

Permanent Editorial Board for the Uniform Commercial Code

PEB COMMENTARY NO. []

**SCOPE OF ARTICLE 9 CHOICE-OF-LAW RULES REGARDING
CHARACTERIZATION OF TRANSACTIONS**

Draft for Public Comment

March 4, 2021

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
subject to revisions based on comments received.
The PEB reserves the right to withdraw this proposed PEB Commentary.**

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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INTRODUCTION

Secured transactions frequently relate to more than one jurisdiction. Accordingly, choice-of-law rules that determine the jurisdiction whose law applies to a particular aspect of a secured transaction are an important part of secured transactions law. Depending on the issue, secured transactions governed by Article 9 of the Uniform Commercial Code may be subject to two different sets of choice-of-law rules – those in UCC Article 1 and those in UCC Article 9. Some uncertainty has arisen as to which of those choice-of-law rules is applicable for determining whether a transaction creates a security interest governed by Article 9.

DISCUSSION

Consistently since the enactment of the Uniform Commercial Code, two different sets of choice-of-law rules have governed secured transactions. The Code’s general choice-of-law rule in Article 1, now codified in UCC Section 1-301 but largely unchanged in substance from previous versions in effect since before the promulgation of Revised Article 9¹, provides parties to a transaction substantial autonomy to choose the law governing their rights and duties with respect to that transaction. The current text of the provision states, in part, that “Except as otherwise provided in this section, when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties.”² This autonomy yields, however, to mandatory choice-of-law rules in Article 9. More specifically, the general choice-of-law rule in UCC Section 1-301 states that it does not apply to, *inter alia*, matters governed by UCC Sections 9-301 through 9-307.³ Those sections, like their predecessors in earlier versions of Article 9, determine the law governing perfection, the effect of perfection or non-perfection, and priority.⁴ While the content of those rules has changed significantly since the pre-2001 version of Article 9, their scope – essentially determining the law governing perfection and priority and leaving other matters to the Article 1 choice-of-law rules – has remained unchanged.

¹ The 2001 Official Text of UCC § 1-301 contained significant changes to this general rule but was enacted only in the U.S. Virgin Islands. Those changes were subsequently removed from the Official Text and replaced with text substantively identical to the rules in former UCC § 1-105.

² UCC § 1-301(a). (As with other UCC provisions, construction and application of this provision is guided by UCC § 1-103(a) and the applicability of supplemental principles of law is guided by UCC § 1-103(b).)

³ See UCC § 1-301(c)(8).

⁴ See UCC § 9-301. Prior to the Article 9 amendments that went into effect in 2001, the Article 9 rules were stated as determining the law governing “perfection and the effect of perfection or non-perfection of a security interest in collateral.” See former UCC § 9-103(1)(b) (1994). The reference to “the effect of perfection or non-perfection” was understood as including priority; the addition of the explicit reference to priority in the 2001 text was intended only for clarity and not to expand the scope of the Article 9 choice-of-law rules.

Case Law Under Pre-2001 UCC

In the 1980s and 1990s, there were several judicial decisions about transactions in the form of a lease (or, in one case, a conditional sale) that (i) would likely create a security interest under the UCC in effect in the state in which the leased goods were located, but (ii) were stated to be governed by the laws of a jurisdiction that would not characterize the transaction as creating a security interest.⁵ In each of these cases, the lessor or conditional seller took no actions that would constitute perfection of a security interest and a competing claimant (a bankruptcy trustee or competing secured creditor) argued that the transaction should be treated as creating a security interest, with the consequence that the security interest was unperfected and would be subordinate to the competing claimant. Thus, resolution of each case required determination of which jurisdiction's law governed whether the transaction did or not create a security interest. Was the issue governed by the law of the jurisdiction selected by the parties to govern their transaction (a determination made by applying the Article 1 choice-of-law rule) or by the law of the jurisdiction in which the goods were located (a determination made by applying the Article 9 choice-of-law rules for perfection then in effect)? Each case concluded that the Article 9 choice-of-law rules should be applied to these characterization issues.

In the most well-known case, *In re Eagle Enterprises, Inc.*, 237 B.R. 269 (E.D. Pa. 1999), the "lessor" was a German company, the "lessee" was apparently located in Pennsylvania, and the equipment that was the subject of the transaction was located in Pennsylvania. The "lease," which would be a security interest under UCC Article 1⁶, provided that it was governed by the law of Germany, and the German "lessor" did not file a financing statement. The German lessor argued that no financing statement was necessary because the choice of German law meant that German law controlled the issue of characterization and German law would characterize the transaction as a lease. The court disagreed, stating:

Under [the lessor's] theory, sellers of business equipment could routinely characterize sales transactions as leases or select the law of a jurisdiction which would so treat them, although they have an option to purchase for token consideration at the end of the lease term and, even without filing a financing statement, would be able to assert a claim to the equipment superior to that of the trustee if the "lessee" declares bankruptcy. This would completely undermine the Uniform Commercial Code requirement that holders of purchase money security interests in business equipment file financing statements to perfect their security interests, the purpose of which is to provide potential creditors with notice that another party in fact owns an interest in a potential debtor's business equipment.

The same issue previously arose in a domestic context in *Carlson v. Tandy Computer Leasing*, 803 F.2d 391 (8th Cir. 1986). In *Carlson*, the lessor argued for the application of Texas

⁵ At that time, under former Article 9, perfection of a security interest in goods, and the effect of perfection or non-perfection of that security interest, were generally governed by the law of the jurisdiction in which the goods were located, while other issues relating to secured transactions were subject to the rule in Article 1 providing parties with significant autonomy to select by agreement the law governing their transaction.

⁶ At that time, the UCC definition of "security interest" was codified in UCC § 1-201(37). Currently, the definition is codified in UCC §§ 1-201(b)(35) and 1-203.

law (the law specified in the agreement) to the characterization issue, believing that that law would have resulted in the “lease” being treated as a lease and not as a security interest governed by Article 9’s perfection and priority rules. On the other hand, the lessee’s trustee argued that the law of Missouri (where the lessee and the equipment were located) should control, believing that Missouri law would treat the lessor’s interest as a security interest governed by Article 9’s perfection and priority rules. The court rejected the lessor’s argument that the choice-of-law clause in the “lease” agreement should determine the characterization for purposes of determining the consequences of the lessor’s failure to file a financing statement:

The policy behind section 1–105(2) [the predecessor of current UCC Section 1-301(a)], especially as it relates to the scope of Article 9 of the Missouri U.C.C., is to prohibit choice of law agreements when the rights of third parties are at stake. If we applied Texas law to determine whether a security interest existed here, this would violate a fundamental purpose of Article 9: to create commercial certainty and predictability by allowing third party creditors to rely on the specific perfection and priority rules that govern collateral within the scope of Article 9. In order to prevent the constant unilateral expansion and contraction of the scope of Missouri’s Article 9, a Missouri court would apply Missouri law to determine the scope of Article 9 of the Missouri U.C.C. [internal citations omitted]⁷

The *Carlson* court also distinguished its choice-of-law analysis from situations in which only rights of the parties to the transaction *inter se* were at stake:

The present case is unlike those situations where only the rights of parties privy to the initial choice of law agreement are implicated. In those situations, no policy is furthered by refusing to allow the parties to select the law governing their rights alone. Nor is this a case where, despite the existence of a secured transaction, no issues concerning the scope or matters within the scope of Article 9 are raised. Instead, the question here concerns the scope of Article 9 of the Missouri U.C.C. Section 1–105(2) of the Missouri U.C.C. requires that we apply Missouri law. [internal citations omitted]

As noted above, the characterization issue has also arisen at least once in the context of a transaction characterized by the parties as a sale of goods with title retained by the seller until the buyer pays the entire purchase price. *Hong Kong and Shanghai Banking Corp., Ltd. v. HFH USA Corp.*, 805 F.Supp. 133 (W.D.N.Y. 1992), cited *Carlson* in rejecting the application of a clause choosing the law of Germany to the question of whether such a retention-of-title credit sale should be characterized as creating a security interest.⁸

⁷ Ironically, after rejecting the choice-of-law clause in the lease and applying Missouri law to the characterization issue, the court concluded that Missouri law would not characterize the lessor’s interest as a security interest.

⁸ In this case, the law of New York, the state in which the goods were located, would have treated the “conditional sale” as creating a security interest, while the law of Germany would not have done so.

Revised Article 9

As noted above, revised Article 9 substantially changed the *content* of the Article 9 choice of rules in UCC Sections 9-301 through 9-307 that determine the law that governs perfection, the effect of perfection or non-perfection, and priority of a security interest.⁹ The statutory text of revised Article 9 made no change, however, with respect to the border between the applicability of the Article 1 choice-of-law rules and the applicability of the Article 9 choice-of-law rules. As before, the UCC continues to state that the Article 1 rules apply except for matters addressed by the choice-of-law rules governing perfection, the effect of perfection or non-perfection, and priority.¹⁰

Nonetheless, as part of the promulgation of revised Article 9, a comment was added to UCC Section 9-301 (the section stating the general choice-of-law rule for perfection). Comment 2 to Section 9-301 states, in relevant part, that the choice-of-law rules in Part 3 of Article 9 address perfection, the effect of perfection or non-perfection, and priority but

[do] not address choice of law for other purposes. For example, the law applicable to issues such as attachment, validity, characterization (e.g., true lease or security interest), and enforcement is governed by the rules in Section 1-301; that governing law typically is specified in the same agreement that contains the security agreement.

There is no indication that the intent of the revisions to the Article 9 choice-of-law rules was to change the pre-2001 status quo under which those rules governed matters related to perfection and priority of security interests (including, as found by the cases such as *Eagle Enterprises* and *Carlson*, whether a transaction creates a security interest that, if not perfected, would be subordinate to most competing claimants) while the general Article 1 choice-of-law rules governed matters relating to rights and duties between the parties to the transaction. Yet, the reference to characterization in the text of Comment 2 might be read as unintentionally changing that status quo so as to apply the Article 1 choice-of-law rules to all matters related to characterization of the transaction, even when characterization would affect the rights of persons who are not parties to the transaction. Such a reading would be inconsistent with the intent of UCC Section 9-301, would undermine UCC perfection rules as stated in the *Eagle Enterprises* opinion, and would erode the distinction noted in the *Carlson* opinion between situations relating to perfection and priority, which have an impact on third parties, and “those situations where only the rights of parties privy to the initial choice of law agreement are implicated.”¹¹

Accordingly, the reference in Comment 2 to characterization of a transaction should be read as referring that issue to UCC Section 1-301 only insofar as characterization affects rights

⁹ Most relevant for the purpose of the issue at hand, revised Article 9 generally changes the law governing perfection of a security interest in goods from that of the jurisdiction in which the goods are located to that of the jurisdiction in which the debtor is located.

¹⁰ As noted above (see note 4, *supra*), the reference to priority was added in 2001 for clarity but priority was generally understood previously as having been included in the concept of “the effect of perfection or non-perfection.”

¹¹ As to the inappropriateness of allowing parties to select the governing law for issues that have an impact on third parties, see *Matter of First River Energy, L.L.C.*, ___ F.3d ___, 2021 WL 358168 (5th Cir. 2021) at *11; *Fishback Nursery, Incorporated v. PNC Bank, National Association*, 920 F.3d 932, 938 (5th Cir. 2019).

between the parties to the transaction. Nonetheless, because the current text of Comment 2 is not as precise as it should be with respect to this point, the Permanent Editorial Board has concluded that the comment should be amended to make the point clearly.

CONCLUSION

Comment 2 to UCC Section 9-301 is hereby amended to add clarifying language as follows:

2. Scope of This Subpart. Part 3, Subpart 1 (Sections 9-301 through 9-307) contains choice-of-law rules similar to those of former Section 9-103. Former Section 9-103 generally addresses which State's law governs “perfection and the effect of perfection or non-perfection of” security interests. See, e.g., former Section 9-103(1)(b). This Article follows the broader and more precise formulation in former Section 9-103(6)(b), which was revised in connection with the promulgation of Revised Article 8 in 1994: “perfection, the effect of perfection or non-perfection, and the priority of” security interests. Priority, in this context, subsumes all of the rules in Part 3, including “cut off” or “take free” rules such as Sections 9-317(b), (c), and (d), 9-320(a), (b), and (d), and 9-332. (The Hague Securities Convention may sometimes modify certain of this subpart’s choice-of-law rules, as well as applying them to the requirements for foreclosure and the like, the characterization of a transfer as being outright or by way of security as it affects rights of third parties, and certain other issues. See PEB Commentary No. 19, dated April 11, 2017.)

This subpart does not address choice of law for other purposes. For example, the law applicable to issues such as attachment, validity, characterization of a transaction (e.g., true lease or security interest) as it affects rights between the parties to the transaction, and enforcement is generally governed by the rules in Section 1-301; that governing law typically is specified in the same agreement that contains the security agreement. ~~In transactions to which the Hague Securities Convention applies, the requirements for foreclosure and the like, the characterization of a transfer as being outright or by way of security, and certain other issues will generally be governed by the law specified in the account agreement. See PEB Commentary No. 19, dated April 11, 2017.~~ And, another jurisdiction's law may govern other third-party matters addressed in this Article. See Section 9-401, Comment 3. As to the law applicable to characterization, see PEB Commentary No. __, dated _____.