

MEMORANDUM

To Edwin E. Smith, Chair, UCC Article 9 Review Committee
Steven L. Harris, Reporter, UCC Article 9 Review Committee
Stephen L. Sepinuck, ABA Advisor

From Thomas E. Plank, Member, ALI Members Consultative Group

Re March 2009 Draft-Proposed Comment 5 for Section 9-318.

Date June 28, 2009

I am writing to express my grave concerns about proposed Comment 5 to UCC § 9-318. My concern is not the policy result that the Committee appears to want to achieve, although the specific result is not altogether clear. If the intent of the proposed Comment is to give a first filer priority over a subsequent perfected buyer of accounts or chattel paper (perfected by filing), the result may be appropriate. If, however, the intent of the proposed Comment is to give an earlier filer priority over a subsequent perfected buyer of other collateral, such as goods, then this is a broader policy change for which I would suggest caution.

My concern is the ineffectiveness of the proposed Comment to implement the policy result. I believe that, given the language of Article 9, the policy result requires amendment of the statute, such as an express amendment to § 9-318. In my view, the proposed Comment contradicts the language of Article 9, specifically, § 9-201, § 9-203(b) and § 9-322, and relies on an overly broad characterization of “priority principles” that does not withstand close scrutiny. Therefore, the proposed Comment would introduce confusion that will result in the non-uniform resolution of the specific fact pattern (between courts that follow the proposed Comment and those that apply the language of the statutes) and may also result in the application by courts in ways that have not been anticipated and that are undesirable. In this regard, the problem that the proposed Comment seeks to address is analytically the same as the problem that the drafters of revised Article 9 solved not by a comment but by the express statutory provisions of § 9-318(b).

First, in the next few sections, I set forth my reasons for concluding that the proposed Comment is inconsistent with the language of Article 9. Second, I provide specific comments on the proposed Comment. Third, I offer a suggested amendment. Finally, I discuss the extent to which the policy result is in fact desirable.

The Interplay of § 9-201, § 9-203(b)(2) and § 9-322(a)(1)

As we all know, under § 9-203(b)(2), one of the requirements for the creation of a security interest is that the debtor have either (a) rights in the collateral or (b) the power to transfer rights in the collateral.

If on Day 1 a person (“SP-1”) files a financing statement covering any type of collateral, and on Day 2 the debtor sells a particular items of collateral to another person (“P-2”), and on Day 3 the debtor signs a security agreement granting SP-1 a security interest in the same type of collateral (often, collateral “now owned or hereafter acquired”), there is no question that debtor does not have rights in the item of collateral sold and, in most cases, SP-1 does not get a security interest in that sold item. For example, it is standard case book knowledge that, if the item of collateral is equipment, SP-1 ordinarily would not get a security interest in the equipment. *See Steven L.*

Harris and Charles W. Mooney, Jr., Security Interest in Personal Property at 299 (4th ed. 2006), problem 4.2.9(a).

There are exceptions, of course. If P-2 buys an account or chattel paper, and fails to perfect its interest, the debtor is deemed under § 9-318(b) to have the power to transfer rights in the sold item, and therefore SP-1 gets a security interest under § 9-203(b). Because § 9-318(b) and the revised § 9-203(b) allows for the creation of a security interest when a debtor has no actual rights, SP1 also gets priority under § 9-322(a)(2), which gives priority to a perfected security interest over an unperfected security interest. Significantly, it is § 9-318(b) that enables the creation of the security interest, not § 9-322 that merely ranks competing security interests.

It is useful to recall that the drafters of revised Article 9 added § 9-318(b) and the “power to transfer rights” in § 9-203(b)(2) specifically to address this particular fact pattern under former Article 9. Under former Article 9, because the debtor had no rights in the collateral after Day 2, P-2 could legitimately argue that it had priority because SP-1 never got a security interest. Therefore, under this argument, the rule giving priority to a perfected security interest over P-2’s unperfected security interest under former § 9-312(5)(a) did not apply because SP-1 did not have a competing security interest. But of course, everyone knew that one of the primary purposes of Article 9’s inclusion of the sale of accounts was to require the filing of financing statements to perfect the sale. Hence, the proper resolution of the conflict between the express provisions of former Article 9 and the general intent and purpose of former Article 9 was that the intent should prevail notwithstanding the express statutory language. In 2001, instead of relying on such an “intent” argument, § 9-318(b) of revised Article 9 expressly provides that, if P-2 fails to file a financing statement, the debtor retains the power to create a security interest in favor of SP-1.

The factual pattern describe by the proposed Comment 5 presents, analytically, the same situation. If P-2 perfects its security interest in an account on Day 2, then SP-1 cannot get a security interest in the account and therefore cannot get priority under the language of § 9-322(a)(1). To change this result, an amendment to Article 9 is, in my view, necessary.

Contrary to the assertion in proposed Comment 5, § 9-322(a)(1) cannot be read to give the debtor the power to transfer rights in collateral in this or any other context. By its very terms, § 9-322(a)(1) is limited to priorities among “security interests.” First, § 9-322 is titled “Priorities Among ***Conflicting Security Interests***” [emphasis added]. Second, § 9-322(a) states: “Priorities among ***conflicting security interests*** and agricultural liens in the same collateral is determined according to the following rules” [emphasis added]. Third, § 9-322(a)(1) states: “***Conflicting*** perfected ***security interests*** and agricultural liens rank according to priority in time of filing or perfection” [emphasis added]. Hence, if P-2 perfects its buyer’s interest in an account (or any other collateral), SP-1 cannot get a security interest under § 9-203(b)(2), § 9-322(a)(1) by its terms does not apply, and SP-1 cannot get priority over P-2.

Further, P-2’s “security” interest as a buyer of an account is bolstered by § 9-201, which provides: “Except as otherwise provided in [the Uniform Commercial Code], a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors.” The UCC does not expressly give the debtor the power to transfer rights in an account that the debtor has sold to P-2 if P-2 perfects.

One could perhaps argue that the “intent” of Article 9 requires that, notwithstanding the non-existence of SP-1’s security interest in the previously sold account, SP-1 should be deemed to have a security interest and therefore be deemed to have priority. As I discuss below under “**The Best Policy**,” however, this “intent”—unlike the case of an unperfected buyer of an account—is not so clear.

Further, proposed Comment 5 does not speak in terms of “intent.” It states as a general proposition that “priority rules” can give the debtor the power to transfer rights. Then, in the example it first asserts that the priority contest is decided under § 9-322(a)(1) and then asserts that SP-1’s security interest attaches because the debtor has the power to transfer rights. The proposed Comment, however, does not state expressly how the debtor has rights in the collateral. The language of § 9-322(a)(1) does not grant the debtor such power.

Given P-2’s rights under § 9-203(b) and 9-201, and the express language of § 9-322(a)(1), I do not think that the proposed Comment 5 will achieve the desired result, especially in view of the fact that Article 9 contains an express provision—§ 9-318(b)—to deal with a similar problem. Further, because of the general language of the proposed Comment, it is not clear that the import of the proposed Comment is limited to priority contests between those claiming interests in accounts and chattel paper or those claiming interests in all types of collateral.

***Nemo Dat* and the Limits of § 9-322(a)(1)**

The proposed Comment asserts that the principles of *nemo dat* should not alter the “priority rules” or the “forgoing principles [of priority]” that somehow give the debtor the power to transfer rights to SP-1 in the previously sold account. The proposed Comment, however, puts the cart before the horse. *Nemo dat* is a fundamental property rule that underlies all property regimes, including Article 9. When the common law effect of *nemo dat* is changed to advance an important policy goal (such as providing public notice or protecting purchase money lenders), the change is implemented through specific statutory provisions (or in some older instances by specific case law). Such alteration does not result from a general policy of priority.

More precisely, a person’s rights under *nemo dat* are altered by a variety of express statutory provisions, such as provisions (a) that “void” a transfer (as in the land recording acts); (b) that provide that a particular person “takes free” of a security interest (§§ 9-317(b)-(d), 9-320(a),(b),(d), 9-321(b),(c), 9-323(d),(f); 9-332, 9-337(1), 9-338(2), 9-615(g)(1)); (c) that provide that a person has the “power to transfer rights” in an item of property when the person has no interest in the property item (§ 9-318(b); § 2-403); (d) that “subordinates” one interest to another (§ 9-317(a); §9-323(b); § 9-325; § 9-326; § 9-334(c); § 9-338(1)); (e) that give priority to one existing security interest over other security interests (§ 9-322, § 9-324; § 9-327 through § 9-329) and (f) that provide that certain “purchasers” of instruments or chattel paper have priority over a secured party that would otherwise have priority (§ 9-330). To achieve these alterations of *nemo dat*, however, the favored person must satisfy the specific elements of these statutory provisions.

Although some rules alter *nemo dat* by giving the debtor the power to transfer rights that the debtor does not have under *nemo dat*, many priority rules alter *nemo dat* without giving such power. Instead, these rules alter *nemo dat* by altering the priority of interests that already exist.

Specifically, § 9-322(a)(1), the first to file or perfect rule, alters *nemo dat* in favor of one person that has a security interest over others that also have security interests. As noted above, § 9-322(a)(1) is expressly limited to conflicting “security interests.”¹ Therefore, to apply § 9-322, one must first look to § 9-203(b) to determine whether a security interest has been created. If no security interest is created, then § 9-322(a)(1) does not apply.

In the case of a true security interest (an interest to secure payment or performance of an obligation) in favor of a P-2 that files second but perfects first, § 9-322(a)(1) works well to alter the *nemo dat* priority of P-2 to accomplish a desirable policy objective—protecting the integrity of the filing regime. If SP-1 files a financing statement covering collateral, and then P-2 obtains a perfected true security interest in the same collateral, P-2’s security interest does not deprive SP-1 of the ability to obtain a conflicting security interest because the debtor as the owner of the collateral continues to have rights in the collateral. In this instance, however, § 9-322(a) does not give the debtor the power to transfer rights. The debtor always has rights because of the nature of a true security interest (and the principle of *nemo dat*), that is, a true security interest does not transfer ownership of the collateral. In this instance, § 9-322 (as well as § 9-324 or § 9-317(a),(b), and perhaps others) is a priority rule that alters P-2’s rights under *nemo dat* but that does not give the debtor the power to transfer rights.

Because of the language of § 9-203(b)(2), on the other hand, SP-1 cannot get the benefit of § 9-322(a)(1) if P-2 becomes a perfected buyer of an account (or any other collateral) before SP-1’s security interest attaches. Notwithstanding the filing of SP-1’s financing statement, § 9-322 does not apply to that item of collateral because SP-1 does not have a security interest in that item of collateral. By purchasing the item, P-2 deprives the debtor of all rights in the collateral. Again, § 9-322(a) does not give the debtor power to transfer rights. This analysis holds regardless of the type of the collateral, including, as discussed above, if the sold collateral is equipment. There is no specific provision of Article 9 that changes this result if the collateral is an account or chattel paper.

Other priority rules in Article 9 operate to alter *nemo dat* without relying on giving the debtor the power to transfer rights. These include the alteration of the priority of a secured party’s security interest in favor of (i) purchase money lenders that satisfy the specific elements of the § 9-324(a),(b); (ii) under § 9-317(a), certain lien creditors; and (iii) a variety of security interests that satisfy the elements of § 9-325 through § 9-329 for super-priority. Note also that some priority rules may have result in giving the debtor the power to transfer rights in the collateral, but the priority rules operate according to their specific terms and do not alter priority by giving the debtor such power.

Of course, if P-2 buys chattel paper and perfects only by filing, SP-1 can later obtain a superior interest in the chattel paper if it obtains possession or control and it otherwise satisfies the

¹ The second sentence of § 9-322(a)(1) states: “Priority dates from the earlier of the time a filing covering the collateral is first made or the security interest or agricultural lien is first perfected.” In context, the word “priority” refers to priority among conflicting security interest. The entire section repeatedly refers to “conflicting” “security interests” [see subsections (a)(2),(3); (c); (d); (g)] or “security interests” [see subsections (b); (f)]. This sentence provides no support for the notion that this section gives the debtor the power to transfer rights to SP-1 simply because SP-1 filed a financing statement.

requirements of 9-330. Here, § 9-330 alters what *nemo dat* gives to P-2 because SP-1 satisfies the specific elements of § 9-330, including being a “purchaser.” Note that the effect of § 9-330 is to give the debtor the power to transfer rights that the debtor does not have, but the priority contest does not depend on this conferring of power. This conferring of power is an effect, not a cause, of the outcome of the priority contest.

It may be that, in the case of accounts and chattel paper, the expectation of the parties is that the earlier filing expectant SP-1 should have priority even if the debtor sold the accounts or chattel paper to P-2. [I question this point in the last section below.] But the language of 9-322(a)(1) does not achieve that result. To solve the problem for SP-1 against a P-2 that is a perfected buyer of an account (or any other type of collateral, if that is the goal), § 9-318 should be expressly amended, perhaps with a new subsection (c) [a draft of I set forth below].

The Role of § 9-318(a)

Some believe that the problem that the proposed Comment seeks to address was created by the inclusion of § 9-318(a) in the 2001 revision of Article 9.² This is not correct. As discussed above, this problem has existed since the enactment of Article 9. The result under former Article 9 flows logically from the language of former § 9-312(5) (1972) governing “priority between conflicting security interests” and the requirement under former § 3-203(1)(c) (1972) that the debtor have rights in the collateral for the creation of a security interest. The problem and the analysis for SP-1 is the same under former Article 9 and current Article 9. In fact, in recognition of the problem caused by the requirement of a debtor having rights and the awarding of priority only among conflicting security interests, the drafters of current Article 9 added to § 9-203(b)(2) the provision for the debtor having the “power to transfer rights” and added § 9-318(b) to ensure that an unperfected P-2 could not defeat an SP-1 that later attempted to get and perfect a security interest on the technical, but accurate, grounds that SP-1 could acquire no security interest because the debtor had no rights.

The erroneous notion that the problem being addressed was created by the addition of § 9-318(a) may explain why the caption for proposed Comment 5 that § 9-318(a) is “Not a Priority Rule,” but this caption does not make any sense. The statement is true, but it does not add anything to the analysis. In addition, I am not aware of anyone who thinks that § 9-318(a) is a “priority rule” in the sense used by the proposed Comment.

Indeed, although § 9-318(b) does alter *nemo dat* by providing that a person without rights nevertheless has power to transfer rights, § 9-318(b) is not by itself a “priority rule.” Instead, § 9-318(b) allows the implementation of the desired priority rule of 9-322(a)(2) by allowing the creation of a security interest under § 9-203(b). Significantly, it is § 9-318(b) and not § 9-322 that provides for the creation of a security interest that becomes subject to the priority rules of § 9-322.

² See, e.g. Barclay Clark, Clark’s Secured Transactions Monthly, Revise Article 9: A Drafting Glitch On Priorities, vol. 22, issue 3, third para. (May 2006), which stated that “SP1 clearly had priority under the first-to-file rule of old UCC §9-312(5)”. The use of the word “clearly” and the absence of any statutory analysis to support this conclusion should serve as a warning. For the reasons discussed above, this statement is not correct.

Specific Comments on the proposed Comment 5

Set forth below is proposed Comment 5, with my comments in **[brackets and boldface]**. I have separated specific sentences of the Comment to make reading easier.

5. Not a Priority Rule. **[I think this caption is not relevant or helpful.]**

If a debtor sells an account, chattel paper, payment intangible or promissory note to a buyer, and the debtor later transfers an interest in the same receivable to another purchaser, a priority contest arises. **[This sentence seems innocuous but the use of the words “later transfers” are ambiguous and, given what follows, also leads to the assumption of the conclusion.]**

If the *interests* **[emphasis added]** are such that the priority contest is governed by article 9, it is resolved by application of the priority rules of article 9. **[This statement makes a leap because it assumes the existence of multiple interests, that is, it assumes what is not true in the case of a perfected sale of an account.]**

Subsection (a) does not import the common-law principle of *nemo dat quod non habet* to displace those rules. **[This statement is problematic for several reasons. First, it contradicts the language of § 9-318(a), which states “A debtor that has sold [a receivable] does not retain a legal or equitable interest in the collateral sold.” This statement is an alternative version of the principle of *nemo dat quod non habet*, that is, that “one cannot give what one does not have.” Second, *nemo dat* does not displace priority rules; instead, priority rules may displace *nemo dat* in different ways and with different effects. Hence, the statement is logically irrelevant. The question is not how *nemo dat* is or is not incorporated in Article 9; it is when and how *nemo dat* is altered.]**

In many circumstances the priority rules of Article 9 will give the interest of the second purchaser priority over the buyer’s previously-acquired ownership interest. **[Again, although a true statement, I think its use is misleading. The real problem, however, is the next sentence.]**

To the extent that the priority rules entail such priority, the debtor necessarily has “power to transfer rights in the collateral” within the meaning of Section 9-203(b)(3). **[This statement is not correct. Some priority rules do operate by giving the debtor the power to transfer rights (a “void” transfer rule or a “takes free” rule). Some rules that are not priority rules by themselves also give the debtor the power to transfer rights. For example, § 9-318(b) is not a “priority” rule per se; it does not change priorities; instead, it allows 9-203 and 9-322(a)(2) to produce the proper priority result. Finally, some priority rules alter *nemo dat* through the operation of specific statutory provision and not by giving the debtor the power to transfer rights. Specifically, the first to file or perfect rule of 9-322(a)(1), as applied to true competing security interests, does not give the debtor the power to transfer rights. The debtor already has rights. As discussed above, there are many other examples**

of priority rules that do not operate by giving the debtor the power to transfer rights, such as § 9-317(a), and § 9-324 through § 9-329. A rule (in Article 9 or anywhere) alters priority by giving the debtor the power to transfer rights only to the extent that, well, the rule gives such power.]

See Section 9-203(b)(3), Comment 6. Subsection (b) is essentially a codification of the foregoing principles as applied to a particular contest of the foregoing type, and various comments note that these principles apply to other particular contests. **[I disagree that there are any “foregoing principles” that are being codified. As noted above, there are at least three different types of rules that alter *nemo dat* and change priorities. Some rules do not operate by giving the debtor the power to transfer rights. It is not priority “principles” but specific rules that give a debtor the power to transfer rights, such as those expressly set out in the statute, such as, specifically, 9-318(b) and 9-330. § 9-322(a)(1) is not one of them.]**

See Section 9-318, Comment 4; Section 9-317, Comment 6. These principles apply generally to all priority contests of the foregoing type. **[This statement is not correct. Again, specific rules, not “principles,” control priority contests. These “principles” do not apply to “all priority contests.” Each specific type of rules applies to specific types of priority contests.]**

However, when a buyer’s ownership interest is awarded priority under the applicable Article 9 priority rule, the identification of the applicable rule as one of “priority” does not imply that the seller has retained any interest. **[What does this mean? What is its purpose? In fact, under some priority rules, the seller does retain an interest.]**

Example 2: SP-1, having authority to do so, files a financing statement against Debtor covering accounts. Debtor then sells to SP-2 a particular account, with requisites for attachment satisfied, and SP-2 files a financing statement against Debtor covering the account. Debtor later grants to SP-1 a security interest (either by sale or by security transfer) in the account, authenticating an appropriate security agreement and with value being given. SP-2 cannot invoke *nemo dat* to claim priority over SP-1 in the account. **[Why not? What provision of Article 9 has excluded *nemo dat* in this case? None. This is a bald assertion without any support.]** Rather, the priority dispute is resolved under the relevant priority rule of Article 9. In this case, SP-1 has priority over SP-2 as first to file, under Section 9-322(a)(1). **[This is not correct. This particular priority rule presupposes that there is a security interest. That is, a condition to the operation of this particular priority rule is that there be conflicting security interests. Again, this statement is directly contrary to the express language of 9-322(a)(1).]** SP-1’s security interest in the account attached because Debtor had “power to transfer rights in the collateral” within the meaning of 9-203(b)(3). **[What section gives the debtor this power? None. 9-322(a)(1) does not.]** If the grant to SP-1 was a sale, SP-2 has no interest in the account; if the grant to SP-1 was a security transfer, SP-2 owns the account subject to SP-1’s security interest.

Another concern with this proposed Comment is that, although it seems to be dealing with a P-2 that is a buyer of accounts, the breadth of the language of the proposed Comment could lend itself to other types of collateral and perhaps other types of “priority” allegedly giving the debtor rights that it does not have. Hence, this proposed Comment could be applied to equipment. It could also be applied to other situations that I have not thought of. For example, does the priority rule in favor of a purchase money security interest give the debtor who receives value to acquire rights in goods the power to confer purchase money status on a lender even if the debtor does not use the value to acquire the goods?

Proposed Amendment

To effect the policy result that the proposed Comment seeks, I propose the following new subsection (c) to § 9-318 that works off of the formulation of existing § 9-318(b). This is just one idea, and there is no pride of authorship. Any express provision that achieves the desired result is fine with me. I also have not done the necessary further analysis of Article 9 to ensure that this provision does not have unintended consequences. Using a formulation that is similar to that of § 9-318(b) should minimize this risk.

§ 9-318(c). **[Deemed rights of debtor if debtor authorized a financing statement.]** For purposes of determining the rights of creditors of, and purchasers for value of an account, chattel paper, payment intangible, or promissory note from a debtor that has sold an account, chattel paper, payment intangible, or promissory note while a filed financing statement authorized by the debtor and covering such account, chattel paper, payment intangible, or promissory note is effective, the debtor is deemed to have rights and title to the account, chattel paper, payment intangible, or promissory note identical to those the debtor sold.

Note that, unlike subsection (b), this proposed subsection includes payment intangibles and promissory notes as well as accounts and chattel paper. This inclusion is necessary to protect lenders who file first against subsequent buyers of the payment intangibles and promissory notes.

The Best Policy

There is no question that, in a contest between a P-2 who buys an account but does not perfect, and an SP-1 who later attempts to acquire a perfected security interest by giving value and getting a signed security agreement, the intent of Article 9 is that SP-1 should have priority, and § 9-318(b) and the expansion of § 9-203(b) together achieve that policy result.

It is less clear that if P-2 perfects its purchase it should lose to SP-1. If P-2 bought equipment, for example, should SP-1 be able to trump P-2 because it filed a financing statement? In other words, should the filing of a financing by itself encumber a debtor’s property with a potential springing security interest? I would not think so.

The question then is whether the result should be different if P-2 buys an account. Do the SP-1s of the world expect to have a security interest in the accounts owned by the debtor when the financing statement is filed? Or do they simply expect to have a security interest in the accounts owned by the debtor when the security agreement is signed (or value is given)? Under the later circumstance, by the terms of a security agreement that transfers all of the debtors accounts “now

owned or hereafter acquired,” SP-1 would not get a security interest if debtor had previously sold the account to P-2.

On the other hand, if SP-1 expects a security interest in specifically listed accounts owned by the debtor when the financing statement is filed, perhaps SP-1 should be protected against a sale of one of the listed accounts to P-2 before SP-1 gets a signed security agreement and gives value. Is this situation any different from an SP-1 that expects to get a security interest in an item of equipment listed in the security agreement? Should SP-1 be protected in the equipment as well as the account? Theoretically P-2 could and should protect itself by doing a search, but given the lag times for searches, this solution has limitations.

I have no strong views on these policy questions. Nevertheless, I would be in favor of an express statutory provision that protects SP-1, but for another reason: My proposed amendment would fix a glitch in the statute that may adversely affect competing purchasers of after acquired accounts, as discussed in my article, Thomas E. Plank, *Assignment of Receivables Under Article 9: Structural Incoherence and Wasteful Filing*, 68 Ohio St. L.J. 231, 246 (2007) [example 2b(ii)].

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