consequently are of much less practical significance.

The situation today differs from 1998 in second way: namely, the 1998 revisions recodified Article 9, while these revisions do not. Consider the undefined term “this [Act]”. In this revision package it means only “the session law that enacts these amendments”. When used in the 1998 transition provisions, “this [Act]” similarly meant “the session law enacting Revised Article 9 and the conforming changes to the other provisions of the state’s UCC”. But since Revised Article 9 was a complete recodification, part 7 could and did also use “this [Act]” to mean “Revised Article 9”. That’s not the case with the current revision package.

If these provisions are codified as part 8, the term “this [Act]” must be defined, and giving it the proper definition means that 9-801 winds up looking something like the following: “This Act takes effect on July 1, 2013. As used in this part 8, ‘this Act’ means [insert cite of state session law].” That looks strange in a codified statute, and I wouldn’t be surprised if state legislative drafters disallow it.

Finally, removing these transition provisions from the codification would help to mitigate the adverse consequences that might follow if these transition provisions contain clauses that address situations that cannot actually arise in this revision package. For example, the Reporter’s Note after 9-805 (p. 55) notes that 9-805(b) may not be necessary in this revision package. Another example (noted later in this memo) is that 9-807(b) (p. 58) implies that there may be some difference between the length of time that an initial financing statement is effective as provided in 9-515 before and after giving effect to this revision package, and I don’t think that is necessarily the case is such a difference. The presence of such inoperative transition provisions (and others not yet spotted) is a problem, given the maxim of statutory construction that denies that any statutory language is meaningless. A court might well be induced to interpret the substantive language of Article 9 in an undesirable way, in order to give meaning to some otherwise-inoperative clause of the transition provisions. I think that this concern has less force if the transition provisions are not codified along with the substantive law.

The concern could be further diminished by tacking onto the end of the transition provisions a further provision that says in effect, “the legislature previously crafted an intricate template of transition rules for amendments to Article 9 and believes it convenient to adhere to that template for the transition

rules to this amendment package, notwithstanding that not all of the transition rules in the template necessarily apply to the current revision package.”<sup>3</sup> I suggest that such a provision be considered.

**pp. 52-61, Part 8 (Transition): Specific Comments.** The following comments assume that the transition rules will remain codified as a part 8.

*p. 53, Lines 26-27 (9-801).* I suggest giving the legislative drafter guidance as to how “this [Act]” is to be defined. As noted above, it should mean the session law that enacts this amendment package. The most direct approach would be to a sentence to 9-801 defining “this Act” for the purpose of part 8, and then removing the brackets from around “[Act]” everywhere else in part 8.

*p. 53, Lines 26-27 (9-801); p. 57, Line 3 (9-806(b)(3)).* The current draft inserts dates for effectiveness and for the end of the period within which otherwise ineffective pre-effective-date filings remain effective. My guess is that it is unlikely that anything resembling the speedy Revised Article 9 enactment process is likely to occur. In my judgment, the sponsors would be better off leaving these dates blank, rather than suffer the humiliation of having their command widely ignored. Maybe I’m too pessimistic. A middle course would be to leave the dates blank in the statute but add a legislative note after each provision recommending that states insert date X.

*p. 54, Line 1 (9-803(a)).* Regarding the reference to “this [Act]” in this line: I think it works as written, but it may be better to underline what this sentence is saying by changing the phrase to “the Uniform Commercial Code, as amended by this [Act]”.

As I understand 9-803(a), all non-Article 9 conforming changes made by the amendment package have retroactive effect. I think that’s reasonable now, since as far as I am aware the only non-Article 9 conforming change in the current package is the Highland Capital revision to Article 8.

*p. 54, Line 22 through p. 55 Line 9 (9-804(b)).* Per the Reporter’s Note, I can’t think of a situation in which the amendments would give rise to a case covered by this provision. Perhaps it might be retained, to be on the safe side, if an explanatory provision is added to the transition rules stating that not every transition provision is necessarily operative in this revision package.

*p. 58, Lines 11 through 58 (9-807(b)).*

a. At p. 58 Line 15: regarding “[former Section 9-515]”. “Former” was proper in the 1998 transition provisions because the amendment was a recodification. For this amendment package, it would seem more correct to say something like “Section 9-515 as constituted before giving effect to this Act”.

b. The distinction between paragraphs (1) and (2) of 9-807(b) is operative only if the amendment package in some case changes the period provided in 9-515 for effectiveness of an initial financing statement. I question whether that is the case. The only change made by this amendment package to 9-515 is set forth on pp. 31-32 of this draft, which specifies that the indication of a transmitting utility’s status as such must be on the “initial” financing statement. It’s debatable whether a court would have construed the language that way anyway. Paragraphs (1) and (2) of 9-807(b) assume that there is some

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<sup>3</sup> Indeed, there may be something to be said for adopting the same transition provisions used in 1998 without making any effort to delete provisions that won’t come into play in this revision package, relying upon such an explanatory provision.

case in which this amendment to 9-515 makes a difference, which implies that a court ought not to construe the current language as meaning “initial” financing statement. I don’t think we want to create such an implication. As suggested above, a quick fix would be to add to the transition provisions an explanatory provision stating that not every transition provision is necessarily operative.

**p. 84, Line 24 (Comment 2 to 9-616).** Typo: replace “(a)(1)(B)” with “(b)(1)(B)”.

**Provisions not in the current draft**

**My memo of February 16 re: treatment of individual debtor names in (a) 9-504(a)(4)(B) (relating to a nameless debtor) and (b) 9-503(b) (relating to mortgage as fixture filing).** I respectfully suggest / remind you to place these two points on the agenda for the committee to consider, time permitting.

**9-101. Comments 4 and 2.** I would suggest adding to the beginning of Comment 4 to 9-101 a sentence to the effect that the comment speaks as of the 1998 revision and does not purport to reflect later revisions. I would also suggest that Comment 2 to be revised to include a similar comment. (This carries forward a comment I made in an earlier memorandum. I apologize if the repetition is tiresome. I know that plenty of work remains to be done writing other and more important comments.)

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Respectfully submitted.

KCK