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PROPOSED REFORM OF U.C.C. § 9-326 SHIFTING PRIORITY DEFAULT RULES IN MERGER CONTEXTS

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Introduction

Part One of this paper provides a background description of the various Article 9 sections that could be triggered during a merger context. This paper utilizes *LMS Holding Co. v. Core-Mark Mid-Continent* as a tool to explain and demonstrate how these provisions interact with one another during a hypothetical merger of MAKO and RMC, both with respect to (1) perfection of transferred and after-acquired collateral and (2) priority default rules per sections 9-325 (2010) and 9-326 of the 2010 Uniform Commercial Code. Next, this paper delves into an in-depth explanation of the existing text, comments, and examples pertaining to revised section 9-326. Part Two of this paper refutes an argument that section 9-325 does not apply to proceeds of transferred collateral; subsequently, it proposes reformatory language, comments, and examples that seek to improve section 9-326. This section relies on cheapest cost avoider analysis as well as fairness considerations in order to support its legislative fix. Finally, this part of the paper responds to three potential criticisms to Part Two's proposed reformatory language.

I.
DESCRIPTIVE

A. *Analysis of* LMS v. Core-Mark *Under Revised Article 9: Hypothetical Merger of MAKO and RMC Regarding Perfection of Transferred and After-Acquired Collateral*

In *LMS Holding Co. v. Core-Mark Mid-Continent* (LMS), the United States Court of Appeals for the Tenth Circuit applied Article 9 when it affirmed a district court's granting of summary judgment in favor of Retail Marketing Company (RMC) because Coremark did not have a perfected security interest in RMC's after-acquired inventory.[2] In that case, Coremark had a security interest in MAKO, Inc.'s (MAKO), inventory and after-acquired inventory. MAKO, a chain of convenience stores, filed for Chapter 11 bankruptcy protection and transferred some of its existing inventory to RMC as part of MAKO's reorganization plan.[3] RMC executed a new security agreement with Coremark, giving Coremark a security interest in RMC's inventory and after-acquired inventory.[4] Coremark "perfected its security interest by filing a financing statement" with respect to MAKO but not with respect to RMC, after RMC acquired MAKO's assets under MAKO's reorganization plan.[5]

Because RMC only had after-acquired inventory at the time of its bankruptcy, under Revised Articled 9, whether or not Coremark had a perfected security interest in RMC turned on whether RMC was a new debtor per section 9-508.[6] Section 9-508 states that a financing statement filed against the original debtor (e.g., MAKO) is "effective to perfect a security interest in collateral acquired by the new debtor (e.g., RMC) before, and within four months after, the new debtor becomes bound under section 9-203(d)."[7]

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2. *See* LMS Holding Co. v. Core-Mark Mid-Continent, 50 F.3d 1520, 1525 (10th Cir. 1995).

3. *Id.* at 1522.

4. *Id.*

5. *Id.*

6. *Id.*

7. U.C.C. § 9-508(b)(1) (AM. LAW INST. & UNIF. LAW COMM'N 2010). The four-month grace period under section 9-508 is a compromise duration regarding the time in which a secured creditor can hold a secret lien. On the one hand, drafters of Article 9 want to vindicate a secured party's justified expectations in situations where a new debtor comes along, acquires all inventory of the original debtor, and agrees to be bound. However, when the

If the new debtor (e.g., RMC) is located in a different jurisdiction from the original debtor (e.g., MAKO), then the secured party's (e.g., Coremark's) original collateral that was transferred from MAKO to RMC remains perfected for one year, assuming its perfected status will not lapse sooner.[8] Regarding after-acquired collateral obtained by the new debtor post-transaction, section 9-316(i) provides that if the new debtor is in a different jurisdiction from the original debtor, the secured creditor has four months to re-perfect under debtor's new name or its security interest will become unperfected and "deemed never to have been perfected as against a purchaser."[9]

Assuming MAKO merged with RMC, RMC would be the new surviving entity as well as the new debtor.[10] Indeed, the third comment in section 9-508 provides examples of a "new debtor becoming bound by other law under subsection (d)(1)

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new debtor's name is so different as to be "misleading," the secured creditor has four months to possess a secret lien, at which point it must reperfect under the new debtor's name or lose perfection with respect to collateral acquired more than four months after the debtor's name change. *Id* § 9-508(b)(1) cmt. 4.

8. U.C.C. § 9-316(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010). In terms of definitions, RMC is a new debtor because a "new debtor" is a "person that becomes bound as debtor under Section 9-203(d) by a security agreement previously entered into by another person." U.C.C. § 9-102(a)(56) (AM. LAW INST. & UNIF. LAW COMM'N 2010). MAKO is an "original debtor" because it is "a person that, as debtor, entered into a security agreement to which a new debtor has become bound under section 9-203(d)." U.C.C. § 9-102(a)(60).

9. Section 9-316(i)(1) of the Uniform Commercial Code is particularly relevant to the application of section 9-326(a), which is discussed in detail below. Section 9-316(i)(1) of the Revised Uniform Commercial Code states that if a new debtor is located in a different jurisdiction from the original debtor, then: "The financing statement is effective to perfect a security interest in collateral acquired by the new debtor before, and within four months after, the new debtor becomes bound under section 9-203(d), if the financing statement would have been effective to perfect a security interest in the collateral had the collateral been acquired by the original debtor." U.C.C. § 9-316(i)(1) (AM. LAW INST. & UNIF. LAW COMM'N 2010).

10. Section 9-203(d) of the Uniform Commercial Code states that "[a] person becomes bound as debtor by a security agreement entered into by another person if, by operation of law other than this article or by contract . . . the security agreement becomes effective to create a security interest in the person's property." U.C.C. § 9-203(d) (AM. LAW INST. & UNIF. LAW COMM'N 2010).

includ[ing] B Corp becoming bound by A Corp's security agreement because it makes a binding contractual commitment to be so bound as well as B Corp becoming bound by A Corp's agreement when A Corp is merged into B Corp and the corporate law of mergers provides that B Corp is bound by A Corp's commitment."[11] In this hypothetical merger, when RMC merges with MAKO and transfers all of its assets to RMC, state corporate law will likely stipulate that, as part of the transaction, MAKO must succeed to RMC all of its liabilities, including the obligations (i.e., debt and collateral) created by MAKO's security agreement with its secured party, Coremark. Thus, Coremark can claim a security interest in the new accounts and inventory acquired by RMC after the merger.[12]

Additionally, a new debtor is bound if it "becomes generally obligated for the obligations of the other person, including the obligation secured under the security agreement, and acquires or succeeds to all or substantially all of the assets of the other person."[13] Thus, RMC's hypothetical acquisition of all or substantially all of MAKO's assets in a merger context would also fall under section 9-203(d)(2).

Accordingly, if MAKO merged into RMC, Coremark's after-acquired inventory clause would attach to the after-acquired inventory of the new debtor and surviving entity, RMC. Moreover, no new security agreement is necessary in order to extend Coremark's security interests in both assets transferred to RMC as well as inventory that RMC acquires post-merger.[14] Because RMC's name is "seriously misleading" under section

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11. JULIAN B. MCDONNELL ET AL, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE (2015).

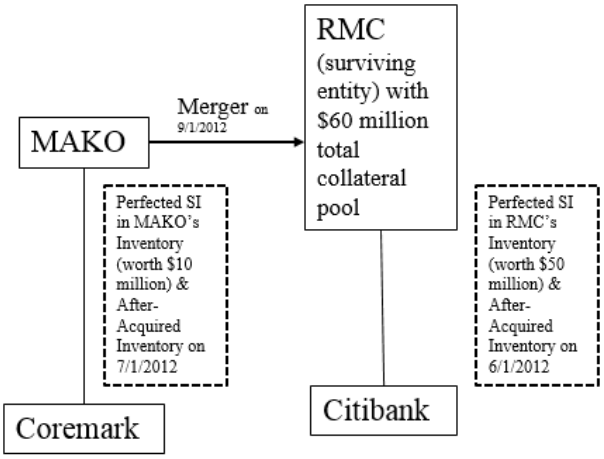
12. U.C.C. § 9-203(d)(2). Essentially, § 9-203(d) states that "if non-Article 9 law or contractual provisions provide that the subsequent party succeeds to all of the liabilities and assets of the earlier party, it will qualify as a 'new debtor' and be bound by the security agreement entered into by the earlier party." Margit Livingston, *Livingston on Changes in a Debtor's Business Structure Under U.C.C. Article 9*, 2013 EMERGING ISSUES 6972.

13. *Id.*

14. U.C.C. § 9-203(e). Indeed, the security agreement attaches to both RMC's existing as well as after-acquired inventory to the extent the inventory is described in the agreement. *See* U.C.C. §?9-203 cmt. 7 (explaining that "[i]f a new debtor becomes bound as debtor by a security agreement entered into by another person, the security agreement satisfies the requirement of subsection (b)(3) as to the existing and after-acquired property of the new debtor to the extent the property is described in the agreement.").

9-506 of the Uniform Commercial Code, i.e., one would not find RMC's name by conducting a search for a filed financing statement under the name "MAKO," Coremark would have four months to re-perfect under the new debtor's name (e.g., RMC).[15] However, during those four months after the date of the merger, Coremark is perfected with respect to all of RMC's after-acquired collateral.[16]

B. *Analysis of* LMS v. Core-Mark *Under Revised Article 9: Hypothetical Merger of MAKO and RMC, and Priority Default Rules per Section 9-325 and Section 9-326*



If both MAKO and RMC had their own secured creditors (e.g., Coremark as a secured creditor of MAKO and Citibank as a secured creditor of RMC), each holding perfected security interests in the inventory and after-acquired inventory of their respective original debtors, the default rules of section 9-325 and section 9-326 govern who gets priority over what collateral. This type of merger transaction is diagramed below.[17]

In general, if there is a conflict regarding collateral transferred by the original debtor (e.g., MAKO) to the new debtor (e.g., RMC), then section 9-325 applies. If there is a priority

15. U.C.C. § 9-508(b).

16. *Id.*

17. The security interests of the two secured parties, Coremark and Citibank, continue in the combined assets after the merger. *See* U.C.C. § 9-315 (AM. LAW INST. & UNIF. LAW COMM'N 2010).

conflict regarding collateral that originates with the new debtor (e.g., after-acquired inventory), then section 9-326 applies.

1. *Section 9-325*[18]

Here, Coremark would retain its security interest concerning its original collateral, the $10 million worth of inventory that is transferred to or acquired by RMC during the transaction.[19] Moreover, Coremark's priority over the collateral after the merger holds true even if Citibank would have priority under the first-to-file-or-perfect rule of section 9-322(a)(1) of the 2010 Uniform Commercial Code. Per section 9-325, the secured party of the transferor has priority if three conditions are satisfied.[20] Namely, a security interest created by a debtor (e.g., RMC, the transferee) is subordinate to a security interest in the same collateral created by another person (e.g., MAKO, the transferor) if (1) the debtor acquired the collateral subject to the security interest created by the other person; (2) the security interest created by the other person was perfected when the debtor acquired the collateral; and (3) there is no

18. Section 9-325 addresses a so-called "double debtor" problem, which occurs when a new debtor (e.g., RMC) acquires property that is subject to a security interest created by a different, original debtor (e.g., MAKO). U.C.C. § 9-325 cmt. 2 (AM. LAW INST. & UNIF. LAW COMM'N 2010).

19. U.C.C. § 9-315(a) ("[A] security interest . . . continues in collateral notwithstanding the sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest."); *see* U.C.C. § 9-201 (establishing that security interests are good against the world); *see also* U.C.C. § 9-508(c) cmt. 5 (clarifying that section 9-508 does not apply to collateral transferred by the original debtor to a new debtor; under those circumstances, the filing against the original debtor continues to be effective until it lapses or perfection is lost for another reason. *See* U.C.C. § 9-316; *see also* U.C.C. § 9-507(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010)).

20. U.C.C. § 9-325(a). Additionally, section 9-325 subordinates a security interest created by a debtor to a security interest created by another person. Section 9-102(a)(28) defines a debtor as "a person having an interest, other than a security interest or other lien, in the collateral, whether or not the person is an obligor." Because the transferee of the collateral has an interest in the collateral, under section 9-325 the referenced "debtor," and the transferor of the collateral who was formerly the debtor, is the "another person" referenced in section 9-325. RICHARD H. NOWKA, MASTERING SECURED TRANSACTIONS: UCC ARTICLE 9, at 165-66 (2d ed. 2014).

period thereafter when the security interest becomes unperfected.[21]

As applied to the facts of this hypothetical merger, section 9-325(a)(1) is satisfied because Citigroup's security interest attaches to the transferred inventory under its after-acquired property clause with RMC. Section 9-325(a)(2) is satisfied because Coremark had a perfected security interest when RMC acquired the collateral. Finally, section 9-325(a)(3) is satisfied assuming there is no period thereafter when Coremark's security interest in unperfected.[22] Thus, Coremark would have priority notwithstanding the fact that Citibank would have priority under section 9-322(a)(1)'s first-to-file-or-perfect rule, given the relevant timeline of events.[23]

Similarly, subject to section 9-325(b), Citibank will have priority with respect to its original collateral (i.e., the $50 million in RMC's inventory prior to the merger) because (1) Coremark's security interest attaches to the transferred inventory under its after-acquired property clause with MAKO; (2) Citibank had a perfected security interest with RMC when MAKO merged with it; and (3) there is presumably no period thereafter when Citigroup's security interest is unperfected.

Section 9-325(b) states that section 9-325(a) subordinates a security interest only if the security interest (1) otherwise would have priority solely under section 9-322(a) (general priority rules among conflicting security interests and agricultural liens on the same collateral) or U.C.C. section 9-324 (2010) (priority rule for purchase money security interests); or (2) arose solely under U.C.C. section 2-711(3) (2002) (buyers remedies in general and security interest in perfected goods) or U.C.C. section 2A-505(5) (2002).[24] As such, if the security

21. U.C.C. § 9-325(a).

22. If Coremark allowed its perfection to lapse at any point, section 9-325 does not apply, and priority is determined under section 9-322(a) and section 9-515(c). *Id.*

23. *See* Nowka, *supra* note 20 at 165–66. The relevant timeline of events include Citibank perfecting its security interest in RMC's inventory and after-acquired inventory on 6/1/2012, Coremark perfecting its security interest in MAKO's inventory and after-acquired inventory on 7/1/2012, and the merger occurring on 1/1/2012.

24. U.C.C. § 2A-505(5) (AM. LAW INST. & UNIF. LAW COMM'N 1977) ("Neither rescission nor a claim for rescission of the lease contract nor rejection or return of the goods may bar or be deemed inconsistent with a claim for damages or other right or remedy.").

interest created by the debtor is already subordinate under the applicable priority rule of section 9-322(a) or section 9-324, then the other secured party does not need the aid of section 9-325.[25]

Applying section 9-325(b) to our hypothetical merger transaction, if Citibank perfects its security interest in RMC's inventory and after-acquired inventory on 1/1/2012, Coremark perfects its security interest in MAKO's inventory and after-acquired inventory on 7/1/2012, and the merger occurs on 12/1/2012, then Coremark needs section 9-325 in order to maintain priority over its $10 million worth of collateral post-merger. By contrast, if Coremark perfects its security interest in MAKO's inventory and after-acquired inventory on 6/1/2012, Citibank perfects its security interest in RMC's inventory and after-acquired inventory on 7/1/2012, and the merger occurs on 9/1/2012, section 9-326(b) applies because Coremark would receive priority in the $10 million in collateral via section 9-322(a), even in the absence of section 9-325. Lastly, section 2-711(3) and section 2A-505(5) do not apply because there is no instance in which a security interest is created for a buyer or lessee after its rightful rejection or justifiable revocation of acceptance.

2. *Section 9-326*

Section 9-326 addresses priority issues arising out of instances when a new debtor becomes bound by the security agreement of an original debtor and each debtor has a secured creditor.[26] As discussed above, RMC is a "new debtor" with respect to Coremark following the merger.[27] Moreover, Coremark's after-acquired property clause will attach to RMC's after-acquired property clause during the four month grace period provided by section 9-508(b). Priority under section 9-326 depends on whether MAKO's secured creditor, Coremark, relied exclusively on section 9-508 or section 9-316(i)(1) to reach RMC's after-acquired inventory.

If Coremark relied on either the section 9-508 four month grace period after a new debtor becomes bound under section 9-203(d) or the four month grace period in section

25. *See* Nowka, *supra* note 20 at 165–66.
26. U.C.C § 9-326 cmt. 2 (Am. Law Inst. & Unif. Law Comm'n 2010).
27. *See* § 9-508 cmt. 3.

9-316(i)(1)—if the original debtor and the new debtor are located in different jurisdictions—in order to reach RMC's after-acquired inventory, then Citibank (i.e., RMC's secured creditor) would have priority over any after-acquired inventory.[28] That is to say, the original creditors would have priority if the new debtor's creditors relied on section 9-508 or section 9-316(i)(1) and did not file a new financing statement in the debtor's new name (i.e., RMC). However, if Coremark filed a new financing statement naming RMC as the new debtor, then the ordinary priority rules of Article 9 would govern any priority conflict between Coremark's and Citibank's security interests, and courts would look to see who filed the relevant financing statement first.

3. *Subordination Agreements*

It is important to note that section 9-325 and section 9-326 are both merely default rules, which parties can, and do, contract around. Namely, the parties can enter into subordination agreements where they agree to reimagine priorities, and these intercreditor agreements are enforceable.[29] In a merger context, these types of agreements could come up in at least the following two ways:

(1) Lender for a target company (e.g., Coremark) says it wants priority with respect to after-acquired inventory by the new debtor (e.g., the surviving entity, RMC) and will not agree to a merger unless it gets it;
(2) Lender for acquirer (e.g., Citibank) places a negative pledge clause in the security agreement with the original debtor and thus wants priority with respect to the target company's original collateral (e.g., MAKO's $10 million in inventory).

In either situation, the parties will need to negotiate a subordination agreement if they want the deal to go through. Sections 9-325 and 9-326 of Article 9 ultimately provide parties with default rules. However, it is important to reiterate that the

28. § 9-326.

29. U.C.C. § 1-310 (AM. LAW INST. & UNIF. LAW COMM'N 2010); *see also id.* ("An obligation may be issued as subordinated to performance of another obligation of the person obligated, or a creditor may subordinate its right to performance of an obligation by agreement with either the person obligated or another creditor of the person obligated") *Id.* § 9-339 ("This article does not preclude subordination by agreement by a person entitled to priority").

parties are free to contract around them, and these intercreditor agreements are enforceable.

C. *In-Depth Explanation of Section 9-326*

1. *Section 9-326(a)*

Section 9-326(a) states that "[s]ubject to subsection (b), a security interest that is created by a new debtor in collateral in which the new debtor has or acquires rights and is perfected solely by a filed financing statement that would be ineffective to perfect the security interest but for the application of Section 9-316(i)(1) or 9-508 is subordinate to a security interest in the same collateral which is perfected other than by such a filed financing statement."[30]

Example 1: "SP-X holds a perfected-by-filing security interest in X Corp's existing and after-acquired inventory, and SP-Z holds a perfected-by-possession security interest in an item of Z Corp's inventory. Both X Corp and Z Corp are located in the same jurisdiction under Section 9-307. Z Corp becomes bound as debtor by X Corp's security agreement (e.g., Z Corp buys X Corp's assets and assumes its security agreement). See Section 9-203(d)."[31]

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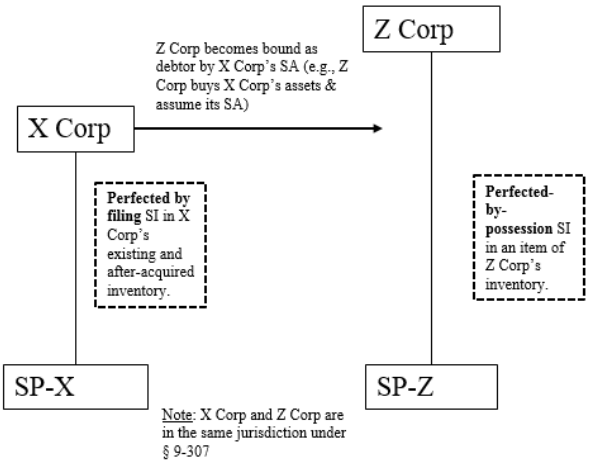
30. U.C.C. § 9-326(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010). As discussed in greater detail above, section 9-210(d) identifies the three contexts in which a "new debtor" can become bound by a security agreement that was executed by an original debtor; namely (1) situations where the new debtor becomes bound under "other law" (e.g., corporate merger law); (2) situations where the new debtor makes a binding contractual commitment to be bound by the original debtor's security agreement; and (3) situations where the new debtor "becomes generally obligated for the obligations of the other person, including the obligation secured under the security agreement, and acquires or succeeds to all or substantially all of the assets."

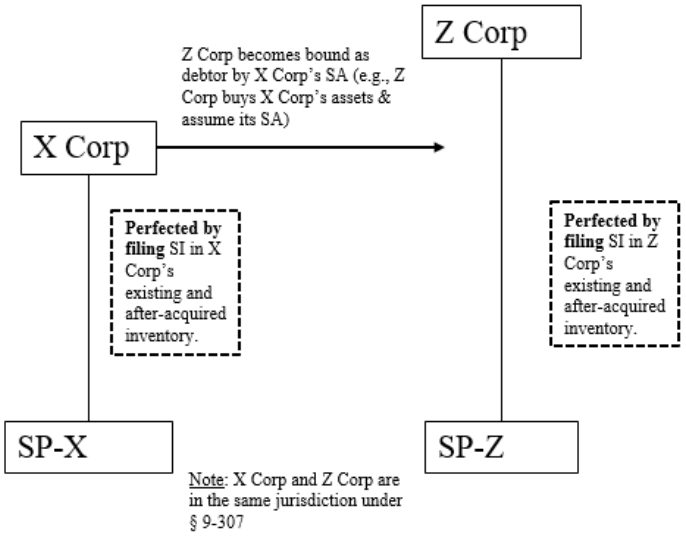
31. *Id.* at cmt. 2, ex. 1.



SP-X's financing statement would not be able to perfect a security interest in an item of inventory in which Z Corp has rights, but for section 9-508.[32] Because of this, SP-X's perfected security interest in any after-acquired inventory by Z Corp is subordinate to SP-Z's, irrespective of whether SP-X's financing statement was filed before SP-Z perfected its security interest.[33]

Example 2: "SP-X holds a perfected-by-filing security interest in X Corp's existing and after-acquired inventory, and SP-Z holds a perfected-by-filing security interest in Z Corp's existing and after-acquired inventory. Both X Corp and Z Corp are located in the same jurisdiction under Section 9-307. Z Corp becomes bound as debtor by X Corp's security agreement. Immediately thereafter, and before the effectiveness of SP-X's financing statement lapses, Z Corp acquires a new item of inventory."[34]

32. *Id*
33. *Id.*
34. U.C.C. § 9-326(a) cmt. 2, ex. 2 (AM. LAW INST. & UNIF. LAW COMM'N 2010).



As in Example 1, SP-X's financing statement would not be able to perfect a security interest in an item of inventory in which Z Corp has rights but for section 9-508's four-month grace period for after-acquired collateral.[35] However, unlike Example 1, in this case SP-Z perfected its security interest in Z Corp by filing a financing statement as opposed to by another method (e.g., by possession). Nevertheless, because the effectiveness of SP-Z's security interest does not depend on section 9-316(i)(1) or section 9-508, SP-X's perfected security interest is junior to SP-Z's security interest.[36] Regardless of whether SP-X or SP-Z filed its financing statement first, SP-Z would still have priority in any after-acquired inventory by SP-Z, unless SP-X filed a financing statement after Z Corp became bound as debtor by X Corp's security agreement under the name Z Corp, because then the effectiveness of SP-X's perfection would not depend on § 9-508. Moreover, this would be the case even if X Corp and Z Corp were located in different jurisdictions because SP-X's security interest would be perfected by a financing statement that would be ineffective but for section 9-316(i)(1); by contrast, the effectiveness of the perfection of

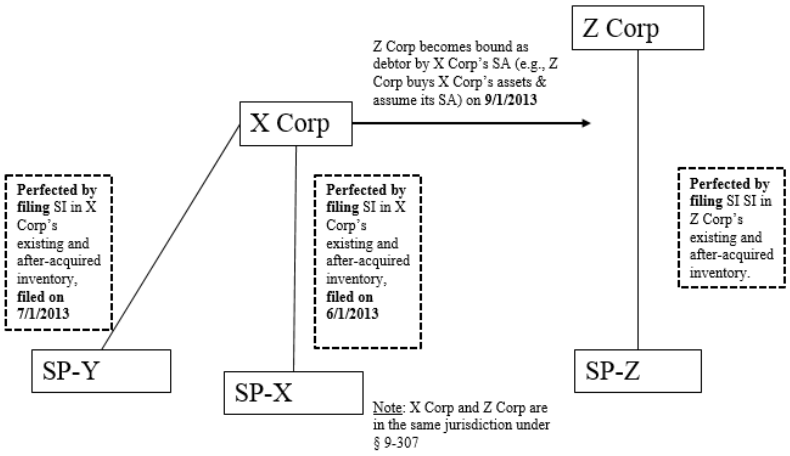
35. *Id.*
36. *Id.*

SP-Z's filing does not depend on section 9-508 or section 9-316(i)(1).[37]

2. *Section 9-326(b)*

Section 9-326(b) addresses priority issues among security interests created by the original debtor.[38] If the new debtor becomes bound by multiple security agreements entered into by the *same* original debtor, the first sentence of section 9-326(b) states that priority is determined by other provisions of Part 3 of Article 9.[39] But, if a new debtor becomes bound by security agreements executed by *different* original debtors, the second sentence of section 9-326(b) applies and "conflicting security interests rank according to priority in time of the new debtor's having been bound."[40]

Example 3: "Under the facts of Example 2, SP-Y also holds a perfected-by-filing security interest in X Corp's existing and after-acquired inventory. SP-Y filed after SP-X."[41]

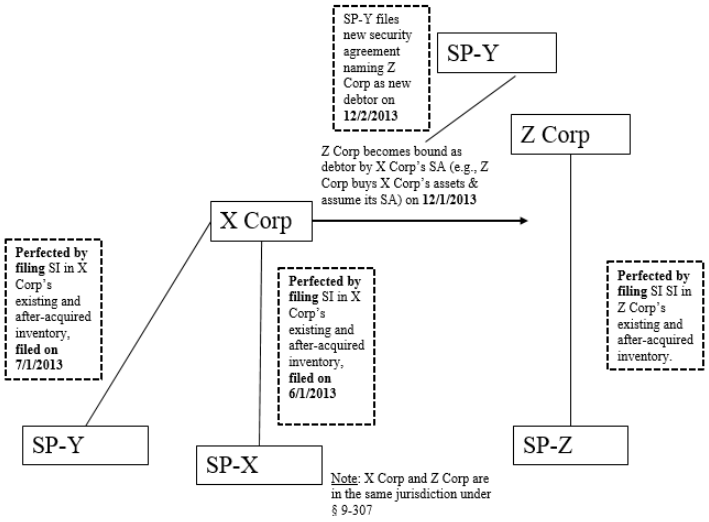


"Inasmuch as both SP-X's and SP-Y's security interests in inventory acquired by Z Corp after it became bound would be unperfected but for the application of section 9-508, the nor-

37. *Id.*
38. U.C.C. § 9-326(b) cmt. 3 (AM. LAW INST. & UNIF. LAW COMM'N 2010).
39. *See* McDonnell, *supra* note 11.
40. U.C.C. § 9-326(b) (AM. LAW INST. & UNIF. LAW COMM'N 2010).
41. § 9-326(b) cmt. 3, ex. 3.

mal priority rules determine their relative priorities."[42] As such, SP-X (filing on 6/1/2013) would have priority over SP-Y (filing on 7/1/2013) under the "first-to-file-or-perfect" rule of section 9-322(a)(1).[43]

Example 4: "Under the facts of Example 3, after Z Corp became bound by X Corp's security agreement, SP-Y promptly filed a new initial financing statement against Z Corp."[44]



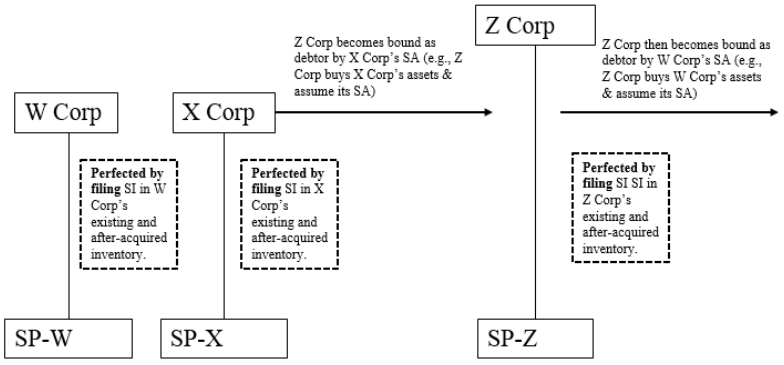
SP-X's security interest remains perfected solely because of its original filing against X Corp, which would not remain perfected but for the application of section 9-508.[45] Contrastingly, SP-Y's security interest is perfected by the filing of a financing statement naming the new debtor, Z Corp, whose effectiveness does not depend on section 9-508 or section 9-316(i)(1).[46] Thus, SP-Y will have priority over SP-X, even though SP-X filed a financing statement under the original debtor's name before SP-Y did.[47] Lastly, normal first-to-file-or-perfect rules govern priority between SP-Y and SP-Z, once

42. *Id.*
43. *Id.*
44. § 9-326(b) cmt. 3, ex. 4.
45. *Id.*
46. *Id.*
47. U.C.C. § 9-326(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010).

again because the effectiveness of SP-Y's perfection does not depend on section 9-508 or section 9-326(a).[48]

The first sentence of section 9-326(b) preserves the relative priority of security interests created by the original debtor.[49] However, section 9-326(b), comment three, example four states that "[w]hen the new debtor has become bound by security agreements entered into by *different* original debtors,. . .priority is based on priority in time of the new debtor's becoming bound."[50] This "effectively limits the applicability of the first sentence to situations in which a new debtor has become bound by more than one security agreement entered into by the *same* original debtor."[51]

Example 5: "Under the facts of Example 2, SP-W holds a perfected-by-filing security interest in W Corp's existing and after-acquired inventory. After Z Corp became bound by X Corp's security agreement in favor of SP-X, Z Corp became bound by W Corp's security agreement."[52]



Per section 9-326(b), SP-W's security interest in after-acquired inventory by Z Corp is junior to SP-X's security interest in after-acquired inventory by Z Corp, because Z Corp became bound under SP-X's security agreement before it became

48. U.C.C. § 9-326(b) note 43 (AM. LAW INST. & UNIF. LAW COMM'N 2010).

49. U.C.C. § 9-326(b) (AM. LAW INST. & UNIF. LAW COMM'N 2010).

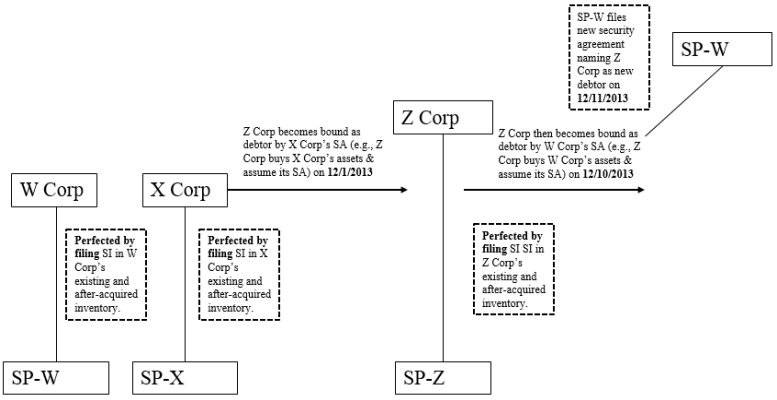
50. U.C.C. § 9-326(b) cmt. 3, ex. 3 (AM. LAW INST. & UNIF. LAW COMM'N 2010).

51. *Id.* (emphasis added).

52. U.C.C. § 9-326(b) cmt. 3, ex. 5 (AM. LAW INST. & UNIF. LAW COMM'N 2010).

bound under SP-W's security agreement—irrespective of whether SP-X's or SP-W's financing statement was filed first.[53]

Example 6: "Under the facts of Example 5, after Z Corp became bound by W Corp's security agreement, SP-W promptly filed a new initial financing statement against Z Corp."[54]

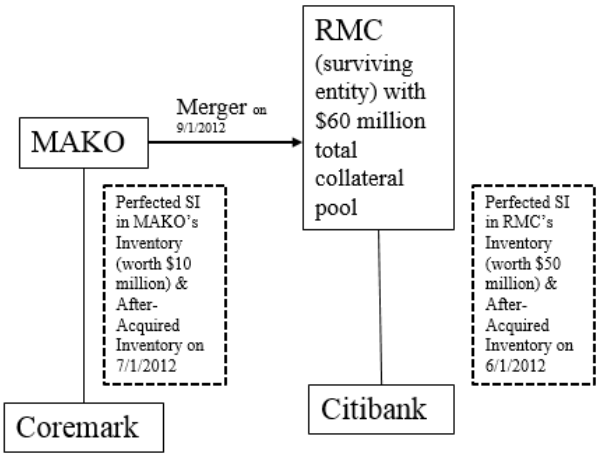


At that time, SP-W files a new security agreement naming Z Corp as the new debtor, the perfection of SP-X's security interest relied solely on application of section 9-508.[55] Because SP-W's security interest is perfected by the filing of a financing statement, naming Z Corp as the new debtor—whose effectiveness does not depend on section 9-316(i)(1) or section 9-508—SP-X's security interest is subordinate to SP-W's.[56] If both SP-X and SP-W file a new initial financing statement against Z Corp, then section 9-322(a)(1) applies.

53. *Id.*
54. U.C.C. § 9-326(b) cmt. 3, ex. 6 (AM. LAW INST. & UNIF. LAW COMM'N 2010).
55. *Id.*
56. *Id.*

II.
ANALYSIS

A. *Section 9-325 Applies to Proceeds of Transferred Collateral*



A brief return to an application of section 9-325 with respect to the *LMS* case shows why a section such as section 9-325 is a necessary component of Article 9. Absent section 9-325, Coremark would not have priority over the $10 million in collateral under the first-to-file-or-perfect rule per the filing dates in the diagram above.[57]

This is an issue because it would be impossible for Coremark to guard against this type of risk.[58] Even if Coremark diligently searched for filings and conducted a physical inspection of MAKO's inventory to ensure that no other creditor was perfected first, Coremark could not discover this problem in advance because there is no way for Coremark to know *ex-ante* who would be (a) the buyer of substantially all of MAKO's assets or (b) the surviving entity in a merger context.[59]

In light of this issue, some people erroneously argue that because nothing in the text of section 9-325 makes the section applicable to proceeds of the transferred collateral, proceeds

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57. U.C.C. § 9-322(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010).

58. Stephen L. Sepinuck, *Perfecting Article 9: A Partial Prescription for the Next Revision*, 46 GONZ. L. REV. 555, 560-62 (2010-11).

59. *Id.*

are not covered by section 9-325.[60] Stephen Sepinuck, and those who subscribe to his interpretation, think that because other priority rules in Article 9 expressively cover all or some types of proceeds, proceeds are *not* covered by section 9-325.[61] Correspondingly, he suggests that section 9-325 should be amended to explicitly mention the inclusion of proceeds of transferred collateral.[62]

This is a bad argument for several reasons. Other sections of Article 9 make it clear that explicit inclusion of proceeds of transferred collateral in section 9-325 would be superfluous. Sepinuck has overlooked section 9-203(f) and section 9-315(a), which state that attachment to proceeds is automatic, and a creditor's security interest in proceeds is perfected as long as its security interest in the original collateral was perfected.[63] Indeed, a security interest in the original collateral "attaches to any identifiable proceeds of collateral."[64]

Moreover, a security interest in proceeds is perfected as long as the security interest in the original collateral was perfected.[65] Thus, if a creditor (e.g., Coremark) had a security interest in the original collateral (e.g., MAKO's inventory), it had been perfected, and the creditor was able to identify the proceeds (e.g., cash, chattel paper, etc.), then the creditor would have a perfected security interest in the proceeds from the sale of the transferred collateral.[66]

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60. *Id.*

61. *Id.* Sepinuck argues that one may make a negative inference that section 9-325 does not cover proceeds of transferred collateral. In making this argument, Sepinuck relies on U.C.C. §§ 9-324(a)-(b), 9-330(c), 9-322(c) (AM. LAW INST. & UNIF. LAW COMM'N 2010).

62. *Id.*; *see also id* Appendix 1.1.

63. U.C.C. § 9-203(f) (AM. LAW INST. & UNIF. LAW COMM'N 2010). "The attachment of a security interest in collateral gives the secured party the rights to proceeds provided by Section 9-315 and is also attachment of a security interest in a supporting obligation for the collateral."); *see also* U.C.C. § 9-315(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010). (A security interest continues notwithstanding sale, lease, or other disposition except as otherwise provided, and "a *security interest attaches to any identifiable proceeds of [the] collateral*") (emphasis added).

64. U.C.C. § 9-315(a)(2) (AM. LAW INST. & UNIF. LAW COMM'N 2010).

65. U.C.C. § 9-315(c) (AM. LAW INST. & UNIF. LAW COMM'N 2010). (stating that a security interest in proceeds is a perfected security interest if the security interest in the original collateral was perfected).

66. U.C.C. § § 9-315(b), (c) (AM. LAW INST. & UNIF. LAW COMM'N 2010).

Finally, proceeds are included squarely in the definition of collateral. Per U.C.C. section 9-102 (12), collateral means "property subject to a security interest or agricultural lien," and "the term includes . . . proceeds to which a security interest attaches." For this reason, and the ones discussed above, section 9-325 unquestionably applies to proceeds of transferred collateral.

B. *Proposed Reform of Section 9-326(a)*

Transitioning to a more detailed reformatory proposal regarding section 9-326, the text of this section is not as clear as it could be regarding when exactly a perfected security interest that is created by one of the original debtor's secured creditors is subordinate to an interest in the same collateral that is created by a new debtor in which the new debtor has acquired rights. Moreover, in certain contexts, existing section 9-326(a) unfairly advantages new filers at the expense of the original secured creditor. To remedy these issues, I propose the following revisions to section 9-326(a):

Section 9-326. PRIORITY OF SECURITY INTERESTS CREATED BY NEW DEBTOR.

(a) [Subordination of security interest created by new debtor.]

Subject to subsection (b), a security interest that is created by a new debtor in collateral in which the new debtor has or acquires rights and is perfected solely by a filed financing statement that would be ineffective to perfect the security interest but for the application of Section 9-316(i)(1) or 9-508 is subordinate to a security interest in the same collateral which is perfected other than by such a filed financing statement.

Subject to subsection (b), when a new debtor, defined in Section 9-203(d), creates a security interest in collateral in which the new debtor has or acquires rights, the following applies:

If that security interest is perfected by a filed financing statement and the effectiveness of that financing statement depends on either Section 9-316(i)(1) or Section 9-508, then that security interest is subordinate to security interests in the same collateral whose perfected status does not depend on either Section 9-316(i)(1) or Section 9-508.

(1) Subsection (a)(1) does not apply to situations where all of the following necessary conditions are met:
   (i) The party whose priority conflicts with the original secured creditor's priority was *not* a secured creditor to the debtor prior to a merger or substantial asset sale;
   (ii) The original secured creditor included a 30 day notice clause, regarding change in business structure, in its respective security agreement(s) with the original debtor prior to any merger or substantial asset sale; and
   (iii) The original debtor failed to notify its original secured creditor(s) of any prospective change in business structure that could trigger Section 9-203(d) prior to 30 days before such a change occurred.
(2) If there are multiple creditors who satisfy the description of (a)(2)(i), then other provisions of Article 9 determine priority among those creditors' conflicting security interests.

Proposed section 9-326(a)(1) retains the crux of what current section 9-326(a) seeks to accomplish because I believe the policy reasons that the drafters of section 9-326 likely weighed are sound. However, the reformed language above seems to accomplish the core of section 9-326(a) in a clearer, more straightforward manner. Specifically, the latter part of section 9-326(a), ". . . is subordinate to a security interest in the same collateral which is perfected other than by such a filed financing statement" is confusing and should be replaced with the above language of reformed section 9-326(a)(1). Proposed section 9-326(a)(2) is a significant addition to section 9-326, which I explain and defend in the sub-sections below.

1. *Reformed Text of Section 9-326(a): Justification*

As Professor Margit Livingston notes in a recent article, "Section 9-326 creates a seeming dichotomy between what one might call 'strong perfection' and 'weak perfection.'"[67] That is to say, section 9-326 demotes perfection achieved merely

67. Livingston, *supra* note 12.

through section 9-508 or section 9-316(i)(1)—so called "weak perfection"—and subordinates it to security interests that were perfected through filing a financing statement in the new debtor's name—so called "strong perfection."[68]

This makes sense to a degree. Section 9-326(a) reflects this value by preferring a properly filed financing statement that does not rely on section 9-508 or section 9-316(i)(1) to one that does rely on one of those two sections in order for it to be effective. As a policy matter, this makes sense because secret liens are bad for stability in secured lending. Moreover, Article 9 "fundamentally is about encouraging the extension of secured credit" because the extension of secured credit arguably enhances economic production and societal welfare, and "the people who are going to be doing that are primarily filers."[69] Thus, Article 9 wants to protect the filer who has diligently provided "notice to the world." This political economy argument is persuasive, which is why reformed section 9-326 leaves the heart of section 9-326(a)'s priority scheme intact.

However, added language per section 9-326(a)(2) negates the priority mechanism set up in proposed section 9-326(a)(1) in certain situations because it is not fair for a diligent, original secured creditor to lose its senior priority to a new creditor who has not been a creditor to the secured party before the new debtor was bound by a security agreement that was executed by an original debtor. This situation seems particularly unfair in circumstances where—unbeknownst to the original debtor's secured creditor(s)—the new debtor enters into and perfects a new security interest with a different creditor who (1) was not a lender prior to the merger or substantial asset sale and (2) files under the new debtor's name, thereby superseding the original secured creditor's priority in the conflicted collateral.

On the one hand, Article 9 should incentive creditors to file financing statements with the correct name of the debtor, for all of the reasons previously discussed. On the other hand, it does not seem fair for secured creditors of the original debtor to face a loss of priority for something that the original secured creditor (1) had no knowledge of and (2) tried to

68. *Id.*
69. *Id.*

contract against in the first place via a notice clause in the security agreement with the original debtor.

Proposed section 9-326(a)(2) addresses just this issue.[70] The new language of proposed section 9-326(a)(2) rewards secured creditors of original debtors who were diligent enough to put a change of business structure notice requirement in their security agreement with the original debtor, while still encouraging filing of financing statements. Because this proposed reform will lower the risk that secured creditors of original debtors will not get paid in bankruptcy—by virtue of increasing their relative priority over other secured creditors post-merger or substantial asset sale—this proposal will facilitate increased secured lending by original lenders. Moreover, because it preserves the existing section 9-326 priority scheme when parties are involved prior to a merger or substantial asset sale, it will not chill merger transactions because existing secured creditors of the surviving entity will know that they will still have priority if the effectiveness of their perfected security interest does not depend on section 9-508 or section 9-316(i)(1).

Furthermore, the new creditor, who was not involved at all with the original debtor prior to the merger or asset sale, is in some ways the cheapest cost avoider because the new creditor only has to run a filing search one time—i.e., when the new creditor is considering lending on a secured basis to the debtor. By contrast, the secured creditor for the original debtor would have to continually run financing statement searches to see if the original debtor has become a new debtor, assuming the debtor has not notified the original secured creditor of its change in business structure.

Admittedly, this proposed reform could chill lending between new debtors and lenders who have not been secured creditors to the debtor prior to a merger or substantial asset sale, since they will likely lose in priority under proposed section 9-326. However, unlike the secured party for the original debtor, new lenders who come in after a merger or substantial

70. In order to fix this inequity, Article 9 should differentiate between situations in which a creditor of the new debtor does not rely on the application of section 9-508 or section 9-316(i)(1) and situations in which the new debtor grants a security interest in its collateral with a completely different creditor who was not involved at all with the original debtor prior to the merger or asset sale.

sale of assets at least have the knowledge that they would be entering a security agreement with the debtor with a likely lower priority over conflicted, after-acquired collateral. As such, they could factor in this cost into the price of the value (e.g., the loan). By contrast, the secured creditor for the original debtor knows in theory that the original debtor could change its business structure in a manner that is consistent with section 9-302(d), at which point a new creditor could come in and file under the new debtor's name, thereby subordinating the original creditor's priority if the original lender's perfection relies on section 9-508 or section 9-316(i)(1). Yet, the secured creditor for the original lender has no way to guard against this other than by (1) placing a change of business structure notification clause in its security agreement with the original debtor and (2) running periodic filing searches to check if the original debtor has merged or sold substantially all of its assets.

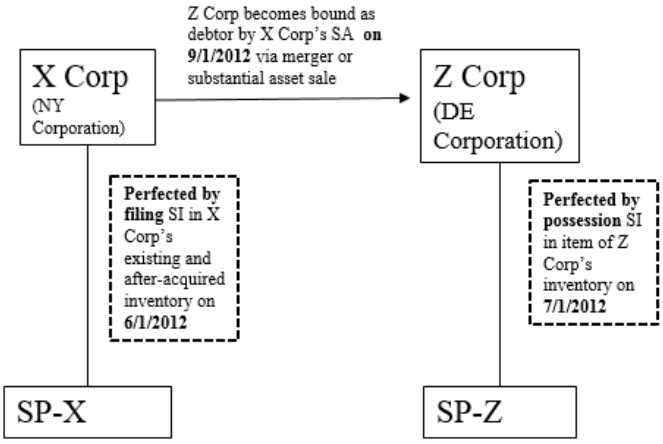
2. *Reformed Text of Section 9-326(a): Examples and Comments*

The examples and comments below clarify how a revised section 9-326(a)(1) and section 9-326(a)(2) would work under the proposed reformatory language.

Comment 1: In situations where there are only two parties, i.e., the secured creditor of the original debtor and the secured creditor of the new debtor, the proposed reform leaves the outcome of section 9-326(a) largely unchanged. The only difference in the proposed language and the language of existing section 9-326(a) is better wording. By contrast, the examples that follow Comment 2 involve at least one new creditor who has not been a creditor to the secured party before the new debtor was bound by a security agreement that was executed by an original debtor (i.e., during a merger or sale of substantially all of debtor's assets). These latter situations implicate proposed section 9-326(a)(2) and generate substantively different results from existing section 9-326(a).

Example 1: SP-X has a perfected-by-filing security interest in X Corp's existing and after-acquired inventory on 6/1/2012. SP-Z has a perfected-by-possession security interest in an item of Z Corp's inventory on 7/1/2012. X Corp is a New York corporation and Z Corp is a Delaware corporation under section 9-307. Z Corp becomes bound as debtor by X Corp's security agreement via merger or substantial asset sale

per section 9-203(d) on 9/1/2012. SP-X does not have a change in business structure notification clause in its security agreement with X Corp.



SP-X's financing statement is "weakly perfected" with respect to the after-acquired collateral because the effectiveness of its perfection depends on application of the four-month grace periods enumerated in section 9-316(i)(1) and section 9-508. By contrast, SP-Z's perfection is "strongly perfected" because the effectiveness of its financing statements does not depend on either section 9-316(i)(1) or (b) section 9-508.[71] Thus, SP-Z would still have priority, even though under normal priority rules SP-X would have priority over SP-Z because SP-X filed in the name of the X Corp prior to the date in which SP-Z perfected its security interest in Z Corp (the surviving entity) as new debtor.[72]

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71. This is the case because SP-Z perfected its security interest in the item of Z Corp's inventory by possession and does not need either of the aforementioned four-month grace periods in order to reach the conflicted collateral. Even if SP-X and SP-Z were located in the same jurisdiction (e.g., they were both New York corporations), the effectiveness of SP-X's security interest would depend on the application of section 9-508.

72. Even if SP-X did have a change in business structure notification clause in its security agreement with X Corp, the priority outcome would not change because proposed section 9-326(a)(2)(i) is not satisfied, i.e., SP-Z was a creditor to the secured party before the new debtor was bound by a security agreement that was executed by an original debtor. Namely, SP-Z had a perfected-by-possession security interest in an item of Z Corp's inven-

C. *Cheapest Cost Avoider Analysis and Fairness Considerations*

Both revised section 9-326 Comment 1 and Example 1 thereto make sense in light of cheapest cost avoider analysis as well as in light of fairness considerations. In instances without new creditors post-merger or substantial asset sale, in which one party (e.g., SP-Z in cmt. 1, ex. 1) is "strongly perfected"—such that the effectiveness of its financing statements does not depend on either section 9-316(i)(1) or section 9-508—and the other party is "weakly perfected" (e.g., SP-X in cmt. 1, ex. 1)—such that the effectiveness of its financing statements depends on section 9-316(i)(1) or section 9-508—both parties are conceptually innocent. Neither party is clearly the cheapest cost avoider. Article 9 must take a position with respect to priority and it makes sense to choose the party filing under the correct name of the surviving entity (e.g., SP-Z in revised section 9-326 cmt. 1, ex. 1) because preferring the "weakly perfected" party (e.g., SP-X in revised section 9-326 cmt. 1, ex. 1) could foster increased amounts of secret liens, which might undermine stability in the secured lending market. Additionally, as Livingston notes in her article, Article 9 places high value on "notice to the world."[73] Given these policy aims, from an equity perspective, such a preference in favor of "strong perfection" does not seem grossly unfair to the weakly perfected party.

Because neither SP-X nor SP-Z is the cheapest cost avoider in this situation and because there are no other significant fairness concerns, Article 9 must select a winner regarding priority. It properly does so in such instances. Correspondingly, as revised section 9-326 Comment 1 and Comment 1, Example 1 reflect, the reform proposed in this paper leaves the outcome of current section 9-326(a) substantively unchanged in contexts that do not involve new creditors who were not involved at all with the original debtor prior to the original debtor's merger or substantial asset sale.

Example 2: SP-X has a perfected-by-filing security interest in X Corp's existing and after-acquired inventory on

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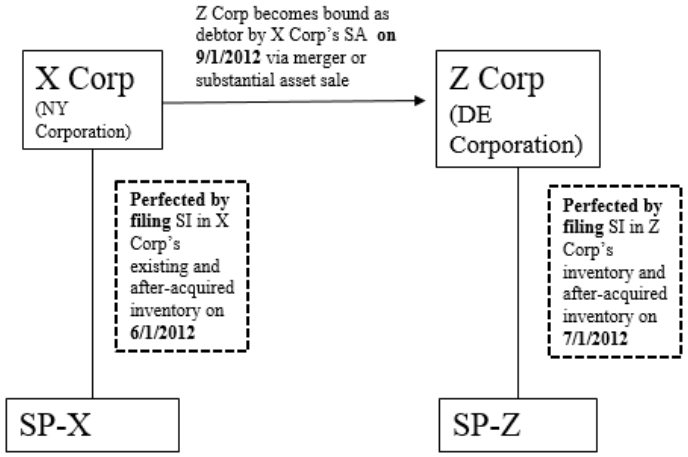
tory on 7/1/2012, prior to the merger or substantial asset sale which occurred on 9/1/2012. Had SP-Z first come on the scene after the merger or asset sale, the priority result would be different and proposed section 9-326(a)(2) would apply. *See* Comment 2 below.

73. Livingston, *supra* note 12.

6/1/2012. SP-Z has a perfected-by-filing security interest in an item of Z Corp's inventory on 7/1/2012. X Corp is a New York corporation and Z Corp is a Delaware corporation under section 9-307. Z Corp becomes bound as debtor by X Corp's security via merger or substantial asset sale per section 9-203(d) on 9/1/2012. SP-X does not have a change in business structure notification clause in its security agreement with X Corp.



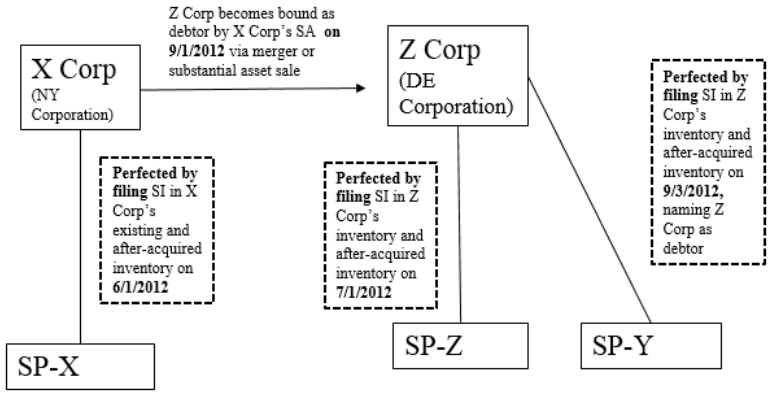
Once again, the effectiveness of SP-X's financing statement depends on both the four-month grace period per section 9-316(i) and section 9-508; thus, SP-X is "weakly perfected." However, unlike in Example 1, here, SP-Z has perfected its security interest in Z-Corp's inventory and after-acquired inventory by filing a financing statement as opposed to by another method (e.g., by possession on control). Nevertheless, because the effectiveness of SP-Z's security interest does not depend on section 9-316(i)(1) or section 9-508, it is considered "strongly perfected" and thus, SP-X's security interest in the collateral will be subordinate to SP-Z's interest in the collateral even though under the ordinary priority rules of Article 9, SP-X would win because SP-X filed in the name of the X Corp on 6/1/2012, which is prior to the 7/1/2012 date when SP-Z perfected its security interest in Z Corp (the surviving entity).[74] Lastly, for reasons touched upon in Example 1,

74. The fact that SP-X and SP-Z are in different jurisdictions is inconsequential because the effectiveness of SP-X's security interest would still de-

even if SP-X did have a change in business structure notification clause in its security agreement with X Corp, the priority outcome would not change because the requirement of proposed section 9-326(a)(2)(i) is not met.

Comment 2: Situations involving third parties implicate the proposed section 9-326(a)(2) and generate results which are strikingly different from those generated from the application of current section 9-326(a).

Example 3: SP-X has a perfected-by-filing security interest in X Corp's existing and after-acquired inventory on 6/1/2012. SP-Z has a perfected-by-filing security interest in an item of Z Corp's existing and after-acquired inventory on 7/1/2012. X Corp is a New York corporation and Z Corp is a Delaware corporation under section 9-307. Z Corp becomes bound as debtor by X Corp's security agreement via merger or substantial asset sale per section 9-203(d) on 9/1/2012. SP-Y—who did not lend to the original debtor, X Corp, prior to the merger or substantial asset sale—has a perfected-by-filing security interest in Z Corp's inventory and after-acquired collateral, naming Z Corp as debtor, which was filed on 9/3/2012. SP-X has a 30 day change in business structure notification clause in its security agreement with X Corp. X Corp fails to notify SP-X within 30 days of 9/1/2012 that it plans on merging into or selling all or substantially all of its assets to Z Corp.



pend on the application of section 9-508 (i.e., "weak perfection") even if SP-X and SP-Z were in the same jurisdiction.

Under section 9-326 as it stands now, SP-Y would have priority over the contested collateral because SP-X relied on section 9-508 in order for its perfection to remain perfected. By contrast, SP-Y named the new debtor, Z Corp, on its filed financing statement and did not rely on either section 9-508 or section 9-316(i)(1) in order for its perfection to be valid.

Under the proposed reform, by contrast, SP-X would have priority over SP-Y, but not priority over SP-Z. This is a salient distinction because unperfected security interests are avoidable in bankruptcy and are also subordinate to the interests of most other claimants to the collateral.[75]

Indeed, under a reformed section 9-326, SP-X's interest in the collateral would be subordinate to SP-Z's interest in the collateral, and SP-Y's interest in the collateral would be subordinate to SP-X's interest in the collateral. SP-X's interest in the collateral would be subordinate to SP-Z's interest in the collateral because the effectiveness of SP-X's perfection depends on the effectiveness of section 9-508 and section 9-316(i)(1), whereas the effectiveness of SP-Z's security interest in the collateral depends on neither of those two sections.[76]

The same analysis in the preceding paragraph applies to the effectiveness of SP-Y's perfected security interest in the collateral acquired post-merger or asset sale by Z Corp. However, under the reform, section 9-326(a)(1) does not apply because all of the requirements of section 9-326(a)(2) are met. Section 9-326(a)(2)(i) is satisfied because the party with whom there was a priority conflict with the original secured creditor (i.e., SP-Y) was not a secured creditor to the debtor prior to a merger or substantial asset sale. Section 9-326(a)(2)(ii) is satisfied because the original secured creditor (i.e., SP-X) included a 30 day notice of merger or substantial asset sale clause in its

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75. Livingston, *supra* note 12. In support of this point, Livingston cites 11 U.S.C. § 544(a)(2011) ((“allowing the trustee in bankruptcy to set aside unperfected security interests.) U.C.C. § 9-317 (2010) (giving perfected security interests priority over lien creditors and certain buyers” § 9-322(a) (according perfected senior secured parties priority over later secured parties)).

76. Once again, even if Corp X and Corp Z were in the same jurisdiction, SP-X's perfected security interest would depend on section 9-508, while the effectiveness of SP-Z's security interest would not depend on an application of section 9-508.

security agreements with the original debtor (i.e., X Corp). Lastly, section 9-326(a)(2)(iii) is satisfied because the original debtor (i.e., X Corp) failed to notify its original secured creditor (i.e., SP-X) of the 9/1/2012 asset sale within 30 days prior to the transaction.

D. *Cheapest Cost Avoider Analysis and Fairness Considerations Revisited*

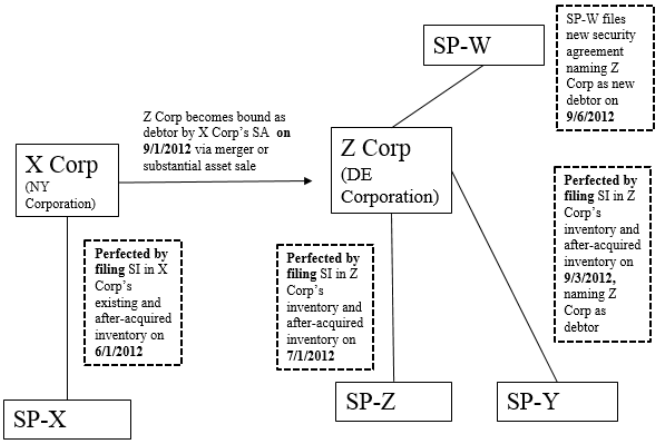
Existing section 9-326 no longer makes sense in terms of cheapest cost avoider analysis and equity analysis once situations emerge involving third parties who did not have preexisting relationships with the original debtor prior to the original debtor's merger or substantial asset sale. Under proposed Comment 2, Example 3, SP-X would justifiably have priority over SP-Y because SP-X and SP-Y are no longer conceptually innocent. In this situation, the new post-merger or substantial asset sale lender (e.g., SP-Y) is clearly the cheapest cost avoider between SP-X and SP-Y. Accordingly, providing priority to SP-Y would be grossly unfair to the existing creditor (e.g., SP-X), who had a preexisting agreement with the original debtor (e.g., X Corp) prior to its merger or substantial asset sale.

As applied to proposed Comment 2, Example 3, SP-Y is the cheapest cost avoider between SP-X and SP-Y because SP-Y only has to run a filing search once, specifically when it is considering lending to Z Corp on a secured basis. Contrastingly, SP-X must constantly run financing statement searches in order to determinate if the original debtor (e.g., X Corp) has become a new debtor (e.g., Z Corp)—assuming the original debtor (e.g., X Corp) failed to notify its original secured creditors of any of the aforementioned changes with respect to mergers and substantial asset sales. Put simply, it is much easier and more efficient for a new, third party creditor to run the search once than it is for a debtor's original secured creditors to continually monitor the debtor for mergers and substantial asset sales.

Moreover, as mentioned earlier in this subsection, this reformed priority scheme also makes sense through an equity or fairness lens. Specifically, language set forth in proposed section 9-326(a)(2) rewards secured creditors of original debtors (e.g., SP-X) who were responsible enough to include a change of business structure covenant in their security agreement with the original debtor (e.g., X Corp). It seems unfair to effectively

ignore this type of diligent lender behavior by allowing a new, third party creditor (e.g., SP-Y) who did not have a preexisting relationship with the original debtor to receive senior priority to the original lender who had the foresight to include such a covenant in its original security agreement.

Example 4: Under the facts of Example 3, SP-W—who did not lend to the original debtor, X Corp, prior to the merger or substantial asset sale—also has a perfected-by-filing security interest in Z Corp's inventory and after-acquired collateral, which was filed on 9/6/2012 and names Z Corp as the debtor.



Here, under a reformed section 9-326(a), priority in inventory that Z Corp acquired after it became bound as debtor by X Corp's security agreement via merger or substantial asset sale would order (from most senior to most junior): SP-Z, SP-X, SP-Y, SP-W. SP-Z receives highest priority because it is "strongly perfected," whereas SP-X relies on both section 9-508 and section 9-316(i)(1) in order for its perfection in after-acquired collateral to remain effective. SP-Y receives higher priority than SP-W because both SP-Y and SP-W meet all three requirements of reformed section 9-326(a)(2). As such, section 9-326(a)(1) does not apply to SP-Y and SP-W and, thus, the default Article 9 first-to-file-or-perfect rule of section 9-322(a)(1) kicks in. Because SP-Y filed a financing statement naming Z Corp before SP-W filed a financing statement naming Z Corp, SP-Y has priority over SP-W.

III.
PROPOSED REFORM OF SECTION 9-326(B)

In order to clarify section 9-326(b), I propose the following revisions to the section:

Section 9-326. PRIORITY OF SECURITY INTERESTS CREATED BY NEW DEBTOR.

(b) [Priority under other provisions; multiple original debtors.]

~~The other provisions of this part determine the priority among conflicting security interests in the same collateral perfected by filed financing statements described in subsection (a). However, if the security agreements to which a new debtor became bound as debtor were not entered into by the same original debtor, the conflicting security interests rank according to priority in time of the new debtor's having become bound.~~

(1) If the new debtor becomes bound by multiple security agreement entered into by the same *original* debtor, other provisions of Article 9 determine priority among conflicting security interests in the same collateral perfected by filed financing statements described in subsection (a);

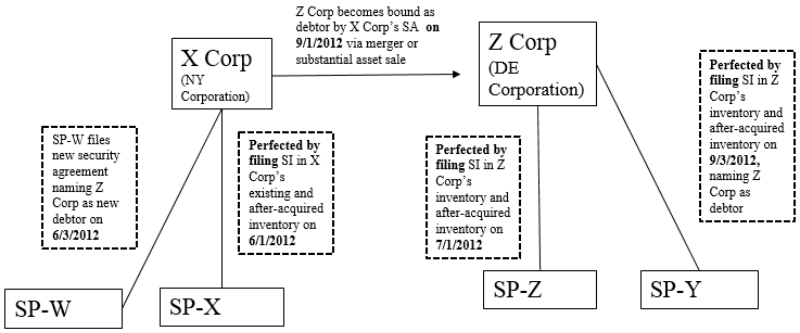
(2) By contrast, if a new debtor becomes bound by security agreements executed by *different* original debtors, conflicting security interests rank according to priority in time of the new debtors having been bound.

1. *Reformed Text of Section 9-326(b): Justification*

I did not make any major changes to section 9-326(b), other than to clarify the way the section is written. Section 9-326(b)(2) makes sense because Article 9 wants to encourage filing of financing statements, and one of the ways that objective is best achieved is via giving priority to the lender who files a security interest in the perfected collateral first. Example 5 shows how revised section 9-326(b)(2) interacts with the more significantly revised language of reformed section 9-326(a). Moreover, revised section 9-326(b)(1) makes sense because it seems logical that security interests should rank according to

priority in time of the new debtors having been bound as debtor by the original debtor's security agreement. Indeed, section 9-326(b)(2) could smoothly be integrated with the proposed changes in section 9-326(a). Example 6 shows how this integration would work.

Example 5: Under the facts of Example 3, SP-W—who did not lend to the original debtor, X Corp, prior to the merger or substantial asset sale—also has a perfected-by-filing security interest in Z Corp's inventory and after-acquired collateral, which was filed on 9/6/2013 and names Z Corp as the debtor.



Under current section 9-326, priority in inventory that Z Corp acquired after it became bound as debtor by X Corp's security agreement via merger or substantial asset sale would order (from most senior to most junior): SP-Z, SP-Y, SP-X, SP-W. SP-Z and SP-Y come ahead of SP-X and SP-W because SP-Z and SP-Y are "strongly perfected," whereas SP-X, SP-W are "weakly perfected." Between SP-Z and SP-Y, SP-Y's security interest subordinates to SP-Z's security interest because SP-Z filed on 7/1/2012 and SP-Y filed on 9/3/2012.[77] Likewise, between SP-X and SP-W, SP-X's security interest subordinates to SP-W's security interest because SP-X filed on 6/1/2012 and SP-W filed on 6/3/2012.[78]

Under reformed section 9-326, priority in inventory that Z Corp acquired after it became bound as debtor by X Corp's security agreement via merger or substantial asset sale would order (from most senior to most junior): SP-Z, SP-X, SP-W, SP-Y. SP-Z receives most senior priority because section

77. U.C.C. § 9-322(a)(1) (AM. LAW INST. & UNIF. LAW COMM'N 2010).
78. *Id.*

9-326(a)(1) applies and section 9-326(a)(2) does not apply. SP-Y has the least priority because all of the requirements in section 9-326(a)(2) are met; specifically, SP-Y was not a secured creditor to the debtor prior to a merger or substantial asset sale. Between SP-X and SP-W, SP-W's security interest subordinates to SP-X's interest because SP-X filed on 6/1/2012 and SP-W filed on 6/3/2012.[79]

Example 6: SP-X holds a perfected-by-filing security interest in X Corp's existing and after-acquired inventory, and SP-Z holds a perfected-by-filing security interest in Z Corp's existing and after-acquired inventory. Both X Corp and Z Corp are located in the same jurisdiction under section 9-307. SP-W holds a perfected-by-filing security interest in W Corp's existing and after-acquired inventory. After Z Corp became bound by X Corp's security agreement in favor of SP-X, Z Corp became bound by W Corp's security agreement and SP-W promptly filed a new initial financing statement against Z Corp.

Under existing section 9-326(b), priority (from most senior to most junior) ranks: SP-Z, SP-W, SP-X. SP-W's security interest in after-acquired inventory by Z Corp is senior to SP-X's security interest in after-acquired inventory by Z Corp because at the time that SP-W filed a new security agreement naming Z Corp as the new debtor, the perfection of SP-X's security interest relied solely on application of section 9-508. SP-Z has priority over SP-W because SP-Z filed a financing statement naming Z Corp as the debtor on 7/3/2012, which was before SP-W filed a financing statement naming Z Corp as the debtor on 9/13/2013. If SP-X filed a financing statement under the new debtor's name (i.e. Z Corp) prior to 9/10/2013, SP-X would have priority over SP-W.[80] Per reformed section 9-326(a), if a new party was not a secured creditor of the original debtor prior to a merger or substantial asset sale (e.g. SP-Y), then that party would have most junior priory among all creditors.

79. *Id.*

80. U.C.C. § 9-322(a) (Am. Law Inst. & Unif. Law Comm'n 2010).

IV.
Response to Proposal Criticisms

The final section of this paper briefly responds to three potential criticisms relating to Part Two's proposed reformatory language. Each potential critique is addressed in turn.

A. *Rarity of Issue*

First, critics may argue that such proposed reformatory language is not necessary because situations that this paper investigates occur with profound infrequency. This may very well be empirically true. That is to say, it may well be the case that situations in which a secured creditor to an original debtor is usurped in priority by a new, third-party creditor after a merger or substantial asset sale occur on an extremely infrequent basis. There could be several reasons why this might be the case. Perhaps debtors nearly always honor change in business structure covenants in their security agreements, thereby reducing instances in which the original secured party would be inadvertently "weakly perfected." Alternatively, perhaps secured parties are closely monitoring their debtors and frequently running financing statement searches to such an extent that situations that this paper has addressed occur with all but the most remote frequency.

Regardless, the legislative fix proposed and justified throughout Part Two of this paper makes sense given the policy reasons pertaining to (1) fairness and (2) analysis of which party is the cheapest cost avoider. Even if situations that this paper contemplates are extremely remote, it still seems prudent to have the proper section 9-326 default rule in place as a safeguard measure.

B. *Ability of Parties to Contract Around Issue*

Second, critics may point to the fact that section 9-326 is merely a default rule, which parties can—and do—contract around. Expanding upon this argument, critics may contend that reformatory default language is not needed because original secured lenders can place enforceable negative pledge clauses in their security agreements with the original debtor,

thereby rendering the default priority issues analyzed throughout this paper largely moot.[81]

This criticism is flawed because even though negative pledge clauses will be contractually enforceable, that does not mollify significant consequences that the original secured creditor may face in bankruptcy as a result of a potential loss of priority to a new, "strongly perfected," post-merger or substantial asset sale secured creditor. This point ties into the immediately below remedy discussion.

1. *Availability of Remedies*

Third, critics may claim that it not necessary to reform section 9-326 default language because secured creditors of original debtors who were diligent enough to put a change of business structure notice requirement in their security agreement with the original debtor will have a breach of contract remedy in the event that the original debtor failed to honor such a notice requirement. This could be a helpful remedy in many cases. However, it does not address the original secured creditor's nightmare scenario in which the surviving entity of the debtor becomes bankrupt and the original secured creditor simultaneously and inadvertently becomes junior to a new, "strongly perfected," post-merger or substantial asset sale secured creditor. While it is beyond the scope of this paper to thoroughly explore such bankruptcy implications, bankruptcy may cause significant issues to the original secured creditor that are not solved by breach of contract remedies.

Additionally, a breach of contract remedy may not be of major benefit to the original secured creditor if the surviving entity's asset base is depleted by "transfer[ing] cash proceeds to certain good faith transferees," whereby—per U.C.C. section 9-332—those transferees are able to take such proceeds free of a security interest.[82]

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81. U.C.C. § 1-310 (AM. LAW INST. & UNIF. LAW COMM'N 2010). ("An obligation may be issued as subordinated to performance of another obligation of the person obligated, or a creditor may subordinate its right to performance of an obligation by agreement with either the person obligated or another creditor of the person obligated."); *see also* U.C.C. § 9-339 (AM. LAW INST. & UNIF. LAW COMM'N 2010) ("This article does not preclude subordination by agreement by a person entitled to priority.").

82. Margit Livingston, *Transfers of Cash Proceeds Under U.C.C. Article 9*, LEXISNEXIS, (Dec. 18, 2009, 10:37 AM), http://www.lexisnexis.com/legalnews

Lastly, litigation may be costly to pursue, thereby foreclosing breach of contract remedies to responsible, original secured creditors in certain situations.

Conclusion

In sum, Part One of this paper provided a description of the relevant Article 9 sections that could be triggered during a merger context: particularly sections 9-325, 9-326, 9-508, 9-316(i), and 9-322. Part One also utilized the *LMS* case as a tool to explain and demonstrate how these provisions would interact with one another during a hypothetical merger of MAKO and RMC. Part Two of this paper (1) rebutted a poor argument that section 9-325 does not apply to proceeds of transferred collateral and (2) provided in-depth reformatory language, comments, and examples concerning section 9-326 that would clarify the section and foster increased lending by secured creditors of original debtors. Most significantly, this paper recommended that the existing priority scheme under section 9-326(a) should not apply to parties who were not secured creditors to the debtor prior to a merger or substantial asset sale. For policy reasons discussed in Part II, which included cheapest cost avoider analysis and fairness concerns, this paper argued that creditors who were not secured creditors to the debtor prior to a merger or substantial asset sale should have junior priory to secured creditors of the original debtor who were involved with the debtor prior to the debtor's change in business structure per section 9-203(d). Finally, Part IV of this paper responded to three potential criticisms with respect to the section's proposed reformatory language.

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room/corporate/b/business/archive/2009/12/18/transfers-of-cash-proceeds-under-u.c.c.-article-9.aspx.

Appendix

1.1

Section 9-325. PRIORITY OF SECURITY INTERESTS IN TRANSFERRED COLLATERAL.

(a) [Subordination of security interest in transferred collateral.]

Except as otherwise provided in subsection (b), a security interest created by a debtor is subordinate to a security interest in the same collateral created by another person if:

(1) the debtor acquired the collateral subject to the security interest created by the other person;

(2) the security interest created by the other person was perfected when the debtor acquired the collateral, *or its proceeds*; and

(3) there is no period thereafter when the security interest is unperfected.