

IN THIS ISSUE

Joint Report from the Chairs

MARK YOUR CALENDARS

FEATURED ARTICLES

[AN EMERGING SPLIT OF AUTHORITY: DOES ACTUAL NOTICE OF A SECURITY INTEREST STILL CUT OFF AN ACCOUNT DEBTOR'S SETOFF RIGHTS UNDER UCC § 9-404\(A\)\(2\)?](#)

By: [Andrew C. Helman](#)

[EXPERT Q&A ON BLOCKCHAIN TECHNOLOGY IN BANKING AND FINANCIAL SERVICES](#)

By: [Todd R. Kornfeld](#), [Gregory J. Nowak](#), [Joseph C. Guagliardo](#) and [Eric Berman](#)

UCC SPOTLIGHT

By: [Carl S. Bjerre](#) and [Stephen L. Sepinuck](#)

USEFUL LINKS AND WEBSITES

ENDNOTES

MARK YOUR CALENDARS

November 16, 2016 – 1:00 p.m. to 2:30 p.m. ET – Structuring Incremental Loan Facilities: Key Terms, Most Favored Nation Provisions and Incremental Equivalent Agreements (CLE Webinar). Click [here](#) for more information.

November 18-19, 2016 – ABA Business Law Section Fall Meeting – The Ritz-Carlton, Washington, DC. Click [here](#) for more information.

Dear Members:

In September, many of us gathered in Boston for the Business Law Section's Annual Meeting. This meeting represented the Section's third annual stand-alone Annual Meeting. The meeting featured a healthy attendance and a robust offering of CLE programming and substantive meetings of the committees and their subcommittees and task forces. Materials from CLE programs are available on the Section of Business Law website. In addition, both ComFin and UCC thanked outgoing, and welcomed incoming, committee, subcommittee and task force leaders, including Jeremy Friedberg, the new Commercial Finance Committee Chair.

The Committees are hard at work on CLE programming and substantive non-CLE meetings for the Business Law Section's Spring 2017 Meeting. The 2017 Spring Meeting will be held on April 6-8, 2017 in New Orleans, Louisiana at the Hyatt Regency New Orleans. Registration for this meeting may be completed on-line at the Section's website. Of course, additional details will be forthcoming.

In addition to the UCC Spotlight by Carl S. Bjerre and Stephen L. Sepinuck, this edition of the newsletter includes two diverse articles written by leading scholars and practitioners of commercial law. Of course, we also extend a hearty thanks to the entire CLN Editorial Board for putting this wonderful newsletter together.

Please email either of us if you have any ideas for either of the Committees or wish to participate in any project, subcommittee or leadership role. The Committees have a number of projects underway. Our subcommittees and task forces are very active and always welcome input. Please do not hesitate to volunteer!

We hope you enjoy this issue, and invite you to get involved in your committee(s).

[Jeremy S. Friedberg](#)
Commercial Finance Committee Chair
jeremy.friedberg@lf-pc.com

[Kristen Adams](#)
UCC Committee Chair
adams@law.stetson.edu

November 22, 2016 – 1:00 p.m. to 2:30 p.m. ET – Structuring Agreements Among Lenders in Unitranche Loan Facilities and Overcoming Bankruptcy-Related Risks (CLE Webinar). Click [here](#) for more information.

November 29, 2016 – 1:00 p.m. to 2:30 p.m. ET – Financial Restructuring of Oil and Gas Companies: Leveraging Second-Lien Financings, High-Yield Bonds, Debt Exchanges (CLE Webinar). Click [here](#) for more information.

November 30, 2016 – 1:00 p.m. to 2:30 p.m. ET – Drafting Legal Opinions for Article 9 Security Interests: Navigating the Complexities and Avoiding Liability (CLE Webinar). Click [here](#) for more information.

December 1, 2016 – 1:00 p.m. to 2:30 p.m. ET – Non-Recourse Carve Outs, Bad-Boy Guaranties, and Personal Liability: Latest Developments (CLE Webinar). Click [here](#) for more information.

February 24-25, 2017 – KCon XII, 12th Annual International Conference on Contracts – Southwestern Law School in Los Angeles, CA. Click [here](#) for more information.

April 6-8, 2017 – ABA Business Law Section Spring Meeting – Hyatt Regency New Orleans, New Orleans, LA. Click [here](#) for more information.

PRO BONO MATTERS

What kind of pro bono work have you done recently? The pro bono committee is seeking stories from our members. We want to publicize the great work that business lawyers are doing in the pro bono area. This may include any type of pro bono work. For example, have you helped a small business settle a legal dispute? Perhaps you represented a tenant in a landlord tenant dispute, assisted with an immigration matter, or helped a

EDITORIAL BOARD

Harold Lee
Editor (ComFin)
Go Fast Pay
(310) 651-9738

Jennifer Wasylyk
Editor (ComFin)
Cassels Brock & Blackwell LLP
(416) 860-6890

Peter Marchetti
Editor (UCC)
Thurgood Marshall School of Law
(713) 313-1008

Sidney Simms
Editor (ComFin)
Sutherland Asbill & Brennan LLP
(404) 853-8216

Christina Goebelsmann
Editor (UCC)
U.S. Small Business Administration
(415) 744-8494

Hilary Sledge-Sarnor
Editor (UCC)
MUFG Union Bank, N.A.
(213) 236-5908

Featured Articles

AN EMERGING SPLIT OF AUTHORITY: DOES ACTUAL NOTICE OF A SECURITY INTEREST STILL CUT OFF AN ACCOUNT DEBTOR'S SETOFF RIGHTS UNDER UCC § 9-404(A)(2)?

By: [Andrew C. Helman](#)

A recent decision from a federal court in Maine signals an emerging split of authority on whether a business credit report from Dunn & Bradstreet provides sufficient notice of a lender's security interest to grant it priority over a creditor's setoff rights with a mutual debtor.¹

The nub of the issue is whether UCC § 9-404, which was revised as part of an overhaul of Article 9 in 1999 and 2000, now requires that notification of a security interest be signed by a debtor or a secured party (digitally or otherwise) *and* be transmitted directly to a creditor, or whether other less-formal electronic notification suffices. The Maine district court ruled that a debtor or lender must execute a notification and send it directly to a creditor, in sharp contrast to an earlier decision of a Delaware bankruptcy court that considered a Dunn & Bradstreet report's notice of a security interest sufficient.²

As a result, secured lenders, factors, or other assignees of accounts receivable should exercise caution and either require debtors or assignors to clearly indicate any assignment of accounts receivable (as collateral or otherwise) on their invoices, or independently notify creditors to ensure priority over setoff rights that have not accrued as of the assignment.

Facts and Procedure

The dispute before the district court can be traced to the chapter 11 case of *In re Montreal, Maine & Atlantic Ry., Ltd.*, which is still pending before the Maine bankruptcy court following confirmation of a chapter 11 plan.³ As part of a compromise of certain disputes in that case, the bankruptcy court granted Wheeling & Lake Erie Railway Co., one of the debtor's pre-petition secured lenders, relief from the automatic stay to enforce some of the debtor's accounts receivable (with proceeds to be credited against Wheeling's secured claim).⁴

In due course, Wheeling filed a complaint against two related railroads, Maine Northern Railway Co. and New Brunswick Southern Railway Co., to collect accounts receivable from them.⁵ In response, the defendant-railroads contended that, among other things, the accounts receivable were subject to their setoff rights.⁶

homeowner with a foreclosure problem. We want to publicize some of these stories to encourage other business attorneys to become more involved helping needy clients. Please send your stories to Professor Candace M. Zierdt at the following address: czierdt@law.stetson.edu.

WORKING GROUP ON
DRAFTING HUMAN RIGHTS
PROTECTIONS IN SUPPLY
CONTRACTS

A new Working Group on Drafting Human Rights Protections in Supply Contracts is being formed to draft model contract language for companies who want to eliminate human trafficking, child labor, forced labor, and other human rights abuses in their supply chains. The new Working Group is a joint project of the UCC Article 1 and Article 2 Subcommittees together with the Implementation Task Force for the ABA Model Principles on Labor Trafficking and Child Labor. The mission of the new Working Group is to provide model contract clauses to interested businesses and trade associations. Ready-made, well drafted language will help move the principles from the realm of admirable aspirations to the workday world where they can make a difference. The legal issues are interesting and challenging because the default rules of UCC Articles 1 and 2 and the UN Convention on Contracts for the International Sale of Goods (CISG) are geared more toward assuring the quality of the goods (e.g., tightly stitched soccer balls or good quality apparel) and largely ignore the problems of a labor force that may be working in life-threatening conditions. A core group of leading lawyers has already signed up to tackle the issues and draft language, but more participants are welcome. This project is truly a working group, and we hope that participants will help with legal research, drafting memoranda, crafting contract language, and writing annotations. We anticipate roughly monthly conference calls as well as live meetings (with a phone-in option) at the Annual and Spring meetings of the Business Law Section.

Prior to completing discovery, the parties initiated summary judgment proceedings on a stipulated factual record to determine the relative priority of Wheeling's security interest vis a vis the defendant-railroads' claimed setoff rights.⁷ Notably, as summarized by the court, the parties' stipulations included the following key facts:

[O]n April 16, 2010 and August 30, 2012, the Defendants obtained credit reports directly from D[unn] & B[radstreet] identifying Wheeling's security interest in the "[i]nventory and proceeds—[a]ccount(s) and proceeds" of [the debtor]. The parties agree that any set-off claim by Defendants accrued after the defendants obtained the first D[unn] & B[radstreet] report on April 16, 2010.⁸

In other words, for summary judgment purposes, the parties stipulated that whatever setoff rights the defendant-railroads had arose *after* their receipt of at least one Dunn & Bradstreet, which arguably provided them with actual notice of the security interest.

The Court's Decision

These facts set the stage for what the court characterized as a "purely legal question"—whether, under UCC § 9-404(a)(2), "the receipt of a D[unn] & B[radstreet] report constitutes sufficient notice to foreclose the rights of the account debtors as against the assignor."⁹ The court's answer to this question was no, based on its determination that the plain language of UCC § 9-404(a)(2) required a lender or debtor to sign (digitally or otherwise) a notification of a security interest and then send it to the creditor.

The court's analysis turned on the interplay between UCC § 9-404 and § 9-102(7), which were amended in connection with a broad overhaul of Article 9 promulgated by the drafters in 1999, with further refinements in 2000, and subsequently adopted throughout the country. Like its predecessor, the basic rule under UCC § 9-404(a)(2) is that a security interest has priority over setoff rights that accrue *after* a creditor receives notification of a security interest.¹⁰ However, the drafters parted ways with former UCC § 9-318(1)(b) by adding the phrase "authenticated by the assignor or the assignee" at the end of the revised text. Thus, UCC § 9-404(a)(2) states in full:

Unless an account debtor has made an enforceable agreement not to assert defenses or claims, and subject to subsections (b) through (e), the rights of an assignee are subject to: [. . .] (2) any other defense or claim of the account debtor against the assignor that accrues before the account debtor receives a notification of the assignment *authenticated by the assignor or the assignee*.¹¹

By the 2000 revisions, the drafters also replaced the term "sign" with the broader term "authenticate," which allows a person to adopt a record with a traditional signature or through electronic means. Thus "authenticate" means "(A) to sign; or (B) to execute or otherwise adopt a symbol, or encrypt or similarly process a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record."¹² (This is consistent with the Uniform Law Commission's promulgation of the widely-enacted Uniform Electronic Transactions Act in 1999, which prohibits a signature or record from being denied legal effect in business or government affairs due to the fact that it exists or was created electronically.¹³)

Against this backdrop, the court considered and rejected Wheeling's two primary arguments.

First, the court turned to Wheeling's contention that UCC § 9-404(a)(2) governs the content of a notification rather than its form—essentially that the statute requires notification of an assignment that is valid because it has been authenticated rather than a particular form of notification.¹⁴ This argument was based on a principle of statutory construction known as the rule of the last antecedent, along with a corollary rule of grammar, which Wheeling

We hope that this work will use commercial law to make the world a better place, and perhaps even to save lives. If you are interested, please contact Professor David Snyder of American University at dsnyder@wcl.american.edu.

VIEW CURRENT REPORTS AND DEVELOPMENTS OF THE FOLLOWING COMMITTEES AND TASK FORCES:

UCC SUBCOMMITTEES AND TASK FORCES

- [Subcommittee on Annual Survey](#)
- [Subcommittee on Article 7](#)
- [Subcommittee on Commercial Law Newsletter](#)
- [Subcommittee on General Provisions and Relations to Other Law](#)
- [Subcommittee on International Commercial Law](#)
- [Subcommittee on Investment Securities](#)
- [Subcommittee on Leasing](#)
- [Subcommittee on Letters of Credit](#)
- [Subcommittee on Payments](#)
- [Subcommittee on Recent Developments](#)
- [Subcommittee on Sale of Goods](#)
- [Subcommittee on Secured Transactions](#)
- [Forms Under Revised Article 9 Task Force](#)
- [Cleared Swaps Task Force](#)

COMFIN SUBCOMMITTEES AND TASK FORCES

- [Subcommittee on Agricultural and Agri-Business Financing](#)
- [Subcommittee on Aircraft Financing](#)
- [Subcommittee on Creditors' Rights](#)
- [Subcommittee on Cross-Border and Trade Financing](#)
- [Subcommittee on Intellectual Property Financing](#)
- [Subcommittee on Lender Liability](#)
- [Subcommittee on Loan Documentation](#)
- [Subcommittee on Loan Workouts](#)
- [Subcommittee on Maritime Financing](#)

relied on to suggest that the modifying phrase “authenticated by the assignor or the assignee” should be read as modifying the word just before it (“assignment”) rather than the more remote word “notification.”¹⁵ Wheeling also contrasted UCC § 9-404(a)(2) with other provisions of Article 9 that it thought clearly required authenticated notification—for example, UCC § 9-406’s “notification, authenticated by the assignor or the assignee.”

The court was unpersuaded. It viewed “notification of the assignment” as an indivisible phrase to which the authentication requirement applied as a whole and determined that “[t]he slightly different structure between the [UCC §§ 9-404 and 9-406] does not justify application of completely different notice requirements in provisions which were both designed to protect the rights of account debtors as against assignees.”¹⁶

Next the court turned to Wheeling’s other argument—that even if the notification had to be authenticated, then the Dunn & Bradstreet reports satisfied this requirement in light of the broad meaning of “authenticate” and the fact that Article 1 states that a person “receives” a notification when, among other things, “[i]t is duly delivered in a form reasonable under the circumstances[.]”¹⁷ In support, Wheeling relied on *In re Communication Dynamics, Inc.*, 300 B.R. 220 (Bankr. D. Del. 2003), apparently the only other widely-available decision to consider the issue. *Communication Dynamics* acknowledged that the addition of the authentication requirement meant that something more than actual or constructive notice is needed. However, it viewed a Dunn & Bradstreet report as meeting this requirement based on the broad definition of “authenticate,” the fact that it authorizes electronic notice, and the fact that Dunn & Bradstreet reports are often relied up to determine whether liens exist.¹⁸ In the court’s view, a different result would have been a drastic change from prior law for which the court found no support:

It makes no commercial sense to require a particular form of notification transmitted directly from a debtor or a secured party to all account debtors. Such a requirement would be a tremendous change from the law as it existed under section 9-318. If that were mandated by section 9-404, the section and the Comments would have made that clear.¹⁹

The Maine court was quick to reject this argument too based on its determination that the plain language of UCC § 9-404(a)(2) required *the debtor or secured party* to authenticate the notification.²⁰ This was an irreconcilable conflict between the two decisions. In the district court’s view: “[E]ven within the broad meaning of ‘authenticated,’ neither [the debtor] nor Wheeling authenticated the D & B reports—these documents do not bear their signatures, signs, or symbols.”²¹ Essentially, the court thought Wheeling’s “interpretation renders the phrase ‘by the assignor or the assignee’ meaningless.”²²

Analysis

Setting aside the technical issues under Article 9, the Maine district court’s decision is a timely reminder that secured parties, factors, or other assignees of accounts receivable can—and should—take appropriate steps to protect their priority relative to setoff rights of a creditor with a mutual debtor. In light of the district court’s decision, this should include, at a minimum, having a debtor indicate the fact of an assignment on its invoices, with a reproduction of the debtor’s signature, though further steps may be warranted for a debtor’s most significant trading partners.

This is especially important if a bankruptcy filing is likely, in which case parties with different interests will be looking to divide up the debtor’s scarce resources, to the extent permitted under applicable law. For example, § 553 of the Bankruptcy Code expressly preserves setoff rights and allows mutual, pre-bankruptcy debts to be offset, once authorized by the court. This is an attractive option for unsecured trade creditors because it essentially “elevates an unsecured claim to secured status, to the extent that the debtor has a mutual, pre-petition claim against the creditor.”²³ A request for relief from the automatic stay to exercise setoff rights typically arises by a motion initiating a contested matter, which will ordinarily be a summary proceeding. In contested matters, most, though not all, of the

- [Subcommittee on Past Chairs Advisory](#)
- [Subcommittee on Programs, Meetings and Communications](#)
- [Subcommittee on Real Estate Financing](#)
- [Subcommittee on Secured Lending](#)
- [Subcommittee on Syndications and Lender Relations](#)
- [ADR Task Force](#)
- [Model Intercreditor Agreement Task Force](#)

COMFIN AND UCC JOINT TASK FORCES

- [Commercial Finance/UCC Online Discussion Forum](#)
- [Commercial Finance Terms Joint Task Force](#)
- [Deposit Account Control Agreements Joint Task Force](#)
- [Filing Office Operations and Search Logic Joint Task Force](#)
- [Legislative Enactment of Article 9](#)
- [Model IP Security Agreement Joint Task Force](#)
- [Security Interests in LLC and other Unincorporated Entity Interests Joint Task Force](#)
- [Survey of Commercial Lending Laws](#)

COMMITTEE LEADERSHIP ROSTERS

- [Uniform Commercial Code Committee](#)
- [Commercial Finance Committee](#)

DO YOU WANT TO...

WRITE FOR AN OFFICIAL ABA PUBLICATION?

GET PUBLISHED, WITHOUT TOO MUCH OF A TIME COMMITMENT?

CONNECT WITH OTHER MEMBERS OF THE UCC OR COMFIN COMMITTEES?

If so, submit an article for possible

usual discovery rules will be available under Rule 9014 of the Federal Rules of Bankruptcy Procedure, but local practice may vary and a bankruptcy court has discretion to limit the availability of discovery in contested matters. Thus, when a priority dispute is in play with respect to setoff rights, a lender should take appropriate steps to initiate an adversary proceeding in which most of the Federal Rules of Civil Procedure will apply.

Conclusion

While the extent to which UCC § 9-404(a)(2) represents a departure from prior law is not yet settled, there are two steps that an assignee can take in the meantime: First, to protect an assignee's priority, make sure a proper notification of the assignment is sent to all appropriate parties. Second, in the event of a bankruptcy filing, consider initiating an adversary proceeding to determine the relative priorities of setoff rights and security interests for greater procedural protections, if necessary.

Andrew C. Helman is an attorney with Marcus Clegg, in Portland, Maine.

EXPERT Q&A ON BLOCKCHAIN TECHNOLOGY IN BANKING AND FINANCIAL SERVICES

By *Todd R. Kornfeld, Gregory J. Nowak, Joseph C. Guagliardo* and *Eric Berman*

The banking and financial services industries are increasingly exploring ways to use blockchain technology, also known as distributed ledgers, to enhance the speed, security, and efficiency of the global financial markets. Below, Todd Kornfeld, Gregory Nowak, and Joseph Guagliardo of Pepper Hamilton LLP and Eric Berman of Practical Law explain blockchain technology and discuss possible blockchain applications.

What is a blockchain?

A blockchain is a type of database. At a very basic level, it is as simple as that. What makes a blockchain different from most other databases is the way in which a user interacts with it. For example, common attributes of a blockchain database are that it is "distributed" and "self-proving."

Distributed means that copies of a blockchain can be kept and maintained by many people or organizations and no copy is the master or lead copy. Self-proving means that by merely looking at a blockchain you can tell whether the data in that blockchain is correct or whether it has been tampered with.

Blockchains can potentially serve at least two functions. A blockchain can:

- Provide a self-contained record of a transaction or series of transactions.
- Serve as a store of value. A well-known example of a blockchain application is the cryptocurrency Bitcoin. Bitcoin uses a blockchain both for recordkeeping and as a store of value because the entries in a Bitcoin blockchain have their own intrinsic value.

What does it mean to be a distributed and decentralized database?

The original creator of a blockchain creates the first entry in a blockchain. The original creator can then establish rules for adding new entries to that blockchain and can make it public and available for copying by anyone on the internet. After that anyone can create their own clone of that blockchain and, with the right software that implements the prescribed rules, that person can update that blockchain and make their updated blockchain available for anyone on the internet to copy. The process then repeats. This is essentially how Bitcoin got started.

publication in a future issue of the Commercial Law Newsletter. Publishing an article with the Commercial Law Newsletter is a great way to get involved with the UCC Committee and the ComFin Committee. Articles can survey the law nationally or locally, discuss particular UCC or Commercial Finance issues, or examine a specific case or statute. If you are interested in submitting an article, please contact one of the following Commercial Law Newsletter Editors [Harold Lee](#), [Sidney Simms](#), [Jennifer Wasylyk](#), [Christina Goebelsmann](#), [Peter Marchetti](#) or [Hilary Sledge-Sarnor](#).

Not only is a blockchain a distributed database, it can be a database with preset rules for adding new data, and those rules may not be in the control of any one party. In other words, control of the blockchain is decentralized. For example, updating the rules for Bitcoin requires a majority vote of the people with the right software and enough computer power to add a new Bitcoin entry. As a practical matter, no one person or organization is in charge of Bitcoin. It is a public blockchain. This structure makes sense because Bitcoin was intended to be a cryptocurrency without (much) government regulation.

Financial applications that use blockchains are most likely to use private or semi-public blockchains, in which only:

- Certain people or organizations can see the blockchain and/or update the blockchain with new data.
- One person or organization (or a limited group) has the power to update the rules that govern the blockchain.

How do you know that a blockchain is correct, and that its data has not been tampered with?

The key to blockchain technology is that it is self-proving. This means by merely looking at the data in a blockchain, a user can tell whether the data in that blockchain is correct or whether it has been tampered with.

As its name implies, a blockchain is built of blocks of data that are chained, or linked, together. Each time a new block of data is added, a complex mathematical algorithm is used to analyze that block of data and all of the prior blocks in that chain. The algorithms are similar to those used for data encryption. The result of that algorithmic process is a unique number. In essence, that algorithmic process converts the data in the blockchain into a code number. That number, usually referred to as a “hash,” is appended to the end of the blockchain along with the new block of data.

If someone subsequently alters the data in the blockchain, anyone with the right software and enough computer power can “rehash” the data in the blockchain and will discover that the data in the blockchain does not match the hash appended to the end of the blockchain. That makes the blockchain a self-proving (in a decentralized system) distributed database.

If different people try to update multiple copies of the same blockchain at the same time, how do we know which copy is correct?

That is potentially a problem, and one that is similar to traditional problems with database concurrency and updating. However, there are ways to solve this problem. For example, Bitcoin uses a series of algorithms and rules to keep distributed copies of its blockchain in sync.

In the case of Bitcoin, however, the solution imposes serious limits on transaction processing speed. Bitcoin is slow because during the updating process, various algorithms are used to compare various public copies of the Bitcoin blockchain in order to determine which is the most recent and complete copy. Some of that time is wait time to see what other updates are being performed on other copies of the Bitcoin blockchain.

What are some of the security issues raised by Bitcoin?

To use Bitcoin, the user needs to have its own set of keys that identify it for its Bitcoin transactions (similar to an ATM card and its related PIN). Bitcoin users keep their keys in electronic “wallets” that are provided by a number of services. Bitcoin users often use “Bitcoin exchanges” to exchange currencies such as dollars for Bitcoins.

Unfortunately, Bitcoin wallets and exchanges have proven to be insecure in some cases, and people have had their Bitcoin keys or Bitcoins stolen. One solution is to have more secure Bitcoin wallets and exchanges. This problem is not specific to Bitcoin. Any platform that uses blockchain technology is going to have a similar need for a secure way for users to prove who they are.

Notably, this problem is not limited to Bitcoin, blockchains, distributed databases, or any other new, similar technology. As has been widely covered in the press, the Central Bank of Bangladesh lost \$81 million when someone broke into its accounts at the Federal Reserve Bank of New York via the SWIFT system. The SWIFT system is used by international banks to transmit messages related to funds transfers. In terms of security, SWIFT, which has been operating since 1977, was designed as a highly secure, private network. Even though SWIFT itself may be very secure and difficult to break into, anyone who steals a SWIFT member’s key can steal that

member's money. Based on press reports, the Central Bank of Bangladesh did not follow best practices with respect to its SWIFT key security. There may have been other incidents in the past with SWIFT keys that received less publicity.

The takeaway, therefore, is that blockchains are not inherently insecure, and that users of blockchains must guard their access keys carefully, the same way people guard their ATM cards and PINs.

Even if users carefully guard their access keys, what other security concerns are raised by blockchains?

Blockchains are as safe, or unsafe, as any other computer application. One issue with Bitcoin and perhaps other fully public blockchains is that there is no master or "golden" copy of the blockchain. That means if someone does manage to break the core security of the blockchain, it may be very difficult or impossible to determine which data has been tampered with.

However, this is not an insurmountable problem. It is possible to design a public blockchain to have certain rules that require a trusted party or parties to keep a golden copy of the blockchain data. For example, for financial applications that trusted party could be a regulated clearinghouse.

What are some possible uses for blockchains?

One possibility is using blockchains as a store of value, like Bitcoin or Ether. These are sometimes referred to as cryptocurrencies, because in theory they hide the identity of their owners and potentially avoid government regulation, including policy changes in the money supply that may cause inflation and deflation. However, cryptocurrencies have their own form of inflation, as new units are "mined." This is why the Bitcoin algorithm recently "halved" the value of newly mined Bitcoins, as a preprogrammed attempt to ward off inflation.

However, for a variety of reasons, it seems unlikely that Bitcoins and other cryptocurrencies will see widespread use in the near term. This is because of the current limits on transaction processing speeds and concerns of both the government (for example, regarding tax issues and a cryptocurrency's use in illegal activities) and potential users (for example, security concerns).

More likely, blockchains will be used as recordkeeping tools, in particular recordkeeping for financial transactions. Beyond financial applications, we are seeing blockchain application testing across many different use cases, including real estate transactions, supply chain management, provenance tracking, personal identity tracking, energy grid optimization, and intellectual property tracking (for example, tracking music royalties), among many other potential use cases.

What are some examples of ways financial institutions might use blockchains?

One possibility is that a bank could keep its clients' checking accounts on a blockchain. The bank could then give each client something similar to an ATM card to prove their identity for use every time the client paid a bill electronically or made a purchase.

While at first glance this may not seem like much of an improvement over the current system, a closer analysis reveals some clear advantages. One benefit is that when a payment is made, the other party can see the payer's blockchain and how much money it has in its account, eliminating overdrawn accounts and bounced checks. In addition, the balance in the payer's account would be accurate, eliminating any question regarding when a check is going to clear. Because the blockchain is separate from a user's bank, its checking account blockchain can be updated and transactions processed when its bank is unavailable.

However, it is unlikely that this application of blockchains will happen anytime soon. This is because the number of payments that go through the checking account clearing system is enormous and there are many parties involved. That said, checking accounts on a blockchain may eventually be common.

What are some other possible blockchain applications in the financial industry?

There are many other potential blockchain applications in the financial industry. For example, companies could maintain their share registers through a blockchain. In fact, industry participants have already made considerable progress towards this goal. For example, last year Chain.com, a blockchain developer, used NASDAQ's "Linq" blockchain ledger technology to complete and record a private securities transaction.

In addition, in December 2015, the SEC accelerated the effectiveness of a Form S-3 registration statement filed by Overstock.com, under which the company disclosed that it might use blockchain technology in connection with a future offering under that registration statement. Overstock.com had previously conducted a private debt offering in July 2015 using blockchain technology.

Blockchain share registers offer significant advantages over the current system. Currently, almost all publicly traded securities are held in book-entry form, where a single share certificate in the name of a nominee represents the ownership interests of thousands, and potentially even hundreds of thousands, of individual investors. Shareholder voting and investor communications are currently cumbersome processes, where materials must be forwarded by the nominee to its participant broker-dealers who must then forward them on, potentially through additional layers of broker-dealers, until they ultimately reach their beneficial owners. In this process, issuers have little information about who their beneficial shareholders are, except for the very largest shareholders who are required to make public filings with respect to ownership.

A blockchain could be an efficient and transparent method of addressing some or all of these issues. Blockchains might allow for same-day, and possibly same-minute, settlement of stock trades. In addition, blockchains might allow for more efficient recordkeeping, requiring less manual reconciliation, and perhaps smaller middle and back offices. In addition, blockchains have the added advantage that an issuer could more easily identify its shareholders and communicate with them.

A related issue is that the current share registration system does not interact well with existing federal securities law and state corporate laws, many of which were generally developed prior to the movement to book-entry share registration. For example, under the Securities Exchange Act of 1934, certain companies with fewer than 300 shareholders of record may essentially deregister, cease periodic reporting, and “go dark.” Since many public companies have very few shareholders of record, with almost all beneficial shareholders holding through book-entry, many public companies are potentially eligible to go dark.

Since beneficial shareholders hold their shares through book-entry, certain companies incorporated in states such as Delaware that have been involved in proxy contests have refused to allow beneficial shareholders to nominate directors. They have apparently based such refusals on a combination of their by-laws or corporate charters and Section 219 of the Delaware General Corporation Law (“DGCL”), which defines the list of shareholders entitled to vote by reference to the company’s share register and does not include the concept of book-entry beneficial owners. While federal securities law and state corporate laws are probably in need of amendment with respect to the concept of “shareholders of record,” blockchain technology might be a good solution for all interested parties.

Have there been any government initiatives for developing blockchains?

Delaware has proposed making changes to the DGCL to encourage the development of a blockchain-based, distributed ledger-based share ownership system. While still in its initial phases, Delaware Governor Jack Markell has announced his support for the creation of a new method of representation of corporate share ownership in which Delaware Corporations will have the ability to issue and register shares using distributed ledger technology. Given the large number of Fortune 500 companies that are incorporated in Delaware, this initiative could quickly move the industry standard from book-entry to blockchain share registration.

Have the banking and financial services industries been developing blockchains?

Most major banks and broker-dealers, and many of their service providers, have active blockchain projects. For example, based on published reports, a working group including Bank of America Merrill Lynch, Citi, Credit Suisse, J.P. Morgan, and The Depository Trust & Clearing Corporation (“DTCC”) has been developing various blockchain-based settlement and recordkeeping systems for credit default swaps (“CDS”).

DTCC has also been working on blockchain systems for securities repurchase agreements (“repos”), which are commonly used by broker-dealers to finance themselves. The repo market is very large, and many broker-dealers use it as the primary means for financing their operations. Yet, the repo market opens and settles trades in a disjointed and antiquated fashion, in which it is very difficult to determine a particular bank’s or broker-dealer’s net exposure and credit risk at any given moment.

This lack of transparency has been a focus of federal regulators who have been pushing for improved processing of repo trades. Regulators are concerned with potential losses by participants in the repo market. Blockchains appear to be a technological way to improve repo settlement risk transparency and reduce counterparty credit risk.

Industry participants have also discussed the possibility of prime brokerage or securities lending being performed using a blockchain. For example, each hedge fund could have its own blockchain, and could then borrow securities from many industry participants and not just their prime broker. While this might raise a variety of issues, including privacy issues, it is likely that some hedge fund managers will choose to use blockchains.

There has also been speculation that blockchains might serve as efficient, automated recordkeeping for, among other things, mortgages, land titles, marketplace (peer-to-peer) lending, and securities and commodities clearinghouses. Blockchains can potentially

offer accurate recordkeeping, the ability to keep track of a chain of title, speedy settlement cycles, and the ability to embed smart contracts.

What are smart contracts and how do they relate to blockchains?

A smart contract is a computer program that has the ability to take action, if contract terms are satisfied, without human intervention. Blockchains allow for the embedding of smart contracts.

To illustrate, consider CDS transactions. CDS are contracts in which one party pays a periodic premium to a second party, and the second party makes a payment to the first party if an extrinsic event, such as bankruptcy, occurs with respect to a third party (“Company Z”).

In this example, the market could create a blockchain for CDS referencing the potential bankruptcy of Company Z. As investors traded CDS on Company Z, corresponding entries would be made in the blockchain. As periodic payments become due, smart contract technology embedded in the blockchain could automatically withdraw the payment from one party’s bank account (which could be kept on a blockchain) and send the payment to the other party’s bank account (which could also be kept on a blockchain).

In addition, if the embedded smart contract detects that Company Z has become bankrupt, then both parties to the CDS could be notified and the appropriate payment or payments could be made automatically. If there are insufficient funds to make a payment, then the embedded smart contract could notify both parties. If a periodic payment is not made within a specified time, then the embedded smart contract could deem the CDS contract in default and could calculate and demand appropriate damages.

There are many potential “smart” blockchain applications in the financial services industry. For example, repos, securities lending, and many swap agreements seem well-suited for smart blockchains. Although often part of a larger, more complex package, prime brokerage for hedge funds and institutional investors is also likely to be suitable as a smart blockchain application. Potential applications could ensure systematic recordkeeping, reduce settlement cycles, and provide more advanced credit exposure netting. As a result, participants could benefit from reduced capital requirements, faster trade execution with broader and deeper markets, and less systemic risk.

The inclusion of smart contract technology might also turn a blockchain into something resembling an exchange, such as a swap execution facility, or a clearinghouse. For example, a smart blockchain could include not only recordkeeping and post-trade execution functions, but it could also include a request to enter into a trade. Market makers could then respond and fill the order request through the smart blockchain.

For a copy of this article published on the Practical Law website, see Article, Expert Q&A on Blockchain Technology in Banking and Financial Services, Practical Law, at <http://us.practicallaw.tr.com/w-002-7866>.

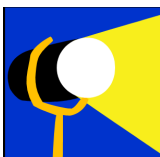
Todd R. Kornfeld is of counsel in Pepper Hamilton LLP’s Financial Services Practice Group. He concentrates his practice in financial services and securities and commodities laws, particularly with respect to private fund formation, trading activities, derivatives, structured finance, and various regulatory matters.

Gregory J. Nowak is a partner and a practice leader for hedge funds in Pepper Hamilton LLP’s Funds Services Practice Group. He concentrates his practice in securities law, particularly in representing investment management companies and other clients on matters arising under the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

Joseph C. Guagliardo is a partner in Pepper Hamilton LLP’s Intellectual Property Transactions and Rights Management Practice Group. He is vice-chair of the Technology Group and a member of the steering committee of the firm’s Emerging Business Group. Joseph’s practice focuses on commercial, intellectual property, and technology transactions, and general counseling of businesses and individuals with respect to legal matters involving intellectual property and technology.

UCC Spotlight

By [Carl S. Bjerre](#) and [Stephen L. Sepinuck](#)



The purpose of this column is to identify some of the most disconcerting judicial decisions interpreting the Uniform Commercial Code or related commercial laws. The purpose of the column is not to be mean. It is not to get judges recalled, law clerks fired, or litigators disciplined for incompetence. Instead, it is to shine a spotlight on analytical errors, and thereby provide practitioners and judges with reason to disregard the decisions.

Stierwalt v. Associated Third Party Administrators,
2016 WL 2996936 (N.D. Cal. 2016)

This case pitted a levying judgment creditor against a secured party. The court's interpretation of the applicable statutory provision is plausible, but its conclusion leads to very troubling results and should not be followed.

The facts are relatively straightforward. In 2012, a lender advanced more than \$12 million to two related entities and obtained in return a security interest in the debtors' goods, contract rights, and deposit accounts. The lender filed an effective financing statement but apparently did not obtain a control agreement or become the customer with respect to the debtors' deposit accounts.

Sometime thereafter, the CEO of both debtors was terminated. He brought an arbitration proceeding against them and obtained an award for more than \$626,000. A federal district court affirmed the award and the former CEO obtained a writ of execution directing the U.S. marshal to levy on a bank account of one of the debtors. The bank turned over to the marshal the funds credited to the account and the lender intervened, claiming priority.

On its face, this would seem to be an easy case for the lender. Under Uniform Commercial Code § 9201 and § 9317(a), a secured party with a perfected security interest has priority over the rights of a subsequent judicial lien creditor. The court correctly observed, 2016 WL 2996936 at *3, that the lender did not appear to have a perfected security interest in the debtor's deposit account as original collateral, because the lender did not have control, *see* § 9312(b). However the court was willing to assume, based on the facts provided, that the deposit account contained only proceeds of the debtor's contract rights, even though most of the debtor's customers paid in advance of when the services were rendered, 2016 WL 2996936 at *4-5, and hence the lender did have a perfected security interest in the deposit account. *See* § 9315(c), (d)(2).

However, the levying creditor argued that it took free of the lender's security interest under § 9332(b), which provides that "[a] transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party." Relying in part on *Orix Financial Services, Inc. v. Kovacs*, 83 Cal. Rptr. 3d 900 (Cal. Ct. App. 2008), the court sided with the levying creditor.

In *Orix*, after a judgment creditor satisfied its judgment by garnishing the judgment debtor's deposit account, a creditor with a security interest in the debtor's deposit account brought an action against the judgment creditor for unjust enrichment. The California Court of Appeal ruled that the garnishing creditor was a "transferee" within the meaning of § 9332(b), took free of the secured party's security interest, and hence was not liable for unjust enrichment.

The ruling in *Orix* was sound. After all, the drafters of Article 9 purposefully chose in § 9332(b) to protect "transferees," not "purchasers." The term "purchaser" is defined to mean anyone who takes property pursuant to a voluntary transaction. *See* § 1201(b)(29), (30). The term "transferee," which is undefined, was no doubt used precisely because "purchaser" is limited to transferees in voluntary transactions and the goal was to protect even those transferees who acquire funds from a deposit account through an involuntary transaction.

However, the facts in *Orix* are distinguishable from the facts in *Stierwalt* in a very important respect. There was no doubt in *Orix* that the judgment creditor was a "transferee." After all, the secured party did not get involved in the case until after the funds were paid to the judgment creditor. In contrast, in *Stierwalt*, the funds were still in the possession of the U.S. marshal (that is, they were no doubt credited to some deposit maintained by the marshal); the funds had not yet been turned over to the levying creditor. The marshal is better viewed – at least for the purpose of applying § 9332(b) – as an agent of the court, not as an agent of the levying creditor. Consequently, the court should not have treated the levying creditor as a "transferee." *Cf. Zimmerling v. Affinity Fin. Corp.*, 14 N.E.3d 325 (Mass. Ct. App. 2014) (an account debtor's wire of funds to an escrow account pursuant to a court order in action brought by judgment creditor did not cause either the escrow agent or the judgment creditor to take free of the secured party's perfected security interest under § 9-332(b), particularly given that the court order was intended to preserve the existing priorities). *See also Sonic Eng'g, Inc. v. Konover Constr.*, 2003 WL 22133874 (Conn. Super. Ct. 2003) (levying judgment creditor that received a bank check from the debtor's bank was not a "transferee" within the meaning of § 9332(b), and thus did not have priority over a creditor with a perfected security interest in the deposit account, because a stop payment order was placed on the check before it was paid).

The court's interpretation of § 9332(b) creates a real problem for secured parties with a perfected security interest in a deposit account. Under *Orix*, a secured party loses if it waits too long and allows a judgment creditor to receive funds from the debtor's deposit account. Under *Stierwalt*, a secured party loses priority much sooner: as soon as funds credited to the deposit account are transferred to the sheriff or marshal. If the secured party is not the depository itself, and thus might not have immediate notice of the judgment creditor's actions, that leaves the secured party with remarkably little time to act.

Moreover, there is no persuasive reason to interpret § 9332(b) as the court in *Stierwalt* did. We should start from the basic proposition

that a secured party with a perfected security interest does and is supposed have priority over the rights of a subsequent lien creditor, *see* §§ 9201, 9317(a). Section 9332(b) is an exception to that basic rule—an important exception designed not to “impair the free flow of funds.” § 9332 cmt. 3. But the exception is nevertheless limited; it is intended to protect finality by not upsetting a completed transaction. *Id.* But the transaction in *Stierwalt* was not completed, the policy underling § 9332(b) was not implicated, and thus the court erred in ruling for the judgment creditor.

This is a rather brief case involving enforcement of a security interest in a New York co-op. The court’s ruling was correct as was the bulk of its analysis, but its reference to a “recognized market” was completely off base.

Under New York law, a co-op consists of shares of stock allocated to a cooperative apartment and a proprietary lease to that apartment. Both of these are treated as personal property, not real property, and hence a security interest in them is governed by Article 9 of the New York Commercial Code, not by real property law.

The debtor in this case had borrowed \$140,000 and secured the debt with her interest in a co-op. After she defaulted, the secured party sent notification that it intended to dispose of her shares and proprietary lease by private sale. The debtor brought an action seeking to vacate the notification of a private sale, enjoin the secured party from proceeding with the sale, and compel the secured party to commence a foreclosure action. In a scant few paragraphs, the court concluded that the debtor had failed to demonstrate her entitlement to any of the requested relief.

Although the debtor claimed that the secured party had failed to comply with New York’s non-uniform § 9-611(f), which requires a 90-day notification of a disposition of an interest in a co-op, the court properly noted that the sale described in the notification had not occurred and that nothing prevented the secured party from scheduling and conducting a future sale, provided it gave proper notification.

The court then turned to the debtor’s claim that a nonjudicial sale of co-op would not be commercially reasonable. The court’s entire discussion of the issue was the following single sentence: “To the contrary, [a] disposition of collateral is made in a commercially reasonable manner if the disposition is made . . . at the price current in any recognized market.” 2016 WL 143496 at *2 (quoting § 9-627(b)(2)).

The court was quite correct in denying the debtor injunctive relief. While the judiciary is empowered to restrain creditor enforcement efforts that fail to comply with Article 9, *see* § 9-625(a), the debtor offered no reason why such a sale would be commercially unreasonable or would otherwise not comply with the law. However, the court was quite incorrect in suggesting that a private sale of a co-op would be on a recognized market.

Article 9 contains three references to a recognized market. Section 9-610(c) allows a secured party to buy at a private sale if the collateral is of a kind that is customarily sold on a recognized market. Section 9-611(d) allows a secured party to sell, without prior notification, collateral that is of a type customarily sold on a recognized market. Finally, § 9-627(b) conclusively treats a disposition as conducted in a commercially reasonable manner if the disposition is made either in the usual manner on a recognized market or at the price current in a recognized market. For each of these purposes, the concept of a recognized market is “quite limited; it applies only to markets in which there are standardized price quotations for property that is essentially fungible, such as stock exchanges.” § 9-627 cmt. 4. The comments add that the New York Stock Exchange is a recognized market but that “[a] market in which prices are individually negotiated or the items are not fungible is not a recognized market, even if the items are the subject of widely disseminated price guides or are disposed of through dealer auctions.” § 9-610 cmt. 9.

Each New York co-op is unique and prices for co-ops are individually negotiated. Consequently, they are not traded on a recognized market. The court was wrong to suggest the opposite.

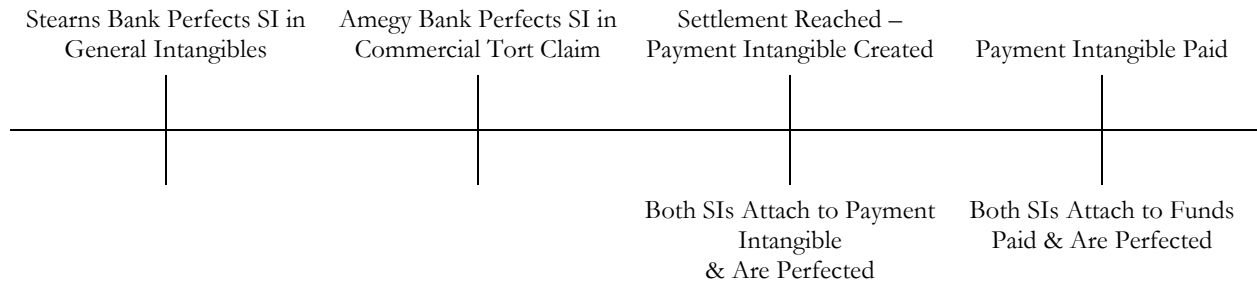
Bayer Cropscience LP v. Stearns Bank,
[2016 WL 5030340](#) (8th Cir. 2016)

This is the second decision in this case to be featured in this column. Last year, we criticized the district court’s decision for misstating and misapplying the first-to-file-or-perfect priority rule in § 9322(a)(1). *See* [Spotlight, Commercial Law Newsletter 18, 21 \(Summer 2015\)](#). Unfortunately, the Eighth Circuit’s decision on appeal is much worse. It completely misunderstands Article 9’s rules regarding commercial tort claims, improperly applying them to the proceeds of such a claim. As a result, the court incorrectly determined which secured party had priority and added to a growing list of flawed decisions regarding commercial tort claims.

The facts of the case can be summarized fairly simply. In 2002 Stearns Bank acquired and perfected a security interest in the debtor’s existing and after-acquired general intangibles. In 2006, Amegy Bank acquired and perfected a security interest in the debtor’s commercial tort claim against Bayer Corp. and several related entities. In 2012, Bayer agreed to pay \$2.1 million to settle the suit.

After a portion of the proceeds were distributed and the remainder deposited with the court, each of the two banks claimed priority in the balance on hand: about \$1 million.

The proper way to analyze and resolve this dispute is not all that complicated. When the commercial tort claim was settled, a payment intangible was created. Amegy Bank’s security interest attached to the payment intangible as proceeds of the commercial tort claim. See § 9315(a)(2). That security interest was immediately perfected by virtue of the earlier financing statement. § 9315(c), (d). At the same moment, Stearns Bank’s security interest attached to the payment intangible as after-acquired property. See §§ 9203(b)(2), 9204(a). That security interest was also immediately perfected. See § 9502(d). Thus, the attachment and perfection of both security interests in the payment intangible were simultaneous. Similarly, when the payment intangible was paid, both security interests simultaneously attached to and were perfected in the cash proceeds.



Under the first-to-file-or-perfect priority rule of § 9322(a)(1), Stearns Bank should have priority because its filing preceded Amegy Bank’s filing or perfection and there was no time after Stearns Bank’s filing that it lacked either filing or perfection.

Unfortunately, the Eighth Circuit balked at this straightforward analysis. Instead, the court fixated on § 9108(e)(1), which requires extra specificity in the description of a commercial tort claim as collateral. The court concluded – without any textual support in the Code – that this rule must also apply to a payment intangible arising from the settlement of a commercial tort claim, as well as to any payment made pursuant to that settlement agreement. 2016 WL 5030340 at *4. In short, the court concluded that “the drafters of the UCC, in implementing the heightened identification requirements of commercial tort claims . . . , intended for the proceeds of a commercial tort claim to be excluded from an after-acquired general intangible clause.”

Alas, this is simply wrong. See *In re Wiersma*, 324 B.R. 92, 106-07 (9th Cir. BAP 2007) (settlement of tort claim created a payment intangible that was automatically within the scope of a secured party’s security interest in after-acquired general intangibles), *rev’d in part on other grounds*, 483 F.3d 933 (9th Cir. 2007). It is also very problematic because there is little that a transactional lawyer can do to draft around the problem that the court has created. In other words, it is not clear what Stearns Bank could have added to its security agreement to make the debtor’s rights under a future settlement agreement additional collateral. In contrast, Amegy Bank could have easily protected itself by searching for filings against general intangibles or payment intangibles, and then insisting on a subordination agreement from Stearns Bank or any other entity with a prior financing statement on filing.

Perhaps most disconcerting, the Eighth Circuit’s decision is now the fifth court decision featured in this column for improperly understanding or applying Article 9’s rules regarding commercial tort claims. See *In re Doctor’s Hospital of Hyde Park, Inc.*, 474 B.R. 576 (Bankr. N.D. Ill. 2012) (discussed in the [Fall 2012 column](#)); *Algonquin Power Income Fund v. Christine Falls of New York, Inc.*, 466 B.R. 175 (N.D.N.Y. 2011) (discussed in the [Spring 2012 column](#)), *rev’d*, 509 F. App’x. 82 (2d Cir. 2013); *In re American Cartage, Inc.*, 656 F.3d 82 (1st Cir. 2011) (discussed in the [Winter 2011 column](#)); *In re Zych*, 379 B.R. 857 (Minn. Ct. App. 2007) (discussed in a [special December 2007 edition of the column](#)). Perhaps it is time for the Permanent Editorial Board to intervene and issue a new commentary that sets these courts right.

DZ Bank AG v. Connect Insurance Agency, Inc.
[2016 WL 631574](#) (W.D. Wa. 2016)

DZ Bank had a security interest in the assets of Advantage Pacific Insurance, Inc., perfected by a financing statement filed in the State of Washington. The assets – which the court presumed were intangibles such as goodwill and client information – were then sold to Connect Insurance Agency, Inc., which was located in Texas or Florida (as discussed below). DZ Bank failed to reperfect in the jurisdiction of Connect’s location for a year following the sale.

DZ Bank sued Connect for conversion. In light of DZ Bank’s failure to re-perfect during the year following the sale, the correct analysis would be that the security interest was retroactively unperfected or “deemed never to have been perfected” as against Connect.

UCC § 9316(a)(3), (b). As a result, Connect would hold the intangible assets free of DZ Bank's security interest, provided that Connect had given value for the assets without knowledge of the security interest. *See* § 9317(d). Moreover, Connect may indeed have satisfied the without-knowledge requirement of § 9317(d), because we are told that Connect "did not conduct any due diligence" before the transaction. 2016 WL 631574 at *6.

Nonetheless, the court ruled in favor of DZ Bank rather than Connect, by resurrecting and misapplying a long-repealed Article 9 concept. The court thought that DZ Bank's failure to re-file in the new jurisdiction resulted in loss of perfection as against Connect only if Connect had bought the collateral "after removal" of the collateral, from Washington to Connect's own jurisdiction in Texas or Florida. This notion comes from old Article 9, as it existed before the thorough revisions that went into effect in 2001. In those olden days, Article 9's choice-of-law rules – for tangible collateral anyway – were based on the location of the assets, rather than on the location of the debtor, and correspondingly, the only purchasers of the assets that were retroactively protected by a secured party's failure to re-perfect in a new jurisdiction were those that purchased after the collateral's removal from the old jurisdiction. *See* § 9103(1)(d)(i) (1994). Under current law, of course, there is no similar limitation even for tangible collateral, because § 9316(a)(3) looks to the location of the debtor rather than that of the collateral.

Compounding the court's already bizarre error is the common-sense fact that intangible collateral – supposedly at issue this case – does not have any location from which to be removed. Accordingly, for such collateral, even the pre-2001 statutes already looked to the location of the debtor. *See* § 9-103(3)(e) (1994). The court barreled past this stumbling block, evidently thinking that the collateral was, in effect, removed from its original location by virtue of the purchase by Connect since Connect was located out of state. Such a premise leads to a true absurdity: if the purchase and the supposed removal are the same event, then the purchase can never be "after removal," and no purchaser of intangible collateral can ever be protected by the secured party's failure to re-perfect in the new state. The court relied solely on cases from the last millennium, seemingly without checking either the current or even the pre-2001 statutes.

In a second set of errors, the court muddled the basic question of what state's version of Article 9 to apply. Article 9's most general choice-of-law principle is that perfection, the effect of perfection or non-perfection, and priority are determined by the location of the debtor. *See* §§ 9301(1), 9-307. But the court instead blithely applied forum law (*i.e.*, Washington law) without regard to Connect's location. Intriguingly, the court writes that Connect was both a Texas corporation and a Florida corporation, which if accurate would mean that Connect was not a "registered organization," because § 9-102(a)(71) limits that term to organizations organized solely under the law of a single state or the United States. As a result, § 9-307(e)'s usual jurisdiction-of-organization rule would not determine Connect's location, and instead Connect would be located at its place of business if there were only one, or otherwise its chief executive office. *See* § 9-307(b). But in a further entertaining passage, the court writes that Connect had its "principal place of business" (sic) in both Texas and Florida. 2016 WL 631574 at *1. This is a logical impossibility and, strictly speaking, irrelevant under the statutes because a principal place of business is not necessarily a chief executive office. Ultimately, though, this second set of errors had no practical effect, because there are no relevant differences among the enactments of § 9316(a)(3) in the three jurisdictions.

In re Flour City Bagels, LLC,
[2016 WL 4595487](#) (Bankr. W.D.N.Y. 2016)

This is the first of two cases that deals incorrectly with general intangibles.

The case involved a Chapter 11 debtor that operated bagel bakeries as a franchisee and sought court approval to sell substantially all of its assets, free and clear of all liens, to a junior secured lender. The junior secured lender had, pursuant to an agreement with the senior secured lender, credit bid the amount of the senior lender's claim. The debtor's franchisor objected to the sale and in so doing claimed that neither the junior lender nor the senior lender had a lien on the debtor's bakery leases.

The court began its analysis by noting that an assignment of leases is typically used to transfer or create an interest in a *landlord's* rights in a lease – most notably the stream of rents – but that this case the debtor's interest in the leases was as a *tenant*. *Id.* at *14. Nevertheless, the court then properly turned to § 9109(d)(11), which excludes from the scope of Article 9 "the creation or transfer of an interest in or lien on real property, including a lease."

Neither lender had recorded a leasehold mortgage pursuant to the requirements of New York real property law. Instead, they claimed that the "economic value" of the leases was personal property and that each of them had a perfected, Article 9 security interest in that economic value pursuant to their loan agreements, which expressly included "general intangibles" in the description of the collateral. 2016 WL 4595487 at *13.

The court quite correctly rejected this argument. Unfortunately, in so doing the court erred in two respects. First, in concluding that the lender's argument – that they had liens not on the leases themselves, but on the debtor's economic interest in the leases – was a distinction without a difference, the court suggested that no case law supported their position. *Id.* at *16. The lenders might have indeed failed to cite support, but there is some, though it arises in a markedly different context. Several of the courts dealing with

security interests in broadcast licenses have managed to get around the federal law requiring the FCC's consent to such a security interest by treating the lender as having a security interest in the "economic value" of the licenses. *See In re Tracy Broadcasting Corp.*, 696 F.3d 1051 (10th Cir. 2012); *In re TerreStar Networks, Inc.*, 457 B.R. 254 (Bankr. S.D.N.Y. 2011). Those cases did not, however, use the "economic value" concept to distinguish real from personal property; nor would it have been sound judicial reasoning to extend those cases with the effect of evading the Article 9 scope limitation. Hence the present court's neglect of the broadcast license cases is at worst a small error.

The court's second error was both more significant and, because it was dicta, more regrettable. The court concluded that even if the lenders' "economic value" argument had had legs, neither the security agreements nor the filed financing statements would have properly described the collateral. Specifically, the court wrote that the financing statements used the terms "general intangibles" and "all assets" to describe the collateral, but that no searcher would have been on notice that this language covered the "economic value" of the debtor's leases. 2016 WL 4595487 at *16.

However, if the economic value of the debtor's leases had counterfactually been personal property, then it would have been a general intangible. *See* § 9102(a) (42). *See also* § 9108(b)(3) (indicating that a description of collateral by a type defined in the UCC is adequate). Moreover, Article 9 expressly provides that a financing statement describing the collateral as "all assets" or "all personal property" is effective. § 9504(2). Thus, the language used in the security agreements and financing statements would have been sufficient if the debtor's economic rights in the leases were considered personal property and the lenders' security interests in those rights were governed by Article 9.

Kirk Excavating & Construction, Inc. v. AYS Oilfield,
[2016 WL 4733277](#) (S.D. Ohio 2016)

In this case, a contractor owed money to several entities. One was a bank with a perfected security interest in the contractor's "accounts and other rights to payment." Two others were parties that later obtained judicial liens on the contractor's rights to payment. The last was an entity that owed the contractor approximately \$440,000 as a retainage under a construction contract but claimed a right to withhold approximately \$12,000 for work the contractor failed to perform.

The court ruled in favor of the first judicial lien creditor. Putting aside the court's surprising and probably erroneous conclusion that the party owing the retainage could not deduct the cost of the work the contractor failed to perform, *cf.* § 9404(a)(1) (subjecting a secured party's rights against an account debtor to any defense or claim in recoupment arising from the transaction that give rise to the contract between the debtor and the account debtor), the court's analysis was clearly wrong.

With respect to the bank, the court first noted that the security agreement had been executed and the financing statement filed before the contractor entered into the agreement under which the \$440,000 was now owing. This meant, according to the court, that there was no "right" for the bank to perfect. *Id.* at *6. The court then suggested that the bank could have "widened its net" by filing against general intangibles or payment intangibles, but that because the bank had not done so, the bank's financing statement was insufficient to perfect against contingent or future rights. *Id.*

Virtually every point in the court's brief discussion is flawed. First, a financing statement does not need to mention after-acquired property to in fact cover it. *See* §§ 9204 cmt. 7, 9502 cmt. 2. Thus, the fact that the contractor's right to payment arose after the financing statement was filed is completely immaterial. Second, the contractor's right to payment was an account, not a general intangible. *See* § 9102(a)(2) (defining "account" to include a right to payment for "services rendered or to be rendered"), (42) (excluding accounts from the term "general intangible"). Consequently, adding the term "general intangibles" to the collateral description in the financing statement would not have helped the bank. Finally, even if the contractor's right to payment of the retainage had been a general intangible, the reference in the financing statement to "other rights to payment" should have been sufficient to cover it. *See* § 9108(a) (a description of collateral is sufficient "if it reasonably identifies what is described").

Nevertheless, the court's ultimate conclusion might be correct. Nothing in the portion of the security agreement quoted by the court references after-acquired property. In the absence of such a clause, the bank might not have had a security interest in the contractor's future accounts. *But cf. In re Filtcorp, Inc.*, 163 F.3d 570 (9th Cir. 1998) (security interests in rotating collateral, such as "inventory" and "accounts receivable," presumptively include after-acquired property). Unfortunately, by focusing on the financing statement rather than the security agreement, and by misunderstanding the distinction between an account and a payment intangible, the court failed to discuss this important point and instead left us all with an opinion that confuses and conflates basic components of a secured transaction.

Born v. Born,
374 P.3d 624 (Kan. 2016)

In 2014, [this column](#) heavily criticized the Kansas Court of Appeals' decision in this case for its conclusion that, despite the debtor's timely objection, a secured party's proposal to accept the collateral in satisfaction of the secured obligation was nevertheless effective. Such a conclusion is directly contrary to § 9620(a)(1) and (c)(2). In a happy development, the Kansas Supreme Court reversed and it did so for all the right reasons.

Carl S. Bjerre is the Kaapcke Professor of Business Law at the University of Oregon School of Law.

Stephen L. Sepinuck is Professor and Associate Dean of Admissions at Gonzaga School of Law.

Useful Links and Websites

Compiled by Commercial Law Newsletter Co-Editors Harold Lee, Sidney Simms, Jennifer Wasyluk, Christina Goebelsmann, Peter Marchetti and Hilary Sledge-Sarnor.

Please find below a list of electronic links that our members may find useful:

1. www.lexology.com – In cooperation with the Association of Corporate Counsel, Lexology provides articles and practical tips relating to the practice of law.
2. The UCCLAW-L listserv is sponsored by West Group, publisher of the “UCC Reporting Service.” The listserv is an e-mail discussion group focusing on the Uniform Commercial Code. To subscribe to the UCCLAW-L listserv, go to <http://lists.washlaw.edu/mailman/listinfo/ucclaw-l>
3. The American Law Institute – <http://www.ali.org>
4. Pace University's database of the United Nations Convention on Contracts for the International Sale of Goods and International Commercial Law Database can be accessed at <http://cisgw3.law.pace.edu>
5. Gonzaga University's new Commercial Law Center has a variety of links to useful sites and can be accessed at <https://www.law.gonzaga.edu/centers-programs/commercial-law/>
6. The International Association of Commercial Administrators (IACA) maintains links to state model administrative rules (MARS) and contact information for state level UCC administrators. This information can be accessed at <http://www.iaca.org>
7. The Uniform Law Commissioners maintains information regarding legislative reports and information regarding upcoming meetings, including the Joint Review Committee for Uniform Commercial Code Article 9. You can access this information at <http://www.uniformlaws.org/Committee.aspx?title=Commercial Code Article 9>
8. Information on the work of The United Nations Commission on International Trade Law (UNCITRAL) (including the work of its working groups on Procurement, International Arbitration and Conciliation, Transport Law, Electronic Commerce and Insolvency Law) is available at <http://www.uncitral.org/uncitral/en/index.html>
9. The American College of Commercial Finance Lawyers – <http://www.accf.com>
10. The Secretariat of Legal Affairs (SLA) develops, promotes, and implements the Inter-American Program for the Development of International Law. For more information, go to <http://www.oas.org/DIL/>
11. The National Law Center for Inter-American Free Trade (NLCIFT) is dedicated to developing the legal infrastructure to build trade capacity and promote economic development in the Americas. For more information, go to <http://www.natlaw.com>
12. Information on the Hague Conference on Private International Law and its current status is available at http://www.hcch.net/index_en.php

With your help, our list of electronic resources will continue to grow. Please feel free to forward other electronic resources you would like to see included in future editions of the Commercial Law Newsletter, by sending them to [Harold Lee](#), [Sidney Simms](#) or [Jennifer Wasyluk](#), the Commercial Finance Committee Editors or [Christina Goebelsmann](#), [Peter Marchetti](#) or [Hilary Sledge-Sarnor](#), the Uniform Commercial Code Committee Editors.

Endnotes

- ¹ *Wheeling & Lake Erie Railway Co. v. Me. N. Railway Co. and New Brunswick S. Railway Co.*, No. 1:14-CV-325-NT, 2015 WL 5440787 (D. Me. Sept. 15, 2015).
- ² Compare *id.* at *6, with *In re Communication Dynamics, Inc.*, 300 B.R. 220, 225 (Bankr. D. Del. 2003).
- ³ *In re Montreal, Maine & Atlantic Ry., Ltd.*, No. 13-10670 (Bankr. D. Me.).
- ⁴ *Id.*, Order Approving Chapter 11 Trustee's Motion For Order Approving Compromise And Settlement With Wheeling & Lake Erie Railway Company, D.E. 1047 (entered Jul. 25, 2014).
- ⁵ *Wheeling & Lake Erie Ry. Co. v. Me. N. Ry. Co. and New Brunswick S. Ry. Co.*, No. 1:14-cv-00325-NT, Complaint For Accounts Due, D.E. 1 (D. Me. Aug. 14, 2014).
- ⁶ *Wheeling & Lake Erie Ry. Co. v. Me. N. Ry. Co. and New Brunswick S. Ry. Co.*, No. 1:14-cv-00325-NT, Joint Answer And Additional Defenses Of Maine Northern Railway Company And New Brunswick Southern Railway Company Limited, D.E. 7 (D. Me. Sep. 23, 2014).
- ⁷ *Wheeling & Lake Erie Ry. Co.*, 2015 WL 5440787, at *1.
- ⁸ *Id.* at *2.
- ⁹ *Id.*
- ¹⁰ *Wheeling & Lake Erie Ry. Co.*, 2015 WL 5440787, at *3.
- ¹¹ UCC § 9-404(a)(2) (emphasis added). There were other revisions that were not material to the issue before the Maine district court.
- ¹² *Wheeling & Lake Erie Ry. Co.*, 2015 WL 5440787, at *4; UCC § 9-102(7).
- ¹³ Uniform Electronic Transaction Act, Uniform Law Commission, available at <http://www.uniformlaws.org/Act.aspx?title=Electronic%20Transactions%20Act> (last visited Jul. 8, 2016).
- ¹⁴ *Wheeling & Lake Erie Ry. Co.*, 2015 WL 5440787, at *4-*5. See also *Wheeling & Lake Erie Ry. Co. v. Me. N. Ry. Co. and New Brunswick S. Ry. Co.*, Case 1:14-cv-00325-NT, Wheeling & Lake Erie Railway Company's Motion For Summary Judgment And Incorporated Memorandum Of Law, D.E. 21, pp. 15-19 (D. Me. Aug. 14, 2014).
- ¹⁵ *Wheeling & Lake Erie Ry. Co.*, 2015 WL 5440787, at *4-*5.
- ¹⁶ *Id.* at *4-*5.
- ¹⁷ *Id.* at *5. See also *Wheeling & Lake Erie Ry. Co. v. Me. N. Ry. Co. and New Brunswick S. Ry. Co.*, Case 1:14-cv-00325-NT, Wheeling & Lake Erie Railway Company's Motion For Summary Judgment And Incorporated Memorandum Of Law, D.E. 21, pp. 9-10 (D. Me. Aug. 14, 2014); 11 M.R.S.A. § 1-1202(1), (5).
- ¹⁸ *In re Communication Dynamics, Inc.*, 300 B.R. at 225.
- ¹⁹ *Id.*
- ²⁰ *Wheeling & Lake Erie Ry. Co.*, 2015 WL 5440787, at *5.
- ²¹ *Id.*
- ²² *Id.*
- ²³ *In re Communication Dynamics, Inc.*, 300 B.R. at 223 (internal quotation omitted).