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CONTRACTING OUT OF ARTICLE 9

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I. INTRODUCTION

Article 9 of the Uniform Commercial Code (U.C.C.),1 Secured Transactions, governs the rights of parties to secured transactions.2 Article 9 also establishes a scheme that determines the priorities of claims against personal and fixture property, whether the claimants are parties to a transaction, such as a secured transaction, or have claims arising outside of contract.3 This priority system is designed to promote certainty and reduce the costs of commercial transactions.4

The parties to a secured transaction can agree to modify or waive many, but not all, of the provisions of Article 9.5 Opting out of Article 9 entirely, however, could result in the circumvention of the Article 9 non-waivable rights benefiting debtors, and, in all probability, would also impact the rights of third parties who might be acting in reliance on the predictability and certainty of the Article 9 priority system.6 Parties should proceed with caution when

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1. Unless otherwise noted, references to specific sections of the U.C.C. are references to the applicable sections of the Official Text. References to U.C.C. section 1-201(37) are references to the former Official Text. U.C.C. § 1-201(37) (1989).
3. See id. § 9-322.
6. See E. States Life Ins. Co. v. Strauss (In re Crawford), 274 B.R. 798, 806 (B.A.P. 8th Cir. 2002) (stating that, under Missouri law, section 9-301’s “perfection and filing requirements are for the benefit of third parties”).
entering into contracts that might benefit themselves at the expense of other stakeholders whose rights would be impaired, or when constructing contracts to avoid the obligations imposed by Article 9 on parties to secured transactions.

Although contracting out of Article 9 entirely is a perilous undertaking, parties may be able to structure transactions in such a way that the fundamental economics more closely resemble another type of transaction that is outside of the scope of Article 9, such as a non-Article 9 "true sale" or "true lease." As discussed in Part II below, tension in this type of structuring tends to arise when the parties wish to retain the economic substance of a secured financing. Transactions structured with this inherent tension may be vulnerable to recharacterization as secured transactions.

Alternatively, the parties might desire to stay within the scope of Article 9, but avoid its most burdensome requirements. Unless there is a legal impediment, parties to secured-transaction contracts can generally waive their own rights, even if statutorily granted, if not the rights of others.\(^8\) Under Article 9, certain provisions that protect the rights of debtors cannot be waived,\(^9\) and others can only be waived or modified under specified circumstances.\(^10\) As discussed further in Part III of this article, other standards, such as commercial reasonableness, may govern any agreement to modify these rights.

Finally, parties may wish to contract out of particular rules under Article 9, and into a different set of rules. Part III of this article addresses whether parties can change the Article 9 rules applicable to their transaction by contractually altering the properties

\(^7\) See 4 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 30-3, at 14 n.18 (5th ed. 2002) ("A lease involves payment for the temporary possession, use and enjoyment of goods, with the expectation that the goods will be returned to the owner with some expected residual interest of value remaining at the end of the lease term. In contrast, a sale involves an unconditional transfer of absolute title to goods, while a security interest is only an inchoate interest contingent on default and limited to the remaining secured debt."); see also In re Grubbs Constr. Co., 319 B.R. 698, 715 (Bankr. M.D. Fla. 2005) ("The central feature of a true lease is the reservation of an economically meaningful interest to the lessor at the end of the lease term."); In re Frady, 141 B.R. 600, 602 (Bankr. W.D.N.C. 1991) (holding that a rental agreement constituted a true lease where debtor could terminate agreement at any time with no further obligation to continue paying rent, but recognizing that "[a] terminable lease with an option to purchase may be characterized as a ‘sale’ . . . if the contract obligates the lessor to transfer ownership for ‘nominal consideration’").


\(^9\) Id. § 9-602.

\(^10\) See id. §§ 9-602, 9-603, 9-624.
of the assets serving as collateral.

II. THE PERILS OF ATTEMPTING TO CONTRACT OUT OF ARTICLE 9 ENTIRELY

By its terms, Article 9 governs any transaction, "regardless of its form, that creates a security interest in personal property or fixtures by contract,"\(^{11}\) in addition to agricultural liens, certain sales, consignments, and certain interests arising under Articles 2, 4, and 5 of the U.C.C.\(^ {12}\) The applicability of Article 9 is a substance-over-form test: "[w]hen a security interest is created, [Article 9] applies regardless of the form of the transaction or the name that parties have given to it."\(^ {13}\) A security interest is usually created in a contract between two parties: a debtor, who owes an obligation, and a secured party, to whom the obligation is owed.\(^ {14}\) The contract generally provides that the secured party will have rights in certain (or substantially all) assets of the debtor as collateral, and can monetize those assets in the event that the debtor fails to repay its obligations.\(^ {15}\) A secured party that has taken the steps under Article 9 to perfect its security interest in the assets of the debtor serving as the debtor's collateral will be entitled to priority over any unsecured creditor with respect to those assets. A perfected security interest takes priority over an unperfected security interest,\(^ {16}\) regardless of whether the unsecured creditor's claim predates the secured claim or arises later,\(^ {17}\) and regardless of whether the unsecured creditor is aware of the secured transaction.\(^ {18}\) As a result, the Article 9 priorities often govern the extent of non-party claimants' recoveries if the

\(^ {11}\) Id. § 9-109(a)(1).

\(^ {12}\) Id. §§ 9-109 (a)(2)–(6).

\(^ {13}\) Id. § 9-109 cmt. 2. See generally U.C.C. § 2-401 (2003) (passing of title to goods); id. § 2-505 (reservation of security interest by bill of lading); id. § 2-711(3) (buyer's security interest in rejected goods); id. § 2A-508(5) (lessee's right to deduct for damages due to default); U.C.C. § 4-210 (1989) (security interest of collecting bank); U.C.C. § 5-118 (1995) (security interest of issuer or nominated person under letter of credit).

\(^ {14}\) See U.C.C. § 1-201 (1989); see also Brown v. Jenkins, 218 S.E.2d 690, 692 (Ga. Ct. App. 1975) ("Unless specifically restricted, a security interest may be created by the contractual agreement of two parties to secure the payment of an obligation by creating rights in one party as to certain designated collateral.").

\(^ {15}\) U.C.C. § 9-607(a) (2001).

\(^ {16}\) See, e.g., id. § 9-322(a)(2).

\(^ {17}\) Id. § 9-322 cmt. 4, ex. 1.

\(^ {18}\) Id.
obligations are not repaid on the contract terms. Given these priorities, why would a secured party choose to contract out of the application of the Article 9 priorities?

Often, business objectives outside of Article 9 drive this decision. For instance, tax benefits may accrue in a leasing transaction that make the economic package more attractive. In addition, bankruptcy planning may play a significant role, since the rights of an owner whose asset was purchased from or leased to a debtor in an insolvency are quite different from the rights of a creditor who has loaned money against that asset. Finally, parties may occasionally wish to structure a transaction as a sale or lease because restrictive provisions in their other agreements prohibit the incurrence of additional debt.

Whatever their reasons, parties that intend to contract out of Article 9, but enter into agreements that have attributes of both secured financings and other transaction types, may still be subject to Article 9, because a court analyzing the economic substance of the transaction may recharacterize it as a disguised financing. Conversely, the transaction could ultimately pass muster as a true lease, true sale or other transaction, but only after a challenge by the debtor, its trustee in bankruptcy or another creditor whose position would be improved if the transaction were recharacterized as a secured financing and the seller or lessor were re-cast as an unperfected secured party. Recharacterization would return the sold or leased assets to the debtor's estate, where they would be

19. *See, e.g.*, Friedman v. Comm'r, 66 T.C.M. (CCH) 1404, 1408 (1993), *rev'd on other grounds*, Friedman v. Comm'r, 53 F.3d 523 (2d Cir. 1995) (finding that "computer-leasing transaction was without economic substance and was entered into solely for the tax benefits").


21. *See, e.g.*, Dev. Specialists, Inc. v. Hamilton Bank, N.A. (*In re Model Imperial, Inc.*), 250 B.R. 776, 781–83 (Bankr. S.D. Fla. 2000) (finding that debtor had fraudulently booked "sales" to obtain improper financing after debtor had entered into a loan agreement that restricted its ability to borrow money to 85% of total receivables and 55% of total inventory).

22. *See, e.g.*, In re Grubbs Constr. Co., 319 B.R. 698, 720 (Bankr. M.D. Fla. 2005) (holding that several "leases" governing the purchase of equipment from third-party vendors were "clearly" security agreements governed by Article 9); Borg-Warner Acceptance Corp. v. Dugger (*In re Teel*), 9 B.R. 85, 89 (Bankr. N.D. Tex. 1981) (finding that a "lease was intended as a security device" and that the lease transaction was a disguised financing subject to Article 9 priority rules). *See also* WHITE & SUMMERS, *supra* note 7, at 11–12.

23. *See, e.g.*, Cook Sales, Inc. v. Shores (*In re Shores*), 332 B.R. 31, 39 (Bankr. M.D. Fla. 2005) (finding existence of a true lease where lessee had option of terminating the lease at any time by written notice to lessor and where the useful life of the leased property exceeded the terms of the lease).
available to other claimants, thus defeating the parties' objectives.\textsuperscript{24}

Alternatively, a secured creditor's interest in contracting out of Article 9 could arise after the fact, such as when the debtor has defaulted and the secured party, in reviewing its records, realizes that it has failed to take the necessary steps to perfect and ensure the priority of its security interest. A secured party with an unperfected security interest will typically be treated as an unsecured creditor.\textsuperscript{25}

In such a predicament, the secured party might consider whether the transaction could pass muster as a sale, lease or other non-Article 9 transaction. In all of these circumstances, the parties, though they may prefer classification of the transaction as a sale or lease, should consider simply filing the financing statements and taking the other steps that will perfect and protect their interests in the event of recharacterization. Prophylactic perfection may also serve as a disincentive to other parties to litigate the matter, as a perfected secured party will still have a priority claim to the assets in question even if the transaction is recharacterized.\textsuperscript{26}

Structuring a transaction as a lease or a sale is a process replete with issues for the contracting parties.

\textbf{A. Structuring Transactions as Leases}

Numerous cases have considered whether particular leases were in fact disguised financings.\textsuperscript{27} While the results are not entirely consistent, the critical factor is usually the "economic substance of the transaction rather than 'the locus of title, the form of the transaction or the fact that the transaction is denominated as a 'lease.'"\textsuperscript{28} "Courts look [to] the economic reality underlying a

\textsuperscript{24} See, e.g., \textit{In re Marhoefer Packing Co.}, 674 F.2d 1139, 1143 (7th Cir. 1982).


\textsuperscript{26} Liona Corp. v. PCH Assocs. (\textit{In re PCH Assocs.}) (\textit{PCH II}), 949 F.2d 585, 600 (2d Cir. 1991) (treating priority claim as an equitable mortgage).

\textsuperscript{27} See Lawrence Ponoroff & Stephen E. Snyder, \textit{Commercial Bankruptcy Litigation} § 1:6, at 1-27 (2004); \textit{WHITE & SUMMERS}, supra note 7, at 24-25.

questioned agreement and not to the labels applied by the parties to determine the true nature of a transaction.\textsuperscript{29} Former U.C.C. section 1-201(37)(b) sets forth a series of objective factors for recognizing when a purported lease is in fact a disguised financing.\textsuperscript{30} These factors create "a bright line test whereby, as a matter of law, a transaction creates a security interest."\textsuperscript{31} The analytic difficulty arises in transactions that do not squarely meet these definitive criteria. In these cases, where the transaction has attributes of both a lease and a secured financing, and recharacterization as a secured transaction is not compelled by the 1-201(37)(b) factors, additional probing is required to determine whether the transaction more closely resembles a lease or a security interest.

Failure to meet one of the conditions says only that the document is not conclusively a security agreement; the pinball has safely rolled past four holes each marked security agreement. Evasion of those four holes does not earn one enough points to become a lease. Finding economic life beyond the lease term and seeing no nominal consideration option what should a court do? The court must then answer whether the lessor retained a reversionary interest. If there is a meaningful reversionary interest—

\textsuperscript{29} In re Dena Corp., 312 B.R. 162, 169 (Bankr. N.D. Ill. 2004).
\textsuperscript{30} The former Official Text of U.C.C. section 1-201(37) provided:

\begin{quote}
Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and
\begin{enumerate}
\item the original term of the lease is equal to or greater than the remaining economic life of the goods,
\item the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,
\item the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or
\item the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.
\end{enumerate}
\textsuperscript{U.C.C. § 1-201(37) (1989).}
\end{quote}

The comment to the Official Text of current U.C.C. section 1-203 provides, "This section is substantively identical to those portions of former Section 1-201(37) that distinguished 'true' leases from security interests . . . ." U.C.C. § 1-203 cmt. (2001).

either an up side right or a down side risk—the parties have signed a lease, not a security agreement. If not, vice versa.\textsuperscript{32}

Courts have reached varying conclusions on the importance of different factors in this second step of the true lease analysis. Some courts have even considered the intent of the parties in conjunction with the objective economic substance test.\textsuperscript{33} After a careful analysis, the court in \textit{In re QDS Components, Inc.} concluded that, if the bright line test is not met, the pivotal question is whether there is "substantial economic life" at the end of the lease term.\textsuperscript{34} This is a logical test, but not an easy one to administer. If the lessor prefers to contract out of Article 9, it may find that its only option is to restructure the transaction so that it not only satisfies the 1-201(37)(b) factors, but also passes economic muster as a true lease. That objective may be at odds with the parties' tax or other economic goals.

An additional danger can arise when a foreign lessor assumes that the law of its jurisdiction will govern the transaction. In \textit{In re Eagle Enterprises, Inc.},\textsuperscript{35} a German lessor and a Pennsylvania company entered into lease arrangements governed by German law for equipment to be used in Pennsylvania.\textsuperscript{36} In the bankruptcy, the lessor sought rejection of the leases and the return of its equipment, as well as compensation for the use of the equipment during the bankruptcy.\textsuperscript{37} Under German law, the transaction would be respected as a lease, but under Pennsylvania law, it would be an unperfected security interest.\textsuperscript{38} The court concluded that Pennsylvania law should govern the dispute, thereby relegating the lessor to the status of an unsecured creditor.\textsuperscript{39}

\textsuperscript{32} WHITE & SUMMERS, \textit{supra} note 7, at 24–25.
\textsuperscript{33} See Gen. Elec. Capital Corp. v. Video Update, Inc. (\textit{In re Video Update, Inc.}), Nos. 00-3663(JHW) to -3670(JHW), 00-3683(JHW), 2002 WL 1765618, at *4–*5 (D. Del. July 30, 2002) (holding that a purported lease was a security interest where lessee bore risk of loss of property and lessor did not customarily engage in the business of refurbishing and reselling leased equipment, which evidenced intent not to return equipment to lessee).
\textsuperscript{34} 292 B.R. 313, 322 (Bankr. S.D. Ohio 2002) (citing \textit{In re Marhoefer Packing Co.}, 674 F.2d 1139, 1145 (7th. Cir. 1982)).
\textsuperscript{36} \textit{Id.} at 291–92.
\textsuperscript{37} \textit{Id.} at 292.
\textsuperscript{38} \textit{Id.} at 292–93.
\textsuperscript{39} \textit{Id.} at 298–99.
B. Structuring Transactions as Sales

Like leases, sale transactions may be structured for a variety of purposes, but frequently transactions are structured as sales to optimize the buyer's bankruptcy planning.\textsuperscript{40} In a secured transaction, the financed collateral remains the property of the debtor's estate in a bankruptcy proceeding.\textsuperscript{41} The secured creditor may have a priority claim to those assets, but it is also subject to the procedural restrictions of a bankruptcy.\textsuperscript{42} If, however, the assets are sold to a third party, the sale proceeds become part of the bankruptcy estate. Then, the buyer retains at least some ownership of the assets and can use them without the necessity of obtaining court orders.\textsuperscript{43} For example, a company can borrow against its accounts receivable and give the lender a security interest. In the company's bankruptcy, the lender may be delayed or prohibited from collecting the receivables.\textsuperscript{44} If, however, the lender has purchased the receivables, it can collect them directly from the account debtors without intervention.\textsuperscript{45} This type of financing structure is particularly useful for cash-generating assets.

The parties to these transactions may be reluctant to contract out of Article 9 entirely, because its priority scheme offers a back-up position if the sale is recharacterized as a financing. In the 2001 revisions to Article 9, provisions were added that enable certain types of sales transactions to benefit from the certainty and predictability of Article 9 perfection and priority rules;\textsuperscript{46} sales of payment intangibles and promissory notes were added to sales of

\textsuperscript{40} See, e.g., In re Keating, No. 05-CV-5921 (JS), 2006 WL 2690239, at *5 (E.D.N.Y. Sept. 18, 2006) (finding that pre-bankruptcy planning by purchaser of an unqualified single premium annuity was permissible where purchaser did not have actual intent to defraud creditors).


\textsuperscript{42} See Maxi Sales Co. v. Critiques, Inc., 796 F.2d 1293, 1300 (10th Cir. 1986) (identifying only four types of assets in which a secured party has a perfected security interest in insolvency proceedings).


\textsuperscript{44} See id. (denying emergency relief where further discovery and evidentiary hearing were necessary to determine whether receivables remained property of debtor's estate).

\textsuperscript{45} If the secured party has become the absolute owner of the receivables and has no right of recourse against the debtor, it is obligated to collect the receivables in a commercially reasonable manner. U.C.C. § 9-607 cmt. 9 (2001). But cf. Mauna Loa Vacation Ownership, L.P. v. Accelerated Assets, L.L.C., No. CV030846PCTDGC, 2005 WL 2410676 at *3–*4 (D. Ariz. Sept. 28, 2005) (rejecting defendant's argument that the "commercially reasonable" standard applies only where the transferee is completely excluded from collecting on the note).

\textsuperscript{46} U.C.C. § 9-109 cmt. 5 (2001).
accounts and chattel paper as transactions subject to Article 9.\textsuperscript{47} Documents for these transactions routinely state that the intent of the parties is for the transaction to be a true sale, but many parties nonetheless include a perfected grant of security interest, just in case. However, parties might desire, for particular business reasons, to structure a sale transaction that falls completely outside the scope of Article 9.

To structure out of Article 9 entirely, parties could structure a transaction involving a sale of assets, other than those enumerated types of asset sales that are specifically included in the scope of Article 9. In contrast to the two-step test used to distinguish security interests from true leases, no guidance is provided by either Article 9 or the definition of “security interest” in Article 1 for distinguishing secured transactions from true sales.\textsuperscript{48} Rather, the question of what constitutes a true sale has been left to other law.\textsuperscript{49} Like the classification of true leases, the analysis should turn on the fundamental economic characteristics of the transaction. Parties seeking to structure true sales transactions should consider whether the asset is truly sold, ultimately a question of whether the risks and benefits of ownership are actually transferred from the purported seller to the purported buyer.\textsuperscript{50} Unlike the case of security interests versus true leases, however, the law has not developed reliable objective factors that would enable parties to structure true sales transactions with confidence.\textsuperscript{51} To distinguish between a true sale and a security interest, courts have considered a number of factors, including:

\begin{itemize}
  \item 47. Id. § 9-109(a)(3).
  \item 48. U.C.C. § 1-201(35) (2001).
  \item 50. Compare Bear v. Cohen (In re Golden Plan of Cal., Inc.), 829 F.2d 705, 709–10 (9th Cir. 1986) (respecting as a sale a mortgage loan sale with no recourse to seller), with Fireman’s Fund Ins. Co. v. Grover (In re Woodson Co.), 813 F.2d 266, 271–72 (9th Cir. 1987) (recharacterizing as a loan a mortgage loan sale where seller retained risk of loss).
\end{itemize}
1. Recourse. Although many courts have held that recourse alone is not sufficient to recharacterize a loan as a financing, it has often been cited as a factor. Where the buyer can collect from the seller if the purchased assets fail to perform, the seller has retained the risk of ownership of the asset. The extent of the recourse is important, as is the issue of whether the sale documents only provide recourse, or also provide reserves, indemnities or other protections for the seller against non-collection of the assets. The buyer is typically permitted to resort to the seller if the seller breaches its own representations and warranties as to the assets. Warranties that the assets will perform, however, or guarantees of collectibility, are indicia of disguised financings. It should not matter whether the recourse is an immediately available remedy or is activated by a condition or event, if the package of rights the buyer retains against the seller means that the buyer bears no risk of loss on the assets.

2. Substitution of Assets. Requiring or permitting the seller to substitute assets for the assets previously sold suggests that the buyer is still responsible for the sold assets, and may be a risky strategy for the parties who intend the transaction to be respected as a sale.

3. Discount Rates and Interest Rates. A number of courts have construed pricing terms that seem to compensate the buyer in a manner typical for lenders rather than buyers as indicia of a disguised financing. In these cases, courts have analogized dis-

52. See, e.g., Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 544 (3d Cir. 1979) (stating that the presence of recourse does not convert a sale into a security interest).


54. Netbank, FSB v. Kipperman (In re Commercial Money Ctr., Inc.), No. SC-05-1238-MOTB, 2006 WL 2505205, at *15 (B.A.P. 9th Cir. Aug. 25, 2006) (recharacterizing transaction as a loan where a buyer had none of the potential benefits of ownership and had not been allocated any risk of loss and the buyer had no possibility of receiving repayment of the "principal" and "interest").


56. See, e.g., In re Coronet Capital Co., 142 B.R. 78, 81 (Bankr. S.D.N.Y. 1992) ("Participation Agreements where the lead lender guarantees a return to the participant have been found to be disguised loans.").

57. See Major's Furniture Mart, 602 F.2d at 545–46.


59. See Liona Corp. v. PCH Assocs. (In re PCH Assocs.) (PCH II), 949 F.2d 585, 600–02
contract on sale to interest on a loan.60

4. Notice and Control. If there is an account debtor or other person obligated on the assets, and that obligated person is not notified of the sale, or the seller continues to hold and service the assets or use the assets in its business, the question arises whether the seller or buyer owns the assets.61

5. Return of Surplus. The buyer should not only bear the risk of loss, but also enjoy the benefits of ownership. True sale status may be undermined when the buyer is contractually required to turn over to the seller any surplus of collections on the sold assets over purchase price, whether by direct return, offset to purchase price on next sale date, automatic dividends or distributions made without director or manager action, or fees not reasonably related to services rendered.62

The foregoing list is not intended to be exhaustive, but merely indicative of the economic factors some courts have considered when distinguishing between a true sale and a security interest. Some courts may still focus the analysis on the intent of the parties.63 Under these circumstances, it is difficult to identify a consistent theme in the case law surrounding the factors courts should consider when distinguishing true sales from security interests.64 Accordingly, parties wishing to contract out of Article 9 and into sale transactions should consider the ramifications of recharacterization under certain standards.

III. CONTRACTING OUT OF SPECIFIC DUTIES

If contracting out of Article 9 entirely is fraught with risk, can the parties contract out of, waive or modify the more onerous duties? In transactions that fall within the scope of Article 9, the primary


61. See CC Fin., Inc. v. Ross, 301 S.E.2d 262 (Ga. 1983).


64. In re Commercial Loan, 316 B.R. at 700.
provisions that impose duties on secured parties for protection of debtors generally may not be waived or varied by agreement. However, Article 9 “does not restrict the ability of parties to agree to settle, compromise, or renounce claims for past conduct that may have constituted a violation or breach of those rights and duties.”

**A. Non-Waivable Rights**

U.C.C. section 9-602 sets forth the unwaivable rights of debtors. "If the parties sign a security agreement containing prohibited waivers, and then seek to enforce them, courts most often remedy violations of Section 9-602 by simply reading the relevant

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66. Id. § 9-602 cmt. 3.
67. Section 9-602 provides:

Except as otherwise provided in Section 9-624, to the extent that they give rights to a debtor or obligor and impose duties on a secured party, the debtor or obligor may not waive or vary the rules stated in the following listed sections:

1. Section 9-207(b)(4)(C), which deals with use and operation of the collateral by the secured party;
2. Section 9-210, which deals with requests for an accounting and requests concerning a list of collateral and statement of account;
3. Section 9-607(c), which deals with collection and enforcement of collateral;
4. Sections 9-608(a) and 9-615(c) to the extent that they deal with application or payment of noncash proceeds of collection, enforcement, or disposition;
5. Sections 9-608(a) and 9-615(d) to the extent that they require accounting for or payment of surplus proceeds of collateral;
6. Section 9-609 to the extent that it imposes upon a secured party that takes possession of collateral without judicial process the duty to do so without breach of the peace;
7. Sections 9-610(b), 9-611, 9-613, and 9-614, which deal with disposition of collateral;
8. Section 9-615(f), which deals with calculation of a deficiency or surplus when a disposition is made to the secured party, a person related to the secured party, or a secondary obligor;
9. Section 9-616, which deals with explanation of the calculation of a surplus or deficiency;
10. Sections 9-620, 9-621, and 9-622, which deal with acceptance of collateral in satisfaction of obligation;
11. Section 9-623, which deals with redemption of collateral;
12. Section 9-624, which deals with permissible waivers; and
13. Sections 9-625 and 9-626, which deal with the secured party’s liability for failure to comply with this article.

Id. § 9-602.
documents as if the offending clause had never been included."\footnote{68} Although parties are unlikely to be successful in waiving the rights of the debtor or obligor and the duties of a secured party,\footnote{69} the parties may agree on standards to satisfy those rights, except breaching the peace, if the agreed standards are not manifestly unreasonable.\footnote{70}

In a ruling on a motion for a new trial, the court in \textit{Still v. Regulus Group LLC}\footnote{71} perhaps set the outer limit for defining manifest unreasonableness. Still had agreed to a formula for valuing shares he had posted as collateral.\footnote{72} The court rejected Still's claim that "no reasonable jury could conclude that the formula was not 'manifestly unreasonable,'" where the formula could result in a negative $257 million valuation for the shares.\footnote{73} Other cases have applied the "manifestly unreasonable" test to a variety of standard-setting agreements, including an agreement that established standards for a foreclosure sale,\footnote{74} and an agreement that did not require the broker-dealer to segregate cash collateral in its possession.\footnote{75}

\textbf{B. Post-Default Agreements}

In addition to non-waivable rights, Article 9 provides debtors with certain rights that may be waived only by "an agreement to that effect entered into and authenticated after default":\footnote{76} (1) the right to notification prior to disposition of collateral,\footnote{77} (2) the right to mandatory disposition of consumer goods\footnote{78} and (3) the right to redeem collateral on tendering fulfillment of all of the obligations secured by the collateral and related expenses.\footnote{79}
IV. EMERGING TRENDS IN CONTRACTING OUT BY MORPHING COLLATERAL

The perfection and priority rules in Part 3 of Article 9 turn upon the type of property serving as collateral. For example, a secured party can perfect a security interest in tangible chattel paper by filing a financing statement or by taking possession of the collateral, but can only perfect a security interest in a deposit account by obtaining control of the collateral.

But is the categorization of collateral absolute, or can collateral metamorphose? Categorization of types of collateral varies with the use the debtor makes of the property. The classic example is a tangible item, such as a telephone, which is always "goods" (and very likely has embedded "software"), but is also "inventory" while it is held for sale or lease, and may become "equipment" if it is purchased for use in a business, or "consumer goods" if purchased for personal or family use. Can the parties to a contract vary the categorization of collateral, and contract out of a particular perfection and priority methodology?

Consider a "payment intangible," which is a "general intangible under which the account debtor’s principal obligation is a monetary obligation." These uncluttered payment rights generally arise when rights to payment are separated from a bundle of other contract rights. For instance, if a bank makes a loan and does not require the borrower to sign a promissory note as tangible evidence of the debt, its right to repayment is a payment intangible. The bank may participate out its interest in the loan by selling rights to payment to another bank, which does not become a party to the loan contract with the borrower or acquire other rights, other than the right to receive its ratable share of the borrower’s payments. Those

80. Id. § 9-312(a).
81. Id. § 9-313(a).
82. Id. § 9-312(b)(1).
83. Id. § 9-102(a)(44).
84. Id.
85. Id. § 9-102(a)(48)(B).
86. Id. § 9-102(a)(33).
87. Id. § 9-102(a)(23).
88. Id. § 9-102(a)(61).
89. Id. § 9-102 cmt. 5(d).
90. See id.
payment rights are also general intangibles, although their characteristics are different from those of the seller bank's payment intangible.91

Sales of payment intangibles enjoy Article 9's lowest-maintenance perfection requirements because they are automatically perfected.92 If, however, the original payment right is not a payment intangible, like the first bank's loan, but a right to receive a royalty payment for a copyright license, the royalty is an account.93 Security interests in accounts must be perfected by filing appropriate financing statements.94 The licensor may wish to monetize that royalty without the necessity of ensuring that the financing statement information is correct, filing the financing statements and remembering to continue them before they expire.

If the licensor who receives that royalty sells the right to payment to a third party without transferring any rights in the underlying license, does the sold payment stream remain a royalty, and thus an account, or does it become only a naked right to receive payment, and thus a payment intangible?95 Does the asset always carry the characteristics of its origin, or can it be refashioned into a different asset type?

Until quite recently, this question remained much discussed but unanswered, suggesting that parties relying on automatic perfection in such situations were at risk. Some illumination, however, has been provided by the recent decision in Netbank, FSB v. Kipperman (In re Commercial Money Center, Inc.)96 The case involved payment streams derived not from license royalties, but from chattel paper.97 The court defined chattel paper as "a record or records that evidence both a monetary obligation and a security interest in or a lease of

91. Id.
92. Id. § 9-309(3).
93. An "account" is "a right to payment of a monetary obligation, whether or not earned by performance." Id. § 9-102(a)(2).
94. Id. § 9-310(a).
95. Note that the definition of "general intangible" in U.C.C. section 9-102(a)(42) excludes "accounts," but does not exclude rights to payment under accounts, while the definition of "accounts" in U.C.C. section 9-102(a)(2) excludes rights to payment arising under chattel paper, instruments, payment for money, and funds advanced or sold. Id. § 9-102(a)(2), (a)(42).
97. Id. at *5.
specific goods. Based on this definition, the court concluded that a severed payment stream was not chattel paper, because it was neither a record nor evidence of a monetary obligation and a security interest, but was itself a monetary obligation.

Since "royalty" is not a term defined in the U.C.C., it is not as clear that a payment stream separated from a royalty would not still be considered a royalty. This is a developing area of law; parties therefore should not rely on automatic perfection for similar transactions, particularly because the automatic perfection rule applies only to sales of general intangibles, not security interests in general intangibles. In the Netbank case, although the court found that the separated payment stream was a payment intangible, the transaction was determined to be a financing, not a sale, and thus did not qualify for automatic perfection.

V. CONCLUSION

In structuring transactions that may challenge the applicability of Article 9 and its priority system, parties should focus on the economic realities of their business deals. If a purported sale or lease bears too many attributes of a secured financing, it runs the risk of being recharacterized as the latter. If non-Article 9 treatment is of paramount importance for tax, bankruptcy planning or other business considerations, the parties may have to accept transactional terms that do not stress-test the analysis. Disclosure is another critical consideration. To the extent that transactions are structured in a way that takes liabilities off the balance sheet, for example, parties should ensure that the liabilities are fully and clearly disclosed in footnotes or otherwise to avoid misleading investors and other interested parties. Within the parameters of careful structuring and disclosure, however, Article 9 proves to be a flexible and responsive system of rules that facilitates commercial creativity.

98. Id. at *7 (quoting NEV. REV. STAT. § 104.9102(1)(k) (2005)).
99. Id.
102. See CSX Transp., Inc. v. Bd. of Equalization, No. 1:02-CV-2634-CAP, 2005 WL 4694636, at *17 n. 18 (N.D. Ga. Sept. 29, 2005) (referring to the recent Enron scandal and noting that one way "Enron was able to deceive investors as to its value was by engaging in extensive off-balance sheet financing transactions").