Winter 1996

Credit Enhancement in Domestic Transactions: Conceptualizing the Devices and Reinventing the Law

Neil B. Cohen
Brooklyn Law School, neil.cohen@brooklaw.edu

Recommended Citation
22 Brook. J. Int'l L. 21 (196-1997)

CREDIT ENHANCEMENT IN DOMESTIC TRANSACTIONS: CONCEPTUALIZING THE DEVICES AND REINVENTING THE LAW

*Neil B. Cohen**

I. THE NEED FOR CREDIT ENHANCEMENT

In virtually all cases, creditors have a business reason to extend credit; it is the profit motive, after all, that drives most transactions. The profits generated by an extension of credit may be direct, deriving from interest charges in excess of the creditor's time value of money, or indirect, financing profitable sales (that might not otherwise have occurred) of the creditor's products to debtor/buyers. Many credit transactions generate profits in both of these ways—enabling a profitable sale that may not otherwise have taken place *and* making a separate profit from the interest charged to the customer.

Individual extensions of credit are obviously profitable for creditors only when the debtors pay their debts. Those who extend credit repeatedly can profit despite a small number of defaulting debtors, but will not profit in the aggregate if too many debtors fail to pay their debts. Indeed, the loss associated with one defaulting debtor is typically several times larger than the profit generated by a fully performing debtor. Take, for example, a one-year $10,000 loan with an annual interest rate of eight percent when the creditor's cost of funds is 4.5 percent per year. The expected profit from this loan is $350.[1] Yet, let us assume that the debtor defaults and, after an additional year of collection efforts, $3,000 is recovered from the debtor. The creditor's loss on the transaction would be $7,920.25.[2] Thus, a single default eliminates the profits gener-

---

* Professor of Law, Brooklyn Law School; S.B., Massachusetts Institute of Technology; J.D., New York University. Preparation of this Article benefitted from a Brooklyn Law School Summer Research Grant.

1. Assuming, for simplicity of illustration, that the creditor has no costs (other than its cost of funds) associated with the loan, and that the loan is payable in a single payment at the end of one year, the loan would generate $800 in interest (8% of $10,000), but the creditor's cost of funds would be $450 (4.5% of $10,000). The difference, then, between the interest charges and the cost of funds is $350.

2. The creditor, in this case, has invested a total of $10,920.25 ($10,000 plus

ated by a large number of fully performing extensions of credit.

Therefore, if the creditor believes that the risk of non-payment associated with a proposed extension of credit is too high, that extension of credit will not take place because non-payment in the transaction would more than offset gains from other transactions in which the debtors fully pay their debts. Similarly, a creditor considering engaging in a particular class of credit extensions will not do so if the risk associated with individual extensions within that class exceeds a certain threshold. Even if the chance that any one debtor will default is relatively low, a small number of projected defaults will yield a negative expected value for the entire class.

Such decisions not to extend credit are, obviously, unfortunate for the debtors who are deprived of credit. They are also, however, a source of disappointment for the prospective creditors, for foregoing an extension of credit is foregoing a potentially profit-making activity. Thus, both prospective debtors and prospective creditors have incentives to seek ways to structure transactions so that the transactions can be profitable for both parties.

Credit enhancement, generally speaking, is the art of structuring a transaction, through economic agreements and legal mechanisms, so that the transaction is seen by both the creditor and the debtor as prospectively profitable. In other words, the goal of credit enhancement is to minimize the creditor's risk of loss due to non-performance while nonetheless allowing the transaction to be profitable for the debtor.

In order to understand how credit enhancement can bring about such a result,[3] one must first consider the situation of a

---

two years' interest at 4.5% compounded annually) and received only $3000, leaving a loss of $7920.25.

3. I am tempted to describe this result as a win-win situation, but that description, while it would likely be accepted "in the field," is controversial in the academic literature. There is a lively cottage industry devoted to debating whether, for example, secured credit is truly efficient. *See, e.g.*, Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGIS. STUD. 1 (1981); Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986); Paul Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984). While other credit enhancement mechanisms have not been analyzed so contentiously, the point can probably be generalized.

garden-variety creditor who has extended credit to a debtor who does not voluntarily repay the debt. If the creditor is to collect the debt, the creditor will have to both obtain a judgment against the debtor and convert that judgment to money. A number of obstacles will be encountered along the way to achieving those steps. First, the debtor may deny the existence of the debt or raise a defense to the obligation to repay it. Even if the debtor's arguments do not ultimately prevail, the creditor will have spent time and money responding to them. If they do prevail, of course, the creditor will not obtain judgment against the debtor or will obtain a judgment for a smaller amount.

Even if the creditor obtains a judgment against the debtor for the full amount of the claim, the creditor is not assured of recovery. A judgment does not automatically translate into money. If the debtor voluntarily pays the judgment, the creditor's claim will be satisfied. If, however, the debtor does not pay voluntarily, the creditor faces several uncertainties. While the legal system will provide the creditor with a potential claim against the debtor's assets, that claim may not be easily reducible to money. For one thing, the debtor may not have sufficient reachable assets to satisfy the creditor's claim. Alternatively, while the debtor may have reachable assets worth more than the claim, other creditors may be chasing those same assets, resulting in insufficient assets to satisfy all the claims and forcing various creditors to share the assets pro rata. Perhaps one of the competing creditors already has a judgment and a judicial lien against the assets. Similarly, the debtor may have made some of those assets collateral for a different debt owed to another party. In all these cases, the judgment against the debtor will not provide the creditor with the equivalent of repayment of the debt.

This article examines the law relating to credit enhancement in the United States, focusing primarily on new developments. Part II discusses some forms of credit enhancement structures. Parts III and IV analyze the current and developing law relating to such structures.

II. BASIC CREDIT ENHANCEMENT STRUCTURES

Credit enhancement devices, in a nutshell, are mechanisms to ameliorate the creditor's risk of non-collection in whole or in part. They do so by effectuating one or both of two

simple principles: making more assets reachable by the creditor to satisfy the claim, or increasing the creditor's priority with respect to assets available to it.

A. Enlarging the Asset Pool Available to the Creditor

As the amount of assets available to the creditor to satisfy a judgment with respect to the debt increases, the ultimate loss flowing from the debtor's default diminishes or is eliminated altogether. Increasing the amount of assets available to the creditor can be accomplished by either assuring the availability of the debtor's assets to satisfy the obligation, or by gaining access to the assets of others to do so.

1. Increasing the Availability of the Debtor's Assets

The creditor is not entitled to reach the debtor's assets merely because the creditor asserts that the debtor owes an obligation to the creditor. Rather, in the absence of a security interest (a credit enhancement device discussed later in this article[4]) the creditor must first obtain a judgment against the debtor. In many situations, there will be no doubt that the creditor is entitled to a judgment. In a simple loan, for example, it is usually conceded that the creditor has fully performed its portion of the contract by lending the money and no longer has any executory duties. All that must be demonstrated is that the debtor has not repaid the loan. In most cases, the creditor would be able to prevail by summary judgment without the necessity of a trial. In other situations, though, the creditor's right to a judgment may not be so clear. If, for example, the original extension of credit was for goods sold or for services rendered, the debtor might claim that the creditor's performance never occurred (i.e., the goods were never delivered or the services were never performed) or that it did not comply with the terms of the contract (i.e., the goods did not live up to express or implied warranties, or the services did not comply with the contractual specifications). If these allegations were true, the debtor would have a defense to the creditor's claim, or would have an offsetting claim in recoupment. At best (from the creditor's perspective), the defense or offsetting claim

---

4. *See infra* part II.A.3.a.

would be defeated at the summary judgment level or at trial. It is possible, of course, that the creditor's claim would be defeated.

Thus, the ability of the creditor to obtain judgment against the debtor quickly and simply is lessened by the ability of the debtor to raise defenses and claims in recoupment. A creditor could seek to structure its contract with the debtor so that the debtor's obligation to pay the creditor is independent of any defenses or claims in recoupment that the debtor may have against the creditor. However, courts are typically hostile to attempts, in a simple contract, to essentially strip a debtor of its defenses in an action brought by the party whose conduct created them.

Yet, there is a way to bring about this advantageous position for the creditor, in part. This brings us to the first credit enhancement mechanism that is the subject of this article — the most basic of negotiable instruments, the note. Negotiable instruments in general, and notes in particular, serve a variety of commercial functions and are the subject of a relatively complex statutory scheme that is, for the most part, beyond the scope of this article. The central feature of negotiable instruments, though, is the aspect that makes them useful as credit enhancement mechanisms. That feature is the holder in due course doctrine.

While a person entitled to enforce[5] a note is normally subject to all defenses and claims in recoupment that could be raised by the maker if the note were a simple contract,[6] matters are very different if the person entitled to enforce the note qualifies as a holder in due course. A holder in due course is subject only to four "real defenses" of the maker: infancy (to the extent that it qualifies as a defense to a simple contract); duress, lack of capacity, or illegality that, under other law would render the maker's obligation a nullity; fraud that induced the maker to sign the note with neither knowledge nor reasonable opportunity to learn its character or essential terms; and discharge of the maker in insolvency proceedings.[7] Quite obviously, a holder in due course occupies a privileged

5. U.C.C. § 3-301 (1995) defines "person entitled to enforce" a note as including primarily, the holder of the note.
6. *Id.* § 3-305(a).
7. *Id.* § 3-305(a)(1), (b).

position. In most cases, though, the payee of a note will not qualify as a holder in due course if the maker has any defenses.[8] Thus, the holder in due course doctrine operates primarily to separate a maker's duty to pay the holder in due course from any defenses or claims in recoupment that the debtor may have. Those defenses and claims in recoupment are not lost by the maker since they may be raised in a separate action against the payee who created them. They cannot, however, be raised against the holder in due course as a defense to an action on the note.

At one level, the note does not seem to be a credit enhancement mechanism. Indeed, strictly speaking, it may not be one. After all, the ability of the original creditor (as payee of the note) to obtain judgment against the debtor (as maker of the note) is not greater than if the creditor's claim were on a simple contract.[9] If, however, the original creditor negotiates the instrument to a person who qualifies as a holder in due course, that transferee, as a holder in due course, will take free of all but the debtor's real defenses.[10] Thus, while the use of a negotiable instrument does not give the creditor as payee an enhanced opportunity to obtain a judgment against the debtor as maker and, accordingly, access to the debtor's assets, structuring the debt in the form of a note makes the creditor's claim against the debtor marketable to someone who will have that enhanced opportunity. Since the value of the claim against the debtor in the hands of a holder in due course is greater than the value of that claim in the hands of the original creditor, the creditor has the opportunity to sell that claim to a person who would qualify as a holder in due course and thereby reap some of the benefits of the enhanced value.

8. Most often, this will be the case because the payee will not have taken the instrument for "value" (as defined in U.C.C. § 3-303 (1995)) if the payee's performance gives the maker a defense to its payment obligation or a claim in recoupment. Taking the instrument for value is one of the prerequisites for qualifying as a holder in due course. *Id.* § 3-302(a)(2)(i).

9. This assumes, as will almost always be the case, that the payee against whom the maker has defenses does not qualify as a holder in due course. *See supra* note 8.

10. U.C.C. §§ 3-203(b), 3-305(b) (1995).

2. Gaining Access to the Assets of Third Parties

Credit enhancement devices that increase the probability of the creditor (or its assignee) obtaining judgment against the debtor and thereby gaining access to the debtor's assets have significant value to the creditor, though, only if the debtor has sufficient assets to satisfy the debt in light of the competing claims against the debtor. In most cases, however, that is the very risk against which the creditor is trying to protect. Thus, much more important as credit enhancement devices are mechanisms that either make additional assets available to the creditor (those of third parties) or increase the creditor's priority of access with respect to the debtor's assets so that the creditor is more likely to obtain satisfaction from them. First, this paper examines those mechanisms providing the creditor with access to the assets of third parties.

a. Third Party as Co-Obligor

One common way for the creditor to obtain access to the assets of a third party with respect to credit extended to the debtor is for the debtor to provide another, more creditworthy person to be an obligor along with the debtor. Once the more creditworthy person (for convenience, let us call this helpful person "the enhancer") is identified, it is simple to structure the transaction so that the enhancer is co-obligated with the debtor. The enhancer can simply be a cosigner (with the debtor) of the loan agreement or other contract creating the debtor's obligation. Alternatively, if the debt is evidenced by a negotiable instrument, the enhancer can be a comaker with the debtor. In either case, the enhancer would be jointly and severally liable with the debtor and could thus be sued without the necessity of first suing the debtor or otherwise trying to collect from the debtor. By making the enhancer a co-obligor, the creditor has gained access to the enhancer's assets to satisfy the debt created by the extension of credit to the debtor.

b. Third Party Liability upon Default

Another way to structure an extension of credit so that the creditor can gain access to the assets of the enhancer is for the parties to agree that the enhancer is liable if (but not until) the debtor defaults on its obligation. This can be accomplished

either in the same contract pursuant to which the debtor agrees to pay the debt in question, or in a separate contract between the enhancer and the creditor. Obligations of this sort are typically known as "guaranties."

Guaranty agreements can take a variety of forms and have a variety of terms. Most often, such agreements are guaranties of *payment*. The guarantor agrees that if the debtor does not pay the debt when it is due, the creditor may call upon the guarantor to perform. In a guaranty of payment, the creditor need not first pursue (or sue) the debtor.

Other guaranties, however, occasionally take the form of a "guaranty of collection." In a guaranty of collection, the guarantor agrees that it will pay the debt only after the debtor's failure to pay *and* the creditor's failure (or presumed failure) to obtain satisfaction from the debtor through legal means. One authority describes the typical guaranty of collection as one in which the guarantor agrees to perform if (and only if):

> (1) execution of judgment against the [debtor] has been returned unsatisfied; or
> (2) the [debtor] is insolvent or in an insolvency proceeding; or
> (3) the [debtor] cannot be served with process; or
> (4) it is otherwise apparent that payment cannot be obtained from the [debtor].[11]

In both the guaranty of payment and the guaranty of collection, the guarantor's obligation is created by simple contract that may either be separate from the contract creating the debt or part of that contract. If, however, the debt is evidenced by a negotiable instrument such as a note, matters are more complicated. The guarantor may incur its liability by entering into a separate contract with the creditor, or the guarantor may incur its liability by agreeing to equivalent liability *on the instrument*. For example, a person who indorses a note agrees that if the note is dishonored, he or she will pay the amount of the note to the person entitled to enforce it. Thus, an indorser incurs a liability with respect to the debt evidenced by the note that is functionally identical to entering into a separate guaranty with respect to that debt. Of course, most often, the moti-

11. RESTATEMENT (THIRD) OF THE LAW OF SURETYSHIP AND GUARANTY § 15(b) (forthcoming 1996) [hereinafter RESTATEMENT OF SURETYSHIP AND GUARANTY].

vation behind indorsement of a negotiable instrument is not to provide credit enhancement for the payee but, rather, to effectuate negotiation of the instrument. In cases where the indorsement functions as a credit enhancement, the indorsement is often known as an "accommodation indorsement."[12]

c. Third Party Liability for Loss

Still another way to structure an extension of credit so that the creditor can gain access to the assets of the enhancer is for the parties to agree that the enhancer will be liable for any loss suffered by the creditor as a result of the failure of the debtor to pay its debt. This agreement might take the form of a warranty by the enhancer that the debtor will pay its debt to the creditor when it is due. If the warranty is breached by the debtor's failure to pay its debt, the enhancer would be liable for the damages that flow from that failure. Typically, the damages will be equal to the unpaid sum. Using such a warranty as a credit enhancement device thus gives the creditor access to the assets of the enhancer in the event of the debtor's default.

d. Third Party Repurchase Agreements

A different mechanism by which the assets of the enhancer can be made available to the creditor is through the use of an agreement pursuant to which the enhancer agrees that, in the event the debtor defaults on its payment obligation, the enhancer will purchase the creditor's claim against the debtor for a specified sum (such as, for example, the unpaid indebtedness). By use of such an agreement, the creditor has two parties from whom it may recover, and, therefore, two parties whose assets are reachable. The creditor may pursue the debtor on the debt or, if the debtor does not pay the debt, the creditor may call upon the enhancer to purchase the claim. Failure of the debtor to pay the debt will give rise to a cause of action against the debtor and, upon judgment, access to its assets; failure of the enhancer to purchase the claim upon the debtor's default, on the other hand, will give rise to a cause of action against the enhancer and, upon judgment, access to *its* assets.

12. U.C.C. § 3-419 (1995).

If the enhancer does purchase the claim from the creditor, the claim is not extinguished or satisfied, of course—it merely has a new owner. But, from the perspective of the creditor, it is as though the claim has been satisfied. Whether the debtor satisfies the claim by performing or the enhancer satisfies its obligation by purchasing the claim against the debtor, in either event the creditor ends up with cash in the amount of its claim and no longer owning a claim against either party.

e. Issuance by Third Party of a Letter of Credit

One other credit enhancement mechanism by which the creditor can gain access to the debts of another must be highlighted. That mechanism is the letter of credit. Often in a sale of goods transaction, the seller is unwilling to rely on the buyer to pay for the goods when they are accepted, but the buyer is unwilling to pay for the goods in advance. One commonly used solution for this conundrum is the documentary letter of credit. The buyer of goods procures such a letter of credit from a bank satisfactory to the seller, with the issuer's payment obligation conditioned on tender to it of a specified document or documents (such as, for example, a bill of lading indicating that the goods have been shipped and a certificate of inspection of the goods by an independent inspector). When the seller tenders the issuer documents conforming to the terms of the letter of credit, the issuer is obliged to pay the letter of credit (and is entitled to reimbursement from its customer).[13] Thus, a seller who fulfills the conditions of the letter of credit has a party from whom it can obtain payment who, almost certainly, has greater assets than the buyer—the issuer of the letter of credit.[14]

An important variant of the documentary letter of credit is the so-called "standby letter of credit." A standby credit is the legal equivalent of a documentary credit, but in a standby

13. U.C.C. § 5-114(3) (1994).

14. It must be emphasized that the issuer's obligation on the letter of credit is independent of that of the buyer on the sale of goods contract. So long as the conditions of the letter of credit are fulfilled, the seller/beneficiary is entitled to payment even if the buyer has a defense or claim against the seller on the sales contract. *See id.* § 5-114(1). Of course, if the issuer pays the letter of credit it is entitled to reimbursement from the applicant. *See supra* text accompanying note 13. Thus, the independence principle, like the holder in due course doctrine, works to separate the buyer's duty to pay from any defenses it might have.

credit the document that must be tendered to the issuer to trigger the issuer's payment obligation is a certificate by the beneficiary of the letter of credit that the applicant has not fulfilled a specified payment obligation. Standby letters of credit are denominated as such because unlike transactions utilizing traditional documentary letters of credit, in which it is anticipated that the beneficiary will be paid by drawing on the credit, they are issued to be drawn on only if the debtor/applicant fails to pay its debt in accordance with the contract that created it.

Thus, the use of a letter of credit provides the creditor with recourse against the assets of two parties. The creditor, of course, has access to the assets of the debtor by virtue of the underlying claim against the debtor. In addition, the creditor has access to the assets of the issuer of the letter of credit because of its claim against the issuer under letter of credit law.

f. Hypothecation Agreements by Third Parties

The previously described mechanisms by which a creditor can gain access to the assets of another to satisfy the indebtedness owed by the debtor all involve contractual arrangements whereby the enhancer is made personally liable and, therefore, subject to judgment and execution upon that judgment generally against his or her assets. It is also possible, though, for the parties to arrange matters so that only certain assets of the enhancer are available to satisfy the claim against the debtor. This can be accomplished by an agreement, often called a hypothecation agreement, pursuant to which the enhancer grants a security interest in specific items of its property to secure the obligation of the debtor to the creditor. In this way, the assets of the enhancer are not generally available to the creditor; rather, only the particular assets in which the security interest was granted can be reached.

3. Increasing the Creditor's Priority with Respect to Assets Subject to the Creditor's Claim

The third major category of credit enhancement devices are those that increase the creditor's likelihood of payment, not by increasing the amount of assets to which the creditor may have access but, rather, by increasing the creditor's priority

with respect to access to those assets. In other words, these devices enable the assets subject to the creditor's claim to be applied to that claim prior to subjecting them to the claims of others.

a. Security Interests

When a debtor grants a creditor a security interest in some of the debtor's property, the debtor is, essentially, agreeing that if the debtor defaults, the creditor will be entitled to seize that property, sell it, and use the proceeds to satisfy the debt. When the grant of the security interest is effectuated properly, it is effective not only between the debtor and creditor but also against third parties.[15] Most third parties who obtain an interest in the property thereafter will be subordinate to the rights of the creditor.[16] When a debtor grants a creditor a security interest in some of the debtor's property, nothing is added to the set of property to which the creditor will have recourse in the event that the debtor defaults and the creditor obtains judgment; after judgment, the creditor could have obtained a lien against that property. Rather, the advantage of a security interest is that the creditor will not have to share the proceeds of that property with other creditors. By use of the security interest, the creditor has increased its priority with respect to assets that were available to it in the event of default.

A security interest may be granted to secure any obligation. Accordingly, not only can the debtor grant a security interest securing its obligation to repay the extension of credit, but a guarantor or other credit enhancer may also grant a security interest in *its* property to secure its obligation to the debtor. In such a case, the creditor has not only increased the set of assets to which it has access (by bringing in the assets of the enhancer) but also has raised its priority with respect to the additional assets.

15. U.C.C. § 9-201 (1995).

16. Priority rules are beyond the scope of this paper, but it can be noted that the bulk of such rules are of the first-in-time, first-in-right variety. *See id.* § 9-312(5).

b. Subordination Agreements

A creditor can also increase its priority with respect to assets reachable by judgment through the use of subordination agreements. In brief, a subordination agreement is an agreement by one creditor that it is not entitled to satisfaction with respect to a particular claim (or group of claims) against the debtor until after certain claims against that debtor by another creditor or creditors have been satisfied. Thus, if one creditor can induce another creditor to subordinate the latter's claims against the debtor to those of the former creditor, the former creditor will have increased its priority of access to the assets of the debtor.

III. GOVERNING LAW

The credit enhancement mechanisms described above are governed by a variety of legal regimes. To understand these mechanisms, and the changes in the law governing them, it is important to first identify those regimes.

A. Contract Law

The credit enhancement mechanisms described in this paper are the product of consensual agreements reached between or among some combination of the debtor, the creditor, and a third party whose assets are made either partially or wholly reachable to satisfy the debt. Thus, not surprisingly, all of these devices are, at least to some extent, governed by the general law of contracts. Indeed, for some devices, such as subordination agreements, the general law of contracts provides essentially all of the governing law. For most of the devices, however, contract law is supplemented (and sometimes supplanted) by more particularized legal doctrines.

B. Uniform Commercial Code Article 3

As described above,[17] the use of a negotiable instrument is, by itself, a credit enhancement device. Rights and duties of parties to negotiable instruments are governed by Article 3 of the Uniform Commercial Code. Whenever the debtor's obliga-

---

17. *See supra* part II.A.1.

tion to the creditor is evidenced by a note, the debtor's obligations (and the creditor's rights against the debtor) are governed by Article 3. Article 3 tells us whether a particular assignee qualifies as a holder in due course[18] and, if so, what defenses the debtor cannot raise against that holder in due course.[19]

Whether an additional credit enhancement device used in conjunction with a debt evidenced by a note is governed by Article 3, though, is a more complicated question.

If, in addition to the use of a negotiable instrument as a credit enhancement device, the creditor has gained access to the assets of a third party as a result of that third party becoming a co-maker or accommodation indorser of the note, Article 3 also governs the rights of the third party as against the co-maker or accommodation indorser.[20] Because the co-maker or indorser qualifies as an accommodation party,[21] Article 3 provides two layers of rules. First, the accommodation party is liable in the capacity in which it signed the instrument. Thus, a comaker has all of the obligations of a maker of a note under the rules governing makers' obligations, and an accommodation indorser has all of the obligations of an indorser under the rules governing indorsers. Second, because accommodation parties incur an obligation without being the direct beneficiary of the value (the extension of credit) for which the obligation was incurred, negotiable instruments law provides accommodation parties with special defenses to liability that are not generally available to makers and indorsers.[22] These defenses, which parallel the defenses provided to secondary obligors in the general law of suretyship and guaranty, relieve accommodation parties of some or all of their obligation when the holder of the instrument has taken certain actions that interfere with the accommodation parties' rights.

C. Suretyship and Guaranty Law

Part II.A.2 of this article catalogs a number of mechanisms which provide the creditor with a claim against the enhancer, thereby subjecting the enhancer's assets to satisfaction of a

18. *See* U.C.C. § 3-302 (1995).
19. *Id.* § 3-305(b).
20. *See id.* §§ 3-305, 3-419, 3-605.
21. *See id.* § 3-419.
22. *See id.* § 3-605.

judgment with respect to the extension of credit. As noted above, when the enhancer becomes a party to a negotiable instrument, the law governing the enhancer's rights and duties is Uniform Commercial Code Article 3. As noted below, when the enhancer is the issuer of a letter of credit, its rights and duties are governed by the law unique to that mechanism. In almost every other case in which the enhancer contracts either to be liable generally with respect to the debtor's obligation or to make certain items of its property collateral for that obligation, the rights and duties of the third party are governed not only by the general law of contracts, but also by its more specific offspring, the law of suretyship and guaranty.

D. Letter of Credit Law

When the enhancer is the issuer of a letter of credit, the rights and duties of the enhancer are governed by letter of credit law. Formally, most letter of credit law is found in Article 5 of the Uniform Commercial Code. A significant proportion of letters of credit, though, incorporate by reference a set of rules that are not, strictly speaking, law, but, by their frequency of incorporation, have attained a law-like status. This set of rules is the Uniform Customs and Practice for Documentary Credits (UCP), promulgated by the International Chamber of Commerce.[23]

E. Uniform Commercial Code Article 9

The second major category of credit enhancement devices are those that increase the creditor's priority with respect to assets already reachable by judgment by giving the creditor a security interest in the debtor's assets or the assets of the enhancer. With few exceptions, when the security interest is in personal property of the debtor, the rights concerning that security interest are governed by Article 9 of the Uniform Commercial Code. Article 9, of course, also governs security interests that are granted pursuant to a hypothecation agreement by an enhancer who is not otherwise assuming responsibility for the debt.

---

23. INTERNATIONAL CHAMBER OF COMMERCE, PUB. NO. 500, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1993).

F. Mortgage Law

While in many cases the assets that are the subject of a security interest constitute personal property within the purview of Article 9 of the Uniform Commercial Code, in other transactions the property that is the subject of the security interest is real property. Security interests in real property are typically referred to as mortgages, and the law governing mortgages is an important division of real property law.

IV. NEW DEVELOPMENTS IN GOVERNING LAW

The domestic law governing credit enhancement devices is in the midst of a process of renewal and revision that rivals the legal revolution that accompanied the development of the Uniform Commercial Code a half-century ago. Almost every body of American law governing credit enhancement devices has either just completed, or is in the process of, major revision or rethinking. The remainder of this article surveys these new developments.

A. Revised Uniform Commercial Code Article 3

As noted above, Article 3 of the Uniform Commercial Code provides the law governing the debtor's obligation when that obligation is evidenced by a negotiable instrument. Thus, it is Article 3 that provides the governing law for negotiability—the credit enhancement device that allows certain assignees from the original creditor to enforce the claim against the debtor without regard to most defenses of the debtor or to claims in recoupment. Article 3 also provides the law governing the rights and duties of accommodation parties—third parties who become liable with respect to the debtor's obligation, thereby making their assets reachable to satisfy that claim, by becoming parties to the same negotiable instrument.

Uniform Commercial Code Article 3 was substantially revised and rewritten just a few years ago. In 1990, the American Law Institute and the National Conference of Commissioners on Uniform State Laws (the co-proprietors of the Uniform Commercial Code) promulgated revised Article 3, representing the first major revision of an article of the Uniform Commercial Code in over a decade. These revisions, now adopted in

over 40 states,[24] made small but important changes in the criteria that must be fulfilled for a holder to qualify for holder in due course status, and made major changes in the rules governing accommodation parties. Inasmuch as the effect of the revised article is prospective only, its impact is only now beginning to be felt.

1. Holder in Due Course

A small but important change in the rules governing attainment of holder in due course status was brought about by a change in the definition of "good faith" as that term is used in Uniform Commercial Code Article 3. To qualify as a holder in due course, a holder must take the note, *inter alia*, for value and in good faith. Previous Article 3 relied on the general Uniform Commercial Code definition of good faith—honesty in fact in the conduct or transaction.[25] Revised Article 3, on the other hand, contains its own definition of good faith that is applicable throughout the Article and, thus, to the definition of holder in due course. Revised Article 3 provides that good faith "means honesty in fact and the observance of reasonable commercial standards of fair dealing."[26] Thus, a person who is subjectively honest, but does not fulfill the more objective test of the observance of reasonable commercial standards of fair dealing, would have qualified for holder in due course status in the original version of Article 3 but does not under the revised text.

2. Accommodation Parties

As noted above, Uniform Commercial Code Article 3 also governs the rights and duties of accommodation parties. The changes made in the rules governing these rights and duties were among the most significant changes in the new Article 3.

An accommodation party may be a comaker, in which case its liability (from the perspective of the holder) is joint and several with the debtor, or an indorser, in which case the accommodation party is liable upon dishonor of the note (i.e.,

24. As of this writing, New York is perhaps the most notable exception.
25. U.C.C. § 1-201(19) (1995).
26. *Id.* § 3-103(a)(4).

default by the debtor).[27] In both cases, the accommodation party's rights and obligations differ from those of ordinary, garden-variety makers and indorsers because of the application of special rules derived from suretyship law that are designed to protect the accommodation party's interests.

The rules governing accommodation parties have been completely rewritten in the new article. Most important, the rules governing "suretyship defenses," which in original Article 3 were essentially rigid calcifications of old suretyship rules, were completely restructured.

In the original Article 3, as in much of the case law existing prior to the adoption of that Article, any change in the obligation of the debtor/accommodated party (such as an extension of the due date of the note, modification of its terms, or release of liability) that was not consented to by the accommodation party automatically resulted in complete discharge of the accommodation party from its obligation on the note.[28] This was the case even in situations in which the change in the debtor's obligation was for the purpose of enabling the creditor to collect more money, rather than less, from the debtor (such as an extension of time that enables the debtor to reorganize its financial affairs and obtain the funds necessary to pay the note), or if the change could not possibly harm the accommodation party (such as a changes that *lowers* the interest rate on the debt evidenced by the note). Thus, application of this rule of absolute discharge often resulted in windfalls for accommodation parties; the benefit they received from discharge was greater than the harm they would have suffered from the change in the underlying transaction. Such accommodation parties were put in a better position by the changed transaction and accompanying discharge than if no change had been made at all.

The original Article 3 also embraced two doctrines from the old common law of suretyship and guaranty that somewhat ameliorated the effect of these absolute discharge rules. First, the Article codified the so-called "reservation of rights" doctrine. That doctrine allowed the creditor/holder to avoid what would otherwise be the automatic discharge of the accommoda-

27. *Id.* § 3-419.

28. U.C.C. § 3-606(1) (1989).

tion party that would accompany a change in the debtor's obligation (such as an extension of time to pay) simply by intoning to the debtor, at the time the change was agreed to, a talismanic phrase such as "but I reserve all my rights against the accommodation party."[29] Second, the original Article 3, like the common law, provided for the ability of the accommodation party to consent (either at the time or in advance) to changes in the debtor's obligation. The obligations of the accommodation party were not automatically discharged by changes to which it had consented.[30]

Revised Article 3, on the other hand, moves away from a doctrine that generates windfall effects as remedies for acts of questionable harm, and moves instead in the direction of modern contract law (and perhaps Gilbert and Sullivan)[31] by, with one major exception, fitting the punishment to the crime. Under revised Article 3, if the creditor agrees to give the debtor an extension of time to pay, or agrees to any other modification of the debtor's duty, the accommodation party may be discharged, but only to the extent that the extension or modification harms the accommodation party.[32] In other words, if, but for the extension or modification, the accommodation party would have ended up paying less (or recovering more from the debtor), then, *to the extent of that harm and only to that extent*, the accommodation party will be discharged.

The exception referred to above has to do with the relatively uncommon context of a release of the debtor. In that case, revised Article 3 is diametrically opposed to its predecessor. Original Article 3 would grant a total discharge to the accommodation party if the creditor released the debtor/accommodated party.[33] Revised Article 3, on the other hand, states that the accommodation party is *never* discharged

---

29. *Id.* § 3-606(2).

30. *Id.* § 3-606(1).

31. The concept—of having the punishment fit the crime—was stated by Gilbert and Sullivan in *The Mikado*:

My object all sublime
I shall achieve in time -
To let the Punishment fit the crime -
The punishment fit the crime.

W.S. Gilbert & Arthur Sullivan, *The Mikado, in* THE COMPLETE PLAYS OF GILBERT & SULLIVAN 343, 352 (Jerome Robinson ed., 1938).

32. U.C.C. § 3-605(c)-(d) (1995).

33. U.C.C. § 3-601(3)(b) (1989).

by such a release.[34] Having ameliorated at least some of the potential windfalls to accommodation parties that were endemic to the old rules by eliminating the automatic discharges, the new Article largely abrogates the reservation of rights doctrine, which no longer serves a needed purpose. The new Article does, however, continue to allow the accommodation party to consent to actions that would otherwise be the basis for discharge. Indeed, those rules are augmented by a provision that makes it clear that there will be no discharge from any such actions if the accommodation party simply states (in the note or otherwise) that it "waives all defenses based on suretyship or impairment of collateral."[35]

B. Restatement of Suretyship and Guaranty

At its May 1995 annual meeting, the membership of the American Law Institute gave final approval to the promulgation of the Restatement of the Law of Suretyship and Guaranty (New Restatement).[36] The New Restatement replaces Division 2 (Suretyship) of the 1941 Restatement of Security.[37] The New Restatement takes an area of the law often marked (as in the case of original Uniform Commercial Code Article 3) by the unthinking application of rigid doctrines and slogans masquerading as concepts and tries to bring it into the modern era of contract and commercial law.

1. Scope

Like Uniform Commercial Code Article 9, the New Restatement takes a functional approach to its coverage. The substance of transactions, rather than their form, is determinative. The New Restatement governs whenever a third party (i) owes the creditor performance of the debtor's obligation, (ii) has another duty to the creditor which is triggered by the debtor's default, performance of which satisfies the debtor's obligation to the creditor, or (iii) can be forced to buy the creditor's rights against the debtor. Given the wide variety of

34. U.C.C. § 3-605(b) (1995).
35. *Id.* § 3-605(i).
36. RESTATEMENT OF SURETYSHIP AND GUARANTY, *supra* note 11.
37. RESTATEMENT OF THE LAW OF SECURITY (1941) [hereinafter RESTATEMENT OF SECURITY].

labels frequently given to varied transactions that can fit within this description, the New Restatement uses generic terminology to avoid misunderstandings that might otherwise result from the use of labels traditionally associated with some, but not all, of these transactions. Accordingly, the party referred to in this paper as the "debtor" is known in the New Restatement as the "principal obligor;"[38] the obligation owed by the principal obligor is the "underlying obligation,"[39] and that obligation is owed to the "obligee."[40] The third party who owes performance of that obligation or another obligation performance of which will satisfy the underlying obligation is the "secondary obligor,"[41] and its obligation is the "secondary obligation."[42]

2. Contract Formation and Interpretation

It is a commonplace maxim that "a surety is the favorite of the law." The maxim, which carries no hint of exactly what that favoritism is, is often invoked reflexively and without critical analysis to justify almost any decision or rule that favors a secondary obligor. In particular, the maxim has been frequently (and, in my view, incorrectly) used to justify construing a contract in the most advantageous way possible from the perspective of the secondary obligor. The New Restatement makes it clear that while there are several substantive rules of suretyship and guaranty law that give secondary obligors benefits not generally available to parties to ordinary contracts, normal rules of contract formation and interpretation apply to secondary obligations. No special solicitude to secondary obligors is called for in determining to what the parties agreed.

3. Misrepresentation, Fraud, and Non-Disclosure

The suretyship provisions in the old Restatement of Security, building on contract law principles, provided that fraudulent or material misrepresentation can void the secondary obligation.[43] The New Restatement builds on this principle,

---

38. RESTATEMENT OF SURETYSHIP AND GUARANTY, *supra* note 11, § 1(1)(a).
39. *Id.*
40. *Id.*
41. *Id.*
42. *Id.*
43. RESTATEMENT OF SECURITY, *supra* note 37, § 113.

casting it in the light of modern contract theory. Importantly, it provides that non-disclosure of facts materially affecting risk to the secondary obligor can sometimes constitute misrepresentation.[44] Thus, unlike the case in general contract law, adverse consequences may flow from the failure to disclose certain facts to the secondary obligor.

4. Secondary Obligor's Rights against Principal Obligor

As between the principal obligor and the secondary obligor, it is, of course, the principal obligor who should bear the cost of performing the obligation owed to the obligee. Historically, suretyship law provided a secondary obligor who performs its obligation a right of reimbursement against the principal obligor and, in appropriate circumstances, a right to be subrogated to the obligee's rights against the principal obligor. In addition, a secondary obligor called upon to perform when the principal obligor was capable of doing so was provided a remedy very much like specific performance known as "exoneration."[45]

The New Restatement more carefully articulates these rights of the secondary obligor to be made whole or kept whole. The right of reimbursement is divided into two complementary provisions governing reimbursement and restitution. Rules governing the right of subrogation have been expanded and clarified. Finally, and most dramatically, the New Restatement reformulates the right of exoneration and its cousin, the preemptive first strike known as *quia timet*.[46] Rather than articulating those methods of keeping the secondary obligor whole as procedural rights in themselves, the New Restatement instead articulates a substantive duty on the part of the principal obligor to: (i) perform the underlying obligation so that the secondary obligor will not have to perform the secondary obligation; and (ii) not to impair the secondary obligor's expectation that the principal obligor will perform.[47] The New Re-

44. RESTATEMENT OF SURETYSHIP AND GUARANTY, *supra* note 11, § 12(3).

45. *See* RESTATEMENT OF SECURITY, *supra* note 37, § 112.

46. *See, e.g.*, Borey v. National Union Fire Ins. Co., 934 F.2d 30 (2d Cir. 1991); *see also* RESTATMENT OF SURETYSHIP AND GUARANTY, *supra* note 11, § 21 cmt. i and sources cited therein.

47. *See generally* RESTATEMENT OF SURETYSHIP AND GUARANTY, *supra* note 11, § 21.

statement then reconfigures exoneration and *quia timet* as possible remedies for the violation of these newly articulated duties.

5. Set-Offs

Because suretyship and guaranty transactions are, at the least, three-cornered relationships, matters get very complicated when obligations flowing between two of the three parties are asserted in such a way as to affect the third party. Most often, this arises when one party seeks to set off against performance it owes to another party either an obligation owed to it by the third party or an obligation owed to the third party by the second party. For example, assume that a secondary obligor who is called upon to perform has a claim of its own against the obligee. May the secondary obligor set off that independent claim against its duty on the secondary obligation? Alternatively, assume that the principal obligor has a claim against the obligee that is unrelated to the suretyship transaction. May the secondary obligor raise that claim of the principal obligor as a set-off against the secondary obligor's duty? The answers to questions such as these are not simple, and the questions have proven difficult for practitioners and courts. The New Restatement provides significant guidance in this area.[48]

6. Suretyship Defenses

One of the most significant developments in the New Restatement is its treatment of the law governing suretyship defenses. As indicated in the discussion of revised Uniform Commercial Code Article 3,[49] one of the most problematic areas of suretyship and guaranty law has been the determination of the effect to be given to acts by the obligee that impact upon the duties of the principal obligor for which the secondary obligor is also responsible. Traditionally, any change in the principal obligor's obligation to the obligee resulted in automatic discharge of the secondary obligor. By the time that the Restatement of Security was approved over a half-century ago,

48. *See id.* §§ 31, 35, 36.
49. *See supra* part IV.A.

though, it was recognized that this rule often gave windfall benefits where there was little or no harm. Thus, that Restatement adopted a set of rules that ameliorated this harshness somewhat,[50] although the core of the doctrine was left unchanged.

In the fifty years between the approval of the old Restatement and the commencement of work on the New Restatement, the biggest advance in the law governing suretyship defenses came in the 1990 adoption of revised Uniform Commercial Code Article 3.[51] That Article, as described above, rejected the absolute discharge theory of suretyship defenses and replaced it with a loss prevention model. That advance, while accomplished in an occasionally quirky and internally inconsistent way,[52] paved the way for a more general application of that principle. Accordingly, the New Restatement adopts the principle that, for all "impairments of recourse," the secondary obligor is discharged from its obligation only to the extent that the secondary obligor would otherwise suffer a loss as result of the impairment.[53] Situations where loss might otherwise occur include cases in which a solvent principal obligor has been granted a release of its duties pursuant to the underlying obligation by the obligee,[54] where a principal obligor's financial situation worsened during the period of an extension,[55] and modifications that make the obligation more burdensome for the secondary obligor to fulfill.[56]

7. Multiple Surety Transactions

Credit enhancement devices can be quite complex even when there is only one credit enhancer. The possible combinations and permutations of relationships between the debtor,

---

50. *See* RESTATEMENT OF SECURITY, *supra* note 37, § 128.

51. *See supra* part IV.A.

52. *See* Neil B. Cohen, *Suretyship Principles in the New Article 3: Clarifications and Substantive Changes*, 42 ALA. L. REV. 595, 597 (1990); *see also* PEB COMMENTARY NO. 11, FINAL DRAFT, SURETYSHIP ISSUES UNDER SECTIONS 3-116, 3-305, 3-415, 3-419, AND 3-605 (Permanent Editorial Board for the Uniform Commercial Code, 1994).

53. *See* RESTATEMENT OF SURETYSHIP AND GUARANTY, *supra* note 11, §§ 37, 39-44.

54. *See generally id.* § 39.

55. *See generally id.* § 40.

56. *See generally id.* § 41.

the creditor, and the enhancer can, as we have seen, present some knotty problems. When there is more than one enhancer in the same transaction, the complications seem to increase geometrically.

Multiple surety transactions are those in which there is more than one secondary obligor. In such cases, the nature of the legal relationships that are created depends on the nature of the relationship between the secondary obligors. Cases in which the secondary obligors qualify as "cosureties"[57] present different legal implications than those in which the secondary obligors have a relationship of "principal surety" and "subsurety."[58] In a cosurety situation, the secondary obligors are on equal, or at least parallel, footing, and the structure of rights and remedies that runs through a cosurety transaction is designed to effectuate that status by having the cosureties share the cost of performance. For example, when one cosurety performs the entire obligation, suretyship law provides that cosurety with a right of contribution against the other cosurety so that each will, ultimately, bear only its "contributive share" of the performance. In a principal surety—subsurety situation, on the other hand, the relationship between the secondary obligors is such that it is the principal surety that should bear the total cost of performance. Thus, if the subsurety is called upon by the obligee to perform, it has a right of reimbursement for the full amount of that performance against the principal surety; conversely, if the principal surety performs, it has no action against the subsurety.

Not surprisingly, courts have often had great difficulty sorting through the issues created by multiple surety transactions. Moreover, the doctrines that distinguish cosuretyship situations from subsuretyship situations have often shed little light, and rules within those situations (such as those used to determine the contributive shares of each cosurety) have often been plagued with logical inconsistency and practical difficulty. The New Restatement brings some order to this complex area by explicitly articulating a framework of rules and making it clear how those rules derive from, and fit into, the relatively simpler cases in which there is only one secondary obligor.

57. *See generally id.* §§ 51, 55-58.
58. *See generally id.* §§ 51, 59-61.

8. Summary

Will the New Restatement have a significant impact on this important credit enhancement device? It is probably too early to tell. The imprimatur of the American Law Institute carries quite a bit of weight, but Restatements are not self-executing (except in the U.S. Virgin Islands). Rather, Restatement rules become the law only by adoption by the courts. Ultimately, therefore, the impact of the New Restatement will be determined by its own persuasiveness.

C. Revised Uniform Commercial Code Article 5

Revised Uniform Commercial Code Article 5, governing letters of credit, received final approval in 1995 from both the National Conference of Commissioners on Uniform State Laws and the American Law Institute, the two proprietors of the Uniform Commercial Code. While a detailed analysis of the provisions of those revisions is beyond the scope of this article, one aspect of the revisions is particularly worthy of attention.

While both letters of credit and secondary obligations governed by the law of suretyship and guaranty are credit enhancement devices, they are distinct legal specialties. A letter of credit, even a standby letter of credit, is not a secondary obligation. Nonetheless, letter of credit issuers have occasionally sought to invoke the law governing secondary obligations. Most often, this occurs when an issuer of a standby letter of credit has sought to become subrogated to the rights of the beneficiary of the letter of credit against the issuer's customer. Normally, there would be no need for this sort of subrogation. After all, the issuer already has a reimbursement claim against its customer. Yet, in some circumstances, piggy-backing on the beneficiary's claim against the customer might be advantageous, which is particularly the case when the issuer's reimbursement claim is not secured by collateral, but the beneficiary's claim is secured. If the customer is insolvent, the difference between asserting a secured claim and an unsecured claim may be the difference between full recovery and little or no recovery. Similarly, if the reimbursement claim is undersecured, but the beneficiary's claim is secured by other collateral, access to that other collateral can keep the issuer from suffering a loss.

Issuers seeking subrogation to the rights of beneficiaries

have generally faced hostility from the courts.[59] Much of this hostility stems from the efforts of the drafters of original Uniform Commercial Code Article 5 to erect firm barriers between the law of guaranties and the law governing letters of credit, primarily to assure the efficacy of the independence principle of letters of credit. Emblematic of these barriers is the assertion in the Official Comment to original Uniform Commercial Code section 5-101 that, prior to the enactment of Article 5, the law governing letters of credit consisted of "the law of contracts *with occasional unfortunate excursions into the law of guaranty*."[60]

Revised Article 5, however, makes an about-face on this issue. Revised Uniform Commercial Code section 5-117(a) provides that:

> An issuer that honors a beneficiary's presentation is subrogated to the rights of a beneficiary to the same extent as if the issuer were a secondary obligor of the underlying obligation owed to the beneficiary and of the applicant to the same extent as if the issuer were the secondary obligor of the underlying obligation owed to the applicant.[61]

As a result, it will be necessary for letter of credit attorneys to familiarize themselves with the law of subrogation in the context of secondary obligations. Subrogation is often referred to as "equitable assignment" or "assignment by operation of law," but those slogans hardly inform as to the contours of the subrogation right. Attorneys will need to be able to answer two questions: When is subrogation available? What

---

59. For examples of cases rejecting a finding of subrogation through total application of suretyship principles to the letter of credit transaction, see Bank of North Carolina, N.A. v. Rock Island Bank, 570 F.2d 202 (7th Cir. 1978); Beach v. First Union Nat'l Bank of N.C. (*In re* Carley Capital Group), 119 B.R. 646 (W.D. Wis. 1990); Berliner Handels-UND Frankfurter Bank v. East Tex. Steel Facilities, Inc. (*In re* East Tex. Steel Facilities, Inc.), 117 B.R. 235 (Bankr. N.D. Tex. 1990); Bank of Am. Nat'l Trust & Sav. Ass'n. (*In re* Kaiser Steel Corp.), 89 B.R. 150 (Bankr. D. Colo. 1988); Pastor v. National Republic Bank of Chicago, 390 N.E.2d 894 (Ill. 1979); New Jersey Bank v. Palladino, 389 A.2d 454 (N.J. 1978). For examples of cases accepting such application, see Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank of San Francisco, 493 F.2d 1285 (9th Cir. 1974); *In re* Sensor Sys., Inc., 79 B.R. 623, (Bankr. E.D. Pa. 1987); *In re* Minnesota Kicks, Inc., 48 B.R. 93 (Bankr. D. Minn. 1985).

60. U.C.C. § 5-101 cmt. 1 (1994) (emphasis added).

61. U.C.C. § 5-117(a) (1995).

rights does one acquire through subrogation? As a result of this about-face in Article 5, it is likely that the extensive subrogation rules in the New Restatement will receive close attention, not only from the suretyship and guaranty portion of the credit enhancement bar, but also from the letter of credit bar.

D. Revised Uniform Commercial Code Article 9

Perhaps the most ambitious of the Uniform Commercial Code drafting projects now in progress is the revision of Uniform Commercial Code Article 9, which governs security interests in personal property and fixtures. Article 9 is probably the most innovative article in the original Uniform Commercial Code, combining the disparate rules governing a variety of credit enhancement mechanisms that were functionally identical but different in superficial form into one conceptually elegant Article. Accordingly, revision must be undertaken with great care. While the finished product is still several years away, early indications are that the quality of the revisions will be quite high.

In 1995, the first portion of the proposed revisions to Article 9 was presented before the annual meeting of the National Conference of Commissioners on Uniform State Laws (NCCUSL). While the project's formal unveiling is important, the revision still has a long journey to travel before it culminates in a new Official Text of Article 9. The project will make at least two more presentations to NCCUSL, and an unspecified number to the American Law Institute, before final promulgation. Then, of course, it must be adopted by the state legislatures. Nonetheless, those with an interest in the future of the law governing security interests in personal property are well-advised to focus on the revision process now, before policy debates are played out and while climate for suggested improvements is most conducive. A summary of the most important substantive provisions in the most recent draft of the revisions follows.

1. Scope

The draft proposes that the scope of Article 9 be expanded in a number of ways. First, the exclusions from Article 9 of security interests in tort claims and insurance proceeds have been cut back to exclude only individuals' claims for health and

disability insurance and personal injury recoveries.[62] It should be noted, of course, that exclusion from Article 9 does not mean that the granting of such security interests is prohibited (that decision is within the province of other state law) but, rather, that such security interests, if they exist, will be governed by non-Code law.

Second, the draft proposes the possibility that security interests in deposit accounts, which are now within the scope of Article 9 only to the extent that the deposit accounts represent proceeds of other Article 9 collateral, be within the scope of Article 9.[63] If adopted, this proposal would eliminate one of the most difficult problems in the law of secured finance—determination of the often obscure non-Article 9 law that applies to a security interest in a bank account.

Third, the draft proposes that revised Article 9 include within its scope the sales of most general intangibles for money due or to become due.[64] At present, Article 9 governs not only security interests, but the sales of accounts and chattel paper. The proposed revision would add a third category, "payment intangibles," to the coverage of sales of rights to collect money.[65] If adopted, the proposed revision would bring into Article 9 both venerable transactions such as sales of the rights to royalties, and new financial specialties such as securitizations.

2. Choice of Law—Jurisdiction of Filing

Choice of law rules in Article 9 determine, *inter alia*, which state's priority rules will govern a particular transaction and, more importantly, in which state a financing statement must be filed in order to perfect a security interest. Under current Article 9, the choice of law rule depends on the type of collateral involved.[66] For most goods, the location of the collateral is the key, while for intangibles such as accounts, the determining factor is the location of the debtor.

Under the proposed draft, the law that governs most se-

62. *See* Proposed U.C.C. § 9-104(2), (11) (Feb. 15, 1996 draft).
63. *Id.* § 9-104(12)-(13) (Alternatives A & B).
64. *Id.* § 9-102(a)(3).
65. *Id.* § 9-106.
66. U.C.C. § 9-103 (1995).

cured transactions would be the law of the jurisdiction in which the debtor is located. Moreover, in the case of a debtor who is a juridical person (such as a corporation), the debtor would be deemed to be located in the jurisdiction in which it is organized, rather than the jurisdiction in which it has its place of business. The change to a location-of-debtor would certainly ease the filing burden for transactions in which goods in many states are the collateral for obligations owed by a debtor. One might think that using the jurisdiction of organization, rather than the principal place of business, to determine the location of the debtor would lead to a large shift of filings (and their concomitant revenue) to jurisdictions such as Delaware, but a recent empirical study suggests the effect on location of filings would be immaterial.[67]

3. Perfection by Filing

Under current Article 9, a security interest in instruments may be perfected, in most cases, only by the possession of the secured party.[68] Under the proposed revision, however, a security interest in an instrument could be perfected by filing a financing statement.[69] The primary effect of this change would be that filing regarding an instrument would enable the secured party to prevail over the bankruptcy trustee under Bankruptcy Code section 544.[70] A purchaser, including a secured party, who took possession of the instrument in the ordinary course of its business without knowledge of the filed security interest, however, would take priority over it.[71]

4. Financing Statements

Under current Article 9, a financing statement must describe the collateral by item or type.[72] Accordingly, it is questionable whether a secured party who has been granted a security interest in all of the debtor's personal property can simply

67. *See* Lynn M. LoPucki, *Why the Debtor's State of Incorporation Should be the Proper Place for Article 9 Filing: A Systems Analysis*, 79 MINN. L. REV. 577 (1995).

68. U.C.C. § 9-304 (1995).

69. Proposed U.C.C. § 9-304(a) (Feb. 15, 1996 draft).

70. Bankruptcy Code § 544, 28 U.S.C. § 544 (1994).

71. Proposed U.C.C. §§ 9-308 to 9-309 (Feb. 15, 1996 draft).

72. U.C.C. § 9-402(1) (1995).

indicate that fact on the financing statement. The proposed revisions, on the other hand, would allow simple descriptions of collateral such as "all assets" or "all personal property."[73]

In addition, several changes are proposed for the filing system. First, and most important, "medium neutral" rules, that do not depend on the filing system continuing to operate solely with tangible written documents, are being drafted.[74] Second, along with other moves that would facilitate electronic filing, the requirement for the debtor's signature on the financing statement is proposed for elimination.[75] Instead, filing an unauthorized financing statement would simply be prohibited.[76]

5. Default

The rules governing the rights of parties to a secured transaction after default undergo significant changes in the proposed revision. First, the draft addresses an area which has caused much confusion and inconsistent case law over the years—the rights of a party who is not the owner of the collateral but is liable for the obligation that it secures. Under current Article 9, such a person (typically a guarantor) may qualify as a debtor.[77] If so, that person is entitled to all of the protections of part 5 of Article 9 (notice of disposition, commercially reasonable disposition, etc.) and may not waive most of them.

The proposed revisions distinguish between debtors who are owners of the collateral and other obligors. Debtor-owners will have the full set of protections under part 5 and may not waive them. As for other obligors, only those obligors who are secondary obligors will have part 5 protections.[78] This revision was made because secondary obligors will be economically affected by the disposition of the collateral. A guarantor or other secondary obligor of the debt secured by the debtor's collateral is affected by the disposition, because the lower the deficiency remaining after that disposition, the less for which

---

73. Proposed U.C.C. § 9-402(g) (Feb. 15, 1996 draft).
74. *Id.* § 9-105(a)(28).
75. *Id.* § 9-402(a)(1).
76. *Id.*
77. U.C.C. § 9-105(1)(d) (1995).
78. Proposed U.C.C. §§ 9-501 to 9-507 (Feb. 15, 1996 draft).

that obligor will be responsible. Similarly, a person other than the debtor who has supplied other collateral for the obligation is affected because that person's equity in that other collateral will be affected by the disposition of the collateral supplied by the debtor. On the other hand, the principal obligor of an obligation for which a guarantor has provided collateral is not affected by disposition of the collateral supplied by the guarantor because, no matter what is received from that disposition, the principal obligor's total liability will remain the same. Thus, the principal obligor who has not supplied the collateral is not protected by proposed part 5. While secondary obligors will also have full Article 9 protections, except for secondary obligors who are "consumer obligors," they will be able to waive those protections.[79]

Second, the rules governing strict foreclosure are changed and extensively rewritten in the revisions. Under current law, a secured party may propose retaining the collateral only in total satisfaction of the secured debt.[80] Under the proposed revisions, however, the secured creditor may also propose a "partial strict foreclosure," in which the secured party would retain the collateral in satisfaction of an agreed portion of the debt.[81]

Third, the proposed revisions would speak explicitly about the sanctions imposed against a secured party who does not follow the rules in part 5 of Article 9. Under current law, Article 9 is largely silent in this area, speaking only briefly in section 9-507.[82] The result is that the states have been left to their own devices to determine what happens when a secured party does not follow the rules. Three approaches have developed. Under the "absolute bar" rule, a secured party who does not play by the rules is barred from collecting any deficiency, regardless of the harm (if any) that flowed from its violation. Under the "damages" rule, a debtor may prove damages from a secured party's part 5 violation, but the violation otherwise has no effect on the secured party's right to a deficiency. Under the "rebuttable presumption" rule, the debtor is presumed to have suffered damages from the secured party's violation that are

79. *Id.* § 9-501.
80. U.C.C. § 9-505 (1995).
81. Proposed U.C.C. § 9-505 (Feb. 15, 1996 draft).
82. U.C.C. § 9-507 (1995).

equal to the amount of the deficiency that would otherwise be owed (thus canceling out the deficiency), but the secured party may rebut this presumption by proving that the damages were less than that amount. The proposed revisions, for the most part, adopt the rebuttable presumption approach.[83]

The draft also suggests a number of changes with respect to the rights of consumer debtors after default. First, the post-default notice of disposition of the collateral must contain, in addition to information given to all debtors, information concerning potential liability for a deficiency, and concerning rights of redemption and reinstatement.[84] Second, after disposition, the secured party must provide specific information concerning the calculation of any deficiency or surplus.[85] Third, a consumer debtor would have the right to reinstate a secured debt by tendering all past due payments without acceleration.[86]

6. Questions for Debate

The Prefatory Note for the draft of Article 9 submitted to the 1995 meeting of NCCUSL concludes with a list, prepared by the reporters, of "the more important questions of policy raised by the draft." While some of the questions are obvious, in light of the provisions in the draft, others suggest paths that were not taken in this draft, but may receive more consideration in the near future. Two such questions are:

- Should the revised Article 9 continue to facilitate and promote the creation and enforcement of security interests?
- Should the revised Article 9 retain its priority scheme under which perfected security interests are senior to the rights of lien creditors and unperfected security interests are junior to those rights? Should the revised Article 9 subordinate perfected security interests to the rights of certain classes of unsecured creditors? Should the revised Article 9 subordinate the rights of lien creditors to unperfected security interests?

---

83. Proposed U.C.C. § 9-507(c)(2)(ii) (Feb. 15, 1996 draft).
84. *Id.* § 9-504(l).
85. *Id.* § 9-504(n).
86. *Id.* § 9-506(b).

V. CONCLUSION: DO THE NEW DEVELOPMENTS REPRESENT IMPROVEMENT?

With the dramatic activity in the domestic law of credit enhancement that has occurred within the last decade and continues apace today, it is important to remember that change is not necessarily equivalent to improvement. Do the new developments make the law better—for either lawyers or commercial parties?

The answer, of course, is that it is too early to tell. The advances in each body of law governing credit enhancement mechanisms over time are likely to diminish many unnecessary legal differences between the mechanisms. This, I believe, is good. Parties to a commercial transaction should be able to select credit enhancement mechanisms based on the economic worth they bring to the transaction, rather than the legal baggage they carry. To the extent that the governing rules move toward a consistent understanding of the economic role played by credit enhancement, and the legitimate needs of those supplying the enhancement as well as the debtor and creditor, those rules will facilitate the extension of credit.

Nonetheless, by the very fact that the various drafting projects governing credit enhancement mechanisms are the product of different groups of people, the potential is created for similar issues to be addressed differently in different regimes when there is no economic or functional reason for the distinction. While this is probably inevitable so long as the different mechanisms are considered to be legally distinct, even if economically similar, perhaps the next logical step for the growth of the law of credit enhancement would be a unified set of principles. Perhaps the agenda for the millennium should be the development of a Unified Field Theory of Credit Enhancement.