Automatic Perfection of Sales of Payment Intangibles: A Trap for the Unwary

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Under Section 9-309(3) of the Uniform Commercial Code, sales of “payment intangibles” are automatically perfected without the requirement of filing financing statements. Originally intended as a concession to the banking industry (to perfect sales of loan participations without filing), this provision has become a trap for the unwary—including unwary banks. It misleads those who think they’re buying payment intangibles (and thus need not file to perfect) only to find out, too late, that a court has construed that arcane definition too narrowly. It also undermines the ability to know one’s priority in purchased or pledged payment intangibles. This essay analyses these problems, examines their historical origins, and suggests potential solutions.

Introduction. A bank pays $47 million, fair value, to purchase certain rights to payment under equipment leases. The seller of these rights eventually goes bankrupt, and its trustee in bankruptcy claims that the seller—not the bank—actually owns these rights even though they were purportedly sold. This nightmarish scenario is real, and indeed has been “blessed” by a

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bankruptcy court. Most troubling, the trustee in bankruptcy’s claim and the bankruptcy court’s decision are not based on any hint of fraud or inequities; rather, they result from a well intentioned, though misguided, provision of revised Article 9 (“Revised Article 9”) of the Uniform Commercial Code (“U.C.C.”)—Section 9-309(3), providing for automatic perfection of sales of payment intangibles.

“Automatic perfection” means that sales of payment intangibles are perfected when they occur, without the need to file financing statements (filing being the U.C.C.’s default rule for perfection). The automatic-perfection rule originated in a political compromise between the drafters of Revised Article 9 and the banking lobby. When Revised Article 9 expanded the category of intangible rights whose sale was governed by the U.C.C., banks realized the expansion would include loan participations, a form of payment intangible consisting of

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2 Commercial Money Ctr., Inc. v. Netbank, FSB (In re Commercial Money Ctr., Inc.), 2005 WL 1365055 (Bankr. S.D. Cal.). While this article was being edited, the bankruptcy court’s decision was overturned on appeal by a bankruptcy appellate panel insofar as it relates to the payment intangibles issue. See NetBank, FSB v. Kipperman (In re Commercial Money Center, Inc.), BAP No. SC-05-1238-MoTB, Bk. No. 02-09721-H7, Adv. No. 03-90331-H7 (Bankr. App. Panel Aug. 2, 2006). That does not, however, change either the analysis or the concerns articulated in this article. Also, although the author is a consultant to NetBank in this litigation, he was concerned about this problem long before he was retained as a consultant, and the views expressed in this essay are entirely his own.

3 Or, more technically, when they “attach” under U.C.C. § 9-203(a) (2005).

4 See U.C.C. § 9-310(a) (2005).

5 The U.C.C. governs certain sales of intangible rights to “avoid[] difficult problems of distinguishing between transactions in which a receivable secures an obligation and those in which the receivable has been sold outright,” since in “many commercial financing transactions the distinction [between these transactions] is blurred.” U.C.C. § 9-109 cmt 4 (2005). Another reason is to apply Article 9’s perfection and priority system to those sales. See Permanent Editorial Board (“PEB”) Commentary No. 14 on U.C.C. [Pre-Revision] Section 9-102(1)(b).
undivided interests in loans. They then became concerned that requiring perfection by filing could be burdensome and costly to the large inter-bank market in loan-participation sales.

Banks argued that, prior to Revised Article 9, they were not required to file financing statements to perfect sales of loan participations, so automatic perfection would simply reflect existing banking practice. Although the drafters of Revised Article 9 ultimately accepted automatic perfection as a compromise, this essay shows that it is a compromise that creates traps for the unwary—and that, ironically, banks are among those most likely to fall into these traps.

**Problems Caused by Automatic Perfection:** Automatic perfection causes two fundamental problems—one a “non-perfection” problem, the other a “priority” problem. The non-perfection problem results from certain complexities and subtleties, discussed in the next paragraph, associated with the term “payment intangibles.” These complexities and subtleties can make it hard for a buyer of intangible rights to determine whether its rights are payment intangibles, which are automatically perfected, or other intangible rights for which the U.C.C. requires filing for perfection. If the buyer decides wrong and does not file, the buyer’s ownership of those rights can be avoided in the event of the seller’s subsequent bankruptcy. Avoidance occurs through the mechanism of U.C.C. § 9-317(a)(2), which provides that an unperfected security interest—which, under U.C.C. §§ 1-201(b)(35) and 9-109 (and Official Comment 5

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8 *Id.* (stating that § 9-309(3) “reflect[s] the practice under former Article 9”). *But see infra* notes 19-22 and accompanying text.
thereto), includes most ownership interests in intangible rights—is subordinate to the rights of a trustee in bankruptcy.\(^9\)

Payment intangibles are defined as “general intangible[s] under which the account debtor’s principal obligation is a monetary obligation.”\(^{10}\) Confusion can arise because the term “general intangible” is a catch-all, consisting effectively of all intangible rights “other than accounts, chattel paper” and other such U.C.C.-delineated categories of intangible rights. In order to conclude an intangible right is a payment intangible, one first must conclude it does not fall within any of these other categories. These categories, however, can be complex and exceedingly subtle.

For example, in *In re Commercial Money Center*, the intangible rights at issue consisted of rights to payment to certain lease installments. NetBank believed, in my view correctly, that these intangible rights were payment intangibles, not falling within any other U.C.C.-delineated category of intangible rights. The trustee in bankruptcy argued, though, that these intangible rights constituted “chattel paper” because that term includes “a record or records that evidence both a monetary obligation and a … lease of specific goods.”\(^{11}\) Although NetBank countered that the intangible rights could not be chattel paper because they neither constitute a “record” nor “evidence” the lease—rather, they were merely rights payable *under* the lease—the bankruptcy judge disagreed. Holding (in my view, incorrectly) that the intangible rights were chattel paper,

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\(^9\) U.C.C. § 9-317(a)(2) technically provides that an unperfected security interest is subordinate to the rights of a “lien creditor,” but that term is defined in U.C.C. § 9-102(a)(52)(c) to include a trustee in bankruptcy. *Accord* 11 U.S.C. § 544 (2005) (the “strong arm” provision of bankruptcy law, through which avoidance would likewise occur).


the judge then concluded (correctly, given that flawed premise) that their sale required perfection by filing. Because NetBank had not filed financing statements, it was unperfected.

The disagreement over the U.C.C. nature of rights to payment under leases illustrated by the bankruptcy court’s decision in In re Commercial Money Center is disturbing because that should have been a relatively easy case. Two prominent commercial law commentators have observed, for example:

Our biggest concern about the [bankruptcy court’s decision in the In re Commercial Money Center] case is its holding that the rental streams, standing by themselves, should be characterized as chattel paper rather than payment intangibles. The court thought its decision was true to the “plain language” of the U.C.C., but that’s questionable . . . . The carved-out payment streams seem to fit the definition of “payment intangible” like a glove.

Indeed, it appears that banks may routinely regard rights to payment under leases as payment intangibles, and therefore do not file to perfect the sale of those rights.

That this degree of controversy exists for so obvious an example of a payment intangible augers poorly for the many truly more difficult cases. And the In re Commercial Money Center bankruptcy court’s interpretation of § 9-309(3), if sustained on appeal to the Ninth Circuit, only compounds the controversy, suggesting, for example, that even participations in equipment loans could be chattel paper whose sale requires perfection by filing.

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12 Cf. note 2, supra (bankruptcy appellate panel overturning that case).


14 Interview with Charles Mooney, Charles A. Heimbold, Jr. Professor of Law, University of Pennsylvania Law School, and Co-Reporter, Revised Article 9 (Jan. 5, 2006).

15 The (twisted) rationale of the bankruptcy court’s decision in In re Commercial Money Center compels this conclusion where, under U.C.C. § 9-102(a)(11), the equipment loans themselves are secured by security interests in specific goods.
Some might propose solving this problem by filing financing statements for all sales of intangible rights, as a prophylactic measure. But § 9-309(3) would still remain a trap for the unwary who, after reading § 9-309(3), justifiably believe they are automatically perfected and fail to file prophylactically. Furthermore, any widespread practice of prophylactic filing for sales of intangible rights could amount to roughly the same filing costs and burdens as simply requiring such filing in the first place. Additionally, even a universal practice of prophylactic filing could not solve the “priority” problem (discussed below), which exists independently of the non-perfection problem.

The priority problem occurs because automatic perfection makes it difficult, if not impossible, to know one’s priority in purchased or pledged payment intangibles. Whereas the U.C.C. filing system not only establishes but also is used to enable one to ascertain priority, payment intangibles sold pursuant to an automatic-perfection rule do not require filing. Any subsequent buyer of, or party secured by, those payment intangibles must therefore take the transferor’s word that such intangibles have not been previously sold. If the transferor is dishonest—indeed, even if the transferor is merely mistaken about the existence of a prior sale—the subsequent buyer or secured party’s interest would be subordinate to the rights of prior automatically perfected buyers. The inability to know ownership priority in turn undermines the market for selling intangible rights and increases costs where sales do occur.16

Potential Solutions to These Problems: There are at least a couple of potential solutions to these problems. Each begins by substituting a perfection-by-filing rule for sales of payment intangibles in place of Revised Article 9’s automatic perfection rule.

One solution is simply to eliminate the automatic-perfection rule for sales of payment intangibles. These sales then would be perfected by filing—the U.C.C.’s default rule. This was the originally intended approach of Revised Article 9.

This solution is likely to meet resistance because sales of loan participations then technically would also require filing for perfection and, as mentioned, the banking lobby has been concerned that requirement would be burdensome and costly to the market in inter-bank loan-participation sales. Banks believed, in contrast, that automatic perfection merely reflects pre-Revised Article 9 banking practice.

That belief may be misplaced, however. The fact that the sale of loan participations was not included within the scope of the U.C.C. prior to Revised Article 9 says nothing about whether an automatic-perfection rule then existed. Absent U.C.C. coverage, perfection of sales of loan participations prior to Revised Article 9 was governed by the common law and lex mercatoria. That hodgepodge of laws in some cases resulted in automatic perfection of sales of loan participations but in many cases did not; and where it did not, it imposed even more burdensome and costly perfection requirements than filing, such as “policing” or notifying obligors on the loans. Banks rarely, if ever, complied with these burdensome and costly perfection requirements.

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17 See supra note 4 and accompanying text.
18 See supra note 6 and following text.
20 See U.C.C. § 1-103(b) (providing that commercial transactions not governed by the U.C.C. are to be governed by principles of law and equity, including the law merchant).
For this reason, many inter-bank sales of loan participations were unperfected prior to enactment of Revised Article 9. If, therefore, the automatic perfection rule under § 9-309(3) were replaced by a perfection-by-filing rule, banks that choose not to file often would be in no worse position under commercial law than they had been in prior to Revised Article 9:

“‘Because few banks complied with pre-U.C.C. perfection requirements for sales of loan participations, the failure to comply with a perfection-by-filing requirement’ would put [banks] in no worse position than at present. Banks would take the insolvency risk of the selling bank, as they likely do now.”23

But banks that decide to comply with such a filing requirement would be able to perfect the sale of loan participations with far greater certainty. In short, therefore, replacing automatic perfection of sales of payment intangibles with a rule requiring perfection by filing would essentially place banks in a no worse, and arguably a better, position than they were in prior to Revised Article 9.24

Another possible solution, more explicitly intended to address the banking industry’s perceived concerns, would begin by substituting a perfection-by-filing rule for sales of payment intangibles in place of Revised Article 9’s automatic-perfection rule; but it then would except out sales of loan participations between banks. This approach simply recognizes that, “as between

22 Schwarcz, A Fundamental Inquiry Into the Statutory Rulemaking Process of Private Legislatures, supra note 21, at 956 n.165.

23 Id.

24 Banks apparently did not worry much in the past about lack of perfection because the Federal Deposit Insurance Corporation, as receiver of failed banks, has a weaker “strong arm” power than a trustee in bankruptcy to challenge unperfected sales. But this same weakness of the FDIC to challenge unperfected sales is all the more reason for banks not to worry about a filing requirement today.
bank . . . purchases and sales of loan participations are not intended to facilitate commercial transactions but, instead, constitute a means of allocating lending risk between such institutions.\textsuperscript{25}

The exception could take several forms. It could provide, for example, that excepted sales of loan participations are automatically perfected, as under Revised Article 9. Alternatively, it could provide, as prior to Revised Article 9, that excepted sales of loan participations are not governed by Article 9 of the U.C.C.. In each case, the challenge is to carefully define what constitutes an excepted sale of loan participations.

At the time Revised Article 9 was being finalized, some claimed that it would be difficult to precisely define this type of exception. I do not see why. Loan participations are simply undivided interests in loans,\textsuperscript{26} and the term “bank” could be defined, for example, by reference to the expansive but precise litany of banking institutions that may not be debtors under the Bankruptcy Code.\textsuperscript{27} Indeed, a similar approach, proposed by the American Bar Association’s Securitized Asset Financing Task Force, was substantially adopted in the Revised Article 9 Drafting Committee’s November 1995 draft report.

\textsuperscript{25} Schwarcz, \textit{A Fundamental Inquiry Into the Statutory Rulemaking Process of Private Legislatures}, supra note 21, at 956 n. 168 (emphasis in original).

\textsuperscript{26} See Schwarcz, \textit{Intermediary Risk}, supra note 6 and accompanying text. I recently learned from Professor Mooney that, at the time Revised Article 9 was being finalized, banks also were concerned that requiring filing for perfection might burden potential markets for the inter-bank sale of undivided interests in letters of credit, banker’s acceptances, and other bank products. To the extent a filing requirement jeopardizes any such markets, inter-bank sales in those markets could, as appropriate, be relieved of filing requirements along the approach discussed above.

\textsuperscript{27} See 11 U.S.C. § 109(b)(2).
I understand that because of continued banking industry opposition, this approach did not become part of Revised Article 9. However, in light of the *In re Commercial Money Center* debacle and the concerns laid out in this essay, perhaps it’s time that banks recognize that this approach may well have merit—and that § 9-309(3) represents neither their best interests nor the best interests of any other buyer or seller of, or party secured by, payment intangibles.

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28 Professor Mooney recalls that there may have been opposition also from non-bank financial institutions that buy and sell loan participations. Theoretically, at least, the approach described in the text above could be adapted to apply to any definable group of financial institutions.