Approved: April 28, 2000
Date

MINUTES OF THE HOUSE COMMITTEE ON JUDICIARY

The meeting was called to order by Chairperson Michael R. O'Neal at 3:30 p.m. on March 14, 2000 in Room 313-S of the Capitol.

All members were present except:
Representative Andrew Howell - Excused
Representative Candy Ruff - Excused
Representative Dale Swenson - Excused

Committee staff present:
Jerry Ann Donaldson, Legislative Research Department
Jill Wolters, Office of Revisor of Statutes
Cindy O'Neal, Committee Secretary

Conferees appearing before the committee:

John McCabe, Uniform Law Commissioner
Joe Lieber, Kansas Cooperative Council
Allie Devine, Kansas Livestock Association
Kathy Olsen, Kansas Bankers Association
Leslie Kaufman, Kansas Farm Bureau
Chuck Stones, Kansas Bankers Association
Rick Ferris, Ferris Brothers, Inc., Custom Harvesting,
Melissa Wangemann, Legal Counsel, Secretary of State's Office
Gail Bright, Assistant Attorney General, Consumer Protection Division

Hearings on **SB 366 - New Article 9 Uniform Consumer Code,** was opened.

John McCabe, Uniform Law Commissioner, informed the committee that the changes are intended to address the fact that paper-based commercial transactions are giving way to electronic transactions; filing systems need to be revised to handle the increase volumes, new kinds of property and transactions need to be recognized in law. (Attachments 1 - 4)

He explained that Article 9 provides the rules governing any transaction that couples a debt with a creditor's interest in a debtor's personal property. If the debtor defaults, the creditor may repossess and sell the property to satisfy that debt. The creditor's interest is called a "security interest".

There are two key concepts: attachment and perfection. The terms describe the two key events in the creation of a security interest. Attachment usually occurs when the security interest is effective between the creditor and the debtor, and that usually happens when their agreement provides that it takes place. Perfection takes place when the creditor establishes his or her priority in relation to other creditor of the debtor in the same collateral. The creditor with priority may use the collateral to satisfy the debtor's obligation when the debtor defaults before other creditors subsequent in priority may do so. Generally, the first to file has the first priority.

The following is a summary of relevant changes:

- The Scope Issue - The revision expands the scope which is what kinds of property in which a security interest can be taken by a creditor under Article 9. Also, certain kinds of transactions will now come under Article 9, such as: sales of payment intangibles and promissory notes; security interests created by governmental debtors; health insurance receivables; consignments; and commercial tort claims. Nonpossessory, statutory agricultural liens are included for determination of perfection and priority.

- Perfection - Filing a financing statement remains the dominant way to perfect a security interest in most kinds of property. The revisions make it clearer that filing a financing statement will perfect a security interest, even if there is another method of perfections. Control is the method of perfection for a letter of credit rights and deposit accounts. A creditor would now have control when the debtor cannot transfer the property without the creditor's consent. Possession, as an alternative method of filing a financing statement to perfect a security interest is the only method for perfecting a security

interest in money that is not proceeds of sale from property subject to a security interest. Automatic perfection for a purchase money security interest would be increased from 10 days to twenty days.

- Choice of Law - In interstate secured transactions it is necessary to determine which state's laws apply to perfection, the effect of perfection and priority of security interests. Revisions would choose the state that is the location of the debtor. If the debtor is an entity created by registration in a state, the location of the debtor in which the entity is created by registration. If an entity is a corporation the location of the debtor is the state in which the corporate charter is filed or registered.

- Filing System - Article 9 includes a centralized filing system. One place in every state in which financing statements are filed, and a filing system that escorts filing from the world of filed documents to the world of electronic communications and records. The office that files financing statements has no responsibility for the accuracy of information on the statements and would be fully absolved from any liability for the contents of any statements received and filed.

- Consumer Transactions - Would make a clear distinction between transactions in which the debtor is a consumer. The revisions would change the way a consumer transaction is handled: a consumer cannot waive redemption rights in a financing agreement; a consumer is a buyer of goods who pre-pays in whole or in part, has an enforceable interest in the purchased goods and may obtain the goods as a remedy; a consumer is entitled to disclosure of the amount of any deficiency assessed against him and the method for calculating the deficiency; and a secured creditor may not accept collateral as partial satisfaction of a consumer obligation.

- Default & Enforcement - Provisions on default and enforcement deal generally with the procedures for obtaining property in which a creditor has a security interest and selling it to satisfy a debt, when the debtor is in default. New rules would require a secured party to notify a secondary obligor when there is a default, and a secondary obligor generally cannot waive rights. A secured party who repossesses goods and sells them is subject to the usually warranties that are party of any sale.

Joe Lieber, Kansas Cooperative Council, appeared before the committee to request that the proposed bill be amended to include Appendix II of the National Conference of Commissioners on Uniform Law, also known as "input liens." Many farm producers are not able to get funds to plant new crops from their lenders because lenders no longer understand agriculture, even though they might be locally owned. Many producers may go to the vendors and ask for inputs on credit, but vendors do not want to do it because if a lien is filed they would be secondary to the lender. (Attachment 5)

Allie Devine, Kansas Livestock Association, appeared before the committee in support of the bill with the exception to the bill including statutory liens being subject to Article 9. She requested an amendment which would clarify the difference between a statutory lien and an agricultural lien. (Attachment 6)

Kathy Olsen, Kansas Bankers Association, appeared before the committee as a proponent of the bill. She suggested ten amendments, of which several would reinstate current law, several were technical, and others would attempt to assure that the rules would apply to all transactions. (Attachment 7)

Chuck Stones, Kansas Bankers Association, appeared in opposition to adding Appendix II to the proposed bill. He stated that, if adopted, it would had an adverse impact on the availability of credit to farmers. It would also change the role of the operating lender, who has traditionally worked closely with the farming community to develop financial plans that provide credit for the entire farm operation. (Attachment 8)

Leslie Kaufman, Kansas Farm Bureau, also appeared in opposition to the suggestion of amending in Appendix II. She believes that the adoption of Appendix II would put statutory agriculture liens under the control of Article 9 and could alter the prioritization of ag liens. She suggested that the committee consider adoption of the amendments presented by the Kansas Livestock Association. (Attachment 9)

Rick Ferris, Ferris Brothers, Inc., Custom Harvesting, stated that Harvest liens should remain in priority status to all other lien or security interests. (Attachment 10)

Melissa Wangemann, Legal Counsel, Secretary of State's Office, requested an amendment which would grant the Secretary of State's Office the discretion to refuse bogus liens. A second amendment would require the court's conclusion of law to include a directive to the filing officer to terminate the lien if the court determines the lien to be invalid. (Attachment 11)

Phill Harness, Director of Workers Compensation, did not appear before the committee but requested his testimony be included in the minutes. (Attachment 12)
Hearings on SB 366 were closed.

Hearings on **SB 559 - Uniform Electronic Transactions Act**, was opened.

John McCabe, Uniform Law Commissioner, explained that the Uniform Electronic Transactions Act (UETA) applies only to transactions in which both parties have agreed to conduct their business by electronic means. It also allows parties to opt out. He provided a brief summary which highlighted some important aspects of the bill. (Attachments 13 - 15)

Gail Bright, Assistant Attorney General, Consumer Protection Division, appeared in opposition of the bill. She stated that The Attorney General was not aware that the Uniform Law Commissioners's were planning on adopting the suggested legislation, nor was she asked to comment on the bill. She believes that the bill should only apply to online transactions. (Attachment 16)

Hearings on **SB 559** were closed.

The committee meeting adjourned at 6:00 p.m. The next meeting was scheduled for March 15, 2000.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

A Few Facts About
REVISED UCC ARTICLE 9, SECURED TRANSACTIONS (1998)

PURPOSE: Updates UCC Article 9, last revised in 1972 and adopted in every state. Article 9 provides a statutory framework that governs secured transactions—transactions which involve the granting of credit secured by personal property.

ORIGIN: Completed by the Uniform Law Commissioners, in conjunction with the American Law Institute, in 1998.

ENDORSED BY: American Bar Association

STATE ADOPTIONS:

Arizona
California
Maryland
Montana
Nebraska
Nevada
Texas

2000 INTRODUCTIONS:

Alaska
Delaware
District of Columbia
Hawaii
Illinois
Indiana
Kansas
Kentucky
Maine
Michigan
Minnesota
Missouri
New Hampshire
South Carolina
Tennessee
Vermont
Washington

For any further information regarding the Revision of UCC Article 9, Secured Transactions, please contact John McCabe or Katie Robinson at 312-915-0195.

(1/21/00)

(Please note: this information can also be found on our Website at www.nccusl.org)

House Judiciary
3-14-2000
Attachment 1

National Conference of Commissioners on Unif[illegible] State La[illegible]
11 East Onta[illegible] Suite 1300, Chicago, Illinois 60611•312/915-0195•F[illegible]simile 312/915-[illegible]87

WHY STATES SHOULD ADOPT
UNIFORM COMMERCIAL CODE ARTICLE 9 - SECURED TRANSACTIONS

Trillions of dollars of commercial and consumer credit are granted each year in secured transactions under Article 9 of the Uniform Commercial Code—a manufacturer finances the acquisition of machinery and raw materials, a retailer finances inventory, a consumer finances furniture for a new house. The manufacturer, the retailer, and the consumer all depend upon Article 9 of the Uniform Commercial Code to make it possible for them to obtain the credit they need. Their creditors get assurance, in the form of the collateral that secures the granting of credit, that it will cushion the risk of default in the event the debtor does not pay the debt. Article 9 of the Uniform Commercial Code is absolutely necessary to economic function in the United States. It is the crankshaft for the American economic engine, and it is the envy of the rest of the world, which often struggles with the mechanics of credit granting and enforcement of creditor's rights.

Major revisions to Article 9 were completed in 1998. These revisions bring Article 9 into the 21st Century. There are many reasons that Revised Article 9 should be adopted in every state.

- **Technology.** Paper-based transactions are giving way to electronic transactions. Revised Article 9 makes way for this revolution.

- **Volume.** Article 9 was first proposed in 1951. Its last update was in 1972. Since 1972 the volume of commerce and the volume of credit has increased exponentially. Volume of secured transactions increases proportionately and directly with increase in economic activity in the United States. *The filing system revisions are particularly necessary to meet the problem of increased volume.*

- **New Collateral.** New kinds of property and transactions have been developed since Article 9 was last amended. The *scope* of Article 9 expands to keep up and the 1998 revisions meet the needs for collateral into the new millennium. Examples of specific new collateral are deposit accounts and health insurance receivables.

- **Certainty of Perfection.** Uncertainties about where to perfect a security interest under old Article 9 are overcome by the new basic rule in the 1998 revisions that makes the location of the debtor the place where the creditor will perfect the security interest.

- **New Liens.** Statutory, non-possessory liens have proliferated since Article 9 was originally approved. Such liens represent a risk for creditors, and a potential conflict with security interests in collateral, if there is no public notice of their existence. Article 9 includes certain statutory, non-possessory liens for the purposes of providing public notice and setting priorities between creditors.

- **Clarification of Rules.** Over time, provisions of Article 9 have been interpreted by courts, sometimes in conflicting ways. Some decisions deal with issues that were not expressly addressed in original Article 9. The result is ambiguity in the application of some rules. The revisions to Article 9 address and cure the accrued ambiguity problems.

- **Consumer Impact.** Revised Article 9 addresses consumer issues that were not addressed in original Article 9.

- **Commitment to Uniformity.** Amendments to Article 9 from state to state have created differences that impair interstate transactions. The revisions address specific kinds of secured transactions in oil and gas and agriculture in an effort to re-establish uniformity of law governing these kinds of transactions.

An introduction to revised UCC Article 9

9

Steven O. Weise

Introduction

Status. The Article 9 Drafting Committee[1] has completed its work. The sponsoring organizations, the American Law Institute and the National Conference of Commissioners on Uniform State Laws, have given their approval. Article 9[2] has now moved to the States for consideration. If everything goes according to plan, Article 9 will become the law in a significant number of states, effective July 1, 2001.[3]

Purposes of changes. The revisions to Article 9 represent the first major revision to Article 9 since 1972. There are significant changes in scope, substantive rules, and procedures. The revisions are intended to bring greater certainty to financing transactions. This certainty should reduce both transaction costs and the cost of credit.

Implementation. The revised Article 9 seeks greater certainty through two primary techniques:

- Expanding the scope of property and transactions covered by Article 9, and
- Simplifying and clarifying the rules for creation, perfection, priority and enforcement of a security interest

Revised Article 9 also clarifies the rules that apply to consumer transactions

Simplification. The Article 9 Drafting Committee established a Simplification Task Force to work with the Reporters and the Drafting Committee to make the revised Article 9 as "user friendly" as possible. The revised Article 9 achieves this goal to a significant extent.

Electronic transactions. Article 9 recognizes emerging methods of engaging in electronic commerce. Article 9 provides throughout its text for the "authentication" of a "record" instead of signing a piece of paper. This follows the lead of other recent revisions to the

[1] The Chair of the Drafting Committee is Bill Burke (wburke@shearman.com). The Reporters are Steve Harris (sharris@kentlaw.edu) and Chuck Mooney (cmooney@oyez.law.upenn.edu).

[2] All statutory references to Article 9 are to the final version of the new Article 9, including the Official Comments, unless otherwise indicated. Copies of various drafts (but not the final draft) of the text and comments are available at: http://www.law.upenn.edu/library/ulc/ulc.htm. Copies may also be obtained from: NCCUSL, 676 No. St. Clair Street, Suite 1700, Chicago, Illinois 60611; (312) 915-0195. The final draft will be available from NCCUSL in due course.

[3] The author is the ABA Advisor to the Drafting Committee and may be reached at Heller Ehrman White & McAuliffe, 601 So. Figueroa Street, 40th Fl., Los Angeles, California 90017-5758; (213) 244-7831; FAX: (213) 614-1868; sweise@hewm.com. The author periodically prepares and distributes information and reports on the new Article 9. Anyone interested in receiving these should let the author know.

House Judiciary
3-14-2000
Attachment 3

UCC.

Consumer matters. Article 9 contains many special rules for consumer transactions. This article sometimes, but not always, refers to special consumer rules in the course of discussing a commercial rule. There is a section devoted to consumer rules near the end of this article that should be referred to for a collection of the principal consumer rules.

Scope

Introduction. Revised Article 9 brings into the fold of Article 9 several kinds of property and transactions that previously resided outside of Article 9. The application of non-Article 9, common law, rules to these transactions made the legal results of these transactions uncertain and accordingly more expensive. This is particularly true for securitization transactions.

Goods v. software. Article 9 draws a line between "goods" and "software." Where software is "embedded" in goods so that the software becomes "part of" the goods, Article 9 treats the software as "goods" for all purposes under Article 9 (such as how to perfect a security interest and buyer in ordinary course rules). When software maintains its independent status it will constitute a general intangible. § 9-102(44), (75).

Accounts. Article 9 has always applied to the *sale* of "accounts." Revised Article 9 continues this rule. § 9-109(a)(3). Current Article 9 defines "accounts" to include only payment obligations arising out of the sale or lease of goods or the provision of services. Under current law, this leaves many kinds of payment rights within the definition of "general intangible." The sale of these types of payment rights often serves as a financing transaction, but current Article 9 does not apply to these transactions.

Revised Article 9 broadens the definition of "accounts" to include:

- payment obligations arising out of the sale, lease or license of all kinds of tangible and intangible property (for example, "accounts" will include license fees payable for the use of software), and
- credit card receivables.

§ 9-102(a)(2). The broader definition expands the scope of Article 9 by bringing into Article 9 more transactions through the continued application of Article 9 to the sale of "accounts" (as newly defined).

Revised Article 9 also clarifies that a seller of accounts (and other property where the sale is an Article 9 transaction) retains no interest in the property sold. § 9-318(a). This rejects the holding in *Octagon Gas Systems v. Rimmer*, 995 F.2d 948 (10th Cir. 1993). *See* PEB Commentary No. 14 (June 10, 1994)

Payment intangibles. The inclusion of many kinds of payment rights in the definition of "accounts" does leave behind in the definition of "general intangible" some important types of payment rights, such as payment rights

that arise out of loan agreements that do not constitute "instruments." Revised Article 9 calls a general intangible where the obligor's "principal" obligation is the payment of money a "payment intangible." § 9102(a)(61). The sale of a payment intangible often functions as a financing transaction.

Revised Article 9 brings certainty to these transactions by bringing the *sale* of a "payment intangible" into the scope of Article 9. § 9-109(a)(3). However, to permit financial institutions that sell loan participations to avoid having a financing statement filed against them, Article 9 provides for the automatic perfection of a security interest created upon the *sale* of a payment intangible (but not a security interest given to secure an obligation). § 9-309(3).

Sale of promissory notes. The sale of a promissory note will also often function as a financing transaction. Revised Article 9 recognizes this fact and treats the *sale* of a promissory note as a transaction subject to Article 9. § 9-109(a)(3). Revised Article 9 defines a "promissory note" as a subset of "instruments." § 9-102(a)(65) "Promissory notes" include "promises," but not "order paper" (*e.g.* checks).

As with the *buyer* of a payment intangible, the *buyer* of a promissory note enjoys automatic perfection of its security interest. § 9-309(4). Unlike payment intangibles where there is nothing to possess and the first buyer of the payment intangible will always have priority, a buyer of a promissory note that relies on automatic perfection, and does not take possession of the promissory note, will lose to a subsequent buyer of the promissory note that does take possession of the promissory note. § 9-330(d).

Investment property. Revised Article 9 continues the rules grafted onto Article 9 at the time of the adoption of revised Article 8. Revised Article 9 distributes those rules, which reside largely in current § 9-115, to their proper homes throughout revised Article 9. Various aspects of these rules are discussed below.

Health-care-insurance receivables.[4] Current Article 9 excludes insurance claims from the scope of Article 9 (except to the extent they may constitute proceeds under current § 9-306). Originators of insurance receivables arising from the provision of health care services frequently sell them in financing transactions. To bring certainty to these transactions, revised Article 9 brings them into Article 9. § 9-102(a)(2), (46). Other insurance claims remain outside of Article 9 (except to the extent they constitute "proceeds"). § 9109(d)(8).

Commercial tort claims. Current Article 9 excludes tort claims from the coverage of Article 9 (except to the extent they constitute "proceeds"). Revised Article 9 continues this rule, except for "commercial tort claims." §§ 9-102(a)(13), 9-109(d)(12). Revised Article 9 defines "commercial tort claims" as

[4] The "-"'s are officially part of the term.

those tort claims:

- where the claimant is an organization, or
- if the claimant is an individual, the claim (i) arose in the course of the claimant's business, and (ii) does not involve personal injury.

A secured party may not obtain a security interest in an after-acquired commercial tort claim. § 9-204(b)(2). The security agreement must describe the commercial tort claim with some specificity. § 9-108(e)(1).

Creation of the security interest

Introduction. The current rules for the creation and attachment of the security interest remain substantially the same under revised Article 9.

Attachment. Attachment continues to require a security agreement, value and that the debtor have rights in the collateral. § 9-203.

The security agreement. The security agreement may be an authenticated record. § 9-203. The security agreement still requires the debtor's authentication and a sufficient description of the collateral. § 9-203(b)(3)(A). Revised Article 9 confirms that the exception to the requirement of a signature where the secured party has possession pursuant to "agreement" means that the "agreement" has to be a "*security* agreement."

Description of collateral. Revised Article 9 clarifies that a description of collateral by Article 9 "type" (*e.g.* "equipment") suffices to "describe" the collateral (except in certain consumer transactions, as described below). § 9-108(b)(3). If the collateral is a commercial tort claim, the description requires some specificity beyond the category of "commercial tort claims" (*e.g.* "all claims arising out of the explosion occurring at the debtor's Chicago fireworks factory on July 4, 2001"). § 9-108(e)(1). Unlike financing statements (as discussed below), a description of collateral in a security agreement may not use a generic statement, such as "all my personal property." § 9-108(c).

Proceeds. As with current Article 9, a security interest automatically attaches to "proceeds" of the collateral. §§ 9-203(f), 9-315(a)(2). Revised Article 9 expands the definition of "proceeds" to include:

- rights arising out of the license of property, and
- distributions on stock.

§ 9-102(a)(64).

Supporting obligations. Revised Article 9 collects into a new concept several kinds of rights, such as guaranties and underlying collateral, that are understood under current law to follow the debt and calls these rights "supporting obligations." § 9-102(a)(77). Under revised Article 9:

- the creation of a security interest in a payment obligation automatically attaches to "supporting obligations" related to the obligation. § 9-203(f), and
- the perfection of a security interest in the supported obligation

automatically perfects the security interest in the supporting obligation. § 9-308(d).

Transfers of intangibles. Current § 9-318(4) renders ineffective any restriction in an account or a general intangible consisting principally of a right to payment that would prevent the sale of the account or the creation of a security interest in the general intangible. Revised Article 9 builds on this. §§ 9-406 and 9-408

If a general intangible or account represents a right to payment (*e.g.* an obligation to pay fees under a license), revised Article 9 renders wholly ineffective any restriction in an account, promissory note, payment intangible, or chattel paper, or under other law, that would interfere with the:

- creation or perfection of a security interest in the right to payment, or
- enforcement of the secured party's security interest in the right to payment.

§ 9-406(d) and (f). These rules do not apply to the *sale* of a payment intangible. The next paragraph describes the rules that apply to the *sale* of that type of collateral.

For other kinds of rights, such as payment intangibles (when sold) and a *licensee's* rights under a license, revised Article 9 renders ineffective a restriction on transfer, in the contract or arising under other law, *to the extent* the restriction would interfere with the creation, attachment or perfection of the security interest. § 9-408(a) and (c). Revised Article 9 does *not* interfere with the enforceability of an otherwise effective restriction (in the contract or under other law) on the secured party's enforcement of its security interest in the general intangible. § 9-408(d).

Perfection: other than filing

Introduction. Revised Article 9 clarifies the application of existing rules. It also applies to different kinds of collateral methods of perfection that under current Article 9 apply to a more limited set of collateral.

Possession by bailee. Revised Article 9 modifies the existing method of perfecting a security interest by possession where a third party has possession of the collateral. Most decisions under current law hold that the secured party can perfect its security interest by giving notice of the security interest to the baileee. Revised Article 9 requires that the bailee:

- receive notice, *and*
- acknowledge in an authenticated record that it is holding the collateral "for the secured party's benefit."

§ 9-313(c).

Control. As a result of amendments to Article 8 completed in 1994, current Article 9 permits "control" of investment property to serve as a method of perfecting of a security interest in investment property. For a security entitlement, this requires an agreement between the secured party and securi-

ties intermediary that the securities intermediary will comply with entitlement orders originated by the secured party without further "consent" of the debtor. §§ 8-106, 9-106(a). Revised Article 9 clarifies that the secured party's agreement with the debtor that the secured party will not exercise its control rights until a subsequent event happens, such as the debtor's default, does not interfere with the present existence of control. § 8-106, Official Comment 4 (revised). Present control (and therefore perfection) will not exist if the secured party's future exercise of control requires the consent of the debtor.

Revised Article 9 also permits use of the control procedure as a method of perfection for:

- deposit accounts,
- letter of credit rights, and
- electronic chattel paper.

§ 9-314(a).

The meaning of "control" for deposit accounts closely resembles that for a security entitlement. § 9-104. For electronic chattel paper, control requires a unique "marking" of the electronic chattel paper. § 9-105. A secured party has "control" of a letter of credit right when it obtains the consent of the issuer of the letter of credit to the assignment of the proceeds of the letter of credit under § 5-114(c). § 9-107.

Automatic. As noted above, revised Article 9 provides for automatic perfection of a security interest in several circumstances, including the following:

- *Sale* of payment intangibles
- *Sale* of promissory notes
- Supporting obligations

§§ 9-308(d) and 9-309. These automatic perfection rules do not apply to an obligation secured by payment intangibles or promissory notes, as opposed to a *sale* of one of those two types of property.

Perfection: filing

Introduction. Revised Article 9 makes extensive changes to the rules of the filing system. These are designed to:

- simplify procedures,
- reduce the costs of compliance, and
- reduce the risk of inadvertent errors.

Kinds of collateral subject to filing. Article 9 greatly expands the kinds of collateral where a secured party can use the filing of a financing statement to perfect its security interest. These now include the following types of property, where a secured party could formerly perfect only by possession:

- Instruments
- Investment property (including stock certificates) (until the 1994 revisions to Article 8)

§ 9-310(a). The availability of perfection by filing does not preclude perfection by other available means, such as possession or control (as appropriate). As discussed below, there are special, non-temporal priority rules for some of

these types of collateral when a secured party perfects *only* by filing.

Location of the debtor. Article 9 changes the rules for the location of filing a financing statement. Generally current law provides for the filing of a financing statement in the state where goods are located for goods and in the state of the debtor's chief executive office for intangible collateral, such as accounts and general intangibles. New Article 9 provides for only one place to file for all kinds of collateral: the place of the debtor's "location." § 9-301.

Article 9 then defines "location":

- for an entity created by a filing with a state, the entity's location is that state. § 9-307(f). For example, for a debtor incorporated in Maryland, with its chief executive office in New Jersey, a secured party would file the financing statement in Maryland, the state of the debtor's formation, for *all* kinds of collateral;
- for an entity not created by a filing, the entity's location is the place of its chief executive office (§ 9-307(b)); and
- for an individual, the person's location is her principal residence (§ 9-307(b)).

The debtor's name. Article 9 continues the requirement that the financing statement include the debtor's name. § 9-502(a)(1). Article 9 also continues the disapproval of the use of a fictitious name in place of the debtor's "real" name. § 9-503(c).

Article 9 also contains a statutory rule to determine when a mistake in the debtor's name is so incorrect as to make the financing statement ineffective. § 9-506c). The financing statement *is* effective if a computer search run under the debtor's correct name turns up the financing statement with the incorrect name. If it does not, then the financing statement is *not* effective. The court has no discretion to determine that the incorrect name is "close enough." As a result the secured party is dependent on the kind of computer search logic used by a particular state's filing office. The simple answer is to get the name right.

Article 9 rejects decisions that suggest that if the secured party is acting on behalf of others that the financing statement must indicate that the secured party is acting in a representative capacity. § 9-503(d).

Indication of the collateral. Most decisions under current law do *not* permit a "supergeneric" "all assets" indication of collateral in a financing statement. New Article 9 will permit the use of this type of description in a *financing statement*, assuming of course that the description accurately describes the deal between the secured party and the debtor. § 9-504(2). Article 9 continues the current rule that a supergeneric description will *not* suffice in a *security agreement*. § 9-108(c).

The debtor's signature. In perhaps the most dramatic change, Article 9 has

done away with the requirement that the debtor sign the financing statement. § 9-502, Official Comment 3. This will facilitate electronic filing of financing statements and, as a result, electronic searches.

A secured party can file a financing statement (without the debtor's signature) only if authorized by the debtor to make the filing. § 9-509(a)(1). Article 9 provides for automatic authorization to file a financing statement consistent with the security interest granted by the debtor in the security agreement. § 9-509(b). A secured party would need express authorization to pre-file a financing statement if the debtor has not yet authenticated a security agreement.

This change should not have any effect on the possibility of the filing of fraudulent financing statements. Under current law and procedures a person can forge a debtor's signature on a financing statement and file it with the filing office. The filing office has no way of checking the validity of a signature.

Priority

General rule. Generally Article 9 continues the long-standing rule that the first secured party to file a financing statement or to perfect its security interest has priority. § 9-322(a)(1). There are a number of non-temporal exceptions, generally based on the method of perfection. Some of these are described below.

Effect of other articles of UCC. Article 9 defers to the rights of holders in due course under Article 3 and protected purchasers under Article 8 "to the extent" those articles provide rights to those persons. § 9-331. The provisions in other articles do not always give priority to persons protected by those articles in all disputes with a secured party under Article 9. *See* §§ 3-305, 3-306, 8-303. *See also* § 8-501 (revised).

Filing v. control. As discussed above, a secured party with a security interest in investment property, a letter of credit right, and electronic chattel paper may perfect its security interest by filing or control. A secured party that perfects a security interest in investment property or a letter of credit right *only* by filing will *not* have priority against a secured party that *later* perfects by control, even if the second secured party knows of the prior perfected security interest. §§ 9-328(1), 9-329(1). A secured party that does not fear a debtor double-financing collateral can rely on a simple filing of a financing statement to perfect the security interest and defeat a lien creditor, including a trustee in bankruptcy and debtor in possession.

Filing v. possession. Similarly, the new right to perfect a security interest in an instrument by the filing of a financing statement does not protect the secured party that perfects by filing against a subsequent secured party that perfects by taking possession of the instrument, unless the second secured party knows that its purchase violates the rights of the first secured party. § 9-330(d). Once again, the decision of whether to depend solely on the filing of a financ-

ing statement to perfect a security interest will turn on the level of confidence in the debtor.

Automatic v. other methods of perfection. As noted above a security interest arising out of the *sale* of a promissory note is automatically perfected. Generally, a subsequent secured party that takes possession of the promissory note will have priority over a secured party that perfects its security interest solely through the automatic perfection rules, unless the subsequent secured party knows that its security interest violates the rights of the first secured party. § 9-330(d). Nevertheless, a secured party purchasing promissory notes, but leaving them in the hands of the seller for servicing, will often take this approach, confident that the secured party's rights will survive the seller's bankruptcy.

The security interest created upon the *sale* of a payment intangible is also automatically perfected. Because there is no alternative means of perfection (such as possession), the buyer ("secured party") does not have to worry about non-temporal priorities.[5]

Control v. control. Current Article 9 provides that two secured parties that each have control of investment property rank equally. New Article 9 changes the rule to temporal priority. § 9-328(2). The same rule applies to perfection of a security interest in a deposit account, where control is the only method of obtaining perfection. § 9-327.

Purchase-money security interests. Article 9 continues the priority for purchase-money[6] security interests. § 9-324. It is not clear under current § 9-312(4) whether a secured party can obtain a purchase-money security interest in intangible collateral. New Article 9 resolves that ambiguity with a rule that a secured party may obtain a purchase-money security interest only in goods, with one exception. § 9-103(a)(1). The exception permits a purchase-money security interest in software if the debtor acquired its interest in the software:

- for the principal purpose of running the software on hardware in which the secured party also has a purchase-money security interest, *and*
- in an integrated transaction with the acquisition of the related hardware.

§ 9-103(c).

Except for consumer-goods transactions, Article 9 rejects the "transformation rule" that some courts applied under the old Article 9 that provided that purchase-money security interest could lose its "purchase-money" character in certain circumstances, such as a refinancing of the purchase-money debt or having other collateral secure the pur-

[5] These priority rules between multiple assignees do not necessarily control the question of whom the account debtor should pay. *See* § 9-406(a) – (c), Official Comment 7.

[6] The "-" is officially part of the term.

chase-money debt. § 9-103(f). Article 9 validates the "dual status" rule that permits collateral to have both purchase-money and non-purchase-money status. § 9-103, Official Comment 7.

Transfers of collateral

General. As under current law, a security interest continues in collateral that the debtor has transferred. § 9-315.

Money. The priority of rights to money and its close equivalents, such as checks, often raise disputes. Article 9 resolves many of these disputes.

A secured party with a junior security interest in accounts may collect checks in which another secured party has a prior security interest. The junior secured party's security interest in the checks will prevail if the junior secured party can establish holder in due course status. § 9-332. It may very difficult (if not impossible) for the junior secured party to establish that fact if it has notice of the senior secured party's claim to the instrument. §§ 3-302, 9-331. *See also* § 9-332. The junior secured party may also have rights under § 9-330(d) as a secured party that has perfected its security interest in an instrument by possession over another secured party that has perfected by a method other than by possession.

If the *debtor* collects the accounts and transfers *money* to a junior secured party (or anyone else), the transferee will take free of a security interest unless the transferee acts in "collusion" with the debtor in violating the rights of the secured party. § 9-332.

New debtor. A person (a "new debtor") will "become bound" by a security interest that another person entered into if under other law:

- o the other person's security agreement becomes effective to create a security interest in the property of the second person, or
- o the second person becomes generally obligated for the obligations of the other person and the second person acquires all or substantially all of the assets of the other person.

§§ 9-102(a)(56), 9-203(d). The financing statement filed against the original debtor will be effective against the new debtor if it would have been effective if filed against the new debtor. § 9-508. This will ordinarily involve a determination whether the name of the new debtor is sufficiently close to the name of the original debtor to pass the computerized "seriously misleading" test of § 9-506(c).

Buyers of goods. Buyers in ordinary course will continue to "take free" of a security interest created by the buyer's immediate seller. § 9-320.

Licensees. A licensee under a *non*exclusive license in ordinary course will also "take free" of a security interest created by its immediate licensor.[7] It is important to note that the nonexclusive

[7] In this circumstance "takes free" means that the nonexclusive licensee can continue to enjoy its rights under the license following a foreclosure against the licensor so long as the licensee performs its obligations under the license.

licensee will not "take free" of a security interest created by a remote licensor. For example, if a licensor grants a security interest in its intellectual property and then grants an *exclusive* license to a licensee, the exclusive licensee would not "take free" of the security interest. A person who obtained a *non*exclusive *sub*license from the original licensee in this circumstance would *not* "take free" of the security interest created by the *original* licensor.

Enforcement

Introduction. Much of the litigation under Article 9 arises in connection with the enforcement of a security interest. New Article 9 resolves many of the disputes that have arisen in litigation.

Commercial reasonableness. Each "aspect" of a foreclosure sale must be "commercially reasonable." § 9-610(b). Some debate has occurred over the years on whether the foreclosure sale price *itself* must satisfy that test. New Article 9 indicates that a low price "of itself" will not make a foreclosure sale not commercially reasonable. § 9-627(a). However a low price obtained at the foreclosure sale "suggests that the court should scrutinize carefully all aspects of a disposition." § 9-610, Official Comment 10. There is one circumstance discussed below where it can have a greater effect.

Guarantors. Article 9 makes clear that a guarantor of an obligation subject to Article 9 is entitled to the same notices and protections as the debtor and may not waive those rights before default. §§ 9-102(a)(59), 9-602.

Notices. New Article 9 returns to the rule of the original Article 9, abandoned in the 1972 revisions, that a secured party must give enforcement notices to other secured parties, as well as the debtor. § 9-611(c)(3)(B). Article 9 implements this rule in a way where the secured party can have confidence it has given notice to all necessary persons without going to extraordinary efforts to identify and locate them. § 9-611(c).

Rebuttable presumption rule. The courts have long debated whether a failure to meet the notice or commercially reasonable requirements of current Article 9 would:

- bar all deficiencies (the "absolute bar" rule"), or
- just reduce the secured party's deficiency to the extent the failure to comply affected the price obtained at the foreclosure sale (the "rebuttable presumption rule").

Except in consumer transactions, Article 9 establishes by statute the rebuttable presumption rule. § 9-626(a)(3).

Certain low-priced foreclosure sales. Article 9 contains a special rule where:

- a secured party, a person related to the secured party, or a guarantor of the secured debt, purchases the collateral at a foreclosure sale, *and*
- The purchase price is "significantly below the range of proceeds that a complying disposi-

tion to a person [other than one of those persons] ... would have brought."

§ 9-615(f). In that circumstance alone, Article 9 reduces the secured party's deficiency claim by the amount that the foreclosure sale would have brought had some other person purchased the collateral at the sale instead of the amount that the secured party or other specified purchaser paid a the foreclosure sale. A secured party should be able to protect itself from this problem by credit bidding an amount that is at least the "strike price" that the secured party would credit bid if there were competitive bidding.

Noncash proceeds. A secured party may sometimes receive something other than cash at a foreclosure sale – such as a note from the foreclosure sale buyer. The secured party does not have to apply the noncash proceeds to the debt unless not to do so would be commercially unreasonable. If a secured party does apply the noncash proceeds to the secured debt, it must do so in a commercially reasonable manner. This gives the secured party some flexibility in placing a value on the noncash proceeds and applying appropriate discounts. § 9-615(c).

Retention in satisfaction of debt. Current Article 9 is ambiguous on whether a secured party can retain collateral in satisfaction of the debt if the secured party does not have possession of the collateral. This effectively limits the ability to retain collateral in satisfaction of the debt to tangible collateral. Except in a consumer transaction, new Article 9 would permit the secured party to retain collateral in satisfaction of the debt even if the secured party was not in possession and also if the collateral is intangible. § 9-620, Official Comment 7. The debtor retains its right to require the secured party to sell the collateral in a foreclosure sale by objecting to the secured party's proposal to retain the collateral. § 9-620(c)(2).

Article 9 rejects decisions that held that a secured party could discover that its extended possession of collateral without disposing of it could result in a constructive retention in full satisfaction of the debt. § 9-620(b).

New Article 9 also clarifies that, except in consumer transaction, the secured party and the debtor can agree that the secured party will retain the collateral in partial satisfaction of the debt. § 9-620(a). An acceptance in partial satisfaction can take place only if the debtor affirmatively agrees to have that happen.

Consumer matters

Introduction. Article 9 contains many provisions providing special rules in consumer transactions. In some instances, the compromise reached was to say nothing in Article 9 and leave it to the courts to decide what to do in a consumer transaction.

Definition. Article 9 defines a "consumer transaction" as one in which:

- o an individual incurred an obligation primarily for personal, family

or household purposes,

- a security interest secures the obligation, *and*
- the collateral is held primarily for personal, family or household purposes

Some of the consumer rules apply only to "consumer-goods transactions,"[8] which are consumer transactions where the collateral is goods.

Creation of security interest. In a non-consumer transaction, a security agreement may, among other ways, describe the collateral by Article 9 type. § 9-108(b)(3). In a consumer transaction, a description by type is not sufficient if the collateral is consumer goods, a security entitlement, or a securities account. § 9-108(e).

Enforcement. There are a variety of special notices that consumers receive in connection with the foreclosure of a security interest. *See generally* §§ 9-612 – 9-616. The "rebuttable presumption" rule that applies to commercial transactions (§ 9-626(a)(3)) does not apply to a consumer transaction. § 9-626(a). The courts are directed "not [to] infer" anything from the fact that the rebuttable presumption rule does not apply by statute to consumer transactions and the courts are free to adopt that rule or any other rule.

Transition rules

Introduction. The many changes in Article 9, especially the perfection rules, inevitably make the transition rules complex. Generally, unless Part 7 of the new Article 9 states an exception, the new Article 9 applies to all aspects of a transaction subject to the new Article 9. There are some important exceptions. The proposed uniform effective date of July 1, 2001 is intended to reduce any disruptive effect of the transition rules by having as many states as possible have the new Article 9 go into effect on the same day.

Pre-effective date transactions (§ 9-702). Earlier transactions outside of Article 9 that are now subject to Article 9 remain effective except *to the extent* provided in Part 7. For example, a security interest in a commercial tort claim effective under other law prior to the effective date of the new Article 9 remains effective and secured party may enforce the security interest under either non-Article 9 law or under the new Article 9.

Earlier perfected security interests (§ 9-703). A security interest perfected under current Article 9 *remains* perfected if:

- the secured party perfected the security interest under prior law (under Article 9 or outside of Article 9), *and*
- the acts of perfection (under current Article 9 or outside of Article 9) would *also* perfect the security interest under new Article 9

Except for security interests perfected by filing under current Article 9 (discussed below), a security interest perfected under current Article 9 maintains

[8] The "-" is officially part of the term.

perfected status for *only* one year after new Article 9 comes into effect if:

- the secured party perfected the security interest under prior Article 9 or outside of prior Article 9, *and*
- those perfection steps do *not* suffice to perfect the security interest under the new Article 9

Such a security interest will remain continuously perfected under new Article 9 if:

- the secured party had perfected the security interest under prior Article 9, *and*
- the secured party satisfies the creation and perfection requirements under new Article 9 within one year after the effective date of the new Article 9

Earlier attached, unperfected security interests (§ 9-704). A security interest that has attached under prior Article 9 remains *attached* (and enforceable) for one year *only* if:

- the security interest has attached (is enforceable) under prior law, *but*
- the security interest has not attached under new Article 9

The security interest remains enforceable *after* one year if the secured party takes any necessary additional steps for attachment under new Article 9 before or within one year after new Article 9 takes effect

An attached, but unperfected, security interest becomes *perfected* under new Article 9:

- if the secured party took appropriate steps to perfect the security interest under the rules of the new Article 9 *before* new Article 9 becomes effective, then when the new Article 9 becomes effective
- if the secured party takes appropriate steps to perfect the security interest under the rules of the new Article 9 steps *after* the new Article 9 becomes effective, then when the secured party takes those steps

Effect of action taken before effective date (§ 9-705). A security interest becomes perfected after the effective date of the new Article 9 and remains *perfected* for one year after the effective date of the new Article 9 if:

- the secured party has taken the acts effective to perfect (*other than by filing* a financing statement) under prior Article 9 at the time of effective date of new Article 9, *and*
- the security interest *attaches after* the effective date of new Article 9[9]

An act to perfect a security interest (other than by the filing of a financing

[9] § 9-703 (discussed above) deals with the circumstance of a security interest perfected before the effective date of the new Article 9 by a method other than the filing of a financing statement. Note that a security interest will not attach and thus not be perfected until the debtor has rights in the collateral. When the debtor acquires its rights in the collateral after the effective date of the new Article 9, § 9-705 applies.

statement) will perfect a security interest under new Article 9 for more than one year if:

- security interest attaches under new law, *and*
- the secured party has taken the acts sufficient to perfect under new Article 9 before *or* after the effective date of the new Article 9

The filing of a *financing statement prior* to the effective date of new Article 9 is effective to perfect a security interest under the new Article 9 to the extent it would be effective under new Article 9. This requires:

- a description of collateral that suffices under the new Article 9, and
- a filing in the correct state under the new Article 9

The filing of an effective financing statement under prior Article 9 remains effective under new Article 9 (including to perfect a security interest in collateral arising after the effective date of the new Article 9) until the *earlier* of:

- the normal lapse date of the financing statement (generally five years after filing of financing statement), and
- five years after the effective date of new Article 9

A secured party may file a "real" "continuation statement" under new Article 9 to continue a financing statement filed under the prior Article 9 *only* if:

- the continuation statement is filed in the state where the financing statement was filed under prior law, *and*
- that state is the correct state for the filing of a *new* financing statement under the *new* Article 9

Initial financing statement filed in lieu of a continuation statement (§ 9-706). Unless a "real" "continuation" statement is filed under § 9-705 (as discussed above), a financing statement filed under the prior Article 9 is "continued" by:

- the filing of a complying *initial* financing statement under new Article 9, *and*
- the initial financing statement is filed in the correct state under the *new* Article 9

Effect of transition rules on priority (§ 2-708). Prior Article 9 governs priorities if the relative priorities of the secured parties were "established" before new Article 9 came into effect. Otherwise, the new Article 9 governs priorities.

Conclusion

Revised Article 9 brings Article 9 into the age of intangible property and adapts it to modern financing techniques. The adoption process now moves on to the states. The effectiveness of the new Article 9 will:

- Facilitate financing,
- Reduce the cost of financing,
- Bring greater certainty to financing transactions, and

- Provide greater protections to debtors in the foreclosure process.

The Chair, the Reporters, the Drafting Committee, and the observers have worked hard and delivered an excellent product. We should all look forward to practicing under the new Article 9. ❾

March 1, 1999

THE BASIC UNIFORM COMMERCIAL CODE, ARTICLE 9

SECURED TRANSACTIONS

AN INTRODUCTION

The Uniform Commercial Code has eleven substantive articles. Article 9 - Secured Transactions may be the most important of the eleven. Article 9 provides the rules governing any transaction (other than a finance lease) that couples a debt with a creditor's interest in a debtor's personal property. If the debtor defaults, the creditor may repossess and sell the property (generally called collateral) to satisfy the debt. The creditor's interest is called a "security interest." Article 9 also covers certain kinds of sales that look like a grant of a security interest.

The operation of Article 9 appears deceptively simple. There are two key concepts: "attachment" and "perfection". These terms describe the two key events in the creation of a "security interest". Attachment generally occurs when the security interest is effective between the creditor and the debtor, and that usually happens when their agreement provides that it takes place. Perfection occurs when the creditor establishes his or her "priority" in relation to other creditors of the debtor in the same collateral. Perfection occurs usually when a "financing statement" is filed in the appropriate public record. Generally, the first to file has the first priority, and so on.

Article 9 relies on the public record because it provides the means for creditors to determine if there is any security interest that precedes theirs - a notice function. A subsequent secured creditor cannot complain that his or her grant of credit was made in ignorance of the prior security interests that the record displays, and cannot complain of the priority of the prior interests as a result. Every secured creditor has a priority over any unsecured creditor.

The somewhat simple description in the prior paragraphs should not mislead anyone. Article 9 is not simple. There are substantial exceptions to the above-stated perfection rule, for example. Filing is not the only method for perfection. Much depends upon the kind of property that is collateral. Possession of collateral by the secured party is an alternative method of perfection for many kinds of collateral. For some kinds of property, control (a defined term) either perfects the interest or provides a better priority than filing does. There are kinds of transactions for which attachment is perfection. Priority is, also, not always a matter of perfecting a security interest first in time.

The following chapters of this back grounder are meant to suggest and highlight Article 9 as revised in 1998. They are not a treatise on revised Article 9, but are meant to be a schematic guide to it. Each chapter addresses a specific topic qua issue. What follows in this introduction is an introduction to each of those issues.

1. *The Scope Issue.* The 1998 revision expands the "scope" of Article 9. What this means literally is that the kinds of property in which a security interest can be taken by a creditor under Article 9 increases over those available in Article 9 before revision. Also, certain kinds of transactions that did not come under Article 9 before, now come under Article 9.

2. *Perfection.* Although filing a financing statement remains the dominant way to perfect a security interest in most kinds of property, there are expanded property types in which "control" is the operative method of perfection. Specific perfection rules are extended to property that comes under the scope of Article 9 for the first time in the 1998 revisions.

3. *Choice of Law.* In interstate secured transactions, it is necessary to determine which state's laws apply to perfection, the effect of perfection and the priority of security interests. It is particularly important to know where to file a financing statement. The 1998 revisions to Article 9 change the rules substantially.

4. *The Filing System.* Improvements in the filing system in the 1998 revisions to Article 9 include a full commitment to centralized filing - one place in every state in which financing statements are filed, and a filing system that escorts filing from the world of filed documents to the world of electronic communications and records.

5. *Consumer Transactions.* Revised Article 9 makes a clearer distinction between transactions in which the debtor is a consumer than prior Article 9 did. Enforcement of a security interest that is included in a consumer transaction is handled differently in certain respects in the 1998 revisions to Article 9 than it was pre-1998. Although it governs more than consumer transactions, the good faith standard becomes the objective standard of commercial reasonableness in the 1998 revisions to Article 9.

6. *Default and Enforcement.* Article 9 provisions on default and enforcement deal generally with the procedures for obtaining property in which a creditor has a security interest and selling it to satisfy the debt, when the debtor is in default. Normally, the creditor has the right to repossess the property. Revised Article 9 includes new rules dealing with "secondary" obligors (guarantors), new special rules for some of the new kinds of property subject to security interests, new rules for the interests of subordinate creditors with security interests in the same property, and new rules for aspects of enforcement when the debtor a consumer debtor.

SCOPE OF UNIFORM COMMERCIAL CODE, ARTICLE 9

SECURED TRANSACTIONS

IMPACT OF THE 1998 REVISIONS

What kinds of property may become collateral under Uniform Commercial Code, Article 9? This is the "scope" question. In the 1998 revision to Uniform Commercial Code, Article 9, scope expands. That is, more kinds of property may be used as collateral and more types of transactions are covered. Also, some kinds of property that may have fallen into a more general category of collateral under pre-1998 Article 9, become defined and subject to specific rules.

SCOPE OF UNIFORM COMMERCIAL CODE, ARTICLE 9 BEFORE THE 1998 REVISIONS

These kinds of property were (and will continue to be in the 1998 revisions to Article 9) subject to Article 9:

1. *Tangible personal property.* Property that is not real estate, but is tangible in form. Subdivisions of "tangible personal property" include "consumer goods", "equipment", "farm products", and "inventory".

2. *Fixtures.* This category of tangible personal property is separated from other personal property. Fixtures are items of tangible personal property that become so attached to real property that they are treated as part of the real estate. Fixtures begin as personal property, become real estate, but become personal property again when removed from the real estate. Special rules apply to fixtures under Article 9.

3. *Documents.* These are "documents of title" which, in general, establish that the person in possession has the rights to the goods which are represented in the title document. Bills of lading, dock warrants, dock receipts and warehouse receipts are included.

4. *Instruments.* An instrument generally is a negotiable instrument that evidences a right to the payment of money. An instrument becomes negotiable when it meets the criteria for negotiability in Article 3 of the Uniform Commercial Code. A note or draft is an example.

5. *General Intangibles.* Any intangible (meaning not goods) property interest that is not specifically addressed in Article 9. This is a gap filling concept. Investment property is intangible property, for example, but because it is specifically addressed in Article 9, it is not a

general intangible.

6. ***Chattel Paper.*** The writings that evidence a debt owed coupled with a security interest in goods or a lease of goods are chattel paper.

7. ***Accounts.*** An account is any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper. A "deposit account" like a bank account is not included.

SPECIFIC EXCLUSIONS FROM UNIFORM COMMERCIAL CODE ARTICLE 9 BEFORE 1998

These kinds of property or transactions are specifically excluded in the pre-1998 Article 9:

1. Statutory or common law liens.
2. Tort claims.
3. Deposit accounts (except those represented by certificates of deposit).
4. Governmental transfers.
5. Insurance claims or interests.
6. A right represented by a judgment.
7. Creation or transfer of an interest in or a lien on real estate.
8. Federally preempted rights.
9. Set off.
10. Transfer of a claim for wages, salary or compensation.
11. Sale of accounts and chattel paper as part of a sale of the business from which they arose:
12. Assignment of accounts and chattel paper for collection only, and
13. Transfer for performance of a contract or transfer of a single account to satisfy a pre-existing indebtedness.

14. Transfer of interest in a letter of credit, except for proceeds of a written letter of credit

CHANGES IN THE SCOPE OF UNIFORM COMMERCIAL CODE, ARTICLE 9 IN 1998

The 1998 revision to Article 9 keeps many of the exclusions in pre-1998 Article 9 but makes some significant changes as well. This list of changes tend to fall (though not wholly) into two categories, interests that are no longer excluded and interests that were included under more general categories such as "general intangibles" or "accounts" but that need to be addressed with specific secured transaction rules:

1. *Nonpossessory, statutory agricultural liens.* These liens were excluded under Article 9 prior to 1998. They are included for purposes of perfection and priority in revised Article 9. *Note other nonpossessory statutory liens remain excluded.*

2. *Sales of payment intangibles and promissory notes.* Payment intangibles were a kind of general intangible, now distinguished by the characteristic of a primary monetary obligation. Promissory notes are a kind of instrument. These interests are sold, securitized and pooled. The interests sold are so like security interests that distinguishing these sales transactions from secured transactions is virtually impossible. The 1998 revision to Article 9 includes these kinds of property.

3. *Security interests created by governmental debtors.* The general pre-1998 exclusion has been narrowed. Only those governmental transfers that are subject to another statute on establishing and enforcing security interests are excluded. Federal preemption would, also, apply.

4. *Health insurance receivables.* The general exclusion of insurance proceeds in pre-1998 Article 9 is curbed for these specific kinds of receivables.

5. *Consignments.* Consignments of goods are included within the scope of Article 9 in the 1998 revisions. A consignment is a delivery of goods by the owner to another person, who sells for the consignor. A consignor is deemed to hold a purchase money security interest as against the consignee's secured creditors in the 1998 revisions to Article 9. Failure to comply with the requirements for a purchase money security interest potentially subjects the goods to the consignee's secured creditors. Before the 1998 revisions, a consignor had to perfect by filing a financing statement even though consignments fell within the scope of Article 2.

6. *Commercial tort claims.* The general exclusion of tort claims is narrowed so that security interests may be taken in commercial tort claims.

7. *Liens on property.* Certain liens on real property are included to the extent the

lien establishes a right to payment.

8. ***Deposit accounts.*** Security interests may be taken in deposit accounts (with some restrictions). A security interest can be taken, therefore, in an ordinary bank account.

9. ***Supporting obligations.*** An example is a guarantee of payment or a letter of credit supporting an obligation to pay money.

PERFECTION OF SECURITY INTERESTS

UNIFORM COMMERCIAL CODE, ARTICLE 9

THE 1998 REVISIONS

A security interest is perfected when the secured creditor has met the statutory requirements for notice to unsecured creditors, and most creditors who perfect their interests after the first secured creditor's perfection. There are four basic kinds of perfection: 1) perfection by filing; 2) perfection by possession; 3) perfection by control; and, 4) automatic perfection. All forms of perfection were available in Article 9 before 1998. However, Article 9 assigns a perfection method for each new kind of property within its scope in the 1998 revisions. "Control" as a method of perfection is expanded beyond the single kind of property, investment property, in which a security interest could be perfected by control in the pre-1998 Article 9. Thus "control" takes on new and larger significance after 1998 than it did before 1998.

Automatic perfection is specific to certain kinds of transactions. Purchase money security interests in consumer goods are a kind of security interest that perfects automatically. However, automatic perfection is usually temporary and extinguishes unless another appropriate form of perfection occurs during the temporary period of automatic perfection. There are more kinds of automatic perfection in the 1998 revisions than was the case before 1998.

Unless otherwise noted, conflicting security interests take priority in order of filing or other perfection in time. First in time usually wins, but note that purchase money security interests often provide a creditor priority notwithstanding the time perfection took place.

Each method of perfecting a security interest is discussed as follows:

1. *Filing a financing statement.* Filing a financing statement in the appropriate place of record maintained by a state will perfect almost every kind of security interest (There are some exceptions.). The 1998 revisions make it clearer that filing will perfect, even if there is another method of perfection available. The old maxim, "When in doubt, file," is even more appropriate after the 1998 revisions. This is the time-honored method of perfection.

2. *Possession.* A secured creditor may perfect a security interest in a broad range of collateral by taking possession of that collateral. Possession is the only way to perfect a security interest in money, except for proceeds from a sale of property subject to a security interest. The 1998 revisions to Article 9 clarify issues of possession as a method of perfection, but do not change the rules materially. For example, there is a method for a third-party bailee to

acknowledge the creditor's interest. Such a method is not expressly provided pre-1998.

3. ***Control.*** Control as a method of perfection first applied to investment property in amendments to Article 9 that followed the 1994 revision of Uniform Commercial Code, Article 8. A creditor has control, and a perfected security interest, when the debtor's interest can be transferred by the secured creditor without the debtor's consent. For certain kinds of property, like certificated securities, possession is tantamount to control. The 1998 revisions of Article 9 allow a creditor to perfect a security interest in deposit accounts and letter-of-credit rights by control, as well as in investment property. Control is effectively the only way to perfect a security interest in deposit accounts and letter-of-credit rights. It is possible to perfect an interest in investment property by filing, but perfection by control always has priority over perfection by filing if there are conflicting security interests, no matter which kind of perfection occurs first in time.

4. ***Automatic perfection.*** In some kinds of secured transactions, attachment is perfection. The "purchase money security interest" (PMSI) in consumer goods is such a case of automatic perfection. It arises when credit is extended to purchase goods. Other types of security interests are automatically perfected but only temporarily. An example is a security interest in a certificated security perfected for 20 days even though there is no filing or possession when it is delivered for sale or the like. Generally, a purchase money security interest has priority over security interests perfected before it in time. There are new specific PMSI's in the 1998 revisions, such as a PMSI in computer software and livestock.

Examples of other kinds of security interests that perfect upon attachment are a sale of a payment intangible, a sale of a promissory note, a security interest in a healthcare insurance receivable (all new in 1998), and a broker's security interest in investment property created by the broker (from the 1994 Article 8 revisions). Most of these security interests will, also, have priority over other kinds of security interests that perfect earlier in time.

CHOICE OF LAW RULES

UNIFORM COMMERCIAL CODE, ARTICLE 9

THE 1998 REVISIONS

A transaction in which a creditor takes a "security interest" in the collateral of a debtor may involve more than one state. The creditor may be in one state, the debtor in another, and the collateral in another. Further, the collateral may move at some point in the transaction from one state to another. Both the creditor and the debtor may be able to claim more than one place as residence or domicile. Therefore, Article 9 has always had rules that determine which state's law will apply to the perfection, the effect of perfection and the priority of creditors in collateral.

When perfection requires filing a "financing statement" it is important to identify with certainty the state in which to file the financing statement. It is also important that creditors know with certainty that same state is the state in which they must search the record for financing statements indicating the existence of prior security interests. The state which the "choice of law" rules identify as the state whose law governs perfection, effect of perfection and the priority of creditors in the collateral, is the state in which the financing statement must be filed.

The 1998 revisions to Article 9 both simplify and substantially change the "choice of law" rules, meaning that in some cases different states will be the states in which perfection, the effect of perfection and the priority of creditors will be established than is the case under pre-1998 Article 9. The ultimate result is greater certainty for those who file financing statements and those who search for filed financing statements about which state is the right state.

Major Changes

There are two major changes in the "choice of law" rules:

1. Pre-1998, the basic rule chooses the law of the state in which the collateral is found to govern perfection and the effect of perfection of a security interest. If perfection occurs when a financing statement is filed, then the filing must take place in the state where the collateral is found. In the 1998 revisions, the basic rule chooses the law of the state in which the debtor is located as the law governing perfection, effect of perfection and the priority of a security interest in collateral. If a filing of a financing statement is required, then the statement must be filed where the debtor is, without regard for the location of the collateral. The location of the debtor is less likely to change than the location of the collateral and reliance on the location of the debtor provides creditors with more certainty about where to file and where to search. **(Exceptions to both these rules to be discussed later on.)**

2. If the debtor is a registered organization (corporation, limited partnership, limited liability partnership, limited liability company, etc.), pre-1998 treated the state with the chief executive office as the debtor's state. In the 1998 revisions, the debtor's state is the state in which it is a registered organization. Again, the objective of certainty about the place to file and the place to search is better served by the new rule than by the old rule, but the change will probably result in very little change in the actual place of filing in the vast number of cases.

Exceptions and Continuity

There are prominent exceptions to the new general rule in the 1998 revisions to Article 9. In most instances these exceptions mean no practical change in the choice of law rules from pre-1998 Article 9:

1. All possessory (meaning that there is no filing of a financing statement) security interests are perfected under the law of the state in which the collateral is located (where the creditor has possession). The practical effect is to leave the law unchanged for possessory security interests in any kind of collateral.

2. For other kinds of collateral, there are also no effective changes in the "choice of law" rules. These other kinds of collateral include property subject to certificates of title, and minerals, letter of credit rights and investment property.

3. For deposit accounts, which were not in the scope of pre-1998 Article 9, the location of the bank determines the place for perfection, effect of perfection and non-perfection , and the priority of security interests.

4. For agricultural liens, which were not within the scope of pre-1998 Article 9, the location of the farm products determines the place for perfection, effect of perfection and non-perfection, and the priority of security interests.

5. There are security interests that perfect in the location of the debtor under pre-1998 Article 9. Since the location of the debtor is the fundamental rule in the 1998 revisions, perfection rules effectively do not change for these security interests under the 1998 revisions to Article 9. Included are security interests in accounts, general intangibles and mobile goods (no distinction between mobile and other goods in the 1998 revisions), automatic perfection of a broker in investment property, and automatic perfection of the security interest of a commodity broker in a commodity contract.

Important Differences for Some Collateral

Under the 1998 revisions, the law governing perfection may be different from the law governing effect of perfection and priority of security interests for some kinds of property. These kinds of property include negotiable documents, goods, instruments, money and tangible chattel

THE FILING SYSTEM

THE UNIFORM COMMERCIAL CODE, ARTICLE 9

THE 1998 REVISIONS

The primary and principal method for perfecting a security interest under Uniform Commercial Code, Article 9 is to file a financing statement with the filing authority or authorities in the appropriate state (which state shall be covered in "Choice of Law, The Uniform Commercial Code, Article 9, The 1998 Revisions). Before 1998, most states had centralized the filing of financing statements covering most collateral in one state office. A few states continued to have both general central and local filing for all collateral. Many of the states that have centralized filing for most collateral, still continue to have local filing for some kinds of collateral. The result is a very mixed array of filing and search requirements. For filing must facilitate the search of records by subsequent creditors who must be able to find prior security interests. The fundamental objective of uniformity has been substantially impaired by the lack of uniformity just in the filing systems.

The new filing system is designed to forge a uniform system that is simpler and more reasonable to use:

1. *Medium neutral.* The new system is designed to be medium neutral. This simply means that the filing systems are no longer to be required to file paper only. The systems can convert to any and all forms of electronic communications for filing purposes.

2. *Centralized filing.* Every state will have a central filling authority. One place to file and one place to search. The only exception is fixture filings, which must continue to be made (and searched) in the real estate records.

3. *Simplified financing statement.* The statement must name debtor, creditor and generally describe some collateral. No signature is required. Identity of filer is immaterial.

4. *Filing office operations.* No discretion resides in the filing office as to sufficiency of a filing. A file cannot be cleared until one year after a termination occurs, extending the availability of the record for one year longer than pre-1998 Article 9.

5. *Correction statement.* A debtor can file a correction to an improper or falsely filed financing statement.

6. *Extended effective dates.* Most financing statements lapse after five years from the

paper. The effect of perfection and priority of nonpossessory security interests in these kinds of collateral will be determined by the location of the collateral. This means that the place to file or the place where automatic perfection takes place, is the location of the debtor, but the impact of filing may be determined under the law of the state where the collateral is.

CONSUMER TRANSACTIONS

GOOD FAITH

UNIFORM COMMERCIAL CODE, ARTICLE 9

THE 1998 REVISIONS

CONSUMER TRANSACTIONS

In the 1998 revisions to Uniform Commercial Code, Article 9, there are special provisions for secured transactions in which the debtor is a consumer. A "consumer transaction" is defined to be one in which an individual incurs an obligation primarily for personal, family, or household purposes, a security interest secures the obligation, and the collateral is held or acquired primarily for personal, family, or household purposes. Most consumer secured transactions are consumer-goods transactions, meaning that an individual purchases an item, i.e. a refrigerator, a couch, and finances the purchase. The item, i.e., the refrigerator, the couch, are the collateral. If the consumer debtor defaults on the debt, the item is repossessed. The 1998 revisions make a distinction between a consumer debtor and a consumer obligor. In Article 9, a "debtor" is defined in terms of an interest in the collateral. An "obligor" is a person obligated to pay the debt. Usually they are the same person, but there are obligors who are not debtors, i.e., a person who guarantees the payment of the debt for the debtor. Most of the special consumer transaction rules pertain to enforcement of a security interest after the debtor defaults on the basic obligation. Some of these rules are as follows:

1. *Right to Redeem.* A consumer-goods transaction debtor may not waive the right to redeem collateral taken to satisfy the debt, a right which all debtors have. Redemption is the right under Article 9 that collateral be returned to the debtor if the debt is satisfied after a default. Commercial and business debtors are able to waive that right as part of credit acquisition. Consumer debtors will not be able to waive their right.

2. *Process Presumption.* In an action against a secured creditor for errors in enforcement and collection process, the presumption is that the collateral is worth the debt. In order to establish a deficiency, a creditor must rebut the presumption. These rules do not apply to consumer transactions. The courts will determine the rule to apply in consumer transactions and could choose a different rule.

3. *No Dual Status Rule.* The 1998 revisions to UCC Article 9 provide that the same collateral may secure a purchase-money security interest and a non-purchase-money security interest. This "dual status" rule is adopted in the 1998 revisions to Article 9, rejecting the

date of filing. Two kinds of financing statements, those for public-finance transactions and for manufactured-home transactions are initially effective for 30 years.

7. ***National forms and fees.*** There is an effort to establish the same forms for filing in every state and to nationalize filing fees. Uniformity, therefore, is intended to go to the administration of filing as well as to the basic law.

opposing "transformation" rule applied in some pre-1998 court cases. Because the "dual status" rule may limit the benefit of purchase money security interests, consumer-goods transactions are excepted from its application. In a consumer-goods transaction, the courts must determine the appropriate rule to apply.

4. *Pre-Payment Rights.* Amendments to Article 2 of the Uniform Commercial Code that accompany the 1998 revisions to Article 9 provide greater protection for a consumer buyer of goods who pays in whole or in part before delivery of the goods. The buyer has an enforceable interest under Article 2 that allows the buyer to obtain the goods.

5. *FTC Rule 433.* A consumer's rights under Federal Trade Commission Rule 433 on preservation of claims and defenses are specifically recognized in the 1998 revisions to Article 9, and will continue even if the required notification in the appropriate record is missing.

6. *Deficiency Statement.* A consumer-goods debtor or consumer obligor is entitled to a written statement which provides the amount of a deficiency (what is owed after collateral is sold to satisfy the debt) and the calculation which results in that amount.

7. *No Partial Satisfaction.* A secured party may not accept collateral as partial satisfaction of a consumer obligation.

8. *Sufficient Description.* A description of consumer goods, a security entitlement, a security account, or a commodity account that is by category only is not a sufficient description when there is a consumer transaction. A security entitlement, a security account and a commodity account are types of investment property under Article 8 of the Uniform Commercial Code.

GOOD FAITH

The 1998 revisions to Article 9 adopt the more "objective" good faith standard: "honesty in fact and observance of reasonable commercial standards of fair dealing."

DEFAULT AND ENFORCEMENT

UNIFORM COMMERCIAL CODE, ARTICLE 9

THE 1998 REVISIONS

When a debtor defaults on an obligation secured under Uniform Commercial Code, Article 9, a secured creditor has a right to take the collateral, sell that collateral, and apply the proceeds to pay off the debt. If the proceeds are insufficient to satisfy the debt, there may be a deficiency that the debtor will be obligated to pay. The creditor will be entitled to pursue the deficiency with the creditor's remedies available under other law. If there is a surplus after sale, that surplus will be the debtor's, unless other creditors act to obtain satisfaction of their debts, as well. Strict foreclosure is an alternative to sale. The creditor keeps the collateral in a strict foreclosure. The procedures under Article 9 are generally non-judicial procedures (Although a creditor may seek enforcement in court.). Usually the secured creditor will repossess the collateral and pursue the available remedies without a court proceeding. Article 9 has its own procedural requirements for creditors. Not following them may mean that a creditor will not obtain a full remedy under Article 9.

The 1998 revisions do not fundamentally change the rules for enforcement of a security interest upon a debtor's default. The revisions provide for problems perceived in enforcement prior to 1998. Some of the important changes are as follows:

1. *Secondary Obligors.* A secured party owes duties to "secondary" obligors on the secured debt. A secondary obligor is liable for a debt only if the primary obligor does not satisfy the debt. A guarantor is an example. There are notifications that must be given to known secondary obligors by secured parties upon default. Contrary to the law of suretyship, the 1998 revisions generally prohibit waiver of rights by a secondary obligor. A secondary obligor can waive notification of disposition of the collateral, and (in a non-consumer transaction) the right to redeem, but only after the default has actually taken place.

2. *Deposit Accounts.* The enforcement rights of a depositary bank holding a security interest in a deposit account are expressly provided for. Security interests in deposit accounts under Article 9 were not possible before the 1998 revision.

3. *Warranties.* A secured party is subject to warranties of title, quiet possession and the like, applicable under other law (usually Uniform Commercial Code, Article 2), including rules for their exclusion or modification when disposing of collateral.

4. *Notification of Junior Creditors.* A secured party taking collateral and disposing of it upon default, has a broader obligation to notify other secured parties and lienholders who have filed financing statements against the debtor covering the same collateral than is the case under pre-1998 Article 9. There are specific notification requirements and a requirement for notification within a reasonable time (no less than 10 days after the earliest time of disposition of the collateral).

5. *Transfer to a Secondary Obligor from Secured Party.* A secondary obligor obtains the rights and assumes the duties of a secured party if it takes an assignment of the secured obligation, agrees to assume the secured party's obligations, or is subrogated to the rights of the secured party. This is not a disposition of the collateral by the secured party, but relieves the secured party of further duties and obligations.

6. *Transfer of Title to Secured Party.* The 1998 revisions make it clear that a transfer of record or legal title to a secured party in order to facilitate a disposition, is not of itself a disposition of the collateral.

7. *Strict Foreclosure.* A secured party may accept collateral in partial (except in consumer-goods transactions) or full satisfaction of a debt. Junior claimants rights are accounted for. Acceptance of collateral in satisfaction of a debt is not of itself an unreasonable delay of disposition. Strict foreclosure is permissible if it is commercially reasonable, and unreasonable delay can occur only if the foreclosure itself is not commercially reasonable.

8. *Damages for Secured Party's Noncompliance.* Secured parties are subject to a "rebuttable presumption" that the collateral value equals the debt if they do not comply with the enforcement procedures and requirements in Article 9 for non-consumer transactions. If there is breach on the part of the secured party, the obligor is credited with the difference between the actual disposition price and the price that would have been paid if the disposition had been conducted in a commercially reasonable manner. The "absolute bar" rule is not mentioned but should be unnecessary (except that it may be selected for consumer transactions).

9. *Deficiency Calculation.* If there is a procedurally regular disposition that nonetheless fetches a low price, and the disposition is to an insider transferee, the deficiency is calculated on the basis of what the price should have been in a commercially reasonable disposition.

SECURITY INTEREST IN CROPS

- **Comments**

The following selected model provisions were proposed by the National Conference of Commissioners on Uniform State Laws, compiled by Douglas A. Baird, Theodore Eisenberg, and Thomas H. Jackson, Commercial and Debtor-Creditor Law 1999 Edition, Appendix II, 1181.

The purpose of these provisions is to allow a farmer "obligor" or "debtor", to grant a "production money security interest" to the supplier of agricultural inputs, which production money security interest in "production money crops" will have priority over a conflicting security interest in the same crops.

- [New Section 2; MODEL SECTION 9-102(a) (65) (66) and (67)] DEFINITION OF "PRODUCTION - MONEY CROPS", "PRODUCTION-MONEY OBLIGATION", and "PRODUCTION OF CROPS". *(Page 9 of SB 366.)*

(65) "Production-money crops" means crops that secure a production-money obligation incurred with respect to the production of those crops.

(66) "Production-money obligation" means an obligation of an obligor incurred for new value given to enable the debtor to produce crops if the value is in fact used for the production of the crops.

(67) "Production of crops" includes tilling and otherwise preparing land for growing, planting, cultivating, fertilizing, irrigating, harvesting, and gathering crops, and protecting them from damage or disease.

- [New Section 3A; MODEL SECTION 9-103a]. *(Page 12 & 13 of SB 366.)* "PRODUCTION-MONEY CROPS"; "PRODUCTION-MONEY OBLIGATION"; PRODUCTION-MONEY SECURITY INTEREST; BURDEN OF ESTABLISHING. *(Loan is for the input only. If farmer owes other money the lien does not apply to that money. If farmer has lien on wheat crop then lien does not apply to corn crop.)*

A security interest in crops is a production-money security interest to the extent that the crops are production-money crops.

(b) If the extent to which a security interest is a production-money security interest depends on the application of a payment to a particular obligation, the payment must be applied:

(1) in accordance with any reasonable method of application to which the parties agree;

(2) in the absence of the parties' agreement to a reasonable method, in accordance with any intention of the obligor manifested at or before the

time of payment; or

(3) in the absence of an agreement to a reasonable method and a timely manifestation of the obligor's intention, in the following order:

(A) to obligations that are not secured; and

(A) if more than one obligation is secured, to obligations secured by production-money security interests in the order in which those obligations were incurred.

(c) A production-money security interest does not lose its status as such, even if:

(1) the production-money crops also secure an obligation that is not a production-money obligation;
(2) collateral that is not production-money crops also secures the production-money obligation; or
(3) the production-money obligation has been renewed, refinanced, or restructured.

(d) A secured party claiming a production-money security interest has the burden of establishing the extent to which the security interest is a production-money security interest.

- **Official Comment**

1. Source. New.

2. Production-Money Priority; "Production-Money Security Interest." This section is patterned closely on Section 9-103, which defines "purchase-money security interest." Subsection (b) makes clear that a security interest can obtain production-money status only to the extent that it secures value that actually can be traced to the direct production of crops. To the extent that a security interest secures indirect costs of production, such as general living expenses, the security interest is not entitled to production-money treatment. *(Money must be used for production crops only. Anything else is not covered.)*

- [New Section 44; MODEL SECTION 9-324(a)]. *(Page ~~42~~ 43 in SB 366.)* PRIORITY OF PRODUCTION-MONEY SECURITY INTERESTS AND AGRICULTURAL LIENS. *(If more than one inputer has a lien on crops then it depends which one if filed first.)*

(a) Except as otherwise provided in subsections (c), (d), and (e), if the requirements of subsection (b) are satisfied, a perfected production-money security interest in production-money crops has priority over a conflicting security interest in the same crops and, except as otherwise provided in Section 9-327, (Page 45 in SB 366) also has priority in their identifiable proceeds.

(b) A production-money security interest has priority under subsection (a) if:

(1) the production-money security interest is perfected by filing when the production-money secured party first gives new value to enable the debtor to produce the crops;

(1) the production-money secured party sends an authenticated notification to the holder of the conflicting security interest not less than 10 or more than 30 days before the production-money secured party first gives new value to enable the debtor to produce the crops if the holder had filed a financing statement covering the crops before the date of the filing made by the production-money secured party; and *(Must tell the bank first. If lender says no, the farmer's only recourse is to inputer. Since input liens are not first, inputers will not give inputs so the farmer must declare bankruptcy.)*

(1) the notification states that the production-money secured party has or expects to acquire a production-money security interest in the debtor's crops and provides a description of the crops.

(c) Except as otherwise provided in subsection (d) or (e), if more than one security interest qualifies for priority in the same collateral under subsection (a), the security interests rank according to priority in time of filing under Section 9-322(a).

(d) To the extent that a person holding a perfected security interest in production-money crops that are the subject of a production-money security interest gives new value to enable the debtor to produce the production-money crops and the value is in fact used for the production of the production-money crops, the security interests rank according to priority in time of filing under Section 9-322(a). *(Page 40 in SB 366.)*

(e) To the extent that a person holds both an agricultural lien and a production-money security interest in the same collateral securing the same obligations, the rules of priority applicable to agricultural liens govern priority. *(Harvest liens would still have priority. Wheat isn't worth anything until it comes out of the field.)*

- **Official Comment**

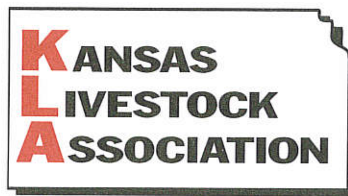
1. **Source.** New; replaces former Section 9-312(2). *(Page 32 in SB 366.)*

2. **Priority of Production-Money Security Interests and Conflicting Security Interests.** This section replaces the limited priority in crops afforded by former Section 9-312(2). That priority generally was been thought to be of little value for its intended beneficiaries. This section attempts to balance the interests of the production-money secured party with those of a secured party who has previously filed a financing statement covering the crops that are to be produced. For example, to qualify for

priority under this section, the production-money secured party must notify the earlier-filed secured party prior to extending the production-money credit. The notification affords the earlier secured party the opportunity to prevent subordination by extending the credit itself. Subsection (d) makes this explicit. If the holder of a security interest in production-money crops which conflicts with a production-money security interest gives new value for the production of the crops, the security interests rank according to priority in time of filing under Section 9-322(a).

3. **Multiple Production-money Security Interests**. In the case of multiple production-money security interests that qualify for priority under subsection (a), the first to file has priority. See subsection (c). Note that only a security interest perfected by filing is entitled to production-money priority. See subsection (b)(1). Consequently, subsection (c) does not adopt the first-to-file-or-perfect formulation.

4. **Holder of Agricultural Lien and Production-money Security Interest.** Subsection (e) deals with a creditor who holds both an agricultural lien and an Article 9 production-money security interest in the same collateral. In these cases, the priority rules applicable to agricultural liens govern. The creditor can avoid this result by waiving its agricultural lien.



Since 1894

March 14, 2000

House Judiciary Committee

Testimony of the Kansas Livestock Association

By: Allie Devine

Re: SB 366

Good afternoon. The Kansas Livestock Association (KLA) is a trade association with nearly 7,000 member/livestock producers representing all segments of the livestock industry.

KLA supports the passage of SB 366, but respectfully requests that you consider amendments to clarify the status of statutory liens under the bill. As you know, this bill was the subject of interim hearings last fall. During those hearings, KLA and a number of other farm organizations requested that the priority status of statutory liens not be changed from current law and that statutory liens not be subject to the filing provisions of Article 9.

Kansas's law provides assurances of payment to artisans, mechanics, or other persons who furnish goods and services. These laws create statutory liens in the property improved. Statutory liens are not consensual and do not depend upon judicial action. Statutory liens are status liens that arise by operation of law. Statutes grant the lien holder rights in the specific property of the debtor. Meyer, "United States Agriculture Production Financing: Sources, Legal Rules, and Controversies," 45 Drake Law Review 435, 445 (1977). These are not voluntary transactions as described in the Article 9 definition of a security agreement. Because of this distinction, the current law excludes statutory liens from Article 9.

From the hearings within the Senate, it was clear that the intent of the Senate was to exclude statutory liens from the filing requirements of article 9 and to reaffirm the priority status of statutory liens now available under current law. The Senate Judiciary Committee and subsequently the Full Senate approved provisions contained on page 16, lines 17-20 that reaffirms the priority positions of statutory liens where there is a conflict with other laws or the uniform commercial code. We suggest additional language to clarify the distinction between statutory liens and "agricultural liens" as used in the bill,

House Judiciary
3-14-2000
Attachment 6

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and to assure that statutory liens are not subject to the provisions of Article 9. Attached is a balloon that outlines amendments to assure no confusion regarding statutory liens.

The amendments are as follows:

1. On page 2, line 32 add language that clearly defines that the term "agricultural lien" does not include the statutory liens created by the specified statutes;
2. On page 16, line 13 add language that clearly defines what is not included by the term "agricultural lien"'
3. On page 17, after line 42 add language that clearly states that liens created by the listed statutes are not within the scope of the article.
4. On page 18, line 18 add the liens that are created by K.S.A. 58-203, 58-204, and 58-218 that deal with threshers or harvesters, and hay bailers.

KLA supports this last amendment to include the statutory liens created when threshers/harvesters and hay bailers perform work. The House did not include these liens.

We respectfully request your favorable consideration of these amendments. We are prepared to work with the Revisor or anyone else to clarify the language. Thank you for your time and consideration.

SB 366 p. 2

1 game by a state or governmental unit of a state. The term includes health-
2 care-insurance receivables. The term does not include: (A) rights to pay-
3 ment evidenced by chattel paper or an instrument, (B) commercial tort
4 claims, (C) deposit accounts, (D) investment property, (E) letter-of-credit
5 rights or letters of credit, or (F) rights to payment for money or funds
6 advanced or sold, other than rights arising out of the use of a credit or
7 charge card or information contained on or for use with the card.
8 (3) ``Account debtor'' means a person obligated on an account, chattel
9 paper, or general intangible. The term does not include persons obligated
10 to pay a negotiable instrument, even if the instrument constitutes part of
11 chattel paper.
12 (4) ``Accounting,'' except as used in ``accounting for,'' means a record:
13 (A) Authenticated by a secured party;
14 (B) indicating the aggregate unpaid secured obligations as of a date
15 not more than 35 days earlier or 35 days later than the date of the record;
16 and
17 (C) identifying the components of the obligations in reasonable
18 detail.
19 (5) ``Agricultural lien'' means an interest, other than a security inter-
20 est, in farm products: (A) Which secures payment or performance of an
21 obligation for:
22 (i) Goods or services furnished in connection with a debtor's farming
23 operation; or
24 (ii) rent on real property leased by a debtor in connection with its
25 farming operation;
26 (B) which is created by statute in favor of a person that:
27 (i) In the ordinary course of its business furnished goods or services
28 to a debtor in connection with a debtor's farming operation; or
29 (ii) leased real property to a debtor in connection with the debtor's
30 farming operation; and
31 (C) whose effectiveness does not depend on the person's possession
32 of the personal property.

(D) Agricultural lien shall not include liens created by K.S.A. 2-1319,2-2608,2-3007,34-239, 47-836,58-201, 58-203,58-204, 58-207, 58-218,58-220, 58-221,58-241, 58-242,58-2524, 58-2525, 58-2526, 58-2527, 58-2528, and 84-7-209.

33 (6) ``As-extracted collateral'' means: (A) Oil, gas, or other minerals
34 that are subject to a security interest that:
35 (i) Is created by a debtor having an interest in the minerals before
36 extraction; and
37 (ii) attaches to the minerals as extracted; or
38 (B) accounts arising out of the sale at the wellhead or minehead of
39 oil, gas, or other minerals in which the debtor had an interest before
40 extraction.
41 (7) ``Authenticate'' means:
42 (A) To sign; or
43 (B) to execute or otherwise adopt a symbol, or encrypt or similarly

SB 364
page 15 except
page 16
except

a commodity contract if:
(1) The secured party is the commodity intermediary with which the commodity contract is carried; or
(2) the commodity customer, secured party, and commodity intermediary have agreed that the commodity intermediary will apply any value distributed on account of the commodity contract as directed by the secured party without further consent by the commodity customer.
(c) **Effect of control of securities account or commodity account.** A secured party having control of all security entitlements or commodity contracts carried in a securities account or commodity account has control over the securities account or commodity account.
New Sec. 7. (UCC 9-107.) A secured party has control of a letter-of-credit right to the extent of any right to payment or performance by the issuer or any nominated person if the issuer or nominated person has consented to an assignment of proceeds of the letter of credit under K.S.A. 84-5-114(a) and amendments thereto or otherwise applicable law or practice.
New Sec. 8. (UCC 9-108.) (a) **Sufficiency of description.** Except as otherwise provided in subsections (c), (d), and (e), a description of personal or real property is sufficient, whether or not it is specific, if it reasonably identifies what is described.
(b) **Examples of reasonable identification.** Except as otherwise provided in subsection (d), a description of collateral reasonably identifies the collateral if it identifies the collateral by:
(1) Specific listing;
(2) category;
(3) except as otherwise provided in subsection (e), a type of collateral defined in the uniform commercial code;
(4) quantity;
(5) computational or allocational formula or procedure; or
(6) except as otherwise provided in subsection (c), any other method, if the identity of the collateral is objectively determinable.
(c) **Supergeneric description not sufficient.** A description of collateral as ``all the debtor's assets'' or ``all the debtor's personal property'' or using words of similar import does not reasonably identify the collateral.
(d) **Investment property.** Except as otherwise provided in subsection (e), a description of a security entitlement, securities account, or commodity account is sufficient if it describes:

(1) The collateral by those terms or as investment property; or
(2) the underlying financial asset or commodity contract.
(e) **When description by type insufficient.** A description only by type of collateral defined in the uniform commercial code is an insufficient description of:
(1) A commercial tort claim; or
(2) in a consumer transaction, consumer goods, a security entitlement, a securities account, or a commodity account.
New Sec. 9. (UCC 9-109.) (a) **General scope of article.** Except as

SB 366, continued

10 otherwise provided in subsections (c) and (d), this article applies to:
11 (1) A transaction, regardless of its form, that creates a security interest
12 in personal property or fixtures by contract;
13 (2) an agricultural lien;
14 (3) a sale of accounts, chattel paper, payment intangibles, or prom-
15 issory notes;
16 (4) a consignment;
17 (5) a security interest arising under K.S.A. 84-2-401, 84-2-505, 84-2-
18 711(3) or 84-2a-508(5) and amendments thereto, as provided in section
19 10 and amendments thereto; and
20 (6) a security interest arising under K.S.A. 84-4-201 or 84-5-118 and
21 amendments thereto.
22 (b) **Security interest in secured obligation.** The application of this
23 article to a security interest in a secured obligation is not affected by the
24 fact that the obligation is itself secured by a transaction or interest to
25 which this article does not apply.
26 (c) **Extent to which article does not apply.** This article does not
27 apply to the extent that:
28 (1) A statute, regulation, or treaty of the United States preempts this
29 article;
30 (2) another statute of this state expressly governs the creation, per-
31 fection, priority, or enforcement of a security interest created by this state
32 or a governmental unit of this state;
33 (3) a statute of another state, a foreign country, or a governmental
34 unit of another state or a foreign country, other than a statute generally
35 applicable to security interests, expressly governs creation, perfection,
36 priority, or enforcement of a security interest created by the state, coun-
37 try, or governmental unit; or
38 (4) the rights of a transferee beneficiary or nominated person under
39 a letter of credit are independent and superior under K.S.A. 84-5-114
40 and amendments thereto.
41 (d) **Inapplicability of article.** This article does not apply to:
42 (1) A landlord's lien, other than an agricultural lien;
43 (2) a lien, other than an agricultural lien, given by statute or other

Strike the ; and insert, "but not liens created by K.S.A. 2-1319, 2-2608, 2-3007,34-239, 47-836,58-201, 58-203,58-204, 58-207, 58-218,58-220, 58-221,58-241, 58-242,58-2524, 58-2525, 58-2526, 58-2527, 58-2528, and 84-7-209."

17

1 rule of law for services or materials, but section 53 and amendments
2 thereto applies with respect to priority of the lien;
3 (3) an assignment of a claim for wages, salary, or other compensation
4 of an employee;
5 (4) a sale of accounts, chattel paper, payment intangibles, or prom-
6 issory notes as part of a sale of the business out of which they arose;
7 (5) an assignment of accounts, chattel paper, payment intangibles, or
8 promissory notes which is for the purpose of collection only;
9 (6) an assignment of a right to payment under a contract to an as-
10 signee that is also obligated to perform under the contract;
11 (7) an assignment of a single account, payment intangible, or prom-
12 issory note to an assignee in full or partial satisfaction of a preexisting
13 indebtedness;
14 (8) a transfer of an interest in or an assignment of a claim under a

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p. 17 continued

15 policy of insurance, other than an assignment by or to a health-care pro-
16 vider of a health-care-insurance receivable and any subsequent assign-
17 ment of the right to payment, but sections 35 and 42 and amendments
18 thereto apply with respect to proceeds and priorities in proceeds;
19 (9) an assignment of a right represented by a judgment, other than a
20 judgment taken on a right to payment that was collateral;
21 (10) a right of recoupment or set-off, but:
22 (A) Section 60 and amendments thereto applies with respect to the
23 effectiveness of rights of recoupment or set-off against deposit accounts;
24 and
25 (B) section 66 and amendments thereto applies with respect to de-
26 fenses or claims of an account debtor;
27 (11) the creation or transfer of an interest in or lien on real property,
28 including a lease or rents thereunder, except to the extent that provision
29 is made for:
30 (A) Liens on real property in sections 13 and 28 and amendments
31 thereto;
32 (B) fixtures in section 54 and amendments thereto;
33 (C) fixture filings in sections 72, 73, 83, 87 and 90 and amendments
34 thereto; and
35 (D) security agreements covering personal and real property in sec-
36 tion 102 and amendments thereto;
37 (12) an assignment of a claim arising in tort, other than a commercial
38 tort claim, but sections 35 and 42 and amendments thereto apply with
39 respect to proceeds and priorities in proceeds; or
40 (13) an assignment of a deposit account in a consumer transaction,
41 but sections 35 and 42 and amendments thereto apply with respect to
42 proceeds and priorities in proceeds.
43 New Sec. 10. (UCC 9-110.) A security interest arising under K.S.A.

(14) liens created by K.S.A. 2-1319,2-2608,2-3007,34-239, 47-836,58-201, 58-203,58-204, 58-207, 58-218,58-220, 58-221,58-241, 58-242,58-2524, 58-2525, 58-2526, 58-2527, 58-2528, and 84-7-209.

1 84-2-401, 84-2-505, 84-2-711(3) or 84-2a-508(5) and amendments thereto
2 is subject to this article. However, until the debtor obtains possession of
3 the goods:
4 (1) The security interest is enforceable, even if section 13(b)(3) and
5 amendments thereto has not been satisfied;
6 (2) filing is not required to perfect the security interest;
7 (3) the rights of the secured party after default by the debtor are
8 governed by article 2 or 2A; and
9 (4) the security interest has priority over a conflicting security interest
10 created by the debtor.
11 New Sec. 11. (UCC 9-201.) (a) **General effectiveness.** Except as
12 otherwise provided in the uniform commercial code, a security agreement
13 is effective according to its terms between the parties, against purchasers
14 of the collateral, and against creditors.
15 (b) **Applicable consumer laws and other law.** A transaction sub-
16 ject to this article is subject to any applicable rule of law which establishes
17 a different rule for consumers ***and, including, but not limited to, K.S.A.***
18 ***2-1319, 2-2608, 2-3007, 34-239, 47-836, 58-201, 58-207, 58-220,***
19 ***58-221, 58-241, 58-242, 58-2524, 58-2525, 58-2526, 58-2527, 58-***
20 ***2528 and 84-7-209***.
21 (c) **Other applicable law controls.** In case of conflict between this
22 article and a rule of law, statute, or regulation described in subsection

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p. 18

58-203, 58-204, 58-218,

6-6

23 (b), the rule of law, statute, or regulation controls. Failure to comply with
24 a statute or regulation described in subsection (b) has only the effect the
25 statute or regulation specifies.
26 (d) **Further deference to other applicable law.** This article does
27 not:
28 (1) Validate any rate, charge, agreement, or practice that violates a
29 rule of law, statute, or regulation described in subsection (b); or
30 (2) extend the application of the rule of law, statute, or regulation to
31 a transaction not otherwise subject to it.
32 New Sec. 12. (UCC 9-202.) Except as otherwise provided with re-
33 spect to consignments or sales of accounts, chattel paper, payment intan-
34 gibles, or promissory notes, the provisions of this article with regard to
35 rights and obligations apply whether title to collateral is in the secured
36 party or the debtor.
37 New Sec. 13. (UCC 9-203.) (a) **Attachment.** A security interest at-
38 taches to collateral when it becomes enforceable against the debtor with
39 respect to the collateral, unless an agreement expressly postpones the
40 time of attachment.
41 (b) **Enforceability.** Except as otherwise provided in subsections (c)
42 through (i), a security interest is enforceable against the debtor and third
43 parties with respect to the collateral only if:

The KANSAS BANKERS ASSOCI
A Full Service Banking Association

March 14, 2000

TO: House Judiciary Committee

FROM: Kathleen Taylor Olsen, Kansas Bankers Association

RE: SB 366: Revised Article 9

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to appear before you today in support of **SB 366**, which contains the revision of Article 9 of the Uniform Commercial Code.

As you might suspect, the provisions of Article 9 are vital to the way our industry conducts business, as secured lending composes a good share of the lending that occurs in banking.

I have attached ten suggestions we would like to make for amendments to **SB 366**. As the summary for those amendments states, several of the amendments suggest that we reinstate language that is particular to Kansas and is current law. Several other amendments we are suggesting represent our attempt to assure that there is a rule that will apply to all transactions, whether consumer-related or not. Finally, several of the amendments are technical in nature.

We recognize that **SB 366** represents major change in the way that our industry will conduct business. We are asking that you consider our amendments favorably and that you pass Revised Article 9 this year, as we believe we will need this coming year to educate our members. Thank you.

House Judiciary
3-14-2000
Attachment 7

800 SW Jackson Suite 1500 • Topeka, Kansas 66612-1265 • (785) 232-3444 FAX (785) 232-3484
email kbaoffice@ink.org

Kansas Bankers Association
Non-Uniform Amendments to Revised UCC Article 9

Some of these amendments fill in blanks left by the uniform law commissioners for individual states to address. There are also some nonuniform provisions that are in the current version of UCC Article 9 that are particular to Kansas that we believe need to be reinstated.

1. Revised UCC section 9-102(47), contains the definitions of "instrument". Kansas added a nonuniform phrase, "a writing that would otherwise qualify as a certificate of deposit (defined in subsection (j) of K.S.A. 84-3-104, and amendments thereto) but for the fact that the writing contains a limitation on transfer". This language was added to ensure that a security interest in a certificated non-negotiable CD may be perfected by simply taking possession of the CD.

2. Revised UCC section 9-103(e), (f) and (g), contain the phrase, "In a transaction other than a consumer goods transaction". In deleting that language from each subsection, we are intending those sections to apply to all transactions, including those involving consumer goods. If there are to be separate rules for consumer good transactions, those would be found in the Kansas Uniform Consumer Credit Code. For the same reason, Subsection (h) of this section is deleted in whole.

3. Revised UCC section 9-201(b), was a blank left by the uniform law commissioners. We filled it with the old language of section 9-201: "Nothing in this article validates any charge or practice illegal under any statute or regulation thereunder governing usury, consumer loans, retail installment sales, or the like, or extends the application of any such statute or regulation to any transaction not otherwise subject thereto."

4. Revised UCC section 9-311, is comparable to the current version of 9-302. The filing of a financing statement is not necessary or effective to perfect a security interest in property subject to state statutes identified in this subdivision. We have deleted the phrase in subsection (a)(2), "and any non-Uniform Commercial Code central filing law of this state", because Kansas does not have such a thing.

5. Revised UCC section 9-312, contains a very minor amendment. In subsection (b)(2), "and" is deleted as it is not needed there.

6. There are two places where we need to insert the words, "of this state": Revised UCC section 9-334(j) and 9-408(e).

7. Revised UCC section 9-503, is amended to add a new subsection containing nonuniform language contained in old 9-402(7), that was crafted for Kansas. New subsection (4) should read, "if the debtors are married debtors jointly engaged in business and it is unclear whether a partnership exists, the financing statement may be filed in the names of the individual debtors." This language was designed to guide lenders filing on a joint farming operation when the parties were unclear whether they unknowingly formed a partnership under the Kansas Uniform Partnership Act.

8. Revised UCC section 9-612, is amended so that there is one rule for determining whether a notification is sent within a reasonable period of time. Subsection (a) is deleted and the following phrase in subsection (b) is deleted, "In a transaction other than a consumer transaction". This would mean that a notification of disposition sent after the debtor defaulted and at least 10 days before the disposition takes place is sent within a reasonable time. This would be fair to both parties and would eliminate litigation on this subject.

9. Revised UCC section 9-625, contain the statutory damages assessed for noncompliance with certain provisions of the law. Subsection (b) tracts with old KSA 84-9-208 and provides that the secured party who fails to comply with a request for statement of account or list of collateral is liable for any loss caused to a debtor. In addition, new Section 9-625 provides that the loss could include the debtor's inability to obtain – or the increased costs of – alternative financing. We believe it is unnecessary to also provide in subsection (f) for additional damages of $500 for failure to comply with the same request.

   Subsection (c) tracts with old KSA 84-9-507. Subsection (e) deals out statutory damages for failure to comply with various filings – some of them new filings that do not exist under current law. Subsection (4) does tract old KSA 84-9-404 in dealing with the failure to file a termination statement. Current law provides that a secured party who fails to file a termination statement is liable for any loss caused by the failure plus $100. Revised 84-9-507 increases the money damages to $500 plus includes the broader definition of "loss" used in Subsection (b) above. We understand that some allowance may be needed for inflation, but believe a 400% increase is unreasonable.

10. Revised UCC section 9-626, contains the rules if there is a deficiency or a surplus after foreclosure. Our amendments delete, "other than a consumer transaction" from subsection (a) and delete subsection (b) altogether, so that the same rule applies to all transactions, including consumer transactions. These rules are very fair and if another rule is to be applied to consumer transactions, it should be placed in the Kansas Uniform Consumer Credit Code.

Kansas Bankers Association

800 SW Jackson, Suite 1500
Topeka, KS 66612
785-232-3444 Fax - 785-232-3484 kbacs@ink.org

3-13-00

TO: House Judiciary Committee
FROM: Chuck Stones, Senior Vice President

RE: Appendix 2 to U.C.C. revised Article 9

Mr. Chairman and Members of the Sub-Committee:

Thank you for the opportunity to appear before you today to urge you to not adopt Appendix 2 to revised Article 9 of the UCC. My name is Chuck Stones, Senior Vice President of the Kansas Bankers Association.

This is not a new topic. Over the years this Legislature has addressed the issue of giving a subsequent provider of services or supplies priority over the secured, primary provider of credit. The Legislature has handled this issue very carefully over the years because of the potential impact it can have on the availability of credit. The adoption of Appendix 2 and the granting of a super lien law giving priority to input suppliers would have a significantly negative impact on many ag banks' ability to provide credit. Any bank that would continue to lend "business as usual" after the implementation of a super lien law would certainly be taking on more risk and would raise a variety of concerns among regulators. Most banks would simply stop making loans if they would be subject to being superceded by an input provider's lien.

Since the ag crisis of the 1980's, ag lending has become much more dependent on cash flow for repayment of loans as opposed to the value of an asset held as collateral. For crop production, a lender often provides substantial credit long before the collateral has value. Many lenders make commitments as long as a year in advance of harvest and three to four months before planting. The ability to rely on the first to file rule in the UCC is essential and a critical incentive without which lenders would be reluctant to make these types of loans.

We believe the adoption of Appendix 2 would not be in the best interests of the farm borrower for many reasons. First, it would undermine the position of the conventional ag lender who has properly filed a financing statement under the traditional rules of the UCC which grant priority to the "first to file". Under current law everybody goes into the transaction with their eyes wide open, i.e., with a full understanding of what their position will be in the chain of priorities. Under the proposed changes, the traditional lender will never know if their position will be maintained or be undermined.

The traditional lender typically provides far more than just inputs for crops. In many cases, the line of credit is used for living expenses and other necessary items such as cars, college expenses, groceries, taxes and insurance. It would be these types of expenses that would become under- or unsecured and probably would be harder to obtain under Appendix 2 if the banker could no longer rely on the proceeds of the crop for repayment of that portion of the line of credit.

Second, basic business practices would change if Appendix 2 were adopted - which no one would like. Historically, farm borrowers have been allowed great flexibility in how they spend the funds advanced from their operating lines of credit. Trust is the operative word in the relationship. Typically, under current law, when an input supplier notifies a bank that they have sold an item to a producer, the banker simply deposits the money in the producer's checking account. At this point, the producer is in control of how the proceeds are disbursed. Appendix 2 would require a cumbersome system of joint-payee checks in order to avoid a situation where the bank disburses funds to pay off the input provider, but the funds were used for another purpose, and yet the input provider still gets a super priority lien.

Under the Agricultural Production Input Lien Law (KSA 58-242), suppliers can avail themselves of the statutory protections by contacting the party that has a previously perfected security interest. Under this law, the prior perfected party has 5 days in which to commit to the payment of the ag inputs which are being provided, either in whole or in part. Or, within 5 days, the previously perfected security interest holder may send a written refusal to furnish such a letter of commitment. In the case of the latter, the supplier of ag inputs may extend credit at their own risk, knowing that the lender has not guaranteed payment nor subordinated its interest to the supplier. Quite the opposite of what would occur should Appendix 2 be adopted, the first to file rule is still in effect and the supplier of ag inputs will be able to make this decision with all the cards on the table, knowing their position <u>before</u> they advance the credit. This provision was enacted, in part, to encourage communication among all parties involved in the production of agriculture. All parties involved must know where they stand so they can make informed, sound decisions regarding the further extension of credit to the farm borrower.

Proponents of Appendix 2 have attempted to compare the production money security interest created by Appendix 2 to purchase money security interests relating to inventory and equipment. Such attempts simply do not hold water. There are significant differences between these two types of security interests. It is logical to grant a purchase money security interest to a lender who has financed the purchase with inventory or equipment since these goods may be physically recovered in the event of a bankruptcy or other default. However, this reasoning does not follow through to justify granting a super priority security interest in any crops to a supplier of seed, fertilizer or chemicals - which cannot be physically recovered.

In conclusion, it is our belief that the adoption of Appendix 2 would have a significantly adverse impact on the availability of credit to farmers, particularly those who may become greater financial risks due to downturns in the ag economy. It will greatly change the role of the operating lender that has traditionally worked closely with its farm customers to develop a comprehensive financial plan that provides credit for the entire farm operation - which frequently includes personal living expenses, in addition to ag production inputs.

Input suppliers have the opportunity under current law to compete with banks for these full-service loans. However, most input suppliers don't want to comply with the requirements of the UCC. They view financing as a sales tool. They do not see the big picture – that financing as an integral part of the farmer's operation. The input suppliers are not willing to provide a total loan package, nor are they willing to do the due diligence necessary to be a true lender to agriculture. The adoption of Appendix 2 will only serve to increase loan risk and reduce the quality of agricultural loan portfolios with the bottom line effect being that conventional ag lenders will be forced to reduce the amount of credit they will extend to ag producers. The first to file rule is essential for the orderly conduct of business transactions. It should not be changed.

We urge you NOT to adopt Appendix 2.

PUBLIC POLICY STATEMENT

HOUSE COMMITTEE ON THE JUDICIARY

RE: SB 366 – Amending Article 9 of the Uniform Commercial Code

March 14, 2000
Topeka, Kansas

Presented by:
Leslie Kaufman, Assistant Director
Public Policy Division
Kansas Farm Bureau

Chairman O'Neal and members of the House Judiciary Committee, thank you for the opportunity to appear before today and comment on SB 366. I am Leslie Kaufman, Assistant Director for Public Policy for Kansas Farm Bureau. KFB is the states largest general farm organization, representing approximately 8 out of every 10 farmers and ranchers across the state.

The availability of credit for agriculture producers is of great significance to our members. This past November, the more than 440 voting delegates at our 81st Annual Meeting reaffirmed and expanded their policy on agriculture credit. Specific points apply to today's discussion of SB 366:

- Farmers and ranchers need a variety of credit facilities to finance operating and ownership expenses.
- Any changes to lending producers, statutes, rules or regulations should not disadvantage agriculture producers.

- Specific agriculture liens exist under current law. We oppose any measure that would eliminate or pre-empt this prioritization of lien holders.

Based on these policy considerations, Kansas Farm Bureau could not support the original version SB 366. Nor can we support any effort to see Appendix II, the model provisions for production-money priority, included within SB 366. The original SB 366, and we believe the Senate version of SB 366, will pull statutory agriculture liens under the control of UCC Article 9 and could alter the prioritization of ag liens.

The Senate Judiciary Subcommittee recommended, and the full committee approved, statutory agriculture liens be listed under new section 11(b) [pg. 18, ln. 15] in order to exempt agriculture liens from UCC Article 9 control. Although we appreciate the intent of this amendment and the efforts of the committee, we do not believe that including the listing of statutory agriculture liens in section 11(b) protects ag liens from Article 9 control.

In order to protect the current status of statutory agriculture liens, we would recommend adopting the amendments in the balloon presented by the Kansas Livestock Association (KLA). We have worked with KLA and the Kansas Bankers Association in the development of these amendments. We believe that these amendments, rather than the listing of statutory ag liens in new section 11, are the appropriate means for protecting the current prioritization of agriculture liens.

We encourage this committee to protect statutory agriculture liens through the adoption of the recommended balloon amendments. With such amendments, Farm Bureau would no longer oppose SB 366. Again, we appreciate the opportunity to appear before you on behalf of the farmer and rancher members of Kansas Farm Bureau. Thank you.

Farris Brothers, Inc.
Custom Harvesting

Box 205 Edson, Kansas 67733
Phone 913-899-2652

March 14, 2000

To: Kansas House Judiciary Committee
Subject: SB 366

Dear Sirs,

My name is Richard Farris and I am a custom harvester from Edson Kansas. My father started harvesting in 1944 and I have operated our family harvesting business since 1965. I am concerned that SB 366 will weaken or eliminate the Kansas Threshers Lein Law. (K. S. A. 58-203 thru 206) This law has been considered model law and used as the basis for harvester lien laws in several states. The statutes 58-203 thru 206 were not listed in section 11b on page 18.

Harvest liens should remain in priority status to all other lien or security interests. Even seed liens should be subordinate to harvest liens. The act of harvesting converts the crop into a marketable asset. Without harvesting of the crop no sales proceeds would exist to pay suppliers or creditors. The seed provides the beginning of the crop production cycle. Weather and other intervening factors affect the chance that the seed will not even grow to maturity. The act of harvesting occours at the end of the crop production cycle when recovery of the crop proceeds is more certain. Creditors should have a greater interest in seeing that the crop is harvested to maxamize the income derived from the crop.

Last fall after I finished harvest a friend of mine from Colorado borrowed one of my grain trailers. He needed to be able to hold enough grain on his trucks to cover the harvesting bill. He believed that the possesory method, retaining or taking possession of the crop harvested, was the only way for him to be paid for his services in Colorado.

Under the Kansas Threshers Lien Law the harvester is allowed to give up possession of the crop but keep the property interest. I think that it is important for the legislature to protect the strength of the Kansas Threshers Lien Law. The act of harvesting a crop is necessary to make the crop marketable.

Thank You,
Richard Farris
Richard Farris

RON THORNBURGH
Secretary of State

First Floor, Memorial Hall
120 SW 10th Ave.
Topeka, KS 66612-1594
(785) 296-4564

STATE OF KANSAS

TESTIMONY OF THE SECRETARY OF STATE ON SB 366

The Secretary of State testified during the interim study, giving general information as to the effects of Revised Article Nine on the operations of our office. As we explained, Revised Article Nine establishes a new filing system for UCC documents, which has been labeled the "open drawer" filing system. The theory behind the filing system is that all documents filed on a security interest become part of the record and are furnished to searchers so that they may examine the record in its entirety to determine the legal sufficiency of the security interest. The filing officer makes no determination on legality but merely adds the filing to the public record. The security interest and all its filings remain on the record until one year after the security interest has lapsed, even if terminated, allowing searchers to review the complete record to determine if the security interest and its subsequent filings are valid.

In establishing the open drawer system, the Revised Act clarifies the role of the filing officer as purely ministerial. The new law bars filing officers from reviewing documents for statutory compliance and requires that they file the documents, regardless of legal sufficiency. The Act sets out specific situations when a filing officer can reject a filing (Section 87). Rejection of a filing for any other reason is an unauthorized rejection and the document is deemed to have been accepted and filed.

Current law requires signatures on UCC documents that are filed with our office. Requiring the appropriate signature prevents the filing of unauthorized liens, amendments or

terminations. The Revised Act omits signatures from all filings, in order to facilitate electronic filing. Because our office can no longer refuse to file documents that omit the signatures, the likely result under the new law is that nonconsensual and unauthorized documents will be filed.

The Revised Act does, however, offer several remedies for unauthorized filings. A person who is harmed by an unauthorized filing may file a correction statement pursuant to Section 89. If an unauthorized financing statement is filed, the named debtor may file his own termination statement pursuant to Section 80(d). The Revised Act allows a person harmed by an unauthorized financing statement or amendment to recover actual damages, plus a $500 penalty (Section 123).

Another available remedy is the expedited process for a court determination of a lien's validity, which was enacted during the 1998 legislative session. This process would allow anyone who has had a fraudulent lien filed against him to seek an ex parte judicial "conclusion of law and fact" declaring the lien invalid. The court decision is then filed with our office. However, the pleading does not *remove* the fraudulent lien from our records; it merely adds another document to the record stating that the original filing has been determined invalid.

Although there are several remedies for unauthorized filings, they are all remedial and none is preventive. The Secretary of State is requesting a provision be added to SB 366, granting the Secretary of State's Office the discretion to refuse bogus liens. The state of Montana has adopted a similar provision in its version of Revised Article Nine. Our office has seen an increase in bogus filings in this last few months, with several filed against law enforcement and judicial officers, including judges, county attorneys, clerks of the district court and highway patrol officers. We believe this amendment is warranted to *prevent* the harm and inconvenience caused by false filings.

In the alternative, the Secretary of State is requesting amendments to the expedited process. The current law requires the victim of a bogus lien to file in the county in which the lien has been filed. Any actions to invalidate liens filed with the Secretary of State must therefore be filed in Shawnee County. This requirement has proven burdensome to individuals who live elsewhere in the state of Kansas. We are requesting an amendment that would allow the victim of a bogus lien to file his claim in the county in which the property or rights pertaining to the property are situated, which in most cases, will be his residential county. This amendment is modeled on K.S.A. 60-614, the statute governing venue in cases arising from any taking or appropriation of property.

The second amendment requires the court's conclusion of law to include a directive to the filing officer to terminate the lien, i.e., remove it, if the court determines the lien to be invalid. The current law does not require the filing officer to remove the fraudulent lien, and therefore searches with our office continue to denote the victim as a "debtor," even after the court has determined that the lien is invalid.

I appreciate the opportunity to appear today and I would be happy to answer any questions.

Melissa Wangemann, Legal Counsel
Deputy Assistant Secretary of State

SECRETARY OF STATE'S AMENDMENTS FOR SB 366
RE: FRAUDULENT FILINGS

Alternate Section One

Removal of improper or fraudulent documents. If a filing officer receives a complaint or has reason to believe that a document submitted or filed with the filing officer's office is improper or fraudulent, the filing officer may reject the submission or remove the filing from existing files after giving notice and an opportunity to respond to the secured party. **Source: Montana law, M.C.A. 30-9-432.**

Alternate Section Two

K.S.A. 58-4301. Liens and claims against real or personal property; expedited process to review and determine validity; forms. (a) (1) Any person who owns real or personal property or an interest in real or personal property or who is the purported debtor or obligor and who has reason to believe that any document or instrument purporting to create a lien or claim against the real or personal property or an interest in real or personal property previously filed or submitted for filing and recording is fraudulent as defined in subsection (e) may complete and file, at any time without any time limitation, with the district court of the county in which such lien or claim has been filed or submitted for filing, or with the district court of the county in which the property or the rights appertaining thereto is situated, a motion for judicial review of the status of documentation or instrument purporting to create a lien or claim as provided in this section. Such motion shall be supported by the affidavit of the movant or the movant's attorney setting forth a concise statement of the facts upon which the claim for relief is based. Such motion shall be in substantially the following form:

MISC. DOCKET No. _____________

In Re: A Purported Lien In the _________ Judicial District
or Claim Against In and For ______________________
(Name of Purported County, Kansas
Debtor)

Motion for Judicial Review of Documentation or Instrument Purporting to Create a Lien or Claim

Now Comes ______________________________(name) and files this motion requesting a judicial determination of the status of documentation or an instrument purporting to create an interest in real or personal property or a lien or claim on real or personal property or an interest in real or personal property filed in the office of the _________________________________ (filing office and location thereof) and in support of the motion would show the court as follows:

I.

_________________________________ (Name), movant herein, is the purported obligor or debtor or person who owns the real or personal property or the interest in real or personal property described in the documentation or instrument.

II.

11-4

On ______________ (date), in the exercise of the filing officer's official duties as __________________________________ (filing officer's position) the filing officer received and filed and recorded the documentation or instrument attached hereto and containing _______ pages. Such documentation or instrument purports to have created a lien on real or personal property or an interest in real or personal property against ______________________, the purported debtor.

III.

Movant alleges that the documentation or instrument attached hereto is fraudulent, as defined by subsection (e) of K.S.A. 1999 Supp. 58-4301 and amendments thereto, and that the documentation or instrument should therefore not be accorded lien status.

IV.

Movant attests that assertions herein are true and correct.

V.

Movant does not request the court to make a finding as to any underlying claim of the parties involved and acknowledges that this motion does not seek to invalidate a legitimate lien. Movant further acknowledges that movant may be subject to sanctions if this motion is determined to be frivolous.

PRAYER

Movant requests the court to review the attached documentation or instrument and enter an order determining whether it should be accorded lien status or whether it should be terminated, together with such other orders as the court deems appropriate.
Respectfully submitted,

____________________________________ (Signature and typed name and address)

(b) The completed form for ordinary certificate of acknowledgment must be as follows:

AFFIDAVIT

THE STATE OF KANSAS)
)
COUNTY OF)
BEFORE ME, the undersigned authority, personally appeared ______________, who, being by me duly sworn, deposed as follows:
"My name is____________________. I am over 18 years of age, of sound mind, with personal knowledge of the following facts, and fully competent to testify.
I further attest that the assertions contained in the accompanying motion are true and correct."
Further affiant sayeth not.
SUBSCRIBED and SWORN TO before me, this ____ day of ________________________.
NOTARY PUBLIC, State of Kansas
Notary's printed name: __________________ My commission expires: ________________.

(2) The clerk of the district court shall not collect a filing fee for filing a motion as provided in this section.
(b) [(c)] The court's finding may be made solely on a review of the documentation or instrument attached to the motion and without hearing any testimonial evidence. The district court's review may be made ex parte without delay or notice of any kind. An appellate court shall expedite review of a district court's finding as provided in this section.
(c) [(d)] After review, the district court shall enter an appropriate finding of fact and conclusion of law in a form as provided in subsection (d) regarding the documentation or instrument purporting to create a lien or claim, which shall be filed and indexed in the same filing office in the appropriate class of records in which the original documentation or instrument in question was filed. The filing officer shall not collect a filing fee for filing a district court's finding of fact and conclusion of law as provided in this section. A copy of the finding of fact and conclusion of law shall be mailed to the movant and the person who filed the lien or claim at the last known address of each person within seven days of the date that the finding of fact and conclusion of law is issued by the district court.
(d) [(e)] The findings of fact and conclusion of law shall be in substantially the following form:

MISC. DOCKET No.

In Re: A Purported Lien or Claim Against (Name of Purported Debtor)	In the _________ Judicial District In and For ______________________ County, Kansas

Judicial Finding of Fact and Conclusion of Law Regarding a Documentation or Instrument purporting to Create a Lien or Claim.

On the (number) day of (month), (year), in the above entitled and numbered cause, this court reviewed a motion, verified by affidavit, of (name) and the documentation or instrument attached thereto. No testimony was taken from any party, nor was there any notice of the court's review, the court having made the determination that a decision could be made solely on review of the documentation or instrument as provided in K.S.A. 1999 Supp. 58-4301 and amendments thereto.
The court finds as follows (only an item checked and initialed is a valid court ruling):
The documentation or instrument attached to the motion IS asserted against real or personal property or an interest in real or personal property and:
(1) IS provided for by specific state or federal statutes or constitutional provisions;
(2) IS created by implied or express consent or agreement of the obligor, debtor or the owner of the real or personal property or an interest in the real or personal property, if required under the laws of this state, or by consent of an agent, fiduciary or other representative of that person; or
(3) IS an equitable, constructive or other lien imposed by a court of competent jurisdiction created or established under the constitution or laws of this state or of the United States.
The documentation or instrument attached to the motion herein:
(1) IS NOT provided for by specific state or federal statutes or constitutional provisions;
(2) IS NOT created by implied or express consent or agreement of the obligor, debtor or the owner of the real or personal property or an interest in the real or personal property, if required under the law of this state or by implied or express consent or agreement of an agent, fiduciary or other representative of that person;

(3) IS NOT an equitable, constructive or other lien imposed by a court of competent jurisdiction created by or established under the constitution or laws of this state or the United States; or
(4) IS NOT asserted against real or personal property or an interest in real or personal property.
There is no valid lien or claim created by this documentation or instrument.
This court makes no finding as to any underlying claims of the parties involved and expressly limits its finding of fact and conclusion of law to the review of a ministerial act. The filing officer shall ~~file this finding of fact and conclusion of law in the same class of records as the subject documentation or instrument was originally filed, and the court directs the filing officer to index it using the same names that were used in indexing the subject documentation or instrument~~ <u>terminate the document or instrument purporting to create the lien or claim.</u>

SIGNED ON THIS THE____________________DAY OF________________
_______________________District Judge
_______________________Judicial District
_______________________County, Kansas

(e) [(f)] As used in this section, a document or instrument is presumed to be fraudulent if the document or instrument purports to create a lien or assert a claim against real or personal property or an interest in real or personal property and:
(1) Is not a document or instrument provided for by the constitution or laws of this state or of the United States;
(2) is not created by implied or express consent or agreement of the obligor, debtor or the owner of the real or personal property or an interest in the real or personal property, if required under the laws of this state, or by implied or express consent or agreement of an agent, fiduciary or other representative of that person; or
(3) is not an equitable, constructive or other lien imposed by a court with jurisdiction created or established under the constitution or laws of this state or of the United States.
(f) [(g)] As used in this subsection, filing office or filing officer refers to the officer and office where a document or instrument as described in this section is appropriately filed as provided by law, including, but not limited to the register of deeds, the secretary of state and the district court and filing officers related thereto.
History: L. 1998, ch. 116, § 1; Apr. 23.

TESTIMONY BEFORE THE HOUSE JUDICIARY COMMITTEE
SENATE BILL 366

BY PHILIP S. HARNESS, DIRECTOR OF WORKERS COMPENSATION
MARCH 14, 2000

After attending a national seminar on workers compensation on Friday, March 10, 2000, it came to my attention that embedded in the Uniform Commercial Code (UCC) amendments are provisions that may impact on workers compensation provisions limiting or prohibiting the attachment or assignment of rights to compensation benefits on behalf of creditors of the injured worker and provisions limiting the utilization of lump sum settlements.

K.S.A. 1999 Supp. 44-514 makes an injured worker's benefits exempt from the claims of creditors and exempt from attachment, garnishment, or execution with the exception of support orders. The proposed Senate Bill 366 New Section 2 (42) at Page 6, lines 22-27, defines "general intangible" to include "payment intangible." The UCC goes on to define a "payment intangible" as "a general obligation under which the account debtor's principle obligation is a monetary obligation," at Page 8, lines 40-41. Certainly the employer's obligation to pay workers compensation benefits is monetary and the UCC defines an "account debtor" as anyone obligated on a general intangible, at new Section 2 (3) at Page 2, lines 8-11. So it appears that, whether intentionally or not, workers compensation benefits may be "general intangibles" under Article 9.

The problem arises when other sections of UCC Article 9 are examined in light of this new definition. New Section 70 (c) at Page 58, purports to render any governmental restriction, including statutes and rules of law, ineffective if they restrict or prohibit assignment, transfer, or creation of a security interest in a payment intangible (and thus workers compensation benefits). Other provisions discharge the obligation of the account debtor (employer) if they pay (workers compensation benefits) to an assignee of benefits, at new Section 68, Page 55. These provisions obviously run afoul the intent of the majority rule that workers compensation benefits cannot be sold, attached, or executed against because they are intended to provide basic living expenses for workers during recovery from work injury.

Another concern involves any restrictions against lump sum settlements. The ability to sell or assign the future income stream represented by workers compensation benefits is the power to receive a lump sum, without going through any approval process or review for protection of the best interests of the worker. Since the UCC changes appear to make future workers compensation benefits a commodity that can be bought, sold, and pledged as security, any restrictions on lump sum settlements that may occur under state law appear to be rendered ineffective.

There is some question whether the courts will allow workers compensation benefits to be treated like other economic transactions. Some states do not allow the repeal of one provision of law by implication of subsequent legislation. In Kansas, one of the rules of statutory

construction is that if two statutes are in conflict, the later enacted legislation controls. If the predicted results are correct, a significant change in workers compensation law and policy may occur.

Attached are two items:

1. A much more extensive review of the proposed impact as analyzed by the General Counsel for the New Mexico Workers Compensation Administration;

2. A proposed "fix" consisting of two different options. The first affects only workers compensation; the second would affect workers compensation as well as tax deferred annuities and structured settlements.

Impact of Proposed Revisions to UCC Article 9 on Various Payment Rights

February 27, 2000

I. Background

The National Conference of Commissioners on Uniform State Laws ("NCCUSL") and the American law Institute ("ALI") have approved and recommended for enactment in all states a Revised Article 9 of the Uniform Commercial Code (the "UCC"). Revised Article 9 contains certain provisions that conflict with and would make ineffective certain existing statutes, private agreements and public policies which restrict the assignment or alienation of various payment rights. These provisions affect a wide range of payment rights, including workers compensation, structured settlements, special needs trusts and various other arrangements which impose restrictions on the assignment or alienation of future payments in order to conform with existing public policy and to secure favorable tax benefits.

The impact of the Revised Article 9 provisions is not understood by legislatures or the legal community. It is also possible that the impact of these provisions is not fully appreciated by NCCUSL, which drafted the revisions. This memorandum introduces the relevant changes proposed in Revised Article 9 and the potential impact of these provisions on various classes of payment rights.

II. Proposed Revisions to Article 9

Revised Article 9 defines a new sub-category of general intangible, a "payment intangible." UCC (Revised) § 9-102(a)(61). "Payment intangible" means a general intangible under which the account debtor's principal obligation is a monetary obligation. "General intangible" means any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software. UCC (Revised) § 9-102(a)(42). An "account debtor" includes any person obligated on a general intangible. UCC (Revised) § 9-102(a)(3).

A "payment intangible" therefore includes virtually any obligation to pay money that does not fall into one of the specifically excluded categories of collateral, i.e. accounts, instruments, chattel paper. For example, rights to receive workers compensation benefits, structured settlement benefits, trust benefits, crime victims' compensation, and lottery winnings, all of which represent contractual obligations to pay money to a recipient or beneficiary, constitute a "payment intangible."

Revised Article 9 contains provisions that would override any contractual, statutory or other legal restriction on the assignment or sale of a payment intangible.

Section 9-406 generally provides that any term in an agreement is ineffective to the extent that it "prohibits, restricts, or requires the consent of the account debtor . . . to the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in, the . . . payment intangible." UCC (Revised) § 9-406(d)(1). Section 9-406(d) does not apply, however, to the sale of a payment intangible. UCC (Revised) § 9-406(e). Thus, section 9-406 overrides any contractual restriction on the right of a payee to assign a payment intangible as security for a loan.

In addition, Section 9-408 of Revised Article 9 overrides any term in an agreement that restricts the *sale* of a payment intangible. In a change to existing law, the sale of a general intangible, including a payment intangible, will be subject to the UCC. UCC (Revised) § 9-109(a)(3). **Section 9-408(a)** provides that a term in an agreement between an account debtor and a payment recipient which prohibits, restricts, or requires the consent of the account debtor to the assignment or transfer of, or creation, attachment, or perfection of a security interest in, a payment intangible is ineffective to the extent that the term impairs the creation, attachment, or perfection of a security interest, or provides that the assignment or transfer may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy. **Thus, Section 406(d), in the case of a loan, and Section 408(a), in the case of a sale, override any contractual provision which restricts the assignment of, or the creation of a security interest in, a payment intangible.** *See* UCC (Revised) § 9-408, Official Comment #4.

Revised Article 9 overrides not only any contractual restriction on the assignment of a payment intangible, but also any rule of law, statutory or regulatory restriction on such assignment. In the case of a loan or a sale, **Section 9-408(c)** provides:

> A rule of law, statute, or regulation that prohibits, restricts, or requires the consent of a government, governmental body or official, person obligated on a promissory note, or account debtor to the assignment or transfer of, or creation of a security interest in, a promissory note, health-care-insurance receivable, or general intangible, including a contract, permit, license, or franchise between an account debtor and a debtor, is ineffective to the extent that the rule of law, statute, or regulation:
>
> (1) would impair the creation, attachment, or perfection of a security interest; or
>
> (2) provides that the assignment or transfer or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the promissory note, health-care-insurance receivable, or general intangible.

UCC (Revised) § 9-408(c). **Thus, Section 408(c), in the case of either a loan or a sale, overrides any rule of law, statute or regulation which restricts the assignment of, or the creation of a security interest in, a payment intangible.**[1]

III. Effect on Payment Rights

The definition of payment intangible is extremely broad, encompassing virtually any obligation to pay money that does not fall into one of the specifically excluded categories of collateral, i.e. accounts, instruments, chattel paper. For example, a right to receive workers compensation benefits, structured settlement benefits, trust benefits, or lottery winnings constitutes a "payment intangible." Each of the foregoing types of payment intangibles may be subject to restrictions on alienation or assignment under existing law either on policy grounds or to preserve favorable tax consequences (e.g. the deferral or complete avoidance of tax) to the parties. Revised Article 9 would make any restriction on the assignment of these payment intangibles ineffective, thus negating existing public policy and jeopardizing the tax benefits to the parties.

General Tax Principles. The ability to restrict the assignment or alienation of a payment right plays an important role in determining if and when a cash-basis taxpayer is required to include an amount in income. A cash-basis taxpayer recognizes income upon the actual or *constructive receipt* of cash or property. Treas. Reg. § 1.446-1(c)(1)(i). In general, receipt of a mere promise to pay in the future does not result in an income recognition event for the recipient of the promise. *See* Rev. Rul. 60-31, 1960-1 C.B. 174 ("a mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income . . ."). An income recognition event occurs, however, if the form of the promise received by the taxpayer is the *equivalent of cash*. *Id.* Moreover, a taxpayer has an income recognition event if he receives property in which he has a present *economic benefit*. Based on these rules, a cash-basis taxpayer generally has an income recognition event if he receives a promise from a third party for a future payment, and the promise is freely transferable, and the taxpayer therefore has the right to realize currently the present value of that future payment.

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[1] In some cases, Section 9-408(d) limits an account debtor's obligation to recognize an assignment by a payment recipient. That section provides that to the extent a term in an agreement, rule of law, statute or regulation would be effective under other law but is ineffective under either Section 9-408(a) or 9-408(c), the creation, attachment or perfection of a security interest is not enforceable against the account debtor, does not impose a duty on the account debtor, does not require the account debtor to recognize the security interest, and does not entitle the secured party to enforce the security interest. UCC (Revised) § 9-408(d). (For the account debtor, Section 9-408(d)'s carve out preserves the protections of rules of law, statutes and regulations in both loan and sales transactions, but preserves the protections of contractual restrictions only in the case of sales. Section 9-408(d) does not preserve for the account debtor the protections of contractual restrictions in the case of loans.)

Thus, Section 9-408(d) may preserve the account debtor's rights in some, but not all, cases regardless of the override provisions contained in Section 9-408(a) and Section 9-408(c). Nevertheless, even though the security interest may not be enforced against the account debtor, the payment recipient's right to sell or assign his or her interest in a payment intangible is not restricted. The Revised UCC is intended to create "free assignability" for the recipient of a payment intangible. *See* UCC (Revised) § 9-408, Official Comment #2.

Under the economic benefit test, the receipt of property that can be assigned or transferred generally indicates an economic benefit. *See Ward v. Commissioner*, 159 F.2d 502 (2d Cir. 1947) *aff'g* 4 T.C.M. 1037 (1945)(receipt of an annuity contract which was assignable created an economic benefit). Similarly, under the cash equivalency test, "if a promise to pay of a solvent obligor is unconditional and assignable, not subject to setoffs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation." *Cowden v. Commissioner*, 289 F.2d 20, 24 (5th Cir. 1961). A taxpayer's rights must be assignable in order for the taxpayer to be able to realize the value of the promise. *See Denver & Rio Grande Western RR Co. v. U.S.*, 318 F.2d 922 (Ct. Cl. 1963)("an obligation to pay in the future can have a current market value, or represent current income, only if it is currently capable of somehow being traded, disposed of, or realized -- *i.e.*, negotiated, assigned, transferred, or paid"); *cf.* Rev. Rul. 72-25, 1972-1 C.B. 127 (employee did not receive cash equivalent where right to deferred compensation was not subject in any manner to anticipation, alienation, sale, transfer, or assignment).

In Revenue Ruling 68-606, 1968-2 C.B. 42, a cash-method taxpayer who received an installment bonus contract was required to include its value in gross income for the year in which the contract was executed because the obligation was transferable and readily saleable. The Internal Revenue Service noted that a deferred-payment obligation which is readily marketable and immediately convertible to cash is property the fair market value of which is income to a cash method taxpayer in the year of receipt. In contrast, where a payment obligation is not transferable and readily saleable, a cash-basis taxpayer realizes income only in the year in which each payment is actually received.

State law controls whether a right can be transferred. Rev. Rul. 73-173, *supra* (when an agreement is silent concerning transferability, it is necessary to examine the local law to determine whether the taxpayer may transfer his rights); *Watson v. Commissioner*, 613 F.2d 594, 598 (5th Cir. 1980)(an irrevocable bank letter of credit was the equivalent of cash even though language on its face stated that it was not negotiable, assignable, or transferable because state law nevertheless permitted assignment of the proceeds).

These general principles of tax law are applied to many different types of future payment obligations where the parties seek favorable tax treatment, including workers compensation, structured settlements and lottery winnings. In addition, restrictions on the assignment of rights to future payments are required by statute in the case of many of these types of payment intangibles, not only for tax reasons but for public policy reasons. Specific examples follow.

Workers Compensation. Every state has statutes and/or regulations prohibiting the assignment or purchase of workers' compensation benefits. *See for example,* Ala. Code § 25-5-86 ("Claims for compensation, awards, judgments, or agreements to pay compensation . . . shall not be assignable"); Ala. Code § 25-5-231 (taking an assignment

or making a loan secured by workers compensation is a criminal offense); Va. Code § 65.2-531 (no claim for workers compensation shall be assignable). Statutes prohibiting assignment of workers' compensation benefits serve the public policy of protecting injured workers' benefits. Revised Article 9 would overrule those statutes, thereby overruling existing public policy.

Structured Settlements. As a matter of public policy, structured settlements encourage personal injury claimants to accept damage awards in periodic payments, thereby reducing the risk of a premature dissipation of benefits which may result in the claimant relying upon public assistance for support. In furtherance of that public policy, structured settlements are designed so that all payments received by the claimant are excludable from income under Internal Revenue Code section 104(a). Structured settlements permit the claimant to exclude from income the interest or other earnings which would have been taxable to the claimant if he had agreed to a lump-sum settlement rather than a structured settlement.

To fully exclude future periodic payments from income, a claimant must not have the constructive receipt or the economic benefit of the present value or the periodic payments. *See* H.R. Rep. No. 97-832, 97th Cong., 2d Sess. (1982), 4; S. Rep. No. 97-646, 97th Cong., 2d Sess. (1982), 4 ("Thus, the periodic payments as personal injury damages are still excludable from income only if the recipient taxpayer is not in constructive receipt of or does not have the current economic benefit of the sum required to produce the periodic payments."); *see also* Rev. Rul. 77-230, 1977-2 C.B. 214 (periodic payment of damages were excludable from income where claimant did not have the constructive receipt or present economic benefit of amount invested in trust to fund the future payments); Rev. Rul. 79-220, 1979-2 C.B. 74 (same); Rev. Rul. 79-313, 1979-2 C.B. 75 (same); *cf.* Rev. Rul. 76-133, 1976-1 C.B. 34 (the exclusion of damages does not apply to investment income generated by a lump-sum award where present economic benefit of lump sum actually or constructively received by claimant).

To promote the public policy of protecting claimants from prematurely dissipating their funds or suffering adverse tax consequences, structured settlement arrangements universally contain provisions that prohibit a claimant from accelerating, deferring, increasing, decreasing, anticipating, selling, assigning or encumbering the periodic payments. Revised Article 9 would make such provisions ineffective, thereby overturning existing public policy and jeopardizing the claimant's ability to exclude from income the full amount of periodic payments.

Lottery. Lotteries are designed so that the winner is taxable on the winnings only as the payments are received. Under the general tax principles discussed above, in order for a lottery winner to be taxable only as payments are received, the lottery winner cannot have the constructive receipt or present economic benefit of a lump-sum amount. For example, many lotteries permit a player to elect either a lump-sum payout or an annuity payout. However, this election must be made before the player purchases the lottery ticket. If the election were made after the winning ticket was drawn, the winner would have the constructive receipt of the lump sum amount. Treas. Reg. § 1.451-2(a).

As a matter of public policy intended to protect lottery winners, lottery laws generally prohibit the assignment of lottery winnings or require court approval before lottery winners can sell or assign benefits. In doing so, the lottery laws protects lottery winnings from being purchased for unconscionably small lump sums, and it ensures that the deferred payments are not freely transferable, thereby ensuring that the lottery winner does not suffer an income recognition event. Revised Article 9 would overrule statutes designed to protect lottery winners and their favorable tax benefits.

Medicaid special needs trusts. To qualify for Medicaid benefits, special needs trusts containing anti-assignment provisions are established. **[cite]** In states adopting the Revised Article 9, anti-assignment provisions would be ineffective, meaning the trusts would not qualify under Medicaid rules and a valuable planning tool would be lost.

Other statutes. Other statutes intended to promote public policies would also be overruled by Revised Article 9:

- statutes exempting from attachment payments under annuities containing spendthrift provisions (see, e.g., Kan. Stat. Ann. § 40-414a);
- statutes exempting from attachment any annuity payments, regardless of spendthrift provisions (see, e.g., N.Y. Ins. Law § 3212 (a)(2), (d);
- statutes prohibiting transfer of payments under annuities containing spendthrift provisions (see, e.g., Ark. Code Ann. § 23-79-134);
- statutes exempting from attachment proceeds from personal injury claims (see, e.g. S.C. Code Ann. § 15-41-30 (11) (B));
- statutes prohibiting or restricting consensual transfers of personal injury recoveries (see, e.g., N.Y. Civ. Prac. L & R Law § 5048);
- statutes prohibiting or restricting assignment of medical malpractice recoveries (see, e.g., Ariz. Rev. Stat. Ann. § 12-591);
- statutes exempting from attachment proceeds from wrongful death recoveries (see, e.g., Va. Code § 34-28.1);
- statutes exempting from attachment proceeds from medical malpractice recoveries (see, e.g., Ariz. Rev. Stat. Ann. § 12-592); and
- statutes prohibiting the transfer of crime victims compensation awards (see, e.g., Tex. Crim. P. Code Ann. § 56.49 (a)).

IV. Conclusion

Revised Article 9 would override any contractual or statutory restriction on the assignment or sale of a payment intangible. Prohibiting the assignment or sale of a deferred payment obligation is critical, however, to existing public policies and to securing favorable tax benefits. By eliminating the ability to restrict the assignment or sale of such obligations, Revised Article 9 jeopardizes important public policies and the ability of individuals to secure valuable tax benefits.

DRAFT 1/13/00

POTENTIAL AMENDMENTS FOR REVISED ARTICLE 9

OPTION 1 (one substantive change)

Proposed Addition to Section 9-109(d):

(__) This article does not apply to:

(__) an assignment of rights in or under:

(A) a claim or right to receive benefits under any workers' compensation, industrial accident or similar statute or regulation which provides benefits for occupational injury or illness; or

(B) a deferred payment or benefit arrangement that enables a participant to exclude or defer recognition of income for purposes of federal or state income taxation.

OPTION 2 (two substantive changes)

Proposed Addition to Section 9-406: [amends existing subsection (e)]

(__) **[Inapplicability of subsection (d) to certain transactions.]** Subsection (d) does not apply to:

(1) a payment intangible which:

(A) arises from a claim or right to receive benefits under any workers' compensation, industrial accident or similar statute or regulation which provides benefits for occupational injury or illness; or

(B) arises under a deferred payment or benefit arrangement that enables a participant to exclude or defer recognition of income for purposes of federal or state income taxation; or

(2) the sale of any other payment intangible or the sale of a promissory note.

Proposed Addition to Section 9-408:

(__) **[Inapplicability of subsections (a) and (c) to certain payment intangibles.]** Subsections (a) and (c) do not apply to any payment intangible which:

(1) arises from a claim or right to receive benefits under any workers' compensation, industrial accident or similar statute or regulation which provides benefits for occupational injury or illness; or

(2) arises under a deferred payment or benefit arrangement that enables a participant to exclude or defer recognition of income for purposes of federal or state income taxation.

UNIFORM ELECTRONIC TRANSACTIONS ACT

- A Summary -

The Uniform Law Commissioners promulgated the Uniform Electronic Transactions Act (UETA) in 1999. It is the first comprehensive effort to prepare state law for the electronic commerce era. Many states have already adopted legislation pertaining to such matters as digital signatures, but UETA represents the first national effort at providing some uniform rules to govern transactions in electronic commerce that should serve in every state. Although related to the Uniform Commercial Code, the rules of UETA are primarily for "electronic records and electronic signatures relating to a transaction" that is not subject to any article of the Uniform Commercial Code, except for Articles 2 and 2A. A "transaction" means an action or set of actions occurring between two or more persons relating to the conduct of business, commercial, or governmental affairs. Much is excluded in this definition, including required notices, disclosures or communications by courts and governmental agencies.

UETA applies only to transactions in which each party has agreed by some means to conduct them by electronically. Agreement is essential. Nobody is forced to conduct to electronic transactions. Parties to electronic transactions come under UETA, but they may also opt out. They may vary, waive or disclaim most of the provisions of UETA by agreement, even if it is agreed that business will be transacted by electronic means. The rules in UETA are almost all default rules that apply only in the event the terms of an agreement do not govern.

Electronic commerce means, of course, persons doing business with other persons with computers and telephone or television cable lines. The Internet is the great marketplace for these kinds of transactions; a marketplace developing almost daily in 1999 (and presumably into the foreseeable future). The outlines and boundaries for this marketplace are still unknown and developments are not predictable. It is not possible to predict with any certainty how new law should develop to serve that marketplace or any other electronic marketplace that might develop in the future.

However, a few things are known about the existing electronic marketplace and there are some assumptions about the law that governs transactions within it that can be made with reasonable certainty in 1999, and that will continue to be reasonably certain into the future.

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Attachment 13

Electronic transactions are conducted by communicating digitized information from one person to another. That digitized information can be communicated and stored without the use of paper, and the basic language of electronic transactions is fully and inherently paperless. In fact, relying on paper for the memorialization of transactions and upon manual signatures for verifying them are most likely to impede electronic transactions, adding to their costs. And there is no benefit to any party to an electronic transaction, with very few exceptions, in requiring that they be memorialized on paper with signatures that are manual. The need to expand requirements in the law for writings and manual signatures so that electronic records and electronic signatures will satisfy those requirements, is the one thing that is reasonably certain with respect to electronic transactions.

UETA does not attempt to create a whole new system of legal rules for the electronic marketplace. The objective of UETA is to make sure that transactions in the electronic marketplace are as enforceable as transactions memorialized on paper and with manual signatures, but without changing any of the substantive rules of law that apply. This is a very limited objective—that an electronic record of a transaction is the equivalent of a paper record, and that an electronic signature will be given the same legal effect, whatever that might be, as a manual signature. The basic rules in UETA serve this single purpose.

The basic rules are in Section 7 of UETA. The most fundamental rule in Section 7 provides that a "record or signature may not be denied legal effect or enforceability solely because it is in electronic form." The second most fundamental rule says that "a contract may not be denied legal effect or enforceability solely because an electronic record was used in its formation." The third most fundamental rule states that any law that requires a writing will be satisfied by an electronic record. And the fourth basic rule provides that any signature requirement in the law will be met if there is an electronic signature.

Almost all of the other rules in UETA serve the fundamental principles set out in Section 7, and tend to answer basic legal questions about the use of electronic records and signatures. Thus, Section 15 determines when information is legally sent or delivered in electronic form. It establishes when electronic delivery occurs—when an electronic record capable of retention by the recipient is legally sent and received. The traditional and statutory rules that govern mail

delivery of the paper memorializing a transaction can't be applied to electronic transactions. Electronic rules have to be devised., and UETA provides the rule.

Another rule that supports the general validity of electronic records and signatures in transactions is the rule on attribution in Section 9. Electronic transactions are mostly faceless transactions between strangers. UETA states that a signature is attributable to a person if it is an act of that person, and that act may be shown in any manner. If a security procedure is used, its efficacy in establishing the attribution may be shown. In the faceless environment of electronic transactions, the obvious difficulties of identification and attribution must be overcome. UETA, Section 9 gives guidance in that endeavor.

Much has been much written about digital signatures in electronic commerce. What is a digital signature? It is really a method of encryption that utilizes specific technology. In the faceless environment of the electronic marketplace and particularly the Internet, such technologies are highly useful.

It is not wholly certain what the legal impact of these technologies should be. For that reason UETA may not be characterized as a digital signature statute. It does facilitate the use of digital signatures and other security procedures in rules such as the one in Section 9 on attribution. Section 10 provides some rules on errors and changes in messages. It favors the party who conforms to the security procedure used in the specific transaction against the party who does not, in the event there is a dispute over the content of the message.

But nothing in UETA requires the use of a digital signature or any security procedure. It is technologically neutral. Persons can use the most up-to-date digital signature technology, or less sophisticated security procedures such as passwords or pin numbers. Whatever parties to transactions use for attribution or assuring message integrity may be offered in evidence if there is a dispute.

UETA is procedural, not substantive. It does not require anybody to use electronic transactions or to rely upon electronic records and signatures. It does not prohibit paper records and manual signatures. Basic rules of law, like the general and statutory law of contracts, continue to apply as they have always applied.

There are three provisions in UETA that need special attention, and that are not directly in support of the basic rules in Section 7. First, UETA excludes transactions subject to the Uniform Commercial Code, except for those under Articles 2 and 2A, the Uniform Computer Information Transactions Act, laws governing estates and trusts, and any other specific laws that a state wants to exempt from the rules applied in UETA. Some writing and signature requirements in state law do not impact the enforceability of transactions, and have objectives that should not be affected by adoption of a statute like UETA. The limitation of UETA to agreed electronic transactions will eliminate any conflict with other writing requirements for the most part. However, there is some room for jurisdiction-specific tailoring of UETA permitted in each state, to assure no conflict. Exclusions should be carefully and conservatively selected. Most law relating to contracts and transactions between persons will serve the public better if electronic records and signatures are recognized.

Second, UETA provides for "transferable records" in Section 16. Notes under Article 3 and documents under Article 7 of the Uniform Commercial Code are "transferable records" when in electronic form. Notes and documents are negotiable instruments. The quality of negotiation relies upon the note or document as the single, unique token of the obligations and rights embodied in the note or document. Maintaining that quality as a unique token for electronic records is the subject of Section 16. A transferable record exists when there is a single authoritative copy of that record existing and unalterable in the "control" of a person. A person in "control" is a "holder" for the purposes of transferring or negotiating that record under the Uniform Commercial Code. Section 16 is essentially a supplement to the Uniform Commercial Code, until its relevant articles can be fully amended or revised to accommodate electronic instruments.

Third, UETA clearly validates contracts formed by electronic agents. Electronic agents are computer programs that are implemented by their principals to do business in electronic form. They operate automatically, without immediate human supervision, though they are certainly not autonomous agents. They are a kind of tool that parties use to communicate. Section 14 provides that a person may form a contract by using an electronic agent. That means that the

principal, which is the person or entity which provides the program to do business, is bound by the contract that its agent makes.

When somebody buys something on the Internet, therefore, that person will be assured that the agreement is valid, even though the transaction is conducted automatically by a computer that solicits orders and payment information. Did anyone really think that every order on the Internet involves a direct communication with a human being?

Three sections of UETA deal with electronic records that state governmental agencies create and retain. Section 17 allows a state to designate one agency or officer as the authority on creation and retention of governmental records. Section 18 allows a state to designate which agency or officer regulates the communication of electronic records and use of electronic signatures between agencies and other persons. Section 19 allows a state to designate an agency or officer to set standards that promote consistency and interoperability between state agencies with respect to the use of electronic records and signatures. All three sections are optional sections, there for the state that needs them, but not mandatory for all states in order to implement uniformity. These are very important provisions, however, because they provide a state with some root law for organizing the electronic business of the state. They should be given very serious consideration in every state.

It is not possible to cover every aspect of UETA in a short summary. This summary highlights some important aspects. The adoption of these rules will be a boon to electronic commerce. They will not artificially skew any market or make any substantive law relating to contracts any different from that governing transactions memorialized on paper. Every state should adopt them as quickly as possible.

Founded in 1892, the National Conference of Commissioners on Uniform State Laws is a confederation of state commissioners on uniform laws. Its membership comprises more than 300 attorneys, judges, and law professors, who are appointed by each of the 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands, to draft uniform and model state laws and work toward their enactment.

A Few Facts About

UNIFORM ELECTRONIC TRANSACTIONS ACT

PURPOSE: The Uniform Electronic Transactions Act is designed to support the use of electronic commerce. The primary objective of this act is to establish the legal equivalence of electronic records and signatures with paper writings and manually-signed signatures, removing barriers to electronic commerce.

ORIGIN: Completed by the Uniform Law Commissioners in 1999.

SUPPORTED BY: American Council of Life Insurance
Equipment Leasing Association of America

STATE ADOPTIONS: California
Pennsylvania

2000 INTRODUCTIONS:

Arizona	Nebraska
Colorado	Ohio
Hawaii	Oklahoma
Idaho	Tennessee
Indiana	Utah
Kansas	Vermont
Maryland	Virginia

For any further information regarding the Uniform Electronic Transactions Act, please contact John McCabe or Katie Robinson at 312-915-0195.

(2/4/00)

(Please note: this information can also be found on our Web Site at www.nccusl.org)

LAYING FOUNDATIONS
FOR ELECTRONIC COMMERCE

THE UNIFORM ELECTRONIC TRANSACTIONS ACT

©Patricia Brumfield Fry
Professor of Law
Chair, Uniform Electronic Transactions Act
Drafting Committee

1. Electronic Commerce and the Law. Electronic commerce refers to the new world of economic activity created by advances in information technology and communication. This economy is generating opportunities across all sectors; it is a source of new jobs and new wealth, and is dramatically reducing the cost of communication, information and transactions.

While electronic commerce has existed for many years, with the earliest uses of EDI dating back into the 1970s, the public emergence of the Internet and the World Wide Web have revolutionized this young and vibrant economic sector. On all levels of government in the United States, efforts are underway to take advantage of these economic opportunities and realize the efficiencies made possible by the technologies.

Taken literally, electronic commerce ranges from old-fashioned telephone conversations, through the use of facsimiles, electronic mail and electronic data interchange, to establishing a presence on and conducting retail transactions

through the use of Internet websites. In each manifestation, electronic commerce presents challenges for the legal system, but these challenges are brought to their fullest, most obvious manifestations with commercial transactions based on Internet websites.

Electronic commerce poses a number of challenges for the law. The first and most fundamental challenge is presented by the simple fact that transactions may be memorialized on electronic communications, rather than solely on paper. It is no longer accurate to say that paper is required in order to assure that there will be a record of a transaction, in order to assure that a party receives a copy of terms and conditions, in order to assure that notice is given to a counter party. It is not accurate to say that paper is required in order to assure that someone has "signed" a communication. Yet most of our laws were written during an era when paper was the only realistic medium for communicating and storing information and when our mental constructs for such concepts as notice, communication, sending and delivering information, recording the terms of final agreements, etc. depended on paper.

The first step toward laying a legal foundation for electronic commerce is to clear away the barriers to electronic commerce. Each state law or regulation, each local or national law or regulation that requires a writing or signature, delivery or production of an original record impairs electronic commerce. The efficiencies are lost if the law requires the production of paper copies. A recent study on behalf of the Federal Reserve Bank of Boston discovered more than

2,500 different state law rules requiring that cancelled checks be stored by drawers. These statutes appear to be designed to assure that records of financial transactions will be available upon subsequent audit. Such records can be made available electronically, but not if the statute says only the paper cancelled check will suffice. And this does not only impose a burden on those who draw and are required to store the cancelled checks. It also means that the check collection system cannot short-circuit the physical travels of the check. If a bank's customers are required by law to store the physical, cancelled checks, the bank cannot store them or authorize anyone earlier in the collection chain to do so.

Unfortunately, it is not possible to simply wave a wand and redefine writings and signatures to include their electronic counterparts. In most instances such a redefinition would serve admirably. It certainly would suffice in all cases in which the purpose of the writing or signing requirement is to insure that there is a record of a transaction which preserves its terms or a record preserving evidence of the parties' assent to the transaction. Electronic records can serve those functions quite well. There is another body of law, however, that governing negotiable instruments, which would be badly disrupted by such a change. This body of law is one where the rights and liabilities of parties depend upon the physical delivery of a token of rights. The technologists tell us that they have not yet invented a technological scheme which would enable us to identify the single, unique and original electronic token. The rights and liabilities that now depend on or arise from negotiable instruments law can be managed in a

legal scheme, but not in one dependent upon the transfer of a single, unique token. Until that sort of technology is in place, however, a provision which merely changes the definition of writing and signature would disrupt the check collection system, the investment markets, commodity and other markets. In the meantime, electronic analogues to the existing paper worlds require a full and complete rethinking of the rights and obligations of parties in those markets, such as was done in the revision of Uniform Commercial Code Article 8. And the Article 8 experience has taught some valuable lessons to the law revisers about the wisdom of technology specific or business model specific statutes or of attempting to draft statutes to govern systems which we believe will come into being, rather than those which already exist.

2. Introduction to the Uniform Electronic Transactions Act. The Uniform Electronic Transactions Act is designed to set a solid legal foundation for the use of electronic communications in transactions. The goal of the draft is to facilitate and support the development of the information economy, and in particular its place in commercial transactions, throughout the States. If the States act in a uniform and constructive manner, the traditional role of the States in the law of commerce may be maintained. If they fail to do so, I believe the imperative need for commercial certainty may lead to a shift of a significant part of the authority of the States to the national government.

The UETA is designed to apply to any transaction where the parties have agreed to deal electronically, validating and supporting the use of electronic communications and records. It provides that parties may choose whether or not to use electronic communications in their transactions. It will put electronic commerce and paper-based commerce on the same legal footing and not discriminate between different forms of technology.

5. The Scope and Provisions of the UETA. The governing principles which have controlled the drafting are fairly simple to state, although not so simple to implement.

1. First, legal barriers to electronic commerce are to be eliminated.

2. Secondly, the barriers should be removed in a manner which assures that the parties' selection or choice of medium does not alter the outcome of disputes between the parties, i.e. whether the parties deal in the paper world or the electronic world, their relationship should be subject to the same legal principles.

3. The draft should maintain medium neutrality and technology neutrality. It should neither assume nor require any particular business model for transactions. The focus should be on the purpose of the legal requirement, rather than the form by which it is satisfied. This also should assure that the draft does not itself become a barrier to electronic commerce as technology and

business practices continue to shift and evolve. Markets and business people should be free to select technologies and business methods according to their needs.

Turning to the UETA, it provides that an electronic record, electronic signature and electronic contract shall not be denied validity on the sole ground that they are electronic. §106. It provides that electronic records shall not be denied admissibility into evidence on the sole ground that they are electronic or that it is not in its original form or is not an original. § 112. It provides that if an offer evokes an electronic response, a contract may be formed with the same effect as if the record was not electronic. §113. These are, I believe, the pivotal provisions of the draft.

A. *Scope*. One of the most difficult problems to resolve has been the question of the appropriate scope of the statute. Literally thousands, perhaps tens of thousands, of paper and signing requirements are buried in state law. These can range from the steps a legislature must follow to demand a special session, to how to execute a will, to rules for filing financing statements with the state, to rules for giving consumer notices, to contract formation rules. And some of the rules are tied to property and legal rights and obligations that cannot readily be translated into the electronic world, i.e. checks and other negotiable instruments.

Although there was some early sentiment favoring a statute which explicitly listed the provisions of state law which would be amended, pragmatists prevailed. They argued, with some merit, that the resources of the Drafting Committee would not permit such specific itemization and evaluation of writing and signing requirements, and that a demand that State legislatures do so prior to enactment would unduly delay enactment. Consensus emerged that the best approach is to provide that the UETA applies to electronic records and electronic signatures that "relate to any transaction." § 103. And then proceed to create appropriate exclusions. Section 103 excludes rules of law relating to the creation and execution of wills and codicils, and testamentary trusts. It excludes existing Article 1 of the Uniform Commercial Code, except §§ 1-107 and 1-206, Articles 3 through 9 of the Code as currently approved, and revised Articles 2 and 2A and UCITA, except as those statutes may provide. It recognizes that some States may choose to specifically exclude particular statutes, although the comments will urge caution in selecting additional exclusions.

In addition, §103 explicitly states that the Act will apply to electronic records or signatures otherwise excluded when used for transactions subject to a law other than the ones specified as excluded. Thus, for example, while UCC Articles 9 applies generally to a transaction creating a security interest in personal property, it excludes landlord's liens. Thus this Act would apply to the creation of a landlord's lien if the law otherwise applicable to such liens did not provide otherwise.

To sum up the discussions on the scope of the UETA, and the conclusions which have been reached, the UETA will apply to "any transaction" unless the law governing it is specifically excluded. Exclusions will include testamentary documents, generally the revised UCC, and any other statutes specifically excluded. All other transactions in which the parties have agreed to deal electronically will be included..

However, the UETA only applies to the procedural aspects of the transaction, i.e. the use of electronic communications and records. A transaction subject to the Act also will be subject to applicable substantive rules of law. The UETA is designed to interact with, not supplant, the bodies of law which otherwise govern contract formation, record-retention, the performance of obligations and rights and liabilities of the parties. The UETA will not, except as is specifically stated, affect requirements relating to a specific mode of delivery or display of information. If a rule of law requires that information be provided in writing, § 107 requires that the information may be furnished in a record that is under the control of the person to which it is provided and capable of retention. This is in accord with the Federal Reserve Board's interim rule for electronic funds transfers. As to notarization, §110 provides that that if the law requires a notarization it is satisfied if an electronic record includes, in addition to the electronic signature to be notarized, the electronic signature of a notary public together with all other information required to be included by other applicable

law. Whether an electronic record or electronic signature will have legal consequences is determined by a combination of UETA and other applicable law

B. *Security Procedures*. Turning to security procedures, the UETA defines a security procedure as:

> a procedure employed for the purpose of verifying that an electronic signature, record, or performance is that of a specific person or for detecting changes or errors in the information in an electronic record. The term includes a procedure that requires the use of algorithms or other codes, identifying words or numbers, encryption, or callback or other acknowledgment procedures.

The UETA does not provide that a security procedure has any particular legal effect. Rather it provides, in § 108, that an electronic record or electronic signature is attributable to a person if it was the act of the person. This may be proven in any manner, including a showing of the efficacy of a security procedure which has been applied. The effect of an electronic record or signature on the responsibility of a person is then determined from the context and surrounding circumstances, including any agreement of the parties. In other words, the effect of the use of the technology is left to the ordinary, garden variety rules of evidence, contracts, etc.

C. *Electronic Agents*. Although the use of automated programs for the conduct of transactions has been possible for a couple of decades, with the emergence of the Internet automation of transactions has become common. Yet most of the law of principal and agent assumes the existence of human actors. From one perspective, electronic agents or 'bots and automated transactions are

merely tools used by individuals or other actors. From another, there is concern that pre-programmed operations of computers or other devices will not be regarded as sufficient "manifestations of assent" in the eyes of some courts. To allay such concerns, the UETA explicitly provides that a contract may be formed by the interaction of electronic agents, whether with other electronic agents or with individuals. § 113.

D. _Automated Transactions._ In addition, concerns have been expressed that in automated transactions an inadvertent pressing of a computer button may result in a party being bound without intending to contract. This might be called the "finger twitching" issue. These concerns have been so pervasive that a special right to avoid a transaction is provided for inadvertent error in automated transactions in cases where the electronic agent did not allow for the prevention or correction of the error. In such a case, a party may avoid a transaction caused by an inadvertent error provided that, on learning that the other party believed a transaction had occurred, the individual gives prompt notice of the error, has not used or received the benefit of the transaction, and complies with any instructions for return or destruction of the consideration received. § 109.

E. _Time and Place of Sending and Receipt._ One of the most difficult issues for any drafters attempting to deal with electronic commerce, and one on which there does not seem to be any developing consensus, relates to issues arising from the irrelevance of geography in electronic commerce. There is a cluster of

issues which are being debated on local, national and international venues. There is plenty of noise, but precious little consensus..

The UETA has taken the position that it should lay foundations. Whatever rules may evolve in the future, they may be applied against Section 114 of the UETA, which specifies both the time and place of sending and receipt of communications. The focus in terms of geography is on the location of the respective parties, i.e. their places of business or residences. The focus in temporal terms is on when messages leave the sender's information system or enter the recipient's system, or one accessible by the recipient.

F. *Transferable Records.* Section 115 explicitly provides that parties may obtain the benefits of negotiability in an electronic environment. It provides that, if the issuer of a record explicitly agrees it is subject to this Act, a person in control of the record may have the rights, and an obligor may have the liabilities, which would exist for an equivalent paper note or document of title under the Uniform Commercial Code. These provisions are designed to permit commercial interests to proceed with the development of appropriate systems for establishing control of such transferable records without hampering expedited review of negotiability in an electronic environment.

G. *Government Records.* Part 2 of the UETA authorizes governmental entities, at all levels of the State, to create and retain electronic records and to convert written records into electronic databases. We have been urged by many to include such provisions, and of course any governmental rules concerning

commercial interactions with governmental agencies will have a major impact on the adoption of technologies, methods of record-keeping, and business models selected by commerce. The Drafting Committee has not felt at liberty to do more than authorize government agencies. We are convinced that a mandate would harm enactment, due to the price tag which could accompany such a bill in many states. Instead, Part 2 authorizes agencies to create and retain records, to accept and distribute electronic records, and to write the regulations which necessarily must govern their use of electronic technologies. Finally, it encourages and urges all such regulations to encourage and promote interoperability of their systems.

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Testimony of
Gail E. Bright, Assistant Attorney General
Consumer Protection Division
Office of Attorney General Carla J. Stovall
Before the House Judiciary Committee
RE: SB 559
March 14, 2000

Chairperson O'Neal and Members of the Committee:

Thank you for the opportunity to appear on behalf of Attorney General Carla J. Stovall today in regard to SB 559. My name is Gail Bright and I am an Assistant Attorney General for Consumer Protection.

First, let me say that Attorney General Stovall is not opposed to the progress of technology in the global marketplace. It is universally accepted that computers and the Internet are here to stay. While applauding the increasing trends of e-commerce, e-marketing, and e-banking for the convenience of consumers, we must not allow the traditional concept of consumer protection to be lost in cyberspace. Otherwise, we are apt to end up with an equal amount of e-scams. As I will explain below, the Uniform Electronic Transactions Act will leave consumers with less protections and more vulnerability in the electronic age. It is important for consumers to have the same protections in the e-world as in the physical world.

As SB 559 indicates, this proposed law is more commonly known as the "Uniform Electronic Transactions Act." It is the product of the National Conference of Commissioners on Uniform State Laws [NCCUSL] and is being offered in numerous state legislatures in this model form. Unfortunately, this model bill has serious problems as it relates to consumer protection and other states are amending their model bills to correct these problems. While the original intent of NCCUSL may have been for a uniform law, that approach is no longer possible because of changes being made across the country at the state level. In particular, California, Pennsylvania, Virginia, Vermont and Maryland have made, or are in the process of making, changes to their respective bills to correct identified consumer problems.

The Uniform Electronic Transactions Act is based upon three premises: (1) that most state law requirements for a writing can be satisfied by an electronic record, including e-mail; (2) that most state law requirements for a signature can be satisfied by an electronic signature; and (3) that, in most cases, the parties to a contract can agree to any form of electronic communication. However, these premises are not necessarily true.

The first premise makes the assumption that e-mail arrives as reliably as regular mail, which is not the experience of most consumers. Consumers currently change e-mail addresses more frequently than they move and they may or may not check them regularly. In addition, Internet e-mail providers may go out of business leaving the consumer no alternative but to obtain a new e-mail address. A consumer who has entered into a five (5) year car loan, or a thirty (30) year mortgage, may have several e-mail addresses through the years and this law would allow the supplier to send notices to the e-mail address provided in the original contract. Because there is currently no "forwarding" mechanism in place for e-mail as there is when a consumer changes their telephone number, the e-mail address provided in the original contract will not insure receipt by the consumer.

With regard to the second premise, an electronic signature does not always fully serve the purposes of a written signature. Specifically, with a risk of forgery, a written signature may provide additional safeguards because it is harder to forge than an electronic signature.

The third premise is reflected by the broad respect given to the autonomy of contracting parties. It does not distinguish between negotiated agreements and standard form contracts or contracts of adhesion. An "adhesion" contract is a "take it or leave it" contract typically found in consumer transactions. For example, when was the last time you modified a contract entered into with a major electronics discount store? This would give wide latitude to drafters of standard contracts to impose deceptive and/or unconscionable provisions.

The concerns of Attorney General Stovall include the following:

- First, and most importantly, the exemption provision for specific state laws, found in the model bill approved by NCCUSL, should be inserted back into this bill. This section allowed states to exempt specific statutes. This is found in the "Scope" section, Section 3(b)(4), of the model UETA and states "...(4)[other laws, if any, identified by State]."

  The drafters of the model bill apparently recognized that electronic notices do not always fully serve the function of a written notice or signature and inserted the provision allowing individual states to amend the proposal. The types of statutes which should be exempted include, but may not be limited to, defaults, eviction, repossession, foreclosure, balloon payments, utility shut-offs, door-to-door sales, insurance notices or any instance where a non-response creates a legal obligation or conclusive presumption. Attached to my testimony is a list of the eighty-three (83) statutes specifically exempted from the California UETA statute. Allowing the exemptions would not defeat uniformity as this is within the approach specifically approved by NCCUSL. [Section 3, p. 2, line 38, new subsection (3)]

- This bill should only apply to online transactions. A provision should be added indicating electronic records should only be provided in electronic transactions, not in person-to-person transactions. Under the current terms of this proposal, a

consumer could sign a contract making them subject to notices and disclosures posted on a website - - when the consumer does not even own a computer. [Section 5 (b); p. 3, lines 8-11]

- If required to receive a notice via e-mail, every reasonable effort must be made to assure the consumer actually receives the electronic record in a format which the consumer can access. Anyone who has a computer has, at some point in time, received a record which could not be accessed. The consent to receive electronic records should be separate, and in the same format as the records, to assure a consumer understands the consequences of the request. [Section 5(b); p. 3, lines 8-11. The suggested language has been adopted by the Virginia House of Delegates and similar language was amended into the bill passed by the Pennsylvania General Assembly.]

- There must be continued assurance the consumer has the ability to receive electronic notices when the failure to reply will lead to a loss of service or property. There remains a significant difference between the receipt of e-mail and the receipt of mail through the U.S. Postal Service. Before a consumer is held in default for failing to respond to an electronic notice, an electronic request should be sent asking if the consumer continues to receive electronic notices. A failure to reply should automatically reverse the consent to receive electronic notices and require a written paper notice to be sent. [Section 7; p. 3, new section (f)]

- There are also general concerns with Section 12 as it removes any requirement for retention of the actual paper document. This would be particularly troublesome in prosecutions of forgery and the unauthorized switching of long distance service, where the written instrument is the primary exhibit.

After sorting through all of the legalese, what exactly would this law, without changes, allow?

- Lenders could send foreclosure notices to old e-mail addresses long since abandoned.

- Sales representatives could sign a consumer up to agree to go to the company's website for notices when the consumer does not own a computer. Over two-thirds of the country's households are not online and the percentage of elderly and poor who do not own computers is higher.

- Utility shut-off warnings could go to an e-mail address shared in one family and primarily checked by children.

As we attempt to keep current with the fast-moving age of technology, let us not forget the need for continued consumer protection. The Committee should exercise care before sweeping

away, with a broad brush, protections currently in place that were passed by this Legislature in past years after hearings and debate on separate and distinct areas of the law. That is why Attorney General Stovall, as well as her counterparts in other states, are opposing the uniform bill and providing information to their respective state legislatures on the pitfalls of enacting this type of legislation.

On behalf of Attorney General Stovall, I urge you to carefully consider this bill and to make substantial modifications before recommending passage. I would be happy to answer questions of the Chair or any member of the Committee.