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MEMORANDUM

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TO: EDWIN E. SMITH
Chair, Article Nine Review Committee

DATE: October 7, 2008

STEVEN L. HARRIS
Reporter, Article Nine Review Committee

FROM: Kenneth C. Kettering

RE: Additions to the Article Nine Review Committee's Issues List

At the end of the Committee's meeting in Chicago on October 5, 2008, in response to Ed Smith's general invitation I presented two issues for consideration by the Committee. This memorandum is responsive to Ed's request that I reduce that presentation to writing.

Proposal 1: The Official Comments to § 9-318 should clarify that § 9-318(a) is not a priority rule. That is, § 9-318(a) is irrelevant to determining the priorities of two competing transferees from the same debtor of interests in an account, chattel paper, payment intangible, or promissory note ("receivable"), insofar as the priority contest is governed by the rules of Article 9..

Explanation: Section 9-318(a) provides that a debtor that has sold a receivable does not retain a legal or equitable interest in the receivable sold. As Official Comment 2 notes, § 9-318(a) merely "makes explicit what was implicit, but perfectly obvious, under former Article 9." It was added to repudiate the misreading of Article 9 in the *Octagon Gas* case. Unfortunately, some have interpreted it to mean that, if debtor sells a receivable to T-1 and later transfers an interest (full or limited) in the same receivable to T-2, the priority contest between T-1 and T-2 should be resolved by applying the *nemo dat* principle, with the result that T-2 takes nothing and loses to T-1.¹ That is not correct. The priority contest should be resolved by the ordinary priority rules of Article 9; § 9-318(a) and *nemo dat* are irrelevant. There are many situations in which the priority rules give T-2's interest priority over T-1's. For some priority contests of this sort, statutory provisions or comments clarify this result. (See (i) § 9-318(b) (unperfected T-1 vs. T-2 who is "creditor" or "purchaser for value"), (ii) Official Comment 4 to § 9-318 (perfected T-1 vs. T-2 who qualifies for priority under §§ 9-330 or 9-331), (iii) Official Comment 6 (final paragraph) to § 9-317.) However, there is no clear statement of the general principle, and the piecemeal clarifications leave other situations unaddressed. (For example, consider the situation in which T-2 files against accounts, then T-1 files against accounts and buys account AC, then debtor grants T-2 either ownership of AC or a security interest in AC securing an obligation. T-2 should have priority over T-1 in AC, but there is nothing specific in the text or comments to negate the *nemo dat* argument in this instance.)

¹ Section 9-318(a) has been so misinterpreted regularly on the UCCLAW-L list, and the misinterpretation has been discussed tolerantly in Thomas E. Plank, *Assignment of Receivables Under Article 9: Structural Incoherence and Wasteful Filing*, 68 OHIO STATE L. J. 231, 242-47 (2007) and Clark's *Secured Transactions Monthly* (May 2006).

In stating the issue, note the use of the terms "T-1" and "T-2," with "T" standing for "transferee," rather than "SP." The principle that the Article 9 priority rules are not displaced by § 9-318(a)/*nemo dat* should apply to any priority contest that is governed by Article 9, including a priority contest between a buyer of a receivable and a lien creditor. If T-2's interest in a receivable is such that a priority contest between T-2 and T-1 (a buyer of the receivable from the same debtor) is not governed by Article 9, then applicable non-Article 9 law might well resolve the priority contest by reference to § 9-318(a)/*nemo dat*.

As an alternative to stating this principle by way of addition to the comments to § 9-318, the Committee may wish to consider stating the principle in the statutory text as a replacement for current § 9-318(b), which is merely a special case of the principle.

Proposal 2: Revise § 9-322(c) to correct its application to competing control security interests, and to correct or explicate its application to situations in which it awards priority in proceeds to a security interest that qualifies for priority under a non-temporal priority rule even though there is no actual conflicting security interest in the original collateral.

Explanation: Loosely paraphrased, § 9-322(c) provides that, subject to certain conditions, if a security interest in “non-filing collateral” qualifies for superpriority, then the superpriority continues in proceeds of the non-filing collateral. “Non-filing collateral” in this context means, generally speaking, collateral of a type for which perfection may be achieved by possession or control and as to which a secured party who perfects by that method generally does not need to conduct a filing search. More closely paraphrased, § 9-322(c) states that if SP-1 has a security interest in an item of non-filing collateral and that security interest would qualify for priority over a *hypothetical* conflicting security interest in the same item under certain specified priority rules, and if certain other conditions are met, then SP-1 has priority over *any* conflicting security interest in proceeds of the collateral.²

Section 9-322(c) yields a contradiction when applied to the following situation (“Example X”): on day 1, SP-1 is granted a security interest in security entitlement X and perfects via a control agreement per § 8-106(d)(2); on day 2, SP-2 is granted a security interest in security entitlement X and perfects via a control agreement per § 8-106(d)(2); on day 3, security entitlement X yields traceable cash proceeds. SP-1 qualifies for priority in those cash proceeds under § 9-322(c) because its control security interest in X qualifies for priority over a hypothetical competing security interest in X under 9-328 (specifically, either (i) a hypothetical security interest perfected by a later control agreement [it happens that there actually is such a security interest, but that is irrelevant], or (ii) a hypothetical security interest perfected by filing); SP-1 also satisfies the other conditions for priority in these cash proceeds under 9-322(c). For exactly the same reasons, SP-2 qualifies for priority in these cash proceeds under 9-322(c). Hence the result is a degenerate circular priority, “degenerate” in that it involves only two parties, each of which is declared to have priority over the other.

Section 9-322(c) similarly yields a degenerate circular priority in other situations involving competing control security interests in the original collateral. For example (“Example Y”): on day 1 SP-3 is granted a security interest in security entitlement Y; SP-3 is the securities intermediary holding Y and

² That 9-322(c) bestows priority on SP-1 in proceeds of the original collateral if SP-1 qualifies for priority against a *hypothetical* competing security interest in the original collateral, and is not keyed to the existence of an actual competing security interest in the original collateral over which SP-1 has priority, is stated explicitly in Official Comment 8 to 9-322: “This rule determines priority in proceeds of non-filing collateral whether or not there exists an actual conflicting security interest in the original non-filing collateral.”

The unqualified statement that an SP-1 who qualifies for priority under 9-322(c) is awarded priority in proceeds over *any* competing security interest ignores the fact that the priority afforded by 9-322(c) is overridden by other priority rules elsewhere in part 3 of Article 9. See 9-322(f)(1). However, that cabining of the 9-322(c) priority does not affect Example X or the other discussion herein.

thus is perfected by control per § 8-106(e); on day 2 SP-4 is granted a security interest in Y and perfects by a control agreement per § 8-106(d)(2); on day 3, Y yields traceable cash proceeds. SP-3 qualifies for priority in those cash proceeds under § 9-322(c), as SP-3's security interest in Y qualifies for priority over a hypothetical security interest in Y under § 9-328 (specifically, a hypothetical security interest perfected by any other type of control, or a hypothetical security interest perfected by filing). Likewise, SP-4 qualifies for priority in those cash proceeds under § 9-322(c), as SP-4's security interest in Y qualifies for priority over a hypothetical security interest in Y under 9-328 (specifically, a hypothetical security interest perfected by a later control agreement, or a hypothetical security interest perfected by filing).

Inconsistencies analogous to Examples X and Y also arise when the original collateral is a deposit account in which competing SPs have control security interests, priority in which is governed by § 9-327. All of these examples are essentially similar, so for brevity I will refer only to Example X.

It is evident that SP-1 should have priority over SP-2 in the cash proceeds in Example X. The failure of § 9-322(b) to yield that result can be attributed to the fact that § 9-322(c) is not drafted to continue into proceeds a priority that exists between two *actual* security interests in the same original collateral. Rather, § 9-322(c) states that if SP-A's security interest in original collateral would qualify for priority over a *hypothetical* competing security interest, then SP-A's security interest in proceeds has priority over *any* competing security interest. It is not apparent why § 9-322(c) was so drafted, because in the examples of its operation, set forth in Examples 6 through 11 of Official Comment 8 to § 9-322, in every instance in which § 9-322(c) operates to award priority in proceeds to an SP-A over an SP-B, both SP-A and SP-B actually had a security interest in the same non-filing original collateral, with SP-A's security interest having priority over SP-B's. If § 9-322(c) were recast to continue into proceeds a priority that exists between two actual security interests in the same non-filing original collateral, it would seem to reach the same results as apply in Examples 6 through 11, and it would also reach the right result in Example X. If § 9-322(c) is not so recast, it would be desirable to add to the Official Comments an explication of why it is so drafted, such as an example of circumstances in which § 9-322(c) would apply to give SP-A priority over SP-B in proceeds even though SP-A did not have priority over SP-B in the original non-filing collateral.

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Respectfully submitted.

KCK