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A SUMMARY OF THE PROPOSED 2022 AMENDMENTS TO THE UNIFORM COMMERCIAL CODE

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INTRODUCTION

The proposed amendments to the Uniform Commercial Code ("UCC") address a limited set of transactions largely involving emerging technologies, such as virtual currencies, distributed ledger technologies, and, to a limited extent, artificial intelligence. The amendments would span most of the Articles of the UCC and add a new Article addressing so-called digital assets.

BACKGROUND

Since 2019, a committee (the "Committee") appointed by the American Law Institute and the Uniform Law Commission, the sponsoring organizations of the UCC, has been considering and formulating amendments to the UCC to address emerging technological developments. The Committee has included and worked with both lawyers experienced in UCC matters and lawyers whose practices concentrate on these technological developments. The work of the Committee has benefitted enormously from the contributions of American Bar Association advisors and more than 300 observers from academia, trade groups, government agencies, law firms, private technology companies, and foreign participants from multinational law reform organizations or who are active in technology-related law reform efforts in their own countries.

The Committee presented its initial draft of the amendments to the Uniform Law Commission at the Commission's annual meeting in July of 2021. The ALI Members Consultative Group ("MCG") met and discussed the draft in October 2021. A revised draft was considered and approved by the American Law Institute Council in January of 2022. The MCG will meet again and consider the latest draft late in April. The Committee hopes to obtain approval of the American Law Institute at the Institute's Annual Meeting in May of 2022, and of the Uniform Law Commission at the Commission's Annual Meeting in July of 2022. The amendments would then be offered for enactment by the states.

The following is a high level summary of the current draft of the proposed amendments.

EXECUTIVE SUMMARY

The proposed amendments respond to market concerns about the lack of definitive commercial law rules for transactions involving digital assets, especially relating to (a) negotiability for virtual (non-fiat) currencies, (b) certain electronic payment rights, (c) secured lending against virtual currencies, and (d) security interests in electronic (fiat) money, such as central bank digital currencies. The amendments would also address other technological developments affecting electronic chattel paper, negotiable instruments, payment systems, and electronic documents of title. The amendments would contain, as well, some miscellaneous amendments to the UCC unrelated to technological developments but providing needed clarifications of provisions of the UCC.

The proposed amendments would address only state commercial law rules. They would not address the federal or state regulation, taxation or money transmitter or anti-money laundering laws. The amendments would look to law outside of the UCC to answer many questions concerning digital assets.

I. Digital Assets

General

The proposed amendments:

• Would concern a class of digital assets – defined as "controllable electronic records" ("CERs") – which would include certain virtual (non-fiat) currencies, non-fungible

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tokens, and digital assets in which specified payment rights are embedded. The amendments would provide for a CER to be in effect negotiable, *i.e.*, capable of being transferred in such a way as to cut off competing property claims (including security interests) to the CER (a "take-free" rule).

• The proposed amendments would also provide for a security interest in a CER to be perfected by "control" (or by filing a financing statement) and for a security interest perfected by "control" to have priority over a security interest in the CER perfected by the filing of a financing statement (or another method other than "control").

• There would also be proposed amendments to address security interests in electronic money.

Definition of "Controllable Electronic Record"

A "controllable electronic record" would be a record in electronic form that is susceptible to "control." For a person to have "control" of a CER, the person must have:

• The power to enjoy "substantially all the benefit" of the CER,

• The exclusive power to prevent others from enjoying "substantially all the benefit" of the CER, *and*

• The exclusive power to transfer control of the CER.

Moreover, the person must be able readily to identify itself to a third party as the person having these powers. Identification can be made by a cryptographic key or account number. The exclusivity requirement would be satisfied even if there is a sharing of these powers through a "multi-sig" or similar arrangement or if changes occur automatically as part of the protocol built into the system in which the CER is recorded.

A virtual (non-fiat) currency would be an example of a CER. If a person owns an electronic "wallet" that contains a virtual currency, the person would have control of the virtual currency if (a) the person may benefit from the use of the virtual currency as a medium of exchange by spending the virtual currency or exchanging the virtual currency for another virtual currency, (b) the person has the exclusive power to prevent others from doing so, ***and*** *(c) the person has the exclusive power to transfer control of the virtual currency to another person.*

If an electronic record is not susceptible of control, it would be outside the scope of the proposed amendments. In addition, the definition of a CER would exclude certain digital assets that might otherwise be considered to fall within the definition of that term. These assets would be excluded because commercial law rules already exist and generally work well for these assets. They include electronic chattel paper, electronic documents, investment property, transferable records under the federal E-SIGN law or the Uniform Electronic Transactions Act ("UETA"), deposit accounts, and electronic money. Nothing in the proposed amendments, for example, would disturb transacting parties' current practices of using transferable records under E-SIGN. Nor would the proposed amendments affect transacting parties' ability, in effect, to "opt-in" to Article 8 of the UCC by arranging for a digital asset to be held with a securities intermediary as a financial asset credited to a securities account. Electronic money would be treated separately under the proposed amendments, as described below.

Rights of a Transferee of a Controllable Electronic Record

Proposed Article 12 governs certain transfers of CERs. If a CER is purchased (which consists of a voluntary transaction, including obtaining a security interest in the CER), the purchaser would acquire all rights in the CER that the transferor had. In addition, if the purchaser is a "qualifying purchaser," the purchaser would benefit from the "take-free" rule, *i.e.*, the purchaser would acquire the CER free from competing property claims to the CER. A "qualifying purchaser" would be a purchaser who obtains control of a CER for value, in good faith, and without notice of a property claim to the CER. As with negotiable instruments and investment property, the filing of a financing statement in and of itself would not be notice of a property claim to the CER.

Consider again the example of a person in control of a virtual (non-fiat) currency. If the person transfers control to another person, the transferee would obtain whatever rights in the virtual currency that the transferor had. If the transferee is a "qualifying purchaser" of the virtual currency, the transferee would also benefit from the "take-free" rule.

Tethering and Certain Payment Rights

With one important exception described in the following paragraph, what rights are embodied in the CER, and whether the "take-free" rule applies to those other rights (in addition to the CER itself) upon a transfer of control of the CER, would all be determined by law outside of the proposed amendments. For example, the proposed amendments would not affect copyright law as it relates to someone in control of a non-fungible token "tethered" to intellectual property. Other law would determine the effect of that "tethering." Similarly, if a CER purported to evidence an interest in real estate, whether the "take-free" rule applies to the interest in the real estate upon a transfer of control of the CER would be determined under other law, presumably the applicable real estate law.

There is one important exception. An "account" or "payment intangible," as those terms are already defined in Article 9 of the UCC, embodied in a CER would be a "controllable account" or "controllable payment intangible" if the account debtor (the person obligated on the account or payment intangible) has agreed to pay the person in control of the CER. If control of a CER with an embedded controllable account or controllable payment intangible is transferred, the controllable account or controllable payment intangible would travel with the CER, and the transferee, if a qualified purchaser, would benefit from the same "take-free" rule that applies to the CER. The effect would be to create what is functionally an electronic instrument even though the payment rights would continue to be classified as a "controllable account" or "controllable payment intangible". If the terms of the CER provide that the account debtor will not assert claims or defenses against the transferee of the CER (as and to the extent permitted by UCC § 9-403 and subject to consumer laws), then the effect would be to create the substantial equivalent of an electronic *negotiable* instrument. These provisions would respond to market concerns in the trade finance area that commercial law rules are currently insufficient for electronic promissory notes and electronic bills of exchange.

> *Consider a buyer of goods who delivers to the buyer's seller a promissory note in payment for the goods. If the promissory note is in a writing, it might, if certain conditions are met, qualify as a negotiable instrument under Article 3 of the UCC, and potentially a holder of the promissory note could be a holder in due course of the negotiable instrument. But, if the promissory note is in electronic form and even if those conditions are met, Article 3 does not apply because the promissory note is not in a writing. Absent the promissory note qualifying as a "transferable record" under UETA, the rights of a transferee of the promissory note would be governed under normal contract rules and some rules under UCC Article 9. Under the proposed amendments, though, the promissory note (in electronic form) could be a CER. If the promissory note were a CER, the "take-free" rule would apply to a qualifying purchaser of the promissory note. If the buyer also agreed not to assert claims or defenses against a transferee of the promissory note, the electronic promissory note would, subject to applicable consumer laws, have negotiability characteristics similar to those of a negotiable instrument under Article 3.*

Secured Lending

The provisions applicable to purchasers of CERs are carefully coordinated with corresponding changes to lending secured by security interests in CERs under Article 9 and are designed to preserve the availability of existing transaction patterns. Under the proposed amendments, there would be no need to change collateral descriptions in security agreements or collateral indications on financing statements. A CER would be a "general intangible," a controllable account would be an "account," and a controllable payment intangible would be a "payment intangible," as those terms are already defined in Article 9 of the UCC. The normal rules for attachment would continue to apply, and a security interest in a CER, a controllable account, or a controllable payment intangible could still be perfected by the filing of a financing statement.

However, under the proposed amendments, a security interest in a CER, a controllable account, or a controllable payment intangible could also be perfected by the secured party obtaining "control" of the CER. A security interest in a CER, a controllable account, or a controllable payment intangible perfected by "control" would have priority over a security interest in the CER, controllable account, or controllable payment intangible perfected by filing (or by another method other than control). Control would be defined as described above.

> *Another example may be helpful. SP-1 lends to Debtor, obtains a security interest in Debtor's accounts, payment intangibles, and other general intangibles, and perfects the security interest by the filing of a financing statement. SP-2 later lends to Debtor, obtains a security interest in a CER in which is embodied what is functionally an electronic promissory note payable to the person in control, and files a financing statement to perfect its security interest. SP-1's security interest has priority under the first to file or perfect priority rule of Article 9. If SP-2 obtains control of the CER, SP-2's security interest in the electronic promissory note is senior to SP-1's security interest in the electronic promissory note.*

Account Debtor Discharge

Similar to current UCC Article 9 for accounts and payment intangibles generally, an account debtor (the obligor on an account or payment intangible) would receive a discharge by paying the person formerly in control until the account debtor receives a notification signed in writing or electronically by the debtor or its secured party that the secured party has a security interest in the controllable account or controllable payment intangible and a payment instruction (often referred to a "deflection notification") to pay the secured party as the person now in control. Following receipt of the deflection notification, the account debtor would be able to obtain a discharge by paying the secured party and would not be able to obtain a discharge by paying the debtor.

Also, similar to current UCC Article 9, the debtor may ask for reasonable proof that the secured party is the person in control before paying the secured party. However, unlike under current Article 9, for a controllable account or controllable payment intangible the method of providing that reasonable proof must have been agreed to by the account debtor, presumably as part of the CER when it was created. Absent there being an agreed method of providing reasonable proof, the deflection notification would not be effective, and the account debtor would be able to obtain a discharge by continuing to pay the debtor.

As a practical matter, few account debtors question a deflection notification or ask for reasonable proof. However, if an account debtor does ask for reasonable proof, the relevant parties would have the flexibility to develop for market acceptance methods for providing the reasonable proof.

Choice of Law

The proposed amendments would include substantially identical choice-of-law rules for the take-free rules for transferees of CERs and the perfection by control and priority of a security interest in a CER, controllable account, or controllable payment intangible perfected by control. Having the same rules promotes consistent results and predictability.

The amendments would generally follow the choice-of-law approach taken in UCC Articles 8 and 9 for financial assets credited to a securities account at a securities intermediary. The application of take-free rules in connection with transfers of CERs and the perfection, effect of perfection or non-perfection, and priority of a security interest in a CER perfected by control would be determined by the law where the CER is deemed to be "located" – *i.e., the CER's* jurisdiction. For a CER that expressly provides its jurisdiction, perfection, other than by the filing of a financing statement, and priority are governed by the law of that jurisdiction. Otherwise the CER's jurisdiction would be the jurisdiction whose law governs the system in which the CER is recorded. If no express provision is made in the CER or the system, the CER would be located in Washington, D.C. If Washington D.C. has not enacted the amendments, the substantive law rules of the Official Text of the amendments would apply. In the case of perfection of a security interest by the filing of a financing statement, the normal debtor location rules would apply.

II. Electronic Money

The current definition of "money" in the UCC is sufficient to include a virtual (fiat) currency authorized or adopted by a government, whether token-based or deposit account-based. The definition of "money" would be revised to exclude a medium of exchange in an electronic record (such as Bitcoin) that existed and operated as a medium of exchange before it was authorized or adopted as a medium of exchange by a government. However, a medium of exchange in an electronic record so excluded might still qualify as a CER.

Under current UCC Article 9 a security interest in money can perfected only by possession. However, electronic money is not susceptible to possession. The proposed amendments would provide that, if electronic money is credited to a deposit account (even one at a central bank), the normal deposit account perfection rules would apply. Electronic money also would exclude money that cannot be subject to "control," similar to control for a CER. If the electronic money is not credited to a deposit account, a security interest would be capable of being perfected by "control." UCC § 9-332, would be amended generally to provide for a transferee of money, whether tangible or electronic, to take free of a security interest in the money. Otherwise, any "take-free" rule would be determined by the law governing the electronic money.

III. Chattel Paper

The proposed amendments would make several changes to the treatment of chattel paper under the UCC:

- The definition of the term "chattel paper" would be modified to refer to a right to payment evidenced by the records constituting chattel paper rather than to the records themselves. This modification would align the definition of chattel paper with the treatment of a right to payment consisting of a controllable account or controllable payment intangible embodied in a CER and which distinguishes between the payment right and the CER itself.

- The definition of the term "chattel paper" would be further modified so that a right to payment from a "hybrid" lease transaction, consisting as a single transaction of a lease of goods, the licensing of software or information (or both) and the provisions of services, is treated as chattel paper if the acquisition of the right to the use and possession of the goods is the predominant purpose of the transaction

- The definition of "control" of electronic chattel paper would be expanded to align with the definition of control for a CER. As a result, instead of a "single" authoritative copy of the chattel paper records being required to fit within the existing "safe harbor" for control of electronic chattel paper, a distinction would be made between "authoritative" copies and "non-authoritative" copies. Control would be achieved when a person has control of all "authoritative" copies. At the same time, in order not to upset settled transactions completed under the existing definition of "control' for electronic chattel paper, the "safe

harbor" in the existing definition would be "grandfathered" under the proposed amendments.

• Given that many chattel paper transactions consist of both tangible and electronic chattel paper and that tangible chattel paper is often converted to electronic chattel paper and vice-versa, the amendments would generally eliminate the distinction between tangible chattel paper and electronic chattel paper. A security interest in chattel paper would be perfected, and non-temporal priority would be achieved, by possession and control of the chattel paper. Possession would be applicable to the extent that the authoritative copies of the chattel paper are tangible; control would be applicable to the extent that the authoritative copies of the chattel paper are electronic.

• The choice-of-law rule for the perfection of a security interest by possession of chattel paper evidenced only by a tangible record, the effect of perfection and non-perfection of a security interest in the chattel paper, and the priority of a security interest in the chattel paper would be determined by the law of the jurisdiction in which the tangible record evidencing the chattel paper is located. Both perfection (other than by filing) and priority for chattel paper that does not consist wholly of such tangible chattel paper (*i.e.*, chattel paper evidenced only by an electronic record or evidenced by both electronic and tangible records) would be governed by the law of the jurisdiction where the chattel paper is deemed to be located—*i.e.*, the "electronic chattel paper's jurisdiction." If the electronic chattel paper expressly provides its jurisdiction, perfection and priority are governed by the law of that jurisdiction. Otherwise the governing law is that whose law governs the system in which the chattel paper or electronic record thereof is recorded. If no governing law is stated in the system, perfection and priority would be governed by the law of the debtor's location. For all chattel paper, the normal debtor location rules would apply to perfection by the filing of a financing statement.

IV. Negotiable Instruments

The amendments propose several changes to Article 3 of the UCC addressing negotiable instruments. First, the amendments would make clear that a choice-of-law or choice-of-forum clause contained in the instrument does not affect the negotiability of the instrument. Second, the amendments would provide that an item may be issued by a maker or drawer by transmission of an image of the item or information describing the image if the information would permit the issuance of an electronic check under Federal Reserve Board Regulation CC. This change addresses the practice of some makers or drawers of sending an image of a check to the payee. Third, amendments would provide that a check destroyed following a remote deposit of the instrument does not discharge the obligation embodied in the instrument. The effect of this change would be to keep the obligation alive if for some technological or other reason the remote deposit was not effective but the check had been destroyed by the payee on the assumption that the remote deposit was effective.

V. Payment Systems

The amendments would provide some clarification of what constitutes a security procedure for a funds transfer under Article 4A of the UCC. Symbols, sounds, and biometrics may constitute a security procedure. Merely verifying an email address, IP address, or telephone phone number would not be a security procedure.

VI. Miscellaneous Amendments

"Writing" Requirements

A number of "writing" requirements in the UCC would be changed to "record" requirements where the effect is to facilitate electronic commerce. The requirements for an "instrument " in UCC Articles 3 and 9 to be in a writing would not be changed.

Article 1

The definition of "signed" would be expanded to apply not only to a signature in a writing, as in the existing definition, but also to an electronic signature. This definition would apply through the UCC where an electronic record is permitted.

The examples in the definition of "conspicuous" in the "black letter" definition of the term would be deleted. The examples were not considered useful for electronic transactions and are even of questionable relevance in some cases for paper-based transactions. The Official Comments would further explain the term including discussing the examples removed from the "black letter" text and providing guidelines for electronic transactions.

A new sentence would be added to the definition of "person" to provide that a protected series of a series organization (such as a limited liability company that established protected series) is a person under the UCC. The protected series would be a person separate from the series organization or from another protected series of the series organization.

Articles 2 and 2A

In a "hybrid" transaction, one involving a sale or lease of goods and a sale, lease, or license of other property or the provision of services, UCC Article 2 or 2A would apply if sale or lease of goods aspects of the transaction predominate.

Otherwise, the provisions of UCC Article 2 or 2A that relate primarily to the goods aspects of the transaction, and not to the transaction as a whole, would apply to those aspects. In the case of a lease of goods, the finance lease provisions of UCC Article 2A would apply to the lease aspects of the transaction even if the lease aspects do not predominate.

Article 5

The amendments would clarify that, if a letter of credit issued by a bank states its governing law, a branch of a bank is still considered as a separate bank for purposes of UCC Article 5.

Article 7

The definition of "control" in UCC Article 7 would be expanded to be similar to the definition of control for electronic chattel paper. As with the chattel paper definition of "control," the existing "safe harbor" for control of an electronic document of title would be "grandfathered."

Article 9

The word "authenticate" would be replaced by the word "sign," with correlative changes, since the new definition of "sign" in UCC Article 1 would eliminate the need for the separate term "authenticate" in UCC Article 9.

The proposed amendments would clarify what should be the case under existing law that (a) an "assignor" is a person who grants a security interest to secure an obligation or a seller of accounts, chattel paper, payment intangibles, or promissory notes, and (b) an "assignee" is a person in whose favor a security interest is granted to secure an obligation or a buyer of accounts, chattel paper, payment intangibles, or promissory notes. The effect is to codify Official Comment 26 to Section 9-102 consistent with Permanent Editorial Board for the Uniform Commercial Code Commentary No. 21.

The proposed amendments would clarify that a security interest in a commercial tort claim as proceeds of original collateral properly described in a security agreement may attach to the commercial tort claim or its proceeds even if the commercial tort claim was not described in the security agreement.

VI. Transition

Transition rules are being developed. These rules will be designed to protect the expectations to parties to pre-amendments effective date transactions and to provide for sufficient time for parties to plan transactions post-amendments effective date.

The transition rules will likely not contain a uniform effective date for the amendments because some states appear ready to enact the amendments as early as possible. However, a uniform adjustment date is being considered. The adjustment date would give transacting parties a grace period to preserve priorities already established on the effective date if the amendments would otherwise affect those priorities.

VII. Additional Information

This summary is a very general overview of the proposed amendments The current draft of the actual amendments and additional information on the work of the Committee are available on the Uniform Law Commission's web site, uniformlaws.org.

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NEW PEB COMMENTARIES AND REPORT

In December, the Permanent Editorial Board for the Uniform Commercial Code (the "PEB") finalized four commentaries and a report. The June and October issues of this newsletter discussed earlier drafts of these documents, but now that the PEB has approved the commentaries and report,[1] additional mention here seems appropriate.

Commentary: Role of § 1-305(b) in Supporting Enforcement and Obligations

This Commentary begins by noting that Article 8 imposes numerous duties on a securities intermediary but provides no express remedy if the intermediary violates any of those duties. The Commentary explains that the absence of a specific remedy means that § 1-305(b) supplies the applicable rule. That provision states, "[a]ny right or obligation declared by [the Uniform Commercial Code] is enforceable by action unless the provision declaring it specifies a different and limited effect."

Accordingly, the Commentary concludes that a customer of an intermediary that violated an obligation imposed by Article 8 is entitled to enforce the statutory right by action for money damages, equitable relief, or otherwise. In doing so, the Commentary expressly rejects a decision by the United States Court of Appeals for the Sixth Circuit,[2] and adds the following sentence to the end of § 8-102 comment 17:

> If a securities intermediary does not perform its obligations to its entitlement holder under the Part 5 rules, the entitlement holder has a right of action against the securities intermediary under Section 1-305(b).

Commentary: Scope of Article 9 Choice-of-Law Rules Regarding Characterization of Transactions

This Commentary makes it clear that, if a transaction bears a reasonable relation to a state, the parties to a transaction governed by the UCC have the freedom to select the law of that state to govern their rights with respect to the transaction, but not the law that governs the rights of third parties. The Commentary addresses some confusion created by comment 2 to § 9-301, which states in 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. The comment then adds:

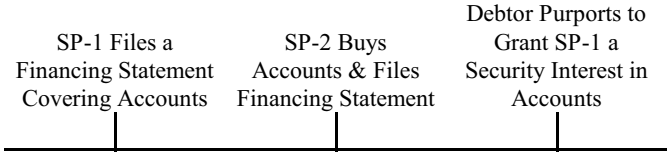
> For example, the law applicable to issues such as attachment, validity, characterization (e.g., true lease or security interest), and enforcement is governed by the rules in Section 1-301; that governing law typically is specified in the same agreement that contains the security agreement.

The Commentary observes that while the reference to "characterization" in this sentence could be read as indicating that contracting parties are free to choose the law relating to characterization for all purposes (subject to the limitations in § 1-301), such a reading would be incorrect. Instead, the parties' freedom applies only to their rights and obligations inter se, and does not affect third parties. The Commentary includes the following amendment to the portion of comment 2 quoted above:

> 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.[3]

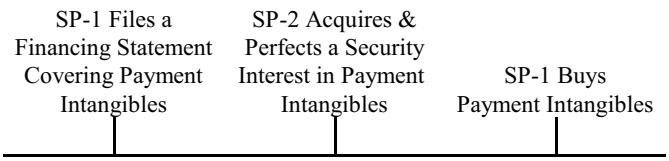
Commentary: Sections 9-203(b)(2) and 9-318
Commentary: Sections 9-309 and 9-322(a)(1)

These two Commentaries deal with the effect of pre-filing a financing statement with respect to receivables that are later sold. Consider the following scenario:



The issue is whether SP-1 in fact acquires a security interest in the accounts previously sold to SP-2. One of the requirements for attachment of a security interest is that the debtor has rights in the collateral or the power to convey rights, *see* § 9-203(b)(2), and the argument is that the debtor no longer had any such rights upon selling the accounts to SP-2. Nevertheless, the Commentary regarding §§ 9-203(b) and 9-318 concludes SP-1 does acquire a security interest in the accounts. In essence, because SP-1 filed an otherwise proper financing statement covering accounts before SP-2 bought the accounts, the debtor retained the *power* to transfer rights in the accounts to SP-1 even though the debtor retained no *rights* in the accounts. The implication of this for transactional lawyers is clear. Search for and do not ignore filed financing statements; they effectively save a spot in the line of priority for the filer, even if the filer acquired no security interest at the time of filing.

Now consider this somewhat related scenario:



The Commentary on §§ 9-309 and 9-322 concludes that even though SP-1's filed financing statement was unnecessary to perfect – because SP-1's interest was automatically perfected pursuant to § 9-309(3) – the financing statement nevertheless preserved SP-1's place in the priority line. Consequently, SP-1's interest has priority over SP-2's interest. Moreover, because SP-1 later bought the payment intangibles outright – rather than obtain a security interest in them to secure a loan – SP-1 acquired full ownership of the payment intangibles, divesting SP-2 of any interest in them. Again, the lesson for transactional lawyers is the same: search for and pay heed to filed financing statements. Absent the filing of a termination statement authorized by the filer, or execution of an intercreditor agreement, the SP-2s of the world cannot rely on having priority even if they are the first to obtain a perfected security interest.

Report: Application of UCC Sections 9-406 and 9-408 to Transfers of Interests in Unincorporated Business Organizations

In 2018, the UCC's sponsoring organizations amended § 9-406 and § 9-408 by adding to each a new subsection stating the section's rules that override restrictions on assignment "do not apply to a security interest in an ownership interest in a general partnership, limited partnership, or limited liability company."[4] To date, no state has adopted these amendments, although at least six states previously enacted non-uniform legislation to the same effect.[5] This Report explains why, even without these amendments, Article 9 does not override most restrictions on transfer of an interest in an unincorporated entity.

This Report begins by noting that Article 9 applies to security interests that secure an obligation and to sales of *payment intangibles*, but not to sales of other *general*

intangibles. If an interest in an unincorporated business is a general intangible, the inapplicability of Article 9 to a sale of the interest means that neither of Article 9's rules that override many restrictions on assignment or transfer – § 9-406 and § 9-408 – will apply. As a result, any restriction on transfer will be enforceable (assuming nothing in the law outside of the UCC renders it unenforceable).

The Report then notes that, if the interest in an unincorporated entity is a "security" within the meaning of Article 8, then neither § 9-406 nor § 9-408 will apply because neither of those provisions deals with a restriction on the assignment of a security.

Finally, the Report addresses the operation of § 9-406 and § 9-408, which do override some restrictions on transfer in an agreement between the debtor and an account debtor. In this context, it is the unincorporated entity that is the "account debtor," not the other owners. So, unless the entity itself is a party to the agreement that purports to restrict transfer – and rarely is the entity a party to its own formation documents[6] – § 9-406 and § 9-408 will not apply. Even if the entity is a party to the agreement, § 9-406 and § 9-408 have no effect on any restriction on transfer that is enforceable by the other owners.

The upshot of all this is that Article 9 will rarely override a contractual restriction on transfer of an interest in an unincorporated entity.

Notes:

1. The Commentaries have not yet been numbered or posted on the PEB's web page. The Commentaries presumably will be, in some order, numbered 24 through 27.

2. Harris v. TD Ameritrade, Inc., 805 F.3d 664 (6th Cir. 2015).

3. This issue can be important. For example, in determining whether a domestic transaction structured as a lease of goods is in reality a sale with a retained security interest – and hence subject to U.C.C. Article 9 – the parties cannot avoid the issue by artfully choosing the law of Germany to govern, relying on the fact that German law would treat the transaction as a lease regardless of the economic realities of the deal. For further information on this topic, see Stephen L. Sepinuck, *What Choice Do I Have? – Choice-of-Law Clauses Governing Attachment of a Security Interest*, 10 The Transactional Lawyer 9 (June 2020).

4. *See* U.C.C. §§ 9-406(k), 9-408(f).

5. *See* Ala. Code § 10A-5A-1.06(e); Colo. Rev. Stat. § 7-90-104; Del. Code Ann. tit. 6, §§ 9-408(e)(4) 15-104(c), 15-503(f), 17-1101(g), 18-1101(g); Ky. Rev. Stat. Ann. §§ 275.255(4), 362.1-503(7), 362.2-702(8); Tex. Bus. & Com. Code §§ 9.406(j), 9.408(e); Va. Code §§ 8.9A-406(k); 8.9A-408(g), 13.1-1001.1(B), 50-73.84(C).

6. If the entity is a party to the agreement restricting assignment, then § 9-408 might apply and override the restriction. Landress v. Sparkman, 2020 WL 561893 (E.D.N.C. 2020). The ruling in *Landress* is questionable for other reasons, however. *See* Stephen L. Sepinuck, *What Choice Do I Have? – Choice-of-Law Clauses Governing Attachment of a Security Interest*, *supra* note 3; Carl S. Bjerre & Stephen L. Sepinuck, *Spotlight*, COMMERCIAL LAW NEWSLETTER 11 (March 2020).

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Recent Cases

SECURED TRANSACTIONS

Attachment Issues

In re Paniolo Cable Co.,
2022 WL 625149 (D. Haw. 2022)
Even though a creditor's mortgage could not, under Hawaii law, extend to after-acquired fixtures, the creditor's security interest did and was perfected by a fixture filing.

Marquis Energy, LLC v. Rayeman Elements, Inc.,
2022 WL 676541 (D. Neb. 2022)
A creditor with a judgment lien on the debtor's interest in a limited liability company did not have standing to claim that the debtor's earlier pledge of the interest to a secured party violated the LLC operating agreement and was therefore ineffective. The judgment creditor did, however, state a claim that the grant of the security interest was avoidable under the state's Uniform Voidable Transactions Act.

First Bank v. Exodus,
2022 WL 843559 (W.D. Wash. 2022)
Even if the debtors' fishing rights were not appurtenances to the debtors' vessel, and thus a maritime lien on the vessel would not extend to the fishing rights, the lender's consensual security interest nevertheless attached to the fishing rights because the security agreement expressly included the fishing rights in the description of the collateral.

Perfection Issues

Kenyon & Kenyon LLP v. Sightsound Technologies, LLC,
2022 WL 452197 (N.Y. Sup. Ct. App. Div. 2022)
A law firm that acquired a security interest in a client's patents, patent licenses, and proceeds of infringement suits effectively subordinated its interest when it consented to a sale of the

collateral to a litigation financier because the terms of the sales agreement expressly gave the financier the right to determine whether the debt to the law firm would be paid as part of the first item in the waterfall distribution of proceeds or as part of the debtor's share, which was to be paid last.

Atlas Uluslararasi Kumanyacilik tic A.S. v. M/V ARICA, 2022 WL 742487 (D. Del. 2022)
A lender with a preferred ship mortgage had a priority interest in the vessel over the suppliers of fuel bunkers that had maritime liens on the vessel. The lender's interest was not subject to equitable subordination because: (i) the lender did not control the debtor merely by freezing the debtor's bank account after default; and (ii) the lender did not engage in inequitable conduct by failing to declare a default earlier, when the debtor breached a liquidity covenant but was still current on payments on the mortgage debt. The lender was not unjustly enriched by refinancing the loans of the buyers of other vessels that also secured the mortgage debt. One supplier did not retain title to the fuel bunkers provided, and thus had no claim for conversion, because under Article 2, retention of title by a seller of goods is limited in effect to the retention of a security interest.

Enforcement Issues

Zentner v. Brenner Car Credit, LLC, 2022 WL 368276 (Pa. Super. Ct. 2022)
Credit buyers of automobiles, whose purchase agreements with the seller included an arbitration clause but whose simultaneously executed retail installment contracts did not, were not required to arbitrate their claims for the secured party's failure to provide proper notification of disposition. The Motor Vehicle Sales Finance Act requires that a retail installment contract contain all the terms of the agreement, and that contract failed to mention arbitration.

Nebari Natural Resources Credit Fund I, L.P. v. Speyside Holdings LLC, 2022 WL 610334 (N.Y. Sup. Ct. 2022)
A creditor that brought an action to foreclose a mortgage and to foreclose security interests did not violate New York's one-action rule. A disposition of personal property under Article 9 is not an action on the note.

Liability Issues

Guy M. Turner Inc. v. KLO Acquisition LLC, 2022 WL 287806 (N.C. Ct. App. 2022)
A bank with a security interest in two deposit accounts it maintained for a customer, and which in response to a garnishment order effected setoff against one deposit account but allowed the customer to use the funds credited to the other, had no liability to the garnishor. The bank's security interest was perfected by control and superior to the garnishor's lien, and the bank did not waive its security interest by allowing the customer to access the funds.

Bonefish Capital, LLC v. Autoshred, LLC, 2022 WL 518021 (N.J. Super. Ct. 2022)
Summary judgment was properly entered against the buyer of a business that promised to pay the portion of the purchase price in a secured promissory note, and against the guarantor, even though the seller might have breached its obligation to indemnify the buyer against losses resulting from third party claims and the seller's broker had asserted a claim against the buyer. There was nothing in the promissory note or guaranty that excused payment merely because there was a claim for indemnification. The sale was completed, the assets sold were as promised, the indemnification obligation was severable from the underlying sale transaction, and the amount of the indemnification was as yet undetermined.

Micro Fines Recycling Owega LLC v. Ferrex Engineering, Ltd., 2022 WL 408818 (N.D.N.Y.), *appeal filed* (2d Cir. March 11, 2022)
A judgment creditor of a bankrupt Canadian corporation had no claim to pierce the corporate veil and impose liability on the corporation's parent or the parent's shareholder. Although the corporation used the parent like a bank by borrowing back the dividends that it paid or declared in the form of demand loans, and the parent obtained a security interest in the corporation's assets to secure the resulting debt, that was an insufficient basis to impose liability. Piercing the corporate veil is available only when the owners exercise complete domination over the corporation with respect to the transaction attacked and used that domination to commit a fraud or wrong against the plaintiff. None of the defendants' conduct qualified under that test. The corporation was created for investment and tax planning purposes, and such a structure is commonly used in Canada. The security interest was created to protect the parent if the corporation became bankrupt, but at a time that the corporation was profitable and long before the transaction with the judgment creditor. Although the parent later operated the corporation at or near insolvency, it did not strip the corporation of assets but instead made further loans, and its later refusal to lend further funds was not problematic because it had no duty to lend more. Threatening to call the loans and using bankruptcy to avoid paying the judgment creditor did not cause the judgment creditor's injury because, by that time, the parent had a security interest and thus priority over the judgment creditor.

King v. Bradley, 2022 WL 678568 (Tenn. Ct. App. 2022)
A wife who orally authorized her husband to sign an indemnity agreement granting an insurer a security interest in the couple's personal property had no claim for negligent misrepresentation against the independent insurance agent who falsely represented

that the agreement did not encumber personal assets. Reliance on the misrepresentation was not reasonable or justifiable because the husband did not read the agreement before signing it on behalf of himself, his company, and his wife.

BANKRUPTCY

In re AJT Services, Inc.,
2022 WL 677457 (Bankr. N.D. Ill. 2022)
A prepetition writ of replevin that required the debtor to return three trucks that the debtor had leased from a lessor precluded the debtor from claiming in its later bankruptcy case that the leases were in fact secured financing arrangements, and as a result the lessor was entitled to relief from the stay. Although the lessor's claim for breach and its right to possession did not depend on whether the transactions were leases or financing arrangements, the debtor could and should have raised this "affirmative defense" because it would have affected what rights and obligations the parties had.

In re Elieff,
2022 WL 832417 (9th Cir. BAP 2022)
A former business partner of the debtor, whose pre-petition settlement agreement with the debtor and the entities they owned required the debtor and the entities to pay lump sums, without allocation, for both the former partner's interest in the entities and to settle numerous tort and contract claims against the debtor, had to be subordinated under § 510(b) as a claim arising from the purchase or sale of a security of the debtor or an affiliate of the debtor. There was no basis for allocating only a portion of the claim to the sale. Subordination also applied to the former partner's judgment liens.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Vermillion State Bank v. Tennis Sanitation, LLC,
969 N.W.2d 610 (Minn. 2022)
An alleged oral agreement to buy and sell the tangible and intangible assets of a trash collection business was predominantly a sale of intangible assets, such as the customer routes, because the intangible assets represented the bulk of the value, and therefore the statute of frauds in U.C.C. § 2-201 did not apply. The predominant purpose test applies to hybrid transactions involving both goods and intangible assets, not merely to transactions involving goods and services. The bifurcation approach, in which Article 2 applies to the goods aspects of the transaction and the common law applies to the non-goods aspects of the transaction, is not appropriate to issues such as the statute of frauds because it could defeat the parties' intentions by dividing the agreement and making only a portion of the agreement unenforceable (*i.e.* leave the buyer with the customer routes but no trucks to serve the customers on those routes).

Freedom Fund, LLC v. LVREIS, Inc.,
2022 WL 793303 (Oho Ct. App. 2022)
Because a limited liability company had no ability to transfer the members' interests in the company, and the operating agreement required the permission of all members to a transfer of any individual member's interest, a purported transfer of all of the interests by the LLC, signed by one member, transferred at most that member's interest. The transferee therefore had no authority to create a new operating agreement converting the LLC from member-managed to manager-managed. One other member's later action in mortgaging LLC real property on behalf of the LLC was effective, even if the mortgage loan did not benefit the LCC, because the operating agreement gave each member the authority to "perform all acts necessary to carry out [the LLC's] business operations," and the LLC's business was to acquire notes and real estate.

Lee v. Amazon.com, Inc.,
2022 WL 736094 (Cal. Ct. App. 2022)
The federal Communications Decency Act, which insulates providers of interactive computer services from liability by stating that they shall not be treated as the publisher or speaker of information posted by another, did not prevent Amazon from being liable under California law for knowingly allowing a third party seller to post for sale items known to cause cancer or reproductive toxicity without a clear warning.

DePuy Synthes Sales, Inc. v. Howmedica Osteonics Corp.,
2022 WL 761495 (9th Cir. 2022)
The trial court properly refused to transfer a case against a former employee for breach of a covenant not to compete to the District of New Jersey. Pursuant to Cal. Labor Code § 925, the former employee could void both the clause requiring adjudication in New Jersey and the clause choosing New Jersey law.

255 Fifth Street Holdings, LLC v.255 Fifth L.P.,
2022 WL 819037 (Ohio Ct. App. 2022)
A mortgage and assignment of rents that assigned all existing and future rents to the lender but gave the borrowers a "license to collect, receive, use and enjoy the Rents" prior to maturity or default did not allow the lender, after maturity, to recover rents collected and retained by the borrowers. Once collected and deposited, the rents were no longer rents, and the borrowers' operating account was not collateral securing the loan.

Wood v. Wade,
2022 WL 335449 (Ga. Ct. App. 2022)
A court could, without violating the First Amendment, enforce a non-disparagement clause in a settlement agreement by enjoining one party from disparaging the other. Although prior restraints on speech and publication are generally impermissible, free speech rights can be contractually waived.

Community First Bank v. First Central Bank McCook, 969 N.W.2d 661 (Neb. 2022)

Ambiguity and issues of fact should have prevented summary judgment on whether an agreement between two banks was a participation agreement or a loan. Several facts indicated that the transaction was a true participation. Chief among these were that the agreement was labeled as a participation agreement, specified the underlying loan to which it related, identified the parties as the originator and the participant, stated that the originator was selling an ownership interest in the underlying loan, and stated that the transaction was "without recourse to" the originator and did not create a debtor-creditor relationship. However, other facts suggested that the transaction was a loan. These included that the underlying loan appeared to be scheduled to mature in December 2030 whereas the agreement between the banks originally matured in August 2017 (and was later extended to December 2018), and a letter between the banks stated that "[a]ll principal and interest is due on August 1, 2017" even though there appeared to be no such obligation in the underlying loan.

Arwood v. AW Site Services, LLC, 2022 WL 705841 (Del. Ch. Ct. 2022)

Even though the buyer of a business had reason to know that the seller's representations and warranties were false when made, and the buyer thus had no claim for misrepresentation because there was no justifiable reliance, the buyer had a claim for breach of warranty.

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COMMERCIAL LAW AMICUS INITIATIVE UPDATE

In February, the Commercial Law Amicus Initiative ("CLAI") filed a brief before the Florida Supreme Court in *1944 Beach Boulevard, LLC v. Live Oak Banking Co.*, a case certified to the court by the United States Court of Appeals for the Eleventh Circuit. *See In re NRP Lease Holdings, LLC*, 20 F.4th 746 (11th Cir. 2021). The case involves Florida's somewhat unusual process for providing the results of a search of the records of the UCC filing office. Under that process, the response to every search is – quite literally – the entire index of filed financing statements, arranged alphabetically by debtor name. The searcher is simply placed, initially, at a particular location in that index, but then permitted to scroll through the entire index, page by page. CLAI's *amicus curiae* brief urged the court not to treat the results as the product of "search logic." A ruling to the contrary would treat as effective filed financing statements that identify the debtor's name incorrectly, and would impel a searcher to scroll through the index an indeterminate number of pages, thereby imposing an onerous due diligence burden. Anyone who wants to review the brief may obtain a copy at CLAI's website: amicusinitiative.org.

If you are aware of a case that you think CLAI should participate in as *amicus curiae*, please contact any of CLAI's officers:

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