MEMORANDUM

To: Article 9 Joint Review Committee

From: Steven L. Harris, Reporter

Re: References to "Security Interest" in UCC Article 3

Date: August 11, 2009

The most recent revision of Article 9 extended the scope of the Article to include sales of promissory notes, including negotiable promissory notes. The revision was accompanied by a conforming amendment to the definition of "security interest" in Article 1. As revised, "security interest" includes "any interest of . . . a buyer of . . . a promissory note in a transaction that is subject to Article 9." Although UCC Article 3 contains three references to "security interest," the Article 9 Drafting Committee did not consider whether those references remained appropriate given the expanded definition of the term. the Scope and Program Committee of the Uniform Law Commission recently expanded the scope of the Joint Review Committee's charge to include consideration of these provisions of Article 3.

This Memorandum discusses the relevant Article 3 provisions and recommends that the Joint Review Committee leave the provisions as they now stand.

1. Indorsements

UCC § 3-304(c) provides that, "For the purpose of determining whether the transferee of an instrument is a holder, an indorsement that transfers a security interest in the instrument is effective as an unqualified indorsement of the instrument." Official Comment 2 gives the following example:

> 2. Assume that Payee indorses a note to Creditor as security for a debt. Under subsection (b) of Section 3-203 Creditor takes Payee's rights to enforce or transfer the instrument subject to the limitations imposed by Article 9. Subsection (c) of Section

> 3-204 makes clear that Payee's indorsement to Creditor, even though it mentions creation of a security interest, is an unqualified indorsement that gives to Creditor the right to enforce the note as its holder.[1]

Regardless of whether the statutory text is understood to apply to all indorsements that actually transfer a security interest—including indorsements made by the seller of a promissory note—or is limited (as the Comment suggests) to indorsements that mention creation of a security interest, there is no reason to amend the text in light of the expanded definition of "security interest."

This is not to suggest that § 3-204(c) could not be improved. One might construe the section to mean that every indorsement of an instrument transferred for collateral purposes or sold is an unqualified indorsement, even if the indorsement contains qualifications other than those relating to the collateral aspect of the transfer. Of course, such a reading would be silly and thus prohibited by UCC § 1-103(a), which commands courts to construe and apply the UCC liberally, to promote its underlying purposes and policies. Moreover, the possibility of such a silly misinterpretation was not created by the revision to the definition of "security interest"; it would arise even if § 3-204(c) were expressly limited to security interests that secure obligations. Any amendment should be left to a future revision of Article 3.

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[1] The term "unqualified indorsement" is not defined. The term appears also in § 3-203(c), which affords to certain transferees "a specifically enforceable right to the unqualified indorsement of the transferor." Comment 3 to that section explains in relevant part:

> 3. Subsection (c) applies only to a transfer for value. It applies only if the instrument is payable to order or specially indorsed to the transferor. The transferee acquires, in the absence of a contrary agreement, the specifically enforceable right to the indorsement of the transferor. Unless otherwise agreed, it is a right to the general indorsement of the transferor with full liability as indorser, rather than to an indorsement without recourse. . . . .

2. Secured Party as Holder in Due Course

UCC § 3-302(e), which deals with the holder-in-due-course rights of a secured party, is another example of a provision that conceivably could be misinterpreted, but as to which a misinterpretation is most unlikely. UCC § 3-302(e) provides as follows:

> (e) If (i) the person entitled to enforce an instrument has only a security interest in the instrument and (ii) the person obliged to pay the instrument has a defense, claim in recoupment, or claim to the instrument that may be asserted against the person who granted the security interest, the person entitled to enforce the instrument may assert rights as a holder in due course only to an amount payable under the instrument which, at the time of enforcement of the instrument, does not exceed the amount of the unpaid obligation secured.

Official Comment 6 provides the following example of the operation of subsection (e):

> *Case #6*. Payee negotiates a note of Maker for $1,000 to Holder as security for payment of Payee's debt to Holder of $600. Maker has a defense which is good against Payee but of which Holder has no notice. Subsection (e) applies. Holder may assert rights as a holder in due course only to the extent of $600. Payee does not get the benefit of the holder-in-due-course status of Holder. With respect to $400 of the note, Maker may assert any rights that Maker has against Payee. A different result follows if the payee of a note negotiated it to a person who took it as a holder in due course and that person pledged the note as security for a debt. Because the defense cannot be asserted against the pledgor, the pledgee can assert rights as a holder in due course for the full amount of the note for the benefit of both the pledgor and the pledgee.

Quite obviously, subsection (e)—which limits the enforcement rights of a holder in due course to "an amount payable . . . which . . . does not exceed the amount of the "unpaid indebtedness secured"—makes sense only when applied to a security interest that secures an obligation. It makes no sense to apply the provision to a security interest that arises from the outright sale of a note. For this reason alone, a court should not apply subsection (e) to a secured party who is a buyer of a promissory note. See UCC § 1-103(a) (requiring courts to construe and apply the UCC liberally) & Comment 1 ("The text of each section should be read in the light of the purpose and policy of the rule or principle in question, as also of the Uniform Commercial

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."); UCC § 1-201(a) (defined terms have the meanings stated in the definitions "[u]nless the context otherwise requires"). Alternatively, or in addition, a court can easily reach the appropriate result by focusing on the first condition for operation of the subsection: the person entitled to enforce the instrument has "*only* a security interest in the instrument" (emphasis added). The buyer of a promissory note in an Article 9 transaction does not have "*only* a security interest"; it has an ownership interest, as well.

3. Definition of Value

Under UCC § 3-303(a)(2), an instrument is issued or transferred for value if "the transferee acquires a security interest or other lien in the instrument other than a lien obtained by judicial proceeding." The phrase, "security interest or other lien," makes the application of the provision quite clear. As Official Comment 3 explains, "The term 'security interest' covers Article 9 cases in which an instrument is taken as collateral as well as bank collection cases in which a bank acquires a security interest under Section 4- 210."

S. L. H.