

**REVISIONS CONCERNING PROCEEDS, PURCHASERS OF
CASH COLLATERAL, CHATTEL PAPER, AND DEPOSIT ACCOUNTS**

Reporters' Prefatory Note Draft

At the November, 1993, meeting, the Drafting Committee instructed the Reporters to prepare draft provisions that would accompany the expansion of Article 9 to include deposit accounts as original collateral. The Drafting Committee discussed those draft provisions at the March, 1994, meeting. During that meeting the Drafting Committee instructed the Reporters to make or consider further revisions. Those revisions follow.

While exploring various possible formulations of priority rules for conflicting claims in deposit accounts, it became apparent to us that the implications of these rules should be addressed first as part of a larger set of issues. Consequently, the following draft includes proposed revisions concerning (i) proceeds and purchases of chattel paper (primarily draft §§ 9-306 and 9-308, previously distributed but revised or reworded slightly), (ii) conflicting claims to "cash collateral" (primarily draft §§ 9-105(x), 9-118, and 9-308A), and (iii) deposit accounts as original collateral. We suggest that the Drafting Committee consider these draft revisions in that order, rather than in the order in which they appear. The draft provisions are not necessarily intended to apply to "consumer deposit accounts" (however the Drafting Committee may decide to define them).

The draft statutory provisions are marked to reflect changes from the current statutory text (additions are underlined and deletions are indicated by ~~strikeout~~); the draft does not reflect revisions proposed elsewhere. We have revised extensively several of the Reporters' Explanatory Notes; they are not marked to reflect changes from the previous versions. References to "Revised Article 8" are to the American Law Institute Proposed Final Draft (April 5, 1994 & Supp. May 16, 1994), which the A.L.I. approved at its 1994 Annual Meeting.

This draft does not contain choice-of-law provisions for security interests in deposit accounts. These were distributed for the March, 1994, meeting. In revising them for the December, 1994, meeting, we will take into account the revisions to § 9-103 that accompany Revised Article 8. We encourage those who have opinions concerning the appropriate approach to choice-of-law questions to communicate with us in the interim.

Scope Provisions and Definitions

§ 9-105. Definitions and Index of Definitions.

(1) In this Article unless the context otherwise requires:

* * *

(x) "Cash collateral" means money, checks, deposit accounts, and the like that are subject to a security interest.

The term includes "cash proceeds" (Section 9-306(a));

(c) "Collateral" means the property subject to a security interest. The term, and includes proceeds to which a security interest attaches pursuant to Section 9-306(b) and accounts, and chattel paper and general intangibles that which have been sold;

* * *

(e) "Deposit account" means a demand, time, savings, passbook or like account maintained with a ~~bank, savings and loan association, credit union or like organization, other than an account evidenced by a certificate of deposit~~ depository institution. The term does not include investment property or an account evidenced by an instrument;

* * *

(y) "Depository institution" means an organization [engaged in the business of banking] that accepts deposits in the ordinary course of its business. The term includes a bank, savings bank, savings and loan association, credit union, or trust company.

Reporters' Explanatory Notes

1. The definition of "cash collateral" in paragraph (x) is new; it derives from the definition of "cash proceeds" in § 9-306(1).

2. The revision of paragraph (c) would make clear that any proceeds to which a security interests attaches constitute "collateral." See also Explanatory Note 1 to draft § 9-306 below.

3. The definition of "deposit account" has been revised in three ways. First, it incorporates the definition of "depository institution," which also is new. The latter term is a useful shorthand that also appears in other related draft provisions. The definition is similar to the definition of "bank" provided in § 4-105(1). Inclusion of the bracketed language--"engaged in the business of banking"--would conform the definition even more closely to the definition in § 4-105(1).

Second, the draft excludes all accounts evidenced by Article 9 "instruments" from the scope of the term. The existing version, which

excludes from the "deposit account" definition "an account evidenced by a certificate of deposit [CD]," does not make clear the treatment of non-negotiable or uncertificated CD's. Under the draft, the latter would be a deposit account (assuming there is no writing evidencing the depository institution's obligation to pay) whereas the former would be a deposit account only if it is not an Article 9 "instrument" (a question that turns on whether the non-negotiable CD is "of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment" within the meaning of § 9-105(1)(i)).

The draft contemplates that a deposit account evidenced by an instrument would be subject to the rules applicable to instruments generally. As a consequence, a security interest in such a deposit account could be not be perfected by "control" (see draft § 9-118 below), and the special priority rules applicable to deposit accounts (see draft §§ 9-312 and 9-312A below) would not apply. In addition, the draft (like existing Article 9) is silent as to the obligation of a depository institution to pay to a secured party any deposit evidenced by an instrument. See Explanatory Note 4 to draft § 9-312A below.

This draft is consistent with the proposal by the State Bar of California, which likewise would exclude instruments from the definition of "deposit accounts." But this draft would treat non-negotiable CD's differently from the California proposal. The latter would add a new definition of "non-negotiable certificate of deposit" and provide that such certificates are "deposit accounts" and not "instruments." This draft would treat a non-negotiable CD as a deposit account only if the CD does not constitute an instrument under the current definition of that term.

Third, the draft excludes "investment property" from the term "deposit account." "Investment property" is a new term that appears in the conforming amendments accompanying Revised Article 8 and includes both securities and securities entitlements (i.e., rights against brokers and other securities intermediaries). Thus, the definition of "deposit account" would not include shares in a money market mutual fund that could be redeemed by check. Note, however, that a "share" account with a credit union is a deposit account, not investment property.

§ 9-104. Transactions Excluded From Article.

This Article does not apply

* * *

(i) to any right of recoupment or set-off, except as provided with respect to the effectiveness of rights of recoupment or set-off against deposit accounts (Section 9-312A), and except as provided with respect to defenses or claims of an account debtor (subsection [(1)] Section 9-318);

* * *

(l) to a transfer of an interest in any deposit account ~~(subsection (1) of Section 9-105), except as provided with respect to proceeds (Section 9-306) and priorities in proceeds (Section 9-312)~~

maintained with a Federal Reserve Bank or maintained by any
depository institution with any other depository institution.

Reporters' Explanatory Notes

1. The revision to subsection (l), drawn from the California State Bar proposal, would remove the general exclusion of deposit accounts as original collateral under Article 9. It would, however, retain the exclusion with respect to accounts maintained with a Federal Reserve Bank and accounts maintained by one depository institution with another. Although we question the need for these exclusions, they may be useful in easing concerns expressed by some federal regulators and appear to be relatively innocuous.

2. The revision to subsection (i) reflects the Drafting Committee's decision to regulate in Article 9 the relationship between a security interest in a deposit account and a depository institution's rights of recoupment and set-off. See draft § 9-312A. It also reflects the fact that existing § 9-318(1) addresses recoupment and set-off rights generally, albeit not in those terms.

§ 9-106. Definitions: "Account"; "General Intangibles".

"Account" means any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance. "General intangibles" means any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, deposit accounts, and money. All rights to payment earned or unearned under a charter or other contract involving the use or hire of a vessel and all rights incident to the charter or contract are accounts.

Reporters' Explanatory Notes

1. This change would establish deposit accounts as a separate type of collateral. One important consequence would be that the depository institution would not be an "account debtor" having the rights and obligations set forth in § 9-318. In particular, it would not be obligated to pay an assignee (secured party) upon receipt of the notification described in § 9-318(3). Another important consequence would relate to the adequacy of the description in the security agreement. See draft § 9-110 below.

2. Under the California State Bar proposal, deposit accounts would be a subset of general intangibles.

§ 9-110. Sufficiency of Description.

(1) Except as provided in subsection (2), for ~~For~~ the purposes of this Article any description of personal property or real estate is sufficient whether or not it is specific if it reasonably identifies what is described.

(2) A description of a deposit account is insufficient unless it describes the deposit account by item or as all or an identified class of the debtor's deposit accounts.

Reporters' Explanatory Note

The revision reflects the Drafting Committee's view that a debtor should be able to grant a blanket security interest in all deposit accounts, existing and after-acquired, but a security agreement containing a "super-generic" description (e.g., "all my personal property") should *not* be deemed to be sufficient evidence that the debtor intended to create a security interest in all its deposit accounts. This draft adds to subsection (2) the language "as all or an identified class of the debtor's deposit accounts" in place of the word "type," which appeared in the previous version. The revision would not affect accounts evidenced by an instrument (e.g., certain CD's), which by definition are not "deposit accounts."

§ 9-118. "Control".

(1) A purchaser obtains "control" over a deposit account if:

(a) the secured party is the depository institution with which the deposit account is maintained; or

(b) the depository institution with which the deposit account is maintained agrees [in writing] that, without further consent by the debtor, the depository institution will comply with instructions originated by the secured party directing payment, transfer or other disposition of the funds in the account.

(2) A purchaser obtains "control" over cash collateral other than a deposit account at the time the purchaser takes possession of the cash collateral.

(3) Whenever there is no outstanding secured obligation and the secured party has no commitment to make advances, incur obligations or otherwise give value, a secured party who has obtained control over a deposit account under subsection (1)(b) must on written demand by the debtor send the depository institution with which the deposit account is maintained a written statement that releases the depository institution from any further obligation to comply with instructions originated by the secured party. If a secured party fails to send such a statement within ten days after [the secured party receives] a proper demand therefor, the secured party shall be liable to the debtor for

[one hundred] dollars, and in addition for any loss caused to the debtor by such failure.

(4) This Article does not require a depositary institution to enter into an agreement of the type described in subsection (1)(b) even though a person for whom it maintains a deposit account so requests or directs. A depositary institution that has entered into such an agreement is not required to confirm the existence of the agreement to another person unless requested to do so by the person for whom it maintains the deposit account.

Reporters' Explanatory Notes

1. This draft follows Revised Article 8 in providing that a security interest in deposit accounts may be perfected by filing or by control (see draft § 9-304(x) below), and in affording priority to security interests perfected by control (see draft § 9-312 below). Subsection (1), which derives from section 8-106 of Revised Article 8, explains the concept of "control" over a deposit account. It does not explicitly provide that the secured party is in control of a deposit account if the depositary institution maintains the account in the name of the secured party (i.e., a deposit account on which the secured party is the customer of the depositary institution). However, such an arrangement normally would constitute control under subsection (1)(b). The official comments should make that point clear.

2. Under Revised Article 8, roughly speaking, a secured party or other purchaser obtains control over a brokerage account by becoming the "entitlement holder" (i.e., by having the account maintained in the secured party's name) or by obtaining the broker's agreement to comply with instructions originated by the secured party without the debtor's further consent. This draft provides a similar alternative to perfection by filing in the case of deposit accounts. Among the reasons underlying this approach are the following:

First, the existence of such an alternative reduces the need to distinguish between securities accounts ("investment property") and deposit accounts.

Second, control provides ample notice to those subsequent secured parties who would act in reliance upon the existence or non-existence of a security interest in the deposit account. A secured party who is concerned about being able to enforce its security interest in a deposit account ordinarily will need to obtain control. See draft § 9-318A below. In attempting to obtain control, the secured party ordinarily will discover whether another secured party has taken control. For example, discovery of the fact that a deposit account is not maintained in the debtor's name (a circumstance that likely would constitute control by the named account holder under subsection (1)(b)) suggests that the account may be encumbered. And the secured party is unlikely to succeed in obtaining the depositary institution's agreement under draft subsection (1)(b) if another secured party already has control.

Third, as a practical matter a secured party who has taken the steps necessary to obtain control but who has not filed (or whose filing is ineffective) will be able to enforce its security interest by obtaining payment from the depositary institution; a secured party who has filed but who lacks control will not (absent a court order). It seems incongruous to elevate the claim of the latter over the claim of the former.

Revised Article 8 does not require that the agreement giving rise to control be written, although any prudent secured party would reduce such an agreement to writing. The Drafting Committee may wish to consider whether to require a writing when the collateral consists of a deposit account.

Section 8-106(g) of Revised Article 8 explicitly prohibits a securities intermediary from entering into a control agreement with a third party without its customer's consent. This draft contains no such provision. Rather, the consent of the debtor (the depository institution's customer) would not be a condition to the effectiveness of a depository institution's agreement conferring control on a secured party. A depository institution that acts on the secured party's instructions in the absence of its customer's consent incurs liability to its customer to the extent provided under Article 4 and non-UCC law. Especially given that Article 4 recently was revised, we doubt that Article 9 should go so far toward codifying the depository institution-customer relationship.

3. Revised Article 8 would afford a third means of obtaining control over a brokerage account. It provides (again, roughly speaking) that a broker obtains control over a brokerage account maintained with that broker if the broker is granted an interest in the account. Draft § 9-118(1)(a) reflects this aspect of control in the deposit account setting, as well. The effect of this aspect of control would be to afford automatic perfection to a security interest granted to the depository institution with which the deposit account is maintained. See draft § 9-302(1)(h). Automatic perfection reflects the Drafting Committee's view that all actual and potential creditors of the debtor are always on notice that the depository institution with which the debtor's deposit account is maintained may assert a claim against the deposit account.

4. Control does not constitute "possession" of a deposit account. Because a deposit account is a claim against a depository institution that is not evidenced by an instrument, it cannot be physically possessed; however, control may be functionally equivalent to possession.

Perfection by control would not be available for accounts evidenced by an instrument (e.g., certain CD's), which by definition are not "deposit accounts." Revised Article 8 reaches an analogous result by defining "control" in the case of a securities certificate (as opposed to a securities entitlement against a broker) to require possession of the certificate by or on behalf of the secured party.

5. Draft subsection (2) provides for control by possession of cash collateral other than deposit accounts--e.g., money and checks. This subsection will be necessary if the Drafting Committee adopts an exculpatory or cut-off rule to protect innocent purchasers (including non-secured party purchasers) of cash collateral generally. See draft §§ 9-308A and the Explanatory Notes thereto. Except with respect to deposit accounts, the draft makes no provision for obtaining "control" over intangible "cash collateral," as to which taking possession is impossible. The Drafting Committee should consider whether cash collateral of this nature exists and, if so, whether the draft should provide for obtaining control over it.

6. Draft subsection (3) parallels § 9-404(1), which likewise requires a secured party to provide a debtor with a termination statement when there is no obligation secured and no commitment to give value. This requirement applies only when the secured party obtains control under draft subsection (1)(b), i.e., when the secured party is not the depository institution at which the deposit account is maintained. This requirement is necessary to enable the debtor to prevent the depository institution from being obligated to follow instructions of the secured party that the secured party had no right to issue. This problem does not arise when the secured party and the depository institution are the same. (Article 4 and non-UCC law govern the liability of a depository institution that misapplies funds on deposit.)

Accordingly the draft contains no "termination" requirement with respect to control obtained under draft § 9-118(1)(a).

7. Under draft subsection (4), which derives from section 8-106(g) of Revised Article 8, a depository institution would have no statutory obligation to enter into a control agreement. Subsection (4) does not prohibit a depository institution from undertaking a contractual obligation to enter into a control agreement, in which case other law would determine the consequences of any breach of that undertaking.

The Drafting Committee may wish to consider whether additional duties should be imposed on depository institutions. For example, arguably a depository institution (whether or not it has a security interest in the deposit account(s) that it maintains for a customer) should be required to identify for its customer any third parties who have obtained control over the deposit account(s). Cf. § 9-208 (requiring secured parties to respond to a debtor's request for information concerning the amount of indebtedness secured and the collateral subject to a security interest).

§ 9-209. Effect of Security Interest on Depository Institution's Right of Set-Off.

The application of this Article to a security interest in a deposit account shall not affect a right of set-off of the secured party as to a deposit account maintained with the secured party.

Reporters' Explanatory Note

This section is new. It makes clear that a depository institution may hold both a right of set-off against, and an Article 9 security interest in, the same deposit account. The section does not pertain to accounts evidenced by an instrument (e.g., certain CD's), which are excluded from the definition of "deposit accounts." Draft § 9-312A (below) addresses the conflict between a security interest in a deposit account and the depository institution's right of set-off.

§ 9-302. When Filing Is Required to Perfect Security Interest; Security Interests to Which Filing Provisions of This Article Do Not Apply.

(1) A financing statement must be filed to perfect all security interests except the following:

* * *

(h) A security interest in a deposit account over which the secured party has control under Section 9-118.

Reporters' Explanatory Notes

1. This revision would make clear that control is an alternative to filing.

2. The California State Bar proposal would amend § 9-302(2) to create a special rule to govern the case where the secured party is the depository institution at which the account is maintained, the security interest is perfected without filing, and the secured party assigns the security interest to a third party. The California proposal would create a 10-day temporary perfection rule. We see no need for automatic perfection in cases of this kind; assignees ordinarily should be able to file before taking the assignment. Moreover, an amendment to § 9-302(2) probably would necessitate a conforming amendment to § 9-402(2). Implicit in the draft is that the security interest would become unperfected upon assignment. This result could be made explicit in the comments.

§ 9-304. Perfection of Security Interests in Instruments, Documents, and Goods Covered by Documents, and Deposit Accounts; Perfection by Permissive Filing; Temporary Perfection Without Filing or Transfer of Possession.

* * *

(x) A security interest in a deposit account may be perfected by filing or by the secured party's obtaining control over the deposit account.

Reporters' Explanatory Note

Draft § 9-118 and the Explanatory Notes thereto explain the concept of "control."

§ 9-306. "Proceeds"; Secured Party's Rights in Proceeds ~~on Disposition of Collateral.~~

(† a) "Proceeds" [includes] [means] the following property:

(1) whatever is ~~received~~ acquired upon the sale, lease, license, exchange, ~~collection~~ or other disposition of collateral ~~or~~ proceeds;

(2) whatever is collected on, or distributed on account of, collateral;

(3) rights arising out of collateral;

(4) to the extent of the value of the collateral, claims arising out of the loss or non-conformity of, defects in, or damage to the collateral; and

(5) to the extent of the value of the collateral and to the extent payable to a party to the security agreement, ~~insurance payable by reason of the loss or non-conformity of, defects in, or damage to the collateral. is proceeds, except to the extent that it is payable to a person other than a party to the security agreement.~~

Money, checks, deposit accounts, and the like are "cash proceeds". All other proceeds are "non-cash proceeds".

(~~2~~ b) Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, lease, license, exchange or other disposition thereof unless the secured party authorized the disposition free of the security interest ~~was authorized by the secured party in the security agreement or otherwise, and also continues in attaches to any identifiable proceeds including collections received by the debtor.~~

(~~3~~ c) The security interest in proceeds is a ~~continuously~~ perfected security interest if the interest in the original collateral was perfected. ~~but it~~ The security interest in proceeds ceases to be a perfected security interest and becomes unperfected ~~ten days~~ on the twenty-first day after the security interest attaches to the proceeds ~~receipt of the proceeds by the debtor unless:~~

- (~~a~~ 1) a filed financing statement covers the original collateral and the proceeds are collateral in which a security interest may be perfected by filing in the office or offices where the financing statement has been filed and, if the proceeds are acquired with cash ~~proceeds,~~ collateral, the description of collateral in the financing statement indicates the types of property constituting the proceeds; or
- (~~b~~ 2) ~~a filed financing statement covers the original collateral and~~ the proceeds are identifiable cash proceeds; or

(c) 3) the security interest in the proceeds is perfected before the twenty-first day after the security interest attaches to the proceeds. ~~expiration of the ten day period.~~

Except as provided in this subsection, a security interest in proceeds can be perfected only by the methods or under the circumstances permitted in this Article for original collateral of the same type.

(d) Where a filed financing statement covers the original collateral, a security interest in proceeds that remains perfected under subsection (c) (1) or (2) becomes unperfected when the effectiveness of the filed financing statement lapses (Section 9-403) or is terminated (Section 9-404), but in no event before the twenty-first day after the security interest attaches to the proceeds.

(e) Where the security interest in the original collateral is perfected by a method other than by filing, a security interest in identifiable cash proceeds that remains perfected under subsection (c) (2) becomes unperfected when the security interest in the original collateral becomes unperfected, but in no event before the twenty-first day after the security interest attaches to the proceeds.

~~(4) In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest only in the following proceeds:~~

~~(a) in identifiable non-cash proceeds and in separate deposit accounts containing only proceeds;~~

~~(b) in identifiable cash proceeds in the form of money which is neither commingled with other money nor deposited in a deposit account prior to the insolvency proceedings;~~

~~(c) in identifiable cash proceeds in the form of checks and the like which are not deposited in a deposit account prior to the insolvency proceedings; and~~

~~(d) in all cash and deposit accounts of the debtor in which proceeds have been commingled with other funds, but the perfected security interest under this paragraph (d) is~~

~~(i) subject to any right to set-off; and~~

~~(ii) limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings less the sum of (I) the payments to the secured party on account of cash proceeds received by the debtor during such period and (II) the cash proceeds received by the debtor during such period to which the secured party is entitled under paragraphs (a) through (c) of this subsection (4).~~

~~(5) If a sale of goods results in an account or chattel paper which is transferred by the seller to a secured party, and if the goods are returned to or are repossessed by the seller or the secured party, the following rules determine priorities:~~

~~(a) If the goods were collateral at the time of sale, for an indebtedness of the seller which is still unpaid, the original security interest attaches again to the goods and continues as a perfected security interest if it was perfected at the time when the goods were sold. If the security interest was originally perfected by a filing which is still effective, nothing further is required to continue the perfected status; in any other case, the secured party must take possession of the returned or repossessed goods or must file.~~

~~(b) An unpaid transferee of the chattel paper has a security interest in the goods against the transferor. Such security interest is prior to a security interest asserted under paragraph (a) to the extent that the transferee of the chattel paper was entitled to priority under Section 9-308.~~

~~(c) An unpaid transferee of the account has a security interest in the goods against the transferor. Such security interest is subordinate to a security interest asserted under paragraph (a).~~

~~(d) A security interest of an unpaid transferee asserted under paragraph (b) or (c) must be perfected for protection against creditors of the transferor and purchasers of the returned or repossessed goods.~~

Reporters' Explanatory Notes

1. Subsection (a) expands the definition of proceeds. For the most part it follows Study Committee Recommendations 15.A.1., 15.A.2., and 15.A.3. The Study Committee recommended that the Drafting Committee consider the issue of licenses of intellectual property; this draft includes in the definition of "proceeds" any property that a debtor acquires upon the license of collateral. We believe that the phrase "whatever is distributed on account of, collateral," in section (a)(2), is broad enough to cover cash or stock dividends distributed on account of securities that are original collateral. Although UCC definitions generally do not control the meaning of terms found in the Bankruptcy Code, this revision might influence courts to reject the reasoning of cases such as *Hastie v. FDIC*, 2 F.3d 1042 (10th Cir. 1993), which held that post-petition cash dividends on stock subject to a pre-petition pledge are not proceeds protected under Bankruptcy Code § 552(b). The deletion of the phrase "or proceeds" in section (a)(1) is not intended to work a change in meaning. We have captured the same idea by revising the definition of "collateral" in § 9-105 to include proceeds.

When collateral is sold subject to a security interest and the buyer then resells the collateral, a question may arise under current law concerning whether the "debtor" has received what the buyer received on resale and, therefore, whether those receipts are "proceeds." See § 9-306(2); proposed revised definition of "debtor" in draft § 9-105. Under this draft, there is no requirement that property be received by the debtor or that the debtor have any interest in property for the property to qualify as proceeds. It is necessary only that the property be traceable, directly or indirectly, to the original collateral.

2. The Study Committee recommended that either § 9-306 or the official comment be revised to recognize that courts should apply non-UCC tracing principles in order to determine whether cash proceeds are "identifiable." Recommendation 15.C. The Study Committee deferred to the views of the Drafting Committee concerning whether it would be better to revise the statute or, instead, the official comment. Any effort to codify tracing principles would be difficult and might result in a complex statutory treatment. For this reason, and because we are inclined to favor addressing this issue in the comments rather than the statute, this draft does not address tracing.

3. Subsection (b) derives from existing subsection (2). The changes are intended to conform that subsection to subsection (a) and to make clear that it addresses authorized dispositions "free of" security interests. See P.E.B. Commentary No. 3. This change is not intended to address the frequently-litigated situation in which the effectiveness of the secured party's consent to a disposition is conditioned upon the secured party's receipt of the proceeds.

4. At the suggestion of Paul Shupack, we have rewritten subsections (c), (d), and (e); the changes from the prior draft are for clarification only; we intend no change in meaning. (Recall that the draft is marked to show changes from the official text and not from the prior draft.)

Paragraph (c)(2) responds to the Study Committee's recommendation that the benefits of existing paragraph (3)(b) "be extended to proceeds of original collateral in which a security interest is perfected by a method other than filing." See Recommendation 15.D. The Study Committee also recommended that when a security interest in cash proceeds continues to be perfected beyond the 20-day period the perfected status should lapse if the filing covering the original collateral lapses or if the security interest in the original collateral otherwise ceases to be perfected. Recommendation 15.E.5. To give effect to that recommendation, we formulated new subsections (d) and (e). We have taken the liberty of addressing an issue that the Study Committee did not focus on and have treated termination in the same fashion as lapse. Many of the situations covered by subsection (e) will not afford perfection in cash proceeds beyond the 20-day period (e.g., when the security interest in the

original collateral is perfected by possession, and possession is relinquished in exchange for cash proceeds). This fact may prompt the Drafting Committee to reconsider the wisdom of conditioning the continuance of perfection in cash proceeds on the continued effectiveness of the filing or other means of perfection in respect of the original collateral. Given the inherent vagaries of tracing and the fleeting nature of cash proceeds, perhaps a simple rule that provides for permanent perfection of security interests in identifiable cash proceeds would be preferable.

Revised paragraph (e) also addresses another issue. Under existing § 9-306, a lender (Lender) who takes a security interest in, say, equipment risks losing priority to a competing secured party (Bank) who claims the equipment as proceeds of its original collateral. Existing § 9-306(3)(a) recognizes that, when the equipment was acquired with cash proceeds, Lender faces particular difficulty in determining whether the equipment constitutes Bank's proceeds. Under that section, if Lender discovers that the debtor paid for the equipment with cash or a check, then once the ten-day period of automatic perfection passes, Lender need not concern itself with any financing statements except those that refer to equipment. (In contrast, if the equipment were acquired in exchange for Bank's inventory-collateral, Bank's financing statement covering "inventory" would be sufficient to continue perfection in the equipment until lapse.) The draft would apply the rule of existing § 9-306(3)(a) to proceeds that have been acquired not only with cash proceeds but also with other "cash collateral", e.g., funds from a deposit account serving as original collateral. Thus, if Bank or any third party claimed a security interest in the deposit account as original collateral, the security interest in the proceeds-equipment would become unperfected on the 21st day, unless a properly filed financing statement covering equipment were of record before the expiration of the period. Arguably the burden on Lender to discover Bank's security interest in the equipment as first-generation proceeds of the deposit account is less than would be the case if the equipment were second-generation proceeds of inventory. Nevertheless, the burden appears to be too great to require Lender to make further inquiry concerning the identity of the account from which payment was made and the status of that account. This burden will be compounded if the Drafting Committee chooses to permit perfection by control. Another explanation of this change appears on pp. 15-16 of the California State Bar proposal (distributed for the November, 1993, meeting).

5. The current text of and comments to section 9-306 do not deal adequately with the rights of a person to whom the debtor has transferred cash proceeds. Consider, for example, a seller of goods who takes in exchange the cash proceeds of SP's collateral (e.g., money or a check drawn on a deposit account containing only proceeds). Standing alone, section 9-306(2) suggests that the payment remains subject to a security interest, so that SP might enjoy a cause of action against seller. This would be the wrong result.

Official comment 2(c) to section 9-306 provides to the contrary (at least as to the check), stating as follows:

Where cash proceeds are covered into the debtor's checking account and paid out in the operation of the debtor's business, recipients of the funds of course take free of any claim which the secured party may have in them as proceeds. What has been said relates to payments and transfers in ordinary course.

The existing comment is problematic. Recent cases that have grappled with issues of this kind have focused on the undefined phrase "ordinary course." In *J.I. Case v. First National Bank*, 991 F.2d 1272 (7th Cir. 1993), for example, the court reached the right result but only after subjecting the comment to the same rigorous linguistic analysis that one properly would apply only to statutes (the court relied in part on the definition of "buyer in ordinary course"). Read in this manner, the comment's limitations are obvious: it makes no mention of cash payments, nor does it address ordinary-course payments by consumers and other non-business entities.

The Study Committee was of the view that, insofar as the rights of purchasers are concerned, a security interest in cash proceeds should be treated no differently from any other encumbrance or other defect in the transferor's title. A body of non-UCC law addresses the rights of those who receive funds (cash or bank credit) in which a third party claims an interest. The Study Committee recommended that the comments be revised to make clear that a good faith purchaser for value of money proceeds or of funds from a deposit account containing cash proceeds cuts off a security interest in the proceeds to the extent that the purchaser would take free of other claims to that property. See Recommendation 15.F. This approach is consistent with PEB Commentary No. 7, concerning the rights of junior secured parties who receive collections on accounts, chattel paper, and general intangibles.

Some people have expressed concern over this approach and have raised the following questions, which the Drafting Committee may wish to consider:

(1) As a general matter, should security interests in cash and cash equivalents (such as deposit accounts) be treated like other interests in property of this kind?

(2) If so, should the reference to non-UCC law appear in section 9-306 itself (e.g., "Except as provided in [Section 9-309], this Article does not govern the rights of purchasers of cash proceeds"), with a comment suggesting some sources of the applicable law (e.g., the law governing the negotiability of money, the law governing finality of payment, the law governing restitution)?

(3) In any event, are special rules needed to enable a senior secured party to recover proceeds that have been paid to a junior secured party? (Adoption of these special rules would constitute a rejection of PEB Commentary No. 7.) In considering this issue, members of the Drafting Committee might wish to read the opinions in *Orix Credit Alliance, Inc. v. Sovran Bank*, 4 F.3d 1262 (4th Cir. 1993). In that case, the Fourth Circuit permitted a contractually subordinated secured party to retain proceeds of collateral in the face of a demand from the senior secured party. Judge Ervin wrote a strong dissent.

As an alternative to the Study Committee's proposal, draft § 9-308A, below, would provide statutory protection for purchasers of "cash collateral."

6. The Study Committee recommended that § 9-318 and its official comment be revised to make it clear that the rules of that section "apply to all account debtors, including account debtors on general intangibles that are proceeds." Recommendation 15.B.1. It also recommended revisions to that section and its comment in order to clarify that the term "assignee" as includes a secured party claiming proceeds and "is not limited to an outright buyer of an account." Recommendation 15.B.2. We are inclined to favor revisions to the official comment that would explain and clarify these issues along the lines of the discussion of Recommendation 15.B. rather than revisions to § 9-318 itself. Accordingly, we have not drafted revisions to the text of that section.

7. This draft deletes subsection (4) of § 9-306, following Recommendation 15.G.

8. In accordance with Recommendation 15.H., this draft also deletes subsection (5) of § 9-306, which deals with returned and repossessed goods. With respect to this issue, the Study Committee recommended revisions to § 9-308, which we have addressed in draft § 9-308, as well as revisions to the official comments to Article 9, in order "to explain and clarify the application of priority rules to returned and repossessed goods in the absence of § 9-306(5)." The Explanatory Notes to draft § 9-308 contain proposed

official comments that address returned and repossessed goods as proceeds of chattel paper.

§ 9-308. Purchase of Chattel Paper and Instruments.

~~A purchaser of chattel paper or an instrument who gives new value and takes possession of it in the ordinary course of his business has priority over a security interest in the chattel paper or instrument~~

~~(a) which is perfected under Section 9-304 (permissive filing and temporary perfection) or under Section 9-306 (perfection as to proceeds) if he acts without knowledge that the specific paper or instrument is subject to a security interest; or~~

~~(b) which is claimed merely as proceeds of inventory subject to a security interest (Section 9-306) even though he knows that the specific paper or instrument is subject to the security interest.~~

A purchaser of chattel paper or an instrument has priority over a security interest in the chattel paper or instrument or in the proceeds of either if the purchaser, in the ordinary course of the purchaser's business and without knowledge that the purchase violates the rights of the secured party, gives new value and takes possession of the chattel paper or instrument.

Reporters' Explanatory Notes

1. The Study Committee recommended that § 9-308 be revised in two respects:

Section 9-308 should be revised to provide that the priority afforded thereunder to purchasers of chattel paper also extends to the goods covered by the chattel paper if the transferor reacquires an interest (other than a bare possessory interest) in the goods.

Recommendation 15.I.

Section 9-308 should be revised either to (i) eliminate the distinction between subsections (a) and (b) by creating a single set of circumstances under which a purchaser of chattel paper achieves priority over an earlier-perfected security interest or to (ii) clarify the bifurcated standards established by clauses (a) and (b).

Recommendation 21.A.

2. The foregoing draft § 9-308 reflects the first alternative presented by Recommendation 21.A.--it would create a single test for priority instead of the bifurcated test of the current clauses (a) and (b). It borrows the "violation of rights" standard from the definition of "buyer in ordinary course of business" in § 1-201(9). We are dubious that the bifurcated standards could be clarified in the absence of undesirable complexity and

detail. (We note that P.E.B. Commentary No. 8 consumed eight full printed pages in clarifying clauses (a) and (b).)

3. The draft retains the giving of "new value" as a condition for priority. In considering the meaning of the term, one should consult § 9-108, which provides as follows:

§ 9-108. When After-Acquired Collateral Not Security for Antecedent Debt.

Where a secured party makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value which is to be secured in whole or in part by after-acquired property his security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given.

The Drafting Committee may wish to consider whether a full definition of "new value" is needed and, if so, what its contours should be. In particular, the Drafting Committee may wish to consider whether § 9-308 should continue to include the idea now expressed in § 9-108.

4. The "superpriority" that § 9-308 affords to certain purchasers of chattel paper or instruments who take possession of the paper has been thought necessary to enable persons to purchase the paper without having to search the UCC filings and, in the case of chattel paper, to enable dealers to finance their paper with persons other than the inventory financier. (In theory, the inventory financier who loses priority in the chattel paper can look to the new value given by the chattel paper purchaser.) No similar priority exists for other types of receivables, such as accounts or general intangibles for money due. The Drafting Committee may wish to consider whether this distinction among different types of receivables should be retained and whether § 9-308 should be limited to instruments (or negotiable instruments) or deleted altogether.

5. The draft responds to Recommendation 15.I. by stating a general principle: the priority afforded a purchaser extends to proceeds of the chattel paper. Although the Study Committee's recommendation called only for a revision that would address returned and repossessed goods as proceeds, we favor a more general statement of the priority principle. Article 9 is silent as to the priority of a security interest in proceeds of chattel paper when a purchaser qualifies for priority under § 9-308. A similar silence under the pre-1972 Article 9 led the drafters to explicate the treatment of proceeds of collateral that qualifies for purchase money priority under § 9-312(3) and (4). The Drafting Committee may wish to consider whether the statute should make explicit that the purchaser acquires priority in proceeds regardless of whether the purchaser perfects as to the proceeds.

6. The Study Committee also recommended that the Drafting Committee revise the official comments to Article 9 in order "to explain and clarify the application of priority rules to returned and repossessed goods in the absence of § 9-306(5)." Recommendation 15.J. We have prepared the following draft official comment, which derives substantially from the discussion of Recommendations 15.H., I., and J. in the Report, for the Drafting Committee's consideration. (Note that, as written, draft § 9-308 makes no reference to returned or repossessed goods.)

X. Returned and repossessed goods may constitute proceeds of chattel paper. Consider the following example:

Secured Party 1 (SP-1) has a security interest in all the inventory of a dealer in goods (Dealer); SP-1's security interest is perfected by filing. Dealer sells some of its inventory to a buyer in the ordinary course of business (BIOCOB) pursuant to a conditional sales contract (chattel paper). Secured Party 2 (SP-2) purchases the chattel paper from Dealer and takes possession of the paper in the ordinary course of business and without knowledge that the purchase violates the rights of SP-1. Subsequently, BIOCOB returns the goods to Dealer because they are defective. Alternatively, Dealer acquires possession of the goods following BIOCOB's default.

The following discussion explains the treatment of returned and repossessed goods as proceeds of chattel paper in the context of this example.

Assignment of Non-Lease Chattel Paper.

- a. *Loan by SP-2 to Dealer Secured by Chattel Paper (or Functional Equivalent Pursuant to Recourse Arrangement).*

(1) *Returned Goods.* If BIOCOB returns the goods to Dealer for repairs, Dealer is merely a bailee and acquires thereby no meaningful rights in the goods to which SP-1's security interest could attach. (Although SP-1's security interest could attach to Dealer's interest as a bailee, that interest is not likely to be of any particular value to SP-1.) Dealer is the owner of the *chattel paper* (i.e., the owner of a right to payment secured by a security interest in the goods); SP-2 has a security interest in the chattel paper, as does SP-1 (as proceeds of the goods under § 9-306(2)). Pursuant to § 9-308, SP-2's security interest in the chattel paper is senior to that of SP-1. SP-2 enjoys this priority regardless of whether, or when, SP-2 filed a financing statement covering the chattel paper. Because chattel paper and goods represent different types of collateral, Dealer does not have any meaningful interest in goods to which either SP-1's or SP-2's security interest could attach in order to secure Dealer's obligations to either creditor. See § 9-105(1)(b) (defining "chattel paper"), (1)(h) (defining "goods").

Now assume that BIOCOB returns the goods to Dealer under circumstances whereby Dealer once again becomes the owner of the goods. This would be the case, for example, if the goods were defective and BIOCOB were entitled to reject or revoke acceptance of the goods. See §§ 2-602 (rejection); 2-608 (revocation of acceptance). Unless BIOCOB has waived its defenses as against assignees of the chattel paper, SP-1's and SP-2's rights against BIOCOB would be subject to BIOCOB'S claims and defenses. See §§ 9-206(1); 9-318(1). SP-1's security interest would attach again because the returned goods would be proceeds of the chattel paper. Dealer's acquisition of the goods easily can be characterized as an "in kind" collection on or distribution on account of the chattel paper. See § 9-306(1). Assuming that SP-1's security interest is perfected by filing against the goods and that the filing is made in the same office where a filing would be made against the chattel paper, SP-1's security interest in the goods would be perfected. See § 9-306(3)(a).

Because Dealer's newly reacquired interest in the goods is proceeds of the chattel paper, SP-2's security interest also would attach in the goods as proceeds. If SP-2 had perfected its

security interest in the chattel paper by filing (again, assuming that filing against the chattel paper was made in the same office where a filing would be made against the goods), SP-2's security interest in the reacquired goods would be perfected beyond 20 days. See § 9-306(3)(a). However, if the SP-2 had relied only on its possession of the chattel paper for perfection and had not filed against the chattel paper or the goods, SP-2's security interest would be unperfected after the 20-day period. See § 9-306(3)[(d)]. Nevertheless, SP-2's unperfected security interest in the goods would be senior to SP-1's security interest under § 9-308. The result in this priority contest is not affected by SP-2's acquiescence or non-acquiescence in the return of the goods to Dealer.

(2) *Repossessed Goods.* As explained above, Dealer owns the chattel paper covering the goods, subject to security interests in favor of SP-1 and SP-2. In Article 9 parlance, Dealer has an interest in chattel paper, not goods. If Dealer, SP-1, or SP-2 repossesses the goods upon BIOCOP's default, whether the repossession is rightful or wrongful as among Dealer, SP-1, or SP-2, Dealer's interest will not change. The location of goods and the party who possesses them does not affect the fact that Dealer's interest is in chattel paper, not goods. The goods continue to be owned by BIOCOP. SP-1's security interest in the goods does not attach until such time as Dealer reacquires an interest (other than a bare possessory interest) in the goods. For example, Dealer might buy the goods at a foreclosure sale from SP-2 (whose security interest in the chattel paper is senior to that of SP-1); that disposition would cut off BIOCOP's rights in the goods. § 9-504(4).

In many cases the matter would end upon sale of the goods to Dealer at a foreclosure sale and there would be no priority contest between SP-1 and SP-2; Dealer would be unlikely to buy the goods under circumstances whereby SP-2 would retain its security interest. There can be exceptions, however. For example, Dealer may be obliged to purchase the goods from SP-2, SP-2 may convey the goods to Dealer, and Dealer may fail to pay SP-2. Or, one could imagine that SP-2, like SP-1, has a general security interest in the inventory of Dealer. In the latter case, SP-2 should not receive the benefit of any special priority rule, since its interest in no way derives from priority under § 9-308. In the former case, SP-2's security interest in the goods reacquired by Dealer is senior to SP-1's security interest under § 9-308.

b. Dealer's Outright Sale of Chattel Paper to SP-2. Article 9 also applies to a transaction whereby SP-2 buys the chattel paper in an outright sale transaction without recourse against Dealer. §§ 1-201(37); 9-102(1)(b). Although Dealer does not, in such a transaction, retain any residual ownership interest in the chattel paper, the chattel paper constitutes proceeds of the goods to which SP-1's security interest will attach and continue following the sale. § 9-306(2). Even though Dealer has not retained any interest in the chattel paper, as discussed above BIOCOP subsequently may return the goods to Dealer under circumstances whereby Dealer reacquires an interest in the goods. The priority contest between SP-1 and SP-2 will be resolved as discussed above; § 9-308 makes no distinction among purchasers of chattel paper on the basis of whether the purchaser is an outright buyer of chattel paper or one whose security interest secures an obligation of Dealer.

Assignment of Lease Chattel Paper.

Chattel paper includes not only writings that evidence security interests in specific goods but also those that evidence true leases of goods. § 9-105(b) (defining "chattel paper").

The analysis with respect to lease chattel paper is similar to that set forth above with respect to non-lease chattel paper. It is complicated, however, by the fact that, unlike the case of chattel paper arising out of a sale, Dealer retains a residual interest in the goods. See § 2A-103(q) (defining "lessor's residual interest"); *In re Leasing Consultants, Inc.*, 486 F.2d 367 (2d Cir. 1973) (lessor's residual interest under true lease is an interest in goods and is a separate type of collateral from lessor's interest in the lease). If Dealer leases goods to a "lessee in ordinary course of business" (LIOCOB), then LIOCOB takes its interest under the lease (*i.e.*, its "leasehold interest") free of the security interest of SP-1. See §§ 2A-307(3); 2A-103(1)(m) (defining "leasehold interest"), (1)(o) (defining "lessee in ordinary course of business"). SP-1 would, however, retain its security interest in the residual interest. In addition, SP-1 would acquire an interest in the lease chattel paper as proceeds. If Dealer then assigns the lease chattel paper to SP-2, § 9-308 gives SP-2 priority over SP-1 with respect to the chattel paper, *but not* with respect to the residual interest in the goods. Consequently, assignees of lease chattel paper typically take a security interest in and file against the lessor's residual interest in goods, expecting their priority in the goods to be governed by the first-to-file-or-perfect rule of § 9-312(5)(a).

If the goods are returned to Dealer, other than upon expiration of the lease term, then the security interests of both SP-1 and SP-2 normally would attach to the goods as proceeds of the chattel paper. (If the goods are returned to Dealer at the expiration of the lease term and the lessee has made all payments due under the lease, however, then Dealer no longer has any rights under the chattel paper. Dealer's interest in the goods consists solely of its residual interest, as to which SP-2 has no claim.) This would be the case, for example, when the lessee rescinds the lease or when the lessor recovers possession in the exercise of its remedies under Article 2A. See, *e.g.*, § 2A-525. If SP-2 enjoyed priority in the chattel paper under § 9-308, then SP-2 likewise would enjoy priority in the returned goods as proceeds. This does not mean that SP-2 necessarily is entitled to the entire value of the returned goods. The value of the goods represents the sum of the present value of (i) the value of their use for the term of the lease and (ii) the value of the residual interest. SP-2 has priority in the former, but SP-1 ordinarily would have priority in the latter. Thus, an allocation of a portion of the value of the goods to each component may be necessary.

7. The Report raises other issues concerning chattel paper that are not related to the questions of good faith purchase or returned and repossessed goods as proceeds. We have not addressed them in this draft.

§ 9-308A. Purchase of Cash Collateral.

(a) Except as provided in subsections (b) and (c),

(1) a person who, without knowledge that its actions were wrongful as to the holder of a security interest in cash collateral, purchases for value and obtains control over the cash collateral, or

(2) any immediate or mediate transferee of such a person is not liable to any person on any legal theory[, including, without limitation, conversion, replevin, constructive trust, equitable lien, and equitable subordination] based upon the security interest in the cash collateral.

(b) Except as provided in subsection (c), subsection (a) applies:

(1) to a purchaser who is a secured party whose security interest secures payment or performance of an obligation or

(2) to a transferee from such a secured party only to the extent that the secured party [gave value] [made advances] [secured by the cash collateral] either without knowledge that its actions were wrongful as to the holder of the security interest or pursuant to a commitment entered into without such knowledge.

(c) Subsection (a) does not apply to actions brought by:

(1) a purchaser or transferee who qualifies for protection under subsection (a) [, or

(2) a purchaser or transferee who qualifies for protection under subsection (b), to the extent set forth therein].

Reporters' Explanatory Notes

1. Explanatory Note 6 to § 9-306 discusses problems under current law arising out of the transfer of cash proceeds, including deposit accounts. It is possible that including deposit accounts as original collateral will exacerbate these problems. The Study Committee recommended that the Drafting Committee address these problems by revisions to the official comments that would explain the applicability of non-UCC law governing the negotiability of money and finality of payment. The following excerpts from the Restatement (2d) of Contracts (1981) and the Restatement of Restitution (1937) are examples of non-UCC approaches to this issue.

Restatement (Second) of Contracts

§ 342. Successive Assignees from the Same Assignor

Except as otherwise provided by statute, the right of an assignee is superior to that of a subsequent assignee of the same right from the same assignor, unless

. . . .

(b) the subsequent assignee in good faith and without knowledge or reason to know of the prior assignment gives value and obtains

(i) payment or satisfaction of the obligation,

- (ii) judgment against the obligor,
- (iii) a new contract with the obligor by novation, or
- (iv) possession of a writing of a type customarily accepted as a symbol or as evidence of the right assigned.

Comment:

. . . .

e. Payment, judgment or novation. Where the subsequent assignee as a bona fide purchaser for value obtains performance by the obligor, judgment against him, or a new contract with him by novation, he is entitled to retain what he has received and enforce the judgment or novation against the obligor, free of any obligation to account to the prior assignee. Historically, this rule was justified on the ground that the right of an assignee was equitable and not enforceable against a bona fide purchaser of the legal right. In modern times the doctrine of bona fide purchase has been extended in the interest of the security of transactions. But where the interest of the first assignee has been perfected pursuant to statute, whether by filing or otherwise, subsequent bona fide purchasers are not protected unless the statute so provides or there is an estoppel. See Uniform Commercial Code Sections 1-103, 9-306, 9-309, 9-312.

Illustration:

3. B owes \$100 to A. A assigns the right to C for value. Later A assigns it for value to D, who takes it in good faith. D notifies B of the assignment to him before C notifies B of his assignment. C's right is superior to D's. But if D, still without knowledge or reason to know of the assignment to C, receives \$50 from B, D can retain what he receives.

Restatement of Restitution

§ 126. RIGHTS OF INTENDED PAYEE OR GRANTEE. BUSINESS TRANSACTION.

(1) Where a person has paid money or transferred property to another in the erroneous belief, induced by a mistake of fact, that he owed a duty to the other so to do, whereas such duty was owed to a third person, the transferee, unless a bona fide purchaser, is under a duty of restitution to the third person.

(2) If the third person had no equitable interest in the property, his right to restitution from the transferee is terminated if the transferor rescinds while solvent and before the third person has elected to hold the transferee solely liable.

Comment:

. . . .

f. Bona fide purchaser. If the transferee is a bona fide purchaser, he is under no duty of restitution either to the transferor or the third person. Thus, if the payee was entitled to receive from the transferor what the transferor gave and was ignorant of the error made by the transferor, he is protected. An

illustration of this is where a claim has been twice assigned by the same assignor and the second assignee, in ignorance of the prior assignment, receives payment from the debtor. If the debtor was unaware of the first assignment, the claim against him is terminated. If the debtor was aware of the first assignment, he remains liable to the first assignee, but the second assignee is under no duty of payment to the first assignee. As to the circumstances under which a person becomes a bona fide purchaser, see §§ 172-176 [of the Restatement of Restitution].

Illustration:

8. A owes B \$1000. B assigns the claim to C. Subsequently, he makes a second assignment of the claim to D. Having no reason to know of the prior assignment, D receives payment of the claim from A. D is entitled to retain what he has thus received. (B is under a duty of restitution to C under the rule stated in § 131 [of the Restatement of Restitution].)

Draft § 9-308A is an alternative to reliance upon non-UCC law. It would provide instead a statutory good-faith-purchase rule for all purchasers for value of cash collateral (including secured parties) who take control of cash collateral without actual knowledge (§ 1-201(25)) that they are acting wrongfully. To qualify under draft § 9-308A(a)(1), the purchaser must be free of wrongful knowledge at the time of purchase, at the time value is given, and at the time the purchaser obtains control. Subsection (a)(2) follows the shelter principle; it protects immediate and mediate transferees of purchasers who qualify for protection under subsection (a)(1). Subsection (b) contains a special value requirement applicable only to secured parties and their transferees. Those persons are protected only to the extent that they [gave value] [made advances] without wrongful knowledge or pursuant to a commitment entered into without such knowledge. Subsection (b) applies only to secured parties whose security interest secures payment or performance of an obligation. It does not affect the rights of buyers of accounts, chattel paper or general intangibles giving rise to cash collateral.

2. The approach taken in this section is one of exculpation from liability; it is inspired in part by sections 8-502 and 8-510 of Revised Article 8. Failure to qualify for protection under draft § 9-308A would mean that otherwise applicable provisions of Article 9 would apply, together with any supplemental principles of law and equity that Article 9 does not displace. See § 1-103. The Drafting Committee may wish to consider, as an alternative approach, the automatic subordination of non-qualifying security interests.

3. It is possible for more than one purchaser to obtain control of a deposit account under circumstances giving rise to protection under this section. In that event, it may be necessary for one person having control to bring an action against another, e.g., to determine priorities. Subsection (c) permits actions of this kind, whose resolution would be governed by other provisions of Article 9 and, to the extent not displaced, non-UCC law. See § 1-103. Subsection (c)(2) is has been bracketed because the persons who qualify under subsection (b) are a subset of those who qualify under subsection (a). Accordingly, the Drafting Committee should consider whether subsection (c)(2) is necessary.

4. Legal rules that turn on subjective knowledge are fraught with difficulties. See Explanatory Note 1 to draft § 9-312, below.

§ 9-312. Priorities Among Conflicting Security Interests in the Same Collateral.

(1) The rules of priority stated in other sections of this Part and in the following sections shall govern when applicable: Section ~~4-208~~ 4-210 with respect to the security interests of collecting banks in items being collected, accompanying documents and proceeds; Section 9-103 on security interests related to other jurisdictions; Section 9-114 on consignments.

* * *

(3) A perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory and, subject to subsections [(x), (y), and (z)] of this section, also has priority in its identifiable cash proceeds received on or before the delivery of the inventory to a buyer if

(a) the purchase money security interest is perfected at the time the debtor receives possession of the inventory; and

(b) the purchase money secured party gives notification in writing to the holder of the conflicting security interest if the holder had filed a financing statement covering the same types of inventory (i) before the date of the filing made by the purchase money secured party, or (ii) before the beginning of the 21 day period where the purchase money security interest is temporarily perfected without filing or possession (subsection (5) of Section 9-304); and

(c) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and

(d) the notification states that the person giving the notice has or expects to acquire a purchase money security interest in inventory of the debtor, describing such inventory by item or type.

(4) A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral ~~or~~ and, subject to subsections [(x), (y), and (z)] of this section, also has priority in its identifiable proceeds if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter.

Subsections (x) and (y) - Alternative 1

(x) A security interest held by a secured party who has control over a deposit account has priority over a conflicting security interest in the same deposit account held by a secured party who does not have control over the deposit account (i) if at the time the secured party obtained control over the deposit account the secured party did not know that its actions were wrongful as to the secured party who held the conflicting security interest, and (ii) to the extent that the security interest secures advances made by the secured party without knowledge that its actions were wrongful as to the secured party who held the conflicting security interest or made pursuant to a commitment entered into without such knowledge.

(y) A security interest in a deposit account held by the depository institution with which the deposit account is maintained has priority over a conflicting security interest in the same deposit account held by a secured party who also has control over a deposit account (i) if at the time the depository institution's security interest attached it did not know that its actions were wrongful as to the secured party who held the conflicting security interest, and (ii) to the extent that the security interest secures advances made by the depository institution without knowledge that its actions were wrongful as to the secured party who held the conflicting security interest or made pursuant to a commitment entered into without such knowledge.

Subsections (x) and (y) - Alternative 2

(x) A security interest held by a secured party who has control over a deposit account has priority over a conflicting security interest in the same deposit account held by a secured party who does not have control over the deposit account.

(y) A security interest in a deposit account held by the depository institution with which the deposit account is maintained has priority over a conflicting security interest in the same deposit account held by a secured party who also has control over a deposit account.

(z) Except as otherwise provided in subsection (y), security interests perfected by control rank equally.

(5) In all cases not governed by other rules stated in this section (including cases of purchase money security interests and security interests in deposit accounts ~~which that~~ do not qualify for the special priorities set forth in subsections (3), ~~and~~ (4), (x), (y), and (z) of this section), priority between conflicting security interests in the same collateral shall be determined according to the following rules:

(a) Conflicting security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither filing nor perfection.

(b) So long as conflicting security interests are unperfected, the first to attach has priority.

(6) For the purposes of subsection (5) a date of filing or perfection as to collateral is also a date of filing or perfection as to proceeds.

(7) If future advances are made while a security interest is perfected by filing, the taking of possession, under Section 9-304(x) on deposit accounts, or under Section 9-115 on investment property ~~8-321 on securities~~, the security interest has the same priority for the purposes of subsection (5) with respect to the future advances as it does with respect to the first advance. If a commitment is made before or while the security interest is so perfected, the security interest has the same priority with respect to advances made pursuant thereto. In other cases a perfected security interest has priority from the date the advance is made.

Reporters' Explanatory Notes

1. During the March, 1994, meeting of the Drafting Committee a substantial number of the committee members, advisors, and observers opposed a priority rule that would afford priority in all cases to a depository institution's security interest in a deposit account maintained with the depository institution. The priority conflict that received the most attention in those deliberations was one between the depository institution and a conflicting security interest in the deposit account as cash proceeds of inventory or accounts. The particular scenario that evoked concern involved a depository institution that acts to achieve priority with knowledge that it is violating the rights of the proceeds claimant. The Drafting Committee give no specific instructions to the Reporters, however. Rather, the Drafting Committee asked the Reporters to propose and draft coherent priority rules for resolving this and other priority contests.

The role, if any, that wrongful conduct should play in Article 9's priority rules is a question with implications that are much more significant than the priority contest between a proceeds claimant and a depository institution concerning a deposit account. This issue was discussed at length and in detail in connection with the ALI's recent approval of Revised Article 8. The conforming amendments to Article 9 that accompany Revised Article 8 contain a rule affording priority to a securities intermediary's security interest in a securities entitlement maintained with it. See Revised § 9-115(5)(b). On the face of the statute, that priority rule would control even if the security interest or the advance it secures is later in time than another security interest or is obtained or made with knowledge of an earlier security interest. During the ALI deliberations it was decided that the Official Comments to § 9-115 would be revised to state that, in appropriate cases of wrongful conduct by a secured party who is afforded priority under the statutory priority rules, a damaged party could invoke other law or principles of equity, applicable through § 1-103, to render the secured party liable or to subordinate its security interest. The Article 9 Drafting Committee will have an opportunity to review and comment on these draft revisions to the Official Comments before they are finalized.

During the discussions of the Article 8/9 revisions it became clear that the Article 9 Drafting Committee should revisit the broader question whether wrongful conduct--and in particular knowledge that one is acting wrongfully--should play a more prominent role in the Article 9 priority scheme. Under the current baseline rule for priority among security interests, the first-to-file-or-perfect rule of § 9-312(5)(a) applies irrespective of the knowledge of the senior party. On the other hand, knowledge does play a role in the Article 9 priority scheme for certain exceptions to the generally applicable first-in-time rule. See, e.g., §§ 1-201(9) ("'buyer in ordinary course of business' [must be] without knowledge that the sale is in violation of the ownership rights or security interest of a third party"); 9-308(a) (priority for purchasers of chattel paper and instruments "who act[] without knowledge that the specific paper or instrument is subject to a security interest"); see also §§ 9-301(1)(c), (d); 9-301(4); 9-307(3); 9-309; 9-314(3); 9-401(2); 9-504(4).

The Study Committee recommended against a revision of the UCC that would seek to clarify when non-UCC principles of law and equity should be invoked to override or modify the otherwise applicable Article 9 priority rules. Recommendation 12, Report at 91-93. Like the Study Committee, we have serious misgivings about a more general interjection of subjective knowledge (§ 1-201(25)) in the Article 9 priority scheme. The test necessarily creates the potential for circular priorities. As mentioned above, it is inconsistent with the treatment of security interests held by securities intermediaries and other secured parties who obtain control of security entitlements. Application of the test requires difficult temporal analyses as well. And it could lead to unpredictable results. For example, assume that a depository institution receives a letter from a putative secured party announcing that the secured party claims a deposit account as proceeds and that the debtor has agreed not to give anyone else an interest in the deposit account. Does the depository institution "know" that taking an interest would be wrongful? Must it also "believe" that the statements in the letter are true? What if it has no idea about the truth of the statements? Must it investigate?

2. We have proposed for discussion purposes draft provisions (draft §§ 9-308A and 9-312(x) and (y) (1st alternative)) that we hope will focus the Drafting Committee's deliberations. As discussed above, draft § 9-308A is an *exculpatory* rule. Under that section, lack of particular knowledge is a factor in determining whether certain good-faith-purchasers (including secured parties) of cash collateral are immunized from liability. A secured party who qualifies under that section would be entitled, for example, to retain collections on accounts or payments from a deposit account, even though the secured party held a junior security interest in the accounts or deposit account.

In contrast, draft §§ 9-312(x) and (y) (1st alternative) are *priority* rules, under which certain security interests are entitled to a special priority in deposit accounts only if the secured party acts without knowledge that its conduct is wrongful. Note that if no secured party qualifies for this special priority, the normal priority rules (e.g., subsections (5) and (z)) would apply. Under these rules, a security interest held by a secured party who acts with knowledge that its conduct is wrongful would not necessarily be subordinated. This point is discussed further in Explanatory Note 5 below.

3. If the Drafting Committee adopts a priority rule that turns on knowledge, it should consider carefully the standard of culpability to be embraced by the priority rule. The draft provisions that we have proposed adopt a general standard of knowing wrongfulness. We believe that knowing wrongfulness would exist, for example, if the secured party who has control knows that taking a security interest in a deposit account, or advancing funds so as to expand an existing security interest, would cause the debtor to violate an agreement (such as a negative pledge clause) with a secured party holding a conflicting security interest. On the other hand, we do not believe that knowing wrongfulness necessarily would exist if the secured party who has control knows only that there exists a conflicting security interest in the deposit account. Moreover, whether or not the Drafting Committee opts for a knowledge-based priority rule in the present context, it may wish to conform the various standards for culpable knowledge that currently appear in Article 9 (for examples, see the sections cited above in Explanatory Note 1).

4. Under draft subsection (x), security interests perfected by control take priority over those perfected by filing or otherwise, regardless of whether the deposit account constitutes the competing secured party's original collateral or its proceeds. Under Alternative 1, the priority conferred by this subsection would apply only to a secured party who acts without wrongful knowledge. The subsection reflects the view that secured parties for whom the deposit account is an integral part of the credit decision will, at a minimum, insist upon the right to immediate access to the deposit account upon the debtor's default (i.e., control). Those secured parties for whom the deposit account is less essential will not take control, thereby running the risk that the debtor will dispose of funds on deposit (either outright or for collateral purposes) after default but before the account can be frozen by court order or the secured party can obtain control. Under Alternative 2, the priority afforded to a secured party who has obtained control would not be limited by the wrongful knowledge test.

5. Under draft subsection (y), the security interest of the depository institution with which the deposit account is maintained would take priority over other conflicting security interests in the deposit that also are perfected by control. As in Alternative 1 to subsection (x), the priority afforded by Alternative 1 of this subsection would be available only to a depository institution that acts without wrongful knowledge. This priority rule would enable depository institutions to extend credit to their depositors without the need to examine the public record. However, it may be necessary for the depository institution to examine its own records to determine whether wrongful knowledge exists. As with Alternative 2 of subsection (x), the priority afforded to a depository institution under Alternative 2 of subsection (y) would not be limited by the wrongful knowledge test.

Neither subsection (x) nor subsection (y) is limited to priority conflicts involving a proceeds claimant. Note as well that a security interest that fails to qualify for the priority afforded by Alternative 1 of subsection (x) or (y) would not be automatically subordinated to the conflicting security interest. Rather, subsections (x) and (y), as drafted, operate like good-faith-purchase rules--security interests that qualify become senior to interests that would have been senior under the otherwise applicable priority rule. In this case, the otherwise applicable priority rules are the purchase money priority rules of subsections (3) or (4) or the first-to-file-or-perfect rule of subsection (5). If the secured party who has control or

the depository institution would have priority under the usual priority rules (e.g., it perfected its security interest before the holder of the conflicting security interest filed or perfected), it would have no need to resort to the special priority rules set forth in subsections (x) and (y). Of course, as mentioned above, a secured party who acts wrongfully nonetheless may be liable to the competing secured party or might be subordinated under other rules of law or equity applied through § 1-103. The special priority rules in subsections (x) and (y) (both alternatives) do not apply to accounts evidenced by an instrument (e.g., certain CD's), which by definition are not "deposit accounts."

6. A secured party who takes a security interest in a deposit account as original collateral can protect itself against the priority rule in subsection (y), which favors the depository institution, by obtaining a subordination agreement from the depository institution. See § 9-316. A secured party who claims the deposit account as proceeds of other collateral can reduce the risk of becoming junior by obtaining the debtor's agreement to deposit proceeds into a specific cash collateral account and obtaining the agreement of that depository institution to subordinate all its claims to those of the secured party. If the debtor violates its agreement and deposits funds into a deposit account other than the cash collateral account, however, the secured party would risk being subordinated.

7. When more than one non-depository institution has control over a deposit account, subsection (z) governs. This case is likely to arise only when the depository institution inadvertently enters into a control agreement with more than one secured party. Subsection (z) follows the approach of Revised Article 8 and would afford equal priority to the security interests. In evaluating this subsection, the Drafting Committee may wish to take into account the difficulties that security interests of equal priority may present. These are discussed in Explanatory Note 5 to § 9-504 (February 8, 1994, draft). If the Drafting Committee favors Alternative 1 to subsections (x) and (y), it should consider whether subsection (z) should be revised to subordinate a control party with wrongful knowledge.

8. The priority afforded by subsections (x), (y), and (z) is not intended to extend to proceeds of a deposit account. Accordingly, subsection (5), the first-to-file-or-perfect rule, will govern priorities in proceeds. This means that a secured party who obtains control but who nevertheless leaves the debtor with the power (but perhaps not the right) to withdraw from the deposit account would not be entitled to special priority as to the proceeds. Rather, the secured party who obtained control would be subordinate to a competing secured party who filed earlier. This result would obtain regardless of whether the earlier filing covered the deposit account or other collateral whose proceeds were deposited into the deposit account. (Draft § 9-306(d) (above) addresses continuation of perfection in proceeds of deposit accounts.)

§ 9-312A. Effectiveness of Right of Recoupment or Set-Off Against Deposit Account.

(a) The depository institution with which a deposit account is maintained may exercise against a secured party who has a security interest in the deposit account:

(1) Any right of recoupment, and

(2) Any right of set-off that accrues before the depository

institution receives [written] notification of the security interest.

(b) The exercise by a depositary institution of a set-off against a deposit account whose exercise is not permitted by subsection (a) (2) is ineffective against a secured party who has a security interest in the deposit account.

Reporters' Explanatory Notes

1. This section would resolve the conflict between a security interest in a deposit account and the depository institution's rights of recoupment and set-off. The Drafting Committee considered several approaches to resolving this conflict during the March, 1994, meeting. A substantial majority favored the approach reflected in this draft, which derives from the proposal of the California State Bar and, in turn, from § 9-318(1). The draft distinguishes between recoupment rights and setoff rights. In this context, recoupment refers to the right of the depository institution to reduce its obligation to the depositor (i.e., the deposit account balance) because of a claim against the depositor that arises out of the deposit account relationship. Recoupment rights would include, for example, claims for bank charges. The draft would subordinate the security interest to all recoupment rights and to those setoff rights that accrue before the depository institution receives notification of the security interest. For a further explanation, see pp. 22-23 of the California proposal (distributed for the November, 1993, meeting).

2. This section is one of several that regulates the adverse relationship between a depository institution to which the debtor owes money and a secured party claiming a security interest in a deposit account. See also draft §§ 9-308A; 9-312(x) and (y); 9-318A. Depository institutions argue, with some force, that they must be free to deal with the deposit account without having to keep track of various papers coming in over the transom. Secured parties argue, with some force, that if they risk losing cash collateral to every depository institution in which it might be deposited, they will need to incur the costs of a lock box for every secured transaction in which cash collateral is likely to arise. The current draft is unlikely to satisfy either group. In assessing the draft as a whole, the Drafting Committee may wish to consider whether the draft strikes an appropriate balance or whether it presents "the worst of both worlds." In particular, the Drafting Committee may wish to revisit whether receipt of a notification is an appropriate standard for purposes of this section in light of its deliberations concerning the role of wrongful knowledge in the preceding sections of this draft. The Drafting Committee also may wish to consider whether this provision should be relocated to draft § 9-318A.

3. Unless the Drafting Committee decides to the contrary (see Explanatory Note 5, below), non-UCC law will continue to determine whether a depository institution enjoys a right of recoupment or set-off. Subsection (a) would apply only when the depository institution enjoys a right of recoupment or set-off against the debtor under non-UCC law. However, once that right exists, this section would preempt the field with respect to the relationship between the depository institution's right and another party's security interest. For example, in the event that this section permits the effective exercise of a right of recoupment or set-off against a secured party under circumstances where non-UCC law would preclude the exercise of the depository institution's right against third parties, this section governs. The prior draft contained only rules indicating when a depository bank "may exercise" a right of set-off. In doing so, it arguably left open the possibility that non-UCC law would be applied to validate a set-off under other circumstances, as well (e.g., even if the right to set off accrued after receipt of notification). Under subsection (b) of this draft, any set-off by a depository institution that subsection (a) does not permit is not effective against the secured party.

4. Under draft § 9-105, a deposit account evidenced by an instrument (e.g., certain CD's) would not be a "deposit account." Accordingly, draft § 9-312A would not apply to the depository institution's right to set off against such an account. The Drafting Committee may wish to consider whether to provide the governing priority rules in Article 9. If the instrument is an Article 3 "instrument" and the secured party is a holder in due course (HDC), Article 9 already makes clear that Article 3 would govern and the secured party would prevail. See § 9-309 (protection of purchasers of instruments). But if the secured party is not a holder in due course, the result under

existing Article 9 is uncertain: either the security interest prevails over the right of set-off under § 9-201 or the secured party has the rights of any other non-HDC under Article 3 (in which case it might or might not prevail, depending on whether the right of set-off is a defense or claim in recoupment of the kind described in § 3-305(a)(2) or (3)). The latter approach seems preferable; it would be anomalous if a non-HDC secured party could acquire greater rights than any other non-HDC purchaser (e.g., a buyer) could obtain. A similar uncertainty arises under current law if the Article 9 instrument is not negotiable: either the secured party prevails over the right of set-off under § 9-201 or the secured party has the rights of any other assignee under the common law or any applicable statute. Again, we do not believe that § 9-201 should control or be applied so as to give a secured party rights that are greater than those of the debtor.

5. In many ways, the right of set-off functions like a security interest. In bankruptcy, the holder of a setoff right holds a secured claim. See Bankruptcy Code § 506(a). The Drafting Committee may wish to consider whether the law of setoffs should be codified as part of, or together with, the Article 9 revision process. For one writer's vision of such a codification, see Sepinuck, *The Problems with Setoff: A Proposed Legislative Solution*, 30 *Wm. & Mary L. Rev.* 51 (1988).

§ 9-318A. Depository Institution's Right to Dispose of Funds Evidenced by a Deposit Account.

Except as provided in Section 9-312A(b), and unless the depository institution otherwise agrees, a depository institution's rights and duties with respect to a deposit account maintained with that depository institution are not terminated, suspended or modified by:

(1) the creation or perfection of a security interest in the deposit account;

(2) the depository institution's knowledge of the security interest; or

(3) the depository institution's receipt of instructions from the secured party.

Reporters' Explanatory Notes

1. This section is designed to prevent security interests in deposit accounts from impeding the free flow of funds through the payment system. It would leave the depository institution's rights and duties with respect to the deposit account and the funds on deposit unaffected by the creation or perfection of a security interest or by the depository institution's knowledge of the security interest. In addition, it would permit the depository institution to ignore the instructions of the secured party unless it had agreed to honor them. Under the draft, a secured party who wished to deprive the debtor of access to funds on deposit or to appropriate those funds for itself would need to obtain the agreement of the depository institution, utilize the judicial process, or comply with procedures set forth in other law. (The Official Comments might be revised to make clear that § 4-303(a) (concerning the effect of notice on a bank's right and duty to pay items) is not to the contrary. That section addresses only whether an otherwise effective notice comes too late; it does not determine whether a timely notice is otherwise effective.)

2. The most important function of this section is to insure the depository institution's right to follow the debtor's (customer's) instructions (e.g., by honoring checks, permitting withdrawals, etc.) until such time as the depository institution is served with judicial process or receives instructions that it previously had agreed to honor. Nevertheless, the events enumerated in it--particularly the last two--may implicate the depository institution's rights as a creditor of the debtor.

Under draft § 9-312A(b), a depository institution's receipt of notification of a security interest may affect its right to set off against a deposit account. Under some circumstances, receipt of the notification may constitute "knowledge of the security interest" within the meaning of this section. Accordingly, the introductory phrase to this section excepts draft § 9-312A. However, our intention is that this section should be read consistently with the exculpatory provisions of draft § 9-308A and the priority rules applicable to a depository institution's security interest in a deposit account maintained with it (e.g., draft §§ 9-312(x) and (y)). That is, none of the facts set forth in this section *ipso facto* should constitute the wrongful knowledge that would result in loss of protection under draft § 9-308A or loss of special priority under §§ 9-312(x) and (y) (1st alternative). The Drafting Committee should consider whether, in light of draft § 9-312A, this is the appropriate relationship between this section and the others and, if so, whether this section makes the relationship sufficiently clear.

3. This section does not address the obligations of depository institutions that issue instruments evidencing deposits (e.g., certain CD's).