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Chuck and Steve's Peccadillo (Symposium: Threats to Secured Lending and Asset Securitization)

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CHUCK AND STEVE'S PECCADILLO

*James J. White**

INTRODUCTION

Are investors in securitized receivables to be treated as the owners of an asset whose sale has taken it beyond the reach of the trustee in bankruptcy of their sellers? Or are they to be treated as holders of a security interest in the transferred asset who have left behind an interest in the sellers' hands that would cause the asset to be subject to claims and interference by the sellers' grasping trustee? By adopting contrasting—arguably conflicting—statements in two subsections of a single section, the drafters of 1999 Article 9 have thrust this issue in the faces of courts and commentators.

They did this by adopting section 9-318 which reads in full as follows:

> Section 9-318. No interest retained in right to payment that is sold; rights and title of seller of account or chattel paper with respect to creditors and purchasers.
>
> (a) [Seller retains no interest.] A debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold.
>
> (b) [Deemed rights of debtor if buyer's security interest unperfected.] For purposes of determining the rights of creditors of, and purchasers for value of an account or chattel paper from, a debtor that has sold an account or chattel paper, while the buyer's security interest is unperfected, the debtor is deemed to have rights and title to the account or chattel paper identical to those the debtor sold.

Subsection (a) embraces the securitizers' position; it unequivocally indorses the form of the transaction. Upon "sale" everything is gone: all is beyond the grasp of the trustee. There are no qualifications; neither perfection, nor notice, nor any other act is required. This "sale" of receivables is as much a "sale" as the debtor's sale of inventory to a buyer for value would be a "sale."

But subsection (b) looks to the substance of the transaction and

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rejects the form. Here a "sale" of certain covered receivables is the grant of a "security interest." Like the grant of a security interest, this sale without perfection leaves behind fragments of title large enough to give purchase to the sellers' creditors.

Of course lawyers are accustomed to ignoring form and following substance, and of doing the opposite. What is different here is that the drafters ask us—with respect to the same transaction—to do one in subsection (a) (respect form) and the other in subsection (b) (ignore form). It may be possible to make the two subsections get along with one another, but it requires work. On their face, they appear inconsistent. I am not the first to see the apparent inconsistency between the two subsections. Members of the drafting committee saw it,[1] and the use of the verb "deemed" in subsection (b) shows that the drafters anticipated this claim.

In this article I consider how we came to this place and whether the drafters have successfully found a path through this thicket that will allow them to satisfy the securitizers (all is gone with a sale) and the creditors of a seller whose buyer has not perfected (enough is left behind despite a sale to give the creditors a hold) without, at the same time, giving purchase to the trustee in bankruptcy of a seller of perfected, securitized receivables.

I. HISTORY

Long before the UCC, the law of America and even earlier, the law of England, disregarded the form of certain credit transactions and recognized their substance at the request of creditors who would have been dispossessed by giving conventional meaning to those transactions.[2]

In the earliest days we see the English courts treating a non-possessory security interest as a fraudulent conveyance that could be upset.[3] In a society where possession by the owner or his agent meant title, the courts were slow to recognize the transfer of a non-possessory security interest to a creditor.[4] So in *Twyne's Case*,[5] the debtor Pierce

[1] For example, ALI Representative Rapson, a member of the drafting committee recognized the inconsistencies between the two subsections.

[2] *See* Peugh v. Davis, 96 U.S. 332 (1877); Maxwell v. Montacute, Prec. Ch. 526 (1719); *see also* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 2.6 (1965); 1 GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 299a (rev. ed. 1940) (collecting cases) [hereinafter FRAUDULENT CONVEYANCES]; 1 GARRARD GLENN, MORTGAGES § 11 (1943) (same) [hereinafter MORTGAGES].

[3] *See* GILMORE, *supra* note 2, § 2.1.

[4] *See id.* at 25-6 (hypothesizing that the rapidly increasing demand for credit during the industrial revolution led to the erosion of the rule against nonpossessory security interests).

owed money to both Twyne and another creditor who had brought suit against him. In satisfaction of the debt to Twyne, Pierce secretly deeded property to Twyne. Despite the conveyance, Pierce remained in possession of the property and continued to treat the property as his own. While the conveyance was supported by good consideration—the value of the property exceeded the debt owed—the court held the transaction void, and so fraudulent as against Pierce's other creditor, because of Pierce's continued possession of the property. The court stated that a "secret transfer is always a badge of fraud."[6] Not until the nineteenth century did courts gradually abandon the rule against nonpossessory security interests.[7]

More modern variations on this theme are claims of "ostensible ownership." If an owner puts goods in the hands of a consignee—or even in some cases of a bailee—the nonowner possessors were found to have ostensible ownership. That ownership was sufficient to cause title to be passed on to transferees from the bailee-apparent owner. This right is now stated most prominently in section 2-403(2). If I entrust my watch to a watch repairman who also sells watches, I have given him the power to pass good title to a bona fide purchaser.[8]

Intangibles presented the same problem but later and in a different form. Since possession means little or nothing in the case of intangible rights, how was the law to recognize the transfer of those rights from the owner to a third party without misleading the creditors of the seller? If one applied the stern logic of the eighteenth and nineteenth centuries to the "sale" of an owner's rights in receivables, he would find that the sale had divested the seller of all of his rights, thus no creditor coming later with a lien nor any subsequent purchaser would or could get anything. In the early days some states—most notably New York—followed that logic and left the later claimants empty handed.[9] Other states recognized the priority of the person who first gave notice to the account debtor (the person whose rights were being sold). Later some states passed laws similar to Article 9 that recognized the rights of the first to do a public filing.[10]

All of these transactions presented the same issue: to what extent should the law search for and recognize substance when the substance

[5] 13 Co. Rep. 806 (Star Chamber 1601).

[6] The discussion of this case is taken from GILMORE, *supra* note 2, § 2.1 n. 1.

[7] *See id.* § 25.6.

[8] U.C.C. § 2-403(2) (2002) ("Any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in the ordinary course of business."); *see also* United States v. Haddix & Sons, Inc., 415 F.2d 584 (6th Cir. 1969); Heinrich v. Titus-Will Sales, Inc., 868 P.2d 169 (Wash. Ct. App. 1994) (stating three general policies supported by UCC 2-403).

[9] *See* GILMORE, *supra* note 2, § 25.6.

[10] *See id.* §§ 8.6-8, 25.6.

of the transaction differed from the form.

II. OLD ARTICLE 9

The original drafters of Article 9 understood all of this better than any of us. Professor Gilmore, one of the drafters, is the source of most of my knowledge of the history of current forms of security. He deals with these issues in his magnificent treatise and he would have taught much of this many times over in classes on security before the UCC was proposed. So one should not be surprised to find extensive consideration of these issues in old Article 9 and Article 2. In one way or another, the following sections deal with these issues: Sections 1-201(37) (the buyer of an account holds a "security interest"), 9-102 (scope of Article 9), 9-105(1)(m) ("secured party" includes a buyer of accounts), 9-105(1)(d) ("debtor" includes a seller of accounts), 9-105(1)(c) ("collateral" includes sold accounts), 9-504(2) (no surplus or deficiency if a sale), 2-326 (consignments, etc.), 2-403 (bailments to sellers).

One might argue that subsections 9-102(1) and (2) were the most revolutionary in the whole of Article 9. Here Gilmore uses a big broom to sweep every conceivable form of security device into Article 9. He well appreciated the clever work of creditors' lawyers in devising new formulas to enable their clients to escape burdensome filing rules or troublesome law on foreclosure or on attachment of security interests. He brushes every transaction "regardless of form" into Article 9 if that transaction is intended to create a security interest. The two subsections read as follows:

> § 9-102. Policy and Subject Matter of Article
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> (1) Except as otherwise provided in Section 9-104 on excluded transactions, this article applies
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> to any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts; and also
>
> to any sale of accounts or chattel paper.
>
> (2) This Article applies to security interests created by contract including pledge, assignment, chattel mortgage, chattel trust, trust deed, factor's lien, equipment trust, conditional sale, trust receipt, other lien or title retention contract and lease or consignment intended as security. This Article does not apply to statutory liens except as provided in Section 9-310.

But even Professor Gilmore found it necessary to have a separate subsection to bring in "sales of accounts or chattel paper." So does that mean that Gilmore recognized that a sale conveyed a larger title than the grant of a security interest? Or was (1)(b) there only to make certain that sales were within Article 9, a result that its language in (1)(a) might not accomplish?

When he gets to 1-201(37), Professor Gilmore still distinguishes sales from interests that "secure payment or performance" but here he is unequivocal about the buyer's interest. The buyer of receivables holds a "security interest." The first two sentences of the section read as follows:

> § 1-201. General Definitions
>
> (37) 'Security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by seller of goods notwithstanding shipment or delivery to the buyer (Section 2-401) is limited in effect to a reservation of security 'interest'. The term also includes any interest of a buyer of accounts or chattel paper which is subject to Article 9.

There are two ways to read Gilmore's distinction between sales and more conventional security interests. This might be no more than the recognition that sales are typically non-recourse arrangements. The implicit deal in a "sale" of receivables is that the buyer enjoys the upside (if all of the accounts pay off) and that he, not the seller, bears the downside (if many account debtors default). On the other hand one might say Gilmore is making a more fundamental distinction and that buried in that distinction is his view that the seller of receivables retains a smaller fragment of title in the receivables than the grantor of a security interest securing an obligation (a recourse transaction) retains. One problem for the second hypothesis is that, in life, the line between sale with no recourse and security with full recourse is seldom so stark. Often "sales" carry some modest rights of recourse. For example a buyer of receivables might bargain for the right to make the seller repurchase all accounts that defaulted within thirty days of the sale—so minimizing the seller's incentive to slip his dog accounts into the pile that is sold.

It is possible that Gilmore and his cohorts, including Llewellyn, never thought it necessary to identify the rights retained by a seller of receivables where the buyer had perfected. No priority rules nor any rights in foreclosure turn on the status of the seller's title. And Llewellyn was notorious for his hostility to the use of title as a means of determining rights under Article 2, and presumably Article 9.[11] Ignoring the status of title freed the drafters from complex and confusing law that determined rights based on title. Avoidance of that

[11] *See* Karl N. Llewellyn, *Through Title to Contract and a Bit Beyond*, 15 N.Y.U. L.Q. REV. 159 (1938) (criticizing the use of the concept of title in sales cases).

terminology made it less likely for the new Code to be embarrassed by old law embedded in common law cases or in earlier statutes.

On the other hand Gilmore's inclusion of certain sales of receivables in Article 9 and his making the buyer's interest into a security interest can only mean that a buyer who did not perfect was subordinate to later perfected interests given by the seller and to subsequent judicial lienors of the seller. If that did not follow, there was no reason to include sales of receivables in Article 9. Of course, this means that Gilmore would have found subsection 9-318(b) (if unperfected, seller is deemed to retain rights he had before sale) to be a tautology. In his kind way he might have said, "Well of course it is true but why must we say it twice? Redundancy is good in some forms of discourse but not in statutes."

So I leave old Article 9 clear that 9-318(b) would be the law of Article 9, but uncertain as to what the drafters of old Article 9 would say about 9-318(a).

III. CASES AND THE PEB

In the early years of old Article 9 a few cases sniffed around the edges of the problem. In one,[12] the court had to decide who was entitled to the excess receivables that were collected. If a sale, they go to the buyer; if a security interest securing an obligation, they go to the seller. A second case,[13] dealing with the same issue, contained a gratuitous statement that any sale "entails the passage of title." That off hand statement, doubtless made by a court unfamiliar with or uninterested in the exquisitely complicated history, would endorse the securitizers' position but conflict with Article 9's rules about priority of buyers who had failed to perfect. Beyond recognizing and applying what Article 9 already said about the proper inferences concerning the right to surpluses and deficiencies where there was a sale, neither of these cases truly examined the rights of a seller who has made a sale of receivables where the buyer has perfected.

In 1993, the first case truly to confront the critical issue, the infamous *Octagon Gas, Inc. v. Rimmer*[14] was decided. There, the Tenth Circuit held that an account that had been sold to a buyer who had perfected was nevertheless part of the seller's bankruptcy estate. This holding directly conflicted with the statement of law that has since become 9-318(a), and it created panic in the securitization trade.[15]

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12 Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979).

13 *In re* Contractors Equip. Supply Co., 861 F.2d 241 (9th Cir. 1988).

14 995 F.2d 948 (10th Cir. 1993).

15 *See, e.g.*, David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY

The Permanent Editorial Board ("PEB") for the Uniform Commercial Code responded to *Octagon Gas* and the ensuing panic in the securitizers' ranks with haste, perhaps even indecent haste. In June of 1994 the PEB issued Commentary Number 14. That commentary "adopt[ed] a contrary position." Acting like an ersatz appellate court, the PEB attempted to overrule *Octagon Gas.* The commentary also proposed an addition to comment 2 to 9-102 that disavowed an intention to leave any interest with a seller of accounts merely because he and his buyer were called "debtor" and "secured party" respectively. The commentary asserts that "a *close reading* of the text of Article 9 and its comments . . . *compels* the conclusion that Article 9 does not prevent the transfer of ownership."[16]

To my mind, the haste with which the PEB acted, the exaggerated claims about Article 9's text and comment, and the reliance on the weak support of the earlier cases give the lie to the Board's apparent confidence. A moderately cynical observer might surmise that the PEB was answering the threat of the securitizers' hot poker. In fact a "close reading" of the text and comments of old Article 9 leaves me in doubt about how its drafters would have decided *Octagon Gas*, and I suspect that the PEB members understood that. I suspect that they hastened their criticism of *Octagon Gas* into print principally to still the cries of the securitization industry.

The PEB commentary seemed to silence the natives until 2001 when Judge Bodoh issued a preliminary opinion in response to an emergency motion in *In re LTV Steel Company, Inc.*,[17] LTV and its

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L. REV. 1055, 1058 (1998):

> In Octagon Gas Systems, Inc. v. Rimmer (*In re* Meridian Reserve, Inc.), Judge Bobby Baldock set off an international fire storm of rage and indignation with the following humble statement: "The impact of applying Article 9 to Rimmer's account is that Article 9's treatment of accounts sold as collateral would place Rimmer's account within the property of [the] bankruptcy estate."

Id. (footnotes omitted); *see also* Thomas E. Plank, *When a Sale is not a Sale: A Critique of Octagon Gas*, 48 CONSUMER FIN. L.Q. REP. 45, 45 (1994) (discussing the *Octagon Gas* decision):

> Although the facts of the case do not involve the typical originator and seller of accounts and chattel paper, the court's erroneous language undermines the legal theory for the sale of all accounts and chattel paper. Destruction of the legal basis for this type of transaction may increase the financing costs of these businesses. First, buyers may exact a higher cost (in the form of a lower price) for buying accounts and chattel paper because they will be assuming the additional risk of the bankruptcy of the seller. Second, many buyers may refuse to buy these receivables. If businesses can only borrow on the security of these receivables, the reduction of the supply of the financing may cause or allow the imposition of greater costs onto the borrower. In addition, those businesses who can sell their receivables but who cannot obtain loans secured by the receivables or otherwise raise money to continue or expand business may lose their only source of financing.

Id. (footnotes omitted).

[16] PEB Commentary No. 14, June 10, 1994, second paragraph (emphasis added).

[17] 274 B.R. 278 (Bankr. N.D. Ohio 2001).

lenders had entered into an unconventional securitization of its receivables and an even more unconventional procedure to move title to LTV's inventory to a wholly owned subsidiary. The subsidiary to which LTV sold the receivables had granted a perfected security interest in those to a British bank. The subsidiary holding "title" to the inventory had granted a perfected security interest to Chase and several other banks.

In his preliminary opinion, Judge Bodoh ordered the "secured lenders to turnover to Debtor the cash proceeds of the inventory and receivables." The Judge refused to reverse that order without an evidentiary hearing. His refusal was accompanied by the following statement that must have sent chills through the securitizers' bones:

> Furthermore, there seems to be an element of sophistry to suggest that Debtor does not retain at least an equitable interest in the property that is subject to the interim order. Debtor's business requires it to purchase, melt, mold and cast various metal products. To suggest that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept. Accordingly, the Court concludes that Debtor has at least some equitable interest in the inventory and receivables, and that this interest is property of the Debtor's estate. This equitable interest is sufficient to support the entry of the interim cash collateral order.

Even though the opinion was only "preliminary" and even though it was issued by a bankruptcy judge and not by an appellate court, this opinion was more threatening than the *Octagon Gas* opinion. First, it was issued in a true securitization case. Second, it was issued in the face of the best legal arguments that the securitization industry could muster. Third and lastly, it was issued despite the industry's explanation of the economic cataclysm that might follow.[18] Unlike *Octagon Gas*, which appeared on the industry's radar screen without

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[18] *See* Greg Zipes, *Securitization: Challenges in the Age of LTV Steel Company, Inc.*, 2002 ANN. SURV. BANKR. L. 105, 113-14:

> Following the entry of the interim financing order, numerous interest groups banded together to convince the court it had made a mistake, and sought leave to file amici curiae memoranda. These groups included sellers of asset-backed securities, issuers of asset-backed securities, the Bond Market Association (which represented that its members account for more than 97% of all primary market distribution and secondary market trading of debt security in U.S. capital markets). (See, Motion For Leave To File A Memorandum On Behalf Of Amici Curiae In Opposition To The Debtors' Emergency Motion For An Order Granting Interim And Final Authority To Use Cash Collateral at 1, 2). They contended that the 'Debtor's Emergency Motion not only challenges the particulars of LTV's own receivable and inventory securitizations, but also launches a frontal assault on the basic legal concepts of absolute transfers among affiliated entities that make securitization possible.' (*Id.* at 3) The groups concluded that the bankruptcy court had erred in assuming that the assets were part of the originator's estate, and for permitting borrowing based upon the mistaken assumption.

Id.

warning and delivered its ordinance without real opposition, here, neither early warning nor a strong defense protected the industry position.

Shortly after the opinion was issued, the secured lenders and LTV entered into a financing agreement to allow LTV to use the receivables and collateral and LTV gave up its challenge to the securitizations. Judge Bodoh's approval of the financing agreement nullified the effect of his interim opinion. Although the opinion was issued after 1999 Article 9 had been promulgated, the opinion makes no reference to 9-318.

IV. THE ARTICLE 9 REVISION

In the Article 9 revision process, the rights of securitizers against the trustees in bankruptcy of their sellers only slowly bubbled to the surface. What grew into section 9-318(b) first appears in the May 1996 draft of revised Article 9:[19]

> (b) For purposes of determining the rights of creditors of, and purchasers of an account or chattel paper from, a debtor that has sold an account or chattel paper, while the buyer's security interest is unperfected, the debtor has rights and title to the account or chattel paper identical to those the debtor sold.

The need for such a section may have occurred to the drafters from their work on old 9-114. That section required a consignor (creditor) to behave like a purchase money lender if he was to achieve priority over secured creditors of the consignee (debtor). The February 1996 draft added a new preliminary sentence that specified the consignee's (debtor's) rights in goods transferred under a consignment.[20] For consignments this is the analog to a statement of the rights of the seller (debtor) of receivables. A consignee in a consignment occupies the

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[19] *See* U.C.C. Revised Art. 9 § 9-114 (Discussion Draft May 1996).

§ 9-114 Rights and Title of Consignee and Seller of Account or Chattel Paper with Respect to Creditors and Purchasers.

> (a) For purposes of determining the rights of creditors of, and purchasers of goods from, a consignee, while goods are in the possession of the consignee and the consignor's security interest is unperfected, the consignee has rights and title to the goods identical to those the consignor had or had power to transfer.
>
> (b) For purposes of determining the rights of creditors of, and purchasers of an account or chattel paper from, a debtor that has sold an account or chattel paper, while the buyer's security interest is unperfected, the debtor has rights and title to the account or chattel paper identical to those the debtor sold.

Id.

[20] For purposes of determining the rights of creditors of, and purchasers of goods from, a consignee, while goods are in the possession of a consignee the consignee has rights and title identical to those the consignor had or had power to transfer.

same position as the seller in the sale of receivables. In the one case we need to know what the debtor-transferee got and in the other we need to know what the debtor-seller retained. So, having specified the status of a consignee's interest in the consigned goods in the preamble to 9-114, the drafters apparently thought it appropriate to state the interest of a seller of receivables.

If my guess is right—that old 9-114 suggested the need for a statement of a consignee's title and that that statement in turn suggested the need for a statement of a receivable seller's title—there is a real irony because section 9-114 was later abandoned as unnecessary once consignments had been redefined and included more extensively in 1999 Article 9. The only thing that remains of 9-114 in 1999 Article 9 is the 1999 drafters' addition put there as part of the revision process.[21]

In the May 1996 draft, the language that later became 9-318(b), became black letter as 9-114(b).[22] In their comments, the drafters acknowledge that they are unsure of the need for the section and suggest that the statement of the debtor's rights in accounts sold is here as a proper partner to the statement of the consignee's rights and title. The section is in brackets to show that it has not yet earned a place in the text.

The section disappears completely from the draft of October 1996. The comments show that "[a]t its June, 1996, meeting the Drafting Committee voted to eliminate 9-114 and requested the reporters to explain in the comments that the same results may be achieved by implication from a proper reading of Article 9's priority rules."[23] In what might be regarded as a modest act of civil disobedience (or perhaps merely an ungracious show of pique), the reporters include the full text of the former 9-114 in the comments with the immodest claim that the now rejected section "addressed this issue directly, clearly, and succinctly." The reporters state that they "continue to prefer the statutory approach . . . ." By February 1997 old 9-114 reappears in the text as section 9-315A;[24] the reporters got their way.

Neither the reporters nor the committee members to whom I have spoken remember just why the committee pushed for removal. Presumably the reporters pushed for inclusion because they believed the statement of the law was accurate and that it would clarify things to have it said in so many words. Recall that 9-318(a) has not yet come on stage. It seems to me that 9-318(b) was redundant but, absent

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[21] *See* U.C.C. Revised Art. 9 § 9-319A (1999).

[22] *See id.* § 9-114(b).

[23] *See* U.C.C. Revised Art. 9 (Discussion Draft Oct. 1996) (referencing more specifically Reporters' cmt. 3).

[24] *See* U.C.C. § 9-315A (Draft Feb. 1997). Rights and title of consignee and seller of account or chattel paper with respect to creditors and purchasers.

juxtaposition with section 9-315A, 9-318(b) would have caused little trouble.

The comments to 9-315A in the August 1997 draft have an example to show that a buyer who fails to perfect will be subordinate to a later buyer who perfects. That draft also has a statement in the comments that foretells 9-318(a):

> However, if the security interest of a buyer of an account or chattel paper is perfected, the seller normally would not retain property rights in the account or chattel paper.

The reporters are not yet unequivocal; only *normally* the seller retains no right. So at least in 1997, abnormally or non-normally the seller would retain some rights even in sold receivables, even if the buyer had perfected.

Things remain more or less unchanged until August of 1998 when 9-318 first becomes the home of the statement of the debtor-seller's rights when the buyer has not perfected. In that draft the quoted language from the August 1997 comments (all is gone on sale) is formalized as comment 3 to 9-318:

> 3. Effect of Perfection. If the security interest of a buyer of accounts or chattel paper is perfected, the seller normally would not retain any property rights in the accounts or chattel paper.

In 1999 the formulation that now appears as section 9-318 is adopted. This language has several significant changes from the 1998 drafts. First, the substance of comment 3 becomes 9-318(a). For the first time the statute itself has the two arguably inconsistent statements side by side. Neither the comments nor anything else written by the reporters shows why subsection (a) came out of the comments and into the text.[25] Is this the hand of the securitizers at work? Perhaps so. One can imagine them saying that the presence of subsection (b) in the statute entitles their provision (subsection (a)) to the same rank.

The statutory version drops the "normally" and the statement now covers title not only to accounts and chattel paper but also to payment intangibles and promissory notes. Were the latter two categories of collateral added to give the securitizers cover for transfers of those

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[25] E-mail from Steven Harris, reporter to the Drafting Committee to revise Uniform Commercial Code Article 9, to James J. White, Robert A. Sullivan Professor of Law, University of Michigan Law School (Aug. 20, 2003) (on file with author).

> It appears that Subsection (a) was added in response to a proposed comment (the final version of which appears as comment 7 to 9-109) to the effect that the seller of a receivable retains no interest in the receivable sold. A drafting committee member thought the proposed comment was inconsistent with the language in the approved draft (which . . . is to the effect that, under specified circumstances and for specified purposes, 'the debtor has rights and title . . . identical to those the debtor sold'.). Subsection (a) was designed to eliminate any argument that the text did not support the comment.

Id.

commonly securitized assets? Of course, a securitizer assumes that he will perfect and is concerned principally with the trustee's capacity to grab hold of something remaining in the debtor's hands even after a sale where the buyer has perfected.

The other change that first appears in 1999 is the addition of the verb "deemed" in 9-318(b). Formerly the section read, "while the buyer's security interest is unperfected, the debtor *has* rights and title . . . identical to those the debtor sold." (emphasis added). In 1999 that becomes "while the buyer's security interest is unperfected, the debtor is *deemed to have* rights and title . . . identical to those the debtor sold." (emphasis added). Is the title of one who "has" rights different from the title of one who is "deemed to have" rights? I am not sure. Here evidently the conflict between (a) "retains nothing" and (b) "has rights" got stuck in the drafters' esophagus. And maybe they are right; the pill is easier to swallow if we say only that the seller will be treated as though he had rights. As a legal realist, I remain skeptical. I would argue that the addition of the verb "deemed" in 1999 shows the drafters' anxiety about the very question dealt with in this paper. It marks where the horse is buried.

Having upgraded "normally" to always, but still aware of the possible conflict between the two subsections, the drafters turned to the comments. As I read the comments to 9-318 and those to 9-109, I think I can sometimes hear Chuck Mooney's voice rising (or perhaps the voices of both Steve and Chuck). It is like speaking to one who does not understand English: if you shout, perhaps they will understand.

In Comment 2 to 9-318 Chuck reinforces the statute by asserting not only that a seller has "no interest" but that he "retains no interest *whatsoever* in the property" (emphasis added).

In Comment 5 to 9-109 he speaks even louder. First he tells the reader to draw no inferences about title from the use of words like "debtor, security interest [or] collateral." His voice rises to a crescendo toward the end:

> It [subsequent creditors' achieving priority over a buyer who has not perfected] *is so for the simple reason that Sections 9-318(b), 9-317, and 9-322 make it so* as did former Sections 9-301 and 9-312. Because the buyer's security interest is unperfected, for purposes of determining the rights of creditors of and purchasers for value from the debtor-seller, under Section 9-318(b) the debtor-seller is deemed to have the rights and title it sold.

Is it unfair to suggest that this shouting shows doubt, or perhaps exasperation with committee members who don't "get it?" And does not the need to change "has" to "deemed to have" show the same? Of course, making it clear that subsection 9-318(b) states the rights of most subsequent takers outside of bankruptcy does not itself answer the real question, whether it is proper for a court to infer from the rule now stated in 9-318(b) that there is a large enough title fragment left behind to give a trustee in bankruptcy a hand hold under section 541 of the Bankruptcy Code even if the buyer has perfected.

CONCLUSION

In this paper I have described but a small by-play in the unceasing effort of secured creditors (in this case securitizers) to escape the grasp of the trustee in bankruptcy and of the opposing effort of the unsecureds to strengthen that reach. Unsecured creditors, through their agent the trustee in bankruptcy, look everyday for ways to avoid security interests (544 et seq.), to forestall secured creditors' claims to interest during the bankruptcy (506), to take a bit of the milk produced by the secureds' cow during bankruptcy (363), to expand the bankruptcy estate (541), and generally to obstruct acts that the secured could take outside of bankruptcy (362).

Because the rights of the trustee arise from federal bankruptcy law, drafters of state law have only a circumscribed capacity to restrict the trustee. According to the Supreme Court, federal bankruptcy law must depend on and respect state law rules on security, passage of title, and the like.[26] But the state law cannot deny rights to the trustee that it would grant to a similarly situated creditor.[27] So limiting a trustee's

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[26] *See* BFP v. Resolution Trust Corp., 511 U.S. 531 (1994) (stating that the Court will not presume an intention on the part of Congress in enacting bankruptcy laws to displace traditional state regulation over the security and stability of title to real property); Butner v. United States, 440 U.S. 48 (1979) (noting that the results in federal bankruptcy proceedings will vary as the state law governing security interests varies).

[27] *See Butner*, 440 U.S. at 52-57 (granting certiorari to resolve a conflict between Circuits on the proper interpretation of the federal statutes governing the administration of bankrupt estates. The Second, Fourth, Sixth, Eighth and Ninth Circuits all look to state law to determine whether a security interest in property extends to rents and profits derived from the property. The Third and Seventh Circuits had adopted a federal rule of equity that affords the mortgagee a secured interest in the rents even if state law would not recognize any such interest until after foreclosure. The Supreme Court held:

> The constitutional authority of Congress to establish 'uniform Laws on the subject of Bankruptcies throughout the United States' would clearly encompass a federal statute defining the mortgagee's interest in the rents and profits earned by property in a bankrupt estate. But Congress has not chosen to exercise its power to fashion any such rule. The Bankruptcy Act does include provisions invalidating certain security interests as fraudulent or as improper preferences over general creditors. Apart from these provisions, however, Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law.

Id. at 54.

The Supreme Court thus rejected a uniform Federal treatment of property interests, which would reduce uncertainty, and discourage forum shopping with the possibility of a windfall by happenstance of bankruptcy, because this approach would afford mortgagee's rights they did not have as a matter of state law. The Court held:

> The rule we adopt avoids this inequity because it looks to state law to define the

rights by state law is like trying to control an obstinate robot from a remote location; sometimes the directions get through and sometimes they don't. Have the drafters succeeded here? Probably.

First one should understand that subsection 9-318(b) does not change the law. The rule stated in that subsection was plainly the law under the former version of Article 9.

Whether the rule stated in subsection (a) was the law before 1999 is less clear. *Octagon Gas* said no, whereas the PEB said yes. Because state laws are coming close to adding a provision that makes special rules for the trustee, compared with others, its success is not assured. For all of the reasons stated above, I think the drafters were themselves unsure of their success. The inclusion of a bulletproof securitizers' protection in the failed Bankruptcy Bill of 2002[28] demonstrates that

> security interest of the mortgagee. At the same time, our decision avoids the opposite inequity of depriving a mortgagee of his state-law security interest when bankruptcy intervenes. . . . The essential point is that in a properly administered scheme in which the basic federal rule is that state law governs, the primary reason why any holder of a mortgage may fail to collect rent immediately after default must stem from state law.

Id. at 56, 57 (citations omitted); *see also* 1 COLLIER ON BANKRUPTCY ¶ 541.LH[3][a](15th ed. Rev. 2000).

> The Bankruptcy Code in Section 541 eliminates any unnecessary, avoidable dependence on nonbankruptcy law. Section 541 provides that the commencement of a case creates an estate consisting, most importantly, of all legal or equitable interests of the debtor in property at the time of the commencement of the case. Under this provision it will still be necessary to look to nonbankruptcy law, usually state law, to determine whether the debtor has any legal or equitable interest in any particular item. However, unlike the requirement of Section 70a(5) of the Bankruptcy Act, it is not necessary under the code to further determine whether the nonbankruptcy law permits the debtor to transfer the property or permits the debtor's creditors to reach it. Although the debtor's interest in an item will be determined by nonbankruptcy law, the question of what constitutes property within the meaning of Section 541 apparently remains a federal question.

Id. (footnotes omitted); *see also* G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 AM. BANKR. INST. L. REV. 3 (2001).

> Since the federal bankruptcy law generally defers to non-bankruptcy law to define the rights of the parties in interest in a bankruptcy proceeding, any significant change in an important area of substantive state law is likely to have bankruptcy implications. However, the bankruptcy implications of the current revision of Article 9 are particularly significant because Article 9 defines the relative rights in the estate's personal property of the most significant players in many bankruptcy cases – the secured and unsecured creditors. Thus, changes in Article 9 can go to the heart of the bankruptcy and reorganization process.

Id.

[28] 11 U.S.C. § 912. Section 541 of title 11, United States Code, is amended —

> (1) in Subsection (b), by inserting after paragraph (7), as added by this Act, the following:
> (8) any eligible asset (or proceeds thereof), to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization, except to the extent such asset (or proceeds or value thereof) may be recovered by the trustee under Section 550 by virtue of avoidance under 548(a); and
> (2) by adding at the end the following new subsection:

even the securitizers have doubt.

Although I am put off by the securitizers' hysterical claims that the sky will fall if they are treated like ordinary secured creditors in bankruptcy, I am convinced that the Bankruptcy Code should be more respectful of security interests than it has been, and, for that reason, I hope that the courts eventually adopt the position of the PEB and of the drafters of 1999 Article 9.

I suspect that the inclusion of 9-318 in 1999 Article 9 has modestly diminished the chances for securitizers. By thrusting the inconsistency (follow form here, follow substance there) before courts' noses, the section makes clear what a court is doing when it treats securitized assets as beyond the trustee's reach. And by leaving behind trash in the

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(f) For purposes of this Section —

(1) the term 'asset-backed securitization' means a transaction in which eligible assets transferred to an eligible entity are used as the source of payment on securities, including, without limitation, all securities issued by governmental units, at least one class of tranche of which was rated investment grade by one or more nationally recognized securities rating organizations, when the securities were initially issued by an issuer;

(2) the term 'eligible asset' means—

(A) financial assets (including interests therein and proceeds thereof), either fixed or revolving, whether or not the same are in existence as of the date of the transfer, including residential and commercial mortgage loans, consumer receivables, trade receivables, assets of governmental units, including payment obligations relating to taxes, receipts, fines, tickets, and other sources of revenues and lease receivables, that, by their terms, convert into cash within a finite period of time, plus any residual interest in property subject to receivables included in such financial assets plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders;

(B) cash; and

(C) securities, including without limitation, all securities issued by governmental units;

(3) the term 'eligible entity' means—

(A) an issuer; or

(B) a trust, corporation, partnership, governmental unit, limited liability company (including a single member limited liability company), or other entity engaged exclusively in the business of acquiring and transferring eligible assets directly or indirectly to an issuer and taking actions ancillary thereto;

(4) the term 'issuer' means a trust, corporation, partnership, or other entity engaged exclusively in the business of acquiring and holding eligible assets, issuing securities backed by eligible assets, and taking actions ancillary thereto; and

(5) the term 'transferred' means the debtor, under a written agreement, represented and warranted that eligible assets were sold, contributed, or otherwise conveyed with the intention of removing them from the estate of the debtor pursuant to Subsection (b)(8) (whether or not reference is made to this title or any Section hereof), irrespective and without limitation of—

(A) whether the debtor directly or indirectly obtained or held an interest in the issuer or any securities issued by the issuer;

(B) whether the debtor had an obligation to repurchase or to service or supervise the servicing of all or any portion of such eligible assets; or

(C) the characterization of such sale, contribution, or other conveyance for tax, accounting, regulatory reporting, or other purposes.

Id.

statute ("deemed") and in the comments (it means what it says and nothing more "whatsoever"), the drafters have shown their own uncertainty. In my opinion it would have been better if the drafters had not felt compelled to say what was already known—that (b) was the law—and if the securitizers had not then insisted on equal billing by the addition of subsection (a).