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Freedom of Contract vs. Free Alienability: An Old Struggle Emerges in a New Context

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I. INTRODUCTION

This article addresses a contemporary reigniting of an ages-old conundrum in Anglo-American law. The conundrum results from the collision of two concepts that are usually thought of as mainstays of the law—freedom of

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contract and free alienability of property—in the context of assignments of receivables.

A prototypical case is easy to imagine. Obligee enters into a contract to do something of value for Obligor in exchange for Obligor's promise to pay Obligee. Obligor not only wants to receive the promised value from Obligee, however, but wants to pay nobody but Obligee for that value, so Obligor insists that the contract with Obligee contain a provision prohibiting Obligee from assigning to anyone else the right to be paid by Obligor.

As a very general matter, our legal system gives effect to contractual provisions agreed to by the parties to a transaction unless they run afoul of a strong public policy. Yet, the history of that same system has been to disfavor restraints on alienation of property. Obviously, these two concepts cannot both be effectuated if Obligee attempts to assign its claim against Obligor to someone else—either the contractual restriction will be given effect (at the expense of free alienability) or free alienability will prevail (at the expense of the contractual prohibition).

Until sometime in the twentieth century, this conflict of concepts was generally resolved in favor of freedom of contract, with the result that receivables created by a contract prohibiting assignment of the right to payment could not effectively be transferred, whether by outright sale (as in the case of factoring) or by the grant of a security interest in a loan context.[1] The tide began to turn early in the century, with the emergence of views such as the following from Justice Holmes:

> Of course a covenantor is not to be held beyond his undertaking and he may make that as narrow as he likes. But when he has incurred a debt, which is property in the hands of the creditor, it is a different thing to say that as between the creditor and a third person the debtor can restrain his alienation of that, although he could not forbid the sale or pledge of other chattels. When a man sells a horse, what he does, from the point of view of the law, is to transfer a right, and a right being regarded by the law as a thing, even though a *res incorporalis*, it is not illogical to apply the same rule to a debt that would be applied to a horse.[2]

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1. *See, e.g.*, Allhusen v. Caristo Constr. Corp., 103 N.E.2d 891, 893 (N.Y. 1952). *See generally* discussion in I GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 7.6, at 210-14 (1965).

2. Portuguese-Am. Bank of S.F. v. Welles, 242 U.S. 7, 11 (1916) (citation omitted). While Gilmore observes that Holmes's argument was, strictly speaking, not necessary for the decision of the case, he points out that "the immense prestige of Mr. Justice Holmes was now available to those who argued for the free alienability of contract rights as well as a neat Holmesian quotation pointing up the essential likeness between horses and debts." I GILMORE, *supra* note 1, § 7.8, at 219. Gilmore goes on to note acerbically that the

Views such as Holmes's began to gain traction. While some courts held out for a strict application of freedom-of-contract principles, even when the result was to limit free assignability of receivables,[3] Professor Grant Gilmore observed (perhaps a bit hyperbolically) that:

> It cannot be denied that by the overwhelming weight of authority the rule [that an obligor can effectively prevent assignment of a contractual claim] is as stated. It is submitted, however, that the rule is always stated but almost never enforced; most courts in most cases find some way of allowing even the assignee who has taken with notice of the prohibition to sue on the debt. That a rule, universally conceded to be "the law," is almost never applied suggests that courts must instinctively feel that it is a bad rule, from which avenues of escape must be discovered and maintained.[4]

Thus, by the time Article 9 was drafted and promulgated, the prior consensus favoring enforcement of contractual restrictions on assignment of receivables had eroded considerably. It is not surprising, then, that the position taken by Article 9 (the principal drafter of which—Grant Gilmore—was a proponent of that erosion[5]) was one that favored free alienability of receivables. The embodiment of that position was former UCC section 9-318(4), discussed in more detail in Part II of this article. So matters stood until the promulgation of revised Article 9 in 1998 and its effectiveness in 2001. As we shall see in Part II, the revised version of the rules addressing the subject made significant changes. Those changes, which were the subject of considerable debate and discussion, were seen at the time of promulgation as settling the matter. As a result, it came as a significant surprise when the preparation in 2007 of a PEB Commentary on application of the revised rules to ownership interests in unincorporated organizations revealed that fundamentally different views as to the meaning of the revised rules were held by several members of the Permanent Editorial Board for the Uniform Commercial Code, even though all of those members had participated in the drafting of revised Article 9. These irreconcilable views resulted in the matter once again being referred to a drafting committee.[6] The dispute and its resolution are the subjects of this article.

Portuguese-American Bank case "has not infrequently been cited in support of propositions which it does not remotely approach." *Id.*

3. Most notable among these was the decision of the New York Court of Appeals in *Allhusen*, 103 N.E.2d at 893.

4. I GILMORE, *supra* note 1, § 7.6, at 211 (footnote omitted).

5. *See id.* at 212.

6. More precisely, the entity that held the drafting pen was known as the "Article 9 Joint Review Committee," but it functioned exactly like a traditional UCC drafting

II. OVERRIDING TRANSFER RESTRICTIONS: AN HISTORICAL OVERVIEW

Article 9 has been the law in the United States for a half-century, so it may seem curious that a collision between concepts of freedom of contract and free alienability has come to a head so recently. Yet, understanding of the nature of the current controversy requires a review of the development of Article 9 that led to the current situation. In particular, the dimensions of the problem are significantly affected by changes in the scope of Article 9 that became effective in 2001.

From its inception, Article 9 has governed not only transactions in which personal property serves as security for an obligation (regardless of whether the parties denominate the transaction as a security interest, lease, or sale – conditional or otherwise[7]) but also transactions in which certain payment rights are the subject of an outright sale.[8] Under former Article 9, the payment rights whose sale was governed were accounts[9] and chattel paper.[10]

The inclusion of such sales within the scope of Article 9 serves several functions. First, it reflects the historical understanding that sales of such payment rights are more akin to transactions in which those rights are used as the mechanism by which to obtain financing than to traditional sales of property such as goods. Second, it obviates the need for the legal system to make difficult decisions about characterizing a transaction as either (i) creating both an obligation and a security right in a payment right that secures that obligation (and, thus, within the scope of Article 9), or (ii) transferring outright ownership of the payment right (and, thus, if the scope of Article 9 were not broadened to cover such sales, outside the scope of the Article). Modern transactions involving the "sale" of receivables, often accompanied by such

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committee, albeit with a narrower scope.

7. Former Article 9 provided that Article 9 applies to, *inter alia*, "any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures. . . ." U.C.C. § 9-102(1)(a) (1999). One of us (Cohen) frequently refers to the phrase in parentheses as the most important parenthetical in American law. Revised Article 9 has essentially the same formulation (minus the parentheses, depriving Cohen of his observation). *See* U.C.C. § 9-109(a)(1) (2008).

8. Former Article 9 covered sales of accounts and chattel paper. *See* U.C.C. § 9-102(1)(b) (1972). By legislative fiat, the rights acquired in such a sale are also denominated as "security interests,"*see* U.C.C. § 1-201(b)(35) (2008), with the buyers and sellers of those rights being similarly denominated as secured parties and debtors, leading to somewhat simpler drafting of the substantive sections of Article 9, but significant confusion among the uninitiated. As a result, in order to avoid such confusion, we use the phrase "security interest securing an obligation" to refer to security interests other than those resulting from outright sales.

9. U.C.C. § 9-102(a)(2) (2008) (formerly U.C.C. § 9-106 (1972)).

10. U.C.C. § 9-102(a)(11) (2008) (formerly U.C.C. § 9-105(1)(b) (1972)).

additional procedures as warranties by the seller and "put" rights by the buyer, are notoriously difficult to characterize as either creating "true" sales or transactions in the form of a sale that create only a security interest securing an obligation.[11] The result of this difficulty of characterization is that enormous resources are spent in other areas of law, such as bankruptcy, in which important substantive differences in treatment flow from differing characterizations. Thus, one benefit of the decision of the drafters of Article 9 to have the Article cover both outright sales of these payment rights and security rights in them that secure obligations is that the need for such expenditures in the Article 9 context is largely eliminated—Article 9 will govern a transaction whether it creates an outright sale or a security interest in an obligation. Finally, the filing requirements for perfection that accompany the inclusion of sales of accounts and chattel paper[12] in the scope of Article 9 promote transparency and protect those who might subsequently deal with the originator of those accounts or chattel paper without notice that the originator has sold them to others.

Interestingly, history suggests that these functional advantages of including sales of such receivables in Article 9 were not the primary motivation for their inclusion. Rather, according to Professor Gilmore, their inclusion was a natural result of the existence of pre-UCC accounts-receivable statutes that were adopted in a large number of states in the first half of the twentieth century.[13] Those statutes, in turn, were generated by several factors, the most important of which was a desire to validate non-notification receivables financing in bankruptcy, an issue created by the decision of the Supreme Court of the United States in *Corn Exchange National Bank & Trust Co. v. Klauder*.[14] The *Klauder* case had held that a rule that was prevalent in many states—that priority among competing assignees of receivables was determined by the order in which the assignees notified the debtor on the receivable—resulted in the potential voidability of assignments of receivables as preferences in transactions in which no notification had been given.[15] Such notification, of course, was antithetical to the business model of non-notification financing. To avoid the likely effect of *Klauder* (diminishment of the viability of non-notification receivables finance), by the late 1950s all but a handful of states had passed statutes designed to validate receivables financing. While the states

11. *See* Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 159, 181-82 (1996).

12. In the case of chattel paper, perfection may also be accomplished by possession, but this also promotes transparency.

13. *See* I GILMORE, *supra* note 1, § 10.5, at 308.

14. 318 U.S. 434 (1943).

15. *Id.* at 436-37.

were split on whether validity would be based on public filing or, rather, whether an assignment of a receivable would be automatically validated without the necessity of a filing, the filing camp eventually prevailed and it was a foregone conclusion by the enactment of Article 9 that validation of outright assignments of receivables would require public filing.[16] Accordingly, when Article 9 was promulgated, it generally imposed the same filing requirements for perfection of an outright sale of a receivable as for perfection of a security interest securing an obligation.[17] Because the pre-UCC accounts-receivable statutes typically dealt with what Article 9 now denominates as "accounts"—that is, rights to payment for goods sold, services rendered, or the like – the inclusion of the sale of receivables in the scope of Article 9 was similarly limited, covering only accounts and their cousin, chattel paper.[18]

With this background, reference should be made to the resolution in original Article 9 of the collision between the principles of freedom of contract (which would effectuate contractual provisions that limit assignability of a contractually created right) and free alienability of property (which would disfavor effectiveness of such privately created limits on alienation). The resolution of this collision was codified in former UCC section 9-318(4).[19] That section provided "A term in any contract between an account debtor and an assignor is ineffective if it prohibits assignment of an account or prohibits creation of a security interest in a general intangible for money due or to become due or requires the account debtor's consent to such assignment or security interest."[20] This formulation is tied to the scope of former Article 9. Because former Article 9 governed sales of accounts but not sales of general intangibles for money due or to become due[21], the override of anti-assignment provisions was applicable in cases in which (i) accounts served as collateral for an obligation, (ii) accounts were sold or otherwise assigned other than as collateral, and (iii) general intangibles for money due or to become due served as collateral. The override was inapplicable to provisions that would prevent the sale of a general intangible for money due or to become due because such sales were outside the scope of Article 9.

The comments to former UCC section 9-318 forcefully advocated for this triumph of alienability over freedom of contract. Comment 4 begins by

16. *See* I GILMORE, *supra* note 1, § 8.7, at 274-75.

17. *See* U.C.C. § 9-302 (1999).

18. *See* U.C.C. § 9-102(1)(b) (1999).

19. *See* U.C.C. § 9-318(4) (1999).

20. U.C.C. § 9-318(4) (1999).

21. Such general intangibles are denominated as "payment intangibles" in revised Article 9. *See* U.C.C. § 9-318(a) (2008).

acknowledging that "Subsection (4) breaks sharply with the older contract doctrines by denying effectiveness to contractual terms prohibiting assignment of sums due and to become due under contracts of sale, construction contracts and the like."[22] After a discussion of the history of these battling concepts, starting from older eras in which contractual limitations on assignability were freely enforced and culminating with the promulgation of Article 9, the comment states that:

> This gradual and largely unacknowledged shift in legal doctrine has taken place in response to economic need: as accounts and other rights under contracts have become the collateral which secures an ever increasing number of financing transactions, it has been necessary to reshape the law so that these intangibles, like negotiable instruments and negotiable documents of title, can be freely assigned.
>
> Subsection (4) thus states a rule of law which is widely recognized in the cases and which corresponds to current business practices. It can be regarded as a revolutionary departure only by those who still cherish the hope that we may yet return to the views entertained some two hundred years ago by the Court of King's Bench.[23]

From the enactment of former Article 9 until the promulgation of revised Article 9, matters remained stable, with freedom of contract prevailing over free alienability except with respect to assignments of accounts (whether outright or for security) and the use of general intangibles for the payment of money as security for an obligation.

Revised Article 9, however, brought about significant differences. Of particular interest are two related changes made with respect to payment rights. The instigating factor for these changes was quite similar to the motivation behind the coverage of sales of accounts in the post-*Klauder* accounts-receivable statutes—inoculation of transactions in which payment rights are sold against the possibility of invalidation in insolvency proceedings by providing an explicit and uniform method of perfection so as to prevent avoidance by the trustee. Those seeking such inoculation in the 1990s were participants in securitization transactions. While many of the receivables that are transferred in securitization transactions fit into the definition of "account" in former Article 9 and, thus, sales of those rights were already within the scope of Article 9, other receivables that are commonly the subject of securitization transactions did not fit within the definition.

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22. U.C.C. § 9-318 cmt. 4 (1999).
23. U.C.C. § 9-318 cmt. 4 (1999).

Former Article 9 defined "account" as "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance."[24] While the sale or lease of goods and the provision of services certainly represent a significant portion of receivables commonly assigned in securitization transactions, many other payment rights do not fall within that description. For example, credit-card receivables, insurance premiums, and rights to payment on energy contracts were not accounts as the term was defined in former Article 9.[25] Accordingly, participants in securitizations expressed a desire to expand the scope of Article 9 to include sales of all payment rights, and were willing to have the newly included sales governed by the same rules as sales of accounts (including filing requirements for perfection). While that solution might work well for securitization transactions, financial institutions that engaged in frequent loan participation transactions were unwilling to be governed by rules that would require such filings.

After several unsuccessful proposals were put forward by the ABA Securitized Asset Financing Task Force,[26] the eventual accommodation of the needs of both securitizers and participants in loan participations, recommended by the Task Force and adopted by the Article 9 Drafting Committee, was to greatly expand the definition of "account" so as to encompass almost every receivable other than the right to be paid for a loan.[27] With this expanded

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24. *See* U.C.C. § 9-106 (1999).

25. *See* U.C.C. § 9-106 (1999).

26. The Reports of this Task Force are described in detail in Paul M. Shupack, *Making Revised Article 9 Safe for Securitizations: A Brief History*, 73 AM. BANKR. L.J. 167, 174-76 (1999).

27. The new definition of account provides that:

> "Account", except as used in "account for", means a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of, (ii) for services rendered or to be rendered, (iii) for a policy of insurance issued or to be issued, (iv) for a secondary obligation incurred or to be incurred, (v) for energy provided or to be provided, (vi) for the use or hire of a vessel under a charter or other contract, (vii) arising out of the use of a credit or charge card or information contained on or for use with the card, or (viii) as winnings in a lottery or other game of chance operated or sponsored by a State, governmental unit of a State, or person licensed or authorized to operate the game by a State or governmental unit of a State. The term includes health-care-insurance receivables. The term does not include (i) rights to payment evidenced by chattel paper or an instrument, (ii) commercial tort claims, (iii) deposit accounts, (iv) investment property, (v) letter-of-credit rights or letters of credit, or (vi) rights to payment for money or funds advanced or sold, other than rights arising out of the use of a credit or charge card or information contained on or for use with the card.

definition of "account" in place, those engaging in securitization transactions would achieve their goal of a simple method of inoculating their transactions against bankruptcy attack by use of the same rules that had applied for several decades to the narrower class of receivables constituting "accounts" under the old definition. Those engaging in loan participation transactions were not troubled by the inclusion of their transactions within the scope of Article 9, as long as there was no filing requirement. The desire on their part for no filing requirement was accomplished by the Drafting Committee in two steps. First, the remaining receivables not included in the expanded definition of "accounts," and not falling into other categories such as securities or instruments, were given a new name—the defined term "payment intangible"[28] replaced "general intangible for money due or to become due"—and the scope provision of Article 9 was revised to include the sale of payment intangibles.[29] Second, the automatic perfection rules of Article 9 were expanded to provide that the security interest created by the sale of a payment intangible is perfected when it attaches (*i.e.*, without the need for filing).[30] Inasmuch as many (if not most) loan receivables are represented by negotiable or non-negotiable notes, the same two-step process[31] was applied to "promissory notes," a newly-defined term that is a subset of the category of so-called "Article 9 instruments"[32] that encompasses both notes that are negotiable instruments and those that do not satisfy the requirements of negotiability under UCC Article 3.[33]

In sum, the accommodation of the needs of those engaging in securitization transactions and those engaging in loan participations was effectuated by four statutory changes. First, the definition of "account" was greatly expanded as

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U.C.C. § 9-102(2) (2008).

28. U.C.C. § 9-102(a)(61) (2008) defines "payment intangible" as "a general intangible under which the account debtor's principal obligation is a monetary obligation."

29. *See* U.C.C. § 9-109(a)(3) (2008).

30. *See* U.C.C. § 9-309(3) (2008).

31. *See* U.C.C. § 9-109(a)(3) (2008) as to scope, and U.C.C. § 9-309(4) as to perfection upon attachment.

32. As used in Article 9, "instrument" includes not only negotiable instruments governed by UCC Article 3 but also other written payment obligations (except investment property, letters of credit, or writings evidencing the right to be paid on credit cards) that are not security agreements or leases and that in the ordinary course of business are transferred by delivery with any necessary endorsement. *See* U.C.C. § 9-102(a)(47) (2008).

33. U.C.C. § 9-102(a)(65) (2008) defines "promissory note" as "an instrument that evidences a promise to pay a monetary obligation, does not evidence an order to pay, and does not contain an acknowledgment by a bank that the bank has received for deposit a sum of money or funds."

described above.[34] Second, the two new collateral categories—"payment intangible" and "promissory note"—were defined.[35] Third, the list of payment rights whose sale is governed by Article 9 was expanded to include payment intangibles and promissory notes.[36] Fourth, the list of transactions in which a security interest perfects automatically upon attachment (without the necessity of filing a financing statement) was broadened to include sales of payment intangibles and promissory notes.[37]

This solution created an additional issue, however. Recall that former UCC section 9-318(4) overrode most contractual restrictions on assignability of payment rights that would interfere with the creation of a security interest, and that "security interest" was defined to include the right of a buyer of payment rights in a transaction that is governed by Article 9.[38] Thus, carrying the policy of former section 9-318(4) forward would have a new, and perhaps controversial, effect. Not only would the policy result in the ineffectiveness of contractual transfer restrictions to prevent the creation of a "true" security interest (*i.e.*, a security interest that secures an obligation) in payment rights but, since the former section covered sales of payment rights that were within the scope of Article 9, the override of anti-assignment provisions would now apply to sales that were not governed by former Article 9 but are governed by the expanded scope of the revised Article. More specifically, because revised Article 9 would govern the sale of payment rights that were not "accounts" under the former definition but which fit within the revised definition of that term and would also govern the sale of payment intangibles and promissory notes, the override, if brought forward intact from former UCC section 9-318(4), would override transfer restrictions that were previously effective to prevent sales of payment rights whose sale was not governed by the former Article. As a result, the Task Force and the Article 9 Drafting Committee realized that it needed to reconsider the fate of section 9-318(4) as it applied to sales of payment rights.

This issue was not the only issue that caused the Drafting Committee to revisit UCC section 9-318(4). Many stakeholders had become concerned with how existing section 9-318(4) applied to emerging market practices. In particular, licensors of intellectual property had become concerned that section 9-318(4) would harmfully override restrictions on transfer in their licenses

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34. *See supra* text accompanying note 27.

35. *See supra* text accompanying notes 28 and 33.

36. U.C.C. § 9-109(a)(3) (2008) now provides that, subject to certain exceptions in subsections (c) and (d) of that section, Article 9 governs "a sale of accounts, chattel paper, payment intangibles, or promissory notes."

37. *See* U.C.C. § 9-309(3)-(4) (2008).

38. *See supra* note 8.

(which are "general intangibles" in Article 9 parlance[39]). Their concern was essentially that, since section 9-318(4) resulted in the inability of licensors to prevent their licensees from granting security interests in their rights under the license, enforcement of such security interests after default by the licensee could result in the licensor being faced with a new licensee with whom it did not want to deal and whom it did not trust with the intellectual property that was the subject of the license. As a result, the licensors sought to have section 9-318(4) revised either to exclude coverage of general intangibles such as their licenses or to limit its reach upon enforcement of security interests in them.

Consequently, the Article 9 Drafting Committee was faced with two knotty problems that forced reconsideration of the long-settled border line between freedom of contract and free transferability of property. The results of that reconsideration are the subject of the next portion of this paper.

III. REVISED ARTICLE 9'S APPROACH TO OVERRIDING TRANSFER RESTRICTIONS

Revised Article 9 creates an intricate, two-track system to deal with the extent to which otherwise-enforceable contractual and legal restrictions on a debtor's right to transfer its interest in certain types of intangible collateral are overridden. The first track, codified in section 9-406, promotes free alienability by substantially overriding such restrictions.[40] The second track, codified in section 9-408, provides for a partial override that might be referred to as override-lite under which contractual and legal transfer restrictions are overridden to the extent they would otherwise "impair the creation, attachment, or perfection of a security interest," but the security interest is not enforceable against the person in whose favor the restriction runs.[41] Which of the two sections applies depends on three factors: the type of collateral, the type of transaction (*i.e.*, whether the collateral is being used as security for an obligation or is being sold), and the type of transfer restriction (*i.e.*, whether the restriction is contractual or legal).

The relevant types of collateral are (i) accounts other than health-care-insurance receivables, (ii) health-care-insurance receivables, (iii) chattel paper, (iv) general intangibles other than payment intangibles, (v) payment intangibles, and (vi) promissory notes. Section 9-406 applies to accounts other than health-care insurance receivables and to chattel paper without regard to the type of transaction or the type of restriction.[42] Section 9-406 also has limited

39. *See* U.C.C. § 9-102(a)(42) (2008).
40. *See* U.C.C. § 9-406(d) (2008).
41. *See* U.C.C. § 9-408 (2008).
42. *See* U.C.C. § 9-406(d), (i) (2008).

application to payment intangibles and promissory notes: it applies if the collateral is being used as security for an obligation and if the transfer restriction is contractual.[43] Section 9-408 applies to payment intangibles and promissory notes if the transaction is a sale or if the transfer restriction is legal.[44] Section 9-408 also applies to health-care-insurance receivables without regard to the type of transaction or the type of restriction, and it applies to the use of general intangibles that are not payment intangibles as security for an obligation without regard to the type of restriction.[45] As noted previously[46], sales of general intangibles that are not payment intangibles are outside the scope of Article 9 and therefore not subject to either section 9-406 or section 9-408.

The effect of section 9-406 on contractual restrictions may be illustrated by the following example. Suppose Buyer purchases a big-screen TV from Seller on unsecured credit, with payment due in installments. Because Buyer once had a bad experience dealing with an assignee, she insists that Seller agree not to assign his right to payment. To buttress the anti-assignment clause, she insists that Seller agree that an attempted assignment will constitute a default that will entitle her to $100 in liquidated damages.[47] Seller agrees to Buyer's demands but once she leaves the store he sells to Bank his right to be paid. Either Seller or Bank then sends Buyer an authenticated notification that the amount due has been assigned to Bank and that payment must be made to Bank.[48] What are the rights of Buyer and Bank?

The transaction between Seller and Bank constitutes a sale (*i.e.*, an outright assignment) of an account[49] and, therefore, the transaction is within the scope of revised Article 9.[50] Section 9-406(d)(1), which addresses Seller's agreement

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43. *See* U.C.C. § 9-406(d)-(e) (2008).

44. *See* U.C.C. § 9-408(b)-(c) (2008).

45. *See* U.C.C. § 9-408(a)-(b) (2008).

46. *See supra* text accompanying note 36.

47. Whether a liquidated damages clause is enforceable is determined under U.C.C. § 2-718(1) (2008). It is assumed that the clause in the example is enforceable.

48. The notification method for collecting from an account debtor is set forth in U.C.C. § 9-406(a)-(c) (2008).

49. U.C.C. § 9-102(a)(2)(i) (2008) ("'account' [includes the right to payment of a monetary obligation . . . for property that has been or is to be sold . . . .").

50. U.C.C. § 9-109(a)(3) (2008) (Article 9 applies generally to "sale of accounts, chattel paper, payment intangibles, [and] promissory notes"). It does not apply if the sale was part of the sale of Seller's business, *id.* § 9-109(d)(4), if it was made for the purpose of collection only, *id.* § 9-109(d)(5), if Bank was obligated to perform under the contract (as by assuming warranty obligations), *id.* § 9-109(d)(6), or if it was the only account assigned and the assignment was made in full or partial satisfaction of a pre-existing debt. *Id.* § 9-109(d)(7). None of those exceptions, however, is present in this example. (The same

not to assign the account, provides in relevant part that "a term in an agreement between an account debtor[51] and an assignor . . . is ineffective to the extent that it: (1) prohibits, restricts, or requires the consent of the account debtor . . . to the assignment . . . of, or the creation, attachment, perfection, or enforcement of a security interest in [an] account . . . ."[52] Accordingly, Seller may assign the account notwithstanding the agreement to the contrary. What about the agreement regarding default and liquidated damages? The underlying policy of section 9-406 is free alienability and if the agreement was allowed to stand it would chill Seller's exercise of his rights. Accordingly, the agreement is overridden by section 9-406(d)(2), which provides in relevant part that:

> A term in an agreement between an account debtor and an assignor . . . is ineffective to the extent that it: (2) provides that the assignment . . . or the creation, attachment, perfection, or enforcement of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the account . . . .[53]

Thus, the provisions for which the Buyer bargained are all unenforceable.

The same rules would apply in a number of other possible situations involving Buyer and Seller, including the sale of chattel paper and the use of an account or chattel paper as security for an obligation. Thus, the same result would have obtained if Seller had assigned the account as security for an obligation or if Seller had retained a security interest in the TV set, thereby rendering the assigned payment right chattel paper[54] rather than an account, and Seller had either sold the chattel paper or used it as collateral for an obligation.

The policy of free alienability is so pervasive with regard to accounts other than health-care-insurance receivables and chattel paper that even legal transfer restrictions are overridden. For example, assume Player wins a state-sponsored lottery and is entitled to receive one million dollars per year for twenty years. Assume also that under the law that existed at the time revised Article 9 was enacted lottery winnings are not assignable. Player's right to be paid is an

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exceptions to Article 9's coverage apply to assignments of chattel paper, payment intangibles, and promissory notes.)

51. An account debtor is "a person obligated on an account, chattel paper, or general intangible." U.C.C. § 9-102(a)(3) (2008). A person obligated on a promissory note is not an account debtor even if the note is part of chattel paper, *id.*, but the distinction is irrelevant for purposes of U.C.C. §§ 9-406 and 9-408, which apply equally to a term in an agreement between an account debtor and an assignor and a term in a promissory note.

52. U.C.C. § 9-406(d)(1) (2008).

53. U.C.C. § 9-406(d)(2) (2008).

54. U.C.C. § 9-102(a)(11) (2008). The conclusion in the text assumes that the payment obligation and the security agreement were set forth in a record or records.

account[55] and section 9-406(f)(1) provides in relevant part that "a rule of law, statute, or regulation that prohibits, restricts, or requires the consent of a government, governmental body or official, or account debtor to the assignment . . . of, or creation of a security interest in, an account . . . is ineffective"[56] Player may sell the winnings or assign them as security for an obligation notwithstanding the legal restriction.[57]

Whereas section 9-406 rolls over transfer restrictions like a steamroller, the interplay between such restrictions and section 9-408 is more complex. The policy that underlies the latter section's approach might best be illustrated by an example that does not involve payment rights. Assume Licensee grants Bank a security interest in its rights with respect to a copy of licensed software[58] as security for an obligation notwithstanding a provision in the exclusive[59] license agreement prohibiting transfer of its rights. Assume also that the transfer restriction would be effective but for any effect of Article 9. This section evidences a policy that, in the case of general intangibles, such as the right of a licensee of intellectual property, as to which the account debtor's principal obligation is not a payment obligation, the person in whose favor a transfer restriction runs (the licensor in this example) may well have an interest more weighty than the mere interest of a payor in the identity of the party to whom

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55. U.C.C. § 9-102(a)(2)(viii) (2008).

56. U.C.C. § 9-406(f) similarly overrides laws that provide that the assignment, transfer, creation, or enforcement of a security interest in an account or chattel paper gives rise "to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy . . . ." *Id.* § 9-406(f)(2).

57. *See, e.g.*, Tex. Lottery Comm'n v. First State Bank of DeQueen, 254 S.W.3d 677, 685 (Tex. App. 2008) (U.C.C. § 9-406(f) overrides restrictions in Texas Lottery Act). Not every court has understood the point. *See, e.g.*, Stone St. Capital, LLC v. Cal. State Lottery Comm'n, 80 Cal. Rptr. 3d 326, 333 (Cal. Ct. App. 2008) (relying on policies underlying restrictions in California Lottery Act, held that U.C.C. § 9-406(f) does not override the restrictions). It would be best for legislation restricting transfer of the right to receive lottery payments that is enacted after the enactment date of revised Article 9 to address the relationship between the restrictions and U.C.C. §§ 9-406 and 9-408; otherwise a court will have to determine the issue based on whether the later enactment constitutes an implicit repeal of the UCC provisions.

58. Software is a subset of general intangibles. U.C.C. § 9-102(a)(42) (2008) (defining general intangible); *id.* § 9-102(a)(75) (defining software).

59. There is some case authority holding that, as a matter of federal law, the interest of a licensee with a non-exclusive license to use a federally created intellectual property right may not assign its rights. Federal law, of course, may not be overridden by the rules of U.C.C. § 9-408. *See, e.g.*, Harris v. Emus Records Corp., 734 F.2d 1329, 1333-34 (9th Cir. 1984) (copyright); PPG Indus., Inc. v. Guardian Indus. Corp., 597 F.2d 1090, 1093 (6th Cir. 1979) (patent); Unarco Indus., Inc. v. Kelley Co., 465 F.2d 1303, 1306-07 (7th Cir. 1972) (patent). *Contra* Superbrace, Inc. v. Tidwell, 21 Cal. Rptr. 3d 404, 407-17 (Cal. Ct. App. 2004) (disagreeing with *Unarco* and *PPG* and applying California law) (patent).

payment is to be made and thus they set out to balance that person's interest against the general policy of free alienability. Section 9-408(a)(1) applies to the transaction and overrides the license restriction to the extent it impairs "the creation, attachment, or perfection of a security interest."[60] Note carefully that unlike section 9-406(d)(1), discussed above, section 9-408(a)(1) does not override the restriction to the extent it impairs the Bank's *enforcement* of its security interest.[61] Indeed, section 9-408(d)(1) places significant limits on Bank's ability to enforce its security interest.[62] Thus, unless the licensor waives the restriction, the value of Bank's security interest will be limited. It will have an enforceable security interest in any identifiable proceeds of the software, and if Licensee files a petition in bankruptcy the contingent value of Bank's perfected security interest in the software might provide a basis for enhancing the amount of its allowed secured claim. If, as is often the case, those rights are not particularly useful, Bank will be all dressed up as a secured party but with no place to go.

Section 9-408(c) takes the same approach with respect to legal restrictions. For example, assume a restaurant has a liquor license issued by the city in which it is located and a municipal ordinance precludes assignment of the license without the consent of the department charged with overseeing liquor sales. Notwithstanding the restriction, and assuming that the liquor license constitutes property under relevant state law, a secured party can obtain a security interest in the license. However, the city's interest in regulating which parties can sell liquor is protected because Bank cannot through foreclosure transfer the restaurant's rights in the license.

As we saw with respect to the software and liquor-license examples, the override provisions of section 9-408 apply to both contractual and legal restrictions if the collateral is a general intangible that is not a payment intangible and is being used as security for an obligation. Section 9-408 also applies to contractual and legal restrictions if the collateral is a health-care-

60. *See* U.C.C. § 9-408(a)(1) (2008).

61. *See* U.C.C. § 9-408(a)(1) (2008).

62. U.C.C. § 9-408(d) amplifies on what it means to have an unenforceable security agreement by providing *inter alia* that to the extent a transfer restriction is enforceable outside Article 9 but is partially overridden under U.C.C. § 9-408(a) (contract restrictions) or (c) (legal restrictions), the security agreement "does not impose [any] duty or obligation" on the person in whose favor the restriction runs, U.C.C. § 9-408(d)(2) (2008), "does not require [that] person [to] pay or render performance to the secured party," *id.* § 9-408(d)(3), "does not entitle the secured party to use or assign [any of] the debtor's rights" in the collateral, *id.* § 9-408(d)(4), and "does not entitle the secured party [to any rights with respect to] trade secrets or confidential information of the person" in whose favor the restriction runs, *id.* § 9-408(d)(5).

insurance receivable being used as security for an obligation or being sold.[63] The inclusion of health-care-insurance receivables in section 9-408[64] reflects industry practice with regard to the reassignment by health-care providers of their right to be paid by private health-care insurers.

This brings us to the last two types of collateral covered by sections 9-406 and 9-408 – payment intangibles and promissory notes – and here the treatment is especially complex because, with respect to contractual restrictions, it is bifurcated. Section 9-408(c) applies if the transfer restriction is legal without regard to whether the transaction involves a sale or the use of the collateral as security for an obligation.[65] Section 9-408(a) applies if the restriction is contractual and the transaction is a sale,[66] but section 9-406(d) applies if the restriction is contractual and the transaction involves the use of the collateral as security for an obligation.[67]

As we shall see in the remainder of this paper, disagreements about the application of sections 9-406(e) and 9-408(b) have generated substantial controversy (and some nonuniform amendments to Article 9) in an important context – contractual and legal restrictions on transfers of interests in unincorporated business entities. Moreover, attempts to resolve that controversy through careful analysis of the statute revealed an important ambiguity in Article 9 that has an impact not only on unincorporated entities but also on restrictions on transfer in other contexts, such as basic loan transactions.

IV. APPLICATION OF SECTIONS 9-406 AND 9-408 TO OWNERSHIP INTERESTS IN UNINCORPORATED ENTITIES

An issue the drafters never considered arose during the effort to gain enactment of revised Article 9 in the state legislatures and led to some nonuniformity. The issue relates to the effect of sections 9-406 and 9-408 on certain types of ownership interests in unincorporated entities, particularly general and limited partnerships and limited liability companies (LLCs). For purposes of Article 9, the interests at issue are general intangibles that may or may not be payment intangibles.

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63. U.C.C. § 9-408(a) (2008).

64. U.C.C. § 9-406(d) and (f) refer broadly to accounts, a term which includes health-care-insurance receivables, U.C.C. § 9-102(a)(2) (2008), but U.C.C. § 9-406(i) makes the section inapplicable to such receivables.

65. *See* U.C.C. § 9-408(c) (2008).

66. *See* U.C.C. § 9-408(b) (2008).

67. *See* U.C.C. § 9-406(e) (2008).

Ownership interests in corporations and in some unincorporated entities are investment property[68] for purposes of Article 9, and sections 9-406 and 9-408 are not applicable to collateral of this type. Investment property includes all securities[69] as that term is defined in Article 8, and corporate stock is a security.[70] An interest in a partnership or LLC may be a security but only if it is "dealt in or traded on . . . securities markets, its terms expressly provide that it is a security governed by this Article [8], or it is an investment company security."[71] An interest in a partnership or LLC that is not a security but is held in a securities account[72] is a financial asset,[73] meaning that it is a security entitlement under Article 8[74] and again constitutes investment property under Article 9.[75] The discussion below assumes that the collateral is not investment property.

An analysis of Article 9's treatment of a member's rights with regard to an LLC will illustrate the issue that arose during the enactment process and, while the terminology may differ, the analysis is applicable to the world of partnerships as well. With an LLC, a member's entire interest consists of a combination of economic rights and governance rights. The economic rights alone are referred to by the Revised Uniform Limited Liability Company Act (RULLCA) as the member's "transferable interest," which is defined as "the right . . . to receive distributions from a limited liability company in accordance with the operating agreement . . . ."[76] "A transferable interest is personal property"[77] and, as the name suggests, may be transferred by the member[78] absent an agreement to the contrary. A transferee of a transferable interest does not become a member merely by virtue of the transfer[79] and accordingly a mere transferee may not participate in the LLC's governance or have access to

68. U.C.C. § 9-102(a)(49) (2008).

69. U.C.C. § 9-102(a)(49) (2008).

70. U.C.C. § 8-102(a)(15) (2008). Shares issued by a business trust, joint stock company, or similar entity are also securities. *Id.* § 8-103(a).

71. U.C.C. § 8-103(c) (2008). The term "investment company security" is defined in U.C.C. § 8-103(b).

72. U.C.C. § 8-501(a) (2008).

73. U.C.C. § 8-102(a)(9)(iii) (2008).

74. U.C.C. § 8-102(a)(17) (2008).

75. U.C.C. § 9-102(a)(49) (2008).

76. RULLCA § 102(21) (2006). The same term is used to describe a partner's economic interest in the partnership in the Revised Uniform Limited Partnership Act § 102(2), 6B U.L.A. 428 (2008), and the Revised Uniform Partnership Act § 502 (1997).

77. RULLCA § 501.

78. RULLCA § 502(a)(1).

79. RULLCA § 502(a)(3).

records or other information concerning the LLC's activities.[80] By contrast, RULLCA provides that a member's entire interest[81] generally may not be transferred without the unanimous consent of the other members.[82] The limitation on transferring membership interests supports what is known as the "pick-your-partner" principle.[83]

RULLCA's approach to the issue of transferability is explained in the following Comment to section 502:

> A member's rights in a limited liability company are bifurcated into economic rights (the transferable interest) and governance rights (including management rights, consent rights, rights to information, rights to seek judicial intervention). Unless the operating agreement otherwise provides, a member acting without the consent of all other members lacks both the power and the right to: (i) bestow membership on a non-member, Section 401(d); or (ii) transfer to a non-member anything other than some or all of the member's transferable interest. Section 502(a)(3). However, consistent with current law, a member may transfer governance rights to another member without obtaining consent from the other members. Thus, this Act does not itself protect members from control shifts that result from transfers among members (as distinguished from transfers to non-members who seek thereby to become members).[84]

Because of the key role played by statutory restrictions on the transfer of ownership interests and by contractual restrictions on the transfer of economic interests, many lawyers who work in the field of unincorporated entities were concerned about the effect of Article 9's override provisions. In response to this concern, a few states, notably Delaware, adopted nonuniform provisions excluding assignments of interests in partnerships and LLCs from the scope of sections 9-406 and 9-408.[85] As the ensuing discussion will demonstrate, concerns over the effect of the sections are somewhat overblown, but to an extent that may result from the fact that commercial lawyers and entity lawyers speak different languages.

The full ownership rights of a partner or a member of an LLC constitute a general intangible that is not a payment intangible. Sales of such general

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80. RULLCA § 502(a)(3).

81. RULLCA does not define a member's entire interest. *See* RULLCA § 102.

82. RULLCA § 401(d) (providing methods of becoming a member after formation of the entity).

83. *See* RULLCA § 502, cmt. ("One of the most fundamental characteristics of LLC law is its fidelity to the 'pick your partner' principle.").

84. RULLCA § 502, cmt.

85. *See, e.g.*, DEL. CODE ANN. tit. 6, §§ 9-406(i)(5), 9-408(e)(4) (2010); VA. CODE ANN. §§ 8.9A-406(k), -408(g) (2010).

intangibles are outside the scope of Article 9,[86] and their use as security for an obligation is governed by section 9-408.[87] Although section 9-408(c) overrides legal transfer restrictions like those imposed by RULLCA, it does so only to the extent necessary to permit the creation, attachment, and perfection of a security interest.[88] A security interest thus created cannot be enforced under the procedures described in Part 6 of Article 9, meaning for example that if a member of an LLC grants a security interest in her membership interest, the LLC, which is an account debtor for purposes of Article 9, need not honor a demand by the secured party for payment of any money due the member or otherwise recognize the security interest in any way.[89] It also means that the LLC need not recognize any purported transferee of the membership interest pursuant to enforcement of the security interest by disposition under UCC section 9-610.[90]

The situation is different, and more complicated, with regard to a member's transferable interest, which constitutes a payment intangible.[91] Section 9-408(a) applies if a member sells her transferable interest and even though transfer restrictions in an agreement between the entity and the member[92] are overridden to the extent they interfere with the creation, attachment, and perfection of the buyer's security interest, the effect of the override is so limited that it is hard to imagine that there would be a market for such assets. Absent a waiver by the LLC, the buyer would not be entitled to collect, or to transfer the right to collect, any sums due the member.

By contrast, if a member's transferable interest is used as security for an obligation, section 9-406(d) applies and transfer restrictions in an agreement between the entity and the member are overridden to the extent they interfere with the creation, attachment, perfection, and enforcement of the security interest.[93] As we shall see below there is an ambiguity in section 9-406(e) that casts doubt on the extent of the secured party's enforcement rights, but at a

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86. The only types of property whose sale is governed by Article 9 are accounts, chattel paper, payment intangibles, and promissory notes. U.C.C. § 9-109(a)(3) (2008).

87. *See* U.C.C. § 9-408 (2008).

88. *See* U.C.C. § 9-408(c) (2008).

89. U.C.C. § 9-408(d) (2008).

90. U.C.C. § 9-408(d) (2008).

91. Although the discussion in this section is limited to payment intangibles, the analysis applies as well to non-negotiable promissory notes, which frequently contain transfer restrictions. Transfer restrictions in promissory notes are discussed to a limited extent *infra* Parts V and VI.

92. U.C.C. § 9-408(b) (2008). UCC §§ 9-406(d) and 9-408(a) apply only to an agreement between the owner and the entity restricting transfer and not to an agreement among the owners *inter se.* This is discussed further *infra* Part VII.

93. U.C.C. § 9-406(d) (2008).

minimum it has the right under section 9-607(a) to collect from the LLC any sums due the member.[94] Providing a secured lender with collection rights is not a major concern to entity lawyers; however, permitting a transferable interest to be disposed of with enforcement rights intact under section 9-610's rules governing commercially reasonable dispositions or under section 9-620's rules governing acceptance of collateral in total or partial satisfaction of a secured obligation distresses some of them greatly. Their concern is that a member who has been divested of her economic rights will have little or no stake in the success of the company, a result that some entity lawyers claim is at odds with the pick-your-partner principle.

Because of the concerns expressed about the reach of sections 9-406 and 9-408 in the context of unincorporated entities, the potential for more nonuniform enactments if the sections were not more readily understood by entity lawyers, and the sheer complexity of the subject matter, the Permanent Editorial Board for the Uniform Commercial Code tentatively determined that a PEB Commentary explaining the effects of these sections on ownership interests in unincorporated entities would be useful and authorized the drafting, but not necessarily the publication, of such a commentary.[95] In the context of preparing and vetting the draft Commentary, it was discovered, quite surprisingly, that different members of the Permanent Editorial Board interpreted section 9-406(e) differently and that the difference was important not only for resolving disputes in the entity context but in other contexts as well.[96]

The difference related to what section 9-406(e) means in the context of enforcement of a security interest that secures an obligation. Ordinarily a secured party may, after default, choose its enforcement mechanism from the array provided by section 9-607 (collection), section 9-610 (disposition), and section 9-620 (acceptance of the collateral in full or partial satisfaction of the obligation), but depending on how one interprets section 9-406(e), not all of those choices may be available in this context.

Here is the interpretive problem: section 9-406(e) provides that section 9-406(d), which overrides contractual transfer restrictions to the extent they interfere with the creation, attachment, perfection, or enforcement of a security interest, "does not apply to the *sale* of a payment intangible or promissory note."[97] If this subsection means that subsection (d) does not free a security

94. *See infra* Part VI.

95. *See* Minutes of PEB Meeting, Permanent Editorial Bd. for the U.C.C. (Nov. 11, 2005), *available at* http://www.nccusl.org/Update/Minutes/PEB111105.pdf.

96. *See* Minutes of PEB Meeting, Permanent Editorial Bd. for the U.C.C. (Apr. 13, 2007), *available at* http://www.nccusl.org/Shared/Minutes/PEBUCC041307mn.pdf.

97. U.C.C. § 9-406(e) (2008) (emphasis added).

interest of restrictions that may interfere with, *inter alia*, enforcement by the secured party if the security interest in question is one that was created by the sale of a payment intangible or promissory note rather than the use of the payment intangible or promissory note as security for an obligation,[98] then subsection (e) has no relevance to enforcement of a security interest securing an obligation, even if enforcement of that security interest may be accomplished by a disposition under section 9-610 or an acceptance under section 9-620. If, on the other hand, subsection (e) means that even if the security interest that is being enforced is a security interest that secures an obligation, contractual restrictions on transfer may nonetheless interfere with enforcement of the security interest by a disposition or acceptance because such a disposition or acceptance is a "sale of a payment intangible or promissory note" that subsection (e) excludes from the override in subsection (d), then those that take security interests in payment intangibles or promissory notes that secure an obligation are placed in a position that may significantly diminish the value of their security interests. The position would be that subsection (d) overrides transfer restrictions that impede the transactions of such secured parties, but with a big exception – the transfer restrictions will nonetheless apply to prevent the secured party from enforcing the security interest in the payment intangible or promissory note by any method other than collection.

While the two possible meanings of section 9-406(e) were discovered in the context of explicating the application of that subsection to security interests in ownership rights with respect to an unincorporated entity, it is apparent that the ambiguity as to the subsection's meaning applies in other contexts as well. Consider, for example, the case of a loan made from Lender to Borrower not evidenced by a promissory note, where Borrower is a substantial enterprise with significant bargaining power in the transaction. Borrower is willing to deal with Lender, but does not want to find itself in a position in which its repayment obligation is owed to someone else, whether that someone else is another financial institution like Lender or, even worse, a firm that competes with Borrower. Accordingly, Borrower insists that the loan agreement contain a provision in which Lender agrees not to transfer its rights against Borrower to anyone else. Subsequently, Lender itself is in need of credit and seeks a loan from Moneycenter Bank. Moneycenter Bank agrees to loan money to Lender, so long as Lender grants Moneycenter Bank a security interest in all of Lender's assets, including its rights to be paid by its borrowers. Obviously, one of those assets is Lender's right to be repaid by Borrower, and that asset is a

98. Recall that the right of a buyer of an account, chattel paper, payment intangible, or promissory note in a transaction governed by Article 9 has a "security interest" in that payment right—even though the payment right has been sold outright to the buyer rather than securing an obligation owed to the buyer. *See* U.C.C. § 1-201(b)(35) (2008).

payment intangible. What are Moneycenter Bank's rights with respect to that payment intangible if Lender defaults? Under the first interpretation of section 9-406(e), the restrictions for which Borrower negotiated are completely ineffective to impede Moneycenter Bank from enforcing its security interest; thus, Moneycenter Bank may collect directly from Borrower, dispose of Lender's rights against Borrower pursuant to section 9-610, or accept them under section 9-620. On the other hand, under the second interpretation of section 9-406(e), Moneycenter Bank would be able to collect from Borrower or retain Lender's rights against Borrower, but would not be able to dispose of those rights under section 9-610. Thus, the two possible meanings of section 9-406(e) can have an impact not only in the context of unincorporated entities but also in lending contexts in which borrowers have sufficient bargaining power to insist on a restriction on transfer by the lender.

Upon close examination, it can be seen that the differing interpretations of section 9-406(e) that can result in important differences in rights in both of these contexts spring from ambiguity as to the meaning of the word "sale" in that section. If the word refers only to sales that are within the scope of Article 9, then the first interpretation should prevail because a disposition pursuant to section 9-610 does not constitute a sale governed by Article 9.[99] If, on the other hand, the word "sale" in section 9-406(e) refers to any sale without regard to whether it is within the scope of Article 9 then a disposition sale or acceptance by the secured party is beyond the reach of section 9-406(d), effectively limiting a secured party's enforcement rights to collection under section 9-607.

When the differing interpretations of section 9-406(e) were discovered in the process of developing the draft PEB Commentary, your authors and two other members of the PEB, Steven Weise and Edwin Smith,[100] were asked to prepare position papers analyzing the meaning of section 9-406(e). We were chosen in part because we disagreed about the subsection's meaning, with Henning and Smith taking the view that it means that the override in section

99. This is because, as noted below in more detail, *see infra* p. 397, the disposition of collateral to someone that buys them does not fit into the definition of "sale" in U.C.C. § 2-106, which we are directed to use by U.C.C. § 9-102(b).

100. Edwin E. Smith is a partner in the law firm of Bingham McCutchen LLP and Steven O. Weise is a partner in the law firm of Proskauer Rose LLP. Both are members of the Permanent Editorial Board for the Uniform Commercial Code and both served on the drafting committee that prepared revised Article 9. In addition, both are members, with Mr. Smith serving as Chair, of the Joint Review Committee that drafted the 2010 amendments to Article 9 and that is discussed *infra* Part VII. The position papers set forth in Parts V and VI of this article were every bit as much the work of Mr. Smith and Mr. Weise as they were the work of your authors and this article would not have been possible without their extraordinary contribution.

9-406(d) does not apply to dispositions to enforce security interests that secure obligations and Cohen and Weise taking the view that subsection (e) does not limit enforcement of security interests that secure obligations.

At roughly the time that these position papers were being prepared, the ALI and ULC, based on a PEB recommendation, approved the formation of a joint committee to study the operation of revised Article 9 and to consider whether enough problems of practical importance had emerged since it became effective that the formation of a drafting committee to prepare amendments would be appropriate. The issue relating to section 9-406(e) was placed within the study committee's charge and further consideration of the proposed commentary was deferred pending the committee's report. The study committee ultimately recommended, and the sponsors approved, the formation of a drafting committee, and the committee drafted a discrete set of amendments that was approved by the sponsors at their respective 2010 annual meetings. The amendments when enacted will clarify the meaning of section 9-406(e) and they are discussed below.

Before considering the approach taken by the amendments, it is important to have a more in-depth understanding of the arguments relating to the subsection's meaning as developed by the members of the task force. The arguments represent a significant expansion of the preceding discussion and shed light on the drafting history of, and policy choices underlying, the bifurcated approach to contractual transfer restrictions affecting payment intangibles and promissory notes. They may be of use to lawyers and legislatures considering nonuniform amendments to sections 9-406 and 9-408. They may also be of practical use to lawyers in cases that arise before the amendments take effect. As academics, we think they may be instructive to lawyers and law students with regard to an appropriate methodology for interpreting complex, interrelated statutory provisions.

V. THE ARGUMENT THAT "SALE" IN SECTION 9-406(e) INCLUDES DISPOSITIONS UNDER SECTION 9-610

The following position, developed in a paper prepared by Smith and Henning, advances the argument that use of "sale" in section 9-406(e) is broad and inclusive and excludes the application of the section 9-406(d) override to all sales, including sales that are dispositions of collateral securing an obligation[101]:

101. William H. Henning & Edwin E. Smith, Permanent Editorial Bd. for the U.C.C., Position Paper on Section 9-406(e): Section 9-406(e) Applies to Dispositions of Payment Intangibles and Promissory Notes (Feb. 2008) (unpublished manuscript) (on file with authors). The following constitutes a verbatim reproduction of a selection of the Smith and

Section 9-406(e) applies to a disposition of a payment intangible or promissory note by sale under section 9-610 or by voluntary acceptance under section 9-620. This conclusion is reached by an examination of the text of sections 9-406 and 9-408, by the drafting history of those sections, and by analysis of the policies underlying those sections. The conclusion will not have adverse consequences even though it may lead to the further conclusion that the sale of certain payment rights under section 9-610 gives rise to a security interest in favor of the disposition-sale buyer.

A. *Text of the Sections*

Section 9-406(d) overrides contractual transfer restrictions on, among other things, the "enforcement" of a security interest in certain payment rights, including payment intangibles and promissory notes. Section 9-406(e) states simply that section 9-406(d) does not apply to a "sale" of a payment intangible or promissory note. The language of section 9-406(e) does not distinguish between a voluntary sale by the debtor, a sale by disposition under section 9-610, or a disposition by voluntary acceptance in whole or partial satisfaction of the secured obligations under section 9-620. In fact, a voluntary acceptance constitutes a sale by the debtor to the secured party as noted in Official Comment 10 to section 9-620. If section 9-406(e) is read literally, as we think that it should, a sale under either section 9-610 or section 9-620 (either of such sales being referred to in this paper as a "sale by disposition") would constitute a sale within the meaning of section 9-406(e), and section 9-406(d) would not govern the transaction.

We do not think that giving "sale" its natural interpretation as including a disposition by sale creates an unacceptable tension with section 9-406(d). To be sure, section 9-406(d) renders ineffective a contractual transfer restriction on enforcement of a security interest in a payment intangible or promissory note. Enforcement under Part 6 of Article 9 generally includes the remedies of disposition under section 9-610, voluntary acceptance under section 9-620, and collection by the secured party under section 9-607. If section 9-406(e) applies to a sale by disposition, the contractual transfer restriction on enforcement would not be overridden by section 9-406(d). Hence, it might be argued that, if section 9-406(e) applies to sales by disposition, the only effective statutory enforcement remedy available to a secured party whose security interest in a payment intangible or promissory note secures an obligation is collection under section 9-607. The narrowing of the secured party's statutory enforcement remedies, the argument goes, so limits the application of section 9-406(d)'s override of a contractual transfer restriction on enforcement that such a result could not have been intended.

Henning position paper.

But this argument ignores other remedies available to a secured party beyond collection. The secured party has the right to proceed judicially by seeking a judgment or seeking other judicial remedies, all as permitted by section 9-601(a)(1). The secured party also has whatever other remedies are provided in the security agreement. *See* section 9-601(a) (rights "provided in the agreement of the parties"). In certain circumstances, these remedies may significantly augment the remedy of collection. If section 406(e) is applied to sales by disposition, section 9-406(d) would still have wide application to payment intangibles and promissory notes.

We also think that section 9-406(e)'s application to sales by disposition is supported by other provisions of Part 4 of Article 9. Section 9-408(b) refers specifically to a security interest that "arises out of a sale of the payment intangible or promissory note". That section 9-406(e) does not use the phraseology of section 9-408(b) suggests that a broader scope of application was intended for section 9-406(e), *i.e.*, application not only to a security interest created voluntarily by a sale to which section 9-408(b) refers (whether as a sale *ab initio* or as a sale under section 9-620 that occurs by voluntary acceptance of collateral that secures an obligation), but also to a sale under section 9-610 on enforcement of security interests that secure obligations.

Section 9-401(a) gives that suggestion very strong weight. Section 9-401(a) leaves to other law the question of whether the debtor's rights in collateral may be voluntarily or involuntarily transferred except as otherwise provided in, among other specified provisions, sections 9-406 and 9-408. As Official Comment 4 to section 9-401 points out, the general intent of section 9-401(a) is to leave to other law the question of whether the debtor's rights in collateral may be voluntarily or involuntarily transferred "subject to *identified* sections" (emphasis added). Given section 9-401(a)'s residual rule of leaving to other law the alienability of the debtor's rights in payment intangibles and promissory notes unless otherwise specified in sections 9-406 and 9-408, we think that any ambiguity as to whether section 9-406(e) should apply to a contractual transfer restriction on a sale by disposition of a payment intangible or promissory note under section 9-610 should be resolved in favor of that application so that the matter is left, consistent with section 9-401(a)'s residual rule, to other law.

B. *Drafting History*

Our recollection of the drafting history of sections 9-406 and 9-408 is that the drafting committee was sensitive to the effect on the loan participation and syndicated loan market of including, within the scope of Article 9, sales of payment intangibles and promissory notes. The drafting committee did not want to disturb the contractual transfer restrictions that borrowers often negotiate in loan agreements identifying who they must recognize as their lenders. For example, it

would not be unusual for a borrower to negotiate a provision in a loan agreement that the lender may not sell the loan to a vulture fund or to a competitor of the borrower. The drafting committee did not want unduly to interfere with those contractual transfer restrictions in the market place for any loan that might be classified under Article 9 as a payment intangible or promissory note. See Steven L. Harris and Charles W. Mooney, Jr. "How Successful was the Revision of UCC Article 9: Reflections of the Reporter," 74 Chicago-Kent Law Review 1357 at footnote 65 (1999).

Section 9-408(a) reflects this sensitivity. It evidences the intent of the drafting committee not to expand the override of a contractual transfer restriction pertaining to a payment intangible or promissory note beyond permitting the creation, attachment, and perfection of a security interest arising out of the sale of the payment intangible or promissory note. We think that section 9-406(e) reflects a similar sensitivity when the security interest secures an obligation and is later enforced by a sale by disposition. We believe that the drafting committee did not want to interfere with a contractual transfer restriction that might limit who the borrower must recognize as a qualified lender by requiring that the borrower deal with the buyer of the loan following a sale by disposition.

It may appear anomalous that under our interpretation a debtor may sell a payment intangible or promissory note under section 9-408(a) notwithstanding an otherwise effective contractual transfer restriction but a secured party may not enforce its security interest in the same payment intangible or promissory note subject to the same contractual restriction in a sale by disposition under section 9-610. However, this result is understandable given the narrow application of former section 9-318(4) and the drafting committee's concern about not expanding the provisions of Article 9 overriding contractual transfer restrictions in a way that would interfere unduly with the use of those restrictions in the loan participation and syndication markets.

To be sure, former section 9-318(4) could have been read to override a contractual transfer restriction on enforcement of a security interest by sale of a general intangible due or to become due. Interpreting section 9-406(e) to cut back on that override for what is now referred to under Article 9 as a payment intangible would be to deny the secured party a remedy that was arguably available under former law.

However, the full effect of former section 9-318(4) on a contractual transfer restriction on the enforcement of a security interest in a general intangible for money due or to become due via sale was unclear under former Article 9. Since sales of general intangibles for money due or to become due were outside of the scope of former Article 9, it was uncertain whether former section 9-318(4) even applied to a contractual transfer restriction on enforcement of a security interest by sale of a general intangible due or to become due.

In any event, former section 9-318(4) did not override a contractual transfer restriction on the enforcement of a security interest in a promissory note via sale since such a restriction was not within the scope of the section. Thus, overriding a contractual transfer restriction on enforcement of a security interest in a promissory note securing an obligation would provide the secured party with a remedy that was not available under former Article 9. There is no basis for reading sections 9-406(d) and 9-406(e) in a manner that treats a contractual restriction on a payment intangible differently than a contractual restriction on a promissory note.

Given the drafting committee's concern about not interfering unduly with contractual transfer restrictions in the loan participation and syndication market, we think the drafting committee would not have intended in Article 9 to expand from former Article 9 the contractual transfer restriction override by applying it to a sale by disposition of a promissory note securing an obligation. It follows that the drafting committee would not have intended to apply the contractual transfer override to a sale by disposition of a payment intangible securing an obligation.

C. *Policy*

The interpretation of section 9-406(e) as applying to a sale by disposition of a payment intangible or promissory note that secures an obligation is strengthened on policy grounds.

1. Direct vs. indirect sale

We see no policy reason for sections 9-406(d) and (e) to be interpreted to permit a contractual transfer restriction that would be effective in a voluntary sale of a payment intangible or promissory note to be overridden indirectly in a sale by disposition. Consider the following example if such an interpretation were adopted:

> Finance Company loans money to Borrower. The loan is either a payment intangible or a promissory note. Borrower negotiates with Finance Company a contractual transfer restriction in the loan agreement that Finance Company will not sell the loan to a competitor of Borrower without Borrower's consent. Finance Company borrows money from Lender and grants to Lender a security interest in the loan to secure Finance Company's loan obligations to Lender. Finance Company defaults on its loan obligations to Lender, and Lender sells the loan under section 9-610 to Buyer, a competitor of Borrower. Buyer is now able to enforce the loan against Borrower, if Borrower defaults, in such a way as to eliminate Borrower as a competitor. If Finance Company had sold the loan directly to Buyer rather than using it as collateral for an obligation, then under sections 9-408(a) and (d) the transfer restriction, if effective

under other law, would have prevented Buyer from enforcing the loan against Borrower.

Interpreting section 9-406(e) not to apply to a sale by disposition under section 9-610 would mean that a contractual transfer restriction that prevented a voluntary direct sale of a payment intangible or promissory note by the debtor would not prevent an indirect sale by the secured party through enforcement of a security interest securing an obligation. There is no policy justification for this different outcome. To the extent that a contractual transfer restriction on a voluntary sale by the debtor of a payment intangible or promissory note is to respected, a contractual transfer restriction on a disposition sale by the secured party arising from a security interest that secures an obligation should be respected as well.

2. Sale by disposition under section 9-610 vs. voluntary acceptance under section 9-620

We also see no policy reason for sections 9-406(d) and (e) to be interpreted to provide for a contractual transfer restriction on a sale of a payment intangible or promissory note to be overridden through a sale by disposition under section 9-610 if the contractual transfer restriction would not have been overridden had the secured party proposed to accept the payment intangible or promissory note in whole or partial satisfaction of the secured obligations under section 9-620. Consider the following example if such an interpretation were adopted:

> Finance Company loans money to Borrower. The loan is either a payment intangible or a promissory note. Borrower negotiates with Finance Company a contractual transfer restriction in the loan agreement that Finance Company will not sell the loan to a competitor of Borrower without Borrower's consent. Finance Company borrows money from Lender and grants to Lender a security interest in the loan to secure Finance Company's loan obligations to Lender. Finance Company defaults on its loan obligations to Lender, and Lender sells the loan under section 9-610 to Buyer, a competitor of Borrower. Buyer is now able to enforce the loan against Borrower, if Borrower defaults, in such a way as to eliminate Borrower as a competitor.
>
> If Lender were itself a competitor of Borrower and Lender had proposed to accept the loan in whole or partial satisfaction of Finance Company's loan obligations to Lender, then under sections 9-408(a) and (d) the transfer restriction, if effective under other law, might have prevented Lender from enforcing the loan against Borrower after acceptance. This would be the case if an acceptance of the loan with the consent, or in the absence of objection, by Finance Company is viewed in effect as a sale of the payment intangible or promissory note by Finance

> Company to Lender. The interest of Lender in the payment intangible or promissory note would then be a security interest. See Official Comment 10 to section 9-620. On account of section 9-408(b), section 9-408(a) would apply to the security interest created by sale. The transfer restriction would not be overridden under section 9-408(a) to the extent that it relates to post-acceptance enforcement of the loan by Lender against Borrower. See also section 9-408(d).

As noted in the example, in the case of a voluntary acceptance under section 9-620, Official Comment 10 makes it clear that the interest of the secured party is that of an ordinary buyer of the payment intangible or promissory note, meaning that it is a security interest. If, on account of section 9-408(b), section 9-408(a) would apply when the secured party is the buyer under section 9-620, the same result should be reached in the case of a buyer at a foreclosure sale conducted under section 9-610. Interpreting section 9-406(e) not to apply to a sale by disposition under section 9-610 would mean that a contractual transfer restriction that prevented post-acceptance enforcement by the secured party of the payment intangible or promissory note would not prevent, in the case of a security interest securing an obligation, post-disposition enforcement by a foreclosure-sale buyer of the payment intangible or promissory note. There is no policy justification for this different outcome. If voluntary acceptance of collateral is viewed merely as a sale of the collateral by the debtor to the secured party, then, to the extent that a contractual transfer restriction on an acceptance of a payment intangible or promissory note in whole or partial satisfaction of secured obligations is to be respected, a contractual transfer restriction on a sale by disposition under section 9-610 should be respected as well.

3. Payment intangible vs. general intangible

We also see no policy reason for sections 9-406(d) and (e) to be interpreted to provide for a contractual transfer restriction on a sale of a payment intangible or promissory note to be overridden through a sale by disposition when a contractual transfer restriction on the sale of a general intangible, which is not a payment intangible but has associated payment rights, would not be overridden by Article 9.

With payment intangibles, there may be non-payment rights associated with a right to payment that, standing alone, would constitute an "ordinary" general intangible (by which we mean a general intangible that is not a payment intangible). If the non-payment associated rights represent the principal obligation of the account debtor, the entire package of rights would be an ordinary general intangible and all the rights, including the rights to payment, would be excluded from section 9-406(d). A sale of the ordinary general intangible would be entirely outside of the scope of Article 9, and a security interest in the ordinary general

intangible created to secure an obligation would be addressed under section 9-408(a) and (d). In either case, though, a contractual transfer restriction on enforcement of a security interest in an ordinary general intangible would not be overridden by Article 9 if the contractual transfer restriction were effective under other law. Consider the following example if section 9-406(e) were interpreted not to apply to dispositions by sale:

> Seller sells a division of its business to Buyer. Under the acquisition agreement, Seller agrees to reimburse Buyer for any inaccuracy in Seller's representations and warranties in the acquisition agreement and also agrees not to compete with Buyer in the business sold. The acquisition agreement contains a restriction on Buyer selling its rights under the acquisition agreement without Seller's consent.
>
> Buyer borrows money from Lender and grants to Lender a security interest in Buyer's rights under the acquisition agreement. If the primary obligation of Seller under the acquisition agreement is its obligation to reimburse Buyer for inaccuracies in Seller's representations and warranties, Buyer's rights under the acquisition agreement constitute a payment intangible. Upon Buyer's default, Lender may sell the rights under the acquisition to a foreclosure-sale buyer notwithstanding the contractual transfer restriction, and the foreclosure-sale buyer may enforce Buyer's rights under the acquisition agreement against Seller. However, if the primary obligation of Seller under the acquisition agreement is not to compete with Buyer, then Buyer's rights under the acquisition agreement constitute an ordinary general intangible. In view of the contractual transfer restriction, whether Lender may, upon Buyer's default, sell the rights under the acquisition agreement to a foreclosure-sale buyer, and, if Lender may do so, whether the foreclosure-sale buyer may enforce Buyer's rights under the acquisition agreement against Seller, will be determined under other law.

If section 9-406(e) is interpreted not to apply to sales by disposition, a secured party with a security interest in a payment intangible securing an obligation would be able to effect a sale by disposition of the payment intangible under section 9-610 notwithstanding a contractual transfer restriction. The disposition would enable the foreclosure-sale buyer to exercise full enforcement rights against the account debtor. However, if the sale were of an ordinary general intangible, Article 9 would not apply, and any contractual transfer restriction on the sale of the ordinary general intangible would not be disturbed by Article 9. We see no policy reason to provide complete protection to an account debtor from recognizing the foreclosure-sale buyer if the non-payment rights associated with a right to payment represented the principal obligation of the account debtor but to leave the transfer restriction undisturbed if the right to payment were a significant but not the principal

obligation of the account debtor.

4. Contractual vs. legal transfer restriction

Furthermore, we see no policy reason for sections 9-406(d) and (e) to be interpreted to provide for a contractual transfer restriction on a sale of a payment intangible or promissory note to be overridden through a sale by disposition when a legal transfer restriction would not be overridden under sections 9-408(c) and (d) to the buyer. Consider the following example if such an interpretation were adopted:

> Finance Company loans money to Borrower. The loan is either a payment intangible or a promissory note. Borrower negotiates with Finance Company a contractual transfer restriction in the loan agreement that Finance Company will not sell the loan to a foreign investor without Borrower's consent. Finance Company borrows money from Lender and grants to Lender a security interest in the loan to secure Finance Company's loan obligations to Lender. Finance Company defaults on its loan obligations to Lender, and Lender sells the loan under section 9-610 to Buyer, a foreign investor. If an applicable state law or regulation would have prevented Finance Company from selling the loan to Buyer, then under sections 9-408(c) and (d) the legal transfer restriction, if effective under other law, would have prevented Buyer from enforcing the loan against Borrower.

Interpreting section 9-406(e) not to apply to a sale by disposition of a payment intangible or promissory note would mean that a contractual transfer restriction that purports to prevent a sale of the payment intangible or promissory note through enforcement of a security interest securing an obligation would be overridden while a legal transfer restriction that prevents the same sale would not. There is no policy justification for this different outcome. To the extent that a legal transfer restriction on a sale of a payment intangible or promissory note is to be respected, a contractual transfer restriction on a sale arising from a security interest that secures an obligation should be respected as well.

5. Relevance of the collection remedy

We do not believe that the fact that the practical effect of a secured party's exercise of its remedy of collection under section 9-607 is a sufficient justification, in terms of policy, for an interpretation that section 9-406(e) does not apply to a sale by disposition. We understand the argument that, since the secured party with a security interest in a payment intangible or promissory note securing an obligation would be able to collect on the payment intangible or promissory note from the account debtor or person obligated notwithstanding a contractual transfer

restriction, it should not matter, as a practical matter, whether collection is accomplished by the secured party or by a buyer at a foreclosure sale.

Furthermore, we recognize that section 9-406(d) overrides a contractual transfer restriction on the secured party's collection of a payment intangible or promissory note securing an obligation while section 9-406(f) does not override a legal transfer restriction on the secured party's collection. Accordingly, it could be argued that, notwithstanding our policy argument above against distinguishing contractual from legal transfer restrictions on a sale of a payment intangible or promissory note, there is precedent in Part 4 of Article 9 for overriding a contractual transfer restriction, but not a legal one, in the case of collection on a payment intangible or promissory note.

But collection on a payment intangible or promissory note is not ownership of the payment intangible or promissory note. From the point of view of the account debtor on a payment intangible or person obligated on a promissory note, the collection remedy merely implicates whom the account debtor or person obligated must pay in order to obtain a discharge unless and until the debtor redeems the collateral by paying the secured obligations. Moreover, if the secured party has recourse against the debtor, the secured party must collect on the payment intangible or promissory note in a commercially reasonable manner. The requirement of commercial reasonableness may not be waived by the debtor, even after default. See section 9-602(3).

The stakes, from the point of view of the account debtor or other obligor, are much higher in the case of a sale by disposition. The debtor's right of redemption is cut off; the transfer of the right of collection is permanent. There is no longer any requirement that the collection be made in a commercially reasonable manner.

Perhaps more importantly, the transfer of ownership of a payment intangible or promissory note may result in undesirable legal, regulatory, or tax consequences for the account debtor or person obligated that would not be present if ownership had not been transferred and the secured party was merely exercising its remedy of collection. Payment intangibles and promissory notes may consist of loans or debt instruments. Under some circumstances, ownership of debt instruments that might be viewed as securities under federal or state law may be transferred only to those who meet certain net worth or sophistication requirements under applicable federal or state securities laws. Some debt instruments may not be owned by certain ERISA qualified trusts, non-profit organizations or foreign investors without fines or other penalties being imposed on the issuer. Some issuers of debt instruments, especially those convertible into equity of the obligor, may lose net operating losses or other tax attributes in the case of a transfer of ownership of the debt instruments.

In balancing the interests of the secured party versus those of the account debtor or person obligated, there is more justification from a policy perspective in overriding a contractual transfer restriction on collection but not on disposition via

sale and for overriding a contractual transfer restriction, but not a legal transfer restriction, on collection but not on a disposition via sale.

6. Impact on loan and capital market transactions

Finally, we are very concerned about the effect on many loan and capital markets transactions if sections 9-406(d) and (e) were to be interpreted to provide for a contractual transfer restriction on a payment intangible or promissory securing an obligation to be overridden through a sale by disposition.

Contractual transfer restrictions on the sale of payment intangibles and promissory notes play an extremely important role in loan and capital markets transactions. Not only do loan agreements often provide for restrictions on who the borrower is required to recognize as a lender, as mentioned above, but also various debt instruments in the capital markets may restrict who the issuer must recognize as holders of its debt instruments. As suggested above, these transfer restrictions, insofar as they relate to who the account debtor or person obligated must recognize as the obligee, meet legitimate commercial, legal, regulatory, and tax expectations of the parties and should not be overridden without substantial justification.

Our concern is particularly acute if none of the protections expressly set forth in section 9-408(d) apply to a sale by disposition of a payment intangible or promissory note securing an obligation. Consider the following example if such an interpretation were adopted:

> Finance Company loans money to Borrower. The loan is either a payment intangible or a promissory note. The loan agreement provides that Borrower will provide to Finance Company, from time to time, confidential financial information relating to Borrower's business. Borrower negotiates with Finance Company a contractual transfer restriction that Finance Company will not sell the loan to a competitor of Borrower. Finance Company borrows money from Lender and grants to Lender a security interest in the loan to secure Finance Company's loan obligations to Lender. Finance Company defaults on its loan obligations to Lender, and Lender sells the loan under section 9-610 to Buyer, a competitor of Borrower. Buyer insists on obtaining the confidential financial information relating to Borrower's business that Borrower was obligated to provide to Finance Company under the loan agreement. If Lender had merely sold the loan to Buyer, then under sections 9-408(a) and (d) the transfer restriction, if effective under other law, would have prevented Buyer from obtaining the information.

The same concerns would arise if Lender had voluntarily accepted the collateral in full or partial satisfaction of the secured obligations under section 9-620. Our interpretation of section 9-406(e) as applying to any sale by disposition would avoid these issues. The effect of a contractual transfer restriction on a sale

by disposition would be left to other law. This would be the case whether one looked to section 9-408, which defers to the effect of other law on the contractual transfer restriction, or whether one looked to other law directly.

D. *A Disposition Sale Under Section 9-610 of Certain Payment Rights May Give Rise to a Security Interest in Favor of the Buyer*

We recognize that our interpretation of section 9-406(e) may lead to the conclusion that a sale by disposition of accounts, chattel paper, payment intangibles, or promissory notes under section 9-610 gives rise to a security interest in favor of the disposition-sale buyer. That conclusion may follow because sections 9-109(a)(3) and 9-406(e) each refer to a "sale" of payment intangibles and promissory notes, and it may be hard to interpret "sale" differently in section 9-109(a)(3) than in section 9-406(e). But, even if our interpretation of section 9-406(e) led to that conclusion, we still think that our interpretation is right.

The analysis of this issue is complicated by two Official Comments. Official Comment 2 to section 9-617 tells us that a buyer at a foreclosure sale is not a "purchaser" since the foreclosure sale is involuntary. See section 1-201(a)(30), (29), defining "purchaser" and "purchase." Official Comment 10 to section 9-620 tells us that a secured party that acquires payment rights by acceptance under section 9-620 has a buyer's security interest. The secured party's acceptance of the payment rights is voluntary on the part of the debtor since the debtor may object to the acceptance and, if the debtor does so, the acceptance may not proceed.

From these two Official Comments one might infer that a person that acquires payment rights by involuntary disposition under section 9-610 does not have a buyer's security interest. The inference leads to the argument that, since the definition of "purchaser" is limited to persons acquiring interests voluntarily and includes a person taking by security interest, all secured parties must acquire their interests in voluntary transactions.

However, the text of the Uniform Commercial Code is to the contrary. Section 9-109(a)(3) states that, except as otherwise provided in that section, Article 9 applies to a sale of accounts, chattel paper, payment intangibles, or promissory notes. The language is broad and inclusive, and it is not limited to sales voluntarily made by the debtor.

In fact, a security interest in an asset under the Uniform Commercial Code is not limited to an interest in the asset acquired voluntarily from the debtor so long as the transaction by which the security interest has its origin arises from a voluntary act by the debtor relating to that asset and governed by the Uniform Commercial Code. For example, a prepaying buyer that rightfully rejects goods has a security interest in the goods under section 2-711(3). Similarly, the interest of a collecting bank in an item under section 4-210 and the interest of an issuer or nominated person in a document presented under a letter of credit is a security interest. The

prepaying buyer, the collecting bank, and the issuer or nominated person are all secured parties under section 9-102(a)(72)(F). All of these security interests are rooted in a voluntary transaction by the debtor – the purchase of goods, the deposit of a check, the application for a letter of credit or request for nomination - without a further voluntary act by the debtor itself later creating the security interest.

Likewise, the interest of a disposition-sale buyer of accounts, chattel paper, payment intangibles, or promissory notes has its origin in a voluntary act by the debtor relating to the payment right and governed by the Uniform Commercial Code - the debtor's original grant of the security interest to the secured party. The security interest of the disposition-sale buyer thus may arise without a further voluntary act by the debtor to create the security interest, just as the security interest of a prepaying buyer, collecting bank, or issuer or nominated person arises without a further voluntary act by the debtor.

Accordingly, we conclude that it is not necessary that a disposition-sale buyer of accounts, chattel paper, payment intangibles, or promissory notes be a "purchaser" at the foreclosure sale in order to have a security interest. The disposition-sale buyer need only be a buyer to have a security interest, as section 1-201(35) states. If a sale by disposition under section 9-610 is governed by Article 9, then the interest of the disposition-sale buyer is a security interest and the disposition-sale buyer is a secured party.

If the interest of a buyer at a sale by disposition under section 9-610 gives rise to a new security interest, we are not concerned that the buyer will need a new security agreement authenticated by the debtor and describing the collateral in order for the buyer's security interest to attach under section 9-203(b)(3)(A). It is true that most such sales of payment rights are voluntarily undertaken by the debtor and that the ordinary rules for attachment apply. We also recognize that in a disposition sale under section 9-610, since title passes from the debtor to the buyer through the intermediation of the secured party, the debtor is the real seller. However, the debtor will have already authenticated a security agreement with the enforcing secured party. That security agreement should be sufficient to satisfy the requirements of section 9-203(b)(3)(A). There is no policy reason to require a new security agreement in the case of a sale by disposition under section 9-610 any more than there is to require a new security agreement in the case of a sale by disposition under section 9-620. See Official 10 to section 9-620 ("the procedures for acceptance of collateral under this section satisfy all necessary formalities and a new security agreement authenticated by the debtor would not be necessary"). Both dispositions have their origin in a voluntary security interest granted by the debtor.

Furthermore, if the interest of a buyer at a sale by disposition under section 9-610 gives rise to a new attached security interest, we are not concerned that the buyer will need to take steps for the security interest to be perfected. Of course, in

the case of a sale by disposition under section 9-610 of payment intangibles or promissory notes, the buyer's security interest would be automatically perfected under sections 9-309(3) and (4). However, in the case of a sale by disposition under section 9-610 of accounts or chattel paper, the buyer would need to take additional steps as required under sections 9-310(a), 9-313(a), or 9-314(a), as applicable, to perfect its security interest and, in the case of chattel paper, to obtain priority under section 9-330.

A cautious buyer of accounts and chattel paper in a sale by disposition under section 9-610 *should* take the appropriate steps to perfect its security interest and, in the case of chattel paper, to obtain priority under section 9-330. Official Comment 10 to section 9-620 suggests that caution. If an acceptance of accounts or chattel paper by the secured party under section 9-620 is a sale of the accounts or chattel paper by the debtor to the secured party and gives rise to a new security interest, the same may be said of a sale by disposition under section 9-610. It is true that an acceptance of collateral under section 9-620 may be distinguished from a sale by disposition under section 9-610 since an acceptance of collateral is more of a voluntary transaction by the debtor than a sale by disposition under section 9-610. However, consistent with our analysis above, that is not a basis for distinguishing the two transactions. Both transactions have their origin in a voluntary security interest granted by the debtor. Moreover, in the case of accounts or chattel paper, requiring the additional perfection steps accomplishes the policy goals of Article 9 by alerting third parties to the interest of the buyer.

Article 9 gives the buyer at a sale by disposition under section 9-610 the ability to perfect its security interest. Consistent with our view that the buyer's interest will have attached on account of the original security agreement authenticated by the debtor, the buyer will be authorized by section 9-509(b) to file a financing statement against the debtor by virtue of that security agreement. The buyer may also obtain an assignment of the secured party's financing statement against the debtor. If the sale is of chattel paper, the buyer will in any event likely obtain possession or control of the chattel paper to ensure itself of the priority of its interest.

In the case of a sale by disposition under section 9-620, as Official Comment 10 to section 9-620 points out, the accepting secured party's interest in the accounts or chattel paper would be perfected in any event by the secured party's financing statement already filed against the debtor.

VI. THE ARGUMENT THAT "SALE" IN SECTION 9-406(e) DOES NOT APPLY TO ENFORCEMENT OF A SECURITY INTEREST SECURING AN OBLIGATION BY DISPOSITION UNDER SECTION 9-610

The following position, developed in a paper by Weise and Cohen, advances the argument that "sale" in section 9-406(e) is limited to sales within the scope of Article 9:[102]

102. Neil Cohen & Steve Weise, Application of UCC § 9-406 to Post-Default Disposition of Payment Rights (Apr. 2008) (unpublished manuscript) (on file with authors). The following constitutes a verbatim reproduction of the Weise and Cohen position paper. The footnotes contained within this section have been reproduced exactly as they appeared in Weise and Cohen's original paper.

A. *Background*

- Two sections in Article 9 limit the effectiveness of otherwise enforceable contractual restrictions on the assignment of accounts, chattel paper, payment intangibles (and other general intangibles), and promissory notes – UCC sections[i] 9-406 and 9-408. There is general agreement about the meaning and application of these sections except for one specific circumstance—whether, in the case of a security interest in a payment intangible or a promissory note[ii] that secures an obligation,[iii] a contractual restriction on transfer of the payment right is effective to limit post-default disposition[iv] of the collateral under § 9-610.
    - Sections 9-406(d) and 9-408(a) each provide rules that invalidate or limit restrictions on the assignment of payment rights. The rules are somewhat different in scope, though:
        - Section 9-406(d) provides that, in the case of a security interest in an account, chattel paper, payment intangible, or promissory note, the anti-assignment restrictions are ineffective to interfere with the creation, attachment, perfection, or *enforcement*[v] of the security interest.
        - Section 9-408(a) provides that, in the case of a security interest in a promissory note, health-care-insurance receivable, or general intangible, the anti-assignment restrictions are ineffective to interfere with creation, attachment or perfection of the security interest. § 9-408(a) does not mention "enforcement" of the security

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i. Unless otherwise indicated, all further statutory references in this paper are to the UCC.

ii. For convenience, this paper refers collectively to payment intangibles and promissory notes as "payment rights."

iii. UCC § 1-201(b)(35) defines the term "security interest" to include both an interest in property that secures an obligation and the interest of a buyer of certain payment rights. The differences between those two types of "security interest" are important to the analysis in this paper. Thus for convenience this paper uses nomenclature that distinguishes between the two types of security interests by referring to a security interest in property that secures an obligation as a "pledge" of that property.

iv. The word "disposition" (and its variations) is used as that word is used in § 9-610(a) ("After default, a secured party may sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing.")

v. Emphasis is added.

interest, and the omission of "enforcement" from § 9-408(a) is reinforced by § 9-408(d).

- Thus, when § 9-406(d) applies, contractual restrictions are ineffective to interfere with enforcement of the security interest; when § 9-408(a) applies, though, that section does not override restrictions that interfere with *enforcement* of the security interest.

- Which, if either, of the two sections applies to the situation that is the subject of the disagreement that generated this paper (post-default enforcement, by disposition, of pledged payment rights) is determined by two other provisions in those sections
  - Section 9-406(e) provides that § 9-406(d) does not apply to the *sale* of a payment intangible or promissory note.[vi]
  - Section 9-408(b) provides that § 9-408(a) applies to a security interest in a payment intangible or promissory note *only* if the security interest arises out of the *sale* of the payment intangible or promissory note.

- There is general agreement that § 9-406(d) applies, and renders a contractual restriction ineffective, to the extent that the restriction would limit the ability of the secured party to collect on the payment right pursuant to § 9-607. Steve [Weise] and Neil [Cohen] disagree with Ed [Smith] and Bill [Henning], though, about the effect of §§ 9-406(e) and 9-408(b) (the scope subsections of §§ 9-406 and 9-408 noted above) and, thus, about whether § 9-406(d) or § 9-408(a) applies to determine whether a contractual restriction on assignment of a payment right is effective to interfere with post-default enforcement of a pledge of that payment right by disposition of it under § 9-610 (as opposed to collection of the payment right).
  - If Steve and Neil are right, a secured party that wishes to enforce its pledge of a payment right by disposing of it under § 9-610 can do so without regard to the contractual restriction because of § 9-406(d)
  - If Bill and Ed are right, a secured party that wishes to enforce its pledge of a payment right by disposing of it under § 9-610 is subject to the contractual restriction (as discussed in detail below)

What is the difference between the Steve/Neil position and the Ed/Bill position?

- The difference arises from different interpretations of §§ 9-406(e) and 9-408(b).

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vi. § 9-406(i) also limits the scope of § 9-406(d) by providing that it does not apply to assignment of a health-care-insurance receivable.

- Steve and Neil believe that the better interpretation of § 9-406(e) is that it excludes from the coverage of § 9-406(d) only those transactions that are themselves "sales" of payment intangibles and promissory notes governed as such by Article 9 and does not exclude from the coverage of § 9-406(d) any aspect of creation, attachment, perfection, or *enforcement* of a pledge of a payment right.
    - Therefore, in the case of a pledge of a payment right, Steve and Neil believe that the effect of a contractual restriction on the transfer of the payment right on *enforcement* of the pledge, including post-default enforcement by disposition of the payment right pursuant to § 9-610, is determined by § 9-406(d) (and not § 9-408(a) or other law).
    - Steve and Neil not only believe that this is a more natural reading of the relevant sections, but also believe that that the § 9-406(e) exclusion can only apply to "sales" of payment rights that are themselves transactions governed as such by Article 9 and that a post-default disposition of a payment right is not a "sale" of a payment right that is governed by Article 9.
    - Applying § 9-406(d), Steve and Neil believe that the contractual restriction on transfer would be ineffective to limit post-default enforcement of a pledge by disposition pursuant to § 9-610.
    - Moreover, as noted later in this paper, Steve and Neil believe that application of the Ed/Bill approach would generate disquieting implications in several other Article 9 contexts.
- Ed and Bill believe that the better interpretation of § 9-406(e) is that it excludes from the coverage of § 9-406(d) not only transactions that are "sales" of payment rights that themselves are governed as such by Article 9, but also excludes from § 9-406(d) post-default enforcement by the secured party of a pledge of a payment right pursuant to § 9-610 by a disposition of the payment right effectuated by selling the payment right even if that disposition is not a "sale" governed as such by Article 9.[vii]
    - Thus, under the Ed/Bill interpretation, § 9-406(d) would apply to make a contractual restriction on transfer of a payment right

vii. Ed and Bill also indicate that § 9-401 suggests a statutory policy that any statutory ambiguity should be resolved in favor of upholding a restriction on transfer. It is difficult to see how that policy emerges from the statutory language. Moreover, we believe that, to the extent there is a statutory view on restrictions on transfer, it is the view expressed in Official Comment 4 to former UCC § 9-318, which dismissed the view in favor of limitations on transfer as being held by "those who still cherish the hope that we may yet return to the views entertained some two hundred years ago by the Court of King's Bench."

ineffective to prevent creation, attachment, or perfection of a pledge of a payment right, but, if the debtor defaults on the obligation secured by the payment right, § 9-406(d) would *not* apply to enforcement of the pledge by the secured party by disposition pursuant to § 9-610.

- Thus, notwithstanding § 9-406(d), under the Ed/Bill view, the contractual restriction on transfer of the payment right would be effective to prevent post-default enforcement of a pledge of the payment right by disposition under § 9-610, even though the same restriction on transfer of the payment right is ineffective to prevent creation of the pledge or enforcement of it via collection by the secured party.

Is the difference between Steve/Neil and Ed/Bill a matter of differing views of secured transactions policy?

- Not really. Steve and Neil are not taking a position as to what a drafting committee (or the incipient Article 9 Review Committee) would or should conclude is better policy. Rather, we are trying only to interpret the words of the current statute faithfully, in the context of the provisions of Article 9.

Are the differences between the Steve/Neil position and the Ed/Bill position substantial in terms of their effect on an obligor of a payment intangible or promissory note?

- Not really. In the context that generated the PEB discussion about §§ 9-406 and 9-408—the ability of a secured party to dispose of a pledged "transferable interest" in a limited liability company or limited partnership—the difference between the Steve/Neil position and the Ed/Bill position has been portrayed as a difference as to whether Article 9 fundamentally impinges on "know your partner" principle of LLC law and partnership law. Yet, both Steve/Neil and Ed/Bill agree that the law (both LLC law and the UCC) already limits that principle in many contexts similar to the one at hand. Thus, the "know your partner" principle, in this context, is hardly an inviolate principle. Rather, it is subject to so many exceptions that the exceptions may be more extensive than the rule itself. More generally, in light of the ability of a secured party with whom an obligor of a payment right has not agreed to deal to enforce the obligation of the obligor under § 9-607, the marginal practical impact on such an obligor of being subject to enforcement of the obligation by a disposition transferee with whom it has not agreed to deal is minimal.
- First consider the following situations in which a "transferable interest" in an LLC is collateral for an obligation and the debtor defaults on the

obligation. In each case, Steve/Neil *and* Ed/Bill agree that the LLC and its members must deal with a "stranger," notwithstanding the "know your partner" principle, even though the stranger is someone with whom the LLC has never agreed to deal and with whom the LLC might have a legitimate reason not to want to deal:

- Notwithstanding a contractual restriction on transfer, the application of § 9-406(d) means that (i) a debtor who owns a transferable interest in an LLC can pledge that interest to a secured party without approval of the LLC and without liability therefore, (ii) the secured party can perfect such a pledge, and (iii) if the debtor defaults with respect to such a pledge, the secured party (who may be a stranger to the LLC) can collect payments owed on the transferable interest from the LLC (the account debtor) pursuant to § 9-607.
- Notwithstanding a contractual restriction on transfer, if the debtor who pledged the transferable interest defaults and the secured party obtains a judgment, the secured party (who may be a stranger to the LLC) may also obtain a charging order pursuant to Re-ULLCA § 503(a). ("A charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor." *Id.*)
- Notwithstanding a contractual restriction on transfer, if the debtor who pledged the transferable interest defaults and the secured party obtains a judgment, under Re-ULLCA § 9-503(c) "upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale only obtains the transferable interest [and] does not thereby become a member . . ." Thus, the purchaser at the foreclosure sale (again, likely a stranger to the LLC) becomes the owner of the transferable interest.
- Notwithstanding a contractual restriction on transfer, if (i) a guarantor has guaranteed the obligation of the debtor that is secured by the transferable interest, (ii) the debtor defaults, and (iii) the guarantor pays the secured party (thereby satisfying the debtor's obligation to the secured party), then the guarantor (again, likely a stranger to the LLC) is subrogated to the rights of the secured party under principles of suretyship and guaranty law and, thus, can collect on the transferable interest from the LLC

pursuant to § 9-607.

- To extend the analysis one step further, assume that the debtor incurs an obligation to a secured party secured by a pledge of the debtor's transferable interest and the agreement between the debtor and the secured party does not contain an anti-assignment provision. Steve/Neil think, and believe that Ed/Bill agree, that, notwithstanding a restriction on transfer in the contract between the LLC and the debtor, if the secured party sells *its* payment intangible (the right to be paid the debtor) to Buyer, the debtor's obligation (which is now owed to Buyer) remains secured by the security interest in the transferable interest pursuant to § 9-203(g). Thus, if the debtor defaults on its payment obligation owed to Buyer, Buyer (again, likely a stranger to the LLC) may collect (as discussed above) on the transferable interest from the LLC pursuant to § 9-607.

- The same analysis applies to promissory notes and to payment intangibles not consisting of transferable interests in LLCs or limited partnerships. Consider the case of a loan from Lender to Account Debtor, governed by a loan agreement pursuant to which Lender agrees not to assign its rights to anyone else. By the above analysis, Steve/Neil and Ed/Bill agree that (i) notwithstanding the anti-assignment clause, Lender may pledge, to Creditor (who may be a stranger to Account Debtor or, worse, someone with whom Account Debtor might have a legitimate reason not to want to deal), Lender's right to be paid by Account Debtor, (ii) if Lender defaults on the obligation owed to Creditor that is secured by the pledge of the Lender's right to be paid, Creditor may enforce by collection the Loan Agreement against Account Debtor, etc.
- Thus, Steve/Neil *and* Ed/Bill agree that there are a large number of circumstances in which, notwithstanding an otherwise-enforceable restriction on transfer, an obligor on a payment right may be required to pay or otherwise deal with a stranger, even though the stranger is someone with whom the obligor has not agreed to deal and with whom the obligor might have a legitimate reason not to want to deal. Thus the "know your partner" principle is already substantially inapplicable and obligors on payment rights are already subject to enforcement by unwanted strangers when a payment right has been pledged.
- Accordingly, the difference between Steve/Neil and Ed/Bill is *not* over an otherwise inviolate principle that protects obligors who have negotiated for restrictions on transfer from having to pay or otherwise

deal with strangers.

- To the extent that that principle exists, it is riddled with exceptions both in and out of Article 9.
- Rather, the difference between Steve/Neil and Ed/Bill is about whether one particular exception exists—whether, in the context of a pledge of a payment right, the account debtor can be compelled to deal with a person to whom the payment right was disposed pursuant to a disposition properly conducted under § 9-610.

The answer to the last question demonstrates that the stakes are not large to the obligor of the payment right. In light of the many exceptions to the know your partner principle catalogued above, a conclusion that the Steve/Neil position is correct would not result in a material diminution in the protections given to LLCs and other obligors of payment rights who have negotiated for contractual restrictions on transfer of those rights. Nonetheless, while this means that the Steve/Neil position should not be resisted on the grounds that it undermines a fundamental principle of obligor protection, it doesn't necessarily mean that the Steve/Neil position is the correct interpretation.

What arguments do Steve and Neil have that their interpretation of 9-406(e) is correct?

- Everyone agrees that § 9-406(e) is ambiguous and, standing alone, is susceptible of more than one interpretation. The question is which interpretation makes more sense in the context of other rules in Article 9. We think that the Ed/Bill reading (i) requires a strained reading of § 9-406(d), (ii) would bring about anomalous results with respect to restrictions on transfer, and (iii) would have disquieting implications outside §§ 9-406 and 9-408.

Strained reading of § 9-406(d).

- Under the Ed/Bill approach, it is conceded that § 9-406(d) applies to the pledge of a payment right. Yet § 9-406(d) renders contractual restrictions on the transfer of payment rights ineffective to the extent that they interfere not only with the creation, attachment, and perfection of a security interest in a payment right but also to the extent they interfere with the *enforcement* of a security interest in a payment right.
  - Under the Ed/Bill interpretation of § 9-406(e), the override of contractual restrictions on enforcement of a pledge of a payment right would be limited to only one particular type of enforcement – collection under § 9-607.
  - We think that if the drafters of § 9-406 had intended the word "sale" in § 9-406(e) to override the use of the word "enforcement" in the neighboring subsection, § 9-406(d), the

drafters would not have used the unqualified word "enforcement" in §§ 9-406(d)(1) and 9-406(d)(2).

Anomalous results as to the effect of restrictions on transfer under §§ 9-406/9-408.

- Under the Steve/Neil view, §§ 9-406(d) and 9-406(a) would together occupy the entire field with respect to the effect of contractual restrictions on transfer of payment rights.
  - In the case of a pledge of a payment right, § 9-406(d) would override transfer restrictions that interfere with all aspects of creation, attachment, perfection, and enforcement of the pledge.
  - In the case of a sale of a payment right, § 9-408(a) (as limited by § 9-408(d)) would provide an override of contractual transfer restrictions for creation, attachment, and perfection, but not for enforcement.
- Under the Ed/Bill view, though, even in the context of a pledge of a payment right, the post-default *enforcement* of the pledge under § 9-610(a) by disposition of the payment right counts as a "sale" of the payment right.
  - Thus, under the Ed/Bill view § 9-406(d) does not apply to override the contractual restrictions insofar as they would otherwise prevent post-default enforcement by disposition (because, under the Ed/Bill interpretation of § 9-406(e), that subsection prevents application of § 9-406(d)).
  - But if the Ed/Bill interpretation is correct, § 9-408(a)– even as limited by 9-408(d) – also would *not* apply (for the reasons noted in the next bullet point) to override restrictions on the creation, attachment, and perfection of the disposition transaction pursuant to § 9-610.The result would be that *neither* § 9-406(d) nor § 9-408(a) would apply to *any* aspect of post-default disposition under § 9-610. Thus the contractual restriction on transfer would render the post-default disposition completely ineffective —not just ineffective to prevent enforcement by the transferee against the obligor of the payment right, but also ineffective so as to prevent the transferee of the payment right from being owner of the payment right for other purposes—anomalously giving the contractual restriction on transfer greater vitality to prevent a post-default disposition than to prevent a voluntary sale by the owner of the payment right. (After all, when § 9-408(a) applies, as all agree it does, to a transaction that is an outright sale of a payment intangible, restrictions on creation, attachment, and perfection of the sale transaction are ineffective.)

- The reason that the § 9-408(a)(1) limited override of contractual restrictions on transfer would not apply to the post-default disposition is that § 9-408(a)(1) overrides only contractual restrictions that impair creation, attachment, and perfection of "security interests." *See* Comment 4 to § 9-408 ("This section does not render ineffective a restriction on an assignment that does not create a security interest").

- Why isn't the right of a transferee of a payment right in a § 9-610 post-default disposition a "security interest"? Two reasons:
  - First, as noted in comment 2 to § 9-617, a buyer at a post-default disposition via foreclosure sale is not a "purchaser." Thus, by definition, such a buyer must not have taken by "purchase." *See* §§ 1-201(b)(29)-(30).Because one who takes by security interest takes by purchase (*see* § 1-201(b)(29)), it must be the case that a buyer at a post-default disposition that did not take by "purchase" also did not take via "security interest."
  - Second, § 1-201(b)(35) defines a security interest as either (i) an interest securing payment or performance of an obligation or (ii) the interest of a consignor or a buyer of accounts, chattel paper, a payment intangible, or a promissory note "in a transaction that is subject to Article 9."
    - Thus, the buyer at a post-default disposition takes by security interest only if the disposition is a transaction to which Article 9 applies.
    - Article 9 applies to the disposition transaction only if it falls within one of the six paragraphs of § 9-109(a). The disposition transaction clearly does not fall within paragraphs (1), (2), (4), (5), or (6).
    - Does the disposition transaction fall within paragraph (3)? For the disposition to fall within paragraph (3), the disposition would have to be a "sale" of the payment right. In order to determine whether the disposition is a "sale," the definition of that term must be consulted. For this purpose, § 9-102(b) tells us to utilize the definition of "sale" in § 2-106. According to that section, a "sale" is "the passing of title from the seller to the buyer for a price." Given that definition, the post-default disposition of a payment right is not a "sale" of the payment right from the secured party to the transferee. This is because no "title" passes from the secured party to the transferee; indeed § 9-617(a)(2) tells us that the secured party's

security interest (the closest thing to "title" that the secured party had) is *discharged* by the post-default disposition.

- Thus, if the post-default disposition is to count as a sale, the "seller" must be the pledgor (the Article 9 debtor); after all, it is the pledgor's "title" that is passed from to the transferee. *See* § 9-617(a)(1). Yet, if the disposition to the transferee is somehow considered to be a "sale" governed by Article 9 because the debtor's "title" to the payment right is passed to the transferee, several illogical results would follow. For example, a security agreement with respect to the disposition would need to be entered into and authenticated by the *debtor* (i.e., the pledgor). Quite obviously, there is no pledgor-transferee agreement in the case of a post-default disposition, much less one that is authenticated by the pledgor; such a disposition goes forward without the necessity of the pledgor agreeing to it. *See* § 9-610(a).
- Thus, a post-default disposition of a payment right should not be considered to be a "sale" of the payment right for purposes of § 9-109(a)(3), and if it is not such a sale the disposition does not create a security interest.

- Steve and Neil believe that the § 9-406(e) exclusion of sales of payment rights from the scope of § 9-406(d) and the statement in § 9-408(b) that § 9-408(a) covers "sales" of payment rights are intended to work together to result in one or the other of those sections governing the effect of a restriction on transfer on the post-default disposition of a payment right that is the subject of a pledge and not to create an anomalous gap in which neither section applies. *See* Comment 4 to § 9-408.
  - Yet, the Ed/Bill approach would appear to exclude post-default disposition of pledged payment rights from § 9-406(d), but *not* include them in § 9-408. This would leave a hole in the application of Article 9 to the enforcement by disposition of the payment right. The Steve/Neil view, which limits the effect of the § 9-406(e) exclusion to Article 9 sales of payment rights that are within Article 9 and therefore within § 9-408 (and does not apply the exclusion to post-default enforcement of a pledge of payment rights) would not bring about this anomalous result.

Disquieting implications outside §§ 9-406 and 9-408.

- If, despite the above analysis, the post-default disposition of a payment right by disposing of it under § 9-610 is the creation of a security

interest in the payment right that is governed by Article 9 (and, thus, as Bill and Ed argue, the § 9-406(e) exclusion applies to that disposition), two disquieting implications outside the context of transfer restrictions would follow from that conclusion:

- As noted above, if the disposition of the payment right by foreclosure pursuant to § 9-610 is the creation of a security interest in the payment right, § 9-203(b) must be complied with in order for that security interest to attach and be enforceable[viii].
  - This means that the "debtor" must have entered into and authenticated a security agreement in favor of the "secured party" (the disposition transferee) with respect to the security interest. Yet, as noted above, the "debtor" in the disposition transaction must be the pledgor of the payment right. Thus, the Ed/Bill theory would seem to require the pledgor to authenticate an agreement in favor of the foreclosure transferee when the pledged payment right is disposed of after the default of the pledgor.
  - This would certainly be disquieting news to both the secured party and the transferee to whom the pledged payment right is disposed of, inasmuch as such cooperation by the pledgor is unlikely.
- Moreover, if the post-default disposition of a payment right is a "sale" of the payment right governed by Article 9 as a security interest in the payment right, it must also be the case that a post-default disposition of an *account* is a sale of the account governed by Article 9 as a security interest.
  - In the case of an account, though, not only must a security interest/sale be enforceable and must the right of the buyer/secured party have attached, but, because there is no automatic perfection pursuant to § 9-609 with respect to sale of accounts, the security interest/sale must be perfected for effectiveness against third parties.
  - This means that a financing statement would need to be filed with respect to the post-default disposition of the

viii. Ed and Bill seek to avoid this implication, and those in the succeeding paragraphs, by suggesting that disposition of a pledged payment right pursuant to § 9-610 is a "sale" of the payment right for purposes of application of § 9-406(e), but is somehow *not* a "sale" of the payment right for purposes of § 9-109(a)(3) and, thus, that the disposition is not within the scope of Article 9 and the rules of Article 9 (except, apparently, § 9-406(e)) do not apply to the disposition. In light of the fact that "sale" is a defined term, and the same definition applies to both uses of the word sale, this argument is difficult to maintain.

account. By the same analysis as above, the "debtor" of this security interest could only be the pledgor. Yet, the transferee of the account, as "secured party," would not be able to file a financing statement without the cooperation of the pledgor. After all, to file an initial financing statement with respect to the disposition transaction, the transferee/secured party would need the authorization of the pledgor in an authenticated record. *See* § 9-509(a). The pledgor is unlikely to provide such an authorization, and the *ipso facto* authorization provided in § 9-509(b) would be inapplicable because the pledgor did not authenticate a security agreement with respect to the disposition to the transferee.

- The need to perfect a post-default disposition of an account, combined with the difficulty of doing so, would be disquieting to most secured parties and those to whom accounts are disposed after default, yet that would appear to be the necessary implication of the Ed/Bill approach.[ix]

Even if the Steve and Neil's analysis is correct, is there a risk that this analysis will create the setting for an unscrupulous buyer of payment rights to structure its transaction as a pledge to take unfair advantage and use § 9-406?

- That won't work because:
  - Under Article 9, the substance of a transaction is determinative, not its form
  - Any buyer that set up a sale disguised as a pledge surely would not satisfy the good faith requirements of the UCC
  - It would be a poor plot in any event because the "pledgee" would have no assurance that it could buy the payment right at the public foreclosure sale; because the types of assets involved are not "customarily sold on a recognized market or the subject of widely distributed standard price quotations" the "pledgee" could

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ix. Ed and Bill suggest that this should not be disquieting, citing Official Comment 10 to § 9-620 for the proposition that "a cautious buyer of accounts or chattel paper at a § 9-610 disposition *should* take appropriate steps to perfect the sale." Yet, that comment relates not to dispositions of the collateral under § 9-610, but to acceptance by the secured party of the collateral in full or partial satisfaction of the indebtedness it secures. Moreover, the comment makes the point that, *in the context of acceptance of the collateral*, neither a new security agreement nor a new financing statement is required in order to fulfill the requirements of enforceability or perfection. After all, there is already a security agreement between the parties to the acceptance transaction [the debtor and the secured party] and there is already a financing statement on file listing the debtor and the secured party. Neither of those things is true, though, in the context of a disposition to a third party under § 9-610.

not buy them at a private sale. § 9-610(c)(2).

This memo has discussed post-default enforcement of a pledge of payment rights by collection under § 9-607 and by disposition under § 9-610. What about the third type of post-default enforcement—acceptance of the payment rights as full or partial satisfaction of the secured obligation under § 9-620?

- The logic of the situation, juxtaposed with the text of Article 9, leaves us a bit confused here.
  - Steve/Neil and Ed/Bill agree that, after default, the secured party with respect to a pledge of a payment right can enforce the security interest by collecting on it pursuant to § 9-607, notwithstanding a contractual restriction on transfer of that payment right.
  - Steve and Neil additionally believe that the secured party can enforce the security interest in the payment right by disposition of it pursuant to § 9-610; if that disposition is by public disposition, the secured party can also be the transferee.
  - It would be certainly be anomalous if the secured party can enforce the security interest by collecting on the payment right in its role as secured party under § 9-607 (as all agree) and (under the Steve/Neil view) enforce the security interest by collecting on the payment right as its owner after a § 9-610 disposition, but is prevented from enforcing the security interest by becoming the owner of the payment right and thereby collecting on it under § 9-620.
    - Rather, it seems more logical and "tidy" to interpret § 9-406(d) as applicable to all modes of enforcement of a pledge of a payment right (i.e., a security interest in the payment right that does not arise from the sale of the payment right) under Part 6 of Article 9, notwithstanding a contractual restriction on transfer, rather than to conclude that the subsection overrides restrictions with respect to two modes of enforcement but not the third mode.
    - On the other hand, Comment 10 to § 9-620 indicates that "if the collateral is accounts, chattel paper, payment intangibles, or promissory notes, then a secured party's acceptance of the collateral in satisfaction of secured obligations would constitute a sale [presumably by the debtor] to the secured party. That sale normally would give rise to a new security interest . . ." This comment could lead to the conclusion that acceptance under § 9-620 is a "security interest" and thus falls within the § 9-406(e)

exclusion from § 9-406(d), even though disposition under § 9-610 does not fall within the exclusion. (It must be noted that there is no parallel comment in § 9-610 with respect to post-default disposition by the secured party.)

- Moreover, inasmuch as the debtor willingly participates in the acceptance transaction, any formalities required of the debtor in order to make the transaction enforceable, attached, and perfected present a less daunting prospect. (Comment 10 goes on to say that "the procedures for acceptance of collateral under this section satisfy all necessary formalities and a new security agreement authenticated by the debtor would not be necessary." This clearly makes sense in the context of a debtor who has consented to acceptance in full or partial satisfaction of the indebtedness in an authenticated record. We are not sure, though, how those procedures satisfy the requirement of an authenticated security agreement when the debtor has consented to acceptance in full satisfaction of the indebtedness by failing to object.)

- Finally, if acceptance of the collateral in full or partial satisfaction of the indebtedness is, indeed, an Article 9 "sale," § 9-408(b) would allow application of § 9-408(a) to that sale. Accordingly, the problem that Steve and Neil pointed out with respect to disposition under § 9-610 (which is not an Article 9 sale) being governed by neither 9-406 nor 9-408 would not be present for enforcement via acceptance of the collateral.

VII. THE 2010 AMENDMENTS TO SECTIONS 9-406(e) AND 9-408(b)

After receiving and considering the position papers set out above, it was clear to the members of the PEB that section 9-406(e) is ambiguous and that the ambiguity has the potential to cause real problems in practice and perhaps to contribute to further nonuniform amendments. Accordingly, the task of clarifying the provision fell within the purview of the Article 9 Joint Review Committee. The original charge to the committee was to review the operation of revised Article 9 in practice and to consider whether enough problems had arisen since it became effective in 2001 that the formation of a drafting committee to address the problems would be appropriate. On June 24, 2008, the committee submitted a report recommending a drafting project and the sponsors subsequently charged the committee with the task of drafting a discrete set of amendments. The amendments prepared by the committee received final approval from each sponsor at its 2010 Annual Meeting and the enactment process is expected to begin during the 2011 legislative sessions. Because adoption of the amendments will create a few choice-of-law issues,[112] the sponsors are again recommending a deferred effective date—in this case July 1, 2013[113] – so that the amendments become effective nationally at the same time.

The ambiguity and its consequences were discussed by the Joint Review Committee in both its study and drafting phases. No recommendation was made during the study phase. During the drafting phase, the committee decided not to alter the policy choice to bifurcate the treatment of contractual transfer restrictions in the case of payment intangibles and promissory notes. This left it with the straightforward task of resolving the ambiguity. Ultimately, it was decided that the appropriate policy is to give a secured party with a security interest that secures an obligation in a payment intangible or promissory note the full range of Article 9 disposition options. Accordingly, section 9-406(e) will be amended to state as follows:

> (e) **[Inapplicability of subsection (d) to certain sales.]** Subsection (d) [on contractual transfer restrictions] does not apply to the sale of a payment intangible or promissory note, other than a sale pursuant to a

112. The primary source of the choice-of-law issues is an expansion of the definition of "registered organization" to include organizations that fall outside the definition of that term under current law. *See* U.C.C. § 9-102(a)(70) (2008) (defining "registered organization"). The expansion of the definition will in some instances change the law governing perfection with regard to the assets of an organization moving into the registered-organization category.

113. U.C.C. § 9-801 (Proposed Revisions 2010), *available at* http:www.iaca.org/downloads/2010Conference/STS/UCC9_AMdraft_Jul10.pdf.

> disposition under Section 9-610 or an acceptance of collateral under Section 9-620.[114]

Because under current law the acceptance of collateral under section 9-620 constitutes a sale that is within the scope of Article 9 and therefore within the scope of section 9-408(a), and also in order to remove any ambiguity about the appropriate treatment of a disposition sale under section 9-610, section 9-408(b) will be amended to state as follows:

> (b) **[Applicability of subsection (a) to sales of certain rights to payment.]** Subsection (a) [on contractual transfer restrictions] applies to a security interest in a payment intangible or promissory note only if the security interest arises out of a sale of the payment intangible or promissory note, other than a sale pursuant to a disposition under Section 9-610 or an acceptance of collateral under Section 9-620.

The Joint Review Committee made the right policy choice in your authors' view. Payment intangibles and promissory notes arise in a number of contexts, primarily for Article 9 purposes loan participation arrangements, and limiting the disposition rights of secured parties that lend against the strength of such assets would inappropriately reduce their value in the marketplace. That said, it is possible that the resolution will cause concern among the entity lawyers who have been concerned generally about the effect of sections 9-406 and 9-408. Under section 9-406 as amended, a contractual transfer restriction between an LLC and a member will not prevent the member from assigning as security for an obligation a fully enforceable security interest in the member's transferable interest (and the same is true with respect to a partner's transferable interest in a partnership). As noted above, some entity lawyers are of the opinion that this result is inconsistent with the "pick-your-partner" principle, even though the result is to transfer only rights to payment and not management or control rights.

Although we are not entity lawyers, we are sufficiently familiar with the subject that we do not think further nonuniform amendments excluding interests in partnerships and LLCs from the scope of sections 9-406 and 9-408 are warranted. Section 9-408 does not now and never has posed a real problem in the context of entity law, and section 9-406 is advantageous to members and partners because it permits them to leverage their transferable interests. The effect on a partnership or LLC from having a particular partner or member deprived of her economic rights is somewhat speculative. Beyond that, even as

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114. The language clarifying the ambiguity is underlined. This is part of the normal strike-and-underline method used by the Code's sponsors for designating changes to existing statutory language. U.C.C. § 9-406(e) (Proposed Revisions 2010).

amended section 9-406 remains limited to transfer restrictions in an agreement between an account debtor and an assignor; that is, again using an LLC as our example, it applies only to an agreement between the LLC and the member and does not invalidate transfer restrictions among the members. Even if transfer restrictions are set forth in an operating agreement to which all members and the LLC are made parties, only the restrictions in favor of the LLC are invalidated while those among the members remain valid and enforceable. Thus any incursion of section 9-406, as existing or as amended, into the "pick-your-partner" principle is minimal.

VIII. CONCLUSION

As this article demonstrates, the old tension between freedom of contract and free alienability continues, and continually manifests itself in new ways. One of the lessons to be drawn from the current controversy is that as the scope of Article 9 expands with respect to outright sales it may enter areas where the tension was previously settled. Although future drafters should be aware of such pitfalls, it may be difficult to avoid them. This controversy reinforced for your authors the extent to which legal practice and the study of law are compartmentalized and lawyers practicing in discrete areas speak a language all their own. Entity lawyers saw grave dangers in sections 9-406 and 9-408 where in fact the dangers are and remain minimal. It took commercial lawyers, who saw the sections as benign and well within long-standing traditions, too long to recognize that any legitimate causes for concern exist. Now that this controversy has been resolved, perhaps disputes about the proper balance between freedom of contract and free alienability of property in the context of secured transactions can be put to rest—until the next time.