

Permanent Editorial Board for the Uniform Commercial Code

PEB COMMENTARY NO. []
SECTIONS 9-203(b)(2) AND 9-318

Draft for Public Comment

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Comments on this draft must be submitted by no later than May 3, 2021.

Comments may be submitted by email to UCCComments@ali.org

**This draft has been approved for publication by the PEB
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PREFACE TO PEB COMMENTARY

The Permanent Editorial Board for the Uniform Commercial Code acts under the authority of the American Law Institute and the Uniform Law Commission (also known as the National Conference of Commissioners on Uniform State Laws). The Permanent Editorial Board has resolved to issue from time to time supplementary commentary on the Uniform Commercial Code to be known as *PEB Commentary*. These *PEB Commentaries* seek to further the underlying policies of the Uniform Commercial Code by affording guidance in interpreting and resolving issues raised by the Uniform Commercial Code and/or the Official Comments. The Resolution states that:

The underlying purposes and policies of the *PEB Commentary* are those specified in UCC Section 1-103(a). A *PEB Commentary* should come within one or more of the following specific purposes, which should be made apparent at the beginning of the Commentary: (1) to resolve an ambiguity in the UCC by restating more clearly what the PEB considers to be the legal rule; (2) to state a preferred resolution of an issue on which judicial opinion or scholarly writing diverges; (3) to elaborate on the application of the UCC where the statute and/or the Official Comment leaves doubt as to the inclusion or exclusion of, or application to, particular circumstances or transactions; (4) consistent with UCC Section 1-103(a)(2), to apply the principles of the UCC to new or changed circumstances; (5) to clarify or elaborate upon the operation of the UCC as it relates to other statutes (such as the Bankruptcy Code and federal and state consumer protection statutes) and general principles of law and equity pursuant to UCC Section 1-103(b); or (6) to otherwise improve the operation of the UCC.

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ISSUE

If (i) a creditor files a financing statement with respect to a debtor's account, chattel paper, payment intangible or promissory note (a "receivable") and only subsequently extends credit to the debtor, which at that time authenticates a security agreement describing the receivable¹, but (ii) between those two events, the debtor sells the receivable to a buyer who perfects its security interest in it, does the creditor have an enforceable security interest in the receivable?

DISCUSSION

From its inception, Article 9 of the Uniform Commercial Code ("UCC") has governed both security interests in personal property that secure obligations and the outright sale of certain payment rights. Article 9 now governs sales of payment rights that are accounts, chattel paper, payment intangibles, or promissory notes.² Because sales of those receivables are within the scope of Article 9, the key terms in the Article have been defined broadly enough to cover those sales. Thus, "security interest" includes the rights of the buyer of covered payment rights,³ "secured party" includes the buyer of those payment rights,⁴ "debtor" includes the seller,⁵ and "collateral" includes the sold payment rights.⁶ As a result, rules that apply to "security interests" (including, with relevance to the question at hand, rules governing enforceability, attachment, perfection and priority of security interests) apply, except where otherwise noted, to the rights of a buyer of a covered payment right.

A question has been raised as to the proper interpretation of Article 9 rules governing enforceability, attachment, and priority of security interests when a receivable has been sold by its owner (thereby creating a "security interest" in the receivable in favor of the buyer) between (i) the pre-filing of a financing statement covering the receivable listing its owner as the debtor and (ii) the conclusion of a transaction in which the secured party listed on that financing statement either extends credit for which the receivable is collateral or sells the receivable and, in either case, the debtor authenticates a security agreement with respect to the transaction.

The question is framed by the following Example A. Example A involves accounts, but the same analysis would apply to any receivables.

¹ Such filing before a security interest is created is authorized by Article 9 (see UCC § 9-502(d)) and is usually referred to, and will be referred to in this Commentary, as "pre-filing."

² In the current version of the UCC, the application of Article 9 to sales of certain rights to payment is set forth in § 9-109(a)(3) (Article 9 applies to "a sale of accounts, chattel paper, payment intangibles, or promissory notes"). Prior to the version of Article 9 that went into effect on July 1, 2001, Article 9 applied to sales of accounts and chattel paper, but not to sales of payment intangibles and promissory notes.

³ See UCC § 1-201(b)(35)

⁴ See UCC § 9-102(a)(73)(D).

⁵ See UCC § 9-102(a)(28)(B).

⁶ See UCC § 9-102(a)(12)(B).

1. At time T, SP-1 (with proper authorization to do so) files a financing statement against Debtor covering accounts. Debtor does not grant SP-1 an interest in any account at that time in an authenticated security agreement.

2. At time T+1, Debtor authenticates an agreement that sells to SP-2, for value, a given account (“Account X”) owned by Debtor. (SP-2’s ownership interest in Account X is a security interest as defined in UCC Section 1-201(b)(35).) SP-2 files a financing statement against Debtor covering Account X.

3. At time T+2, for value given that day, Debtor authenticates an agreement stating that Debtor grants to SP-1 a security interest in Account X that secures an obligation.

What are the rights of SP-1 and SP-2 in Account X after these events?

Some have taken the position that, because Account X was sold by Debtor before value was given by SP-1 and Debtor authenticated the security agreement on Day T+2, SP-1 does not have an enforceable or attached security interest because Debtor did not have “rights in the collateral” on Day T+2). For the reasons explained in this commentary, that position should not prevail.

Article 9 has two sets of rules that determine the rights of putative secured parties vis a vis other claimants – (i) rules such as that in UCC Section 9-203(b)(2) (providing that one element of an enforceable and attached security interest is that the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party), which give effect to the property maxim *nemo dat quod non habet*⁷ and (ii) priority rules found in UCC Sections 9-322 *et seq.* While the borderline between the applicability of these two sets of rules has not been explicitly stated in Article 9, the language and structure of Article 9 demonstrate that the priority rules, rather than the *nemo dat* maxim, apply when a debtor purports to grant a security interest in the same property to two different secured creditors.

The application of the *nemo dat* rule of UCC Section 9-203(b)(2) to most situations is quite clear. For example, if a debtor purports to grant a security interest in an asset in which the debtor has never had any rights or the power to transfer rights, the putative secured party will not have an enforceable and attached security interest in that asset. The same is true if the debtor owned the asset at some time in the past but transferred that asset to a transferee before the purported grant of the security interest in that asset. Thus, if a debtor today purports to grant a security interest in an automobile that it sold three years ago, the security interest will not be enforceable or attached because the debtor no longer has rights in the collateral or the power to transfer rights to a secured party. Similarly, if a debtor purports to grant a security interest in an item of property of which it was formerly the sole owner, but in which the debtor transferred an undivided half-interest to another person three-years ago with the result that the debtor and transferee own as tenants in common, the secured party will have an enforceable and attached security interest only in the debtor’s interest as tenant in common in the item of property.

⁷ The maxim is usually translated as “one cannot give what one does not have.” It is frequently referred to in abbreviated form, and will be so referred to here, as *nemo dat*.

By way of contrast, the relative rights of two secured parties to whom the debtor has purported to grant security interests in the same item of property have been resolved by application of Article 9's priority rules rather than the *nemo dat* principle of UCC Section 9-203(b)(2).

Consider the following Example B. Example B is identical to Example A, except that in Example B the security interest in Account X granted to SP-2 at time T+1 is an interest that secures an obligation rather than outright ownership:

1. At time T, SP-1 with proper authorization files a financing statement against Debtor covering accounts. Debtor does not at that time grant SP-1 an interest in any account.

2. At time T+1, SP-2 makes a loan to Debtor and Debtor authenticates an agreement that, to secure its repayment obligation, grants to SP-2 a security interest in a given account ("Account X") owned by Debtor. SP-2 files a financing statement against Debtor covering Account X.

3. At time T+2, SP-1 makes a loan to Debtor and Debtor authenticates an agreement that, to secure its repayment obligation, grants to SP-1 a security interest in a given account ("Account X") owned by Debtor.

As of time T+1, Debtor owned Account X subject to the enforceable and attached security interest of SP-2. Thus, if the *nemo dat* principle applied, Debtor would subsequently be capable of creating a security interest only in its remaining interest in Account X – that is, ownership subject to the security interest of SP-2 – and SP-1 would therefore obtain its rights in Account X from Debtor subject to the security interest of SP-2.

But it has been clear since the original promulgation of Article 9 that Example B is to be resolved by application of the Article 9 priority rules rather than its *nemo dat* rules. Under former Article 9, this result was mandated by former UCC Section 9-312(5) (the predecessor of current UCC Section 9-322(a)(1)), and was explained in Official Comment 5, Example 1 to former UCC § 9-312:

5. A files against X (debtor) on February 1. B files against X on March 1. B makes a non-purchase money advance against certain collateral on April 1. A makes an advance against the same collateral on May 1. A has priority even though B's advance was made earlier and was perfected when made. It makes no difference whether or not A knew of B's interest when he made his advance.

As the comment further explains:

This Article [i.e., former Article 9] follows several of the accounts receivable statutes in determining priority by order of filing. The justification for the rule lies in the necessity of protecting the filing system—that is, of allowing the secured party who has first filed

to make subsequent advances without each time having, as a condition of protection, to check for filings later than his.

Thus, even though, when debtor X granted A a security interest in the collateral on May 1, it owned the collateral subject to the security interest of B, A's security interest is not subject to that of B. The same is true in current Article 9 (see e.g., UCC § 9-322(a)(1)) and essentially the same explanation is given in Official Comment 4 to that section.

Accordingly, under both former Article 9 and the current version, the Article's priority rules determine the relative rights of two secured parties and its *nemo dat* principles do not otherwise limit the rights of the party whose security interest was created second. Those who would take the position that, in Example A, because Account X was sold by Debtor before value was given and Debtor authenticated the security agreement on Day T+2, SP-1 does not have an enforceable or attached security interest, are arguing that the principle that requires application of Article 9's priority rules rather than *nemo dat* does not apply when one of the security interests arises from a sale. There was no textual basis for that distinction in former Article 9 and, notwithstanding additional language in current Article 9, this Commentary concludes that the answer in current Article 9 is the same.

The position taken by some that current Article 9 mandates a different result with respect to this issue than that resulting from former Article 9 is inspired by UCC Section 9-318, which was added to Article 9 in the revision that went into effect in 2001. Subsection (a) of that section states: "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." This subsection codifies the criticism of *Octagon Gas Systems, Inc. v. Rimmer*⁸ that was initially published in PEB Commentary No. 14 and does not represent a change in the law. Rather, as Comment 2 to the section observes, subsection (a) merely "makes explicit what was implicit, but perfectly obvious, under former Article 9."⁹ Thus, UCC Section 9-318(a) can be seen as making a forceful statement about the *nemo dat* rule but not changing the implicit principle that determines which issues are controlled by *nemo dat* and which are controlled by the Article 9 priority rules.

Support for the assertion that current Article 9 mandates the application of *nemo dat* rather than priority rules when one or both of the competing security interests is created by the sale of a receivable is sometimes more particularly drawn from UCC Section 9-318(b). That subsection provides:

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.

⁸ 995 F.2d 948 (10th Cir. 1993)

⁹ See also Steven L. Harris & Charles W. Mooney, Jr., *Using First Principles of UCC Article 9 to Solve Statutory Puzzles in Receivables Financing*, 46 GONZ. L. REV. 297, 305-06 (2010/11) (statement by the co-reporters for Revised Article 9); Steven L. Harris & Charles W. Mooney, Jr., *How Successful Was the Revision of UCC Article 9?: Reflections of the Reporters*, 74 CHI-KENT L. REV. 1357, 1398 n.178 (1999) (same).

Read in conjunction with Section 9-318(a) but in isolation from the remainder of Article 9, Section 9-318(b) could leave the impression that only when a sale of a receivable is unperfected does the seller retain an interest in the receivable sufficient to enable the seller to create a security interest in it.¹⁰ If this were the case, SP-1 in Example A would not have a security interest in Account X, even though it filed a financing statement before SP-2 obtained its interest, because at the time that Debtor purported to grant a security interest in the account to SP-1, it has already sold the account to SP-2 and SP-2 had perfected its security interest.

While that reading of Section 9-318, standing alone, could be seen as consistent with the language of the section, it becomes less supportable when the section is read in conjunction with (i) the implicit structure of Article 9 described above, (ii) changes made to Section 9-203(b)(2) at the same time that Section 9-318 was added, (iii) the Official Comment indicating that the addition of Section 9-318 did not represent a change in the law, (iv) the presence in current Article 9 of priority rules that cannot be applied in a way that is consistent with that reading, and (v) the drafters' intent to avoid the necessity to distinguish between sales of receivables and their use as collateral for an obligation.

The changes to Section 9-203(b)(2) deserve a further explanation. When Section 9-318 was added to Article 9, Section 9-203(b)(2) was amended at the same time to recognize explicitly that a debtor can create an enforceable security interest even if it no longer has “rights in the collateral.” The new language states what was previously implicit – that there are exceptions to *nemo dat* in situations in which a debtor has “power to transfer rights” in an item that exceed the debtor’s own rights in the item. The provision does not attempt to identify those situations. Some are set forth in provisions of the UCC outside Article 9, of which several are referred to in Article 9¹¹ and others are not.¹² Other exceptions follow by necessary implication from the provisions of Article 9 itself. The priority rules set forth in Part 3, Subpart 3 often give a later-in-time interest priority over an earlier-in-time interest. As the Official Comments note, it is a necessary implication of those rules that the debtor has power, to that extent, to transfer greater rights than the debtor owns. Indeed, the Comments make the relationship to the priority rules explicit: “Certain exceptions to the baseline rule [of *nemo dat*] enable a debtor to transfer, and a security interest to attach to, greater rights than the debtor has. See Part 3, Subpart 3 (priority rules).”¹³

In addition, there are priority rules in current Article 9 that are not consistent with the view that once a receivable has been sold and the buyer’s security interest has been perfected, the seller can no longer create a security interest in the receivable. Consider the following Example C:

¹⁰ Subsection (b) refers only to accounts and chattel paper because the sales of the other types of receivables – payment intangibles and promissory notes, perfect automatically upon their attachment. See UCC § 9-309(3)-(4). Accordingly, there cannot be an enforceable and attached, but unperfected, security interest in payment intangibles or promissory notes.

¹¹ See, e.g., § 9-331(a) (referring to the rights of a holder in due course of a negotiable instrument under Article 3, the rights of a holder to which a negotiable document of title has been duly negotiated under Article 7, and the rights of a protected purchaser of a security under Article 8).

¹² E.g., § 2-403(1) (providing that a person with “voidable title” to goods has power to transfer “good title” to a good faith “purchaser,” which term includes a secured party).

¹³ § 9-203 cmt. 6 ¶2.

1. At time T, Debtor authenticates an agreement that sells to SP-1, for value, a promissory note owned by Debtor. SP-1's ownership interest in the promissory note is a security interest as defined in UCC Section 1-201(b)(35). SP-1's security interest is perfected when it attaches pursuant to UCC Section 9-309(4).

2. At time T+1, Debtor authenticates an agreement that grants to SP-2, for value, a security interest in the promissory note that secures an obligation. SP-2 takes possession of the promissory note in good faith and without knowledge that its purchase violates the rights of SP-1.

UCC Section 9-330(d) affords SP-2's security interest priority over that of SP-1. This necessarily must mean that Debtor can create an enforceable and attached security interest in the promissory note even after selling the note to SP-1 and the perfection of SP-1's security interest. Thus, while under Section 9-318 Debtor had no "rights in" the promissory note at T+1, it must be the case that Debtor had "power to transfer rights" in the promissory note greater than Debtor's own rights in it. As a result, SP-1 owns Y subject to SP-2's security interest.

Finally, one of the reasons for including the sale of receivables in the scope of Article 9 was to

avoid difficult problems of distinguishing between transactions in which a receivable secures an obligation and those in which the receivable has been sold outright. In many commercial financing transactions the distinction is blurred.¹⁴

Yet, if Article 9 were interpreted so that, in Example A, SP-2 has a security interest and SP-1 does not, that "blurred distinction" would be outcome determinative. This is because, if the transaction with SP-2 had created a security interest securing an obligation rather than being an outright sale, SP-1 would not only have a security interest but its security interest would have priority over that of SP-2 under UCC Section 9-322(a)(1). One of the cardinal principles of interpretation of the UCC is that it must be liberally construed to promote its underlying purposes and policies.¹⁵ More specifically, "the text of each section should be read in light of the purpose and policy of the rule or principle in question, as also of the Uniform Commercial Code as a whole, and the application of the language should be construed narrowly or broadly, as the case may be, in conformity with the purposes or policies involved."¹⁶ Following this principle, an interpretation that would make resolution of the rights of competing assignees of a receivable depend on determination of whether the assignment to one of them was to secure an obligation or was an outright sale should be avoided if possible.

CONCLUSION

In sum, UCC Section 9-318, read in isolation, might leave the impression that, in situations such as Example A, SP-1 would not obtain a security interest in the assigned

¹⁴ § 9-109 cmt. 4 ¶1.

¹⁵ UCC § 1-103(a).

¹⁶ Id. cmt. 1 ¶3.

receivables. However, when that section is read in context with the remainder of Article 9, it can be seen that that is neither the intended result nor the result mandated by the language of the statute.

This conclusion is supported not only by the priority structure in Article 9 but also by additional factors. Importantly, the Comment to Section 9-318 indicates that the section was not intended to change the law as it existed before the addition of that Section. In addition, there is no indication that the drafters of revised Article 9 intended to change the policy under former Article 9 that a party that pre-files with respect to receivables when there no other financing statements on file that could perfect a security interest in those receivables need not worry about losing priority to a subsequent filer. Similarly, there is no indication that the addition of Section 9-318 was intended to create a situation under which the priority of a pre-filer with respect to receivables, and the existence of its subsequently created security interest, depends on the characterization, as sale or security interest securing an obligation, of a subsequent, possibly complex, transaction involving receivables. Moreover, since the details of a subsequent transaction that would determine that characterization typically are private, the earlier filer would not have the ability to determine whether a subsequent filing covering the same receivables related to an outright sale of receivables or a security interest securing an obligation. Accordingly, if the rights of the pre-filing secured party depended on that characterization, that party would be unable to determine its rights from the record.

Thus, in the context of a security interest resulting from the sale of receivables, the *nemo dat* rule in UCC Section 9-203(b)(2) must be read not only in conjunction with UCC Section 9-318 but also in conjunction with the priority rules in Sections 9-322 *et seq.* The result is that the priority rules, rather than the *nemo dat* rules, determine the effect on each other of two transactions that would create security interests in the same receivables.

1. Official Comment 6 to Section 9-203 is amended by inserting the following after the third sentence of the second paragraph (with the current fourth sentence beginning a new paragraph after the insertion):

Thus, when a debtor engages in two transactions and each transaction, if considered separately from the other, would create an enforceable security interest in the same item of property, the effect of each transaction on the other is determined by the priority rules in UCC Sections 9-322 *et seq.* and the rights of the secured party in the second transaction are not limited solely because, as a result of the first transaction, the rights of the debtor in the collateral were diminished.

Example 1: On February 1, A files a financing statement covering a certain item of Debtor's equipment. At that time, Debtor has not granted to A a security interest in the equipment. On March 1, B makes a loan to Debtor secured by a security interest in the same equipment and files a financing statement covering the equipment. On April 1, A makes a loan to Debtor and Debtor authenticates a security agreement granting A a security interest in the item of equipment. A's security interest is enforceable and has attached and, under the priority rules of Section 9-322, has priority over that of B. This is the case even though, after March 1, Debtor's rights in

the equipment were diminished by the security interest granted to B. The reason is that Debtor had “the power to transfer” greater rights in the equipment than Debtor had.

Example 2: On February 1, A files a financing statement covering certain of Debtor’s accounts. At that time, debtor has not granted to A a security interest in the accounts. On March 1, Debtor sells the accounts to B (creating a security interest in them) and B files a financing statement covering the accounts. On April 1, A makes a loan to Debtor and Debtor authenticates a security agreement granting A a security interest in the accounts. A’s security interest is enforceable and has attached and, under the priority rules of Section 9-322, has priority over that of B. This is the case even though, after March 1, Debtor no longer had rights in the accounts (see Section 9-318), because Debtor had “the power to transfer” greater rights in the accounts than Debtor had.

See PEB Commentary No. [___], dated [TBA].

2. Official Comment 4 to § 9-318 is deleted and replaced with the following:

4. Effect of Perfection. If the security interest of a buyer of accounts or chattel paper is perfected, ordinarily transferees from and creditors of the seller cannot later acquire an interest in an item so sold because, after the security interest is perfected, the seller no longer has a legal or equitable interest in the item. This does not always mean, however, that the seller cannot thereafter create a security interest in the item. A debtor may create a security in an item of property if it has either “rights in the collateral” or “the power to transfer rights in the collateral. See Section 9-203(b)(2). One example of a situation in which a debtor has the power to transfer rights in an account or an item of chattel paper – and, thus, to create a security interest in it – even after the account or chattel paper has been sold and the buyer has perfected its security interest is provided in Section 9-203, Comment 6, Example 2 (describing a transaction in which the post-sale security interest was perfected by a financing statement filed before the sale).

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