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REVISED ARTICLE 9: WHAT BANKS NEED TO KNOW

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In this article, the authors suggest a practical approach for secured lenders and other parties involved with secured transactions to prepare themselves for the new regime contained in Revised Article 9 of the Uniform Commercial Code.

As no doubt many are aware, in 1998 the American Law Institute and the National Conference of Commissioners on Uniform State Laws approved a fairly comprehensive set of revisions to Article 9 of the Uniform Commercial Code (Secured Transactions), which was produced by the Article 9 Drafting Committee appointed and sponsored by such organizations. For purposes hereof, the uniform version of the Article 9 (1972 text, as amended) that is currently in force in most states shall be referred to as "Current Art. 9," Current Art. 9, together with any applicable statutes (other than Current Art. 9) and case law governing secured transactions excluded from Current Art. 9, shall be referred to as "Present Law," and Article 9 as revised by the Article 9 Drafting Committee shall be referred to as "Revised Art. 9." References to statutory sections are to the sections of Revised Art. 9, unless otherwise specified.

The changes brought about by Revised Art. 9 are, among other things, intended to accommodate new forms of business, transactions and technology (including electronically-based documentation) that have developed over the years since the last set of comprehensive revisions which led to the promulgation of Current Art. 9, and streamline the financing statement filing process. It is fair to say, however, that Revised Art. 9 represents more of an evolution of Current Art. 9, rather than a revolution. Many, though certainly not all, of the Current Art. 9 concepts, terminology and general framework survive in Revised Art. 9. Revised Art. 9 contains numerous technical changes that are designed to clarify perceived ambiguities in Present Law or, in certain cases, reverse specific jurisprudence under Present Law. Conforming and clarifying amendments will likewise be made to other Articles of the Uniform Commercial Code as part of the process of enacting Revised Art. 9.

New categories of assets and types of transactions have been brought within the scope of Revised Art. 9 that are excluded from Current Art. 9, and in connection therewith certain defined terms have been added and certain others, such as "accounts" and "chattel paper," have been revised and expanded. Rules governing perfection and priority have been revised to accommodate such new or modified asset categories and transaction types. Part of the motivation for Revised Art. 9's expanded coverage is to apply statutory rules to secured transactions that otherwise might be governed by common law principles, a situation that can lead to ambiguity as to the validity and priority of the secured party's interest in the collateral and thereby diminish its value in the secured lending market. For example, that has been the case with respect to deposit accounts, long excluded from Article 9 but now included in Revised

Art. 9. In New York, the courts developed the concept of “dominion and control” as a method of perfecting a common law pledge of such accounts, but not all market participants consider that the applicable criteria articulated by the courts afford sufficient legal certainty.

As of January 1, 2001, Revised Art. 9 had been adopted in twenty-eight states[1] and the District of Columbia, and there was legislation pending to adopt Revised Art. 9 in at least twelve more.[2] Regardless of when adopted by each state, Revised Art. 9 is intended to have a uniform effective date of July 1, 2001 (the “Effective Date”), as further discussed below.

It should be noted that in certain cases rules different from those described herein may be applicable when the secured transaction involves consumers and consumer goods. Such transactions, as well as transactions involving agricultural liens and consignments, are beyond the scope of this article.

The purpose of this article is to suggest a practical approach for secured lenders and other parties involved with secured transactions to prepare themselves for the new regime contained in Revised Art. 9. To facilitate discussion, it is helpful to think of two “transitions” to be made. The first such transition concerns any necessary or desirable adaptations and modifications to be made to transactions that will have been entered into prior to the Effective Date to ensure that security interests (or other arrangements of similar effect, regardless of their formal title) created under Present Law remain valid, perfected and eligible for the priority intended by the parties following the Effective Date, after giving effect to any “grandfather” rights such transactions may enjoy. These issues are primarily dealt with in the transition provisions contained in Part 7 of Revised Art. 9. The second “transition” concerns any necessary or desirable adaptations and modifications to be made to current security documentation forms and perfection and due diligence procedures to ensure that they remain suitable for secured transactions entered into after the Effective Date.

Actions To Be Taken With Respect To Loan And Security Documentation (Other Than Financing Statements)

With the Effective Date looming, the prudent creditor would be well advised, if it has not done so already, to conduct a review of the potential effects of Revised Art. 9 on its portfolio of secured transactions. Such review should, at a minimum, be thorough enough to enable the creditor to determine whether any changes should be made to its security documentation, methods of perfection, filing program, and due diligence procedures (for determining the existence of prior encumbrances on property it is considering taking as collateral), both with respect to pre-Effective Date and post-Effective Date secured transactions.

To assist the creditor in conducting its review, this section provides an overview of certain issues to be considered in deciding whether a secured party’s security documentation and perfection methods (other than those related to financing statements) should be changed in response to Revised Art. 9. It is not intended to be comprehensive, but rather to highlight changes likely to be of importance to typical financing arrangements, and secured parties would be well advised to consult counsel to ensure that they are adequately prepared for Revised Art. 9 in light of their particular circumstances. Certain aspects regarding the filing of financing statements and due diligence procedures to be undertaken when evaluating encumbrances on collateral are discussed below.

The discussion in this section is divided between the effects of Revised Art. 9 on transactions that have already closed or that will in fact close prior to the Effective Date ("Pre-Effective Date Transactions"), and transactions closing on or after the Effective Date ("Post-Effective Date Transactions"). In terms of presentation, Post-Effective Date transactions are discussed first, so as to lay the groundwork for understanding the changes brought about by Revised Article 9 and their effects on transaction documentation and perfection methods prior to integration with the transition rules applicable to Pre-Effective Date Transactions. Once secured creditors and their counsel have assimilated the Revised Art. 9 changes themselves, they can then better assess what may need to be done with respect to Pre-Effective Date Transactions, the analysis of which is more complicated due to the overlay of the Revised Art. 9 transition regime.

Post-Effective Date Transactions

In order to create a valid lien in collateral that is enforceable against the debtor and third parties (subject to the rules governing priority), Post-Effective Date Transactions must satisfy the minimum requirements for attachment and perfection set forth in Revised Art. 9 applicable to the particular type of collateral and transaction involved.

Certain Issues Relating to the Creation and Attachment of the Security Interest

Under Revised Art. 9, there are three basic requisites for attachment: (i) that the secured party shall have given "value," (ii) that the debtor shall have rights in the collateral or at least the power to transfer such rights to a secured party and (iii) that the debtor shall have agreed to create the security interest in favor of the secured party.[3] Requirement (i) above repeats verbatim the language of Current Art. 9. Requirement (ii) is broader under Revised Art. 9, in that it no longer requires that the debtor have rights in the collateral so long as it has the power to transfer rights to a secured party. This would occur, for example, in a sale of accounts or chattel paper, should the debtor (wrongfully) create a security interest in the same accounts or chattel paper in favor of a third party creditor subsequent to the sale but before the buyer thereof has perfected its "security interest" arising from such sale.[4] As is the case under Current Art. 9, requirement (iii) may be satisfied under Revised Art. 9 by the execution of a "security agreement"[5] which contains an adequate description of the collateral. However, if the collateral is of a type for which perfection may be achieved by possession or control, the requirement for a security agreement may be satisfied by the secured party taking possession or control thereof with the consent of the debtor. As explained in greater detail below, new types of collateral for which control is an effective method of perfection have been added by Revised Art. 9, with the result that the universe of transactions for which a formal security agreement is not strictly necessary has expanded.

Developments Regarding Security Agreements

Revised Art. 9 makes a number of changes regarding security agreements.

"Electronic" security agreements

In a nod to the electronic age, security agreements will no longer have to be "signed" (implying they must be in tangible written form) by the debtor, but rather the debtor's assent may be evidenced by an "authenticated record" which is, simply put, either a signed written agreement or an agreement stored in electronic or other medium which is retrievable in perceivable form and which has been the subject of some act by the debtor which indicates adoption or acceptance of the record by the debtor (e.g. through encryption or other process).[6]

No supergeneric or "all assets" description of collateral

Revised Art. 9 now expressly prohibits describing the collateral in a security agreement as all of the debtor's "assets" or "personal property" or similar generic expressions.[7] At a minimum, the description must identify or provide a means to identify a particular asset or class or type of asset, and for these purposes reference to Revised Art. 9 collateral types will suffice, except with respect to commercial tort claims, which must be specifically identified (with the effect that the particular events giving rise to the claim must have already occurred). Most institutional secured lenders already follow this approach.

Collateral descriptions must be carefully drafted, taking into account new or modified definitions contained in Revised Art. 9

As has already been mentioned, certain terms used in Current Art. 9 have different meanings in Revised Art. 9, such as "accounts," "chattel paper" and "general intangibles" and certain new defined terms reflect subsets of terms already existing (e.g. "payment intangibles," which is a subset of "general intangibles"). Therefore, persons drafting collateral descriptions in security agreements and other relevant security documentation for Post-Effective Date Transactions must exercise particular caution to ensure that defined terms reflect the meaning of such terms in Revised Art. 9, and not as defined in Current Art. 9. Some of the new and revised asset categories are described in more detail below.

When a formal security agreement is not required

Under Revised Art. 9 an authenticated security agreement is not strictly necessary for certain kinds of collateral, namely collateral for which perfection will be achieved through possession or control by or, in the case of a registered and certificated security, delivery[8] to the secured party, although the debtor must nevertheless consent to such possession, control or delivery.[9] While this concept also exists under Current Art. 9, Revised Art. 9 provides for an expanded class of collateral for which an authenticated security agreement is not necessary, mainly reflecting the addition of new collateral types (e.g. deposit accounts, letter of credit rights). Still, it is, and is likely to remain, common practice to document the secured transaction in a written security agreement, both as a means of tailoring the secured transaction to the specific needs of the parties beyond the Article 9 "default" rules, and as a means of assuring that, by being supported by express and unambiguous documentation, the security interest has a better chance of withstanding the scrutiny and attack to which it would likely be subject should the debtor become financially distressed.

Expanded Scope Of Revised Art. 9

As is mentioned above, one of the most important areas of change ushered in by Revised Art. 9 is the inclusion of several new types of collateral, security interests and transactions excluded from Current Art. 9, which are briefly described in the following paragraphs. To the extent that a secured party anticipates involvement with such collateral, security interests or transactions, it will need to conduct a review of its current form of security documentation and perfection procedures to ensure they are adequate to protect the secured party's interests.

There are two categories to be examined here: (i) new types of assets and security interests subject to Revised Art. 9 that are excluded from Current Art. 9 (except to the extent they may be covered as proceeds of other collateral types), regardless of the form of transaction, and (ii) new categories of transactions constituting outright sales of asset (as distinguished from transactions involving the creation of a security interest in such assets) that will become subject to Revised Art. 9.

New Types of Assets and Security Interests That May Constitute Original Collateral under Revised Art. 9

The following types of assets and security interests, which are excluded from the uniform version of Current Art. 9, will be governed by Revised Art. 9:

- deposit accounts;
- certain letter of credit rights;
- security interests granted by governments and governmental units (to the extent not expressly governed by another statute);
- commercial tort claims; and
- health care insurance receivables.

The description and perfection method of each is discussed below.

Deposit accounts

Deposit accounts are bank accounts in the nature of demand, time, savings, passbook or similar accounts, excluding investment property and instruments.[10] Except when they represent proceeds of other collateral, security interests in deposit accounts may only be perfected by "control" and a filing is ineffective for such purposes.[11] Control is achieved if the bank itself is the secured party, the secured party becomes the record owner of the deposit account (that is, it becomes the bank's customer), or the bank, the debtor and the secured party execute a "control agreement" in which the bank agrees to comply with funds disposition instructions from the secured party without further consent from the debtor.

A word of caution is in order for all creditors, not just those taking deposit accounts as original collateral. Cash proceeds of other kinds of collateral can take the form of deposit accounts. Should such an account also be subject to a security interest in favor of another creditor who has managed to obtain control, the holder of the security interest in proceeds would be subordinate to the control creditor's security interest.[12] To help mitigate this risk, the proceeds creditor could incorporate safeguards into its security documentation by placing a duty on the debtor to deposit any proceeds of collateral only in accounts controlled by the creditor that are maintained at banks that have no claims against the debtor or that have agreed to subordinate any such claims, and to obtain undertakings from relevant third parties to make payments to the debtor only to such accounts.

Letter of credit rights

Current Art. 9 excludes from its scope transfers of interests in letters of credit, except for the assignment of proceeds of a *written* letter of credit. Revised Art. 9 will apply to "letter of credit rights," a new defined term introduced by Revised Art. 9. Letter of credit rights is a somewhat broader concept than what is covered by Current Art. 9, in that it extends to electronic and other "non-written" letters of credit, and encompasses any right to *performance* (as well as payment) under a letter of credit. Like Current Art. 9, however, it does not include the right to demand payment or performance under the letter of credit (which right is reserved for the beneficiary and any transferee beneficiary of the letter of credit). The definition of letter of credit rights clarifies for Article 9 purposes what can be gleaned from Article 5 of the Uniform Commercial Code, i.e., that a present security interest (by way of an "assignment") can be granted in such rights whether or not there is a present right to draw under the letter of credit.

Perfection of a security interest in letter of credit rights is discussed below.

Security interests granted by governments and governmental units

All security interests granted by governments and governmental units are excluded from the scope of Current Art. 9, regardless of whether any other specific legislation or enabling statute governs such security interests. New York, however, adopted a non-uniform version of Current Art. 9 with respect to these security interests, and excludes them only to the extent they are expressly governed by other New York state legislation. Revised Art. 9 adopts a variant of the New York approach, in that it excludes security interests created by governments and governmental units only if other specific legislation governs them, but for such purposes any legislation of the relevant state or foreign jurisdiction, as well as that of the local jurisdiction, will be taken into account.[13]

Prudent creditors dealing with debtors who are governments or governmental units will want to obtain adequate assurances that Revised Art. 9 is applicable because there is no other relevant legislation which would govern the security interest, or that Revised Art. 9 is not applicable due to other relevant legislation, as the case may be. Such assurances could take the form of representations from the debtor (in the security documentation), officer's certificates and legal opinions.

Commercial tort claims

Whereas Current Art. 9 excludes from its scope all assignments of tort claims, Revised Art. 9 will apply to *commercial* tort claims, which will be classified as general intangibles, with perfection being achieved through the filing of a financing statement. A commercial tort claim is a claim arising in tort in favor of an organization, or in favor of an individual if arising in the course the individual's business or profession; it does not include personal injury or death claims.

Security interests in commercial tort claims cannot be created in advance, and thus are not covered by after-acquired property clauses.[14] If commercial tort claims are to constitute collateral, the security agreement (and any related financing statement) will have to be amended or supplemented to include specific reference to a claim once the facts giving rise thereto have occurred. One approach would be to impose a covenant on the debtor to notify the secured party of the claim and execute such amendment or supplement.

It is conceivable that a commercial tort claim could also constitute proceeds of other collateral, since the Revised Art. 9 definition of "proceeds" includes claims arising out of the loss, damage, impairment or interference with the use of collateral.[15] In such case, it would seem evident that the secured party should be entitled to enforce its security interest in the commercial tort claim *as proceeds*, even if the security documentation has not been amended or supplemented such that a security interest attaches in the commercial tort claim *as original collateral*. Any security interest in such proceeds would be limited, however, to the value of the original collateral.[16]

Once a commercial tort claim has been settled and converted to a contractual obligation to pay money, it will no longer be governed by the special rules applicable to commercial tort claims and will instead be treated as a generic payment intangible.[17] If, on the other hand, the claim is reduced to judgment rather than settled, it is at best unclear how the claim would be characterized. In principle, the claim becomes a "right represented by a judgment," the assignment of which is excluded from both Current Art. 9 and Revised Art. 9.[18] While it would be difficult to imagine that the drafters of Revised Art. 9 intended for a security interest in a commercial tort claim duly created prior to judgment to cease to be governed by Revised Art. 9 merely because judgment is subsequently rendered, Revised Art. 9 may in fact not be applicable if the purported security interest is created *after* judgment is rendered.

Health-care insurance receivables

Current Art. 9 excludes all claims under and rights in insurance policies. However, Revised Art. 9 now includes assignments of health-care insurance receivables (that is, an interest or claim under an insurance policy which is a right to payment for medical goods and services provided) by or to health-care providers, and any subsequent assignment of the right to payment (e.g. from the health-care provider to a lender).[19] Such receivables will be classified as "accounts." Assignments of health-care insurance receivables will be perfected by filing, except in cases in which an assignment is automatically perfected (namely, in the case of the original assignment from the patient to the provider of the healthcare goods or services).[20]

New Categories of Transactions Involving Outright Sales of Assets that Will Be Covered by Revised Art. 9

Revised Art. 9 will apply to an expanded range of asset sale transactions. Outright sales, a technique commonly used in securitization transactions, contemplate that there will be an indefeasible transfer of the asset from the seller to the buyer, in return for the payment of the "sale price" by the buyer. Unlike an ordinary security interest, the seller owes no "repayment" obligations to the buyer and the asset is not expected to be returned to the seller.[21] Current Art. 9 already applies to outright sales of accounts and chattel paper (in addition to conventional security interests created in such assets). Revised Art. 9's reach will be increased by expanding the scope of the defined terms “accounts” and “chattel paper” and by including two new categories of sales transactions: sales of “payment intangibles” and sales of promissory notes. In each case, the seller is analogous to the “debtor” and the buyer is analogous to the “secured party.”

Accounts

The Current Art. 9 definition of “accounts,” which includes rights to payment arising from the sale or lease of goods or services provided, has been revised to include rights to payment for (i) property licensed, assigned or otherwise disposed of, (ii) issuance of insurance policies (e.g. policy premiums), (iii) energy provided, (iv) credit card receivables, (v) health-care insurance receivables and (vi) lottery winnings.

Chattel paper

The Current Art. 9 definition of “chattel paper” is amplified by Revised Art. 9 to include chattel paper in electronic form (“electronic chattel paper”) and licenses and other rights granted in software used in specific goods. Chattel paper in tangible (as opposed to electronic) form is referred to as “tangible chattel paper”.

Payment intangibles

Payment intangibles, a subset of general intangibles (and therefore not accounts), are intangibles under which the account debtor’s principal obligation is monetary.

Promissory notes

Promissory notes are a subset of “instruments.” Just as is the case with any secured party holding a conventional security interest, a buyers’ interests in accounts, chattel paper, payment intangibles and promissory notes must be “perfected” in order to be protected against third parties. Buyers of accounts and chattel paper must file financing statements, take actual or constructive possession thereof (in the case of tangible chattel paper), or obtain control (in the case of electronic chattel paper). Buyers of payment intangibles and promissory notes, however, are “automatically” perfected without any further action, though the interests of buyers of promissory notes may become subordinate to the rights of third parties who obtain possession of or become holders in due course of the physical notes.

As between the buyer and seller, and in contrast with conventional security interests, the seller of accounts, chattel paper, payment intangibles or promissory notes maintains no property interest in the asset sold (the “collateral”) following the sale, and the buyer will not be subject to those provisions of Revised Art. 9 that impose certain duties on secured parties to preserve and protect the collateral and act in a commercially reasonable manner, namely those set forth in Sections 9-207 through 9-210 (general duties of secured parties) and Sections 9-601 through 9-628 (rights and duties of secured parties in connection with default and enforcement of security interests) of Revised Art. 9, except to a limited extent where the buyer has full or limited recourse against the seller.

Certain Issues Relevant To Collateral Perfected By “Control”

Several additional issues raised by Revised Art. 9 with respect to collateral for which perfection can be achieved by control are discussed below.

Involvement of Third Parties in the Perfection of Security Interests Expands under Revised Art. 9

Perfection by control has taken on much greater importance under Revised Art. 9, since it is the perfection method applicable to many of the new types of collateral added by Revised Art. 9, and since secured parties obtaining control take priority over secured parties who have perfected by any other applicable means. In most instances, obtaining control requires that affirmative steps be taken by disinterested third parties, such as banks, brokers and other financial institutions, who may have no particular incentive to cooperate with the secured party's efforts to perfect its security interest. Therefore, it is important that the security documentation impose affirmative duties on the debtor to cause these third parties to take the necessary steps to achieve control in favor of the secured party, and allocate the related costs and expenses (both initial and ongoing) to the debtor.

It is important from the secured party's perspective that these third parties not only take the necessary action to give the secured party control, but also that they represent that they have not previously done so for any other creditor (if they have, such creditors would rank ahead of the secured party seeking to obtain control). Revised Art. 9 does not impose any duty on these third parties to recognize control in favor of a secured party or acknowledge or deny the existence of control in favor of any other secured party; it is strictly voluntary. Therefore, they are unlikely to take any action without the debtor's instructions and, in many instances, the debtor's agreement to indemnify the third party for losses suffered in connection with the control arrangement.

Creditors with Control Rank According to Time of Obtaining Control, Not Pro Rata

Under Current Art. 9 (with reference to Article 8), control as a method of perfection exists only with respect to investment property. Secured parties who have obtained control in the same investment property will rank equally and share pro rata in the value thereof. However, Revised Art. 9 provides, with respect to deposit accounts and letter of credit rights, as well as investment property, that secured parties with control will rank in accordance with the time of obtaining control. In cases where the value of the collateral is not sufficient to satisfy all secured claims, this places a premium on ensuring that a secured party is either first in time to obtain control (which would need to be supported by a representation from the bank, broker or financial institution that in fact no other secured party has previously been granted control in the collateral), or obtains an effective subordination agreement from any pre-existing secured parties with control.

Creditors with Control Must Apply Proceeds Constituting Money or Funds to Reduce the Debt or Remit Such Proceeds to the Debtor

Revised Art. 9 imposes additional affirmative duties, as well as limitations, on secured parties during the term of the secured transaction, even prior to default. One such duty and limitation placed upon secured parties who have control (or possession, for that matter) of collateral is to apply proceeds of collateral constituting money or funds to reduce the secured obligation, or to remit such money or funds to the debtor (under Current Art. 9, the limitation only applies to money).[22] The secured party may not hold such proceeds as additional security.

Such a duty and limitation runs counter to the intent of the parties in a number of secured transactions involving investment property, where it is customary to allow the secured party to hold funds received on account of the collateral (e.g. interest, dividends and proceeds of the liquidation of the securities or security entitlements) as additional collateral until the termination of the security arrangement, especially since investment property positions are frequently liquidated and proceeds thereof used to acquire other investment property. In fact, it is not uncommon that the increase in value of the investment property position over time (through income and reinvestment of proceeds) will be scheduled to correspond to the increase in the value of the secured obligation. If such is the intent of the parties, the debtor will need to agree in the security documentation that this duty and limitation will not apply.

Repledge of Investment Property Without Losing Control

Repledges of investment property will be facilitated under Revised Art. 9, because it clarifies an area of ambiguity by expressly stating that secured parties will maintain perfection by control in investment property collateral they have transferred to a third party (e.g. pursuant to a repledge), so long as the investment property is not effectively returned to the debtor.[23]

A secured party who anticipates significant repledging operations may wish to consider placing a covenant in the relevant repledging documentation that the repledgee will not return the property to the original debtor, and that it will obtain a similar undertaking from subsequent repledgees.

Other Collateral For Which The Acknowledgment Or Consent Of Third Parties Is Required To Achieve Perfection

In one of the few instances in which Revised Art. 9 actually imposes a more burdensome requirement than Current Art. 9, acknowledgment from, rather than mere notice to, a third party[24] will now be required to perfect a possessory security interest in tangible collateral other than certificated securities and goods covered by a document issued by a bailee, where possession of the collateral is or will be maintained by such third party for the benefit of the secured party.[25] Such acknowledgment must take the form of an authenticated record. As in the case of obtaining perfection by control, and depending on the circumstances, the secured party may wish to require the third party to represent that it has not previously acknowledged possession of the collateral for the benefit of any other secured parties.

Another instance where Revised Art. 9 imposes a more burdensome requirement to achieve perfection is the case of security interests in letter of credit rights. Whereas under Current Art. 9 the security interest is perfected by possession of the written letter of credit by the secured party[26], under Revised Art. 9 a security interest in letter of credit rights *as original collateral* may only be perfected by control and not by possession or filing (except where the letter of credit constitutes proceeds of other collateral or is a "supporting obligation" for collateral perfected by some other method[27]). Control is achieved with respect to the issuer and any "nominated person" when each has consented to the assignment of proceeds of the letter of credit pursuant to Section 5-114(c) of the Uniform Commercial Code or other applicable law or practice.[28] Although possession of the letter of credit does not give the secured party control, the fact of the secured party's possession does place a duty on the issuer and any nominated person to not unreasonably withhold their consent to the assignment of the proceeds of the letter of credit, provided certain other requirements are met.[29]

Pre-Effective Date Transactions

The considerations described above for Post-Effective Date Transactions are equally applicable to Pre-Effective Date Transactions. However, since in certain cases this could involve amending or otherwise taking actions with respect to deals already closed, secured parties and their counsel should carefully study the transition rules described below to ensure that action is in fact required.

Action would be required, for example, to the extent Revised Art. 9 includes within its scope previously excluded collateral or transactions that the parties wish to be included upon the Effective Date. Also, action will eventually be required to the extent any changes to the rules of attachment or perfection will cause the security interest to be impaired, and it is anticipated that the secured transaction will extend in time past the transition dates set forth in the transition rules. One suggestion for getting started with the review of Pre-Effective Date Transactions is for the secured party to prepare a checklist of items which may require action as a result of Revised Art. 9. Such a checklist could include the following:

1. Re-perfection under the rules of Revised Art. 9, to the extent the current method of perfection is inadequate, such as:

(a) collateral in possession of a third party (which, as is explained above, will require acknowledgment by the third party);

(b) security interests in collateral now included in Revised Art. 9, that were perfected under common law methods while such collateral was excluded from Current Art. 9;

(c) security interests in accounts and general intangibles for the payment of money granted by foreign debtors that are perfected under Current Art. 9 by means of a notice to the account debtor (under Revised Art. 9, such security interests will be perfected under the law of the foreign debtor's jurisdiction, or, under the circumstances described below, by filing a financing statement in the District of Columbia);

(d) security interests created by governments and governmental units, to the extent now governed by Revised Art. 9;

(e) with respect to electronic chattel paper, to the extent the secured party wishes to obtain control over the collateral, adequate procedures meeting the requirements of Section 9-105 will have to be arranged with the debtor; and

(f) outright sales of assets not covered by Current Art. 9, which assets will be considered accounts or chattel paper under the revised definitions of Revised Art. 9.

2. Any additional protections the secured party may require as a result of Revised Art. 9, such as:

(a) obtaining a bring-down opinion from the debtor's counsel as to any actions needed to be taken to maintain the validity and enforceability of the security interest, or that no action is required (collateral agents and agent banks will probably insist on such opinions prior to taking any action with respect to collateral);

(b) obtaining representations, certificates and opinions from debtors which are governments or governmental units as to whether or not Revised Art. 9 will apply to security interests created by them;

(c) obtaining control over any deposit accounts to which proceeds of other collateral may be transferred, and other appropriate protections; and

(d) inserting a transition clause in the security documentation to deal with any changes in defined terms under Revised Art. 9, to the extent such changes would be given effect in the interpretation and enforcement of the security documentation and would contradict the intent of the parties (e.g. the security documentation states that the relevant defined terms "shall have the meaning given thereto in the Uniform Commercial Code as in effect in the state of ____________ *from time to time*", but the collateral is limited to "accounts" based on the narrower Current Art. 9 definition).

Pre-Effective Date Transactions that have not yet closed can anticipate the effects of Revised Art. 9, and incorporate any necessary changes into the security documentation. Of course, they will need to comply with the Current Art. 9 requirements for the period of time prior to the Effective Date.

Revised Art. 9 Transition Regime

To be in a position to analyze what actions may be required with respect to Pre-Effective Date Transactions as a result of Revised Art. 9, it is important to have a basic understanding of the Revised Art. 9 transition regime, which is found at Sections 9-701 through 9-708. To facilitate such understanding, the transition regime may be summarized by the following rules:

Uniform Effective Date of July 1, 2001

The basic transition rule is that Revised Art. 9 is to have a uniform effective date of July 1, 2001, regardless of the date of enactment by the relevant state legislature.[30] The primary reason for a uniform effective date is to avoid the potentially adverse consequences and confusion which could surround a staggered adoption, which would most likely occur if it were left open for the individual states to determine the effective date. It is not difficult to imagine the myriad problems that could arise if Revised Art. 9 were in force in some but not all states at a given time. Collateral descriptions, types of collateral and methods of perfection (including place of filing) could all be governed by conflicting rules that would not be susceptible to easy resolution.

While uniform effectiveness is certainly a sensible goal, events over the next six months will determine whether it will in fact be achieved. As of late January 2001, some twenty-two states had yet to adopt Revised Art. 9, and in fact in as many as ten states there was not even a bill pending before the legislature to consider enacting Revised Art. 9. Individual state enactments subsequent to July 1, 2001, if any, will have to be examined very carefully, especially regarding transition rules. Perhaps those states adopting Revised Art. 9 prior to the Effective Date will consider adding special conflicts rules to deal with transactions which also have a relation with any state which has not enacted Revised Art. 9 as of the Effective Date.

Revised Art. 9 Applies to All Secured Transactions Within Its Scope, Regardless of when Entered Into, with Certain Exceptions

The second important general transition rule is that, from the Effective Date, Revised Art. 9 will govern all secured transactions within its scope, even secured transactions consummated prior to such date, with two exceptions: (i) secured transactions that are not governed by Current Art. 9 (meaning that they are governed by common law or other statute), and (ii) legal proceedings which are initiated prior to the Effective Date.[31] The precise meaning of this rule is not clear. Presumably terms in security documentation which referred to statutory definitions will be interpreted in light of their Current Art. 9 meaning, as that would best reflect the intent of the parties. With respect to amendments to secured transactions after the Effective Date, as well as requirements for attachment and perfection, presumably Revised Art. 9 will apply (including its transition rules).

Section 9-702(b) provides that secured transactions that are not subject to Current Art. 9, such as security interests in deposit accounts, commercial tort claims and letter of credit rights, and security interests granted by governmental entities may, following the Effective Date, be "terminated, completed, consummated, and enforced" either in accordance with Present Law or Revised Art. 9. It is not clear which of the parties, the secured party or the debtor, or both, can determine which law shall apply. Furthermore, it is not entirely clear what role Present Law will have with regard to such transactions, assuming the parties opt to have them continue to be governed by it after the Effective Date. For instance, this exception does not appear to supplant the more specific transition rules regarding attachment, perfection and priority described below. If not, then this exception has little practical relevance.

"Do Nothing Rule"

If, immediately before the Effective Date, the requirements for both enforceability (attachment) and perfection were satisfied under Present Law as well as Revised Art. 9, no further action is required under Revised Art. 9 (the "Do Nothing Rule").

Under the Do Nothing Rule[32], no further action is required to maintain a valid and perfected security interest in the relevant collateral if the requirements for attachment and perfection are satisfied at all relevant times both before and after the Effective Date. Notice, however, that this does not assure the secured party that it will maintain the same level of priority, even if perfected. That is because it is possible that another perfection method is available under Revised Art. 9 for that type of collateral which would afford priority over the current perfection method. If so, the secured party would want to perfect under such other method to ensure that it will enjoy the highest level of priority under Revised Art. 9.

"One Year Rule"

Security interests that (immediately before Effective Date) have attached and/or been perfected (whether or not attached) other than by filing, remain unaffected by Revised Art. 9 for up to one year following the Effective Date (the "One Year Rule").

The One Year Rule is a rather important transition rule, because it imposes the first fixed deadline for bringing certain Pre-Effective Date secured transactions into compliance with Revised Art. 9, and because it applies to virtually all aspects of the validity and perfection of a pre-Effective Date security interest other than perfection by filing (which is governed by the Five Year Rule discussed below).

The operation of the One Year Rule is apparently simple. If prior to the Effective Date a security interest has attached, but is not perfected, then the security interest remains attached, even if the requirements for attachment under Revised Art. 9 have not been satisfied, until June 30, 2002. After that, the security interest must attach in accordance with Revised Art. 9 or be rendered unenforceable. In a similar fashion, under the One Year Rule a pre-Effective Date security interest that has validly attached and is perfected under Present Law will continue to be a perfected security interest for up to one year following the Effective Date, even if the requirements for attachment or perfection, or both, are not satisfied under Revised Art. 9.

The application of the One Year Rule is a little trickier when it comes to security interests with respect to which the act of perfection has taken place prior to the Effective Date, but which have not attached as of such date (e.g. security interests in after-acquired property). In such case, the method of perfection will continue to be effective for up to one year following the Effective Date for collateral in which the security interest attaches during that period, even if the requirements for perfection under Revised Art. 9 have not been satisfied. However, when the security interest in the collateral attached, it must attach in accordance with Revised Art. 9 even if this occurs during the first year following the Effective Date.

"Five Year Rule"

Financing statements (including applicable continuation statements) that do not otherwise satisfy all Revised Art. 9 criteria for effectiveness, but which are effective under Current Art. 9, remain effective until the earlier of (a) the date on which they would lapse in accordance with Current Art. 9 (usually 5 years after filing) and (b) June 30, 2006 (the "Five Year Rule").

The Five Year Rule is sensible, in that it allows secured parties to transition to the Revised Art. 9 filing scheme in an orderly fashion, and in accordance with the schedule for taking action pursuant to the filing tickler systems maintained by most institutional lenders. Secured parties should understand, however, that the Five Year Rule provides a maximum five year grace period for complying with Revised Art. 9, but not a minimum grace period. Once the financing statement lapses by its terms it becomes ineffective immediately (which, depending on the circumstances, could be as soon as the Effective Date) unless action is taken prior thereto in accordance with Revised Art. 9.

The One Year Rule and the Five Year Rule operate to preserve the status quo for the secured party as it existed immediately prior to the Effective Date, at least for a limited period of time following the Effective Date. However, if an aspect of attachment or perfection was not satisfied under Present Law immediately prior to the Effective Date, then in order to achieve attachment or perfection after the Effective Date, the requirements under Revised Art. 9 must be satisfied in all relevant respects.

Transition Rule for Priority

Revised Art. 9 does not per se alter priorities between competing claims to collateral established under Present Law, but such priorities can be altered by actions taken on or after the Effective Date. The implications of this rule, found at Section 9-708, should be studied carefully be secured parties and their counsel. It purports to say that if nothing further is done by any party on or after the Effective Date with respect to a Pre-Effective Date Transaction, priority between conflicting security interests will be determined in accordance with Current Art. 9's priority rules. However, if any party takes action on or after the Effective Date which would alter the status quo (e.g. perfects a security interest that was previously unperfected, or perfects under a different method entitled to priority over other available methods), then Revised Art. 9's priority rules will govern.

Actions Required With Respect To Filing Program

Shortcomings of Filing System under Current Art. 9

One of the most welcome changes brought about by Revised Art. 9 is the simplification of the system for filing financing statements as a means of perfection of a security interest. This will bring benefits to a wide range of secured transactions for which financing statements are either the only method of perfection or the preferred method of perfection.

The filing system under Current Art. 9 could best be described as complicated, and often leads to filings being made in multiple jurisdictions in respect of a single secured transaction and debtor, a phenomenon which is duplicative and inefficient. Current Art. 9 provides two basic rules for determining where to file a financing statement: (i) where the collateral is located (if the collateral is tangible and its location is not expected to change with great frequency) or (ii) where the debtor is located (in respect of intangible collateral, which has no meaningful physical location, and tangible collateral which is by its nature mobile and thus its location can be expected to change frequently, such as cars and trains). The practical application of these two apparently simple rules often leads to either ambiguous or burdensome results. For example, it is not always easy to determine a debtor's "location". For corporate debtors, location is the chief executive office. In practice, however, it can be difficult, especially in times of significant merger activity or in the case of a holding company with multiple subsidiaries, to determine which office is the "chief executive office." Also, if the debtor possesses goods (other than mobile goods) in more than one state, a financing statement must be filed in each state where the goods are located (e.g. in 48 states, for a debtor operating equipment in the entire continental

United States). Finally, the determination of the location of collateral for filing purposes requires application of the so-called “last event” test, which requires close monitoring in practice of where the collateral is located when the steps for attachment and perfection are satisfied.

Filing Scheme Under Revised Art. 9

Single rule: file in place where debtor located

Revised Art. 9 purports to eliminate much of the burden and uncertainty associated with Current Art. 9’s filing system. Under Revised Art. 9, and with only certain narrow exceptions (e.g. fixture filings), financing statements shall be filed only in the jurisdiction *where the debtor is located*, regardless of type of collateral. It should be noted that location of the collateral will continue to be relevant for certain types of tangible collateral, but only for purposes of determining which jurisdiction’s law will govern possessory security interests (i.e. where the secured party perfects its security interest by obtaining possession of the collateral) therein and priority conflicts between possessory and nonpossessory security interests in such collateral.

Location of the debtor

There are two sets of rules for determining the location of the debtor, one for domestic registered organizations and branches and agencies of foreign banks, and the other for individuals and all other organizations. There are also special rules for the United States, which is deemed to be located in the District of Columbia, and foreign air carriers, which are deemed to be located in the jurisdiction of their process agent’s designated office.[33]

- **Domestic registered organizations; branches and agencies of foreign banks**
  Determining the location of a registered organization is relatively mechanical and objective: it will be located either (i) in the state in which it is registered (if the organization is organized under state law),[34] (ii) in the state (if any) designated by (U.S.) federal law or designated by the organization in accordance with federal law (if the organization is organized under federal law or is a branch or agency of a foreign bank), or, in the absence of any such designation, the District of Columbia,[35] or (iii) in the state where all of a foreign bank’s branches and agencies are licensed, if licensed in only one state.[36]

It should be noted that the main criteria for an organization to qualify as a registered organization is that either the relevant state or the United States is obliged to maintain a public record of the registration of the organization. This would include entities such as corporations, limited liability companies and limited partnerships, but would exclude entities such as general partnerships. In the latter case there is no need for a public record in order for the entity to exist.

- **Unregistered domestic organizations; foreign organizations generally; individuals**
  The place of filing rule for unregistered domestic organizations, foreign organizations generally and individuals is similar to that under Current Art. 9. The place of filing with respect to such organizations is the jurisdiction of their place of business, or if there is more than one, the chief executive office. Individuals are deemed to be located at their principal residence.

These rules apply only to the extent that such jurisdiction requires information concerning a nonpossessory security interest to be maintained in a public filing, recording or registration system as a condition of perfection.[37] If such is not the case, the organization is deemed to be located in the District of Columbia.

Revised Art. 9's default to the District of Columbia avoids an ambiguity that exists under Current Art. 9 in the case of certain foreign debtors that are located in jurisdictions which have no public filing or recording system for perfection of security interests. Important offshore financial centers such as the Cayman Islands do not appear to have a filing or recording system for security interests (charges) that would be likely to be construed as "public" for these purposes. If such foreign debtor has no executive office in the United States, under Current Art. 9 the security interest may be perfected by giving notice thereof to the account debtor, but only if the collateral constitutes an account or general intangible (in each case, as such term is defined in Current Art. 9) for the payment of money.[38] In other cases, it is not clear that the secured party would be left with a place to file or other method to perfect a nonpossessory security interest under the Uniform Commercial Code.

There is a nuance which arises from the Revised Art. 9 dichotomy between registered and unregistered organizations when the debtor is a trust, which is frequently the case in leveraged leasing and structured financing transactions. One common practice under Current Art. 9 is to file where the trustee of the trust is located, with the rationale being that the trust's place of business is where the trustee carries out its business. Presumably that rationale will continue to hold for private grantor trusts, because they would be treated as unregistered organizations. If, however, the trust is organized pursuant to statute in a jurisdiction that would give rise to treating the trust itself as a registered organization, then a financing statement against the trust would be filed in the jurisdiction where the trust, rather than the trustee, is registered.

Revised Art. 9 Transition Regime for Financing Statements Filed Before the Effective Date

In accordance with the Five Year Rule discussed above, financing statements remain effective until they lapse in accordance with their terms, or until June 30, 2006, whichever is earlier. Thereafter, they must be renewed in accordance with Revised Art. 9.

Pre-Effective Date financing statements may be continued by a continuation statement complying with the requirements of Revised Art. 9, so long as they would be filed in the same jurisdiction and office within that jurisdiction under both Current Art. 9 and Revised Art. 9. If not, then in lieu of a continuation statement, an "Initial Financing Statement" ("IFS") must be filed in the correct jurisdiction and office as determined under Revised Art. 9. Such IFS must, of course, comply in all respects with Revised Art. 9's requirements for initial financing statements, and, in addition, it must specifically refer to the pre-Effective Date financing statement being continued by the IFS. If all such requirements are satisfied, the perfection of the security interest will "relate back" to the date on which the financing statement initially became effective under pre-Revised Art. 9 law, provided it has remained continuously perfected since then.

The secured party may wish to obtain representations from the debtor, perhaps supported by legal opinions, as to where the proper place for filing is under Revised Art. 9, as well as the specific type of filing that should be made (e.g. continuation statement versus IFS).

Due Diligence Program When Considering New Post-Effective Date Financings

While certainly Revised Art. 9 brings welcome changes for secured parties, simplifying the filing process with respect to financing statements and including new types of collateral so as to facilitate secured financings, this will also place additional burdens on secured parties in terms of the due diligence process that must be engaged in when evaluating collateral offered by the debtor. For example, due to the Five Year Rule for financing statements, secured parties will need to conduct lien searches under the rules of both Current Art. 9 and Revised Art. 9 until June 30, 2006. Also, secured parties will need to be aware of changes in terminology which can affect the scope of security interests in certain collateral, and may have to refer to the underlying security documentation to satisfy themselves whether defined terms have their meaning under Current Art. 9 or Revised Art. 9.

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NOTES

[1] Alaska, Arizona, California, Delaware, Hawaii, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Minnesota, Montana, Nebraska, Nevada, North Carolina, Oklahoma, Rhode Island, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington and West Virginia.
[2] Including Arkansas, Colorado, Massachusetts, Mississippi, Missouri, New Hampshire, New Jersey, New York, North Dakota, Oregon, Wisconsin and Wyoming.
[3] Section 9-203(b).
[4] Section 9-318.
[5] A security agreement is an agreement that creates or provides for an interest in personal property or fixtures which secures payment or performance of an obligation. Sections 9-102(a)(73), 1-201(37).
[6] Sections 9-102(a)(7), 9-102(a)(69) and 9-203(b)(3)(A).
[7] Section 9-108(c). Such generic expressions are acceptable, however, in filed financing statements. This deferential treatment for financing statements presumably flows from the fact that they serve a notice function in respect of third parties but do not themselves define rights between the parties, and thus require less precision.
[8] For these purposes, mere possession by or on behalf of the secured party is sufficient, even if the additional requirements for "control" are not satisfied. Sections 9-203(b)(3)(C), 8-301.
[9] Section 9-203(b)(3)(B)-(D).
[10] Section 9-102(29).
[11] Section 9-312(b)(1).
[12] Section 9-327(1).
[13] Section 9-109(c)(2).
[14] Section 9-204(b)(2).
[15] Section 9-102(a)(64)(D).
[16] Ibid.
[17] Section 9-109, Official Comment 15.
[18] Section 9-109(d)(9); Current Art. 9, Section 9-104(h).
[19] Section 9-109(d)(8).
[20] Section 9-309(5).
[21] Except to the extent there may be limited recourse to the seller by the buyer, e.g. in the event the asset sold does not conform to the seller's representations with respect thereto.
[22] Section 9-207(c)(2).

[23] Section 9-314(c).
[24] For these purposes, the third party is someone other than the debtor, the secured party or a lessee of the collateral from the debtor in the ordinary course of the debtor's business. If the third party is an agent of the secured party, no acknowledgment would be required since the secured party would be viewed as holding the collateral itself, through its agent.
[25] Section 9-313(c).
[26] N.B. that although the security interest is perfected in this manner, even under Current Art. 9 the assignment of proceeds is not effective against the issuer and any nominated person until they consent to the assignment. Uniform Commercial Code, Section 5-114(c).
[27] Section 9-312(b).
[28] Section 9-107.
[29] Uniform Commercial Code, Section 5-114(d).
[30] Section 9-701.
[31] Section 9-702.
[32] Section 9-703(a).
[33] Section 9-307(h) and (j).
[34] Section 9-307(e).
[35] Section 9-307(f).
[36] Section 9-307(i).
[37] Section 9-307(c).
[38] Current Art. 9, Section 9-103(3)(c).