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“Deemed” Security Interests in UCC Article 9: Avoiding Traps for the Unwary

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INTRODUCTION

Uniform Commercial Code (“UCC”) Section 1-201(35) provides in its detailed definition of security interests that “security interest” means “an interest in personal property or fixtures which secures payment or performance of an obligation.” Other parts of the UCC demonstrate that two relatively distinct kinds of security interests exist. First, the UCC notes that parties to transactions can create security interests by executing “security agreements.”² For convenience sake, the security interests created by security agreements can be called “conventional” or “agreed upon” security interests. Second, various sections of the UCC describe security interests that come into existence by operation of law rather than by execution of security agreements.

For convenience sake, this second group of security interests will herein be called “deemed” security interests. The “deemed” terminology is drawn from the analog in some Commonwealth countries to Article 9 of the UCC. That Commonwealth analog is the Personal Property Security Act (PPSA).³ It is unclear why the PPSA uses the

1. Paul Wangerin teaches at the John Marshall Law School (Chicago).

2. U.C.C. § 9-102(a)(73) (2015) (stating that security agreement means an agreement that creates or provides for a security interest).

3. See CUMMING, WALSH AND WOOD, *PERSONAL PROPERTY SECURITY LAW* 90-96 (2005); see also, Allan McDougall, *Personal Properties Securities Act*, Pringott Stinson (Sept. 27, 2011), <http://pigott.com.au/publications/another-super-duper-publication>; see also, Brown and Gagic, *PPSA Pt 2 — Key Implications for Leases, Other “Deemed Security Interests” and Liens* University of Adelaide Law School, University of Adelaide Law School Research Paper No. 2012-22 (Nov/Dec 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2132357. Note that in Commonwealth countries, non-true (aka dirty lease) cases are classified as being deemed security interests. It is important to note in this context that a number of differences exist between the Personal Property Securities Act (PPSA) of the Commonwealth countries and Article 9. The most important difference (for our purposes) between Article 9 and the PPSA is that the PPSA says that ALL leases of personal property are deemed security interests. This means that under the PPSA, ALL leases of personal property require affirmative steps for perfection of security interests, with those affirmative steps almost always being the creation of public records, filings. Conversely, Article 9 says that only SOME leases of personal property, “dirty” leases, are deemed security interests. So, under Article 9 only SOME leases of personal property require affirmative steps for perfection of interests.

term “deemed” to describe these kinds of security interests. However, it appears that the PPSA uses the term “deemed” for some security interests because in some cases the PPSA itself – rather than explicit agreement of the parties — creates security interests.⁴ “Deemed” security interests could also be called “operation of law” security interests. The contrast, of course, is to what herein are called “conventional” or “agreed upon” security interests, interests created by the execution of security agreements by the parties to transactions.

For several reasons, it is important to differentiate conventional (agreed upon) security interests and “deemed” (created by law) security interests. First, with conventional security interests, everybody involved will know of the existence of the security interests because the parties to secured transactions will have intentionally created these interests. If you intentionally create something, you know that it exists.⁵ So, people or businesses that have conventional security interests in property will always know that they have secured claims that they can assert. That is NOT the case with deemed security interests because in lots of situations parties protected by deemed security interests won’t even know that they are protected by such interests. This is because deemed security interests, as the following analysis demonstrates, sometimes are created by operation of law rather than by agreement of the parties⁶ If people don’t know they are protected by interests, they will not know to assert those interests. Second, with conventional security interests, all parties will know – or should know – that in many cases (though not all cases) they must take affirmative steps to perfect the security interests that they have, with those affirmative perfection steps usually being having possession of or taking control of property or creating public records of the interests in that property by filing. Different things are likely to happen with deemed security interests. Because parties protected by deemed security in-

4. CUMMING, WALSH AND WOOD, *supra* note 3 at 90-96; DEL DUCA, REILLY, SMITH AND WINSHIP, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE, 42-65 (2011); Claire Petereson, *Deemed security interests under Personal Property Securities Act 2009*, (Feb. 1, 2012), http://www.lavanlegal.com.au/index.php/publications/publicationdetail/deemed_security_interests_under_personal_property_securities_act_2009; Julian Lane and Laura Steele, *The effect of Personal the Personal Property Securities Act 2009 (cth) on the construction industry*, (Apr. 30, 2012), <http://www.holdingredlich.com/construction-infrastructure/the-effect-of-the-personal-property-securities-act-2009-cth-on-the-construction-industry>.

5. JAMES J. WHITE, & ROBERT S. SUMMERS, WHITE AND SUMMERS’ UNIFORM COMMERCIAL CODE 1148-49 (6th ed. 2010).

6. Conventional security interests are created by agreement of the parties to secured transactions, the debtors and the creditors. Since the parties themselves will create the security interests, they must necessarily know of the existence of the interests. See U.C.C. § 9-102(a)(73); see generally WHITE & SUMMERS, *supra* note 5, § 22-1.

terests sometimes don’t know that these security interests exist, some parties protected by deemed interests do not take affirmative steps to perfect the interests when such affirmative steps are needed for perfection.

Non-perfection of deemed security interests, in turn, can create two distinct problems. First, people or businesses who have unperfected deemed security interests in property are likely in many cases to lose out in priority battles to other creditors of the possessors of the pertinent property, and to the bankruptcy trustees or debtors in possession (DIP’s) for the possessors of the property.⁷ Second, if parties protected by deemed security interests have only unperfected interests in the property, then the bankruptcy trustees or DIP’s *for the protected parties* will get only unperfected security interests in the property. Thus, in unperfected deemed interest cases, the possessors of property might be able to keep that property away from the bankruptcy trustees or DIP’s for the protected parties.

I. ARTICLE 9’S “DEEMED” SECURITY INTERESTS IN GENERAL

Article 9 describes “deemed” security interests in several places. First, 9-109(a)’s description of the “Scope” of Article 9. Section 9-109(a) lists six kinds of transactions that are included in that scope.⁸ Section 9-109(a)(1) describes *both* “conventional” security interests

7. U.C.C. § 9-317 (provides that an unperfected security interest in property is subordinate to a judicial lien on the pertinent property). So if a judicial lien is obtained on property before the property is encumbered with a perfected security interest, that judicial lien has priority. This is important because § 544(a)(1) of the Bankruptcy Code says that as of the bankruptcy petition date, the trustee of the bankrupt (or the debtor-in-possession (DIP)), has the rights and powers of: a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists. In other words, the trustee (or DIP) is a hypothetical lien creditor that enjoys the protections of U.C.C. § 9-317. So if a secured creditor is perfected as of the petition date, its security interest trumps the DIP, and the estate benefits from the secured creditor’s collateral only after the secured creditor is repaid. However, if the secured creditor is not perfected as of the petition date, then the DIP prevails and the secured creditor shares pro rata with other unsecured creditors. Deemed security interests in property, in turn, allow claimants who have earlier-in-time deemed interests in property to have priority over later-in-time claimants to the property, including later-in-time bankruptcy trustees or DIPs. In some cases, the deemed interest holders need do nothing at all to have priority over later-in-time claimants because the deemed interests perfect automatically. In other cases, the deemed interest holders must take affirmative steps to perfect their interests, steps involving taking possession of or control over property or filing.

8. *Id.* § 9-109(a).

and some “deemed” interests.⁹ Parts (2) – (6) of 9-109(a) explicitly describe only “deemed” security interests.¹⁰

In particular, section 9-109(a) provides that Article 9 applies to:

- (1) a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract;
- (2) an agricultural lien;
- (3) a sale of accounts, chattel paper, payment intangibles, or promissory notes;
- (4) a consignment;
- (5) a security interest arising under Section 2-401, 2-505, 2-711(3), or 2A-508(5), as provided in Section 9-110;
- (6) a security interest arising under Section 4-210 or 5-118.¹¹

Section 9-102(a)(73), defining “secured party,” continues the description of “conventional” and “deemed” security interests. Note in particular how the six parts of 9-102(a)(73) parallel – though not perfectly – the six parts of 9-109(a). Note in particular how Sub (F) in 9-102(a)(73) is completely different from anything in 9-109(a). Note also that sub (A) explicitly addresses only “conventional” security interests, i.e. interests created by security interests, whereas its parallel in section 9-109(a)(1) describes both conventional and deemed security interests. Everything after (a) is “deemed.”

In particular, section 9-102(a) (73) says that Secured Party means:

- (A) a person in whose favor a security interest is created or provided for under a security agreement, whether or not any obligation to be secured is outstanding;
- (B) a person that holds an agricultural lien;
- (C) a consignor;
- (D) a person to which accounts, chattel paper, payment intangibles, or promissory notes have been sold;
- (E) a trustee, indenture trustee, agent, collateral agent, or other representative in whose favor a security interest or agricultural lien is created or provided for; or
- (F) a person that holds a security interest arising under Section 2-401, 2-505, 2-711(3), 2A-508(5), 4-210, or 5-118.¹²

References to deemed security interests also occur in 1-201(35)’s definition of “security interest.”¹³ Note in particular section 1-201(35)’s reference (in the last sentence) to the question of whether “leases” are or are not security interests. Section 1-201(35) of the U.C.C. states:

9. *Id.* § 9-109(a)(1). The “regardless of its form” language includes some deemed interests.

10. *Id.* § 9 109(a)(2)-(6).

11. *Id.* § 9-109(a).

12. U.C.C. § 9-109(a)(73).

13. *Id.* § 1-201(35).

“Security interest” means an interest in personal property or fixtures which secures payment or performance of an obligation. “Security interest” includes any interest of a consignor and a buyer of accounts, chattel paper, a payment intangible, or a promissory note in a transaction that is subject to Article 9. . . [Exclusion Omitted] The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer under Section 2-401 is limited in effect to a reservation of a “security interest.” Whether a transaction in the form of a lease creates a “security interest” is determined pursuant to Section 1-203.¹⁴

Finally, section 9-309, the section of the UCC which describes security interests that perfect upon attachment (that perfect “automatically”), also contributes some references to deemed security interests, including some references that are in parallel with the lists in 9-109(a) and 9-109(a)(73). Again, the pattern of description of conventional and deemed interests is the same as already seen. Section 9-309 starts by referring to a category of security interests that clearly are conventional interests (interests in consumer goods).¹⁵ But section 9-309 then shifts and thereafter describes categories of security interests that clearly are deemed.¹⁶ Note also that section 9-309 once again omits reference to leases.

14. *Id.* § 1-201(35).

15. *Id.* § 9-309(1) (“a purchase-money security interest in consumer goods, except as otherwise provided in Section 9-311(b) with respect to consumer goods that are subject to a statute or treaty described in Section 9-311(a)”).

16. *Id.* § 9-309: The following security interests are perfected when they attach:

- (1) a purchase-money security interest in consumer goods, except as otherwise provided in Section 9-311(b) with respect to consumer goods that are subject to a statute or treaty described in Section 9-311(a);
- (2) an assignment of accounts or payment intangibles which does not by itself or in conjunction with other assignments to the same assignee transfer a significant part of the assignor’s outstanding accounts or payment intangibles;
- (3) a sale of a payment intangible;
- (4) a sale of a promissory note;
- (5) a security interest created by the assignment of a health-care-insurance receivable to the provider of the health-care goods or services;
- (6) a security interest arising under Section 2-401, 2-505, 2-711(3), or 2A-508(5), until the debtor obtains possession of the collateral;
- (7) a security interest of a collecting bank arising under Section 4-210;
- (8) a security interest of an issuer or nominated person arising under Section 5-118;
- (9) a security interest arising in the delivery of a financial asset under Section 9-206(c);
- (10) a security interest in investment property created by a broker or securities intermediary;
- (11) a security interest in a commodity contract or a commodity account created by a commodity intermediary;
- (12) an assignment for the benefit of all creditors of the transferor and subsequent transfers by the assignee thereunder; and
- (13) a security interest created by an assignment of a beneficial interest in a decedent’s estate.

The various descriptions and definitions of deemed security interests mentioned earlier indicate, collectively, that “deemed” security interests can be divided into two relatively distinct groups. First, as will be demonstrated below, some deemed security interests – particularly those involving transfers of payment rights, agricultural liens, some retention-of-title cases, some consignments and some leases of personal property — require affirmative conduct for perfection, with that affirmative conduct usually being filing. These are the deemed security interests that principally present “traps for the unwary,” with those traps usually being the failure to take affirmative steps to perfect the security interests. Further, and also as demonstrated below, other deemed security interests perfect upon attachment, i.e. automatically. The traps for the unwary here are different. Here the problem is that people or businesses protected by the deemed interests may not even know that the interests exist and thus may not assert their rights under the interests.

II. “DEEMED” SECURITY INTERESTS THAT REQUIRE AFFIRMATIVE CONDUCT FOR PERFECTION

As noted earlier, some deemed interests can only be perfected by the taking of affirmative perfection steps. Other deemed interests perfect automatically. We’ll look first at the deemed interests that need affirmative conduct for perfection. We’ll look later at the deemed interests that perfect automatically.

A. *Transfers of Payment Rights*

Generally speaking, people and businesses that deal in transferring payment rights create conventional security interests when they transfer the payment rights, including when they “sell” the payment rights. Since the parties who deal in this kind of finance usually knowingly create security interests in many cases, perfection of the knowingly created interests usually follows as a matter of course.¹⁷

Sections 9-109(1), and (3), however, tell us that it doesn’t really matter whether the parties to payment rights transfers create conven-

17. Interestingly, the characters in transfer of payment right cases are sort of backwards from the norm in Article 9. In normal Article 9 cases, the sellers of things take security interests from the buyers to secure future payments by the buyers. With payment rights, however, the “buyers” of the payment rights, or the parties comparable to buyers, take security interests. That’s backwards. But, actually it’s not backwards. The way to think about transfers of payment rights is that the transferors are akin to borrowers (of immediate cash or other rights) and that the transferees are akin to lenders of the immediate cash (or other rights). The transferees, therefore, who are akin to lenders, take security interests in the transferors’ property, notably the right that the transferors have to receive future payments.

tional security interests in connection with the transfers.¹⁸ Even if the parties to payment right transfers don’t create conventional security interests, Article 9 itself creates deemed security interests. It’s in these latter cases – where Article 9 creates deemed interests — that trouble can arise. If the transferees of payment rights don’t know that Article 9 has created deemed security interests in connection with these transactions, those transferees won’t know that they must perfect the security interests. And if those transferees don’t perfect the interests in the payment rights, then those transferees will likely lose out to other creditors (of the transferor of the rights) and the bankruptcy trustees (of the transferors).

Article 9 draws transactions involving transfers of payment rights into itself for an important reason. In many cases, the transferors of the payment rights collect payments from account debtors and then forward those collected payments on to the transferees of the payment rights. Further, the transferors in these cases generally do NOT create a public record of the transactions. This is because in many cases the transferors do not realize that they are creating security interests by these transfers. Rather, the transferors usually think that they are simply selling the payment rights, or assigning them or pledging them. Because of these two things, unscrupulous transferors of payment rights sometimes transfer the same payment rights several times, first to Bank 1, for instance, and then later to Bank 2, and still later to Bank 3. Article 9 solves this problem by requiring the initial transferees of payment rights to perfect security interests in the rights and probably to do that perfection by filing.¹⁹ The filing then gives later potential lenders notice of the existing security interests of the first lenders. (We’ll see some exceptions later.)

The perfection requirement for the deemed security interests in the payment rights also protects the initial transferees against bankruptcy trustees that might take over for the transferors. Absent the deemed interests, and the perfection of them, the bankruptcy trustees might well get the rest of the payments that are due to the transferors.

The good news for transferees of payment rights in these “deemed” security interest cases is that in an important segment of this group of deemed interests – the segment that includes payment rights that are expressed in physical documents – the interests will perfect when the creditors take possession of or gain control over the physical documents. So, in these cases, the creditors will take the necessary affirma-

18. U.C.C. § 9-109(1) and (3).

19. *Id.* § 1-201(36)-(37), § 9-102(a)(61), § 9-102(a)(72), § 9-102(a)(73), § 9-109(a)(1), § 9-109(a)(3), § 9-309(3)-(4), § 9-313(a)-(b).

tive steps to bring about perfection without even knowing that they are taking these affirmative steps. A creditor doesn't have to know that he or she is perfecting a security interest in a payment right by taking possession of or gaining control over a payment right. The creditors just take these affirmative steps as a matter of course.

The other good news is that perfection of security interests in some situations involving transfers of payment rights occurs automatically. We'll get to those automatic perfection situations later.

B. *A Quick Word about Agricultural Liens*

For completeness sake, this analysis of deemed security interests that require affirmative steps for perfection, must talk briefly about agricultural liens.²⁰ Reference to these kinds of deemed security interests is quick because anecdotal evidence suggests that these instances do not create traps for the unwary. This is so, it seems, because the rules about these kinds of transactions have been in operation in the pertinent industries for many, many years. Further, experience suggests that almost all creditors and debtors in the pertinent industries know about these rules. Thus, for example, anecdotal evidence suggests that almost everybody who deals with farm financing knows that agricultural liens exist in many farming interests and also knows that these interests must be perfected, usually by filing.

Agricultural liens are a hybrid. Some attributes of agricultural liens connect these liens to other kinds of liens, principally statutory and judicial liens. Mostly importantly, agricultural liens are like other kinds of liens because agricultural liens come into existence by operation of law rather than by agreement of the parties. However, some attributes of agricultural liens also connect agricultural liens to security interests and particularly to deemed security interests.²¹ Most importantly, agricultural liens, like security interests, are fully effective only if they are perfected. Further, though some differences exist between the way Article 9 deals with security interests and the way Article 9 deals with agricultural liens, a great deal of overlap exists between Article 9's approach to security interests and Article 9's approach to agricultural liens.

As noted repeatedly, Article 9 treats agricultural liens as if they are deemed security interests, deemed interests that must be perfected

20. Agricultural liens are handled under U.C.C. § 9-109(2).

21. *Id.* § 9-109(a), for example, the section of Article 9 that describes the "scope" of Article 9, explicitly states in subpart (2) that agricultural liens are within the scope of Article 9. In addition, 9-102(73) explicitly notes in subpart (B) that "secured party" includes a person that holds an agricultural lien.

through filing, possession or obtaining control. These ideas and rules, in turn, seem to be well known in the farm finance industry. Thus, there really are no “traps for the unwary” in this context. Everybody seems to know what they have to do to be fully protected. So, nothing more needed be said about this kind of deemed security interest.

C. *A Quick Word about 2-401 Retention-of-Title Transfers*

Subsection (5) of 9-109 indicates that “deemed” security interests come into existence by operation of law in some “retention-of-title” cases. In an important way, retention-of-title instances are similar to agricultural liens. Deemed security interests most certainly come into existence in retention-of-title cases, as they most certainly do with agricultural liens. But, it seems that almost everybody in the pertinent industries knows that these interests come into effect in some situations and also knows that these interests must be perfected.

A cryptic phrase in section 2-401 states the retention-of-title idea, and introduces this quick analysis: “Any retention or reservation by the seller of the title (property) in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest.”²²

The back story to the rule just stated comes out of the auto finance industry.²³ For a time in the fairly distant past, automobile manufacturers wanted to make credit sales of cars to automobile dealers but did NOT want to be bothered with having to file financing statements. So, for a time, automobile manufacturers entered into agreements with car dealers in which the dealers got physical possession of cars but the manufacturers retained title to the cars until the dealers had completed making payments on the cars. Since the manufacturers retained title, the manufacturers believed that they weren’t taking security interests in the cars but rather retaining ownership of the cars. Thus, the manufacturers believed that they did not have to file financing statements.

As we will see later, the automobile finance strategy just described — which was used a goodly long while ago — is similar to the finance strategy currently used in connection with so-called “non-true leases” and in connection with so-called “finance consignments.” In non-true

22. *Id.* § 2-401.

23. See Girard Trust Corn Exchange Bank v. Warren Lepley Ford, Inc., 12 Pa. D. & C. 2d 351 (1957); see also, Rolf B. Johnson, *A Uniform Solution to Common Law Confusion: Retention-of-title under English and U.S. Law*, 12 BERKELEY JOURNAL OF INTERNATIONAL LAW, 99, 118 (1994); Robert Laurence, *Some Practical Advice About Taking Security Interests in Gemstones, Accompanied by a Theoretical Discussion of the Negotiability of Goods, New and Used*, 2004 ARK. L. NOTES 75, <http://lawnotes.law.uark.edu/wp-content/uploads/Laurence-Some-Practical-Advice-About-Taking-Security-Interests-in-Gemstones-Arkansas-Law-Notes-2004.pdf>.

lease cases, “lessors” transfer possession of property to “lessees” but do not transfer ownership of the property. So, in theory, “lessors” in dirty lease instances do not have to perfect security interests in the transferred property (because they retain ownership of the property). Likewise, in finance consignment cases, “consignors” transfer possession of property to “consignees” but do not transfer ownership of the property. So, in theory, “consignors” in finance consignment instances do not have to perfect security interests in the transferred property (because they retain ownership of the property).

Courts long ago realized that retention-of-title transactions created a serious “ostensible ownership” problem. That’s so because in retention-of-title cases, it appeared to the world that the dealers owned the cars whereas in fact, and at least in connection with title, the manufacturers owned the cars. This appearance issue made it likely that unscrupulous dealers could deceive third party lenders and purchasers. Because of the foregoing, courts realized long ago that retention-of-title transactions actually were credit sales with retention by the automobile dealers of security interests in the cars. The courts so ruled.²⁴ Those court rulings, in turn, became the cryptic sentence in section 2-401 stating, “Any retention or reservation by the seller of the title (property) in goods shipped or delivered to the buyer is limited in effect to the reservation of a security interest.”²⁵ As we will see later, these court decisions in the past in the automobile industry, and the deemed security interest idea in retention-of-title instances under 2-401 are today being echoed in non-true lease and finance consignment cases.

It is clear that section 2-401’s rules about retention-of-title situations involve creation of deemed security interests. It is also clear that these deemed security interests must be perfected by filing, possession or obtaining control over the pertinent property. The fact is, however, that everybody in the pertinent finance industries seems to know about the retention-of-title rules and everybody in the pertinent finance industries seems to know that the security interests created in this context must be perfected by filing, possession, or obtaining control. So, there really are no “traps for the unwary” in this context.

24. See generally WHITE & SUMMERS, *supra* note 5, § 4-12, § 6-1(b).

25. U.C.C. § 2-401.

D. *Leases True and Non-True (aka” Dirty Leases”)*

Leases are transfers of the right to possession and use of property in return for a payment.²⁶ Although the term “lease” usually is used by laypeople in connection with discussions of real property, leases are very common in connection with personal property. That’s so because tax and accounting rules frequently make it sensible for commercial actors to lease property rather than to purchase it outright.

Careful analysis quickly reveals the likelihood of ostensible ownership and priority problems with “leases” of personal property. Assume, for example, that Seller offers to sell a large piece of machinery to Buyer for \$12K, payable in 12 monthly installments of \$1K. Buyer’s accountant, however, tells Buyer that it would make tax and accounting sense for Buyer to “lease” the machine from Seller. Buyer and Seller then draw up paperwork in which Buyer offers to “lease” the machine for a year from Seller, and to pay “rent” of \$1K per month for a year. Is this transaction actually a lease, or is it actually a disguised credit sale? Now also note this. It is very common in “lease” cases for the parties to transactions explicitly to state in paperwork for the transactions that the transferors of the property (the “lessors”) at all times retain ownership of the property.²⁷ “Title” to the property, the paperwork also frequently states, does NOT transfer to the transferee (the lessees). Title remains with the lessor. Does the wording in the documents matter?

The UCC deals with the problem just described by differentiating between “true leases” on the one hand and “non-true” (aka “dirty leases” or “lease purchase agreements” or “purchase leases”) on the other hand.²⁸ True leases actually are leases, according to the UCC, and are treated as such. Non-true leases, however, are NOT leases and are NOT treated as such. Rather, non-true leases actually are disguised sales (with retentions of security interests). Because non-true leases are disguised sales (with retentions of security interests), they are subject to Article 9. Therefore, to be protected, non-true “lessors” must file financing statements about the subject property.

There is good news and bad news in connection with the UCC’s discussion of the methodology for differentiating true leases from non-true leases. The bad news is that the UCC’s formal method for differentiating between these kinds of transactions is complex. The

26. See, e.g., U.C.C. § 2A-103; see also U.C.C. § 1-203; see, e.g., WHITE & SUMMERS, *supra* note 5, at 1148-1247.

27. See U.C.C. § 1-203.

28. *Id.*

good news is that a very simple test often is the only thing necessary to use to differentiate these different transactions.

The UCC proposes a complicated and elaborate methodology for differentiating between true leases (on the one hand) and non-true leases (on the other hand). UCC section 1-203 starts the true lease / dirty lease differentiation process by stating that the determination of lease or security interest status is based on the facts of the individual case. Section 1-203 then immediately goes on with what is sometimes called the “bright line” test or the “mandated” security interest cases. Under this test, a determination is first made as to whether a “lease” is or is not terminable before the end of the “lease” term. If the “lease” is NOT terminable before the end of the term, then the “lease” is a disguised sale with a security interest if *one of four additional* elements exist:

- (1) the original term of the lease is equal to or greater than the remaining economic life of the goods; (2) the “lessee” is bound to renew the “lease” for the remainder of the economic life of the goods or is bound to become owner of the goods; (3) the “lessee” has the 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” terms; (4) or, the “lessee” has the option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the “lease” agreement.²⁹

If determination of true lease / dirty lease status can't be made with the “bright line” test just described, section 1-203 says determination of this status should be made in light of the facts of the case. That test is as follows:

A transaction in the form of a lease creates a security interest if the consideration that 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 and is not subject to termination by the lessee, and: (1) the original term of the lease is equal to or greater than the remaining economic life of the goods; (2) 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; (3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement; or (4) the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement.³⁰

29. *Id.* § 1-203(b).

30. *Id.*

In connection with the factual analysis of these points, 1-203(c) describes some transactions that do NOT create security interests even though these transactions have lease-looking elements. Finally, sections 1-203(d) and (e) provide some definitions including definitions of "nominal payments," "remaining economic life," and "reasonably predictable."

As noted above, there also is good news in the context of differentiating between true and non-true (aka dirty) leases. In many cases, a determination of whether a transaction is a true lease on the one hand or a non-true lease on the other hand can be made simply by looking at the residual value of the property at the end of the "lease" term. If the property that is subject to a "lease" likely will have substantial residual value at the end of the lease term, and if, therefore, the "lessor" of the property likely will take back the property at the end of the term, then the transaction is a true lease. (Think of leases of apartments and automobiles. Leases for these kinds of property have substantial residual value. So, the lessors in these cases almost certainly will take back the property at the end of the lease term.)

One last point about leases, true and non-true (dirty) must yet be made. In cases wherein the parties to transactions are unsure as to whether the transactions are true leases or non-true leases, careful commercial actors can simply do a "protective compliance" (aka a "protective filing").³¹ Protective compliance can't hurt because section 9-505(b) says that filing or compliance with Article 9 is not "of itself a factor in determining whether the collateral secures an obligation."³² But protective compliance can certainly help. Protective compliance can help because if a judge later rules that the "lease" actually is a non-true lease, then the protective compliance will give the "lessor" priority in the "leased" priority over other creditors of the "lessee" and over the "lessee's" bankruptcy trustee. Bottom Line: Compliance with Article 9 (filing) is easy and cheap; litigation is difficult and expensive.

E. *Consignments (Shop, Finance and Quasi)*

Several different kinds of "consignments" exist, some of which kinds are included in Article 9's definition of consignments and some of which are excluded from Article 9's definition. The first kind of consignment is the kind that lay-people (and, probably, lots of lawyers) think of when they hear the word consignment. This is a con-

31. *Id.* § 9-505(b).

32. *Id.*

signment where people give goods, often old or used goods, to merchants that hold themselves out as being in the business of selling the property of others. Often the stores involved in these kinds of consignments outright call themselves “consignment shops.”³³ Interestingly, Article 9 does NOT include these kinds of consignments in its definition of consignment. Indeed, section 9-102(2)(A)(iii) explicitly EXCLUDES these kinds of consignments from its definition of consignments.³⁴ Nevertheless, for want of better terminology and because, candidly, so many lay people and lawyers think of these kinds of consignments as being consignments, we’ll call these kinds of consignments “shop consignments” (though, again, they are flat out excluded from Article 9’s definition of consignments).

The second kind of consignment, which is the only kind included in Article 9’s definition of consignment, is described in section 9-102(20) as the following:

“Consignment” means a transaction, regardless of its form, in which a person delivers goods to a merchant for the purpose of sale and: (A) the merchant: (i) deals in goods of that kind under a name other than the name of the person making delivery; (ii) is not an auctioneer; and (iii) is not generally known by its creditors to be substantially engaged in selling the goods of others; (B) with respect to each delivery, the aggregate value of the goods is \$1,000 or more at the time of delivery; (C) the goods are not consumer goods immediately before delivery; and (D) the transaction does not create a security interest that secures an obligation.³⁵

As noted earlier, the foregoing kind of consignment is the *only* kind of transaction that is a “consignment” in Article 9. However, because there is such widespread use of the term “consignment” for other kinds of transactions, we’ll use the term “finance consignment” to describe these transactions and to differentiate them from what we are called “shop” consignments. Remember: “Shop consignments” are what lay people (and probably a goodly number of lawyers) think of when they hear the word “consignment.”

33. U.C.C. § 9-102 (2); see John Hicinbothem, *Consignments, Creditors’ Rights and U.C.C. Section 2-326*, 9 B.C.L. REV. 62 (1967), available at <http://lawdigitalcommons.bc.edu/bclr/vol9/iss1/3>; Richard W. Duesenburg, *Consignment Distribution Under the Uniform Commercial Code: Code, Bankruptcy, and Antitrust Decisions*, 2 VAL. U. L. REV. 227 (1968), available at <http://scholar.valpo.edu/vulr/vol2/iss2/2>; see, e.g., Bernstein and Berkeley, *Consignments: My, How You’ve Changed!*, (Sept. 2003), available at <http://bernsteinlaw.com/publications-list/consignments-my-how-youve-changed/>; see also, Nathan, *infra* note 45; WHITE & SUMMERS, *supra* note 5, § 22.

34. U.C.C. § 9-102(2)(A)(iii).

35. *Id.* § 9-102(20).

We’ll come later to a third kind of “consignment,” again a kind NOT included in Article 9’s definition of consignment. This third kind of consignment is sometimes called a “quasi consignment” or a “tolling agreement” or a “customer owned equipment / inventory arrangement.”

A preliminary word must quickly be said by way of introduction to this analysis of deemed security interests in the consignment context. Recall the back story for the retention-of-title deemed security interests that was discussed earlier herein. For a period of time a long while ago, automobile manufacturers wanted to sell cars to dealers on credit but didn’t want to have to bother filing financing statements. So, long ago, automobile manufacturers prepared paperwork for their sales of cars to dealers that showed that the automobile manufacturers retained title to the cars even though the cars were in the possession of the dealers. This financing scheme, the manufacturers thought, made it unnecessary for the manufacturers to file financing statements on the sold cars. As noted earlier, the courts long ago saw through this retention-of-title financing scheme. So, this particular financing scheme has long since been discredited in connection with basic sales. Nevertheless, watch for echoes of this retention-of-title financing idea in connection with the following analysis of leases.

Let’s start with what we are calling “shop consignments.” (Again: “Shop consignments” is NOT Article 9 terminology. Indeed Article 9 explicitly excludes these kinds of transactions from its definition of consignment.) With shop consignments, it is clear that the transactions are closer to bailments than to sales. That’s because with shop consignments, as with bailments (and as NOT with sales), title to property does NOT transfer from the consignor (JMLS) to the consignee. Rather, with shop consignments, as with bailments but as NOT with sales, title to property stays with the consignors.³⁶ The only thing that transfers with shop consignments is the right to possess the property for future sale. Further, everybody who deals with consignment shops knows that the shops themselves do not own the goods. It’s kind of like bailments: Everybody knows that carriage and warehousing companies don’t own the property that they possess.

But now consider this new situation. And while considering this new situation, recall again the now-discredited “retention-of-title” finance scheme used long ago by automobile manufacturers:

36. *Id.* § 2-401, of course, states that title to property is not particularly important in connection with Article 2 transactions. Here, however, we just using transfer of title in a non-technical sense.

Assume that Manufacturing Co. has manufactured a new item, 10,000 smallish-sized toys. Manufacturing Co. primarily sells its toys through Retailer, Inc. In connection with this new toy, however, Retailer Inc. doesn't want to take the risk of the toys not selling. So, Retailer proposes a "sell or return" transaction. Under a sell or return transaction like this, Retailer will take delivery of the toys but will NOT pay Manufacturing Co. for them. Further, under this a deal, Retailer will not take ownership of the toys. Rather, with a sell or return deal, Retailer will take the toys from Manufacturing and attempt to sell them. If Retailer sells the toys, or some of them, it will reimburse Manufacturing for the toys and will deduct from the reimbursement a fee for itself. This is the "sell" part of a sell or return transaction. However, if Retailer does NOT sell some of the toys, or any of them, Retailer will just return the unsold toys to Manufacturing. Retailer can do this because, as stated earlier, Retailer never took ownership of the toys. Further, and just as importantly, in connection with the unsold toys, Retailer will make no payment whatsoever to Tacky for the toys.

Sell or return transactions³⁷ such as the one just described are surprisingly common. In many cases, for example, the books / magazines in bookstores are the subjects of sell or return transactions. The book stores do NOT own the books / magazines. Rather, the bookstores only have the right to possess the books / magazines for further sale. Sell or return transactions also are common in the fashion industry. Retailers in these cases do NOT purchase the products from the manufacturers. Rather, the retailers in these cases take only the right to possess the property for future sales. Ownership stays with the manufacturers. In addition, sell or return transactions are common in connection with seasonal goods — Christmas / Halloween decorations, for example. If the retailers sell the seasonal products, they reimburse the manufacturers (minus a fee). But if the seasonal products do NOT sell, the retailers just return them to the manufacturers and make no payment at all. Finally, sell or return deals are common in situations where manufacturers are launching new or unconventional products. If retailers don't want to take a risk of non-sale with these new or unconventional products, the retailers sometimes insist on sell or return deals with the retailers. If the new or unconventional products sell, the retailers pay a fee to the manufacturer for them. If the products do not sell, the retailers just return the products to the manufacturers.

For various reasons, the UCC calls sell or return transactions like the ones just described "consignments" or even "true consign-

37. *Id.* § 2-326; *see also*, U.C.C. § 9-102(2), § 2-105, § 2-401.

ments.”³⁸ The UCC uses this consignment terminology even though sell or return transactions are totally different from the kinds of consignments that most people think of when the term consignment is used, namely, “shop consignments.”

Note carefully now an important difference between what we are calling “shop consignments” on the one hand and what we are calling “finance consignments” (or just “consignments” or “true consignments” or “sell or return transactions”) on the other hand. The environment of possession of the property in the two different kinds of consignment situations suggests different things about ownership and non-ownership of the property. When property is consigned to consignment shops, third parties who see the property in the physical possession of the shops will immediately notice that the property is owned by somebody other than the shop consignees. That’s because the shops themselves usually state as much on the tags, or generally on signage in the shops. So no knowledgeable third-party lender or third-party purchaser will assume that property in a “consignment shop” is owned outright by the consignee. Rather, third-party lenders or third-party purchasers will in these cases assume, correctly, that the property belongs to somebody other than the consignment shop. Conversely, when property is consigned to finance consignees, third parties who see the property in the physical possession of the finance consignees are NOT likely to think that the property has been “consigned” to the consignees. Rather, in finance consignment cases, third parties who see property in the possession of finance consignees are likely to think that the finance consignees outright own the property, probably as “inventory.”³⁹ So, again, the appearance of ownership of the property involved is different between shop consignments and finance consignments.

An important question now arises. Why should we care about the difference between shop consignments (usually of used furniture, jewelry, clothes, antiques) and finance consignments (usually of new books / magazines, clothes and seasonal goods, etc.)? The answer is straight-forward.

The UCC treats *shop* consignments as similar to bailments.⁴⁰ That treatment has several ramifications. First, consignors in shop consignment situations do NOT have to comply with Article 9 to protect themselves in connection with payment for or return of the consigned

38. U.C.C. § 2-326, § 9-102, § 9-317.

39. Inventory in Article 9 is goods that are held for sale or that is used up quickly in the manufacture of other goods. U.C.C. § 9-102(a)(48).

40. See WHITE & SUMMERS, *supra* note 5, at 1148-1247.

property. That's because shop consignors always retain ownership of the property. Second, if *shop* consignors declare bankruptcy, bankruptcy representatives for the shop consignors will likely get bankruptcy priority against the consigned property even though the property is in the possession of the consignees.⁴¹ Third, if *shop* consignees declare bankruptcy, the bankruptcy representatives for the shop consignees will likely NOT get bankruptcy priority against the consigned property.⁴²

Conversely, the UCC says exactly the opposite about what we are calling *finance* consignments.⁴³ *Finance* consignments, the UCC says, are much closer to credit sales than to bailments.⁴⁴ The reasoning for this probably involves the appearance of ownership in *finance* consignment cases. Recall that in finance consignments situations, 3rd parties who come to the physical locations of the finance consignees are likely to think that property that is possessed by the finance consignees (the retailers) is actually owned by those finance consignees. If third parties think that — particularly third parties who represent banks and finance entities that are considering the possibility of making second loans to the finance consignees — are likely to think that finance consignees are much more solvent than they actually are.

Assume, for example, that Manufacturing Co. finance consigns 10,000 plastic toys to Retailer and that Retailer takes possession of the toys. Assume further that an officer from Second Bank, from which bank Retailer wishes to get a second loan, comes to Retailer's shop. The bank officer will see the 10,000 toys and assume that Retailer owns them as inventory. "You've got plenty of inventory," the bank officer might then say to Retailer. "So, you're good for the [second] loan." Because of the foregoing, the UCC treats finance consignments as much closer to sales than to bailments.

It should quickly be said that it is very common in both shop and finance consignment cases for the parties to the transactions explicitly to state in the paperwork for the transactions that the transferors of the property (the consignors) at all times retain ownership of the property.⁴⁵ Title to the property, the paperwork frequently goes on to

41. Bankruptcy representatives for the shop consignors will likely get bankruptcy priority against the consigned property because ownership of the property has never moved from the consignors to the shop consignees and because bankruptcy trustees only get the status of lien creditors in connection with property owned by the bankrupt. See 11 U.S.C. § 544(a) (1999).

42. *Id.*

43. U.C.C. § 9-102.

44. *Id.*

45. Bruce S. Nathan, *Bailment or Consignment: It Makes a Difference!*, BUSINESS CREDIT, Nov./Dec. 2006, at 26.

state, does NOT transfer to the transferee (the consignees). Notwithstanding explicit statements in the paperwork about non-transfer of ownership, the why-it-matters ideas described above control. With shop consignments, the consigned property is treated as if it is owned by the shop consignors. The shop consignees only have the right to possess the property for future sale, which is consistent with the terminology in the paperwork. Conversely, with finance consignments, the consigned property is treated as if it is owned by the consignees rather than by the consignors even if the paperwork says exactly the opposite. Because of that, the consignors in finance consignment situations must protect themselves by complying with Article 9.

The UCC's rules about finance consignments potentially can generate serious problems in connection with the four inter-related why-it-matters ideas mentioned repeatedly herein. First, with finance consignments, consignors will not necessarily know that they have secured claims.⁴⁶ So, consignors will NOT always know that they can pursue such claims in court or otherwise. Second, with finance consignments, consignors may NOT know that they will have to take affirmative steps to perfect their security interests unless the interests are of a type where interests perfect automatically. Third, with finance consignments, if debtors declare bankruptcy, finance consignors will be ahead of debtors' bankruptcy representatives, likely depending on whether the consignors took or did not take affirmative steps to perfect their security interests. This is because finance consignors by operation of law liens against the "consigned" property.⁴⁷ Fourth, and finally, with finance consignments, if consignors (as opposed to debtors) declare bankruptcy, then the debtors' bankruptcy representatives will or will not gain possession of the creditors' deemed interests, usually depending on whether the consignors took or did not take affirmative steps to perfect the interests.⁴⁸

A third kind of transaction must now be described, a kind of transaction that is sometimes called a "quasi consignment."⁴⁹ These kinds of transactions sometimes also are called "tolling" arrangements or "customer owned inventory / equipment" arrangements."

Superficially, quasi consignments are NOT Article 9 consignments because they do NOT involve the transfer of property for future sale. However, Comment 14 to 9-102 clearly indicates that some consign-

46. It is likely that the consignors will NOT necessarily have played a role in the creation of their security interests.

47. U.C.C. § 9-109(a)(4); WHITE & SUMMERS, *supra* note 5, § 22-2.

48. U.C.C. § 9-109(a)(4); WHITE & SUMMERS, *supra* note 5, § 22-2.

49. WHITE & SUMMERS, *supra* note 5, § 22-5.

ment transactions involve transfers with two or more purposes, future sales AND one or more other things. (The specific language in this comment is that the goods are delivered to the consignee “for another purpose as well [as future sale], such as milling or processing.”) If the transactions involve future sales AND other things, the transactions clearly *do* fit into Article 9’s seemingly strict definition.⁵⁰

The definition of “consignment” requires that the goods be delivered “to a merchant for the purpose of sale”. If the goods are delivered for another purpose as well, such as milling or processing, the transaction is a consignment nonetheless because a purpose of the delivery is “sale”. On the other hand, if a merchant-processor-bailee will not be selling the goods itself but will be delivering to buyers to which the owner-bailor agreed to sell the goods, the transaction would not be a consignment.⁵¹

Quasi-consignments — aka “tolling” agreements⁵² as in toll road or toll bridge – usually involve the transfer of raw materials from companies that own those raw materials to other companies that will process the raw materials.⁵³ The owners / suppliers of the property then pay the processors. These transactions also sometimes involve the transfer of heavy equipment or expensive machinery from companies that own that equipment or machinery to companies that will use that equipment or machinery to manufacture things for the owners of the equipment or machinery. Again, the owners / suppliers of the equipment pay the processors for the work done by the processors.

White and Summers give this helpful summary of the variety of these kinds of transactions:

The parties’ plans for goods in these cases are varied and uncertain. In some cases, the owner has the right to get the goods back; in others the processors are to ship the goods to third parties at the owners’ direction; in still others, the possibility exists that the processors will sell the goods and remit the proceeds. None are

50. *Id.*; see also U.C.C. § 9-102, comment 14.

51. U.C.C. § 9-102, comment 14.

52. These comments draw heavily on the following articles. See, LLowenstein.com, [https://www.lowenstein.com/publications/list.aspx?VIEWSTATEGENERATOR=39712451&Header1\\$Search\\$txtSearchText=Site+Search&Header1\\$MegaPeople\\$xdLastName=Last+Name&Header1\\$MegaPeople\\$FirstName=First+Name&KeywordPhrase=consignment&PublicationTypes=2556D3E2-F367-4151-9054-0C3860758F4A&ibSearch.x=0&ibSearch.y=0&](https://www.lowenstein.com/publications/list.aspx?VIEWSTATEGENERATOR=39712451&Header1$Search$txtSearchText=Site+Search&Header1$MegaPeople$xdLastName=Last+Name&Header1$MegaPeople$FirstName=First+Name&KeywordPhrase=consignment&PublicationTypes=2556D3E2-F367-4151-9054-0C3860758F4A&ibSearch.x=0&ibSearch.y=0&); see also Nathan, *supra* note 45; Deborah Thorne, *Bailment vs Sale: Another View*, Business Credit, (April 2007), http://www.btlaw.com/files/BC_Apr07_Thorn_1.pdf; see also George R. Hirsch, *Mysteries Of Uniform Commercial Code Article 9: Security Interests In Commingled Goods*, THE METROPOLITAN CORPORATE COUNSEL (February 9, 2012, 10:50 AM), <http://www.metrocorpocounsel.com/articles/17575/mysteries-uniform-commercial-code-article-9-security-interests-commingled-goods>.

53. The term “tolling agreement” is sometimes also used to describe agreements whereby the period of a statute of limitations is extended by agreement of the parties to a potential lawsuit. The present analysis has no interest in that other use of the tolling agreement term.

pure consignments or pure bailments; all have some qualities of each.⁵⁴

The paperwork for quasi-consignments almost always explicitly states that the parties to the agreements agree that ownership of the property at all times stays with the transferors, the owners / suppliers. The transferees, the paperwork says, the processors, have only the right to process the property. The idea of this language in the paperwork, of course, is to make these transactions look like bailments and only bailments. That’s because if the transactions are bailments, compliance with Article 9 is NOT required.

But what if the paperwork for quasi-consignments uses the word “sale,” as in the processor can sell the processed property to third parties on behalf of the owners / suppliers? Because of the “sale” language, a court might classify this transaction as a consignment. In that case, the transaction is drawn into Article 9 and the owner / supplier must comply with Article 9 to be protected from other claimants to the property, especially bankruptcy trustees or DIP’s.⁵⁵ Failure to perfect a security interest in these cases will cause the owners / suppliers to lose out in priority conflicts with other creditors, including the bankruptcy trustee or DIP for the processor. Or what if the paperwork calls the quasi-consignment a “consignment?” If the transaction actually is a consignment, then the transaction is drawn into Article 9 and failure to perfect a security interest in the transferred property will cause the owner / supplier to lose priority in the transferred property, potentially allowing the bankruptcy trustee or DIP for the processor to get the transferred property. This is exactly what the issue was in some cases recently addressed by some bankruptcy commentators.⁵⁶

One last point must yet be made about consignments, shop and finance and quasi. (Again, according to Article 9, the only transactions

54. WHITE & SUMMERS, *supra* note 5, at 1168.

55. JAMES J. WHITE, *AUTO SUPPLIER INSOLVENCIES & BANKRUPTCIES: ISSUES FOR SUPPLIERS AND CUSTOMERS OF FINANCIALLY TROUBLED AUTO SUPPLIERS*, 79 6th ed. (2006); *see also* GMAC Business Credit LLC v Ford Motor Co. 271 B.R.534 (Bankr. E. D. Mich. 2002), *aff’d* 100 Fed. Appx 404 (6th Cir. 2004) (stating that no bailment of inventory under Michigan law but a sale); General Motors Corp. v. Bristol Industries Corp., 1981 WL 138044 (Bankr. D. Conn. 1981), *rev’d* on other grounds, 690 F.2d 26 (2d Cir. 1982) (stating that a tolling agreement constituted a sale of goods and not a bailment); *In Re Etch-Art-Inc.*, 65 B. R. 183 (Bankr. D. R. I. 1986); *Morton Booth Co. v. Tiara Furniture Inc.*, 564 P.2d 210 (Okla. 1977); *Litwiller Mach. & Mfg. Inc. v NBD Alpena Bank*, 457 N. W. 2d 163 (Mich. Ct. App. 1990); *see also* *In re Georgetown Steel Co. LLC*, 318 B.R. 352 (Bankr. D. S.C. 2004) (holding no bailment where goods provided by one person to manufacture for fabrication and sale to third parties).

56. *See*, Nathan, *supra* note 49; *see also* Deborah Thorne, *Bailment vs. Sale: Another View*, BUS. CREDIT 2 at 3, (Apr. 2007), http://www.btlaw.com/files/BC_Apr07_Thorn_1.pdf; *see also* Hirsch, *supra* note 52.

that actually are consignments are transactions herein called “finance consignments.”⁵⁷ In cases wherein the parties to transactions are unsure as to whether the transactions are shop or finance consignments or whether they are quasi-consignments, or whether they are something else entirely, careful commercial actors should simply do a “protective compliance” (aka a “protective filing”). As noted earlier, protective compliance can’t hurt because section 9-505(b) says that filing or compliance with Article 9 is not “of itself a factor in determining whether the collateral secures an obligation.” But protective compliance can certainly help because if a judge later rules that the consignment is a finance consignment rather than a shop consignment, then the protective compliance will give the consignor priority in the property over other creditors of the consignee and over the consignee’s bankruptcy trustee. Bottom Line: Compliance with Article 9 (filing) is easy and cheap; litigation is difficult and expensive.

A quick summary of the foregoing ideas addressed can now be made. In a number of different instances, Article 9 creates “deemed” security interests by operation of law. Some of these interests, such as the ones already discussed, require affirmative steps for perfection. Hence, lack of knowledge of these interests by the protected parties will likely cause those protected parties to fail to perfect these interests. The principal instances here involve transfers of payment rights, agricultural liens, some retention-of-title cases, leases (true and dirty) and consignments (shop, finance and quasi). In the agricultural lien and retention-of-title cases, everybody involved with the financing seems to know about the perfection issue. So, mistakes don’t seem to be too common in those cases. Serious problems come up, however, in connection with transfers of payment rights, leases and the various different kinds of consignments.

III. DEEMED SECURITY INTERESTS THAT AUTOMATICALLY PERFECT

Deemed security interests that perfect automatically come in three distinct varieties. First, some deemed security interests come into existence in Article 2 cases, notably, sellers’ shipments under reservation and buyers’ rejection or revocations of acceptance.⁵⁸ Second, in some cases deemed security interests that involve transfers of payment rights automatically perfect.⁵⁹ Third, a “motley lot” of other deemed

57. WHITE & SUMMERS, *supra* note 5, § 22-4.

58. U.C.C. § 9-109(a)(5); WHITE & SUMMERS, *supra* note 5, § 22-2.

59. U.C.C. § 9-109(a)(3); WHITE & SUMMERS, *supra* note 5, § 22-2, § 22-6.

interests – with no logical connection between these different kinds of deemed interests – also perfect automatically.⁶⁰

Recall now that the “traps for the unwary” that exist in connection with deemed security interests that perfect automatically are different from the traps for the unwary that exist in connection with deemed security interests where perfection requires affirmative steps. With the affirmative steps kinds of deemed interests, the trap is that people or businesses protected by these interests will not know of the existence of the interests and thus may not take the affirmative steps to perfect the interests. With deemed security interests that perfect automatically, the problem is only the first just mentioned (because perfection in these cases happens automatically). With automatic perfection of deemed interests, the problem is that the possessors won’t know of the interests and thus might not even assert their rights under the interests.

A. *Deemed Security Interests in Several Article 2 Instances*

The lists of deemed interests in 9-109(a) and 9-102(a)(73) do NOT reference 9-110 when those lists mention some Article 2 and 2A security interests. But, the connection between 9-110 and Article 2 deemed security interests is obvious. 9-110 states that a “security interest arising under Section 2-401, 2-505, 2-711(3), or 2A-508(5) is subject to this article.” Those sections in Articles 2 and 2A are explicitly mentioned in the lists of deemed security interests in 9-109(a) and 9-102(a)(73).

Two instances of section 9-110 security interests involve deemed security interests that automatically perfect. These two instances are discussed immediately below. However, another instance where Article 2 creates deemed security interests – instances involving retention-of-title cases – involves interests that must be perfected by filing, possession or obtaining control of the collateral. The retention-of-title instance was discussed earlier in this analysis, when the analysis discussed deemed interests that must be perfected by the taking of affirmative perfection steps.

Not uncommonly, writings that exist between sellers and buyers in connection with sales of goods say that the sellers retain ownership to goods “identified to the contract”⁶¹ until some condition occurs, with that condition frequently being payment made by the buyers. Further, and again not uncommonly, sellers deliver sold goods to carriers

60. U.C.C. § 9-309; WHITE & SUMMERS, *supra* note 5, at 1195.

61. Identification to the contract means that sellers have identified specific goods that are the subject of particular contracts.

and in exchange get bills of lading from the carriers. Sometimes these bills of lading are “negotiable” (meaning that the bills of lading can easily be transferred from one person or business to another). In other cases, the bills of lading are “non-negotiable” (meaning that the bills of lading do NOT transfer easily from one party to another).

The following question frequently arises in these cases: Who — the sellers or the buyers — has rights to disputed goods that have been (a) identified to the contracts but still are in the physical possession of the seller or (b) have been delivered to carriers in exchange for bills of lading or that are (c) in the possession of buyers after rightful rejections or rightful revocations of acceptance. In the first case just mentioned, the seller has possession of the property. In the second case, a carrier or warehouse has the property. Finally, in the third case, the buyer has the property but has indicated that the property should return to the seller.

The reasons that these who-has-rights-to-the-property questions come up when sellers have the property are multi-fold. First, not uncommonly, goods that have been identified to contracts but still remain in the possession of the sellers are damaged or destroyed. Who bears the risk of that damage or destruction, the sellers or the buyers? Second, not uncommonly, goods that are in the possession of carriers are damaged or destroyed. Again, who bears the risk of that loss, the sellers or the buyers? Finally, it is not uncommon for sellers or buyers who are parties to sales transactions to file for bankruptcy after sellers have identified goods to contracts or delivered goods to carriers but before the buyers get the goods. Whose bankruptcy trustees in these cases gets the goods, the sellers’ bankruptcy trustees, or the buyers’ bankruptcy trustees, or neither?

Historically, Article 2 addressed these issues (and related ones) by focusing on “passage of title” to property. If title to property had not passed, sellers had the pertinent rights in the property. Conversely, if title had passed, then buyers had rights in the goods. The UCC no longer relies so heavily on “passage of title” ideas. Rather, the UCC now has very specific rules for dealing with these who-has-the-rights issues in very specific cases, rules such as those outlined in sections 2-505⁶² and 1-203.⁶³ These very specific rules differ from one kind of property to another.⁶⁴

62. U.C.C. § 2-505 deals with situations involving seller’s shipments under reservation.

63. U.C.C. § 2-103 deals with “leases” of personal property.

64. *See, e.g.*, S. HARRIS, SECURITY INTERESTS IN PERSONAL PROPERTY (Foundation Press, 5th ed. 2011).

The UCC deals with seller-side issues in these contexts in sections 2-401 and 2-505. 2-401 starts things off by suggesting that passage of title is the controlling idea.⁶⁵ However, section 2-401 quickly notes that its own general passage of title ideas apply only when more specific rules in the UCC apply.⁶⁶ Thus, section 2-401 immediately sends us to section 2-505. 2-505 then provides the specific rules for dealing with the property. The section 2-505 rules, in turn, note that in some instances, sellers get “security interests” in the good.⁶⁷ Since the “security interests” described in section 2-505 most assuredly are NOT conventional security interests, these interests are “deemed” security interests.

Note now the perfection issue, or, better said, the perfection non-issue. In many situations covered by sections 2-401 and 2-505, the to-be-protected parties will not know that deemed security interests have come into existence to protect them. And why should they know this? These are sales transactions, not secured transactions. The good news, however, is that Article 9 says that the deemed security interests in this context perfect automatically.⁶⁸ So, as soon as the deemed interests come into existence, they are perfected. Since the to-be-protected parties need do nothing at all to perfect the interests, it matters nothing, at least at this stage, that the to-be-protected parties don't know the interests exist.

Though the foregoing analysis repeatedly referenced section 2-401, the foregoing did NOT note that section 2-401 itself describes deemed security interests. The omission was not casual. The deemed security interests that section 2-401 itself describes require affirmative perfection steps. So, those particular deemed interests were covered earlier.

A comparable deemed security interest issue also arises on the of buyer side of buyer / seller transactions and is dealt with in section 2-711(3). A lessee's version of this problem is dealt with in section 2A-508(5).

Not uncommonly, buyers (or lessees) “reject” delivered goods when the buyers determine that the goods failed to conform to the requirements of the contracts. Further, it is not uncommon for buyers / lessees to “revoke acceptance” of goods when the buyers discover after acceptance that the goods don't conform to the contracts. In both of these cases, the buyers are likely to be in possession of the goods even though the buyers have rejected the goods or have revoked accept-

65. U.C.C. § 2-401.

66. *Id.*

67. *Id.* § 2-505.

68. *Id.* § 9-109.

ance of them. Who — the buyers or the sellers — has rights to goods that are in the possession of buyers but that are the subject of rejections or revocation of acceptances by the buyers? Again, the reasons that these who-has-the-rights questions matter are these. First, not uncommonly, goods that have been rejected or that are the subject of revocations but that nevertheless are in the possession of buyers are damaged or destroyed. Who bears the risk of that damage or destruction, the sellers or the buyers? Second, it is not uncommon for sellers or buyers who are parties to sales transactions to file for bankruptcy when buyers are in possession of goods that have been rejected or that are subject to revocations of acceptance. Whose bankruptcy trustees in these cases gets the goods, the sellers' bankruptcy trustees, or the buyers' bankruptcy trustees, or neither?

Article 2 addresses these buyer side issues in sections 2-401, 2-711(3), and 2A-508(5).⁶⁹ Again, section 2-401 announces a “passage of title” idea. However, section 2-401, to repeat, says its own passage of title rules apply only when the UCC doesn't have more specific rules for particular cases.⁷⁰ Section 2-711(3) gives us the more specific rules. Section 2-711(3) states that buyers who have possession of goods after rightful rejection of the goods or after reasonable revocation of acceptance of the goods, deemed security interests in the goods for any payments made on their price and for expenses reasonably incurred in their inspection, transportation, care and custody.⁷¹ Again, these security interests clearly are NOT “conventional” security interests. Hence, section 2-711(3) security interests must be “deemed” security interests. These deemed security interests potentially put the buyers of the goods ahead of other creditors in connection with the goods. These interests also potentially put the buyers ahead of the sellers' bankruptcy trustees.

Note now the perfection issue, or, better said, the perfection non-issue. In many situations covered by Article 2 deemed security interests, the to-be-protected parties will not know that deemed security interests have come into existence to protect them. And why should they know this? These are sales transactions, not secured transactions. The good news, however, is that Article 9 says that the deemed security interests in this context perfect automatically. So, as soon as the deemed interests come into existence, they are perfected. Since the to-be-protected parties need do nothing at all to perfect the inter-

69. *Id.* § 2-401, § 2-711(3), § 2A-508(5).

70. U.C.C. § 2-401.

71. *Id.* § 2-711(3).

ests, it matters nothing, at least at this stage, that the to-be-protected parties don’t know the interests exist.

Because the Article 2 deemed security interests just describe perfect automatically, perfection issues are NOT likely to present much in the way of problems here. Further, the bankruptcy issues repeatedly mentioned already in this analysis, will be handled the same way that bankruptcy issues are handled for conventional security interests. So, really, only one of the four inter-related why-it-matters ideas repeatedly described herein will potentially cause problems. When creditors don’t know that they have security interests, those creditors will not know that they can assert secured claims.

One additional thing deserves mention here. In some cases, the facts of the cases generate considerable ambiguity as to whether Article 2 creates, and then automatically perfects, deemed security interests. Sometimes this ambiguity will cause courts to conclude that no security interest exists in the particular case. In other situations, this ambiguity will cause courts to determine that security interests have come into existence (by attachment). In both of these cases, court rulings could leave some creditors incompletely protected.

Interestingly, Article 9 itself supplies a simple solution to this does-it-apply / does-it-not apply ambiguity issue. Article 9 authorizes what are sometimes called “protective” filings.⁷² Protective filings allow parties to transactions who aren’t sure whether a security interest exists at all in connection with a transaction, or who aren’t sure whether they must take affirmative steps to perfect security interests, to file a financing statement about the security interests involved “just to be safe.” Since section 9-505(b) says that filing or compliance with Article 9 is not “of itself a factor in determining whether the collateral secures an obligation,”⁷³ protective filings have no negative consequences. It can’t hurt to file. And it potentially can help. Bottom Line: Compliance with Article 9 (filing) is easy and cheap; litigation is difficult and expensive.

B. Deemed Security Interests in Some Cases of Rights to Receive Payments

As noted earlier, Article 9 says, essentially, that *all* transfers of payment rights create security interests in the payment rights.⁷⁴ If the parties to the transfers explicitly state that the transfers create security

72. *Id.* § 9-505(b).

73. *Id.*

74. *Id.* § 9-109(a)(1).

interests, then the security interests created in these transactions are conventional security interests and normal rules about security interests apply. However, if the parties to transfers of payment rights do NOT explicitly state that the transfers create security interests in the payment rights, or explicitly state that they are NOT security interests, then the security interests created by these transfers are deemed security interests.

Note now the perfection rules for security interests involving transfers of payment rights. First, if the security interests created by transfers of payment rights are conventional security interests, meaning if the parties to transactions explicitly state that the transactions are meant to create security for payment or performance, then the to-be-protected parties in these transactions must take affirmative steps to perfect the interests.⁷⁵ The affirmative steps usually will involve filing. Second, as demonstrated earlier herein, deemed security interests that arise in connection with various different kinds of transfers of payment rights must generally be perfected by filing.⁷⁶ We addressed those issues above. Third, in some cases security interests in payment rights in some contexts perfect automatically.⁷⁷ Creditors need NOT take affirmative steps to perfect in these cases.

Our focus now turns to the fact that 9-309 says that the deemed interests in a long list of different kinds of payment rights cases perfect automatically.⁷⁸ In these cases, the protected parties need NOT take affirmative steps to perfect the interests that the law has created for them. Rather, as soon as the deemed interests come into existence, they are perfected.

Perhaps the most important example here is deemed security interests that are the result of “casual or isolated” transfers of payment rights.⁷⁹ In these casual or isolated cases, the transferees of the payment rights simply can’t be expected to know that Article 9 has created security interests to protect them and that they, the casual or isolated transferees have to take affirmative steps to perfect those interests (which they probably don’t even know exist).

75. See U.C.C. § 9-308-316; WHITE & SUMMERS, *supra* note 5, § 22-4.

76. See U.C.C. § 9-308-316; WHITE & SUMMERS, *supra* note 5, § 22-4.

77. See U.C.C. § 9-308-316; WHITE & SUMMERS, *supra* note 5, § 22-5.

78. The list of situations where security interests perfect automatically includes “isolated and casual” transfers of payment rights, transfers of health care receivables, lottery winnings, and beneficial interests in decedents estates. More importantly, the list of automatic perfection cases involves “sales” of payment rights and all kinds of transfers of payment intangibles. These cases encompass the huge number of deemed security interests that come into existence in connection with securitizations and debt warehousing.

79. The “casual and isolated” language is from U.C.C. § 9-309, Comment 3.

But, the “casual and isolated” deemed interests are NOT the only payment right instances that provide automatic perfection. Rather, other examples also exist. For example, for various reasons, the bank lobbyists did not want deemed security interests to exist at all in connection with “sales” of payments rights (as opposed to transfers of such rights to create security) and any kinds of transfers of payment intangibles.⁸⁰ And the bank lobbyists certainly didn’t want an affirmative perfection steps requirement in these contexts. The compromise ultimately was that deemed security interests come into existence in these banking contexts but that these deemed interests perfect automatically (so that banks don’t have to take affirmative steps to perfect the interests).

Several additional instances also need mention. These too involve automatic perfection of deemed security interests.⁸¹ First, section 4-210 says that a collecting bank has a security interest in an item and any accompanying documents or the proceeds of either:

- (1) in case of an item deposited in an account, to the extent to which credit given for the item has been withdrawn or applied;
- (2) in case of an item for which it has given credit available for withdrawal as of right, to the extent of the credit given, whether or not the credit is drawn upon or there is a right of charge-back; or
- (3) if it makes an advance on or against the item.

Second, 5-118 states that an issuer or nominated person has a security interest in a document presented under a letter of credit and any identifiable proceeds of the collateral to the extent that the issuer or nominated person honors or gives value for the presentation. Again, in both of these cases, 9-309 says that the deemed security interests perfect automatically.

Finally, section 9-309(7) through section 9-309(13) gives us a list of additional instances where deemed security interests – mostly in payment rights or things related to payment rights – perfect automatically. These instances do not display any kind of pattern. In fact, Professors White and Summers refer to them as “a motley lot of transactions.”⁸² Rather, these remaining cases probably are just a random collection of situations where lobbyists for financial entities who deal with particular kinds of transactions wanted those transactions (1) to create security interests in property and (2) wanted the interests to perfect automatically. Chances are that a major part of the thinking

80. Payment intangibles are a hybrid kind of payment rights, a kind that usually occurs in the context of securitization and loan warehousing.

81. See U.C.C. § 9-309(7)-(8).

82. WHITE & SUMMERS, *supra* note 5, at 1195.

here is that the creditors in these transactions want to have priority over the bankruptcy trustees / DIPs of the debtors and to get that priority without filing. A mere listing of the components of this last group of automatically perfecting deemed security interests is sufficient. As noted, section 9-309(7) through section 9-309(13) really is just a “motley lot:”

- (7) a security interest of a collecting bank arising under Section 4-210;
- (8) a security interest of an issuer or nominated person arising under Section 5-118;
- (9) a security interest arising in the delivery of a financial asset under Section 9-206(c);
- (10) a security interest in investment property created by a broker or securities intermediary;
- (11) a security interest in a commodity contract or a commodity account created by a commodity intermediary;
- (12) an assignment for the benefit of all creditors of the transferor and subsequent transfers by the assignee thereunder; and
- (13) a security interest created by an assignment of a beneficial interest in a decedent’s estate.

Overall, therefore, the following can be stated about “deemed” security interests that perfect automatically. First, in several Article 2 instances, notably, sellers’ shipments under reservation and buyers’ rightful rejection or revocation of acceptance, sellers and buyers have deemed interests in the pertinent goods. These deemed interests usually protect sellers and buyers from the bankruptcy trustees of the opposite parties to the contracts. Because the protected parties in these cases are unlikely to know that they have deemed interests in the particular property involved, Article 9 says that these deemed interests perfect automatically. Second, although the general rule is that deemed security interests in transferred payment rights usually must be perfected by the taking of affirmative steps, Article 9 gives automatic perfection to deemed interests that come into existence in some payment right cases. The most important of these cases involve “casual or isolated” payment right transactions. But automatic perfection also occurs in some cases involving collecting banks, issuers of letters of credit and a “motley lot” of other kinds of transactions (in some of which cases the creditors are unlikely to know that deemed security interests protect them).

CONCLUSION

In summary, a couple points need emphasis. Article 9 refers, *inter alia*, to two relatively distinct kinds of security interests. Some security interests – called “conventional” security interests herein — are

created by security agreements and come into existence through a two-step process of attachment and perfection. Second, some security interests — called “deemed” security interests herein (borrowing terminology from the law in some Commonwealth countries⁸³), are created by operation of law rather than by security agreements of parties to transactions.

In some of these deemed security interest cases, creditors must take affirmative steps to perfect their interest, with those steps usually involving filing. Failure to perfect in these cases will potentially cause these creditors to lose out in priority battles to other creditors, and, perhaps more importantly, to the bankruptcy trustees or DIPS of the transferees of the property. These are the principal “traps for the unwary” that deemed security interests create. Other deemed security interests perfect automatically. Thus, creditors do NOT need to take affirmative steps to perfect these deemed interests. The traps for the unwary here are simply the fact that creditors protected by these automatically perfected interests will not know that they are so protected and, therefore, will not assert rights that they have but don’t know that they have.

One last thing, a repetition of what has been stated repeatedly herein, must again be mentioned. In all of the security interests cases just mentioned, the smart plan is for potentially protected parties to do “protective compliances” (aka “protective filings”). Protective compliance can’t hurt because 9-505(b) says that filing or compliance with Article 9 is not “of itself a factor in determining whether the collateral secures an obligation.”⁸⁴ But protective compliance certainly can help. If judges later rule that the transactions generated deemed security interests, or if judges later rule that affirmative steps were required to perfect various security interests that were created by the transactions, then protective compliances with Article 9 will give the potentially protected parties protection against non-perfection mistakes. Bottom Line (Again): Compliance with Article 9, including protective compliance, is easy and cheap. Litigation is difficult and expensive.

83. See CUMMING, WALSH AND WOOD, *supra* note 3 at 90-96; see also, McDougall, *supra* note 3.

84. U.C.C. § 9-505(b).