11-1-1994

Article 9 in Revision: A Proposal for Permitting Security Interests in Nonassignable Contracts and Permits

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ARTICLE 9 IN REVISION: A PROPOSAL FOR PERMITTING SECURITY INTERESTS IN NONASSIGNABLE CONTRACTS AND PERMITS

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I. INTRODUCTION

As we practitioners address in this Symposium the issue of whether the Uniform Commercial Code (UCC) is dead or alive, many of us will focus upon our "pet peeves." These are those little annoyances that arise in our practice when we whimsically find that the language of the UCC first appears to help us reach a result for a client but does not actually do so. Many of you who read this paper may conclude that it addresses merely one commercial lawyer's favorite pet peeve in an isolated area of practice. I urge you, however, to read on.

The question that I raise in this Essay is whether a secured party should be permitted to take a security interest in otherwise nonassignable rights that the debtor may have obtained from contracts with third parties or from licenses or permits—which I shall refer to generally herein as "permits"—issued by federal, state, or local governmental agencies. This question, which surfaced in the deliberations of the Article 9 Study Committee appointed by the Permanent Editorial Board (PEB) of the UCC, eventually became Study Committee Recommendation No. 23.[1] It is likely that this question will be addressed

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1. PERMANENT EDITORIAL BD. FOR THE UNIFORM COMMERCIAL CODE, PEB STUDY GROUP, UNIFORM COMMERCIAL CODE ARTICLE 9 REPORT § 23 (Dec. 1, 1992) [hereinafter STUDY GROUP REPORT].

as the Article 9 Drafting Committee[2] attempts to revise Article 9 to meet today's commercial needs.[3]

The answer to this question may be an important component in the answer to the larger question raised in this Symposium: whether the UCC is dead or alive. I say this, because, while the UCC may be alive today in our daily practices, many aspects of it are aging. For it to continue to have the vitality with which we have become accustomed in our practices, we need to be sensitive to areas where the economy, on which the text of the existing UCC was based, has changed. In so doing, we must consider where old concepts and approaches should be adjusted and where new concepts and approaches should be considered.

For purposes of this discussion, I will first mention why the issue—whether a secured party should be permitted to take a security interest in otherwise nonassignable rights that the debtor may have in either contracts or permits—is an important one. Second, I will give several examples of cases where the issue is likely to arise. Third, I will comment briefly upon some recent cases at the federal level. Fourth, I will make suggestions how a revised Article 9 might address the issue. Finally, for purposes of completeness, I will set forth what may be recognized as the limitations of a revised Article 9 in addressing the issue.

II. Importance of the Issue

The issue of whether the debtor can grant a security interest in its rights in otherwise nonassignable contracts and permits is primarily important in the context of what are commonly referred to as secured "cash flow" credit facilities extended by institutional lenders. In these secured credit facilities, the debtor's ability to repay the lender is predicated on the debtor continuing in business and generating the cash flow to service the debt. Often the size of the credit facility, or the amount of credit extended, is based upon a projection of the earnings that the debtor should generate over the loan's term. The lender

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2. The Article 9 Drafting Committee is appointed by the American Law Institute and the National Conference of Commissioners of Uniform State Laws. Agreement Describing the Relationship of the American Law Institute, The National Conference of Commissioners on Uniform State Laws, and the Permanent Editorial Board with Respect to the Uniform Commercial Code, *reprinted in* 64 A.L.I. Proc. 769, 771 (1987) (discussing relationship between American Law Institute and National Conference of Commissioners on Uniform State Laws).

3. Article 9 was last revised in a comprehensive way over twenty years ago. *See* Study Group Report, *supra* note 1, at 2.

typically tries to secure payment of the credit by taking a "blanket" security interest in all or substantially all of the existing and after-acquired assets of the debtor, including the "goodwill" of the debtor's business. Unlike secured "asset based" credit, if the debtor is unable to generate the requisite cash flow or stops doing business, liquidating the debtor's assets will probably not generate sufficient proceeds to repay the lender. When a cash flow loan becomes troubled, the lender's "workout" strategy is often to assist the debtor in a financial or operational restructuring, or a sale of all or some part of the debtor's assets as a "going concern." Such a strategy may or may not involve the debtor becoming a debtor under Chapter 11 of the Bankruptcy Code.

Assuming that the debtor continues operations, the secured cash flow lender usually regards the premium comprising the debtor's going concern value over its liquidation value as a goodwill element that is captured by the lender's security interest. In Article 9 terms, a goodwill element is classified as a "general intangible."[4] The lender's argument is that if the debtor's assets were sold as a going concern, the sales proceeds, including the goodwill premium, would belong to the secured creditor as proceeds of the collateral regardless of how a buyer itself may allocate the purchase price among the assets.

In many instances, in an enforcement or bankruptcy context, the cash flow lender's assertion of its entitlement to the entire proceeds of the sale of the debtor's assets[5] goes unchallenged.

In other instances, however, the lender's assertion is challenged in a serious fashion by a bankruptcy trustee, creditors' committee, or the like where the going concern value of the debtor's business is dependent upon nonassignable contracts or permits in favor of the debtor. The argument against the secured lender capturing the debtor's going concern value as part of its security interest is framed along the following lines: The debtor cannot grant to the secured lender a security interest in the particular contract or permit because it is by its terms nonassignable. In other words, the debtor has no rights in this particular item of collateral in which to grant a security interest. If the lender has no security interest in that contract or permit, then the lender cannot have a security interest in the debtor's going concern value. That is because, without that contract or permit,

4. *See* U.C.C. § 9-106 cmt. (1990) (stating that goodwill is example of general intangible).

5. In a Chapter 11 plan, the lender would typically assert an interest in an amount equal to the total appraised value of the debtor's business as a going concern.

the debtor could not operate as a going concern at all. The most that the lender can capture as part of its blanket Article 9 security interest is the sales proceeds at liquidation prices or, in the context of valuing the security interest in a Chapter 11 plan, the liquidation value of the individual assets of the debtor in which the lender's security interest has attached and become perfected. But the going concern value of the debtor's assets in excess of the liquidation value of those assets, the argument goes, belongs not to the secured creditor but to general unsecured creditors or, if the debtor is a debtor in a bankruptcy case, to the bankruptcy estate.

While the secured lender may point to various provisions of the UCC permitting its security interest in the otherwise nonassignable contract or permit to attach, usually these provisions do not go far enough. Although section 9-318(4) invalidates anti-assignment clauses restricting the grant or enforcement of a security interest in an account or general intangible for money due or to become due,[6] it does not provide much help to the lender if the contract or permit in question does not involve payments to the debtor. Similarly, section 2-210(2) invalidates anti-assignment clauses relating to breach of contract actions,[7] but it does not provide assistance to the lender where the contract is not for the sale of goods or where the other party to the contract has not breached. Moreover, while revised section 2A-303[8] would appear to permit, notwithstanding the existence of an anti-assignment clause, the grant of a security interest in the personal property leasehold interest of a debtor-lessee, nevertheless the contract in question must be a lease of goods governed by Article 2A.

Perhaps the secured lender could point to section 9-311 as authority for the proposition that a debtor may always convey its interest in a nonassignable contract or permit.[9] But section 9-311 by its terms only applies where the debtor already has rights in the collateral; it does not create rights for the debtor in collateral which do not already exist independent of section 9-311. A closer reading of the literal language of section 9-311 indicates that the section assumes that the secured party already has a security interest in the collateral that is to be conveyed. Indeed, section 9-311, by its reference to a restriction on transfer contained in a security agreement, appears to address a restriction on transfer that is not inherent in the collateral itself but is

6. U.C.C. § 9-318(4).
7. *Id.* § 2-210(2).
8. *Id.* § 2A-303 (Official Text 1990).
9. *See id.* § 9-311.

imposed by a supplemental agreement once the security interest has already been created.

Furthermore, the argument that section 9-311 authorizes the debtor to grant a security interest in a nonassignable contract or permit may, even if successful, provide little solace to the lender. Unlike section 9-318(4) or revised section 2A-303, section 9-311 does not, of course, invalidate any rights of the party in whose favor the restriction on transfer was made. Accordingly, that party may still have the right to claim that, by the creation of the security interest, an event of default or other breach of contract or grounds for termination has occurred. In such a case, the secured party would, absent a "hell or high water" clause in the contract or permit which prohibits the assertion of defenses,[10] take its security interest subject to whatever those rights are, including the rights of the other party to terminate the contract or permit.[11] That party may in some circumstances even have grounds to bring an action against the secured party for tortious interference with its contract or permit with the debtor.

A discerning critic, observing these limitations under the existing UCC, might be tempted to say to the lender, "Too bad." Such credit facilities, which have no traditional asset coverage in the form of realizable collateral value on liquidation, are inherently risky. A lender that extends such credit facilities, the critic might say, deserves little sympathy from Article 9.

I would offer two responses to that critic. First, cash flow credit facilities have become an increasingly vital means for businesses to raise credit in this country. We see them in the "high tech" industry, in the media and entertainment industry, and in the financial services industry, among others. As our economy becomes more service based than manufacturing based, they may become even more common as a structure for financing businesses. To the extent that Article 9 can provide greater protections to secured lenders under these facilities, arguably the cost of credit to debtors under these facilities should be lower, and some businesses which might otherwise not be financed will obtain financing. Article 9 would then be fulfilling one of its purposes of permitting the continued expansion of commercial practices.[12]

Second, the protections that Article 9 could afford to such lenders with respect to otherwise nonassignable contracts and permits would

10. *See id.* § 9-206.
11. *See id.* § 9-318(1).
12. *See id.* § 1-102(2)(b).

not be so dramatic as to encourage the financing of businesses that, as a matter of prudent credit analysis, should not be financed at all. The protections that are suggested in this Essay would be relatively modest. They would be helpful to a secured lender where the debtor's business continues—whether in the hands of the debtor or a third party—as a going concern, but they would provide little protection to the secured lender where the debtor's business is liquidated. Moreover, even where the lender is well aware of the risks of taking a security interest in nonassignable contract and permit rights of its debtor and refuses to proceed with the credit transaction until those risks are eliminated by the obtaining of third-party consents, these suggestions for revising Article 9 may minimize the need for those consents or the transaction costs in obtaining them. Thus, while a revised Article 9 would enable a lender to extend credit in more situations, it would not affect the lender's overall credit judgment that it needs to be protected from those risks before it extends the credit.

III. EXAMPLES

The following examples illustrate situations where the issue of the extent of a secured lender's security interest in a debtor's nonassignable contract or permit rights might arise.

A. *Example 1*

Debtor is in the business of developing and licensing customized computer software to end users. The software is based on a special program licensed to Debtor by Big Licensor. Under the terms of Debtor's license agreement with Big Licensor, Debtor is permitted to modify and sublicense Big Licensor's software as an element of Debtor's customized software. Although Big Licensor has licensed a large number of licensees on this basis, each license, including that which Debtor has entered into with Big Licensor, requires Big Licensor's consent to any assignment by Debtor, whether by encumbrance or otherwise, of Debtor's rights in the license agreement. Bank provides working capital to Debtor and claims a security interest in all of Debtor's assets. Bank monitors Debtor's performance based upon covenants designed to insure that Debtor's projected earnings will be more than sufficient for Debtor to pay its debt service. When Debtor's financial performance deteriorates, it files for bankruptcy. Buyer acquires Debtor's business out of the bankruptcy for cash and, as part of that transaction, obtains Big Licensor's consent to the assignment to Buyer of Debtor's license agreement with Big Licensor.

Debtor's bankruptcy trustee, while acknowledging that Bank is entitled to the nominal cash proceeds attributable to Debtor's goods and accounts, contests Bank's entitlement to the balance of the cash proceeds. The bankruptcy trustee claims that these proceeds are attributable to Debtor's ability to create a future stream of earnings and that that earnings stream would not have been possible if Buyer were not also acquiring Debtor's license from Big Licensor. Because Bank's security interest in that license never attached, the bulk of the sales proceeds are not proceeds of Bank's collateral.[13]

B. *Example 2*

Debtor is in the cable television business. It provides cable television services to numerous communities under franchise agreements with those communities. Each agreement provides that the franchise may not be assigned, by encumbrance or otherwise, without the community franchisor's consent. Bank has provided financing to Debtor to enable Debtor to acquire cable television equipment and to install hookups in each community and for general working capital purposes. Bank has claimed to have taken a security interest in all of Debtor's assets to secure that financing. Bank monitors Debtor's performance based upon covenants designed to insure that Debtor's expected customer subscription revenues after operating expenses will be more than sufficient to pay Debtor's debt service. Experiencing fierce competition, Debtor decides to sell several franchises to Buyer, a competing cable television company, for cash. Buyer attends several public hearings held by the franchisor communities and obtains their permission for Debtor to assign the franchises to Buyer. At the closing, the cash proceeds of the sale are paid to Bank. Sixty days later, Debtor files for bankruptcy. The bankruptcy trustee claims that Bank was undersecured because it did not have a security interest in the franchises. Therefore, from the trustee's perspective, any proceeds that Bank received in excess of the value of Debtor's other assets in which Bank had a perfected and unavoidable security interest was a preference and recoverable under the Bankruptcy Code.[14]

13. *Cf. In re* Specialty Foods, Inc., 98 B.R. 734, 735 (Bankr. W.D. Pa. 1989) (holding that lender's security interest in debtor's "rights to the payment of money however evidenced or arising including each existing and future . . . general intangible . . . with all trademarks" did not include, within grant of security interest, security interest in debtor's rights as licensee under trademark licensing agreement so as to entitle lender to proceeds of sale of debtor's rights in that licensing agreement).

14. *Compare* First Pennsylvania Bank, N.A. v. Wildwood Clam Co., 535 F. Supp. 266, 268 (E.D. Pa. 1982) (holding that lender's security interest in general intangibles extends to

C. *Example 3*

Debtor operates a hotel. Bank has provided financing to Debtor to acquire the property and build the hotel and is being repaid out of ongoing hotel receipts. To secure that financing, Bank has taken a real estate mortgage over the hotel and claims a security interest in all of Debtor's personal property assets. Debtor files for Chapter 11. At the time, Bank's loan is $20,000,000; the appraised value of Debtor's hotel, if sold as a going concern, is $25,000,000; and the appraised value of Debtor's real estate, goods, and accounts, if sold at liquidation, is $15,000,000. Debtor proposes a Chapter 11 plan which values Bank's secured claim at $15,000,000. Debtor claims that the premium of $10,000,000 of going concern value over liquidation value is attributable to Debtor's ability to operate a hotel. That operation, however, requires a liquor license for Debtor's restaurant and bar facilities. And Bank does not have an attached security interest in Debtor's liquor license which, under applicable state law, could not be "assigned" without the local liquor license authority's consent. That consent never having been obtained, Bank's security interest must be valued at what Bank could realize on liquidation of Debtor's real property, goods, and accounts, that is, only $15,000,000.[15]

These few examples highlight what is becoming an increasingly problematic situation for secured cash flow lenders. With any ongoing business, the debtor's otherwise nonassignable contract and permit rights may in fact be assigned as part of a sale of the debtor's business or otherwise have to be valued in the context of a bankruptcy reorganization. Lenders that have provided financing based upon the cash flow of the business and believe that that financing is secured by the value that a third party would attribute to that cash flow are often

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proceeds of sale of debtor's arguably nontransferable clamming license) *with In re* Amereco Envtl. Servs., Inc., 129 B.R. 197, 198 (Bankr. W.D. Mo. 1991) (holding that lender's security interest in general intangibles does not extend to purchase price of debtor's assets allocable to nonassignable hazardous waste operating permits reissued in name of buyer).

15. *See* Bogus v. American Nat'l Bank, 401 F.2d 458, 460-61 (10th Cir. 1968) (holding that security interest in debtor's liquor license was valid where state statute was narrowly construed to prohibit involuntary attachment or other judicial lien, but not to prohibit grant of security interest). *Compare In re* Rudy's Inc., 23 B.R. 1, 3 (Bankr. E.D. Mich. 1981) (holding that lender's security interest in debtor's liquor license was invalid where state liquor license commission, by administrative regulation, prohibited granting security interest in liquor license) *with In re* Pike, 62 B.R. 765, 769 (Bankr. W.D. Mich. 1986) (holding that where state liquor control act did not expressly prohibit grant of security interest in liquor licenses and administrative rule prohibiting such security interest was issued without proper legislative authority, Article 9 security interest in debtor's liquor license was valid).

unaware, or not fully aware, of how much of that cash flow depends upon those otherwise nonassignable rights. Although the lender's financing may have helped to create that cash flow and third-party contract and permit rights are not being affected upon a sale or bankruptcy valuation of the debtor's business, other creditors are often able to claim that some portion of the value of the debtor's business attributable to that cash flow has not been included in the lender's security interest.

IV. CASES AT THE FEDERAL LEVEL

Some recent related court decisions on the federal level deserve particular comment. Because the Federal Communications Commission's (FCC) regulations prohibit the encumbrance of an FCC broadcast license, several courts have had to face the issue of whether a lender's Article 9 security interest may attach to a debtor's FCC broadcast license. The issue becomes acutely relevant in valuing the secured party's collateral in the bankruptcy of a debtor broadcaster because a broadcaster's assets are virtually worthless without its ability to transfer its FCC license to a third party, albeit subject to FCC consent.

So far the Seventh Circuit in *In re Tak Communications, Inc.*[16] has taken the approach that the anti-encumbrance provisions of the FCC's regulations prohibit a security interest in an FCC license from attaching where the debtor has granted to the secured party a security interest in the debtor's general intangibles.[17] Accordingly, without the value of the debtor's business attributable to those licenses being captured by their security interest, the syndicate banks claiming a security interest in the debtor's FCC licenses were significantly undersecured, and the benefit of the debtor's going concern value passed to the bankruptcy estate.

But lower courts in other circuits have declined to follow the *Tak* decision. These courts have viewed the secured party's security interest in general intangibles, while not comprising a broadcast license itself, as somehow encompassing a proprietary right of the debtor prospectively to receive proceeds of a transfer of the broadcast license if and when a transfer of the broadcast license were to take place.[18] In

16. 985 F.2d 916 (7th Cir. 1993).

17. *Id.* at 918-19.

18. State St. Bank & Trust Co. v. Arrow Communications, Inc., 833 F. Supp. 41, 48-49 (D. Mass. 1993); *In re* Thomas Communications, Inc., 161 B.R. 621, 626-27 (Bankr. S.D. W. Va. 1993); *In re* Ridgely Communications, Inc., 139 B.R. 374, 379-80 (Bankr. D. Md.

facing a like argument from an Article 9 secured party over the proceeds of a consensual termination by a bankruptcy debtor of a nonassignable automobile franchise agreement, an Illinois bankruptcy court found these lower court arguments persuasive and, notwithstanding its situs in the Seventh Circuit, courageously held for the secured party.[19]

While the efforts of these lower courts are sympathetic, they are not without controversy. Normally, a secured party's security interest in proceeds of collateral does not attach until the proceeds are created.[20] If the debtor's interest in an asset in which the secured party had not perfected its security interest were sold during the preference period prior to the debtor's bankruptcy, any claim of the secured party to a then perfected security interest in the proceeds of the sale of that asset would be subject to preference attack.[21] If the interest were sold post-petition, the secured party's claim to the proceeds of the sale of that asset would be cut off by Bankruptcy Code section 552 because the proceeds would not be proceeds of collateral in which the secured party had an unavoidable perfected pre-petition security interest.[22]

To say that a secured party, however, may perfect its security interest today in a right to receive proceeds tomorrow—without perfecting its security interest today in the underlying collateral—proves too much under the current version of Article 9. If accepted, the argument would permit a secured party, for example, to perfect a security interest today in a right to receive ongoing payments under a promissory note where the secured party had failed to perfect its security interest in the promissory note by taking possession of it. That is certainly not the law today.[23] Further, it is difficult to see a distinction between underlying collateral consisting of a promissory note where the secured party has failed to take possession of the note in order to perfect its security interest and underlying collateral consisting of a nonassignable contract or permit where the secured party has failed to obtain a waiver of the valid nonassignability provision in order to permit the secured party's security interest to attach. If creating a security interest in a right to receive proceeds in the future as a

1992); *cf. In re* Cheskey, 9 F.C.C.R. 986, 986-87 (1994) (holding that security interest in proceeds of sale of license does not violate Commission's policy of preventing creditors from obtaining licenses through foreclosure without Commission's approval).

19. *In re* SRJ Enters., Inc., 150 B.R. 933, 941 (Bankr. N.D. Ill. 1993).

20. *See* U.C.C. § 9-203(1)(c) (stating debtor must have rights in collateral for security interest to attach).

21. *See* 11 U.S.C. § 547(e)(3) (1988).

22. *See id.* § 552.

23. *In re* Melon Produce, Inc., 976 F.2d 71, 76 (1st Cir. 1992).

separate item of collateral is not possible in one case, it would seem that it should not be possible in others as well.

Nevertheless, these lower court decisions may well be justified in their regulatory context. These courts have interpreted the FCC's regulations in ways that confine their impact to the regulatory framework in which they arose. They have done so by interpreting the FCC's regulations to leave the debtor licensee with some proprietary interest in its FCC license, a proprietary interest that is capable of being encumbered so long as the FCC's regulatory scheme is not prejudiced by the private contractual arrangements between the debtor and its creditors. In doing so, these courts struggled with the anomaly that, notwithstanding prohibitions on the encumbrance of the debtor's rights under the license involved, those prohibitions were designed to serve particular regulatory objectives that have little relevance to how proceeds of the transfer of the debtor's rights in the license, even with FCC consent, are divided among the debtor's creditors.

In narrowing the reach of the FCC's anti-encumbrance regulations to serve the purpose for which they were designed, these lower court decisions provide guidance to a more general statutory approach applicable to all contracts and permits where anti-assignment provisions are present.

V. Suggestions for Revised Article 9

The Article 9 that emerges from the current revision process might contain a provision by which assignment prohibitions relating to contracts and permits are ineffective where such prohibitions (1) would otherwise prevent a security interest in the debtor's rights in the contract or permit from attaching, or (2) would create a default by the debtor under the contract or permit. That same provision might also contemplate that enforcement of that security interest would be permitted only if (1) the consent of the third party, which is a party to the contract or has issued the permit, is not required under the terms of the contract or permit or on account of other applicable law, or (2) the third party in fact consents to any assignment effected by enforcement of the security interest. Absent any of those circumstances, however, the assignment prohibition and event of default would be given full effect with regard to any intended enforcement of the security interest.

The invalidation of an anti-assignment provision in a contract or permit so as to allow a security interest to attach deserves further explanation. Anti-assignment provisions, of course, are usually designed to prevent rights granted by contract or permit by a particular party or issuer from being given to someone not qualified or deserving, in the opinion of that party or issuer, to exercise those rights. In Example 1 above, Big Licensor does not want its software modified and customized by someone who might botch the job and leave Big Licensor with a black eye in the marketplace. In Example 2, each community franchisor wants to make sure that cable television services are provided to its community by someone who has both the expertise and financial resources to provide those services. In Example 3, the liquor licensing authority would want to make sure that, among other things, liquor is sold only by those in a position and having a record of responsibility.

But none of the legitimate interests of these third parties are being undermined or otherwise affected by permitting a secured lender's security interest in the debtor's rights in the contract or permit merely to attach. Attachment alone would provide inchoate rights to a secured lender; that is, rights that would be meaningful if the secured lender were to enforce its security interest. But, short of enforcement by the secured lender, it is hard to see why the transferability concerns of the third party do not remain protected. Indeed, it would appear to be this very distinction—between attachment of a security interest where third-party rights are not affected and enforcement of the security interest where third-party rights might well be affected—that lead to revised section 2A-303(3) invalidating clauses in Article 2A leases which would prevent a debtor-lessee from granting a security interest in its leasehold interest in the leased goods.[24]

It would likewise make sense that an event of default arising under the contract or permit on account of the debtor's granting a security interest to its lender should not be given effect short of enforcement of the security interest. Once again, the legitimate rights and concerns of the third party to the contract or the third party that issued the permit are not being affected. So long as that is the case, the third party should not have the ability to terminate the contract or permit or to bring an action against the lender for tortious interference.

24. *See* U.C.C. § 2A-303(3) (Official Text 1990) (stating that provision in lease agreement making creation of security interest in interest of party to lease in event of default is unenforceable unless or until lessee transfers its right of possession or use); *cf. id.* § 9-318(4) (stating that provision in contract between account debtor and assignor prohibiting creation of security interest in general intangible for money due or requiring account debtor's consent to such security interest is unenforceable).

Nevertheless, upon enforcement of the security interest, the third party's interest in preventing an unapproved transfer of the debtor's rights under the contract or permit should be protected. Assignment prohibitions in contracts and permits, and related events of default arising upon unapproved transfers, should be valid as a general matter and honored by Article 9 in security interest enforcement situations.

It is not unusual for a security interest to attach without the secured party being able to exercise remedies upon a default of the obligations secured. The Supreme Court, approximately sixty years ago, validated security interest-like status in favor of the Chicago Board of Trade.[25] The Board, which was owed unpaid membership dues by one of its members, could not compel the member to sell his seat on the Board to pay for unpaid dues.[26] But under the terms of the Board membership agreement, the Board was entitled, if the debtor member did decide to sell his seat, to withhold its permission for the seat to be sold unless the unpaid dues were paid.[27] The Supreme Court upheld the Board's ability to require payment of the unpaid dues as a condition to the sale of the membership seat even though the Board itself had no ability to force such a sale.[28] Furthermore, "toothless" security interests often exist in practice. For example, junior secured parties fairly routinely obtain waivers of inferior lien restrictions from senior secured parties. These waivers are often granted by senior secured parties on the condition, evidenced by an intercreditor agreement, that (1) the junior secured party acknowledge to the senior secured party that the junior secured party's security interest is in fact junior, and (2) the junior secured party agree with the senior secured party that the junior secured party will not exercise remedies without the senior secured party's consent.

However, there are two instances where those prohibitions on transfer contained in the otherwise nonassignable contract or permit, even on enforcement of a security interest, should not be respected. First, the prohibitions should not be respected where the secured lender can show that the transfer, if made directly by the debtor, would be permitted by the contract, permit, or other applicable law. For example, a contract, permit, or other applicable law may allow the debtor to transfer its rights in the contract or permit to anyone within a class of permitted transferees who have already been approved by

25. Chicago Bd. of Trade v. Johnson, 264 U.S. 1 (1924).
26. *Id.* at 14.
27. *Id.*
28. *Id.* at 15.

the third party to the contract, or by the third party that has issued the permit, but not to any transferee who does not fall within that class. A sale by the secured lender at a public or private sale pursuant to section 9-504 to a member of that class should be permitted even though, as a technical matter, the secured lender is arguably itself an unauthorized transferee momentarily in the "chain of title" relating to the transfer of the contract or permit. Second, the otherwise prohibited transfer by way of enforcement of a security interest should, of course, be permitted where the third party has in fact consented to the transfer. In this way, the secured lender would be able to retain whatever value is attributable to the otherwise nonassignable contract or permit as part of its security interest, less any cost to the secured lender of obtaining that third party's consent.

If a revised Article 9 were to address the issue of the debtor's ability to grant a security interest in an otherwise nonassignable contract or permit in this manner, the legitimate rights of third parties would remain protected. However, as may be the case under existing law, those third-party rights would not extend beyond protecting the third party itself. In particular, restrictions on assignment of contracts or permits would not be used as a means of allocating the value of those contracts and permits in the hands of the debtor among the debtor's secured lender and other creditors when the third party's rights are not being affected.

VI. LIMITATIONS OF ARTICLE 9

Even if these suggestions were adopted, they would not address for a cash flow lender every situation where the lender wished to take a security interest in an otherwise nonassignable contract or permit of its debtor. Federal governmental permits may remain nonassignable, even as collateral security, where federal law in fact prohibits the encumbering of such permits.[29] State or local governmental permits may also remain nonassignable, even as collateral security, where a state expressly chooses to adopt a rule for that governmental permit contrary to that suggested here for Article 9.

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29. U.C.C. § 9-104(a). *Compare In re* Rainbo Express, Inc., 179 F.2d 1, 5 (7th Cir.) (holding that certificates of public convenience, issued by Interstate Commerce Commission as nontransferable, may be subject to valid mortgage), *cert. denied*, 339 U.S. 981 (1950) *with* Stephens Indus., Inc. v. McClung, 789 F.2d 386, 390 (6th Cir. 1986) (holding that FCC antireversionary interest rules do not permit seller to retain purchase money security interest in broadcast license transferred to buyer as part of sale of broadcast station).

Moreover, where the debtor becomes a debtor under the Bankruptcy Code, other issues may arise. Notwithstanding that Article 9 may render invalid an anti-assignment provision in a contract or permit, the contract or permit may not be capable of assignment or assumption by the debtor, either because of the nature of the contract or permit,[30] or because of the inability of the debtor to meet the requirements for assumption or transfer.[31] Furthermore, even where the contract or permit is capable of assumption or assignment by the debtor, if the ability of the debtor to assume or assign the contract arises *solely* by virtue of the invalidation of anti-assignment clauses under the Bankruptcy Code itself,[32] the trustee may claim that the secured lender is not entitled to any benefit arising on account of that invalidation. This is based upon the theory that any such benefit so effected by the Bankruptcy Code should flow to the bankruptcy estate rather than to a particular creditor otherwise not entitled to that benefit under nonbankruptcy law.[33]

In revising Article 9, these limitations should not be overlooked. Nevertheless, these limitations do not justify a revised Article 9's failure to address the issue of a debtor granting to its secured lender a security interest in otherwise nonassignable contract or permit rights in so far as it can.

30. 11 U.S.C. § 365(c)(1)-(2) (1988).

31. *Id.* § 365(b), (f).

32. *Id.* § 365(f).

33. *Cf.* James F. Queenan, Jr., *Standards for Valuation of Security Interests in Chapter 11*, 92 COM. L.J. 18, 62-63 (1988).