

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.

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