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REVISED ARTICLE 9:
Summary and Analysis

One in a Series of Continuing Reports

State legislatures across the nation are currently adopting substantial revisions to Article 9 of the Uniform Commercial Code, the legal cornerstone of secured commercial transactions. With a delayed effective date of July 1, 2001, Revised Article 9 to the UCC will expand finance opportunities for commercial lenders, simplify important public filing procedures, provide a flexible blueprint for the continued evolution of electronic commercial transactions and will revise certain enforcement rights with respect to perfected security interests. In April of 2000, Goldberg, Kohn, Bell, Black, Rosenbloom & Moritz, Ltd. published "Revised Article 9: Changes for the Commercial Lender," which set forth a synopsis of the numerous changes adopted by Revised Article 9. This newsletter, and those to follow, will provide a more detailed examination of specific reforms and key policy initiatives underlying Revised Article 9, with an emphasis on changes to commercial finance practices in light of the statutory overhaul. For purposes of these newsletters, statutory references preceded by an "R" will refer to Revised Article 9 of the UCC, while statutory references preceded by the letters "C" will refer to Current Article 9.

TRANSITION RULES AND PRACTICES FOR REVISED ARTICLE 9

Revised Article 9 contains the most significant changes to the laws of secured transactions since at least 1972 and perhaps since the inception of Article 9 itself. Some of the more significant changes address where financing statements must be filed, where debtors are deemed to be located for purposes of perfection, how a security interest may or must be perfected with respect to certain types of collateral, permitted collateral descriptions on financing statements and how particular types of collateral are defined under Article 9. These changes are intended to, and indeed probably will, clarify and simplify the law and practice of secured transactions. However, the transition to such a different set of rules is fraught with the potential for confusion and error that could have costly consequences for secured creditors and their counsel. To minimize this potential, Revised Article 9 includes specific transition rules, which are set forth in Part 7 of Revised Article 9.

The first transitional rule is found in R9-701, which provides that Revised Article 9 takes effect on July 1, 2001. The drafters of Revised Article 9 chose July 1, 2001 in order to give each state enough time to enact Revised Article 9 prior to the effective date with the intended result being that Revised Article 9 would become effective simultaneously in all states. The Official Comment to R9-701 recognizes that the failure of all states to enact Revised Article 9 prior to July 1, 2001 may result in "horrendous consequences." For example, the status of whether a particular security interest is perfected or unperfected might turn on whether the state in which the issue is litigated has adopted Revised Article 9. The transition rules set forth in Part 7 of Revised Article 9 assume that Revised Article 9 will become effective in each state simultaneously and do not attempt to address complications that would arise if this is not the case. If, as July 1, 2001 approaches, it appears all states will not have enacted Revised Article 9, the interaction of Current Article 9 and Revised Article 9 will need to be analyzed. The only persons who could reasonably hope for this situation are law school professors since the subtle factual twists they could introduce on exam questions appears to be infinite. As of the date of this publication, approximately half the states have adopted Revised Article 9, in each case with a delayed effective date of July 1, 2001. Representatives of the National Conference of Commissioners on Uniform State Laws, in phone conversations with members of this firm, have expressed cautious optimism that all states will complete legislative adoption of Revised Article 9 by the critical July, 2001 date.

Perhaps the most important transitional issue facing secured creditors is what, if anything, must be done to ensure that a security interest perfected under Current Article 9 remains perfected under Revised Article 9. Fortunately, the answer to this question in many instances will be nothing. If, in the course of complying with Current Article 9, a secured creditor has already taken actions sufficient to perfect under Revised Article 9, the secured creditor need not do anything more. See R9-703(a). An example of such a situation is where the debtor is an Illinois corporation with its principal place of business located in Illinois. To perfect against the debtor's assets under Current Article 9, a secured creditor will have filed a financing statement with the Secretary of State of Illinois which is also the proper place to file a financing statement under Revised Article 9. Accordingly, in this example no further action need be taken. The secured creditor would, of course, need to file its continuation statement within six months of the underlying financing statement's expiration date, which would not be effected by the adoption of Revised Article 9. See R9-510.

In many cases, the proper jurisdiction for filing under Current Article 9 (typically, where the assets are located or are deemed located) will be different from the proper filing jurisdiction under Revised Article 9 (typically, where the debtor is organized). To ease the administrative burden on secured creditors of having to immediately refile, on or prior to July 1, 2001, Revised Article 9 provides that financing statements properly filed under Current Article 9 remain effective to perfect the security interest until the sooner of (a) the expiration of such financing statements (five years from filing in most states), and (b) June 30, 2006. See R9-705(c). In order to preserve the relative priority of prior financing statements the secured creditor must file by the earlier of the two dates described in the preceding sentence a special type of financing statement created by Revised Article 9 called the Initial Financing Statement in Lieu of Continuation Statement (with the easier nickname of "In Lieu Filing"). In Lieu Filings must reference the prior financing statements (and multiple financing statements may be referenced under a single In Lieu Filing) and contain an appropriate collateral description. In Lieu Filings need not be signed by the debtor and may be filed anytime during the effectiveness of a pre-effective date financing statement -- not merely during the six month window prior to the scheduled lapse date. R9-706(b). In Lieu Filings may also be filed prior to the effective date of Revised Article 9. R9-706(b). Notwithstanding these liberalized rules regarding the timing of filing, there is no advantage under Revised Article 9 to filing earlier, and most commercial lenders may find it easiest to prepare and file In Lieu Filings during the same period they would otherwise prepare and file routine continuation statements. In Lieu Filings, like other initial financing statements, will be effective for a period of five years from the date of their filing. They are, therefore, in this regard different from routine continuation statements which, when properly filed, extend the life of an initial financing statement measured from the date of filing of the initial financing statement, rather than as of the filing date of the continuation statement itself.

A substantial trap exists in transitional rules relating to changed filing locations. In order to prepare for Revised Article 9, many competent commercial finance attorneys have started to record filings in the debtor's jurisdiction of formation even if the debtor did not have a place of business or property located in that jurisdiction. Distinguished debtor's counsel have been heard to say, in effect, "let's do a filing in Delaware so that when Revised Article 9 comes into effect we do not have to do anything." While these pre-effective date filings will operate to perfect a security interest under Revised Article 9, the effective date of such filings under Revised Article 9 is exactly July 1, 2001. Failure to file In Lieu Filings for pre-effective date filings will expose secured creditors to intervening liens (those arising between the date of the of the original filing and July 1, 2001), not to mention preference claims in the event of a bankruptcy.

Secured creditors should also be aware that the filing of an In Lieu Filing prior to July 1, 2001 does not eliminate the requirement that the original financing statement be continued under Current Article 9 if the original financing statement expires prior to July 1, 2001. Also, one commentator has suggested that since the In Lieu Filing must reference the most recent continuation statement for the original financing statement, In Lieu Filings may not be filed with respect to financing statements that must be continued before July 1, 2001 under Current Article 9 until they have been so continued since the most recent continuation statement that will exist on the effective date may not be referenced until such time.

The drawback of the grace period for filing In Lieu Filings is that, for at least five years, secured creditors should conduct pre-closing searches in all of the jurisdictions in which a security interest could have been perfected by filing a financing statement under Current Article 9. Failure to do so could result in missing valid filings which may remain perfected by the filing of an In Lieu Filing at a later date.

Where a secured creditor has obtained a perfected security interest under Current Article 9 by a method other than filing, but which would not qualify as a perfected security interest under Revised Article 9, the transition rules provide a one year grace period from the effective date of Revised Article 9 for the secured creditor to take such action as is required to obtain a perfected security interest under Revised Article 9. R9-703. An example of such a situation would be where a secured creditor has obtained a possessory security interest under C9-305 by providing notice of a security interest to (but not obtaining the acknowledgment of) a bailee that holds collateral. Since the bailee's acknowledgment is required for perfection under R9-313, the secured creditor's security interest would become unperfected unless the bailee's acknowledgment is received by the secured creditor within one year of the Revised Article 9 effective date or other action is taken to perfect the security interest.

The result is similar where a secured creditor previously obtained a security interest in property that is not within the scope of Current Article 9 but is within the scope of Revised Article 9 (examples of such property include commercial tort claims and, in most states, bank accounts). Unless the secured creditor takes action to perfect its security interest under Revised Article 9 within one year from the effective date, the security interest loses its priority. R9-703.

Part 7 of Revised Article 9 also contains rules regarding priority with respect to security interests that were unperfected under Current Article 9. These rules are necessary but are of limited use in transitional planning. If, prior to July 1, 2001, a secured creditor discovers that it is unperfected under Current Article 9, its focus should be becoming perfected as soon possible under Current Article 9. Once that has been accomplished the rules described above will apply.

RESTRICTIONS ON ASSIGNMENTS OF GENERAL INTANGIBLES INEFFECTIVE UNDER REVISED ARTICLE 9

One of the goals of Revised Article 9 is to encourage the development of new finance opportunities through the removal of existing legal barriers. This goal is manifest most directly in R9-408, which renders customary anti-assignment provisions in general intangibles, including contract rights, ineffective to the extent that such provisions would impair the creation, attachment or perfection of a security interest. Secured lenders that desire to fully avail themselves of the significant benefits of this new provision should consider taking affirmative steps, discussed below, with respect to certain existing loans and all future loans.

Secured lenders have long benefited from an existing close cousin of R9-408 which deals with a specific type of anti-assignment provision in contracts and general intangibles. C9-318(4) provides that contract terms are ineffective to the extent that they preclude the assignment of an account or prohibit the creation of a security interest in a general intangible for money due or to become due. On this simple provision rests the entire market of receivables financing and factoring. Without this provision, lenders would be required to conduct extensive, costly and ongoing due diligence to determine whether each account receivable of an existing borrower may, according to its terms, be assigned to the lender, either outright or as collateral security. Such due diligence would dramatically if not entirely dampen finance opportunities regarding receivables.

C9-318(4), however, is limited to accounts and general intangibles for money due or to become due. A lender desiring to take a security instance in, for instance, a franchise in which a debtor has rights as a franchisee must today review the underlying franchise documents to determine whether the consent of the franchisor is required in order to create a lien on the franchisee's franchise rights. The lender could, under C9-318(4), take a security interest without the franchisor's consent on the franchisee-debtor's rights to payment under the franchise documents. Such payment rights, however, may be of limited value -- the true collateral value more likely than not would be embedded in the franchise itself, and C9-318(4) would not permit the granting of a security interest on such assets in the face of a prohibitive anti-assignment clause.

R9-408 nullifies such anti-assignment provisions to the extent they preclude the creation of a security interest on the underlying asset, yet does so in a way that seeks to protect the legitimate business interests in third-parties protected by such anti-assignment provisions. R9-408(a) renders ineffective terms in agreements or general intangibles, including permits, licenses and franchises, to the extent such terms prohibit or restrict the creation of a security interest in such assets or otherwise require the consent of a third-party prior to the creation of a security interest. R9-408(c) contains an analogous provision which renders ineffective any rules of law, statutes or regulations to the extent such provisions prohibit or restrict the creation of a security interest in such assets or otherwise require the consent of any governmental entity or private third-party prior to the creation of a security interest, such as is typically the case with respect to liquor licensing, gambling licensing and certain other regulated industries.

Note, however, an important limitation of R9-408(c) contained in clause (e) of the uniform statute. Clause (e) instructs the legislatures to list any applicable anti-assignment statutes that are intended to be subject to the operation of R9-408(c). One may reasonably infer, therefore, that any anti-assignment statutes which are neither identified under clause (e) nor independently amended to conform to the provisions of R9-408(c) are not subject to the provisions of this section. Accordingly, lenders that desire to avail themselves of the benefits of clause (c) with respect to any particular piece of anti-assignment legislation will need to determine whether that legislation is either specifically identified in clause (e), or has otherwise been separately amended to conform to R9-408(c). As alternatives to this statutory interplay, the Revised UCC Article 9 Enactment Guide (2nd Ed.), prepared by the Joint Task Force on Revised Article 9 Enactment Process, states that state legislatures may either (i) entirely omit clause (e), on the theory that clause (c) should stand as a general override to all anti-assignment statutes, or (ii) revise clause (e) to expressly state that it prevails over any inconsistent statutes. The Illinois legislature, in adopting Revised Article 9, has chosen to entirely omit clause (e), presumably on the theory that clause (c) is sufficient by itself to override any inconsistent state statutes. See IL Public Act 91-893.

The beneficiaries of such anti-assignment provisions -- licensors, franchisors and/or governmental entities -- receive protection under R9-408(d). This clause provides that to the extent that an anti-assignment provision is set aside due to the operation of R9-408(a) or (c), the security interest created thereby (i) is not enforceable against any such parties, (ii) does not impose any duties on such parties, (iii) does not require any such parties to recognize the security interest, pay or render performance to the secured party or accept payment or performance from the secured and, most importantly, (iv) does not entitle the secured party to enforce such security interest.

In brief, R9-408 permits the creation, attachment and perfection of a security interest in general intangibles, notwithstanding anti-assignment provisions to the contrary, yet provides protection for the beneficiaries of such provisions by precluding the enforcement of such security interests. One may ask: what's the value of the resulting security interest if it cannot be enforced?

The commentary to R9-408 provides two responses to this question. First, the commentary states that a valid, perfected lien, even one that cannot be enforced, confers significant advantages to a secured creditor in the context of a bankruptcy proceeding pertaining to the debtor. Bankruptcy Code Section 552 provides, in key part, that a perfected pre-petition lien does not extend to collateral acquired after the commencement of a bankruptcy proceeding, except to the extent that the post-petition property constitutes proceeds of pre-petition collateral. Should a debtor, in the context of a bankruptcy proceeding, sell collateral which became subject to a pre-petition security interest pursuant to R9-408, the proceeds of that sale will constitute proceeds of pre-petition collateral (See Example 4 to Comment 7 to R9-408). Second, the commentary to R9-408 states that the operation of this statute will confer material benefits to both secured creditors and debtors outside the context of a bankruptcy. The commentary states that many lenders, notwithstanding their inability to enforce a security interest arising by virtue of R9-408, may nonetheless ascribe value to the collateral subject to anti-assignment provisions. "This may be the case", the commentary provides,

> where the secured party sees a likelihood of obtaining that agreement [to obtain a valid, enforceable lien] in the future. This may also be the case where the secured party anticipates that the collateral will give rise to a type of proceeds as to which this section would not apply. (Comment 8 to R9-408)

The doctrine which emerges from R9-408 -- allowing for the creation, attachment and perfection of a valid, yet unenforceable lien in light of governing anti-assignment statutes or contractual provisions -- received its most thorough exploration and articulation in a line of relatively recent case decisions principally concerning the financing of Federal Communication Commission broadcast licenses. Federal statutory law confers upon the FCC the authority to grant licenses for radio communication and for the transmission of energy and other communications. 47 U.S.C. § 301 et. seq. This legal framework specifically prohibits the assignment or other transference of FCC licenses absent the FCC's consent (47 U.S.C. 309(h)), and early FCC administrative rulings had little difficulty construing these statutory provisions as preventing the granting of security interests in FCC licenses, often on the theory that FCC licensees held no property interest in FCC licenses, at least none that could be mortgaged. E.g. In re Merkley, 94 FCC 2d 829 (1983), recon. den., 56 RR 2d 413 (1984), aff'd sub nom., Smith v. Heckler, 766 F.2d 365 (D.C. Cir. 1985). Notwithstanding the foregoing, a number of lenders were drawn toward FCC licenses as an arena ripe for finance opportunities. Inevitably, a number of failed credits wound up in bankruptcy cases in which bankruptcy trustees challenged the validity of security interests purportedly obtained by such lenders without the consent of the FCC.

Two dominant lines of cases emerged virtually simultaneously in the early 1990s establishing contrary legal doctrine regarding the extent of the FCC's ban on security interests in FCC licenses. One line of cases approached the issue as a simple matter of statutory construction and case precedent which, so this camp maintained, taken together invalidated any effort to mortgage FCC licenses. A common law exception to the general "no-lien" rule emerged from cases which highlighted the inequities of an absolutist approach. These inequities derived from the fact that FCC licenses held significant economic value, often the single most valuable asset owned by FCC licensees. To finance their acquisition of such licenses, FCC licensees invariably attempted to pledge their licenses to their lenders who, in turn, urged courts to approve a limited form of security interest over FCC licenses which would not abrogate the FCC's control over license ownership.

The court in Ridgely Communications, Inc., 139 B.R. 374 (Bkrtcy.D.Md. 1992), has generally been credited as representative of the "limited lien" doctrine. In this case, the principal secured creditor of a bankrupt FCC licensee moved for distribution of proceeds from the debtor's bankruptcy asset sale, including proceeds of the debtor's FCC broadcasting licenses. The secured creditor argued, ultimately successfully, that the FCC's rightful interest in controlling ownership of FCC broadcast licenses need not interfere with private agreements over the disposition of proceeds of such assets. A rigid approach to the "no-lien" rule, the secured creditor also argued, would unfairly penalize the secured creditor by depriving it of approximately $1.25 million of the $2 million collected in the asset sale, which would otherwise redound to the benefit of the principal unsecured creditors of the debtor, in this case corporate insiders.

The Ridgely court agreed with the secured creditor, holding that "a creditor may perfect a security interest in a debtor's F.C.C. broadcasting license, limited to the extent of the licensee's proprietary rights in the license vis-à-vis third parties. The right of the licensee crucial to this decision ... is the right of the creditor to claim proceeds received by the debtor licensee from a private buyer in exchange for the transfer of the license to that buyer." Id. at 379. The court carefully emphasized that this right would not entitle a secured party to foreclose on a broadcasting license, or to compel the initiation of a transfer or assignment of an FCC license to a third-party, all of which remained powers reserved by the FCC pursuant to statutory law. However, the right to "receive remuneration for the transfer [of an FCC license sanctioned by the FCC] is a right with respect to the two private parties", which need not be stymied by the FCC's monopoly over transfer rights. Id. at 378-79.

Ironically, while upholding and codifying the analysis articulated in Ridgely, R9-408 will not, by itself, reverse federal anti-assignment statutes. Being a creature of state law, R9-408 cannot supplant federal law occupying the same substantive field. Note, however, in this regard that the drafters of R9-408 have expressly stated their preferences that the new statute "reflect[s] an important policy judgment that should provide a template for future federal law reforms." (Comment 9 to R9-408).

What should secured creditors do in order to take full advantage of the increased rights afforded by R9-408? First, for deals booked under existing Article 9, the existing security agreements should be reviewed on a case-by-case determination to determine whether granting clauses exclude from the collateral package general intangibles, including contract rights, to the extent that the grant of a security interest therein would violate either a controlling statute or the terms of the agreement under which such contractual rights arise or exist. A typical exclusionary clause would read as follows:

> "The Collateral shall not include any (x) contractual rights (other than rights relating to the proceeds thereof) to the extent that (1) the grant of a security interests therein would violate the terms of the agreement under which such contractual rights arise or exist and such agreement is not subject to Section 9-318(4) of the UCC, (2) such rights are not assignable or require consent for assignment and in either case the agreement pursuant to which such rights arise or exist is not subject to Section 9-318(4) of the UCC, or (3) the assignment thereof would violate applicable law, and (z) rights (other than rights relating to the proceeds thereof) under government licenses and authorizations to the extent that the grant of a security interest therein in prohibited by law or which by their terms are not assignable."

Such "carve backs" have become relatively customary over the years as part of overall negotiations, and would inappropriately deprive secured lenders of added collateral value pursuant to R9-408. Such negotiated provisions, moreover, should be strictly avoided in all security agreements prepared on a going forward basis, to the extent that R-408 would allow for the creation of a security interest on the applicable asset.

The text of R9-408 leaves two areas for possible future redress. First, as noted above, federal legislation is not directly affected by the UCC, and will need to be specifically amended to achieve the policy balance struck by R9-408. Second, as also noted above, states adopting Revised Article 9 may decide, through the identification of specific statutes under R9-408(e), to keep certain other anti-assignment statutes in place. Creditors unable to benefit from R9-408 for either of these reasons should, nonetheless, be aware of a competing "pro-creditor" theory recently addressed by certain courts. Under this theory, creditors barred from attaching a particular asset due to the operation of anti-assignment statutes or contractual provisions may nevertheless attach the proceeds of such asset (see, e.g. In re SRJ Enterprises, Inc., 150 B.R. 933 (Bkrtcy. N.D.Ill. 1993) (lender's lien against payment proceeds were not prohibited by contractual anti-assignment provision in a franchise agreement). This theory, however, has been specifically rejected by other courts, and cannot be relied on as settled law. (see, e.g. In re Main Street Beverage Corporation, 232 B.R. 303 (Bkrtcy., D. N.J.) (lender's lien on proceeds of sale of liquor license are inseparable from the license itself, and are therefore unattachable in light of state anti-assignment statute).