Chicago-Kent Law Review

Volume 74
Issue 3 *Symposium on Revised UCC Article 9*

Article 5

June 1999

The Impact on Securitization of Revised UCC Article 6

Steven L. Schwarcz

THE IMPACT ON SECURITIZATION OF REVISED UCC ARTICLE 9

STEVEN L. SCHWARCZ*

The recent revisions of Article 9 of the Uniform Commercial Code ("UCC") are expected to have a significant impact on securitization—a type of financing that is perhaps the most rapidly growing segment of the U.S. credit markets and increasingly a major part of foreign credit markets. In its current form, Article 9 governs the sale of only certain types of assets that are involved in securitization transactions. Revised Article 9 attempts to broaden its coverage to virtually all securitized assets. I analyze how it does that and what it means for Article 9 to apply to these transactions, addressing issues of perfection and priority of asset transfers, commingling of proceeds, assignability of assets in the face of contractual restrictions, and the effect of negative pledge covenants. Finally, I show that the revisions of Article 9 do much to bring the commercial law setting for securitization into the twenty-first century.

INTRODUCTION

Asset securitization is "by far the most rapidly growing segment of the U.S. credit markets"[1] and increasingly is becoming a major part of foreign credit markets.[2] In a typical securitization, a company (usually referred to as the "originator"[3]) sells rights in income-

* Professor of Law, Duke University School of Law; Faculty Director, Duke Global Capital Markets Center; and Special Counsel to Kaye, Scholer, Fierman, Hays & Handler. E-mail: schwarcz@law.duke.edu. The author thanks Bruce Bernstein, Carl Bjerre, Jason Kravitt, Eric Marcus, Sandra Rocks, and Ed Smith for helpful comments on a draft of this article.

1. Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 24 (1996).

2. *See generally* Symposium, *International Issues in Cross-Border Securitization and Structured Finance*, 8 DUKE J. COMP. & INT'L L. 229 (1998) (bringing together leading scholars and practitioners from the private and public sectors to examine these issues). These articles also are available on-line at http://www.law.duke.edu/journals/djcil/. For a discussion of the fundamental legal principles of cross-border securitization and finance, see Steven L. Schwarcz, *The Universal Language of Cross-Border Finance*, 8 DUKE J. COMP. & INT'L L. 235 (1998).

3. References in this article to originator, company, or debtor (the generic term favored by Article 9) will generally mean the originator in a securitization transaction.

producing or financial assets[4]—such as accounts, instruments, lease rentals, franchise and license fees, and other intangible rights to payment—to a special purpose vehicle ("SPV"). The SPV, in turn, issues securities to capital market investors and uses the proceeds of the issuance to pay for the assets.[5] The investors, who are repaid from collections of the assets, buy the securities based on their assessment of the value of the assets. Because the SPV (and no longer the originator) owns the assets, their investment decision often can be made without concern for the originator's financial condition. Thus, viable companies that otherwise cannot obtain financing because of a weakened financial condition now can do so. Even companies that otherwise could obtain financing now will be able to obtain lower-cost capital market financing.[6]

What does Article 9 of the Uniform Commercial Code have to do with securitization? In its current form, Article 9, which generally addresses only secured transactions, nonetheless governs the sale of certain types of financial assets—accounts and chattel paper—that are commonly involved in securitization transactions.[7] The rationale for including sales of these assets in Article 9 was that "[c]ommercial financing on the basis of accounts and chattel paper is often so conducted that the distinction between a security transfer and a sale is blurred, and a sale of such property is therefore covered . . . whether intended for security or not."[8] This same rationale, and the significant

4. The reader should not confuse my use of the securitization term "financial assets" with the unrelated term "financial asset" used in UCC Article 8 (and defined in UCC section 8-102(a)(9)).

5. For authorities on securitization generally, see TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES (1991 & Supp. 1999); STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (2d ed. 1993); THE SECURITIZATION OF FINANCIAL ASSETS (Jason H.P. Kravitt ed., 2d ed. 1996 & Supp. 1999); Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TULANE L. REV. 101 (1997); Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061 (1996); and Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STANFORD J.L. BUS. & FIN. 133 (1994).

6. Securitization has an increasingly international focus in part because companies that wish to raise funds from the capital markets may not be located in countries with established capital markets or because developing capital markets lack the depth of developed markets in other countries. In order to access capital market funding, those companies will have to structure deals that cross their national borders. *See* Schwarcz, *supra* note 2, at 236-37.

7. Current UCC section 9-102(1)(b) provides that Article 9 applies "to any sale of accounts or chattel paper." (Subsequent references in this article to a current section of UCC Article 9 will simply refer to that "Current" section, and subsequent references in this article to a revised section of UCC Article 9 will simply refer to that "Revised" section.) The implicit assumption is that a given transfer either is intended for security and is, therefore, a secured transaction or else is a sale, and that Article 9 will govern both such transfers.

8. U.C.C. § 9-102 cmt. 2.

minimization of transaction costs that the rule achieves,[9] holds equally true today.

What has changed today, however, is that, increasingly, many other types of financial assets are sold as part of commercial financing transactions. Whereas factoring[10] was the only significant form of commercial financing to involve sales of financial assets (accounts and chattel paper) when the UCC originally was adopted,[11] securitization—which involves the sale of a whole range of financial assets—has now become significant. Yet, Article 9 had not been amended to take securitization into account. Revised Article 9 is a bold and largely successful attempt to remedy that omission and to adapt the law governing secured transactions to the realities of modern commercial and financial transactions. It accomplishes these goals in several ways.

I. REVISED ARTICLE 9 BRINGS THE SALE OF MOST TYPES OF FINANCIAL ASSETS WITHIN ITS SCOPE

As a threshold matter, Revised Article 9 brings within its scope the sale not only of accounts and chattel paper, as under current law, but also of "payment intangibles" and "promissory notes."[12] Significantly for securitization, the definition of an account is expanded from current law to include not only credit card receivables[13] and health-care-insurance receivables[14] but also any

9. Transaction costs are minimized for several reasons. Parties do not have to make the difficult determination of whether each transfer is a secured transaction or a sale. Also, filing for both types of transfers will forestall litigation attempting to second-guess that determination if the debtor eventually goes bankrupt. Finally, pre-UCC sales of accounts had to be perfected under the common law procedures of the state where the seller was located. *See* SCHWARCZ, *supra* note 5, at 38-39. Different states had different rules and some required the account debtors to be notified of the sale. *See id.* Notification of numerous account debtors always would be costly and often would be impractical, creating uncertainty in the latter case as to the buyer's ownership rights in the accounts and sometimes discouraging the sale altogether. *See id.* at 39. Inclusion of sales of accounts and chattel paper in Article 9 circumvents those common law requirements.

10. For an introduction to factoring, see PETER H. WEIL, ASSET-BASED LENDING: A PRACTICAL GUIDE TO SECURED FINANCING § 2.3 (3d ed. 1998). For a discussion of the relationship between factoring and securitization, see Schwarcz, *supra* note 5, at 144-46.

11. *See* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 8.7, at 275, § 10.5, at 308 (1965) (explaining that the inclusion of sales in Article 9 was necessary to protect "arrangements of the factoring type").

12. See Revised section 9-109(a)(3), the successor provision to Current UCC section 9-102(1)(b) (defining scope).

13. *See* R. § 9-102(a)(2)(vii) (including within the definition of an "account" rights to payment arising out of the use of a credit or charge card).

14. Revised section 9-102(a)(2) provides that "[t]he term [account] includes health-care-insurance receivables," a term itself defined in Revised section 9-102(a)(46) to mean "an

"right to payment ... for property that has been or is to be ... licensed, assigned, or otherwise disposed of,"[15] thereby covering license and franchise fee receivables. Moreover, the term payment intangible is broadly defined as "a general intangible under which the account debtor's principal obligation is a monetary obligation."[16] This definition appears intended to cover financial assets that are not already covered by the terms account, chattel paper, and promissory notes. For example, loan participations and commercial loans not evidenced by instruments[17] would be payment intangibles.

Accordingly, Revised Article 9 will apply to securitization transactions so long as the financial assets being sold consist of accounts (including credit card, health-care-insurance, license, and franchise fee receivables), chattel paper, promissory notes, or payment intangibles. I will refer to these types of financial assets as "covered financial assets." The reader should note, however, that in some securitization transactions, financial assets are not sold but are merely transferred as security.[18] Revised Article 9 then will apply, as does Current Article 9, to virtually any financial asset so transferred.[19]

The remainder of this article discusses what it means for Article 9 to apply to the securitization of financial assets. Most significantly, all sales of covered financial assets will be perfected, and the priority of the SPV as against creditors or a trustee in bankruptcy of the originator will be governed, by the rules of Article 9. Establishing clear and pragmatic rules for perfection and priority of the transfer of covered financial assets will minimize transaction costs for the reasons previously explained in the context of transferring accounts

interest in or claim under a policy of insurance which is a right to payment of a monetary obligation for health-care goods or services provided." In that connection, Article 9's traditional insurance exclusion no longer will exclude "an assignment by ... a health-care provider of a health-care-insurance receivable." *Id.* § 9-109(d)(8).

15. *Id.* § 9-102(a)(2)(i).

16. *Id.* § 9-102(a)(61). The term general intangible is defined in Revised section 9-102(a)(42).

17. These being financial assets that are often transferred in collateralized loan obligation transactions.

18. *See* Schwarcz, *supra* note 5, at 135, 140 n.26 (observing that whereas originators often structure the transfer of financial assets as a "true sale" in order to achieve bankruptcy remoteness, the transfer of financial assets from an investment grade originator to the SPV need not be structured as a sale).

19. *See* R. § 9-109(a)(1) (providing that Revised Article 9 applies to any "transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract"). Subsections (c) and (d) of section 9-109 contain certain exclusions from Revised Article 9, few of which relate to securitization transactions. And even though Revised Article 9 does not apply to security interests in (non-fixture) real property, it does apply to security interests in obligations secured by real property, such as mortgage loans. *See id.* § 9-109(b).

and chattel paper: parties to the securitization transaction will not have to make the difficult determination of whether each transfer of a covered financial asset is a secured transaction or a sale; filing for both types of transfers will forestall litigation attempting to second-guess that determination if the originator in the securitization transaction eventually goes bankrupt; and sales of covered financial assets no longer will have to be perfected under state common law procedures that often are costly and impractical.[20]

But Revised Article 9 will apply to securitization in a myriad of other ways. In this article, I focus on the more significant impacts most likely to be encountered in a typical securitization transaction, such as mitigating the effect of commingling proceeds of financial assets and promoting assignability of financial assets, notwithstanding contractual restrictions to the contrary. The reader must recognize, however, that Revised Article 9 will have other impacts on securitization, some less significant,[21] some that will be significant in only certain transactions,[22] and some whose significance might not become obvious until transactions are actually done under the revised statute.[23]

Of course, the fact that Revised Article 9 will apply to the sale of covered financial assets does not mean that Article 9 applies to those sales for *all* purposes. In interpreting Oklahoma's enactment of Current Article 9, the Tenth Circuit Court of Appeals previously had concluded that Article 9's application to the sale of accounts—characterizing the buyer of accounts as a "secured party," the seller as a "debtor," and the sold accounts as "collateral"—means that accounts cannot be sold under Oklahoma law.[24] Although that

20. *Cf. supra* note 9 (explaining why the inclusion in Article 9 of accounts and chattel paper reduces the transaction costs of transferring those assets).

21. For example, Revised section 9-209(c) sensibly provides that certain duties of a secured party that arise when a secured obligation is repaid do not apply to sales of covered financial assets, and Revised section 9-323(c) sensibly provides that certain priority rules regarding future advances also do not apply to such sales.

22. Such as the ability to take a security interest in a deposit account under Revised section 9-304 or the rules for bank setoff against such deposit account under Revised section 9-340.

23. *See, e.g.*, Steven L. Schwarcz, *A Fundamental Inquiry into the Statutory Rulemaking Process of Private Legislatures*, 29 GA. L. REV. 909, 918 & n.23 (1995) (discussing that a Revised Article 9 can raise new problems of interpretation).

24. *See* Octagon Gas Sys., Inc. v. Rimmer, 995 F.2d 948, 955 (10th Cir. 1993). Octagon Gas Systems, which had sold the accounts, went bankrupt, and federal bankruptcy law looks to state law to determine whether an asset has been sold. *See* Butner v. United States, 440 U.S. 48, 55 (1979) (holding that property rights are determined by state law and the involvement of an interested party in a bankruptcy proceeding has no effect on these rights).

decision was much criticized,[25] and the Permanent Editorial Board of the UCC issued a commentary stating that the case was incorrect[26] and also amended comment 2 to Current section 9-102 to clarify interpretation,[27] those actions have not generally been approved by legislatures or courts and do not necessarily have the force of law.[28] Revised Article 9, once approved by legislatures, is intended to drive the final nail into the *Octagon* coffin by providing not only that the question "whether a debtor's rights in collateral may be voluntarily or involuntarily transferred is governed by law other than this article [9],"[29] but also that 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."[30] The latter point attempts to address the "rarified" argument that *Octagon* was correctly decided because certain limited property interests may remain with the originator after the sale of financial assets.[31]

25. *See, e.g.*, Thomas E. Plank, *Sacred Cows and Workhorses: The Sale of Accounts and Chattel Paper Under the U.C.C. and the Effects of Violating a Fundamental Drafting Principle*, 26 CONN. L. REV. 397 (1994); Steven L. Schwarcz, "Octagon Gas" *Ruling Creates Turmoil for Commercial and Asset-Based Finance*, N.Y.L.J., Aug. 4, 1993, at 1.

26. *See* PEB COMMENTARY NO. 14, TRANSFER OF ACCOUNTS OR CHATTEL PAPER (1994) (referring to the *Octagon* decision as "erroneous" and noting that "[t]o the extent the [*Octagon*] court relied on Article 9 in reaching its determination, this Commentary adopts a contrary position").

27. PEB Commentary No. 14 amended comment 2 to Current section 9-102 to read in part as follows:

> Neither Section 9-102 nor any other provision of Article 9 is intended to prevent the transfer of ownership of accounts or chattel paper. The determination of whether a particular transfer of accounts or chattel paper constitutes a sale or a transfer for security purposes (such as in connection with a loan) is not governed by Article 9. . . . The use of terminology such as . . . "collateral" to include accounts or chattel paper that have been sold is intended solely as a drafting technique . . . and is not relevant to the sale or secured transaction determination.

28. Only three states have addressed *Octagon* head-on by amending Current Article 9. Oklahoma and Utah added a new subsection (4) to section 9-102, *see* OKLA. STAT. tit. 12A, § 9-102 (Supp. 1999); UTAH CODE ANN. § 70A-9-102 (1997), and Texas added new language to section 9-102(a)(2), *see* TEX. BUS. & COM. CODE ANN. § 9.102 (West 1991 & Supp. 1999), in each case clarifying that the application of Article 9 to sales of accounts and chattel paper does not affect sale characterization. Even before those amendments, however, the practical effect of *Octagon* may have been limited to transactions undertaken by originators located in the Tenth Circuit. *See* Plank, *supra* note 25, at 459 n.278 (observing that rating agencies ignore the *Octagon* case when the originator is outside the Tenth Circuit).

29. R. § 9-401. For an analysis of that other applicable law, see SCHWARCZ, *supra* note 5, at 28-35.

30. R. § 9-318(a).

31. *See* David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055, 1059-61 (1998) (characterizing this argument as rarified). Revised sections 9-207(d) and 9-601(g) address the same point by providing that the secured party as a buyer of accounts, chattel paper, payment intangibles, or promissory notes generally owes no duty to the debtor regarding the collateral. There is, however, a potential ambiguity in the language of Revised section 9-318(a). By stating that "a debtor that has sold an account, chattel paper, payment

II. REVISED ARTICLE 9 ESTABLISHES CLEAR AND PRAGMATIC RULES FOR PERFECTION AND PRIORITY

Two of the essential goals of a commercial law statute are clarity[32] and simplicity of implementation.[33] In the context of the commercial law rules for perfection and priority, Revised Article 9 furthers both of these goals.

A. *Perfection*

Perfection refers to the protection of a transferee's interest in transferred assets from creditors of the transferor and from the transferor's trustee in bankruptcy.[34] Under Current Article 9, perfection is generally achieved by filing financing statements in jurisdictions where the debtor (originator) or the collateral is located.[35] The problem, however, is that it is often unclear where the debtor and the collateral are located and, in the latter case, the location may well change.

Revised Article 9 addresses this problem in two ways: by making the location of the debtor—as opposed to the location of the collateral—determine the jurisdiction whose law governs perfection in most cases;[36] and by clarifying where a debtor is deemed to be located.[37] The former point is less critical to securitization, which involves intangibles, than to other forms of secured financing where

intangible, or promissory note does not retain a legal or equitable interest in the collateral sold," it invites a court to find that when the debtor is in fact shown to have retained a legal or equitable interest, there is no sale under state law. Perhaps Revised section 9-318 or its comments should be amended to clarify that is not the intention.

32. *See, e.g.*, Schwarcz, *supra* note 23, at 928 ("A statute . . . governing commercial law . . . should be clear. Clarity is important to minimize mistakes, ambiguities, and resulting disputes and litigation. Clarity also helps to preserve expectations, which is essential to market transactions."); *see also* Security Nat'l Bank & Trust Co. v. Dentsply Prof'l Plan, 617 P.2d 1340, 1343 (Okla. 1980) ("Although strict adherence to [Uniform Commercial Code] requirements may at times lead to harsh results, efforts by courts to fashion equitable solutions for mitigation of hardships experienced by creditors in the literal application of statutory filing requirements may have the undesirable effect of reducing the degree of reliance the market place should be able to place on the Code provisions. The inevitable harm doubtless would be more serious to commerce than the occasional harshness from strict obedience.").

33. *See* Schwarcz, *supra* note 23, at 939 ("Simplicity of implementation . . . has two aspects. First, it should be simple to understand how to apply commercial law. In this sense, simplicity is related to the principle of clarity, which maintains that the law should be straightforward, unambiguous, and clear. Second, the implementation of commercial law should be practical and cost-effective." (footnote omitted)).

34. *See* Schwarcz, *supra* note 2, at 240 & n.19 (defining perfection).

35. *See* U.C.C. §§ 9-103, 9-302, 9-401.

36. *See* R. §§ 9-301(1), 9-305(c).

37. *See id.* § 9-307.

the assets are tangible items that can be moved around. But the latter point is quite significant to securitization. Section 9-307 of Revised Article 9 changes the rule of Current section 9-103(3) to provide that registered organizations, such as corporations, organized under the law of a particular state are deemed to be located in that state.[38] Thus, one would file financing statements against an originator incorporated under the laws of Delaware in Delaware, irrespective of where the originator's assets or business are located.[39] Furthermore, where the originator is a foreign company not incorporated under state law, Revised Article 9 provides that its location is in the foreign jurisdiction where the originator has its chief executive office (or, if the originator has only one place of business, in the jurisdiction where that place is located), but only if that jurisdiction itself has a public filing system for perfection.[40] If that jurisdiction does not have a public filing system, the originator is deemed to be located in the District of Columbia.[41] Of course, whether filing in the District of Columbia will achieve perfection under the law of the foreign jurisdiction is also a question of that jurisdiction's law.[42]

Revised Article 9 also brings a measure of pragmatism to the securitization of payment obligations evidenced by instruments. Under current law, a security interest in instruments can only be perfected by taking possession of the instrument.[43] That may be impractical, however, where (as is common) a securitization transaction involves the transfer of large pools of instruments. The revision solves that

38. *See id.* § 9-307(e). This does not completely eliminate the problem that the filing location would change if the debtor reincorporates in another state, but that rarely happens.

39. *Cf.* Schwarcz, *supra* note 23, at 968 & n.215 (arguing that "[i]n this age where personal computers and telefaxes permit executives to work at home, bricks and mortar no longer are the sole determinants of a company's location" and that "it sometimes may be costly to verify the location of a small business or to monitor whether the business remains in that location"; and therefore recommending an easier filing location, such as "the state of the debtor's organization"). *See also* Lynn M. LoPucki, *Why the Debtor's State of Incorporation Should Be the Proper Place for Article 9 Filing: A Systems Analysis*, 79 MINN. L. REV. 577, 638-45 (1995) (arguing that a state of incorporation rule should not significantly alter the distribution of filing revenues among states).

40. *See* R. § 9-307(b)-(c).

41. *See id.* § 9-307(c). For a discussion of the merits and rationale of this rule, see Carl S. Bjerre, *International Project Finance Transactions: Selected Issues Under Revised Article 9*, 73 AM. BANKR. L.J. 261, 271-75 (1999).

42. Compare the United Nations Commission on International Trade Law ("UNCITRAL") proposed Convention on Assignment in Receivables Financing, 28 U.N. Comm'n on Int'l Trade L. Y.B. (1998) (discussed in Schwarcz, *supra* note 2, at 240 & n.21, and in Spiro V. Bazinas, *An International Legal Regime for Receivables Financing: UNCITRAL's Contribution*, 8 DUKE J. COMP. & INT'L L. 315, 320 (1998)), which provides that the law of the assignor's location governs perfection of cross-border receivables financings.

43. *See* U.C.C. §§ 9-304(1), 9-305.

problem by allowing a security interest in instruments to be perfected by filing.[44] Nonetheless, holders in due course and certain other purchasers for value of instruments would have priority on the rationale that requiring them to check the filing system in connection with each purchase would impede those transactions, whereas there is only "a remote possibility that is not of serious concern" that an originator will voluntarily transfer instruments to third parties in breach of contractual restrictions.[45]

One of the major controversies that arose during the Article 9 revision effort was how to perfect the sale of payment intangibles. Bankers were concerned that a perfection requirement of filing financing statements would subject them to costly new procedures when selling loan participations, a form of payment intangible.[46] A somewhat practical solution was reached to mitigate this concern: the sale of payment intangibles would be deemed to be automatically perfected, without the need to file financing statements.[47] This solution, however, is imperfect. Buyers of payment intangibles cannot search filing records to determine whether those intangibles previously have been sold to others. Thus, an SPV in a securitization transaction cannot ascertain the priority (discussed below) of the SPV's ownership rights, other than by relying on representations of the originator. Originators that are insufficiently capitalized to back up their representations therefore may find it difficult to securitize payment intangibles.

44. *See* R. § 9-312(a).

45. *See* PEB STUDY GROUP, PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, UNIFORM COMMERCIAL CODE ARTICLE 9 REPORT 155 (Dec. 1, 1992) [hereinafter PEB REPORT]; Schwarcz, *supra* note 23, at 970-71 (arguing that filing should be a permitted way to perfect a security interest in instruments). Thus, Revised section 9-331 provides that a filed financing statement does not constitute notice that would preclude a purchaser from becoming a holder in due course, and Revised section 9-330(d) provides that purchasers for value who take possession of an instrument generally have priority over a security interest perfected by filing.

46. Parties to the Article 9 revision process found it difficult to differentiate loan participations, which are typically undivided interests in loans, from other types of payment intangibles. In the debate over this issue, I argued:

> Few banks . . . comply with [the pre-UCC] common law requirements [for sales of loan participations], which may involve obligor notification or "policing." . . . If a bank does *not* comply, then its failure to file financing statements under Article 9, if it applied to sales of loan participations, would put it in no worse position than at present. Banks would take the insolvency risk of the selling bank, as they likely do now.

Schwarcz, *supra* note 23, at 956 n.165 (citation omitted). Nonetheless, the political heat of the controversy overwhelmed rational inquiry. For a history of this controversy and its solution, see Paul M. Shupack, *Making Revised Article 9 Safe for Securitizations: A Brief History*, 73 AM. BANKR. L.J. 167 (1999).

47. *See* R. §§ 9-309(3), 9-310(b)(2).

B. Priority

Priority refers to the ranking of multiple claims against a transferred asset.[48] In a securitization context, it means that "the SPVs and investors' claims against the transferred financial assets are superior [in ranking] to any third-party claims," including that of the originator's trustee in bankruptcy.[49] Under Current Article 9, priority is generally accorded to the first secured creditor to file or perfect, under a rule usually referred to as "first in time, first in right."[50] Revised Article 9 continues that rule.[51]

There is, however, one exception under Current Article 9 to first in time, first in right. A holder of a purchase money security interest ("PMSI") generally takes priority over an earlier perfected security interest in the same collateral.[52] That exception, however, would create a significant problem for securitization and other forms of accounts receivable financing: because accounts are the proceeds of inventory, it would mean that a later perfected inventory financier with a PMSI would take priority over an earlier perfected SPV or accounts financier. To ensure that the PMSI exception does not discourage accounts receivable financing, Current Article 9 has a special rule that favors accounts receivable financiers, including SPVs that purchase accounts, over purchase money financiers of inventory.[53] Revised Article 9 continues that special rule.[54]

III. REVISED ARTICLE 9 MITIGATES THE EFFECT OF COMMINGLING OF PROCEEDS

Commingling refers to the mixing of proceeds of collateral with assets of the originator. Under Current Article 9, in an "insolvency

48. *See* Schwarcz, *supra* note 2, at 241.

49. *See id.*

50. *See* U.C.C. § 9-312(5).

51. *See* R. § 9-322(a)(1) (providing that "[c]onflicting perfected security interests . . . rank according to priority in time of filing or perfection"). For an interesting critique of this rule, see ALAN SCHWARTZ & ROBERT E. SCOTT, COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES 660, 664-65 (2d ed. 1991).

52. *See* U.C.C. § 9-312(3)-(4). Current UCC section 9-107 defines a PMSI as a security interest "taken or retained by the seller of the collateral to secure all or part of its price" or "taken by a person who by making advances . . . gives value to enable the debtor to acquire rights in or the use of collateral." The former is sometimes referred to as a "seller PMSI" and the latter as a "lender PMSI." *See* Schwarcz, *supra* note 23, at 963.

53. UCC section 9-312(3), which governs a PMSI in inventory, fails to give the PMSI priority over a conflicting security interest in accounts generated by such inventory. *See also* U.C.C. § 9-312 cmt. 3.

54. *See* R. § 9-324(b).

proceeding" (such as bankruptcy),[55] the secured party or SPV's interest in cash proceeds will be lost if the cash is commingled with other funds of the originator, except to the extent that an artificial formula preserves the security interest.[56] However, this rule is unfair to secured parties because it can arbitrarily limit the amount of a perfected security interest in commingled cash proceeds and it allows an originator contemplating bankruptcy, in what has become a commonplace legal strategy for debtors, to intentionally commingle proceeds of a perfected security interest in advance of filing a bankruptcy petition in order to use the formula to defeat the perfected interest.[57]

Revised Article 9 will remedy that unfairness. Rejecting the artificial formula, it returns to the common law principles of "tracing," under which a perfected security interest will continue in traceable cash proceeds of the original collateral.[58] This would permit common law tracing rules such as the "lowest intermediate balance rule," in which it is presumed that funds remaining in an account after withdrawal by the debtor include the proceeds of collateral (or, put another way, that withdrawals from a deposit account following the deposit of proceeds are first made from non-proceeds).[59]

Revised Article 9 also expands the definition of proceeds, which currently includes only what "is received upon the sale, exchange, collection or other disposition of collateral or proceeds."[60] This relatively narrow definition had created confusion, for example, as to whether dividends of stock are proceeds.[61] Under the expanded

55. *See* U.C.C. § 1-201(22) (defining "insolvency proceedings").

56. UCC section 9-306(4)(d)(ii) sets forth that formula.

57. *See* Schwarcz, *supra* note 23, at 957 (describing and commenting on that strategy).

58. *See* R. § 9-315(a)(2), (b)(2) (permitting the secured party to identify the proceeds "by a method of tracing, including application of equitable principles, that is permitted under law other than this article [9]").

59. For a more complete explanation of these tracing rules, see *Universal C.I.T. Credit Corp. v. Farmers Bank*, 358 F. Supp. 317, 325-27 (E.D. Mo. 1973); and BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 10.03 (rev. ed. 1993 & Supp. III 1999). *Cf.* RESTATEMENT (SECOND) OF TRUSTS § 202 (1959) (similar rule under trust law). The only problem, however, with rejection of the artificial formula of Current section 9-306(4)(d)(ii) is that "the tracing/LIBR approach may be more difficult and expensive to apply." PEB REPORT, *supra* note 45, at 124. For an approach that would combine the relative simplicity of the artificial formula with the fairness of a tracing approach, see Schwarcz, *supra* note 23, at 958.

60. U.C.C. § 9-306(1) (defining "proceeds").

61. *See, e.g.*, FDIC v. Hastie (*In re* Hastie), 2 F.3d 1042, 1045-46 (10th Cir. 1993) (holding that stock dividends do not constitute proceeds because the payment of dividends does not constitute "an event whereby one asset is disposed of and another is acquired as its substitute," as contemplated by Current section 9-306(1)'s definition of proceeds). For a general analysis of this case, see Steven L. Schwarcz, *Protecting Rights, Preventing Windfalls: A Model for*

definition, stock dividends clearly would be included.[62]

This expanded definition of proceeds can have major significance for securitization. Increasingly, the financial assets used in securitization transactions represent rights to payment that arise in the future ("future assets"). If, however, the originator goes bankrupt after the securitization transaction is entered into, section 552(a) of the Federal Bankruptcy Code may cut off the SPV's interest in future assets.[63] While section 552(b)(1) generally would preserve the SPV's interest in future assets, that interest is only preserved to the extent that the future assets constitute "proceeds, product, offspring, or profit[]" of the SPV's prepetition assets.[64] In this connection, courts interpret the term "proceeds" by reference to the UCC definition.[65] Thus, Revised Article 9's expanded definition of proceeds will expand the universe of future assets that can be sold to SPVs without the fear of the SPVs' interest in those assets being cut off in the event of the originator's bankruptcy.[66]

IV. REVISED ARTICLE 9 PROMOTES ASSIGNABILITY NOTWITHSTANDING CONTRACTUAL RESTRICTION

Parties to contracts sometimes restrict the assignment of rights and obligations thereunder.[67] These restrictions are often referred to

Harmonizing State and Federal Laws on Floating Liens, 75 N.C. L. REV. 403, 441-45 (1997).

62. *See* R. § 9-102(a)(64) (defining proceeds to include not only "whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral," but also (among other things) "whatever is collected on, or distributed on account of, collateral," and "rights arising out of collateral"). My example of stock dividends is illustrative; the reader should be aware that Current section 9-306(1) was amended in 1994 specifically to provide that "[a]ny payments or distributions made with respect to investment property collateral are proceeds."

63. Section 552(a) provides that "[e]xcept as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the [bankruptcy] case [post-petition] is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case [prepetition]." 11 U.S.C. § 552(a) (1994). I have argued, however, that section 552 should not cut off a prepetition *sale* of the right to post-petition payments, such as a prepetition sale of future assets. *See* Schwarcz, *supra* note 61, at 456-58 (analyzing the tension between section 552 of the Federal Bankruptcy Code and UCC section 9-204 (permitting "floating liens")).

64. *See* 11 U.S.C. § 552(b)(1).

65. *See, e.g.*, Unsecured Creditors Comm. v. Marepcon Fin. Corp. (*In re* Bumper Sales, Inc.), 907 F.2d 1430, 1437 (4th Cir. 1990) (holding that "the UCC's definition and treatment of proceeds applies to Section 552 of the Bankruptcy Code").

66. The SPV's interest in those assets, in the event of the originator's bankruptcy, nonetheless might be subject to the automatic stay in bankruptcy. *See* Schwarcz, *supra* note 61, at 458. If the relevant transfer of future assets is not a true sale, the SPV's interest also may be subject to the equitable powers of a bankruptcy judge. *See id.* at 458-61 (discussing judicial interpretation of the equities exception in 11 U.S.C. § 552(b)(1)).

67. For example, franchise agreements commonly restrict the right of either party to assign the agreement or any right therein.

as "anti-assignment clauses." In a securitization transaction, the parties to that contract are the originator and a third party obligated on the financial asset. Because the focus is on the originator's transfer of its rights in the financial asset to an SPV, we need only examine the obligor's ability to restrict that transfer.

Current Article 9 nullifies anti-assignment clauses that prohibit "assignment of an account or ... creation of a security interest in a general intangible for money due or to become due."[68] The rationale given is that the nullification of anti-assignment clauses "is widely recognized in the cases and ... corresponds to current business practices."[69] An implicit rationale, however, might be that the obligor on the account or general intangible is not prejudiced by its assignment,[70] whereas enforcing the anti-assignment clause would impair the free alienability of property rights.[71]

Revised Article 9 clarifies the rule of Current Article 9. First, the revision eliminates any argument that a transfer of financial assets in violation of an invalidated anti-assignment clause nonetheless constitutes a breach as between the obligor and the originator.[72] Second, the revision treats anti-assignment clauses in payment intangibles and promissory notes differently depending on whether the transfer in question is a sale or merely a transfer for security. Anti-assignment clauses would be ineffective in both cases from preventing perfection of the transfer of the right to payment,[73] but they would be upheld to prevent an originator from selling its underlying business relationship.[74] Thus, if the originator is a bank which has made a loan to a borrower, the bank could sell a participation in that loan—a loan participation being a payment intangible[75]—to an SPV or other third party and could perfect that sale notwithstanding an anti-assignment clause in the underlying loan

68. U.C.C. § 9-318(4).

69. *Id.* § 9-318 cmt. 4. But note that non-UCC law sometimes upholds anti-assignment clauses. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 317(2)(c) (1981).

70. Current section 9-318 protects the obligor from being prejudiced by the assignment.

71. A financial asset represents the originator's right to payment, and property, after all, is merely a bundle of rights.

72. *See* R. §§ 9-406(d)(2), 9-408(a)(2) (providing that a transfer in violation of an anti-assignment clause does not constitute a default).

73. *See id.* §§ 9-406(d), 9-408(a)-(b).

74. Revised section 9-408(d) effectively provides that, in the case of sales of payment intangibles or promissory notes and in the case of any transfer of a health-care-insurance receivable, anti-assignment clauses are ineffective to thwart perfection of the sale or other transfer but may be effective for all other purposes.

75. *See supra* text accompanying note 17.

agreement; but the bank could not alter the underlying debtor-creditor relationship with its borrower. The buyer of the loan participation therefore would have no direct collection rights against the borrower.

V. REVISED ARTICLE 9 CLARIFIES THE EFFECT OF A NEGATIVE PLEDGE COVENANT

A negative pledge covenant is an agreement by a debtor in favor of a third party (typically, a creditor) in which the debtor agrees not to grant a security interest in or otherwise encumber its assets.[76] In a securitization context, originators often make negative pledge covenants in favor of SPVs regarding transferred and to-be-transferred financial assets. If, of course, those financial assets already have been sold to the SPV and the originator retains no interest therein, the originator would have no power to grant a security interest and a negative pledge covenant then would be superfluous. But it is sometimes unclear whether the financial assets have been sold; and originators often do retain interests, such as interests in financial assets not yet sold, or undivided interests in financial assets that have been sold, or rights to surplus collections. In those cases, negative pledge covenants may be important.

Current Article 9 is unclear as to the enforceability of a negative pledge covenant.[77] Revised Article 9 offers clarity by providing that while negative pledge covenants cannot restrict alienability, a transfer of financial assets in breach of a negative pledge covenant nonetheless constitutes a default by the originator.[78] That default could entitle the SPV to exercise remedies against the originator and

76. Sometimes, the debtor agrees not to grant a security interest in its assets without equally and ratably securing the creditor, in which case the negative pledge covenant is commonly referred to as an "equal and ratable clause."

77. Current section 9-311 provides that "[t]he debtor's rights in collateral may be voluntarily or involuntarily transferred ... notwithstanding a provision in the security agreement prohibiting any transfer or making the transfer constitute a default." It is uncertain whether this means that negative pledge covenants are unenforceable or merely that negative pledge covenants cannot restrict the transfer but the transfer nonetheless constitutes a breach of the covenant.

78. Revised section 9-401(b) provides that "[a]n agreement between the debtor and secured party which prohibits a transfer of the debtor's rights in collateral or makes the transfer a default does not prevent the transfer from taking effect." Comment 5 explains that if, in violation of a negative pledge covenant, the debtor "purports to grant a security interest in the same collateral to another secured party[,] [s]ubsection (b) validates [the] creation of the subsequent (prohibited) security interest.... However, ... subsection (b) does not provide that the [negative pledge covenant] itself is 'ineffective.' Consequently, the debtor's breach may create a default."

might also allow the SPV to sue the transferee, if it knew or should have known of the breached covenant, for tortious interference with contract.

CONCLUSION

The revision of Article 9 does much to bring the commercial law setting for securitization into the twenty-first century by embracing a broader range of financial assets, setting clear and pragmatic rules for perfection and priority of their transfer, clarifying inadvertent legal ambiguities, and reducing unnecessary transaction costs.