State of New Jersey

NJLRC

New Jersey Law Revision Commission

FINAL REPORT

relating to

UNIFORM COMMERCIAL CODE ARTICLE 9 – SECURED TRANSACTIONS

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NEW JERSEY LAW REVISION COMMISSION
153 Halsey Street, 7th Fl., Box 47016
Newark, New Jersey 07102
973-648-4575
(Fax) 648-3123
email: njlrc@njlrc.org
web site: http://www.lawrev.state.nj.us

Introduction

In July 1998, the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI) approved and recommended for enactment in all the states Uniform Commercial Code (UCC) Revised Article 9. Secured Transactions. The New Jersey Law Revision Commission (Commission) has reviewed Revised Article 9 to determine whether the Official Text is appropriate for enactment in New Jersey. N.J.S.A. 1:12A-8.

Article 9 is largely the product of Professor Grant Gilmore and is regarded as the crown jewel of the UCC. It sets forth a comprehensive system of rules to govern the creation and perfection of security interests in personal property. The Official Text of Article 9, or a close variant of it, has been adopted in every State in the Union. New Jersey adopted Article 9 in 1961. That act, amended several times since then, is codified at N.J.S.A. 12A:9-101 et seq. Article 9 has operated effectively in New Jersey and has not generated a strident local demand for revision.

In 1990, NCCUSL and ALI approved the creation of a drafting committee to revise existing Article 9. The drafting committee met fifteen times from 1993 to 1998. The meetings took place in different major US cities. The length of each meeting was approximately two and one-half days. The meetings were open to the public, but, in fact, were attended regularly by the same group of approximately 35-50 persons—lobbyists for lenders of credit, lawyers specializing in Article 9 and a small consumer delegation. Various interest groups also appeared at the meetings to provide facts for the drafting committee and to argue for specific provisions to be included in the Article.

Revised Article 9, like its predecessor, is difficult to read. Reporter Chuck Mooney has stated, Article 9 is not only part of the Code but it is written in Code.[1] Edwin Smith, Esq., a member of the drafting committee, advised, with reference to the transition provisions, don't even bother reading the statutory language, read the official comments.[2] Revised Article 9 contains more sections and more legal categories than existing Article 9. Inside knowledge is often required to understand specific statutory language.

Revised Article 9 expands the scope of Article 9 to cover collateral not previously considered Article 9 assets. For example, debtors may create Article 9 security interests in health care receivables and deposit accounts. The revision also fine-tunes the perfection and priority rules for various kinds of Article 9 property. For example, a creditor's security interest in payment intangibles is automatically perfected upon sale, and security interests in bank deposit accounts and investment property are perfected by control generally by tripartite agreement.

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[1] ALI-ABA Conference on Revised Article 9 of the UCC held April 22, 23 1999 at the Sheraton New York Hotel, N.Y.

[2] Id.

The Article also improves but does not resolve the myriad problems arising from the necessity to determine which jurisdiction's law governs any particular legal issue. For example, the revision clarifies that the debtor's jurisdiction is the place to file a financing statement. However, the debtor's jurisdiction may not govern the effect of perfection or non-perfection. The revision modifies the filing rules by moving toward a central filing system. Finally, the Article expands rights of consumers particularly in the case of default.

The Commission has studied the Revised Article pursuant to its statutory obligation under N.J.S.A. 1:12A-8 and has made the following findings. Revised Article 9 moderately improves the law of secured transactions by repairing technical problems that have arisen under existing law. The revision is not innovative and does not raise issues requiring independent reconsideration at the state level. The revision presents New Jersey with the opportunity to establish a central filing system for UCC financing statements. Revised Article 9 is expected to be the de facto law of the country by July 2001, the effective date of the act. New Jersey thus has an interest in adopting the revision.

The Commission therefore recommends that the Legislature adopt Revised Article 9 (with conforming amendments to Articles 1, 2, 2A, 4, 5, 7, and 8). The Commission also recommends that the Legislature adopt non-uniform amendments to (1) establish a central filing system and (2) provide a Part 6 default rule for consumer transactions, and enact conforming amendments to statutes referencing the former Article 9.

Currently, ten states have adopted the Revised Article 9: Connecticut, Indiana, Minnesota, Nebraska, Nevada, North Dakota, Puerto Rico, Rhode Island, Texas, and Washington. In 2012, twenty-three states and two territories have made introductions to their respective legislatures: Colorado, District of Columbia, Florida, Hawaii, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, New Hampshire, New Mexico, Ohio, Oklahoma, Oregon, Pennsylvania, Puerto Rico, South Dakota, Tennessee, Virginia, West Virginia, and Wisconsin.

Summary of Changes

The scope of Article 9 is expanded to include collateral that the former Article 9 did not cover or treated in a restricted manner. The Article allows a secured creditor to take a security interest directly in deposit accounts. The former Article 9 recognized security interests in deposit accounts only as proceeds of original collateral. The Article also covers sale of payment intangibles and promissory notes. The former Article 9 included only the sale of accounts and chattel paper. Broadening the scope of collateral increases a debtor=s access to credit.

Second, the Article simplifies the choice of law governing the place to perfect security interests. For most collateral, the debtor's location controls which jurisdiction governs perfection, the effect of perfection or non-perfection and priority. In the case of business entities, the debtor's location is the state of incorporation or registration. If the debtor is a registered entity, the secured

creditor need only verify its place of incorporation to determine the correct jurisdiction in which to file its financing statement and perfect its security interest by filing. For security interests based on possession, the location of the collateral determines the jurisdiction.

Third, the perfection rules are clarified for new types of collateral. For example, a secured creditor perfects a security interest in deposit accounts by control. A secured party has Acontrol@ of a deposit account when, with the consent of the debtor, the secured party obtains the depositary bank's agreement to act on the secured party's instructions (including when the secured party becomes the account holder) or when the secured party is itself the depositary bank. The control requirements are patterned on Section 8-106, which specifies the requirements for control of investment property. The concept of perfection through control applies to letters of credit and other collateral. In addition, the Article provides for automatic perfection for certain categories of collateral such as the sale of payment intangibles thus obviating the filing of financing statements.

Fourth, the Article enhances consumer protection, mainly by requiring that the secured party satisfy several notification requirements prior to foreclosing on the collateral. The Article also excludes security interests in consumer deposit accounts.

Recommended Non-Uniform Amendments

1. Central Filing System

New Jersey has a dual filing system for filing UCC financing statements. N.J.S.A. 12A-9-401. The central office is the Division of Commercial Recording located in Trenton. The local offices are the twenty-one county clerk's offices scattered throughout the state. The identity of the collateral determines the place to file. Financing statements covering the following types of collateral are filed locally: (1) farm equipment, farm products or general intangibles arising from them, (2) accounts, (3) crops, (4) consumer goods, (5) timber to be cut, (6) minerals and (7) fixture filings that, as explained below, are not financing statements. UCC financing statements covering everything else are filed in Trenton.

The dual filing system is inefficient. First, it requires lenders to determine the classification of the collateral. The classification of certain assets sometimes is not an easy task. For example, the question of whether an asset constitutes a fixture or good poses a thorny legal question inducing lenders to file at both the local and state level and avoid the risk of losing the perfected status of their lien. Second, the concept of a "fixture filing" is redundant. Real property law not the UCC governs the effect of a mortgage on fixtures. Establishing a central filing system simplifies the filing process.

Revised Article 9 moves in the direction of central filing. It dictates central filing for most collateral.[3] It permits central filing for financing statements covering fixtures provided the financing

[3]Section 9-501. Filing Office provides:

statement is not a fixture filing.[4] It dictates local filing for certain real-estate related collateral. Finally, it designates the central office as the place to file financing statements for transmitting utilities. The configuration of Part 5 does not constitute a central filing system. Left out of central filing are: fixture filings, filings covering utility companies and filings for crops and minerals. Retaining the dual filing system for these three left-out categories is not justified given the benefits of central filing.

Central filing provides one-stop shopping and eliminates the risk of filing in the wrong place. Any person wanting to learn whether particular assets of a debtor are subject to the claim of a secured creditor has to look in only one set of records. Likewise, a secured party that wants to perfect by filing does not need to determine whether to file in the central or local office. Central filing is simple, efficient and logical. The arguments against the central filing system are not persuasive. There are three main arguments: (1) sanctity of land records, (2) loss of county revenue from filing fees and (3) the effect of a recorded mortgage on fixtures. None of the arguments overcomes the efficiencies of central filing.

Eliminating fixture filings would not alter the effect of a recorded mortgage on fixtures. The effect of the mortgage on fixtures is due to real property law, not Article 9. "Fixture filings@ do not give mortgage holders rights that they do not already have under real property law. Lenders worried about prior security interests in debtor's fixtures must check both the land records and the Trenton office. "Fixture filings" are an unnecessary and confusing legal creation that does not spare lenders the expense of checking the central office records.

New Jersey is not a large producer of minerals or timber. Financing statements filed at the local level in New Jersey to perfect security interests in minerals or timber do not constitute a significant percentage of local filings. Requiring secured creditors to file these financing statements at the state level would not disrupt lending practices or cause local recording offices to sustain

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A(a) Except as otherwise provided in subsection (b), if the local law of this State governs perfection of a security interest or agricultural lien, the office in which to file a financing statement to perfect the security interest or agricultural lien is:

(1) the office designated for the filing or recording of a record of a mortgage on the related real property, if:

(A) the collateral is as-extracted collateral or timber to be cut; or

(B) the financing statement is filed as a fixture filing and the collateral is goods that are or are to become fixtures; or

(2) the office of [ ] [or any office duly authorized by [ ], in all other cases, including a case in which the collateral is goods that are or are to become fixtures and the financing statement is not filed as a fixture filing.

(b) The office in which to file a financing statement to perfect a security interest in collateral, including fixtures, of a transmitting utility is the office of [ ]. The financing statement also constitutes a fixture filing as to the collateral indicated in the financing statement which is or is to become fixtures.@

[4] A fixture is collateral that is goods that are or are to become fixtures.

substantial revenue loss. The change will make searches easier.

Loss of county revenue collected from fixture filing fees does not justify retention of the Byzantine-like structure of the dual filing system. The negative impact on the county must be viewed against the benefits bestowed upon the persons the county was created to serve. Most of those persons would be better off with central filing. Limited loss of revenue from filing fees should not hold up innovation.

Both NCCUSL and the ALI support central filing. Official Comment 2 to Section 9-501 states, The more completely the files are centralized on a state-wide basis, the easier and cheaper it becomes to procure credit information; the more the files are scattered in local filing units, the more burdensome and costly. Adoption of the Official Text dual filing system is not integral to the uniformity of Article 9. A central filing system benefits both secured parties and debtors.

2. Rebuttable Presumption Rule for Consumer Transactions

'9-626 entitled AAction in which Deficiency or Surplus is in Issue@ provides in pertinent part:

> (A)[Applicable rules if amount of deficiency or surplus in issue] In an action arising from a transaction, other than a consumer transaction, in which the amount of a deficiency or surplus is in issue, the following rules apply:
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> (3) Except as other wise provided in Section 9-628, if a secured party fails to prove that the collection, enforcement, disposition, or acceptance was conducted in accordance with the provisions of this part relating to collection, enforcement, disposition, or acceptance, the liability of a debtor or a secondary obligor for a deficiency is limited to an amount by which the sum of the secured obligation, expenses, and attorney's fees exceeds the greater of:
>
> (A) the proceeds of the collection, enforcement, disposition, or acceptance; or,
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> (B) the amount of proceeds that would have been realized had the non-complying secured party proceeded in accordance with the provisions of this part relating to

collection, enforcement, disposition, or acceptance.

(4) For purposes of paragraph (3)(B), the amount of proceeds that would have been realized is equal to the sum of the secured obligation, expenses, and attorney's fees unless the secured party proves that the amount is less than that sum.

Subsection (a) codifies the rebuttable presumption rule for commercial transactions. The rule applies to a deficiency action and works in the following way. First, the secured party does not need to prove that it complied with Article 9, Part 6 as part of its prima facie case. Second, if the debtor raises the issue of compliance, then the secured party must prove that it complied. Third, if the secured creditor cannot meet this burden of proof, then the deficiency is calculated according to the statute. The debtor or obligor is credited with the greater of the actual proceeds of the disposition or the proceeds that would have been realized had the secured party complied with Article 9. The amount that would have been realized is equal to the secured obligation, expenses and attorney's fees unless the secured party proves that the amount would have had less value. The secured party is entitled to recover any remaining deficiency.

The rebuttable presumption rule does not apply to consumer transactions. '9-626(b) provides, The limitation of the rules in subsection (a) to transactions other than consumer transactions is intended to leave to the court the determination of the proper rules in consumer transactions. With respect to consumer transactions, three general approaches emerged under existing Article 9. Some courts held that a noncomplying secured creditor was barred from recovering a deficiency (the absolute bar rule). Other courts held that a debtor could offset the deficiency by all damages recovered under 9-507 (the offset rule). Other courts held that the noncomplying creditor's action was barred unless the secured party overcame the presumption that compliance would have yielded an amount adequate to satisfy the secured debt.

New Jersey Courts have not developed different rules for consumer as opposed to commercial transactions in a deficiency action under Article 9. The Courts generally have adopted the rebuttable presumption test. Security Sav. Bank v. Tranchitella, 249 N.J. Super. 234 (App. Div. 1991) ; Caterpillar Fin. Services Corp. v. Wells, 278 N.J. Super. 481 (Law Div. 1994); Franklin State Bank v. Karl Parker, 136 N.J. Super.476 (D. Ct. 1975); Conti Causeway Ford v. Jarossy, 114 N.J. Super. 382 (D. Ct. 1971); and T & W Ice Cream, Inc. Carriage Barn, Inc., 107 N.J. Super. 328 (D. Ct. 1969).

In Security Sav. Bank, the Appellate Division considered whether a secured party's failure to dispose of collateral in a commercially reasonable manner operated to bar a deficiency judgment. The Appellate Division rejected the absolute bar rule stating:

AThere is no reason why a debtor should receive a windfall solely

> because of a technical lapse. The debtor's interests can be protected by the Code provisions which allow the debtor to recover losses incurred as a result of the failure to comply with the requirement that the collateral be disposed in a commercially reasonable manner. 249 N.J. Super., supra at 245.

The Appellate Division explicitly adopted the rebuttable presumption test. Although we hold that the creditor who does not dispose of collateral in a commercially reasonable manner is not wholly barred from a deficiency recovery, such creditor must nonetheless overcome the presumption that the value of the collateral at least equaled the debt it secured. Id. The presumption may be overcome by proof of the reasonable value of the collateral, plus or minus payments incurred in disposing of the collateral, and comparing it with the price realized at the actual sale.

The decision in Security Sav. Bank represents the clearest statement of New Jersey law on the question of the noncomplying secured party's right to a deficiency judgment. The rebuttable presumption test balances the interests of the secured party and debtor, regardless of whether the debtor is a consumer or commercial party. The test also avoids the windfall received by debtors under the absolute bar rule. For example, under Revised Article 9, the secured party is noncomplying if information pertaining to the calculation of the deficiency does not appear in a precise order on a writing. '9-616(c). Codification of the rebuttable presumption test for consumers is preferable to leaving that decision to the first court to consider the issue.

Conclusion

For the foregoing reasons, the Commission recommends that the Legislature adopt Revised Article 9. Secured Transactions (With conforming amendments to Articles 1, 2, 2A, 4, 5, 7, and 8), the proposed non-uniform amendments and conforming amendments to New Jersey statutes referencing former Article 9.