Using First Principles of UCC Article 9 to Solve Statutory Puzzles in Receivables Financing

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INTRODUCTION

Despite its name, the Uniform Commercial Code ("UCC") is far from a complete codification of commercial law, or even of the topics that the UCC addresses. Principles of common law and equity supplement the provisions of the UCC.[1] Some of these principles are among the foundational, albeit unarticulated, principles upon which the UCC is built.[2] Like the rest of the UCC, Article 9 does not codify the entire law of competing claims to personal property. Determining the proper relationship between the rules of Article 9 and other law, not covered by the article, presented considerable challenges in the drafting and revision of Article 9. It continues to offer challenges in the interpretation and application of its rules.

In this Article we consider two areas in which the relationship between Article 9 and related non-UCC law is unclear. Part I explores the relationship between Article 9's priority rules—in particular, the first-to-file-or-perfect rule

1. *See* U.C.C. § 1-103(b) (2008).

2. *See, e.g.*, Steven L. Harris, *Using Fundamental Principles of Commercial Law to Decide UCC Cases*, 26 LOY. L.A. L. REV. 637, 637-38 (1993).

in section 9-322(a)(1)—and the baseline conveyancing rule of property law, *nemo dat non quod habet* (one cannot give what one does not have). Part II considers the extent to which the common-law concept of reification, which treats the written evidence of an intangible right as if it were the right itself, is reflected in Article 9's provisions governing security interests in chattel paper. Both of these areas were debated by the Joint Review Committee, which was charged with drafting what became the 2010 Amendments.[3] The 2010 Amendments to the text of Article 9 do not address either area; however, the second area was addressed in amendments to the Official Comments.[4] There is no question that the relationship between Article 9 and related common-law principles gives rise to some difficult puzzles in the interpretation and application of the statutory provisions. However, in each Part we propose what we believe are sound approaches for construing Article 9 in a principled manner that solves these puzzles.

I. APPLICATION, SCOPE, AND FUNCTIONS OF ARTICLE 9 PRIORITY RULES FOR RECEIVABLES: EXAMPLES AND SOLUTIONS

During the few years between the time revised Article 9 took effect and the time the Joint Review Committee was established,[5] the proper relationship between *nemo dat* and section 9-322(a)(1)'s first-to-file-or-perfect ("FTFOP") priority rule was the subject of intense debate over the internet, in print, and by the Article 9 Review Committee.[6] The interpretive issues arise primarily when

3. The Joint Review Committee was established by the ALI and ULC in 2008. Between its establishment and the presentation of its final draft in 2010, the committee held five meetings and ten conference calls.

4. *See* U.C.C. § 9-102 cmt. 5(d) (Proposed Revisions 2010); *id.* § 9-330 cmt. 4.

5. Revised Article 9 provides for a uniform effective date of July 1, 2001. *See* U.C.C. § 9-701 (2008). By that date all the states had enacted revised Article 9 and it was in effect in all but four. Table of Jurisdictions Wherein Code has been Adopted, 3 U.L.A. 1 (2010). By January 1, 2002, the revised article was effective in all fifty states. *Id.* The drafting process resulting in revised Article 9 began in 1993, following a two-plus year study under the auspices of the Permanent Editorial Board for the Uniform Commercial Code. *See* PEB STUDY GRP., PERMANENT EDITORIAL BD. FOR THE U.C.C. UNIFORM COMMERCIAL CODE ARTICLE 9 REPORT (Dec. 1, 1992) [hereinafter REPORT].

6. *See, e.g.*, Barkley Clark & Barbara Clark, *Revised Article 9: A Drafting Glitch on Priorities?*, CLARKS' SECURED TRANSACTIONS MONTHLY, May 2006, at 1-2 (discussing an alleged "glitch" in U.C.C. § 9-318(a)); Thomas E. Plank, *Assignment of Receivables Under Article 9: Structural Incoherence and Wasteful Filing*, 68 OHIO ST. L.J. 231, 242-45 (2007) (discussing "glitches" of Revised Article 9). The Review Committee to which the text refers was appointed by the PEB in early 2008. One of us (Harris) was a member. U.C.C. Article 9 Review Comm., *Current Projects*, A.L.I., http://www.ali.org/index.cfm?fuseaction=projects.members&projectid=21 (last visited Nov. 20, 2011). The committee produced two lists, one describing select issues that a drafting committee might consider addressing in

one of the competing claims to a right to payment (receivable) arises from a sale (or sales) of the receivable.[7] In this Part, we explain that FTFOP not only resolves priority contests but also serves another function as well. FTFOP sometimes empowers a debtor to transfer rights that it does not have (or greater rights than it has). We also explain that, under the proper understanding of the rule, in some cases the holder of what appears to be a junior interest (i.e., an interest that does not achieve priority) actually has no interest whatsoever.

A. *How FTFOP Creates the Power to Transfer a Security Interest*

Article 9 permits a secured party to "prefile" a financing statement, i.e., to file before a security agreement has been entered into or a security interest has attached.[8] By ranking security interests according to priority in the time of perfection or filing, FTFOP allows a prefiling secured party to lock in its priority based on the time of the filing.[9] If priority could not be fixed by prefiling, a potential secured party who was negotiating for the grant of a security interest would risk the possibility that, during the negotiations, the debtor might encumber the collateral with a senior, competing security interest. The following example is illustrative:

EXAMPLE A (competing collateral assignments of accounts):

At T-1 *SP-1* files a financing statement against *D* covering all accounts.[10] At T-2 *D* makes a collateral assignment of all *D*'s

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amendments to the text of Article 9, and another for consideration as modifications to the Official Comments. *See* U.C.C. Article 9 Review Comm., *Statutory Modification Issues List*, A.L.I. 1, 15 (June 24, 2008), *available at* http://extranet.ali.org/directory/files/UCC9_IssuesList.pdf. The Review Committee's "issues lists" formed the agenda for the Joint Review Committee, which was appointed later that year. Although there was some support for including the issues discussed in this Part of the Article, the Review Committee declined to do so, in part because the issues are so complex.

7. A receivable may be assigned to secure an obligation or assigned outright (i.e., sold). Both types of assignments create Article 9 security interests. *See* U.C.C. § 1-201(b)(35) (2008) (defining "security interest" to include the interest of "a buyer of accounts, chattel paper, a payment intangible, or a promissory note in a transaction that is subject to Article 9"). To distinguish between these two types of security interests, we use the term "collateral assignment" to refer to an assignment of a receivable by a debtor-assignor to a secured party-assignee for the purpose of securing an obligation.

8. *See* U.C.C. § 9-502(d) (2008). Note, however, that a secured party who prefiles without being entitled to do so is liable for damages. *See id.* § 9-625(b), (e) (providing for damages in the amount of any loss and for additional damages in the amount of $500).

9. *See* U.C.C. § 9-322(a)(1) (2008).

10. In this and all other examples, we assume that *D* authorized each filing before it

> accounts to *SP-2* to secure an existing obligation of *D* to *SP-2; SP-2*'s security interest thereupon attaches to (becomes enforceable against) the accounts.[11] At T-3 *SP-2* files a financing statement, thereby perfecting its security interest.[12] At T-4 *D* signs a security agreement in favor of *SP-1* covering all *D*'s accounts, and *SP-1* extends credit to *D*; *SP-1*'s security interest thereupon attaches and, by virtue of *SP-1*'s having prefiled at T-1, simultaneously becomes a perfected security interest.[13]

The following timeline illustrates Example A:

SP-1 files FS	Collateral assignment to *SP-2* (attaches)	*SP-2* files FS (perfected)	Collateral assignment to *SP-1* (attaches/perfected)
|	|	|	|
T-1	T-2	T-3	T-4

There is no doubt that, at T-4, *SP-1*'s security interest achieves priority over *SP-2*'s security interest under section 9-322(a)(1) (FTFOP).[14] *SP-2*'s security interest attached and was perfected before *SP-1* acquired a perfected security interest. But because *SP-1* was the first to *file* or perfect, *SP-1*'s security interest achieved priority over that of *SP-2*. Under a strict application of *nemo dat*, SP-1's security interest could attach only to *D*'s rights in the collateral, which, at T-4, were already encumbered by *SP-2*'s security interest. FTFOP overrides *nemo dat* in this respect and allows *D* to transfer to *SP-1* rights that *D* previously had transferred to *SP-2* and so no longer had. Of course, as a practical matter this result normally should not jeopardize the interests of persons in the position of *SP-2*. Had *SP-2* conducted a search of the relevant filings, it would have discovered *SP-1*'s financing statement. In that event *SP-2* would have been foolish to proceed as it did in Example A.[15]

was made. *See* U.C.C. § 9-509(a) (2008) (explaining when a person may file an initial financing statement).

11. *See* U.C.C. § 9-203(a), (b) (2008).

12. *See* U.C.C. § 9-308(a) (2008); *id.* § 9-310(a).

13. *See* U.C.C. § 9-308(a) (2008).

14. Example A incorporates essentially the same facts as Example 1 in the Official Comments to section 9-322, except that the collateral in Example 1 is an item of equipment. *See* U.C.C. § 9-322 cmt. 4, ex. 1 (2008). FTFOP applies to "[c]onflicting perfected security interests." *Id.* § 9-322(a)(1). At T-3 there was no priority contest, because only *D* and *SP-2* had an interest in the accounts; *SP-1*'s interest did not arise until T-4.

15. *SP-2* could have protected itself by refusing to proceed in the face of *SP-1*'s filing unless *SP-1* filed a termination statement for its financing statement, *see* U.C.C. § 9-513(d) (2008), or agreed to subordinate its security interest to *SP-2*'s. *See id.* § 9-339.

It is important to note that section 9-203, which deals with attachment (enforceability) of security interests, complements FTFOP. Under section 9-203(b)(2), a security interest does not attach unless the debtor has "rights in the collateral" or "the power to transfer rights in the collateral to a secured party."[16] The first quoted phrase reflects *nemo dat*. A debtor cannot create a security interest in collateral in which the debtor has no rights, and a debtor who has rights in collateral can create a security interest only in those rights that it has.[17] The second phrase limits the application of *nemo dat* by allowing for circumstances in which a debtor can transfer (create a security interest in) rights that the debtor does not have. An interpretive problem arises because Article 9 does not state all the circumstances in which a debtor has the power to transfer rights it does not have.[18] Some of these circumstances are found elsewhere in the UCC.[19] Others must be inferred from—indeed, they are immanent in—the priority rules themselves. The application of FTFOP in Example A reflects *D*'s power to transfer the rights that it previously had transferred to *SP-1*. But FTFOP is not unique in this regard. All the priority rules in Article 9 constitute exceptions to *nemo dat* to the extent they award priority to a later-in-time interest over a pre-existing interest.[20]

One cannot understand and properly apply Article 9's priority rules, including FTFOP, without recognizing that those rules can create the power to transfer rights in collateral. As we shall see, however, the priority rules do not override *nemo dat* entirely; there remains a proper domain for application of the doctrine. Below we analyze some complex and subtle scenarios and provide a coherent explanation for when *nemo dat* does and does not play a role in the realm of Article 9 priorities.

B. *The Application of FTFOP to the Sale of Accounts*

We begin with a variation on Example A in which *SP-2* is a *buyer* of accounts.

16. U.C.C. § 9-203(b)(2) (2008).

17. *See, e.g.*, STEVEN L. HARRIS & CHARLES W. MOONEY, JR., SECURITY INTERESTS IN PERSONAL PROPERTY 26 (4th ed. 2006).

18. *But cf.* U.C.C. § 9-401 (2008) (providing that Article 9 generally defers to other law regarding the transferability of a debtor's rights in collateral).

19. *See, e.g.*, U.C.C. § 2-403(2) (2008) (providing that a person who has voidable title can transfer good title to a good faith purchaser for value); *id*. § 3-306 (providing that "[a] person having rights of a holder in due course takes free of the claim to the instrument").

20. *See* U.C.C. § 9-203 cmt. 6 (2008) (explaining that the priority rules of Article 9, Part 3, Subpart 3, are examples of a debtor's power to "transfer . . . greater rights than the debtor has").

EXAMPLE B (competing collateral assignment of accounts and assignment of accounts to a buyer; collateral assignee files first):

> At T-1 *SP-1* files a financing statement against *D* covering all of D's accounts. At T-2 *D* assigns outright (sells) specific accounts to *SP-2*, who buys the accounts; *SP-2*'s security interest (i.e., its ownership interest) thereupon attaches to the sold accounts.[21] At T-3 *SP-2* files a financing statement, thereby by perfecting its security interest (i.e., its ownership interest as buyer). At T-4 *D* signs a security agreement in favor of *SP-1* covering all *D*'s accounts, and *SP-1* extends credit to D; *SP-1*'s security interest thereupon attaches and, by virtue of *SP-1*'s having prefiled at T-1, simultaneously becomes a perfected security interest.

The following timeline illustrates Example B:

SP-1 files FS	Sale to *SP-2* (sec. int. attaches)	*SP-2* files FS (sec. int. perfected)	Collateral assignment to *SP-1* (sec. int. attaches/perfected)
|	|	|	|
T-1	T-2	T-3	T-4

We think there is widespread agreement that, under the FTFOP rule of section 9-322(a)(1), *SP-1 should*, as a policy matter, achieve priority as to the accounts sold to *SP-2*.[22] The relevant policy here is identical to that in Example A. Dating *SP-1*'s priority from T-1 would eliminate the risk that *D* might effectively sell the intended collateral to *SP-2* while continuing to negotiate with *SP-1*. *SP-2* could have protected itself by conducting a search, discovering *SP-1*'s financing statement, and refusing to proceed without first protecting itself. Despite their apparent agreement on what policy dictates, some commentators have questioned whether the statutory text yields the "right" outcome. They argue that *SP-1* does not achieve priority because its security interest never attached.[23] This argument is based on section 9-318(a),

21. In Example A the assignments to *SP-2* covered "all *D*'s accounts," whereas we refer here to an assignment of "specific accounts." This variation reflects the fact that buyers of accounts, such as *SP-2*, typically do not take an assignment of all the seller's accounts. Although the variation has practical consequences, it has no legal significance for the resolution of the competing claims to the assigned accounts.

22. *See, e.g.*, Clark, *supra* note 6; Barkely Clark & Barbara Clark, *A Dialogue Between Two UCC Gurus on a Drafting Glitch Under Revised Article 9*, CLARKS' SECURED TRANSACTIONS MONTHLY, July 2006, at 4-5; Plank, *supra* note 6, at 244-45.

23. *See, e.g.*, Clark, *supra* note 6 (outlining the argument, made by the late Donald Rapson and discussed below, that a "glitch" in UCC section 9-318(a) prevents attachment occurring in this situation); Plank, *supra* note 6, at 244-45 (agreeing with Rapson that section

which provides: "A debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold."[24] Section 9-318(b) calls off the rule of subsection (a) in the case of an *unperfected* security interest of a buyer of an account (or chattel paper); however, this exception does not apply to Example B, in which *SP-2*'s security interest is *perfected* (by filing). Consequently, the argument goes, the perfected sale to *SP-2* deprived *D* of its legal and equitable interests in the sold accounts. Because *D* had no rights (interest) in the collateral, *SP-1*'s security interest never attached.[25]

This argument, that *SP-1*'s security interest did not attach, fails under a proper analysis of FTFOP. As we discussed, that priority rule is designed to enable a second-to-attach but first-to-file secured party to achieve priority over an earlier perfected security interest. Implicit in the rule is that a debtor retains "the *power* to transfer rights" (as that phrase is used in section 9-203(b)(2)) that the debtor previously assigned,[26] even though the debtor retains no legal or equitable interest in the sold accounts under section 9-318(a).[27] The application of FTFOP in the context of a sale (Example B) overrides *nemo dat* in precisely the same manner as it does when two competing collateral assignments are involved (Example A). In each case *D*'s power to transfer more than *D* has is implicit in the priority rule. It makes no difference that, following the assignment to *SP-2*, in Example A *D* retained this power while also retaining an ownership interest in the collateral subject to *SP-2*'s security interest, whereas in Example B *D* retained the power while retaining no interest in the collateral. The fact that a person lacks a "legal or equitable interest" under section 9-318(a) or "rights in collateral" under section 9-203(b)(2) does not prevent that person from having the "power" to create a security interest in the collateral. The proper result is that *SP-1*'s security interest attaches to the accounts previously bought by *SP-2*, and *SP-2* now owns the accounts subject to *SP-1*'s security interest.[28]

9-318(a) deprives debtor of rights in the collateral and prevents first-filed party from achieving priority notwithstanding FTFOP). Plank, however, argues that as to after-acquired collateral in which SP-1's and SP-2's security (ownership) interests attach simultaneously, SP-1 has priority under FTFOP. In that respect Plank agrees with the position taken by Ed Smith. (Plank arrived at his conclusion independently.) *Id.* at 245-46; *see also* Clark, *supra* note 22 (outlining Rapson's and Smith's positions on the operation and effects of section 9-318).

24. U.C.C. § 9-318(a) (2008).

25. *See* U.C.C. § 9-203(b)(2) (2008) (conditioning attachment and enforceability on the debtor having "rights in the collateral or the power to transfer rights in the collateral to a secured party").

26. U.C.C. § 9-203(b)(2) (2008) (emphasis added).

27. *See* U.C.C. § 9-318(a) (2008).

28. Our core analysis of the implicit power to transfer that is inherent in the Article 9

As already mentioned, even those who would read section 9-318(a) as preventing *SP-1*'s security interest from attaching appear to be uncomfortable with the result produced by that reading. We have suggested a reading of section 9-203(b)(2), as informed by FTFOP, that reaches the desired result.[29] The Official Comments, which provide specific examples in which a purchaser of receivables prevails over the perfected security interest of an earlier-in-time buyer, are consistent with our analysis and conclusion.[30] Our reading also is consistent with an understanding of the background of section 9-318(a) that is shared by at least some of those who disagree with our statutory interpretation. This background undercuts their argument to the contrary. The first point of agreement is that section 9-318(a), which had no analogue in former Article 9, was intended to overrule a wrongly-decided bankruptcy case and not to change

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priority rules and in particular in FTFOP is consistent with that offered by Kenneth Kettering. *See* Memorandum from Kenneth C. Kettering, Assoc. Professor, N.Y. Law Sch. to Lance Liebman et al. (June 21, 2006) [hereinafter Kettering Memo] (on file with authors); *see also* Kenneth C. Kettering, *True Sale of Receivables: A Purposive Analysis*, 16 AM. BANKR. INST. L. REV. 511, 536 n.106 (2008). Plank ignores this line of analysis and apparently accepts uncritically Rapson's analysis that a "glitch" in section 9-318(a) precludes attachment of *SP-1*'s interest in the setting of Example B. *See* Plank, *supra* note 6, at 244-47. Almost twenty years ago Dan Coenen outlined a similar argument that a sale of an account to a buyer who failed to perfect its interest nonetheless could deprive the debtor-seller of rights in the collateral to the end that no subsequent security interest could attach, much less be perfected and achieve priority. Dan T. Coenen, *Priorities in Accounts: The Crazy Quilt of Current Law and a Proposal for Reform*, 45 VAND. L. REV. 1061, 1077-80 (1992). However, Coenen properly concluded that this argument should be rejected, as it "would in effect exempt outright buyers of accounts from the filing requirement." *Id.* at 1078.

29. One might argue that the desired result is mandated by Article 1, which requires that the UCC be "liberally construed and applied to promote its underlying purposes and policies." U.C.C. § 1-103(a) (2008).

30. *See* U.C.C. § 9-318 cmt. 4 (2008) (a purchaser of a promissory note who takes possession may qualify for priority, under section 9-330 or 9-331, over an earlier-in-time, perfected security interest of the buyer of the promissory note); *id.* § 9-330 cmt. 7 (a purchaser of a promissory note who takes possession may qualify for priority, under section 9-330(d), over an earlier-in-time buyer of the promissory note whose security interest is perfected automatically under section 9-309(4)); *see also id.* § 9-317 cmt. 6 (buyers of accounts, chattel paper, payment intangibles, and promissory notes are not subject to the buyer cut-off rules of section 9-317(b) and (d) but are subject to the priority rules generally applicable to security interests). It appears that sections 9-330 and 9-331, as each relates to promissory notes, and possibly section 9-330 as it relates to chattel paper and imbedded, stripped payment intangibles (discussed *infra* Part II.B.2.) are the only examples other than FTFOP in which an implicit power to transfer is derived from an Article 9 priority rule notwithstanding the earlier sale of the collateral. Conversely, if *D* retains no interest *and* a subsequent purchaser cannot acquire priority even if its security interest were to attach, then the subsequent purchaser acquires no interest. For a fuller discussion of this point, see *infra* Part II.B.2.

the priorities that resulted from the application of FTFOP.[31] The second point of agreement is that, for purposes of the priority contests under discussion, the articulation of FTFOP in revised Article 9 is identical to that in former Article 9.[32] The third point of agreement is that former Article 9's version of FTFOP would have awarded priority to *SP-1* over *SP-2*, which is the result that we advocate here under revised Article 9's FTFOP.[33] The fourth point of agreement is that section 9-318(a) codifies the common-law doctrine of *nemo dat*.[34] If the fourth point is correct, of course, then that provision did not change the common law in effect before Article 9 was revised, which is another point of agreement.[35] If *nemo dat* was the law before and after enactment of

31. The case is *Octagon Gas Systems, Inc. v. Rimmer*, 995 F.2d 948, 956-57 (10th Cir. 1993), holding that receivables that had been "sold" nevertheless remained property of the bankruptcy estate because the buyer's interest is defined in Article 9 to be a "security interest," the buyer is defined to be a "secured party," and the seller is defined to be a "debtor." The case was uniformly criticized as failing to appreciate that including sales of receivables within the scope of Article 9 for purposes of the relevant perfection and priority rules in no way suggests that the seller has retained any rights. *See* U.C.C. § 9-318 cmt. 2 (2008) ("Subsection (a) makes explicit what was implicit, but perfectly obvious, under former Article 9: The fact that a sale of an account or chattel paper gives rise to a 'security interest' does not imply that the seller retains an interest in the property that has been sold."). For criticism of *Octagon Gas*, see PERMANENT EDITORIAL BD. FOR THE U.C.C., *Commentary No. 14, Section 9-102(1)(b)* (June 10, 1994), *reprinted in* 3A U.L.A. 178 (2002); Plank, *supra* note 6, at 246 n.70; Thomas E. Plank, *When a Sale of Accounts is Not a Sale: A Critique of Octagon Gas*, 48 CONSUMER FIN. L.Q. REP. 45, 45-53 (1994). For a somewhat friendlier view, see James J. White, *Chuck and Steve's Peccadillo*, 25 Cardozo L. Rev. 1743, 1748-49 (2004).

32. The only difference between the FTFOP rules in UCC section 9-322(a)(1) and former section 9-312(5)(a) is that the former also governs conflicting agricultural liens and is expressly limited to competing security interests that are perfected. *Compare* U.C.C. § 9-322(a)(1) (2008) (providing that "[c]onflicting perfected security interests and agricultural liens rank according to priority in time of filing or perfection"), *with* U.C.C. § 9-312(5)(a) (1999) (providing that "[c]onflicting security interests rank according to priority in time of filing or perfection").

33. *See* Clark, *supra* note 6, at 1 ("SP1 [i.e., the first to file] clearly had priority under the first-to-file rule of old UCC § 9-312(5).").

34. *See* U.C.C. § 9-318 cmt. 2 (2008) (quoted *supra* note 31); Clark, *supra* note 6, at 2 ("UCC §9-318(a), intended to overrule *Octagon Gas*, . . . really doesn't change the rule from what existed under the old version of Article 9."); Clark, *supra* note 22, at 5 (according to Rapson, section 9-318 "is broadly written and codifies the common law property rule of nemo dat"); Kettering Memo, *supra* note 28, Attachment, Unauthorized Draft of PEB Cmt., at 5 ("Section 9-318(a) did not change prior law. Its role is to serve as a reminder of the fact that Article 9 applies to outright sale of a Receivable as well as to creation of an interest in a Receivable to secure an obligation, and of the obvious truth that even though the transferee's interests in these two transactions are both defined to be 'security interests' those interests differ in the attribute mentioned in [section 9-318, comment 3].").

35. Kettering Memo, *supra* note 28, Attachment, Unauthorized Draft of PEB Cmt.,

section 9-318(a) and that provision did not change the law, and if the proper result (*SP-1*'s priority) would have been reached under former Article 9's FTFOP rule even in the face of the same *nemo dat* rule, then it necessarily follows that revised Article 9's FTFOP provides for the same result.[36]

Section 9-318(b) has no bearing on the analysis. As noted above, in the case of an unperfected security interest held by a buyer of accounts or chattel paper, subsection (b) deems the seller-debtor to have the rights and title that it sold.[37] When subsection (b) applies, the debtor is deemed to have "rights in the collateral" for purposes of attachment.[38] Such a debtor can create a security interest in those rights without having to rely on the "power to transfer" a security interest that derives from the applicable priority rule.[39] The fact that subsection (b) deems a debtor to have certain "rights" in specified circumstances[40] does not negate the possibility that there may be other circumstances in which a seller may have "power" to create a security interest even in the absence of "rights in the collateral."[41] The whole point of the "power" phrase in section 9-203(b)(2) is to allow for attachment in those other circumstances.

Revised Article 9 quite plausibly could have omitted section 9-318(b) and still reached the same result, i.e., a security interest can attach to accounts after they have been sold to a buyer who fails to perfect its security interest.[42]

at 5. It should come as no surprise that, as the principal authors of the Official Comments, we agree with the comment 2 and with the statement in the text. James White is less sure about the matter. White, *supra* note 31, at 1756 ("Whether the rule stated in subsection [9-318](a) was the law before 1999 is less clear.").

36. The text demonstrates that the "*nemo dat* prevents attachment" argument is undercut by important points upon which at least some of the proponents appear to agree. Had the proponents merely noted that revised Article 9 is not a statute for dummies and that a court that fails to understand how FTFOP works might make a mistake, then we would take a more sympathetic view of the concerns. But the proponents actually suggested changes to the statute to address what they perceived to be a "glitch," and actually recommended that, until the "glitch" is fixed, the *SP-1*'s of the world change their behavior by updating searches (to discover any *SP-2*'s of the world who may have filed between T-1 and T-4). Clark, *supra* note 22, at 4.

37. *See* U.C.C. § 9-318(b) (2008).

38. U.C.C. § 9-203(b)(2) (2008).

39. U.C.C. § 9-203(b)(2) (2008).

40. *See* U.C.C. § 9-318(b) (2008).

41. U.C.C. § 9-203(b)(2) (2008).

42. For that matter, revised Article 9 also might plausibly have omitted section 9-318(a), which also reflects prior law. Each of these provisions has been criticized. *See, e.g.*, White, *supra* note 31, at 1754-58 (arguing that section 9-318 may impose risks on a buyer in the seller's bankruptcy because it may be read to imply that some rights remain with seller and suggesting that the section may be an improper attempt to influence bankruptcy law). White also suggests that "securitizers" somehow played an influential role in the

FTFOP was understood to implicitly override the common-law of *nemo dat* under former Article 9, even though that article did not expressly allow for attachment when the debtor had the "power to transfer a security interest" but lacked "rights in the collateral."[43] Having expressly allowed for attachment under these circumstances, the Drafting Committee could have relied on FTFOP to override section 9-318(a).[44] The addition of subsection (b) does not detract from, and is not inconsistent with, the implicit power conferred by Article 9's priority rules.

C. *The Application of FTFOP to the Sale of Payment Intangibles*

1. The Effect of Prefiling by a Collateral Assignee

Like the sale of accounts, the sale of payment intangibles is an Article 9 transaction. The sale of payment intangibles differs, however, in that the buyer's security (ownership) interest is automatically perfected upon attachment, without the need for filing or another perfection step.[45] The following examples consider whether the fact of automatic perfection affects the application of FTFOP.

EXAMPLE C (competing collateral assignment of payment intangibles and assignment of payment intangibles to a buyer; collateral assignee files first):

> At T-1 *SP-1* files a financing statement against *D* covering all *D*'s payment intangibles. At T-2 *D* assigns outright (sells) specific payment intangibles to *SP-2*, who buys the payment intangibles; *SP*-

process of drafting section 9-318 and the relevant Official Comments. *Id*. As the primary statutory drafters and authors of the comments, our recollections do not match White's musings. Every word was chosen with only one goal in mind: to reflect the correct result as determined by the Drafting Committee and to do so clearly. We eschew for now any reassessment of the wisdom of either subsection of section 9-318 and are satisfied to demonstrate that the statute as written achieves its intended results.

43. *Compare* U.C.C. § 9-203(1)(c) (1999) (providing that a security interest does not attach unless "the debtor has rights in the collateral"), *with* U.C.C. § 9-203(b)(2) (2008) (providing that a security interest does not attach unless "the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party").

44. *See* U.C.C. § 9-318 cmt. 3 (2008) ("Another aspect of sales of accounts and chattel paper also was implicit, and equally obvious, under former Article 9: If the buyer's security interest is unperfected, then for purposes of determining the rights of certain third parties, the seller (debtor) is deemed to have all rights and title that the seller sold."). The applicable priority rule was U.C.C. § 9-312(5)(a) (1999).

45. *See* U.C.C. § 9-309(3) (2008).

> *2*'s security interest (i.e., its ownership interest) thereupon attaches to the payment intangibles and is perfected. At T-3 *D* signs a security agreement in favor of *SP-1* covering all *D*'s payment intangibles, and *SP-1* extends credit to *D*; *SP-1*'s security interest thereupon attaches and, by virtue of *SP-1*'s having prefiled at T-1, simultaneously becomes a perfected security interest.

The following timeline illustrates Example C:

SP-1 files FS	Sale to *SP-2* (sec. int. attaches/perfected)	Collateral assignment to *SP-1* (sec. int. attaches/perfected)
T-1	T-2	T-3

Just as in Example B, *SP-1*'s security interest has priority over *SP-2'*s security (ownership) interest. *D* retained the power, implicit in FTFOP, to create a security interest in favor of *SP-1* notwithstanding *D*'s earlier sale of the payment intangibles to *SP-2*. *SP-2* is the owner of the payment intangibles, but subject to *SP-1*'s security interest. In this setting the rules for payment intangibles do not differ from those applicable to accounts in Example B.[46]

2. The Effect of Prefiling by a Buyer

Now suppose that *SP-1*, like *SP-2*, is a buyer rather than a collateral assignee of the payment intangibles. Will this variation affect the outcome? Consider Example D.

EXAMPLE D (competing assignments of payment intangibles to buyers):

> At T-1 *SP-1* files a financing statement against *D* covering all *D*'s payment intangibles. At T-2 *D* makes a collateral assignment of specific payment intangibles to *SP-2*, who advances funds to D; *SP-2*'s security interest thereupon attaches to the payment intangibles and is perfected. At T-3 *D* assigns outright (sells) the same specific payment intangibles to *SP-1*, and *SP-1* buys the payment intangibles; thereupon *SP-1*'s security interest, i.e., its ownership interest, attaches to the

46. Automatic perfection for sales of payment intangibles is an exception to this statement, of course. The relevant perfection and priority rules for sales of payment intangibles discussed here are the same as those for promissory notes (other than priority based in part on possession of a promissory note under sections 9-330 and 9-331). For convenience, however, this discussion addresses only payment intangibles.

payment intangibles. SP-1's security interest also is automatically perfected (although *SP-1* had filed a financing statement on T-1, as well).

The following timeline illustrates Example D:

SP-1 files FS	Collateral Assignment to *SP-2*; *SP-2* files FS (attach/perfected)	Sale to *SP-1* (attach/perfected)
T-1	T-2	T-3

If *SP-1*'s priority under FTFOP is based on its filing at T-1, then the analysis of this example would be identical to that of Example C: *SP-1* would have priority as the first to file or perfect. The result, though not identical, would be similar. Here, *SP-1* is a buyer and not a collateral assignee. Rather than subordinating *SP-2*, awarding priority to *SP-1* at T-3 would cut off any interest that *SP-2* may have acquired at T-2.[47]

This analysis and result are consistent with the statutory text of Article 9. FTFOP provides that:

> Conflicting perfected security interests and agricultural liens rank according to priority in time of filing or perfection. Priority dates from the earlier of the time a filing covering the collateral is first made or the security interest or agricultural lien is first perfected, if there is no period thereafter when there is neither filing nor perfection.[48]

Read literally, any filing—no matter what information it provides or where it is filed—is relevant for purposes of this rule, as long as it "cover[s] the collateral."[49] It should be obvious that a literal reading would subvert Article 9's purposes and policies and so should be rejected.[50] FTFOP links priority to the time of filing because filing affords notice to subsequent creditors that the collateral may be encumbered. A filing does not "count" for purposes of FTFOP unless the filed financing statement affords the requisite notice, i.e., it satisfies the applicable requirements for sufficiency[51] and is filed in the right

47. Although *SP-2*'s interest in Example D arises from a collateral assignment, the same result would obtain if *SP-2* had bought the payment intangibles at T-2 rather than taken a collateral assignment: *SP-1*'s interest would prevail over *SP-2*'s. We discuss this scenario *supra* at pp. 308-09.

48. U.C.C. § 9-322(a)(1) (2008).

49. U.C.C. § 9-322(a)(1) (2008).

50. *Cf.* U.C.C. § 1-103(a) (2008) (mandating that the U.C.C. "must be liberally construed and applied to promote its underlying purposes and policies").

51. U.C.C. § 9-502 (2008) (specifying the requirements for sufficiency of a financing

office[52] in the proper state or other jurisdiction.[53] A filing also does not "count" for purposes of FTFOP if the security interest in question cannot be perfected by filing.[54] In the words of an Official Comment, in section 9-322(a)(1) "'[f]iling,' of course, refers to the filing of an effective financing statement."[55]

3. Why Prefiling by a Buyer Fixes the "Time of Filing" Under FTFOP

One might argue that, because a sale of payment intangibles is automatically perfected under section 9-309, *SP-1*'s filing has no legal effect and so is not relevant for determining the "time of filing" under FTFOP.[56] If that were so, then *SP-1*'s priority under FTFOP would date from the time of sale (attachment plus automatic perfection) rather than from the time of filing, and *SP-2*'s security interest, which was perfected first, would have priority. Not only that, but if *SP-2* had been a buyer rather than a collateral assignee, then the sale to *SP-2* would deprive *D* of the implicit power to transfer rights to *SP-1*, who would acquire nothing. In our view the argument that *SP-1*'s filing is not the "time of filing" for purposes of FTFOP conflicts with the structure of Article 9's perfection and priority rules and the policies underlying those rules.

Article 9 expressly gives effect to a filing that is made at a time when no security interest exists and no one can know with certainty whether one ever will exist.[57] By dating priority from the time of filing, FTFOP permits a prospective secured party to "lock in" its priority date (vis-à-vis other security interests) in advance.[58] Prefiling is also a fundamental attribute of Article 9's "notice filing" architecture, in which indications of collateral on a financing

statement).

52. U.C.C. § 9-501 (2008) (specifying the office where a financing statement is to be filed to perfect a security interest when the law of "this State" applies).

53. U.C.C. § 9-301 (2008) (specifying the law governing perfection and priority of security interests).

54. Notwithstanding the general rule that "a financing statement must be filed to perfect all security interests," U.C.C. § 9-310(a) (2008), some security interests cannot be perfected by filing. *See, e.g.*, *id.* § 9-311(a) (providing that the filing of a financing statement is not necessary or effective to perfect a security interest in, inter alia, goods covered by a certificate-of-title statute); *id.* § 9-312(b) (providing, inter alia, that a security interest in a deposit account (other than as proceeds) may be perfected only by control and a security interest in money (other than as proceeds) may be perfected only by taking possession).

55. U.C.C. § 9-322 cmt. 4 (2008).

56. On its face such an argument is circular, inasmuch as the financing statement would have legal effect if it is effective for purposes of determining the time of filing under FTFOP.

57. *See* U.C.C. § 9-502(d) (2008) (providing that a financing statement may be filed before a security agreement has been entered into or a security interest has attached).

58. *See infra* Part I.E. (describing situations in which the "lock in" does not apply).

statement need not contain the details of the collateral or of other aspects of a transaction (which, of course, may not yet have taken place when the financing statement is filed).[59] No one would doubt that if *SP-1* had received a collateral assignment from *D* at T-3, the filing would have been effective and FTFOP would award priority to SP-1. (This is Example B.) But at T-1, when *SP-1* filed, one could not know for sure whether *SP-1* would enter into a transaction with *D* at T-3 (or at any other time in the future), nor could one know whether any future transaction would be a collateral assignment or a sale. It would be an odd reading of the statute indeed to conclude that *SP-1*'s filing on T-1 was effective on that date (and so fixed the "time of filing") if in the future the parties entered into a collateral assignment, but was not effective on that date if the parties subsequently entered into a sale. In our view the filing must have been effective or not based on information that existed on T-1, which is the "time of filing" under FTFOP.[60] Moreover, the idea that a filed financing statement's effectiveness is tied to a particular transaction intended or contemplated by the parties at the time of filing has been a dead letter for many years.[61] There is no reason to imagine that this obsolete concept has been unintentionally resurrected by revised Article 9's provision for automatic perfection of sales of payment intangibles.

It is particularly significant from a policy perspective that *not* applying FTFOP to sales of payment intangibles would be quite disruptive of Article 9's priority system, including FTFOP. Consider again Example C, in which *SP-1*, the first-filed collateral assignee of payment intangibles, achieved priority over *SP-2*, who bought certain payment intangibles after *SP-1*'s filing but before *SP-*

59. *See* U.C.C. § 9-502 cmt. 2 (2008).

60. That is not to say that subsequent events cannot make ineffective a financing statement that is effective for purposes of FTFOP at the time it is filed. For example, a filing in the jurisdiction in which the debtor is located can become ineffective if the debtor changes its location. This is because section 9-301 provides that the law of the jurisdiction in which the debtor is located governs perfection "while a debtor is located in [that] jurisdiction." U.C.C. § 9-301(1) (2008). Just as a financing statement filed in the "wrong" location does not fix the "time of filing" for purposes of FTFOP, so a financing statement that is filed in the "right" location but becomes ineffective because the debtor relocates does not fix (or no longer fixes) the "time of filing." *See, e.g.*, *id.* § 9-316(a)-(b) (concerning the effect on perfection of a change in the governing law).

61. Recall the infamous case, *Coin-O-Matic Service Co. v. Rhode Island Hospital Trust Co.*, 3 U.C.C. Rep. Serv. (West) 1112 (R.I. Super. Ct. 1966), which held that a financing statement was ineffective to perfect a security interest arising in a subsequent transaction involving future advances when the security agreement in the original transaction did not cover future advances. The holding in the case was rejected by the Permanent Editorial Board for the UCC, *see* U.C.C. app. B, ¶¶ E-39 to E-40 (1972) (General Comment on the Approach of the Review Committee for Article 9), and the overwhelming weight of case law on the issue. *See, e.g.*, Provident Fin. Co. v. Beneficial Fin. Co., 245 S.E.2d 510, 513-14 (N.C. Ct. App. 1978).

1's security interest attached. We take it that everyone would agree that, as in that example, FTFOP can work against (i.e., subordinate) a buyer of payment intangibles. What is the sense, then, of the result that FTFOP cannot work in favor of such a buyer?

Now consider a modified version of Example D, in which *SP-2* bought the payment intangibles (instead of taking a collateral assignment) before they were sold to *SP-1* but after *SP-1* filed a financing statement. As previously noted, if FTFOP were not applicable to these facts, then *SP-1* would acquire nothing; the collateral had already been sold to *SP-2* when *D* purported to sell it to *SP-1*. This result would be the opposite of the outcome under the facts of Example D as written, where *SP-1*, by prefiling, was able to buy the collateral free of *SP-2*'s perfected security interest. We see no reason to commend this state of affairs. Moreover, had *SP-2* been a collateral assignee who had filed, then *SP-1* could have searched, discovered *SP-2*'s filing, and refused to proceed. But when *SP-2* is an automatically perfected buyer of payment intangibles who has not filed, *SP-1* has no way to discover *SP-2*'s interest save for *D*'s honesty. Applying FTFOP provides an inducement for buyers of payment intangibles to search and file.[62] And it allows a prospective buyer such as *SP-1* to lock-in its priority like other prospective secured parties. If FTFOP is good policy generally, then it is good policy to apply it for the benefit of buyers of payment intangibles.

We appreciate that the ultimate source of mischief in these transactions is the "secret lien" of the automatic-perfection rule for sales of payment intangibles. Automatic perfection was a purely political compromise of Article 9's filing regime, adopted as the *quid pro quo* for bringing sales of payment intangibles (and promissory notes) within the scope of Article 9.[63] It may not be optimal. But applying FTFOP for the benefit of a prefiling prospective buyer goes far toward ameliorating the costs of automatic perfection. It allows a prefiling buyer to become a full participant in the baseline priority scheme of Article 9.

It is fair to ask whether the reading of FTFOP that we advocate would in any way impair the interests of those who rely on automatic perfection, such as the loan participation markets. Those markets have functioned for many years (long before the advent of revised Article 9) on the basis of first-in-time and while assuming the risk that something bought may have earlier been effectively sold to another buyer. The automatic-perfection rule of revised Article 9 did not create this "double-sale" risk, it merely preserved it.[64] While

62. We recognize that, regardless of the applicability of FTFOP, buyers have some incentive to search and file, in order to discover collateral assignees who may have filed and to protect against recharacterization of a putative sale as a collateral assignment.

63. For a more detailed discussion of automatic perfection, see *infra* Part II.B.1.

64. *See* U.C.C. § 9-309 (2008).

FTFOP can provide some protection to a first-filed prospective buyer, it does not eliminate the double-sale risk in respect of a sale that may have occurred before the filing is made. More pertinent for present purposes, we doubt that the applicability (or not) of FTFOP will have much impact in the markets for whose benefit automatic perfection was adopted. In these markets filing simply is not the norm, and there is no reason to believe that the same participation will be sold twice.[65]

The foregoing argues that treating an optional filing with respect to the sale of payment intangibles as the "time of filing" for purposes of section 9-322(a)(1) is consistent with the text and policy underlying FTFOP. The argument to the contrary, which we reject, is premised on the notion that the filing of a financing statement that is not *necessary* for *perfection* of a sale of payment intangibles is ipso facto not *effective* for purposes of *priority* (i.e., FTFOP). Nothing in Article 9 supports this premise. To the contrary, Article 9 contains several examples of filings that are relevant when determining priority even though they play no role in perfection.[66]

Consider, first, the relationship of the temporary-perfection rules to FTFOP. These rules provide that a qualifying security interest is perfected for twenty days "without filing."[67] Under FTFOP, the priority of a temporarily perfected security interest as to which there has been no filing dates from the time of perfection.[68] When collateral secures a series of advances, the time of perfection ordinarily is the same for each advance.[69] However, when a security interest is temporarily perfected without filing, "perfection of the security interest dates from the time an advance is made."[70] Suppose that, at the start of the applicable twenty-day period of temporary perfection, the secured party makes a proper filing. Like a filing with respect to a sale of payment intangibles, such a filing would not be necessary for perfection. Yet there is no doubt that the filing would affect the priority of the secured party's advances.

65. In taking the risk that a loan participation previously has been sold, buyers of loan participations rely on the honesty and creditworthiness of their sellers. Buyers are most unlikely to buy from a person who is discovered to have deliberately sold the same participation interest twice. Moreover, many sellers of loan participations are regulated financial institutions.

66. "No role" may be too strong if one accepts the "concurrent perfection" approach discussed *infra* in Part I.D.

67. U.C.C. § 9-312(e)-(g) (2008).

68. *See* U.C.C. § 9-322(a)(1) (2008).

69. *See* U.C.C. § 9-323 cmt. 3 (2008).

70. U.C.C. § 9-323(a) (2008). The same rule applies to advances that are made while a security interest is perfected only automatically under section 9-309. *See id.* In both cases, section 9-323(a) applies only to advances that are not made pursuant to a commitment entered into before or while the security interest is perfected by a method other than under section 9-309 or temporarily under section 9-312(e), (f), or (g). *See id*.

Inasmuch none of the advances would have been made "while the security interest is perfected only" under section 9-309 or 9-312(e), (f), or (g), the filing would render section 9-323(a) inapplicable.[71] Under FTFOP, the priority for all advances would date from the earlier of the time of filing or perfection.[72]

A filing that is unnecessary to perfection can affect priority even when future advances are not involved. Suppose that a secured party holds a security interest that is temporarily perfected for twenty days without filing. After the twenty-day period expires, "perfection depends upon compliance with this article."[73] If the secured party had filed a financing statement before its security interest attached and the twenty-day period began, the filing would have no impact on perfection until the expiration of the period. But there is no reason to doubt that the filing nonetheless would be effective, *ab initio*, to achieve a priority ranking under FTFOP.

FTFOP is not the only rule under which the relative priority of a security interest turns on a filing that has no effect on perfection. The overall structure of Article 9's perfection and priority regimes reflects a pervasive bifurcation of the concepts of perfection and priority. Consider the plight of a consumer buyer who buys consumer goods in which the seller previously granted a purchase-money security interest ("PMSI"). Purchase-money security interests in consumer goods are automatically perfected.[74] Because automatically perfected security interests cannot be discovered by searching among the filed financing statements, section 9-320(b) provides that a consumer buyer of consumer goods from a consumer seller takes free of a perfected security interest if the buyer does not have knowledge of the security interest and buys before a financing statement covering the goods is filed.[75] A secured party can protect itself against such a buyer by filing a financing statement. The filing provides a basis for priority but plays no role in perfection. A filing made with respect to a sale of payment intangibles should receive the same treatment: It should be effective for purposes of priority, even if it is not necessary for perfection.

Nontemporal priority rules also reflect the bifurcation between perfection and priority. For example, purchase-money priority for inventory contemplates perfection by filing alone but other steps are required to achieve priority.[76] In

71. U.C.C. § 9-323(a) (2008).

72. *See* U.C.C. § 9-322(a)(1) (2008).

73. U.C.C. § 9-312(h) (2008).

74. *See* U.C.C. § 9-309(1) (2008); *see also id.* § 9-103(b) (defining "purchase-money security interest"); *id.* § 9-102(a)(23) (defining "consumer goods").

75. U.C.C. § 9-320(b) (2008).

76. To qualify for priority a purchase-money security interest must be perfected when the debtor receives the inventory and, in addition, the purchase-money secured party must give notice to holders of conflicting security interests. *See* U.C.C. § 9-324(b) (2008).

the case of a certificated security, perfection may be achieved by filing or delivery, or control.[77] But for purposes of priority, delivery trumps filing[78] and control trumps mere delivery.[79] Example D is merely another example of the bifurcation of the applicable perfection rules—filing is required to perfect a collateral assignment of payment intangibles but not a sale—from the applicable priority rule, FTFOP.

We think the foregoing arguments compel the conclusion that a filing by the buyer of payment intangibles is effective as the "time of filing" for purposes of determining priority under FTFOP.[80] We would be remiss, however, in not acknowledging the countervailing textual arguments.[81] In particular, section 9-513(c)(1) requires a secured party, on a debtor's demand, to send a termination statement to the debtor if "there is no obligation secured by the collateral covered by the financing statement and no commitment to . . . give value."[82] A literal application of the provision would require the buyer of a payment intangible, upon the seller's demand, to terminate a prefiling in its favor, even after the payment intangible has been sold. Former section 9-404(1) contained nearly identical language with respect to financing statements covering sales of accounts and chattel paper, yet no one ever doubted that those financing statements were relevant for purposes of FTFOP.[83] Likewise, one should not infer from section 9-513(c)(1) that a financing statement covering the sale of a payment intangible is irrelevant for purposes of FTFOP.

Section 9-513(c)(2) reflects an effort to eliminate any potential termination problem by adding an exception, under which a termination statement for a

77. *See* U.C.C. § 9-312(a) (2008) (filing), *id.* § 9-313(a) (delivery), *id.* § 9-314 (control).

78. *See* U.C.C. § 9-328(5) (2008).

79. *See* U.C.C. § 9-328(1) (2008).

80. U.C.C. § 9-322(a)(1) (2008).

81. *See* Kettering, *supra* note 28, at 536 n.106 (stating that that sections 9-513(c)(1) and 9-505(a) can be read to support an interpretation contrary to the one that a prefiling by a buyer of payment intangibles is relevant for purposes of FTFOP).

82. U.C.C. § 9-513(c)(1) (2008). Section 9-505(a) also may raise an implication that FTFOP does not apply in the case of prefiling for a sale of payment intangibles or promissory notes. *See* Kettering, *supra* note 28, at 536 n.106. The implication would be that the section permits a filing by a "buyer" (using that label instead of "secured party") only as a precaution against recharacterization of a putative sale as a collateral assignment. Such an implication seems inappropriate in light of the fact that a filing under section 9-505 also may be made by a consignee, who must file to protect its security interest even if the transaction is not recharacterized as a secured loan.

83. U.C.C. § 9-401(1) (1999); *see* U.C.C. § 9-513 cmt. 4 (2008) ("Applied literally, former Section 9-404(1) would have required many buyers of receivables to file a termination statement immediately upon filing a financing statement.").

financing statement covering "accounts or chattel paper that has been sold" need not be provided until "the account debtor or other person obligated has discharged its obligation."[84] The policy that underlying this special treatment for the termination of financing statements covering sold accounts and chattel paper applies equally to financing statements covering sold payment intangibles (and promissory notes). The failure to exclude them from the general rule was an oversight—and primarily ours at that. Courts should not infer from this oversight that a prefiling against payment intangibles has a different effect for purposes of FTFOP from a prefiling against accounts or chattel paper.[85]

D. *Concurrent Perfection by Two Methods*

Another plausible reading of Article 9 contemplates that the security interest of a buyer of payment intangibles could be perfected concurrently by two methods of perfection: perfection upon attachment under section 9-309 *and* by filing under section 9-310. Perfection by two methods concurrently is not unusual. Secured parties that perfect by taking possession sometimes file a financing statement as well.[86] Nor is perfection by two methods inconsistent with Article 9.[87] Filing is required to perfect a security interest, except in the situations specified in sections 9-308(a) and 9-312(b).[88] Section 9-310(b)

84. U.C.C. § 9-513(c)(2) (2008).

85. In addition, courts should apply section 9-513(c)(2) to financing statements covering the sale of payment intangibles, so that buyers are not compelled to terminate filings prematurely and thereby lose the benefits of FTFOP. *See* U.C.C. § 1-103(a) (2008) (providing that the UCC "must be liberally construed and applied to promote its underlying purposes and policies"). In any event, a buyer of payment intangibles can eliminate any risk that section 9-513(c)(1) will be misapplied if the seller waives any right to demand a termination statement before the account debtor has discharged its obligation. *See* U.C.C. § 1-302(a) (2008) (providing that, with certain exceptions not relevant here, the effect of provisions of the UCC may be varied by agreement).

86. *Cf.* U.C.C. § 9-312(a) (2008); *id.* § 9-313(a) (specifying types of collateral in which security interests may be perfected by filing or possession); *id.* § 9-312 cmt. 7 (discussing concurrent perfection in goods through perfection in negotiable document of title and by filing). As mentioned above, under this conceptualization a security interest also could be perfected by filing and by temporary perfection. Kettering also raised the possibility of concurrent perfection by automatic perfection and filing. Kettering Memo, *supra* note 28, at 3-4; Kettering, *supra* note 28, at 536 n.106.

87. Indeed, Article 9 acknowledges that a security interest may be perfected by two methods concurrently. *See* U.C.C. § 9-306(c) (2008) (referring to security interests that are "perfected only" under section 9-308(d)); *id.* § 9-323(a) (referring to security interests that are "perfected only" under section 9-309 or 9-312(e), (f), or (g)).

88. *See* U.C.C. § 9-308(a) (2008); *id.* § 9-312(b). When goods are covered by a certificate of title, compliance with the perfection requirements of the certificate-of-title

specifies the situations in which the filing of a financing statement "is not necessary to perfect a security interest."[89] These circumstances include two examples we considered above (i.e., temporary perfection and PMSIs in consumer goods), as well as the sale of payment intangibles.[90] As we discussed, the fact that a filing is not *necessary* to perfect a security interest does not mean that it has no legal effect. Section 9-312(b) provides for certain exclusive, nonfiling methods of perfection, but it omits any mention of automatic perfection under section 9-309.[91] The omission suggests that concurrent perfection may occur by filing (section 9-310) and upon attachment (section 9-309). We think Article 9 gives a potential buyer of payment intangibles a choice: It can take no perfection step, in which case its security interest would be perfected automatically at the time of attachment, or it can claim its place in line by prefiling. Obviously, the conclusion that a buyer could perfect its security interest by filing concurrently with automatic perfection would preclude any argument that the filing is not effective to fix the "time of filing" for purposes of FTFOP.

E. *When Priority Rules Create the Power to Transfer Rights in Collateral*

The implication of power to transfer notwithstanding an earlier sale of the collateral is essential for the proper functioning of FTFOP, inasmuch as that priority regime must embrace not only collateral assignments but also sales—assignments to buyers—of accounts, chattel paper, payment intangibles, and promissory notes.[92] An implied power arises under FTFOP because it is necessary to enable a filer to "lock in" its priority over a subsequent secured party. The UCC must be construed and applied liberally to promote its underlying purposes and policies.[93] One should read FTFOP, and the other priority rules, as implicitly overriding *nemo dat* and granting the power to transfer only when such a reading is necessary to promote the policy underlying the rule. Otherwise, *nemo dat* applies.

For example, although prefiling enables a debtor to create a security interest in accounts that it previously had sold, it does not have the same effect

statute is the equivalent of filing. *Id.* § 9-311(a),(b).

89. U.C.C. § 9-308(b) (2008).

90. *See* U.C.C. § 9-310(b)(1)-(2) (2008).

91. *See* U.C.C. § 9-312(b) (2008) (providing that a security interest in a deposit account or letter-of-credit right may be perfected only by control and a security interest in money may be perfected only by taking possession).

92. The statement in the text takes the existing structure and scope of Article 9 as a given. It does not address Plank's claim that Article 9's lien priority structure is incoherent for sales of receivables and ownership interests and should be replaced by a separate article covering sales of receivables. *See* Plank, *supra* note 6, at 234-40.

93. *See* U.C.C. § 1-103(a) (2008).

with respect to goods. Consider Example B, in which *SP-2* bought accounts at T-2 and perfected its interest at T-3, between the time *SP-1* filed (T-1) and the time *SP-1*'s security interest attached (T-4). Suppose the collateral had been equipment instead of accounts and that at T-2 *D* sold the equipment to a buyer who took it away at T-3. FTFOP does not apply as between a secured party and a buyer of goods.[94] Section 9-317(b) provides the applicable rule: A buyer of goods "takes free of a security interest . . . if the buyer gives value and receives delivery of the collateral without knowledge of the security interest . . . and before it is perfected."[95] One must read "before [the security interest] is perfected" to mean "before the security interest is a perfected security interest," i.e., before the security interest "has attached and all of the applicable requirements for perfection . . . have been satisfied."[96] The security interest from which the buyer "takes free" presumably must exist. A buyer could not have knowledge of something that did not exist. Having earlier sold the equipment, *D* would have had no rights in the collateral at T-4; *SP-1* would have acquired nothing. One cannot infer from the applicable priority rule, Section 9-317(b), that *D* retained an implied power to transfer an interest in the equipment to *SP-1*. Accordingly, the baseline rule of *nemo dat* governs, as it does in the following example:

EXAMPLE E (competing sales of chattel paper):

At T-1 *SP-1* buys chattel paper from *D* and takes possession of the chattel paper. At T-2 *D* purports to sell the same chattel paper to *SP-2*, who files a financing statement covering the chattel paper at T-3.

The following timeline illustrates Example E:

Sale of chattel paper to *SP-1* (possession/perfection)	Sale of chattel paper to *SP-2*	*SP-2* files financing statement
|	|	|
T-1	T-2	T-3

Applying FTFOP, *SP-1*'s interest in the chattel paper is paramount to that of *SP-2*. *SP-1* perfected before *SP-2* took any action. But does FTFOP, which

94. Unlike a sale of accounts, a sale of goods is not an Article 9 secured transaction; unlike a buyer of goods, a buyer of goods is not a secured party. *See* U.C.C. § 9-109(a) (2008) (providing that Article 9 applies to the "sale of accounts, chattel paper, payment intangibles, [and] promissory notes"); *id.* § 9-102(a)(72)(D) (defining "secured party" to include "a person to which accounts, chattel paper, payment intangibles, or promissory notes have been sold").

95. U.C.C. § 9-317(b) (2008).

96. U.C.C. § 9-308(a) (2008).

governs priority among "conflicting perfected security interests" even apply (to the end that *SP-2* has a junior, subordinate interest in the chattel paper)?[97] Or, did *SP-2* acquire nothing at all when it purported to "buy" the chattel paper because it was already owned by *SP-1*? We believe that the answers are clear: FTFOP does *not* apply and *SP-2* does not acquire *any* interest. After the perfected sale to *SP-1*, D had neither rights in the collateral nor power to transfer rights (i.e., to create a security interest pursuant to a sale or a collateral assignment).[98]

The difference between Example E and Example C is instructive. Under the facts of Example C, *D* retains the implicit power to sell accounts that *D* previously had sold. In that situation FTFOP enables *D* to transfer more than it has in order to permit *SP-1* to "lock in" its priority by prefiling. In Example E, however, there is no reason to override *nemo dat*. To the contrary, *SP-1*'s possession of the chattel paper serves as a signal to *SP-2* that the collateral may be encumbered. Given the role of possession in Article 9, *SP-2* took the risk that *D* did not own the chattel paper that *D* purported to sell to *SP-2*. Because *D* lacks the power to transfer rights in the sold chattel paper, *D* can create a security interest only in the rights that *D* has.[99] Inasmuch as *D* has no rights in the collateral at T-2, *SP-2* receives nothing.[100]

One might reach the same result—that *SP-1*, as the owner, has *all* the rights to the chattel paper and *SP-2* has *none*—by applying FTFOP and concluding that *SP-1*'s interest has "priority" over *SP-2*'s. Properly understood, ranking *SP-1*'s *ownership* interest ahead of *SP-2*'s necessarily means that *SP-2* acquires nothing. Nonetheless, we think there are good reasons for rejecting this approach and adopting our more straightforward *nemo dat* analysis to reach the same conclusion. The notion of the "priority" of an ownership over a junior interest harbors potential for mischief. In *Aircraft Trading and Services, Inc. v. Braniff, Inc.*, a buyer bought an aircraft engine that the debtor had encumbered with an unperfected security interest and then resold the equipment to a second buyer.[101] The second buyer then resold the equipment to a third buyer after the security interest had been perfected.[102] Applying former section 9-301(1)(c), under which "an unperfected security

97. *See* U.C.C. § 9-322(a)(1) (2008).

98. *See* U.C.C. § 9-318(a) (2008) (discussed *supra*, note 44); *id.* § 9-203(b)(2) (conditioning attachment on a debtor's having rights in the collateral or the power to transfer rights in the collateral to a secured party).

99. *See* U.C.C. § 9-203(1)(b) (2008).

100. The statement in the text is accurate with respect to *SP-1*'s ownership share, which is assumed to be 100%. Of course, had *SP-1* bought, *e.g.*, a 50% undivided interest, then SP-2's security interest would attach to the 50% undivided interest retained by *D*.

101. 819 F.2d 1227, 1229-30 (2d Cir. 1987).

102. *Id.*

interest is subordinate" to the rights of a qualifying buyer,[103] the Second Circuit erroneously held that the third buyer acquired ownership subject to the then-perfected security interest.[104] The court's refusal to apply the "shelter" aspect of *nemo dat*, which would have given the third buyer the unencumbered ownership rights of the first and second buyers, has been widely criticized.[105] Revised Article 9 precludes the incorrect result.[106]

II. ISSUES ARISING FROM CHATTEL PAPER [107]

A. *Why the Law Governing Assignments of Chattel Paper Is Complicated*

1. Chattel Paper as a Bundle of Rights

This Part of the Article tackles a cluster of issues arising from the financing of chattel paper. Chattel paper is a curious kind of collateral inasmuch as it comprises both an intangible right to payment of a monetary obligation and a related interest in specific goods.[108] The related interest often is a security interest in specific goods (chattels) that secures the monetary obligation. The prototype of this type of chattel paper is an installment sale contract in which

103. U.C.C. § 9-310(1)(c) (1999).

104. *Braniff*, 819 F.2d at 1233-36.

105. *See, e.g.*, PERMANENT EDITORIAL BD. FOR THE U.C.C., *Commentary No. 6, Section 9-301(1)* (March 10, 1990), *reprinted in* 3A U.L.A. 130 (2002) (rejecting the holding in *Braniff)*; Harris, *supra* note 2, at 639-42 (observing that the court's failure to appreciate the policy underlying *nemo dat* led the court to some incorrect conclusions).

106. The successor provision to former section 9-301(1) provides that a qualifying buyer "takes free" of an unperfected security interest. U.C.C. § 9-317(b) (2008).

107. This Article does not discuss the statutory amendments to section 9-105, which add a general standard for control of electronic chattel paper and turn the current, mandatory requirements for control into a safe harbor. For a discussion of those amendments, see Jane K. Winn, *Electronic Chattel Paper: Invitation Accepted*, 46 GONZ. L. REV. 407 (2011).

108. In Article 9:

> "Chattel paper" means a record or records that evidence both a monetary obligation and a security interest in specific goods, a security interest in specific goods and software used in the goods, a security interest in specific goods and license of software used in the goods, a lease of specific goods, or a lease of specific goods and license of software used in the goods.

U.C.C. § 9-102(a)(11) (2008). The definition goes on to explain that the "monetary obligation" is a monetary obligation secured by the goods or owed under a lease of the goods; that chattel paper "does not include (i) charters or other contracts involving the use or hire of a vessel or (ii) records that evidence a right to payment arising out of the use of a credit or charge card"; and that "[i]f a transaction is evidenced by records that include an instrument or series of instruments, the group of records taken together constitutes chattel paper." *Id.*

the buyer promises to pay the price of specific goods and grants to the seller a security interest in the goods to secure the unpaid price.[109] "Chattel paper" also includes leases of personal property, which evidence the lessee's monetary obligation (to pay rent) together with the lessor's leasehold interest in the leased goods, i.e., the lessor's rights with respect to the leased goods that arise under the lease.[110] These rights may include the right to retake and dispose of the goods upon the lessee's default.[111]

2. Chattel Paper as a Reified Intangible

Compounding the complexity of the nature of chattel paper is a peculiar, though not unique, relationship between the bundle of rights and the paper or other record evidencing them. The pre-Article 9 common law was clear that, in two very meaningful senses, a secured right to payment might not only be evidenced by security chattel paper but also embodied in the paper. Put otherwise, the common law reified certain secured, intangible rights to payment, i.e., treated the rights to payment as if they were the thing (paper) evidencing the right.[112] By taking an assignment of an installment sale contract, for example, a person took an assignment of the secured right to payment evidenced by the contract.[113] Indeed, the only way in which to acquire an interest in the secured right to payment was to acquire an interest in the paper.[114]

Former Article 9 did not expressly adopt the reification principle. However, it embraced it substantially by providing that a security interest in chattel paper could be perfected by taking possession of the chattel paper.[115] It

109. Included within this type of chattel paper, which often is referred to as "security chattel paper," are records evidencing a transaction in the form of a lease but constituting a security interest as a matter of law. *See* U.C.C. § 1-203 (2008) (distinguishing leases from security interests).

110. This type of chattel paper often is referred to as "lease chattel paper."

111. *See* U.C.C. § 2A-525 (2008) (providing for a lessor's right to possession); *id.* § 2A-527 (providing for a lessor's right to dispose). *See generally id.* § 2A-523 (setting forth a lessor's remedies).

112. *See* I GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 1.3 (1965).

113. *See* Amelia H. Boss, *Lease Chattel Paper: Unitary Treatment of a "Special" Kind of Commercial Specialty*, 1983 DUKE L.J. 69, 92-93. Grant Gilmore argued that whether rights under a conditional sale contract should be transferrable by delivery of the contract under pre-UCC law "should turn . . . on whether possession of the paper is recognized in commercial practice as having some significance." I GILMORE, *supra* note 112, at 16.

114. *See* Boss, *supra* note 113.

115. *See* U.C.C. § 9-305 (1999).

defined "chattel paper" to include a "writing or writings which evidence both a monetary obligation and a security interest in . . . specific goods."[116] Like the rest of the UCC, this definition should be read to make commercial sense.[117] The likelihood that one might take a security interest in the "paper," but not in the rights it evidences, is trivial at best. Did the drafters create a category of collateral that would provide so little utility? Given the structure and common-law history of former Article 9, the only sensible way in which to understand the definition is to read it as if "chattel paper" means not only the writing itself but also the rights evidenced by the writing. By taking chattel paper as collateral, a secured party acquires a security interest in the rights evidenced by the chattel paper.[118]

Although former Article 9 borrowed the idea of reification from the common law, the consequences of reification under Article 9 differ somewhat from those at common law. At common law, the only way to acquire a security interest in a reified intangible was to take delivery of the paper; i.e., a transfer of the right to payment could be effected only by a physical transfer of the paper.[119] Under former Article 9, as under current Article 9, one can acquire a security interest in a reified intangible such as a negotiable instrument or chattel paper without taking possession.[120] The idea of a nonpossessory—albeit unperfected—security interest in a negotiable instrument or chattel paper marks

116. U.C.C. § 9-105(1)(b) (1999).

117. *See* U.C.C. § 1-102(1), (2) (1999); U.C.C. § 1-103(a) (2008).

118. Boss acknowledges that, even in the face of some interpretive issues, there is no question that a transfer of the chattel paper is the transfer of the rights it evidences. *See* Boss, *supra* note 113, at 92-94; *see also* Commercial Mgmt. Serv., Inc., v. Jefferson Loan & Inv. Bank (*In re* Commercial Mgmt. Serv., Inc.), 127 B.R. 296, 302 (Bankr. D. Mass. 1991) (citing Boss with approval). Consistent with this conclusion, note that an "account debtor" is defined to include "a person obligated on . . . chattel paper . . . ." U.C.C. § 9-102(a)(3) (2008). Former Article 9 was in accord. U.C.C. § 9-105(1)(a) (1999). Under section 9-607 a secured party is entitled to collect upon and enforce collateral against an account debtor. *See* U.C.C. § 9-607(a) (2008).

119. *See* Boss, *supra* note 113. Boss cites, in addition to case law, comment 2 to section 9-103 of the 1962 Official Text of the U.C.C.: "in contemplation of law and by common understanding and practice the property right or claim evidenced by an instrument . . . or chattel paper is thought of as being merged in or symbolically represented by the piece of paper, whose endorsement or delivery is a prerequisite to a transfer of the underlying claim or rights." Boss, *supra* note 113, at n.129.

120. *See* U.C.C. § 9-203(1) (1999); U.C.C. § 9-203(b) (2008).

a departure from traditional common-law principles,[121] as does the idea that a nonpossessory security interest can be perfected by filing.[122]

The common-law reification idea apparently was so pervasive that the drafters of former Article 9 saw no need to craft the statute in a way that would reveal it. Had they perceived a need to be more precise, they might have defined "chattel paper" and expressed the rule for perfecting a security interest in chattel paper along the following lines:

> "Chattel paper" means a right to payment secured by a security interest in specific goods or arising under a lease of specific goods, in each case evidenced by a writing or writings.[123]
>
> A security interest in chattel paper may be perfected by filing a financing statement or by taking possession of the writing or writings evidencing the chattel paper.

Having provided for nonpossessory security interests in chattel paper, former Article 9 also departed from the common-law "merger" rule, under which a person obligated on a negotiable instrument or other reified intangible can discharge the obligation only by paying the person in possession of the paper.[124] Former section 9-318 applies the common-law "notification" rule with respect to discharge of an obligation evidenced by chattel paper: once the

121. *See* Boss, *supra* note 113, at 93-94 (equating transfer with perfection, which was the case at common law). The reference in the text to "chattel paper" is properly limited to security chattel paper. *See infra* pp. 338-39 (observing that lease chattel paper apparently was not reified at common law).

122. *See* U.C.C. § 9-304(1) (1999); U.C.C. § 9-312(a) (2008).

123. Note, however, that although this more precise formulation is more accurate, the statement that "chattel *paper* means a *right* to payment" is more awkward than the actual statutory formulation. *See* U.C.C. § 9-105(1)(b) (1999) (providing that "'[c]hattel paper' means a writing or writings . . . ."); U.C.C. § 9-102(a)(11) (2008) (providing that "'[c]hattel paper' means a record or records . . . .").

124. Section 3-603(1) of the1962 Official Text of the U.C.C. reflects the traditional rule that a person obligated on a negotiable instrument discharges the obligation by paying the holder. The 1990 amendments to Article 3 provided for discharge by paying a holder or other person entitled to enforce the instrument. *See* U.C.C. § 3-601; *id.* § 3-602(a) (1990). Except in unusual circumstances, a person entitled to enforce an instrument must be in possession of the instrument. *See* U.C.C. § 3-301 (2008) (defining "person entitled to enforce"). The 2002 amendments supplement the "merger" rule with a "notification" rule for negotiable notes. *See id.* § 3-602(b).

"Merger" in negotiable instruments law should be distinguished from "merger" doctrines in other fields of law. *See*, *e.g.*, 1 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 6.15, at 584 (4th ed. 2002) (explaining that, under the merger theory, "when a mortgagee's interest and a fee title coincide and meet in the same person, the lesser estate, the mortgage, merges into the greater, the fee, and is extinguished.").

obligor has been properly notified of an assignment, the obligor may discharge the obligation by paying the assignee, even if the assignor retains possession of the paper.[125]

The common law apparently did not extend the idea of reification from the monetary obligation evidenced by a contract for the installment sale of goods to the monetary obligation (rent) evidenced by a lease of goods; however, former Article 9 did. Just as the term "chattel paper" includes the buyer's payment obligation under an installment sale contract, so it includes the lessee's payment obligation under a lease.[126]

The locution in former Article 9 ("'[c]hattel paper' means a writing or writings . . . .")[127] gave rise to some discussion in the scholarly literature and reported cases,[128] but it did not give rise to much concern. Although the Drafting Committee devoted a considerable amount of time to the definition of "chattel paper,"[129] to the best of our recollections, the possibility of rewriting the definition to be more precise (i.e., to refer expressly to the rights evidenced by the chattel paper) was never raised during the seven-year (or nine-year, counting the PEB study) Article 9 revision process.

3. Reification in an Electronic Record

The 1998 amendments to Article 9 made chattel paper even more complicated by introducing the concept of "electronic chattel paper," i.e., chattel paper that is evidenced by an electronic, rather than a tangible, record.[130] Following the principle that, whenever possible, the rules in revised

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125. *See* U.C.C. § 9-318(3) (1999) ("The account debtor is authorized to pay the assignor until the account debtor receives notification that the amount due or to become due has been assigned and that payment is to be made to the assignee."). Revised Article 9 retained and clarified this rule. *See* U.C.C. § 9-406(a) (2008). However, by amending the definition of "account debtor," revised Article 9 excluded from the application of the rule a person who is obligated on a negotiable instrument that constitutes part of chattel paper. *See id.* § 9-102(a)(3) (defining "account debtor"). For a statement of the common-law rule, see RESTATEMENT (SECOND) OF CONTRACTS § 338(1) (1981).

126. Boss suggests that "the drafters' preoccupation with security leases explains the mention of leases in the chattel paper definition." *See* Boss, *supra* note 113, at 91.

127. U.C.C. § 9-105(1)(b) (1999).

128. *See* Boss, *supra* note 113, at 92-94; Commercial Mgmt. Serv., Inc., v. Jefferson Loan & Inv. Bank (*In re* Commercial Mgmt. Serv., Inc.), 127 B.R. 296, 299 (Bankr. D. Mass. 1991).

129. The primary issues that the Drafting Committee considered in connection with the definition concerned software licenses and monetary obligations evidenced by electronic records.

130. "'Electronic chattel paper' means chattel paper evidenced by a record or records consisting of information stored in an electronic medium." U.C.C. § 9-102(a)(31) (1999). The Drafting Committee was willing to live with "electronic paper." But perhaps because it

Article 9 should not distinguish between tangible and electronic records, the Drafting Committee created the concept of "control" of electronic chattel paper as an analogue to "possession" of tangible chattel paper.[131] Just as taking possession of tangible chattel paper enables a purchaser to perfect its security interest and become eligible for the special priority in section 9-330(a) and (b), having control affords the same benefits to a purchaser of electronic chattel paper.[132] Revised Article 9's treatment of electronic chattel paper stretches the idea of reification almost to the breaking point and so gives rise to a number of practical problems in interpreting Article 9. We discuss some of these problems in Part II.D. below. We turn first to puzzles that may arise when the rights constituting chattel paper are unbundled or otherwise divided.

B. *Classification of a Rental Stream Evidenced by Lease Chattel Paper: The Commercial Money Center Case*

1. Is "Chattel Paper" a Record or a Right?

The bankruptcy of Commercial Money Center, Inc., afforded an opportunity for judicial consideration of the question, "What is chattel paper?" The resulting opinions implicate Article 9's treatment of the "bundle of rights" and "reification" issues described above and raise questions of attachment, perfection, and priority.[133]

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was unwilling to create "chattel paper" that was neither paper nor connected to a chattel, it denied requests to expand the definition to include stand-alone software licenses.

131. *See* U.C.C. § 9-105 (2008) (explaining when a secured party has control of electronic chattel paper); *id.* § 9-105 cmt. 2 ("This section provides that control of electronic chattel paper is the functional equivalent of possession of 'tangible chattel paper.'").

132. *See* U.C.C. § 9-330(a), (b) (2008).

133. *See In re* Commercial Money Ctr., Inc., 350 B.R. 465, 473-79 (B.A.P. 9th Cir. 2006), *rev'g*, 56 U.C.C. Rep. Serv. (West) 54 (Bankr. S.D. Cal. Jan. 27, 2005). We served as experts on opposite sides of one of the controlling issues in *Commercial Money Center*. In the ensuing years, our thinking has evolved. We have made every effort not to allow the fact that we previously have "gone public" to affect our current analysis.

For other discussions of these opinions and related issues see generally David Frisch, *Chattel Paper, Shakespeare, and the Insoluble Question of "Stripping*,*"* 40 UCC L.J. 3 (2007); Michael D. Sousa, *MUCH ADO ABOUT NOTHING? Collateral Fractionalizing and In re Commercial Money Center Inc.*, 26 AM. BANKR. INST. J., Apr. 2007 at 28; David P. Weber, *The Intangibles of Payment Stream Stripping: Why Article 9 Should Not Leave You Baring Your Assets (Applying a Common Law Remedy to a Creature of Statute)*, 79 MISS. L.J. 419 (2009); Jacob Cohen, Comment, *Animal, Vegetable, or Mineral?:* In re Commercial Money Center *and the Classification of Payment Streams "Stripped" from Chattel Paper*, 39 U. TOL. L. REV. 861 (2008); Anthony N. Kaim, Note, *Classifying the Right to Rental Payment Streams Stripped Off a Lease: An Examination of the Issues Not Discussed in Commercial Money Center*, 86 TEX. L. REV. 857 (2008).

Before entering bankruptcy, Commercial Money Center ("CMC") assigned to NetBank, by way of a purported sale, its contractual rights to future payments under certain leases.[134] CMC did not purport to sell the related leases themselves, but it did grant to NetBank a security interest in the leases to secure its obligations to NetBank.[135] CMC's bankruptcy trustee sought to avoid NetBank's interest under section 544(a)(1) of the Bankruptcy Code, under which a bankruptcy trustee enjoys the rights and powers of a creditor that acquires a judicial lien on the debtor's property as of the commencement of the bankruptcy case.[136] The trustee argued that because NetBank neither took possession of the leases nor filed a financing statement against CMC, the bank held an unperfected security interest subject to defeat by a judicial lien creditor under section 9-317(a)(2) of the UCC and therefore to avoidance by the trustee.[137] NetBank defended by arguing that its interest was perfected without the need for filing or taking possession.[138] Specifically, it argued that the assignment was a true sale and not a collateral assignment, and that the property assigned consisted of payment intangibles and not chattel paper.[139] A sale of payment intangibles is perfected "automatically" upon attachment, takes priority over a subsequent judicial lien creditor, and therefore is not subject to avoidance by a trustee in bankruptcy under section 544(a)(1) of the Bankruptcy Code.[140]

The trustee's dispute with NetBank reached the Bankruptcy Appellate Panel (BAP) for the Ninth Circuit. The court had no difficulty concluding that the assigned rental streams were not chattel paper.[141] The court's discussion begins with the observation that "[t]he UCC distinguishes between the

134. *In re Commercial Money Ctr*., 350 B.R. at 469.

135. *Id.*

136. *Id.* at 472; *see also* 11 U.S.C. § 544(a)(1) (2006).

137. *In re Commercial Money Ctr*., 350 B.R. at 486.

138. *Id.* at 472.

139. "'Payment intangible' means a general intangible under which the account debtor's principal obligation is a monetary obligation." U.C.C. § 9-102(a)(61) (2008).

140. As a general matter, Article 9 applies to an assignment of accounts, chattel paper, payment intangibles, and promissory notes, regardless of whether the assignment constitutes a sale or is for collateral purposes, i.e., to secure an obligation. *See* U.C.C. § 9-109(a)(3) (2008). Although a collateral assignment of any of these four types of receivables is unperfected unless the assignee (secured party) takes an appropriate perfection step, a sale of a payment intangible or promissory note is perfected without the need to take an additional step. *See id.* § 9-308(a) (providing that a security interest is a perfected security interest "if it has attached and all of the applicable requirements for perfection" have been taken); *id.* §§ 9-310 to 9-316 (providing the applicable perfection requirement); *id.* § 9-309(3), (4) (providing that a sale of a payment intangible or a promissory note is perfected when it attaches). A perfected security interest, whether arising from a collateral assignment or a sale, is senior to a subsequent judicial lien. *See id.* § 9-317(a)(2).

141. *In re Commercial Money Ctr*., 350 B.R. at 488.

monetary obligation *evidenced* by chattel paper and the chattel paper itself."[142] After setting forth the definition of chattel paper, the court explained:

> This language on its face defines chattel paper to mean the ''records'' that ''evidence'' certain things, including monetary obligations. Payment streams stripped from the underlying leases are not records that evidence monetary obligations—they *are* monetary obligations. Therefore, we agree with NetBank that the payment streams are not chattel paper.[143]

The court here misapprehends the connection between chattel paper and the rights it evidences. As we explained above, although "'[c]hattel paper' means a record or records" that evidence a monetary obligation and an interest in specific goods, the only sensible reading of the definition is that "chattel paper" also means the rights that the record or records evidence.[144] The characterization of the collateral in *Commercial Money Center* as chattel paper or payment intangibles should not have turned on whether the paper (lease) itself was assigned.[145] If CMC had assigned *all* its rights under a lease, there would be no question that CMC had assigned chattel paper. The same conclusion would follow even if for some strange reason the assignment expressly excluded "the lease."[146]

2. How Should a Rental Stream Evidenced by Chattel Paper Be Classified?

The real question, then, is how the collateral should be characterized when some, but not all, of the lessor's rights under a lease are assigned—more

142. *Id*. at 475.

143. *Id*. at 476.

144. U.C.C. § 9-102(a)(11) (2008).

145. It is clear that the court was moved primarily by the "plain meaning" of the definition of "chattel paper" as "a record or records." *See In re Commercial Money Ctr.*, 350 B.R. at 480 ("[W]e must apply the plain meaning of the statute: the payment streams separated from the underlying leases do not fall within the definition of chattel paper."). One of us (Mooney) took the view in *Commercial Money Center* that the definitional structure was indeed significant, but not to the end that chattel paper as collateral was merely the "record or records" as opposed to the underlying rights. *See* Declaration of Charles W. Mooney Jr., In Support of Memorandum of Points and Authorities: (1) In Opposition of Trustee's Cross-Motion on Partial Summary Judgment; and (2) In Reply to Opposition to Netbanks's Motion for Partial Summary Judgment at 4, *In re Commercial Money Center*, 350 B.R. 465 (2006) (Bk. No. 02-09721-JH) (on file with authors). The point was that lease chattel paper is the whole lease, or an undivided interest in the whole lease, inasmuch as (the argument goes) chattel paper necessarily embodies a goods-related interest. The BAP ignored that issue. *See infra* pp. 346-47.

146. For another critical analysis of the BAP's emphasis on the "records" component of the definition of chattel paper, see Kaim, *supra* note 133, at 864-65.

specifically, whether the lessor's right to rentals retains its character as chattel paper when it is "stripped" from the lessor's leasehold interest.[147]

a. Classification as a Payment Intangible

At the outset, it is important to note that, with respect to the "stripping" of the rental stream from the lessor's leasehold interest, *Commercial Money Center* ("*CMC*") presents an aberrant transaction. There is no evidence that the assignee of a rental stream would typically disclaim the right to collect unpaid rent from the value of the leased goods. To the contrary, even when a payment stream, whether rents under a lease or installment payments of an obligation secured by specific goods, is fractionalized or otherwise divided among multiple assignees, the assignees typically retain the benefits of enforcement rights.[148] It was also an aberrant transaction by virtue of the assignee's failure to file a financing statement. For the assignee to achieve perfection automatically it would be necessary to determine that the rights assigned were payment intangibles *and* that the transaction was a true sale. Surely prudence would dictate filing in that setting.[149] For these reasons the issue addressed in

147. As we explained above, the lessor's leasehold interest in the goods comprises the lessor's rights under the lease and may include the right to retake and dispose of the goods upon the lessee's default. *See* U.C.C. § 2A-525 (2008) (lessor's right to possession); *id.* § 2A-527 (lessor's right to dispose). *See generally id*. § 2A-521 (lessor's remedies). The lessor's right to resort to the goods to enforce the lessee's obligations under the lease should not be confused with the lessor's residual interest, which is "the lessor's interest in the goods after expiration, termination, or cancellation of the lease contract." *See id*. § 2A-103(1)(q). For a discussion of the relationship between the leasehold interest and the residual interest in the context of secured financing, see *Leasing Consultants Inc. v. First Nat'l City Bank* (*In re Leasing Consultants, Inc.*), 486 F.2d 367, 371-72 (2d Cir. 1973) (holding that the lessor's residual, or reversionary, interest in goods leased under a true lease constitutes "goods," a different type of collateral from the lessor's rights under the lease, i.e., chattel paper).

148. *See, e.g.*, Alan J. Mogol, *Taking Another Look at Syndication Risks in the Changed Economy*, 27 J. EQUIPMENT LEASE FINANCING, Fall 2009, at 1, 1-2 (focusing on assignments of leases). In many cases a person other than the assignee is designated for purposes of actual enforcement. This person might be the lead lessor or lender in a participation arrangement, an agent bank in a syndicated transaction, or an indenture trustee under a securitization structure. *See id.*; STEVEN L. SCHWARCZ, ET AL., SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS 34-36 (2004) (enforcement of security interest by indenture trustee).

149. As David Weber noted:

> [I]t is difficult to believe that a financier would structure an acquisition of an equipment lease portfolio by using stripping solely to take advantage of automatic perfection. Such a strategy, without more, would be reckless to say the least. A prudent financier would always file a financing statement, if only to mitigate the risk that the transaction be classified as a loan rather than a sale, thus negating automatic perfection in a fell swoop.

CMC is unlikely to arise in a well-lawyered transaction. We discuss it nevertheless because it tests the limits of reification and has been the subject of heated discussion among Article 9 mavens.

One might argue that, by definition, "chattel paper" requires both a right to payment and a security interest in, or lease of, specific goods (chattels).[150] When the right to payment is assigned without the related interest in the chattel, the assignment is not (under this conceptualization) an assignment of chattel paper.[151] Consider the case of security chattel paper consisting of (1) a promissory note evidencing the maker's obligation to repay a loan and (2) a related security agreement, securing the maker's obligation with a security interest in specific equipment. If the owner sells all the rights under the note and security agreement, then of course it is a sale of chattel paper. Suppose, however, that the owner of the promissory note sells it (or a fractional interest in it) to a buyer under the express terms that the buyer will not receive any interest in or benefits from the collateral securing the note.[152] It would seem that here, as elsewhere, the sale of a note, standing alone, should constitute the sale of an instrument, not the sale of chattel paper. Essentially the same analysis can be applied to find a payment intangible imbedded in lease chattel paper. In every large block of marble there exists another Pietà; the only problem is the small detail of first removing the excess marble that is surrounding it. This is the case with lease chattel paper, which may contain an imbedded payment intangible.[153] The argument is that, when the imbedded payment intangible has been carved out of chattel paper, it should be classified differently.

Recall, however, that one aspect of the reification doctrine is that the only way in which to take a security interest in the rights evidenced by chattel paper is by taking a security interest in the chattel paper.[154] This rule prevents a conflict from arising between one assignee, who has a first priority assignment of the chattel paper, and another, who has a first priority assignment of the

Weber, *supra* note 133, at 453 (footnotes omitted).

150. *See* U.C.C. § 9-102(a)(11) (2008).

151. For an argument that the goods-related default enforcement remedies are an essential attribute of lease chattel paper, see Kaim, *supra* note 133, at 870-73.

152. Like the transaction in *CMC*, this would be an aberrant transaction, but of course that is the nature of the stripping transactions under consideration here. Note that, in the absence of an express agreement, the buyer of the note would automatically also acquire the related security interest. *See* U.C.C. § 9-203(g) (2008). Having acquired both the note and related security interest, the buyer would have bought chattel paper. *See* discussion *infra* pp. 346-47.

153. We discuss below in Part II.B.3 whether a stripped right to payment of rents, if not classified as chattel paper, should be classified as an account.

154. *See* discussion *supra* Part II.A.

rights evidenced by the paper (in the case under discussion, the rental stream and the related leasehold interest in the goods).

If an assignment of the rental stream alone is not an assignment of chattel paper, then a priority dispute may arise between an assignee of the rental stream and an assignee of the chattel paper. Although FTFOP may not literally apply to such a dispute, in many cases affording temporal priority seems to lead to a sound result.[155] For example, if the assignment of the chattel paper is perfected first, the risk to the subsequent assignee (*SP-2*, who takes the rental stream) is the same as if *SP-2* had taken an assignment of the chattel paper. Regardless of whether it takes an assignment of chattel paper or the rental stream, *SP-2* can protect itself by checking the filings (which will reveal the existence of an assignee of the chattel paper who has perfected by filing) and determining whether the lease remains in the possession of the assignor (which will negate the possibility that an assignee has perfected by possession). Likewise, if the rental stream is classified as a payment intangible and is collaterally assigned to *SP-1* (i.e., assigned to secure an obligation), who files, then *SP-2* (whose collateral, the chattel paper, includes the rental stream) can protect itself by checking the filings and determining whether the lease remains in the possession of the assignor.[156]

The real problem created by characterizing a rental stream as a payment intangible arises when the rental stream is sold before the chattel paper is assigned. A security interest arising from the sale of a payment intangible is automatically perfected.[157] If the rental stream is classified as a payment intangible (as in the *Commercial Money Center* opinion under discussion) and the payment intangible is sold to a buyer (*B*), then a subsequent purchaser of the chattel paper (*P*) will have no way to determine whether the rental stream has been previously assigned, other than to rely on the assignor's warranty to that effect. A major purpose of Article 9's perfection rules is to provide a mechanism by which a potential assignee can verify that it will acquire the best claim to the assigned collateral. Classification of the "stripped" rental stream as a payment intangible tends to undermine the efficacy of these rules.

One way to minimize these adverse consequences would be to read section 9-330 creatively, to award priority to *P*. This section affords priority to certain good-faith purchasers of chattel paper for value who take possession of the

155. FTFOP regulates priority among "conflicting security interests . . . in the same collateral . . . ." U.C.C. § 9-322(a)(2008). One might argue that, in this setting, a payment intangible and chattel paper should be considered "the same collateral."

156. As a general matter, "a financing statement must be filed to perfect [a] security interest[] . . . ." U.C.C. § 9-310(a) (2008). In the case under discussion *SP-1* would not be automatically perfected. U.C.C. § 9-309(3) provides automatic perfection for a sale of a payment intangible but not for a collateral assignment.

157. *See* U.C.C. § 9-309(3) (2008).

chattel paper.[158] A purchaser, such as *P*, who qualifies under section 9-330 achieves priority over a [competing] "security interest in the chattel paper."[159] The right to the rental stream is part of the chattel paper that is assigned to *P*.[160] Thus, if *P* perfects by taking possession of the chattel paper, one might give *P* priority by interpreting the reference in section 9-330 to a competing "security interest in the chattel paper" to include *B*'s security interest in the payment intangible. This reading would preserve the comfort that section 9-330 is designed to afford to purchasers of chattel paper who take possession. But it would create the odd situation in which *B* has a security interest in a payment intangible for purposes of perfection but in chattel paper for purposes of priority.[161]

Steven Weise has offered a possible way around this problem for *P*, arguing that whether *P* achieves priority in the chattel paper over *B*'s interest in the payment intangible normally will not matter.[162] This is so because the meaningful value to either party is not the chattel paper or the payment intangible, but the collections of cash proceeds. Weise observes that the

158. Section 9-330 provides:

> (a) A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed merely as proceeds of inventory subject to a security interest if:
>
> > (1) in good faith and in the ordinary course of the purchaser's business, the purchaser gives new value and takes possession of the chattel paper or obtains control of the chattel paper under Section 9-105; and
> >
> > (2) the chattel paper does not indicate that it has been assigned to an identified assignee other than the purchaser.
>
> (b) A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed other than merely as proceeds of inventory subject to a security interest if the purchaser gives new value and takes possession of the chattel paper or obtains control of the chattel paper under Section 9-105 in good faith, in the ordinary course of the purchaser's business, and without knowledge that the purchase violates the rights of the secured party.

U.C.C. § 9-330(a)-(b) (2008).

159. U.C.C. § 9-330(a), (b) (2008).

160. In some sense this argument is circular. The right to payment is part of the assigned chattel paper if the assignor has the power to assign it to *P* notwithstanding that it was previously sold to *B*. The assignor would have this power if section 9-330 awards priority to *P* over *B*. But does it?

161. Returning to the example of a promissory note secured by specific equipment, if the buyer of the note failed to take possession and the chattel paper was then purchased by a purchaser qualifying for priority under section 9-330, the original note buyer would be subordinated because it has a security interest in the note that is a component of the chattel paper. The same would be true for a payment intangible imbedded in lease chattel paper.

162. *See* E-mail from Steven Weise, to http://lists.washlaw.edu/mailman/listinfo/ucclaw-1/ (Aug. 31, 2006, 17:32:20) (subscription required for access).

possessory purchaser of chattel paper who "qualifies for priority" under section 9-330 (*P* in our example) achieves priority over *B* in the cash proceeds under section 9-322(c).[163] The use of the phrase "qualifies for priority"—and not "has priority"—means that section 9-322(c) governs priority in proceeds regardless of whether there is an actual conflict with respect to the original collateral.[164] Thus *P* would achieve priority in the proceeds, even if section 9-330 does not afford priority to a chattel paper purchaser over the buyer of the imbedded payment intangible (because the latter is not the holder of a competing security interest *in the chattel paper*).[165] Even if sound,[166] this analysis may not provide priority for *P* in all circumstances.[167]

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163. *Id.*; *see also* U.C.C. § 9-322(c) (2008), which provides, in relevant part:

> (c) [A] security interest in collateral which qualifies for priority over a conflicting security interest under Section . . . 9-330 . . . also has priority over a conflicting security interest in:
>
> . . .
>
> (2) proceeds of the collateral if:
>
> (A) the security interest in proceeds is perfected;
>
> (B) the proceeds are cash proceeds or of the same type as the collateral; and
>
> (C) in the case of proceeds that are proceeds of proceeds, all intervening proceeds are cash proceeds, proceeds of the same type as the collateral, or an account relating to the collateral.

Id.

164. *Compare* U.C.C. § 9-322(c) (2008) (referring to a security interest that "qualifies for priority"), *with id.* § 9-330(c) (referring to a purchaser "having priority"). Comment 8 supports this reading. *See id.* § 9-322 cmt. 8 ("The rule [in section 9-322(c)] determines priority in proceeds of non-filing collateral whether or not there exists an actual conflicting security interest in the original non-filing collateral.").

165. We think the analysis follows from the text of section 9-322(c) ("qualifies for priority") and not, as David Weber suggests, from a "hyper-textual analysis" of section 9-322, comment 8. Weber, *supra* note 133, at 463.

166. The analysis assumes that the earlier, perfected sale of the rental stream to *B* does not prevent *P* from becoming a purchaser of chattel paper. *See generally supra* Part I.A.

167. Consider just one example in which section 9-322(c) would not protect *P*: *B* could exchange its senior interest in the imbedded payment intangibles for noncash proceeds. *P* would not have priority under section 9-322(c). Rather, the normal priority rule would apply and *B* would have priority as the first-to-perfect. *See* U.C.C. § 9-322(b)(1) (2008) (time of filing or perfection for original collateral is time of filing or perfection for proceeds). Because *B* was the owner of the payment intangibles and consequently of the noncash proceeds, *P* would have no interest in them. (The example assumes, of course, that *P* would not have priority under section 9-330.) Whether the analysis would apply to collections received after the assignor entered bankruptcy is well beyond the scope of this Article.

Others have discussed Weise's analysis under section 9-322(c) with approval, while also noting some qualifications. *See* Weber, *supra* note 133, at 446-49, 462-64; Cohen, Suppose, however, that *P* perfects by filing instead of by taking possession. In that scenario the only statutory basis for giving *P* priority would be to rely on section 1-103(a) and conclude that allowing *B*'s "secret" interest to prevail over *P* would subvert Article 9's public-notice policy.[168] But the beneficiaries of Article 9's public-notice policy include not only purchasers of collateral but also lien creditors.[169] If the policy compels the result that *P* prevails over *B*, then the debtor's bankruptcy trustee—who enjoys the rights of a judicial lien creditor—should prevail, as well. The alternative is to subordinate both *P* and the bankruptcy trustee to *B*'s interest, even though *B* gave no public notice. Under this regime, which *Commercial Money Center* creates, filing would not be a viable perfection alternative for a potential purchaser of chattel paper who is unwilling to rely on the integrity of the assignor without first verifying the assignor's assertion that the rental stream has not previously been sold.[170]

One might respond that this state of affairs is precisely the one contemplated by the Drafting Committee when it provided for automatic perfection of sales of payment intangibles. We are not so sure. The prototypical payment intangible is the right to payment of a loan that is not evidenced by chattel paper or an instrument. The prototypical sale of a payment intangible is the sale of a participation interest in such a loan.[171] Several years ago we had occasion to consider whether the automatic perfection of sales of payment intangibles undermines the integrity of the filing system and the need for public notice.[172] We concluded that it does not.

supra, note 133, at 872-74.

168. Section 1-103(a) provides:

> (a) [The Uniform Commercial Code] must be liberally construed and applied to promote its underlying purposes and policies, which are:
>
> (1) to simplify, clarify, and modernize the law governing commercial transactions;
>
> (2) to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties; and
>
> (3) to make uniform the law among the various jurisdictions.

U.C.C. § 1-103(a) (2008).

169. *See* U.C.C. § 9-317(a)(2) (2008).

170. This state of affairs is not troubling to Thomas Plank, who advocates scrapping the filing system altogether for receivables. *See* Plank, *supra* note 6, at 264-70.

171. Assignments of interests (which may be undivided fractional interests or even 100% interests) in loans and other receivables are commonplace among banks and certain other professional investors and financial market participants. *See* Patrick J. Ledwidge, *Loan Participations Among Commercial Banks*, 51 TENN. L. REV. 519, 520-22 (1984).

172. *See* Steven L. Harris & Charles W. Mooney, Jr., *How Successful Was the Revision of UCC Article 9?: Reflections of the Reporters*, 74 CHI.–KENT L. REV. 1357, 1372-73 (1999).

> Every potential buyer of a loan participation from a bank knows that the bank sells participations. The filing of a financing statement covering "general intangibles" or "loan" gives no information. Even a financing statement that describes a particular loan is unlikely to give sufficient information to justify the delay that might result if sales of participations routinely were preceded by a search of the files against the seller. Under the Former Article, a prospective buyer of a loan participation had no way to insure that it was buying something that had not been sold before. Participants took this risk and were forced to rely on the honesty of the seller (often the lead bank that made the loan to the borrower) to minimize it. Revised Article 9's automatic-perfection rule applicable to sales of payment intangibles does not exacerbate the situation.[173]

The market considerations that led to automatic perfection of sales of payment intangibles have no application to the assignment of a stripped rental stream.[174] On the other hand, based on *CMC* we now "know" that a rental stream might be effectively stripped from chattel paper and sold as a payment intangible.[175] Stripping is seen as a sufficiently large risk that at least some chattel paper assignees seek to reduce it by contract.[176] For others, perhaps the unusual nature of the stripping transaction, the likelihood that an assignee in such a

173. *Id.* at 1372.

174. Note also that the Drafting Committee took no action on a recommendation that Article 9 be revised to provide that "loan participations and other loan sales by financial institutions (and, possibly, sales by other classes of professional lenders) do not constitute the sale of chattel paper that is within the scope of Article 9." REPORT, *supra* note 5, Recommendation 21.C., at 169.

The decision to provide for automatic perfection for sales of payment intangibles has engendered some controversy. Steven Schwarcz has argued that the idea is misguided. *See* Steven L. Schwarcz, *Automatic Perfection of Sales of Payment Intangibles: A Trap for the Unwary*, 68 OHIO ST. L.J. 273 (2007). Thomas Plank's views are diametrically opposed; he thinks automatic perfection should be extended from payment intangibles and promissory notes to sales of accounts and chattel paper. *See* Plank, *supra* note 6. More recently, however, Schwarcz concluded that, "[o]n balance, . . . the benefits of allowing automatic perfection might or might not outweigh, but are unlikely to heavily outweigh, the costs," and that "[a]ll that can be said with confidence is that the distortion that automatic perfection causes should be allowed only when its benefits truly heavily outweigh its costs." Steven L. Schwarcz, *Distorting Legal Principles*, 35 J. CORP. L. 697, 716 (2010). At least as regards payment intangibles, we think the current rule is just about right.

175. *See In re* Commercial Money Ctr., Inc., 350 B.R. 465, 476 (B.A.P. 9th Cir. 2006), *rev'g*, 56 U.C.C. Rep. Serv. (West) 54 (Bankr. S.D. Cal. Jan. 27, 2005).

176. One observer reports that *CMC* "caused tremors within the equipment finance industry" and that "careful funders are now requiring an additional specific representation that the originator [lessor] has not previously sold or conveyed an interest in the payment stream becoming due under the subject equipment lease." Mogol, *supra* note 148, at 6-7.

stripped sale would file a financing statement, and the revised comment to section 9-102 provide sufficient comfort.[177]

b. Classification as an Account

There is another way to minimize the deleterious effects on Article 9's public-notice while still treating a "stripped" rental stream as collateral other than chattel paper. The definition of "account" includes a right to payment for goods leased.[178] One might argue that, if the "stripped" rental stream is not chattel paper because it does not include an interest in the related chattel, the rental stream should be classified as an account. To perfect an assignment of accounts, whether a sale or a collateral assignment, filing is required.[179]

The statutory argument for excluding a "stripped" rental stream from the definition of "account" is that the rental stream is "evidenced by chattel paper."[180] But that locution is necessary because of the drafters' decision, discussed above, to define chattel paper by reference to the writing rather than by reference to the rights evidenced by the writing.[181] The reason for excluding from "accounts" a right to payment that is evidenced by chattel paper is that the rules applicable to chattel paper—including the possibility of perfection by possession—should apply to those rights. Thus a right to payment "*evidenced* by chattel paper" should be understood to mean a right to payment that "*is* chattel paper."

Treating a stripped right to payment as an account rather than as a payment intangible would eliminate the possibility of automatic (secret) perfection. However, it still would create problems in interpreting the priority rules. To protect a purchaser of chattel paper who would qualify for priority under section 9-330, a security interest in a rental stream that is an account must constitute a "security interest in the chattel paper" for purposes of that section.[182] Of course, classifying a rental stream as an account also would require a purchaser of chattel paper (*P*) who perfects by filing to be concerned about earlier filings against *accounts* as well as against chattel paper. Otherwise, *P*'s position is no worse than that of a person who takes a security

177. *See* U.C.C. § 9-102 cmt. 5.d (Proposed Revisions 2010); *see also* discussion *infra* pp. 340-41; Mogol *supra* note 148 at 7 (suggesting that "[r]elief," in the form of draft revisions to section 9-102, comment 5.d., "may be on the way").

178. *See* U.C.C. § 9-102(a)(2) (2008) (defining "account").

179. *See* U.C.C. § 9-310(a) (2008) (general rule), (b) (exceptions); *id.* § 9-312(b) (exceptions).

180. "['Account'] does not include (i) rights to payment evidenced by chattel paper . . . ." U.C.C. § 9-102(a)(2) (2008).

181. *Supra* Part II.A.2.

182. U.C.C. § 9-330 (2008).

interest in accounts. Because the accounts or chattel paper might constitute the proceeds of inventory, both must be concerned about earlier filings against inventory.[183]

c. Which Arguments Win the Day?

Where does our evaluation of the various solutions to the classification puzzle lead us? We share the view of David Frisch that the text of Article 9 itself may not dictate a "right" answer to the question of how to characterize rights to rentals stripped from chattel paper.[184] We also share his view that policy considerations should be controlling.[185] Indeed, the UCC mandates that its provisions be read to promote its underlying purposes and policies.[186] Inasmuch as treating a stripped right to rentals as "chattel paper" simplifies all of the priority contests greatly, we would adopt this characterization.[187]

3. Perfecting a Security Interest in a Rental Stream that is Classified as a Payment Intangible or an Account

In *Commercial Money Center*, the BAP found that the assignment to NetBank was not a sale but rather a collateral assignment and that, as a consequence, NetBank's security interest in what the court had characterized as payment intangibles was not automatically perfected.[188] NetBank admitted that it did not perfect by filing a financing statement.[189] The BAP found, however, that "there are genuine issues of material fact as to who had possession [of the

183. *See* U.C.C. § 9-315 (2008) (governing security interests in proceeds); *id.* § 9-322(b)(1) (providing that, for purposes of the first-to-file-or-perfect rule, "the time of filing or perfection as to [original] collateral is also the time of filing or perfection as to . . . proceeds").

184. *See* Frisch, *supra* note 133, at 8-9.

185. *See id.* at 9 ("[T]he issue of 'stripping' . . . ought to be resolved on the basis of the functions Article 9 rules were designed to perform, or the results these rules are meant to achieve, rather than under the pretext of a predetermined statutory mandate.").

186. *See* U.C.C. § 1-103(a) (2008).

187. David Weber is of the view that, under the most appropriate statutory construction, the payment streams stripped from lease chattel paper are payment intangibles. *See* Weber, *supra* note 133, at 434, 436, 441. But he concludes that this "proper interpretation of Article 9 leads to more commercial uncertainty rather than less." *Id.* at 443. For a contrasting view on the question of statutory construction, see Kaim, *supra* note 133, at 858, 864-65.

188. 350 B.R. 465, 481-85 (B.A.P. 9th Cir. 2006), *rev'g*, 56 U.C.C. Rep. Serv. (West) 54 (Bankr. S.D. Cal. Jan. 27, 2005).

189. *Id.* at 486.

leases], when, and in what capacity."[190] The court then denied the trustee's motion for summary judgment and remanded the case to the Bankruptcy Court.[191]

Why is the possession of the leases relevant to perfection of a security interest in the rental streams, which the BAP had concluded were payment intangibles? One cannot perfect a security interest in a payment intangibles or accounts by taking possession of the collateral.[192] The reason for this rule is obvious: Being intangible, accounts and payment intangibles are not susceptible to physical possession. Moreover, Article 9 goes to great pains to create mutually exclusive categories of collateral. Chattel paper is not a payment intangible, and a payment intangible is not chattel paper.[193] The BAP's opinion in *CMC*, however, raises and leaves open the question whether stripped rentals create an exception to these rules; specifically, whether one can perfect a security interest in a rental stream (which the court characterized as a payment intangible) by taking possession of the written lease evidencing the rental stream (which all agree is chattel paper).[194]

The argument for allowing an assignee to perfect a security interest in a rental stream (payment intangible) by taking possession of the lease evidencing the stream rests upon the reification principle. Just as taking a security interest in a lease creates a security interest in the rights evidenced by the lease, so perfecting a security interest in the lease perfects a security interest in those rights. The BAP suggested that this argument may have merit, at least if one were to follow the approach of the Bankruptcy Court opinion in *In re Commercial Management Service*.[195]

The BAP was correct that *Commercial Management* recognizes that "delivery of the chattel paper may 'operate[ ] to transfer' a perfected interest in the associated payment streams."[196] But the BAP appears to have misunderstood *Commercial Management* as also having rejected the view that "stripped" "payment streams were general intangibles and that [the assignee] had not perfected its interest in those payment streams because it had not filed

190. *Id.* at 488.

191. *Id.*

192. *See* U.C.C. § 9-313(a) (2008) (specifying the types of collateral as to which the secured party may perfect a security interest by taking possession of the collateral).

193. By definition, a payment intangible is a general intangible. *See* U.C.C. § 9-102(a)(61) (2008) (defining "payment intangible"), *id.* § 9-102(a)(42) (defining "general intangible"). "General intangible" excludes chattel paper. *See id.*

194. *See In re Commercial Money Ctr.*, 350 B.R. at 479 ("[A] perfected interest in chattel paper includes the associated payment streams, at least if the reasoning in [*In re Commercial Management Service, Inc. v. Jefferson Loan and Investment Bank*, 127 B.R. 296 (Bankr. D. Mass. 1991),] applies.").

195. *Id*. at 477-79 (discussing *In re Commercial Mgmt. Serv., Inc.*, 127 B.R. 296).

196. *Id*. at 478 (quoting *In re Commercial Mgmt. Serv., Inc.*, 127 B.R. at 302).

any financing statements."[197] To the contrary, the court in *Commercial Management* "simply is unable to fathom the . . . argument that the right to receive rental payments under a lease is a general intangible . . . ."[198] It cites Professor Boss for the proposition that "[t]he Code treats the transfer of the right to payment under a sales contract as an account, but considers the transfer of the right to payment under a lease to be chattel paper."[199] *Commercial Management* suggests that one cannot take a security interest in rights evidenced by chattel paper without taking a security interest in chattel paper. It is consistent with the view that "chattel paper" comprises the rights that the paper evidences.

In its opinion on remand, the Bankruptcy Court succinctly rejected the argument that a security interest in a payment intangible might be perfected by taking possession of the related chattel paper: "The Court finds, as a matter of law, NetBank could perfect its interests in the rental streams only by filing a financing statement."[200] NetBank appealed this ruling to the Bankruptcy Appellate Panel. Once again the BAP expressed sympathy towards the contrary view. But having concluded that NetBank did not effectively take possession of the leases for perfection purposes outside the preference period, the BAP affirmed the Bankruptcy Court's avoidance of NetBank's security interest as unperfected.[201]

Regardless, to reject the Bankruptcy Court's approach and permit perfection of a security interest in a rental stream by taking possession of the leases evidencing the rental stream would create a very odd set of rules. A security interest in "stripped" rental streams would be a security interest in a payment intangible for purposes of determining whether a sale of the rental stream is automatically perfected under section 9-309, but it would be a security interest in chattel paper for purposes of perfection under section 9-313 and priority under section 9-330. And, if the security interest arose out of a sale of the rental stream, the security interest would be automatically perfected and thus senior to a subsequent secured party who purchased the chattel paper and perfected by filing.

197. *Id*. at 477.

198. *In re Commercial Mgmt. Serv., Inc.*, 127 B.R. 296, 303. *Commercial Management* was decided under former Article 9, which did not distinguish payment intangibles from other general intangibles. *See* U.C.C. § 9-105 (1999) (listing terms defined in former Article 9).

199. *In re Commercial Money Ctr.*, 127 B.R. at 303 (quoting Boss, *supra* note 113, at 87).

200. *In re* Commercial Money Ctr., Inc., No. 02-09721-H7, 2007 WL 7144803, at *4 (Bankr. S.D. Cal. June 6, 2007), *aff'd*, 392 B.R. 814 (B.A.P. 9th Cir. 2008).

201. *See In re* Commercial Money Ctr., Inc., 392 B.R. at 828-32.

One way to minimize this difficulty would be to construe an assignment of a rental stream as an assignment of both the rental stream and the lessor's leasehold interest in the goods, at least when the assignment is silent with respect to the leasehold interest. Both Article 9 and the common law take an analogous approach—that the collateral follows the debt—with respect to obligations that are secured.[202] The reason is simple: A security interest secures an obligation. A security interest ordinarily is of no value to a person who is not entitled to payment of the secured obligation.[203] Like a security interest, goods-related enforcement rights arising under a lease are ancillary to the right to receive the rent. A presumption that assignment of the rental stream carries with it the lessor's leasehold interest in the related goods would give effect to the intentions of the parties in all, or nearly all, cases.

As the revised comment to section 9-102 explains:

> A right to the payment of money is frequently buttressed by ancillary rights, such as rights arising from covenants in a purchase agreement, note, or mortgage requiring insurance on the collateral or forbidding removal of the collateral, rights arising from covenants to preserve the creditworthiness of the promisor, and the lessor's rights with respect to leased goods that arise upon the lessee's default (see Section 2A-523). This Article does not treat these ancillary rights separately from the rights to payment to which they relate. For example, attachment and perfection of an assignment of a right to payment of a monetary obligation, whether it be an account or payment intangible, also carries these ancillary rights. *Thus, an assignment of the lessor's right to payment under a lease also transfers the lessor's rights with respect to the leased goods under Section 2A-523.*[204]

Taken together, the lessor's rights to payment and with respect to the leased goods normally will be evidenced by chattel paper, in which case an assignment of the lessor's right to payment would constitute an assignment of the chattel paper.[205]

It would seem to be a rare case in which there would be a good commercial reason for a lessor to assign a portion or all of the rental stream divorced from the related rights, including goods-related rights, arising under the lease.[206]

202. *See* U.C.C. § 9-203(g) (2008); RESTATEMENT (THIRD) OF PROP: MORTGAGES § 5.4(a) (1997). *See generally* David G. Epstein, *Security Transfers by Secured Parties*, 4 GA. L. REV. 527, 534 (1970).

203. The statement in the text is qualified, because the secured party may be obligated to act on behalf of holder of the secured obligation.

204. U.C.C. § 9-102 cmt. 5.d. (Proposed Revisions 2010) (emphasis added).

205. U.C.C. § 9-102 cmt. 5.d. (Proposed Revisions 2010).

206. *See* Frisch, *supra* note 133, at 19 (indicating that, if there are any singular

Yet, as we have discussed, in such a situation the secret sale of a rental stream can work to the prejudice of a subsequent financier of the chattel paper. Normally the UCC permits parties to vary the effect of its provisions.[207] The revised comment to section 9-102 would protect the subsequent financier by giving effect to an agreement excluding the lessor's rights with respect to the leased goods from an assignment of the lessor's right to payment, but only as between the parties. Such an agreement "does not affect the characterization of the collateral to the prejudice of creditors of, and purchasers from, the assignor."[208] In effect, then, the revised comment adopts our preferred approach that a rental stream retains its character as chattel paper even after it is stripped.[209]

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benefits to be gained from stripping, "they have yet to be presented in convincing fashion"). Perhaps such situations would involve goods-related enforcement rights that are of little practical value. For example, the leased goods could be subject to a foreign legal regime of suspect utility, located in space, or of little value except while remaining in place (such as a billboard). Alternatively, multiple strips might be assigned to different assignees who rely primarily on a guarantor or other credit enhancement for the lessee's payment obligations. In that situation the original lessor or guarantor might retain the goods-related remedies (for its own benefit or for the benefit of the assignees) in order, *inter alia*, to avoid collective action problems resulting from the multiple assignments.

207. *See* U.C.C. § 1-302 (2008).

208. U.C.C. § 9-102 cmt. 5.d. (Proposed Revisions 2010). It is reasonable to expect an assignee of a payment obligation to be aware of the nature of the obligation. Thus, on the basis explained in the revised comment, assignees of payment obligations embodied in chattel paper will know that they must play by the perfection and priority rules applicable to chattel paper and not those applicable to payment intangibles or accounts. The Cape Town Convention addresses a somewhat analogous situation. Article 36 awards priority to an assignment of "associated rights" (such as a secured obligation or lease rentals) only if the associated rights are sufficiently related to an object of mobile equipment (such as a purchase-money obligation or lease rentals). Convention on International Interests in Mobile Equipment, *opened for signature* Nov. 16, 2001, S. Treaty Doc. No. 108-10, 2001 WL 34360428, *available at* http://www.unidroit.org/english/conventions/mobile-equipment/main.htm. A prospective assignee will thereby be on notice that a receivable is related to an object and will then be in a position to search the international registry against the relevant object to discover any conflicting, earlier assignments.

209. *See supra* Part II.B.2.c. David Weber argues for a similar approach: "Prohibiting the separation of payment streams from chattel paper, *for the purposes of priority under Article 9*, will arguably affect neither the parties' freedom of contract, nor their ultimate decision to engage in such a transaction" but views the "lack of precedent in this context" as the "obvious drawback." *See* Weber, *supra* note 133, at 461-62. Weber suggests that litigation is "[t]he only way to overcome this obstacle with any certainty and without resort to the legislative process." *Id.* at 62. The revised comment, which prohibits the separation of rental streams from chattel paper for the purposes of both perfection and priority, may well provide another way. Anthony Kaim develops the policy argument that the goods-related lease enforcement remedies should follow the assignment of putatively stripped lease rentals by analogy to U.C.C. § 9-203(g). *See* Kaim, *supra* note 133, at 876-78. Note that neither the

C. *Classification of an Undivided Interest in Chattel Paper*

The problem addressed in *Commercial Money Center* arises when the rights evidenced by lease chattel paper are unbundled and some, but not all, are assigned. The division of chattel paper (both leases and secured obligations) arises more commonly in another context, when the lessor assigns an undivided interest (or "participation") in the chattel paper. What type of collateral is being assigned under these circumstances?

When the question is posed with respect to a transfer of a limited interest in other types of collateral, the answer is easy. Suppose, for example, that the owner of a fifty percent undivided ownership interest in an item of equipment creates a security interest in its ownership interest. Surely the secured party acquires a security interest in "equipment." Similarly, if the lessor of equipment creates a security interest in its residual interest, the secured party acquires an interest in "inventory."[210]

We think the answer is equally easy in the case of chattel paper: An assignment of an undivided interest in chattel paper is an assignment of chattel paper. In some sense, all collateral consists of the debtor's rights with respect to a particular asset. A security interest is "an interest in personal property,"[211] and "property" includes rights as against third parties with respect to a particular asset.[212] The characterization of an asset that is assigned does not differ depending on whether the debtor assigns a limited interest in its rights.

Comment 5 to section 9-109 makes this point. It states, in relevant part, "A 'sale' of an account, chattel paper, a promissory note, or a payment intangible includes a sale of a right in the receivable, such as a sale of a participation interest."[213] One could understand this sentence as stating a truism, i.e., that by buying a receivable, a person buys the seller's rights in the receivable. The comment should be read, however, as saying the converse. A reference in Article 9 to the "sale of chattel paper" is a reference to the sale of a participation interest in the chattel paper as well as a reference to the sale of all the seller's rights in the chattel paper.

revised comment nor Kaim's policy arguments (with which we generally agree) negates the possibility of severing the assignment of lease rental payments from the goods-related rights under the lease, at least as between the parties.

210. *See* U.C.C. § 9-102(a)(48)(A) (2008) (defining "inventory" to include goods that are "leased by a person as lessor").

211. U.C.C. § 1-201(b)(35) (2008) (defining "security interest").

212. *See* JOHN P. DWYER & PETER S. MENELL, PROPERTY LAW AND POLICY: A COMPARATIVE INSTITUTIONAL PERSPECTIVE 1 (1998) ("[P]roperty is not the thing itself [but rather] a 'bundle of rights' concerning things. Some of the more notable sticks in the bundle include the right to exclude others from . . . using the 'thing' . . . .").

213. U.C.C. § 9-109 cmt. 5 (2008).

D. *Classifying the Collateral When Tangible and Electronic Records Exist with Respect to the Same Right to Payment*

Revised Article 9's introduction of "electronic chattel paper" as a distinct type of collateral has given rise to a variety of puzzles. In this Part of the Article we discuss some questions that may arise when a single lease or secured transaction is reflected in both tangible and electronic records. In pondering these questions, it may be useful to keep in mind what difference it might make if a given item of chattel paper is classified as tangible chattel paper, electronic chattel paper, or both.

The proper classification of collateral under Article 9 is a determinant of both perfection and priority. As long as every copy of a given item of chattel paper exists only in one medium (tangible or electronic), there should be no doubt about how to classify the collateral and, consequently, no doubt about which perfection and priority provisions apply. A security interest in chattel paper in either medium may be perfected by filing.[214] By enabling a purchaser of tangible chattel paper to perfect its security interest in a monetary obligation by taking possession of chattel paper, former Article 9 reified in tangible chattel paper what otherwise may have constituted intangible collateral not susceptible of possession.[215] The ability to take possession opens the possibility of distinguishing between the effect of perfection by filing and perfection by taking possession. Former section 9-308 drew this distinction by affording priority over earlier-perfected security interests to certain purchasers who take possession of tangible chattel paper.[216]

Under former Article 9, a monetary obligation that is coupled with a security interest in or lease of specific goods and is not evidenced by a writing would not have constituted chattel paper. Rather, the bundle of rights would have been classified as either an account or a general intangible.[217] As an intangible right that has not been reified, an account or general intangible is not susceptible of possession, and a purchaser of the right cannot avail itself of the

214. *See* U.C.C. § 9-310(a) (2008) (perfection by filing); *id.* § 9-312(a) (same). Of course, an indication of collateral on a financing statement as "tangible chattel paper" would not serve to perfect a security interest in original collateral constituting electronic chattel paper, and vice versa. We think it most unlikely that a secured party sophisticated enough to appreciate that chattel paper may be tangible or electronic would file a financing statement covering chattel paper in the "wrong" medium.

215. *See* U.C.C. § 9-305 (1999) (providing for perfection of a security interest in chattel paper by possession); *cf.* U.C.C. § 9-313(a) (2008) (same). Chattel paper evidencing a secured transaction generally was reified under pre-Article 9 law, but lease chattel paper apparently was not. *See supra*, Part II.A.2.

216. *See* U.C.C. § 9-308 (1999); *cf.* U.C.C. § 9-330(a), (b) (2008) (drawing this distinction).

217. *See* U.C.C. § 9-106 (1999) (defining "account" and "general intangibles").

special priority available to purchasers who take possession. To enable purchasers of rights that are evidenced by electronic records to obtain a priority comparable to that which was available to purchasers of tangible chattel paper, Article 9 was revised to create a new type of intangible collateral, electronic chattel paper, for which a new method of perfection, control, would provide the benefits of reification.[218] Under revised Article 9, control of electronic chattel paper is analogous to possession of tangible chattel paper. A purchaser of electronic chattel paper who has control of the chattel paper under the circumstances specified in section 9-330 acquires priority identical to that of a purchaser of tangible chattel paper who takes possession under the same circumstances.[219]

1. When Copies Are Created in a Different Medium

The Official Comments acknowledge that "a record consisting of a tangible writing may be converted to electronic form" and that "the resulting records are electronic chattel paper."[220] There is no reason why the converse should not be equally true, i.e., that electronic chattel paper can be converted to tangible chattel paper. It makes good sense to reclassify chattel paper that is converted from one medium to another. Anyone dealing with post-conversion chattel paper will appropriately take account of its then-existing medium and may have no means of determining its pedigree. An amendment to the Official Comments acknowledges this possibility.[221]

When is chattel paper in one medium "converted" to chattel paper in another medium, such that it becomes a different type of collateral under Article 9? The comments suggest that conversion occurs, and electronic chattel paper is created, "by creating electronic images of a signed writing."[222] We are troubled by this example, which the 2010 Amendments delete. To see why, it may be useful to take a step back from chattel paper and consider the case in which there are two copies of a negotiable note. One of these copies is signed by the maker; the other is a photocopy. Article 9 provides that a secured party may perfect a security interest in a negotiable note or other instrument "by

218. *See* U.C.C. § 9-102(a)(31) (2008) (defining "electronic chattel paper"); *id.* § 9-105 (explaining when a secured party has "control" of electronic chattel paper).

219. *See* U.C.C. § 9-330(a), (b) (2008).

220. U.C.C. § 9-102 cmt. 5.b. (2008). This statement is deleted in the comment as revised by the 2010 Amendments, U.C.C. § 9-102 cmt. 5.b. (Proposed Revisions 2010), but the revised comments continue to contemplate such a conversion. *See id.* § 9-330 cmt. 4.

221. *See* U.C.C. § 9-330 cmt. 4 (Proposed Revisions 2010). The process of converting electronic chattel paper to tangible chattel paper sometimes is referred to as "papering out."

222. U.C.C. § 9-102 cmt. 5.b (2008).

taking possession of the collateral."[223] The perfection step—whether taking possession or filing—is meant to give potential purchasers and creditors a signal that the collateral may be encumbered. Possession of a negotiable instrument has significance outside the world of Article 9; possession normally is a condition to enforcement of the obligation embodied in the instrument.[224] For this reason, a secured party takes possession of, and perfects a security interest in, a negotiable note by taking possession of the original, even if the debtor retains possession of a photocopy. Put otherwise, the right to payment is reified (or embodied) in the signed, original note, not in the photocopy. Likewise, when the collateral is tangible chattel paper that includes a negotiable note, the right to payment is reified in the signed, original writings.

A similar analysis would apply to the much more common situation in which the chattel paper evidences a monetary obligation that is not in negotiable form. Indeed, comment 4 to section 9-330 implies that some copies of a written lease (e.g., signed "originals") are relevant to perfection by possession but others (e.g., photocopies) are not.[225] Chattel paper of this kind often consists of multiple originals.[226] A corollary of the idea that perfection by possession refers to possession of the salient copies ("originals") is that, where there are multiple originals, taking possession of the chattel paper requires taking possession of all the relevant originals, not just one.[227] Comment 4 recognizes that, in many cases, taking possession of all originals may pose a practical problem. This problem, says the comment, "is easily solved. The parties may in the terms of their agreement and by designation on the chattel paper identify only one counterpart as the original chattel paper for purposes of taking possession of the chattel paper."[228] Implicit in this observation is that

223. *See* U.C.C. § 9-313(a) (2008).

224. *See* U.C.C. § 3-412 (2008) (providing that the issuer of a note is obligated to pay it to a person entitled to enforce); *id.* § 3-301 (ordinarily conditioning a person's status as a "person entitled to enforce" on the person's possession of the instrument).

225. *See* U.C.C. § 9-330 cmt. 4 (2008).

226. In contrast, only a foolish maker would sign more than one copy of a negotiable instrument. Each signed original would be a separate negotiable note that the maker would be obligated to pay. *See* U.C.C. § 3-104(a) (2008) (defining "negotiable instrument"); *id.* § 3-412 (stating the obligation of the issuer of a note). A holder in due course of each note would take free of any defense arising from the fact that the maker had signed another original. *See id.* § 3-305(b).

227. *See* Funding Sys. Asset Mgmt. Corp. v. Chemical Bus. Credit Corp. (*In re* Funding Sys. Asset Mgmt. Corp.), 111 B.R. 500, 518-19 (Bankr. W.D. Pa. 1990) (holding that a security interest in a lease was not perfected by the secured party's having taken possession of a signed original, when the debtor also had possession of such an original; secured party "failed to perfect its security interests in . . . leases by virtue of its possessing . . . chattel paper because it had not exercised absolute dominion and control over *all available originals*") (emphasis added).

228. U.C.C. § 9-330 cmt. 4 (2008).

the other counterparts, whose possession is irrelevant to perfection, would not constitute chattel paper.

We return now to the situation we introduced above, to which the comments refer: An electronic image of a signed writing is created (e.g., a data file is produced when a written lease is scanned).[229] Does the image constitute electronic chattel paper? There is no reason why the creation of an electronic copy should not have the same effect, or noneffect, as the creation of a photocopy. The collateral remains the original written lease, which is tangible chattel paper. Unless the electronic copy becomes relevant to perfection by control, it would not constitute electronic chattel paper. "Control" of electronic chattel paper requires the existence of a single authoritative copy of the record that is unique and identifiable.[230] A purchaser cannot satisfy this requirement if relevant paper originals of the chattel paper are outstanding. The 2010 Amendments add a general standard for control of electronic chattel paper: "a system employed for evidencing the transfer of interests in the chattel paper reliably establishes the secured party as the person to which the chattel paper was assigned."[231] The mere creation of an electronic copy of electronic chattel paper would not satisfy this test.

The comment to section 9-102 notwithstanding, the creation of an electronic copy of a written lease does not ipso facto convert the tangible chattel paper into electronic chattel paper; in fact, it does not even create electronic chattel paper.[232] The perfected status and priority of a secured party who retains possession of the original, signed writings is not affected by the mere existence of an electronic copy. The consequences would be dramatically different, however, if an electronic record were to *replace* tangible chattel paper, i.e., if the tangible chattel paper were *converted* to electronic chattel paper. Conversion would require not only creation of an electronic copy but also destruction of the written originals or some other action that reliably identifies the originals as no longer constituting "originals" for purposes of possession.[233] The latter step is necessary to prevent a single bundle of rights

229. U.C.C. § 9-102 cmt. 5.b (2008).

230. *See* U.C.C. § 9-105(1) (2008). The 2010 Amendments would renumber this paragraph as section 9-105(b)(1).

231. U.C.C. § 9-105(a) (Proposed Revisions 2010).

232. *See* U.C.C. § 9-102 cmt. 5.b (2008). As indicated above, the revised comment would remove the erroneous suggestion.

233. *See* U.C.C. § 9-105 cmt. 3 (2008) ("When tangible chattel paper is converted to electronic chattel paper, in order to establish that a copy of the electronic chattel paper is the authoritative copy it may be necessary to show that the tangible chattel paper no longer exists or has been permanently marked to indicate that it is not the authoritative copy."). The 2010 Amendments would renumber this paragraph as comment 4. Although the quoted sentence refers to control under what would become section 9-105(b), we think the principle is equally applicable to what would become the new, general standard for control in section

(monetary obligation and related interest in specific goods) from becoming embodied in both tangible chattel paper and electronic chattel paper. If Article 9 did not preclude that possibility, one purchaser might qualify for priority under section 9-330 by taking possession of the tangible chattel paper, and a competing purchaser might qualify for priority with respect to the same asset by having control of the electronic chattel paper.[234] Another possible consequence, equally (or perhaps more) undesirable, would be that a purchaser would qualify for priority under section 9-330 only by both having control of the electronic chattel paper *and* taking possession of the tangible chattel paper (i.e., neither possession without control nor control without possession would qualify for section 9-330 priority).[235]

A revision to the Official Comments explains that priority to chattel paper under section 9-330 may be "preserved," even if the chattel paper is converted from one medium to another.[236] To a considerable extent, the revision addresses a nonissue. Preserving priority is not likely to be of significance to a secured party who achieves priority under section 9-330 with respect to converted chattel paper. Unlike Article 9's basic, "first-to-file-or-perfect" priority rule, section 9-330 does not rank competing, perfected security interests on basis of when each secured party took specific actions.[237] Section 9-330 awards to a qualifying purchaser a "superpriority" over earlier-perfected security interests. Consider the case of a purchaser of tangible chattel paper that subsequently is converted to electronic chattel paper. By satisfying the requirements of section 9-330 with respect to the electronic chattel paper, the purchaser will achieve priority over competing security interests, even if the purchaser lacked priority with respect to the tangible chattel paper.[238] Indeed, by having control, the purchaser will achieve priority with respect to the electronic chattel paper even if its security interest in the tangible chattel paper was unperfected.

There is, however, one situation, not likely to occur, in which preconversion priority under section 9-330 by control should carry forward to postconversion priority by possession (and vice versa). A purchaser should not

9-105(a), U.C.C. § 9-105(a) (Proposed Revisions 2010).

234. Unlike the foolish maker of multiple negotiable notes described in note 221, *supra*, the account debtor on chattel paper that does not include a negotiable note would be obligated to pay only once.

235. This result would be consistent with the treatment of multiple original counterparts of nonnegotiable chattel paper under the *In re Funding Systems Asset Management Corp.* case. *See supra* note 227.

236. *See* U.C.C. § 9-330 cmt. 4 (Proposed Revisions 2010).

237. *Cf.* U.C.C. § 9-322(a)(1) (2008) (providing that conflicting security interests rank according to priority in time of filing or perfection).

238. For example, the purchaser may have been junior to a competing secured party under FTFOP. *See* U.C.C. § 9-322(a)(1) (2008).

lose priority under section 9-330 if, after achieving priority but before converting the chattel paper, the purchaser acquires knowledge that the purchase violated the rights of the holder of a competing security interest.[239]

To this point, the discussion has focused on chattel paper that begins its life in tangible form. Much the same analysis would apply, however, to chattel paper that is originated electronically. Just as the creation of an electronic copy of tangible chattel paper does not create electronic chattel paper, so the mere printing of a copy of electronic chattel paper should be a nonevent with respect to chattel paper that is originally created in an electronic medium. The printed copy would not constitute tangible chattel paper, and its creation would not affect the priority of a person who retains control of the electronic chattel paper. On the other hand, electronic chattel paper can be converted into tangible chattel paper.[240] Conversion would occur when the resulting tangible record is reliably identified as a copy that is relevant for purposes of taking possession.[241]

Electronic chattel paper does, however, differ from tangible chattel paper in one important respect. One cannot distinguish among identical electronic copies of the same information. In that sense, there is no "original" electronic chattel paper. "Control" is essentially the process of designating the relevant copy (the "res" into which the obligation has been reified) in such a way that it reveals the identity of the current assignee.

2. "Hybrid" Chattel Paper

The preceding discussion focuses on two situations in which tangible and electronic records exist with respect to the same monetary obligation and related security interest in or lease of specific goods: (1) when records in one medium are copied into the other medium, e.g., when a copy of electronic chattel paper is printed on paper or tangible chattel paper is scanned into a data file, and (2) when the relevant records are converted into the other medium,

239. A similar result obtains when a holder in due course of a negotiable instrument acquires notice of a claim to the instrument; the holder does not lose its status as a holder in due course. *See* U.C.C. § 3-302(a)(2) (2008) (providing that "'holder in due course' means the holder of an instrument if . . . the holder took the instrument . . . without notice of a claim"); *see also supra* pp. 332-33 discussing *Braniff*.

It is conceivable that the process of converting chattel paper may entail a very brief interval between possession and control. We think such an interval should not be treated as a gap in perfection that makes the security interest vulnerable as a preference if the debtor should enter bankruptcy. *See* 11 U.S.C. § 547(b), (e) (2006). In any event, any preference risk that might arise from conversion can be eliminated by filing.

240. *See* U.C.C. § 9-330 cmt. 4 (Proposed Revisions 2010) ("A secured party may wish to convert tangible chattel paper to electronic chattel paper and vice versa.").

241. *See* U.C.C. § 9-330 cmt. 4 (Proposed Revisions 2010).

e.g., when an electronic copy of tangible chattel paper is susceptible of control or when a tangible copy of electronic chattel paper is susceptible of possession—i.e., when the copy replaces the initial chattel paper as the relevant "res."

A third situation is worthy of discussion. A single lease or secured transaction may be (or become) evidenced by one or more tangible records and one or more electronic records. Chattel paper of this kind often is referred to as "hybrid" chattel paper.[242] Is an assignee of hybrid chattel paper eligible for the special priority afforded by section 9-330(a) and (b) to a purchaser who "takes possession of the chattel paper or obtains control of the chattel paper under Section 9-105"?[243] The Official Comments have been revised to provide a definitive answer to that question: "When chattel paper comprises one or more tangible records and one or more electronic records, a purchaser may satisfy the possession-or-control requirement by taking possession of the tangible records under Section 9-313 and having control of the electronic records under Section 9-105."[244] We think this is a fair—and commercially desirable—reading of section 9-330. Like the rest of the UCC, Article 9 "must be liberally construed . . . to promote its underlying purposes and policies," one of which is "to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties."[245] Nothing in the definitions of "chattel paper," "electronic chattel paper," or "tangible chattel paper" mandates that all the records making up a single item of chattel paper must be in the same medium.[246] The alternative approach—that hybrid chattel paper, which is neither entirely tangible nor entirely intangible, is not susceptible to either possession or control—serves no useful purpose. A purchaser will "paper out" the electronic records or convert the tangible records to electronic form if it makes commercial sense to do so. There is no need to require a purchaser to do so as a condition of achieving priority under section 9-330.[247]

242. *See* Memorandum from Thomas J. Buiteweg to the Article 9 Joint Review Committee (Dec. 23, 2008) [hereinafter Buiteweg Memo], *available at* http://www.law.upenn.edu/bll/archives/ulc/ucc9/buitewegmemo.pdf.

243. U.C.C. § 9-330(a), (b) (2008).

244. U.C.C. § 9-330 cmt. 4 (Proposed Revisions 2010).

245. U.C.C. § 1-103(a)(2) (2008).

246. *See* U.C.C. § 9-102(a)(11), (31), (78) (2008) (defining "chattel paper," "electronic chattel paper," and "tangible chattel paper," respectively).

247. We suggested above that Article 9 should be construed to preclude the possibility that one purchaser might qualify for priority under section 9-330 by taking possession of tangible chattel paper and a competing purchaser might qualify for priority with respect to the same bundle of rights by having control of the electronic chattel paper. But we understand hybrid chattel paper to present a different situation, one in which *some* (but not all) of the records constituting the chattel paper exist in one medium and *others* exist in another medium.

More generally, in the context of hybrid chattel paper, Article 9 should be interpreted in a way that does not adversely affect the perfection or priority of security interests that exist at the time the chattel paper acquires hybrid status. The revised Official Comment to section 9-330, under which a purchaser may achieve priority under that section by a combination of possession and control, applies neatly to hybrid chattel paper existing as such at the time of perfection. Often, however, "[e]lectronic records are modified using . . . paper agreements . . . . For example, paper records are often used to document the extension or rescheduling of payments due under an electronic retail installment sale contract or lease."[248] We think the revised comment would not apply to this example because, even after the modification, the chattel paper comprises only electronic records.

To see why this might be so, consider a secured party who has perfected its security interest in tangible chattel paper by possession and has achieved priority under section 9-330. Thereafter, in a tangible record, the account debtor (obligor) agrees with the debtor-assignor to modify (by way of amendments or restatements) one or more terms of the tangible chattel paper. The failure of the secured party to obtain possession of the new tangible records should not impair the perfection or priority of the security interest, even if the modification is binding on the secured party.[249] This is for the same reason that making an electronic copy of the tangible chattel paper would not impair perfection or priority: Possession of the original chattel paper adequately serves the public-notice function; the original chattel paper remains the "chattel paper."[250] We see no reason why the result should differ if the modification is made by way of an electronic record. If a record constituting a part of the chattel paper subsequently is replaced by (or converted to) an electronic record, neither perfection nor priority of the security interest should be impaired, as long as the secured party continues to maintain possession of the original tangible chattel paper and the secured party's possession continues to provide adequate public notice that the debtor may have created a security interest in the chattel paper.[251] The same should be true if a record constituting a part of electronic chattel paper is replaced by (or converted to) an electronic record. A full analysis of the issues raised by postperfection modifications of chattel paper is beyond the scope of this Article. For present purposes our general point is that the legal effect of such modifications should not differ based on the form of the records evidencing the modifications.

248. Buiteweg Memo, *supra* note 242, at 1.

249. *See* U.C.C. § 9-405(a) (2008) (addressing circumstances in which such modifications are binding on the secured party).

250. *See supra* Part II.D.1.

251. This scenario may involve a subsequent agreement between the account debtor and the debtor-assignor but without the participation or consent of the secured party.

CONCLUSION

The overarching point of this Article is straightforward: Article 9 must be applied and interpreted as a complex system of interrelated principles and not as a collection of stand-alone, self-contained definitions and rules. To be sure, Article 9 does indeed contain many—perhaps too many—specific rules. The temptation is great to focus on the trees and to overlook the forest. That approach is unwise. We do not, of course, recommend that the specific rules be ignored. But we do believe that, in addition to its detailed, rule-oriented content, Article 9 reflects some deeper principles. We have developed this overarching theme in two contexts.

First, we addressed the relationship among the Article 9 priority rules, in particular FTFOP, and the basic conveyancing principle of *nemo dat*. Because Article 9 is not a complete codification of personal property law, or even the law of competing interests in personal property, it is essential to recognize the relationship between the Article 9 "rules" and that body of "other," non-Article 9 law. For both historical reasons and drafting convenience, Article 9 has a distinctive structure that must be understood before Article 9 can be properly applied. The relationship between *nemo dat* and FTFOP is a perfect example. In this setting we illustrated how Article 9's priority rules inherently (albeit implicitly) anoint a debtor with the power to transfer more than it has, even when it may have nothing at all.

This understanding is especially important for the application of Article 9's "lien priority" structure to priority contests involving one or more sales of receivables. Based on this analysis we offered solutions to a number of puzzling priority contests involving sales of receivables and demonstrated that there is no "glitch" in Article 9 in this respect. In particular we explained that when FTFOP awards priority in a receivable to a first-filed secured party, it implicitly empowers the debtor to create a security interest in favor of that secured party, notwithstanding the debtor's earlier sale of the receivable to another secured party.

Second, we explored a host of issues related to security interests in (including sales of) chattel paper and rights to payment evidenced by chattel paper. In this connection we considered the definition of "chattel paper" and other receivables-related definitions of collateral. In particular we addressed these definitions in the context of "stripping" payment streams from chattel paper and the question whether the stripped receivable is a payment intangible or retains its status as (a part of) chattel paper. While these chattel paper-related issues are important in their own right, our discussion also reflects another important structural aspect of Article 9: The Article 9 definitions of types of collateral are essential to the application and interpretation of Article 9. The only reason for defining different types of collateral is that different types of collateral demand different rules for perfection and priority.

Thus in close questions of interpretation of the scope of these definitions, one must take into account the underlying policies reflected by the applicable Article 9 perfection and priority rules. This is especially true in the case of rules designed for collateral of a type that is reified, such as chattel paper and instruments. The clash between a security interest held by a buyer of a stripped payment stream and a security interest in the chattel paper from which the payment stream was stripped is exemplary. Does the payment stream continue to be reified and evidenced by the chattel paper for purposes of, for example, the application of section 9-330(a) and (b)?[252] If a post-stripping possessory purchaser can achieve priority over the buyer of the stripped payment stream under (or by virtue of) section 9-330, most would conclude that the *Commercial Money Center* opinion characterizing the stripped payment stream as a payment intangible is relatively benign.[253]

In our view, however, the stripped-payment-stream aspect of *CMC* arose from an aberrant transaction. For this reason we do not believe that it will prove to be problematic, however the section 9-330 question ultimately may be resolved (if it is ever resolved). The case provides a good lesson nonetheless. In interpreting the definitions of types of collateral it is essential to consider how one interpretation or the other would play out through application of the perfection and priority rules. Normally, an interpretation that creates chaos and confusion will be less desirable than one that does not. And one that respects settled expectations in the financial markets will be preferred over one that does not. As the principal drafters of revised Article 9, we can state with confidence that the stripping issue addressed in *CMC* and its implications for potential priority disputes was not one that we focused on. As far as we know it was not considered by anyone else in the drafting process. But considering the substantial expansion of the scope of Article 9 to include sales of payment intangibles and promissory notes and the attendant automatic-perfection rule, no one should be too surprised to find at least some unintended consequences.

Although we, and the Drafting Committee, did try to foresee problems that might arise from the introduction of electronic chattel paper as a new type of receivable and control as a new method of perfection, revised Article 9 does not include specific rules to address the situation when tangible and electronic records exist with respect to the same right to payment. Here, too, we have shown how a proper application of the policies underlying Article 9's perfection and priority rules can enable a court to reach a sound result from the statutory rules.

252. U.C.C. § 9-330(a), (b) (2008).

253. 350 B.R. 465 (B.A.P. 9th Cir. 2006), *rev'g*, 56 U.C.C. Rep. Serv. (West) 54 (Bankr. S.D. Cal. Jan. 27, 2005).