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UNDER THE SPREADING U.C.C.— SUBORDINATIONS AND ARTICLE 9

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When William Schnader first stepped before his fellow Commissioners in the grand ballroom of the Bellevue-Stratford Hotel in Philadelphia on September 2, 1940 and proposed that a "great uniform commercial code be prepared,"¹ he undoubtedly had two goals with respect to what was to become Article 9 of the Uniform Commercial Code.² The first was to clear the confusion created by the topsy-like growth of chattel security legislation, and the second was to give the

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¹ It was the occasion of the fiftieth annual meeting of the National Conference of Commissioners on Uniform State Laws. The session was convened at 2:15 P.M. by the President, William A. Schnader, a Philadelphia lawyer and now Chairman of the Permanent Editorial Board for the Uniform Commercial Code. There was an address of welcome from Joseph P. Gaffney, Chancellor of the Philadelphia Bar Association, who said that his Association "throws open to you its heart and its home." Then followed a speech by Judge William M. Hargest of Harrisburg, the calling of the roll and the dispensing of the reading of the minutes. And then—the address of the President. It was not an encouraging talk. Mr. Schnader complained that of the eighty-four acts promulgated by the Conference prior to 1939, the average number of enactments was only ten. Besides which, "our splendid commercial acts" were beginning to become dated. Then he asked: "Could not a great uniform commercial code be prepared, which would bring the commercial law up to date, and which could become the uniform law of our fifty-three jurisdictions, by the passage of only fifty-three acts, instead of many times that number?" Handbook of the National Conference of Commissioners on Uniform State Laws & Proceedings of the Fiftieth Annual Conference 51, 58 (1940). It was bright and clear in Philadelphia that Labor Day—the temperature reached 84 degrees. And, as might be expected, there was a new moon in the sky that night. N.Y. Times, Sept. 3, 1940, p. 35, col. 7.

² The Uniform Commercial Code will hereafter be referred to as the "Code."

parties greater freedom of contract, thus making their objectives easier to achieve. It certainly was not in Mr. Schnader's mind, nor in the minds of Karl Llewellyn and the other drafters of Article 9,³ to make simple transactions difficult.⁴ Yet, in a few areas, this has been the case.

The broad language of the Code's definition of security interest⁵ may encompass some transactions which the framers never intended to cover, and for this reason, if these transactions are within the Code's scope, they are covered only ineffectually. It is possible that in some of these areas, Article 9 creates the very problems it was intended to cure. Fortunately, these areas are few and are on the periphery of the Code where correction can be accomplished without damaging the fundamental provisions and purposes of the otherwise smoothly-functioning Article 9. Most of these troublesome problems are in the somewhat esoteric fields in which institutional lenders like to probe.⁶ Because the center for these large scale financial activities is New York, and because of the relatively prosperous nature of the American economy in the 1950's and 1960's, it has only been since the passage of the Code in New York⁷ that institutional lenders have become especially concerned with these problem areas.⁸ One such area involves subordination agreements.

³ The National Conference of Commissioners on Uniform State Laws joined forces with the American Law Institute to draft the Code. These organizations are hereinafter referred to as the "Sponsoring Organizations." Karl N. Llewellyn, Professor of Law at Columbia Law School, who was in attendance when Mr. Schnader delivered his famous address, was named Chief Reporter and Miss Soia Mentschikoff (later to become Mrs. Llewellyn), then of Harvard Law School, was named the Associate Chief Reporter.

⁴ Harold F. Birnbaum, one of the original advisors on the Code, representing the American Law Institute, wrote that the purposes of Article 9 were "(1) to facilitate the legal perfection of security interests; (2) to leave unaffected any procedures which give practical protection; and (3) to disregard all distinctions based solely on form and technicality." Birnbaum, Article 9—A Restatement and Revision of Chattel Security, 1952 Wis. L. Rev. 348, 353. Mr. Birnbaum's second point is especially commended to the reader's attention. Other interesting articles discussing the development of the Code in general and Article 9 in particular include Braucher, The Legislative History of the Uniform Commercial Code, 58 Colum. L. Rev. 798 (1958); Braucher, The 1956 Revision of the Uniform Commercial Code, 2 Vill. L. Rev. 3 (1956); Gilmore, The Secured Transactions Article of the Commercial Code, 16 Law & Contemp. Prob. 27 (1951); Gilmore, On the Difficulties of Codifying Commercial Law, 57 Yale L.J. 1341 (1948).

⁵ U.C.C. § 1-201(37) defines "security interest," *inter alia*, as "an interest in personal property or fixtures which secures payment or performance of an obligation."

⁶ Besides subordination agreements, there are some other complex Code problems that arise in connection with large corporate financing. These problems involve the so-called "back-stop agreements" with third parties, which in various ways assure that the borrower will be in a position to repay the debt, assignments of ship charters and even negative pledge clauses. With respect to the latter category, see *Coast Bank v. Minderhout*, 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

⁷ N.Y. Sess. Laws 1962, ch. 553 (effective Sept. 27, 1964).

⁸ Some of the drafters expressed concern about the fact that there were certain specialized areas of financing with which they were largely unfamiliar:

Generally, a subordination agreement provides for the priority of payment for certain of a debtor's indebtedness (the senior debt) before payment of his other indebtedness (the junior debt).⁹ This article discusses subordinations in the light of Article 9 and reaches the conclusion that, while the Code was not intended to cover subordination agreements, doubt exists in certain areas as to whether it does, and this doubt should be eliminated by amendment to the Code. In this connection, the present status of corrective legislation is reviewed.

I. ARE SUBORDINATION AGREEMENTS SECURITY INTERESTS?

A. "Subsequent" Subordinations

Certain types of subordination agreements may possibly fit within the Code's definition of security interest in section 1-201(37). For want of a better name, we will call these agreements "subsequent" subordinations because the subordination generally occurs sometime after the note is issued. The following is an example of such a subordination.

In 1965 the Obscure Electronics Company borrows \$100,000 from

The thing that troubles me is a pair of recent conversations in which bank lawyers from leading firms told me how they puzzle over *Benedict v. Ratner* in rarified fields of security. One was the hypothecation of actors' employment contracts and other intangible rights to inchoate and partly completed films and any revenues derived in leasing the films. In the other case, the problem was an inventory loan on oil in a tank farm, in which the field warehousemen lost possession when the oil moved from a raw oil tank into the refinery and before it got back into a processed oil tank. Now I am not concerned here with *Benedict v. Ratner* but my point is that there are fields of security that are totally outside my experience or the experience of any of those who worked on Article 9 over the years, with the possible exception of Walter Malcolm. Charlie Willard, another experienced bank lawyer, has always stayed away from Article 9. Coogan's first brush with the Code was to point out the broad language which brought in all forms of personality but left general intangibles unprovided for. I hesitate to see Article 9 frozen against the possibility of suitable adaptation in fields unknown to me and perhaps presently unknown to anyone.

Letter from Homer Kripke to Professor Grant Gilmore, October 22, 1954 (during the reappraisal of the Code which led to the 1956 revision). Mr. Kripke was then and is now a member of the subcommittee on Article 9 of the Permanent Editorial Board for the Uniform Commercial Code, then known as the "Enlarged Editorial Board." Mr. Kripke's objective was to keep the Code flexible enough to meet changing circumstances and financial practices. The purpose of the drafters in broadly wording the definition of "security interest" in § 1-201(37) and the later inclusion of a category of collateral known as "general intangibles" would seem to be to provide room for development of the Code in new and different forms of genuine security transactions. See U.C.C. § 9-106 and accompanying Comment; 1956 Recommendations of the Editorial Board for the Uniform Commercial Code 261. However, this broad language permits the argument that certain financing procedures which were never thought of as security transactions, in fact create security interests under the Code.

⁹ See Calligar, Subordination Agreements, 70 Yale L.J. 376 (1961). Among the few other fine articles on the subject of subordinations are Everett, Subordinated Debt-Nature, and Enforcement, 20 Bus. Law. 953 (1965); and Golin, Debt Subordination as a Working Tool, 7 N.Y.L.F. 370 (1961).

its Secretary-Treasurer, Credson, and gives Credson an unsecured note. In 1967 Obscure develops a new pocket-size laser light and asks Conservative Insurance Company for a one million dollar loan to produce it. Obscure meets the earnings requirements of Conservative's states' insurance laws and Conservative agrees to make the unsecured loan on condition that Credson subordinate to Conservative. Credson readily agrees. Conservative makes the loan to Obscure, and Conservative and Credson enter into a separate agreement under which Credson agrees that no payment may be made to him by Obscure so long as Obscure's debt to Conservative is outstanding. He further assigns to Conservative all his right, title and interest in and to any payment to which he might otherwise have been entitled.¹⁰

It is possible that this subordination may be held to create a security interest within the meaning of section 1-201(37). That section defines security interest as, *inter alia*, "an interest in personal property or fixtures which secures payment or performance of an obligation."¹¹ Section 9-102(1)(a) provides that Article 9 is applicable to any transaction "intended to create a security interest in personal property." The question is whether the parties intended an interest in personal property to serve as security for an obligation. Although this was probably not the parties' intention, a logical argument can be made that it was.

The definition of "security interest" is the key to Article 9. While it is true that Article 9 was intended to be flexible, this definition could, nevertheless, have been more explicitly worded. For example, what is personal property and to whose interest in personal property does the section refer?

Personal property is not defined in the Code. However, section 9-102(1)(a) provides that personal property includes "goods, documents, instruments, general intangibles, chattel paper, accounts or contract rights." Thus "personal property" would seem to cover everything from tangible chattels¹² to "miscellaneous types of contractual rights;"¹³ in short, anything capable of being owned which is not real

¹⁰ This type of subordination is described as a "complete" subordination because "no payment of principal or interest on the subordinated debt is permitted so long as the debtor is obligated to the senior creditor." Calligar, *supra* note 9, at 378. If a subordination "does not become operative" until the happening of some future event such as the bankruptcy or insolvency of the debtor, the subordination would be "inchoate" under Mr. Calligar's definition. *Id.* at 377-78. It should be emphasized that Mr. Calligar's definitions cut across the distinctions made in this paper; thus the subsequent subordination may be either inchoate or complete.

¹¹ Unless otherwise specifically stated, all quotations from the Code used herein are from ALI & National Conference of Commissioners on Uniform State Laws, Uniform Commercial Code, 1962 Official Text.

¹² See U.C.C. § 9-105(1)(f) (definition of "goods").

¹³ U.C.C. § 9-106, Comment.

property. This seems consistent with non-Code law.¹⁴ As for whose interest in personal property is intended, the definition undoubtedly refers to an interest of the secured party in the property of another. Any other interpretation would not make apparent sense.¹⁵

Thus, in order for the subordination agreement described above to be or to create a security interest, the secured party (Conservative) must have an interest in personal property belonging to Credson which secures payment of Obscure's debt to Conservative. While it is clear that no security interest was created against Obscure, since Conservative and Credson are simply general creditors of Obscure and none of Obscure's property secures its obligation to Conservative, a different situation exists between Conservative and Credson. Credson held Obscure's obligation and had the right to payment as a general creditor. Now, by agreement with Conservative, this right becomes a form of security for Obscure's debt to Conservative.¹⁶ It could be argued forcefully that the right to payment as a general creditor is not an interest in personal property in spite of the broad scope generally given to this term.¹⁷ However, it is certainly possible that a court would hold that a security interest is created between Conservative and Credson, just as if Credson had mortgaged his car or assigned

¹⁴ See, e.g., N.Y. Gen. Constr. Law § 39 which defines personal property, in part, as including:

chattels, money, things in action, and all written instruments themselves, as distinguished from the rights or interests to which they relate, by which any right, interest, lien or incumbrance in, to or upon property, or any debt or financial obligation is created, acknowledged, evidenced, transferred, discharged or defeated, wholly or in part, and everything, except real property, which may be the subject of ownership;

Black, Law Dictionary 1301 (4th ed. 1951).

¹⁵ While this may seem elementary, it should be realized that it is possible to argue, under a strict reading of the definition, that a simple guaranty of a loan is a security interest. The recipient of the guaranty has an interest in personal property, i.e., the guarantor's promise to pay if the obligor does not. This promise helps to secure the obligation. Thus there is "an interest in personal property which secures payment or performance of an obligation." See U.C.C. § 1-201(37). But here the interest belongs to the secured party. The guarantor has an obligation, not a property right. Surely the drafters did not intend that one could obtain a security interest in one's own property.

¹⁶ "[S]ubordinations have the practical effect of making the subordinated debt a type of security for the senior debt, available to the senior creditor upon a distribution of the assets to the debtor—[obligor]." Calligar, *supra* note 9, at 378. Calligar goes on to point out that where payments are permitted on the subordinated debt until the happening of a specified event (he calls this an "inchoate" subordination) "the 'security' may decrease or even vanish." But in the case of the subordination under which the subordinating creditor may not be paid until the senior creditor is paid in full (the "complete" subordination), "the subordinated debt is 'locked in' and its distributional value in bankruptcy becomes in effect, just as much a security benefiting the senior debt holder as would, for example, a chattel mortgage in the hands of the foreclosing mortgagee." *Ibid.*

¹⁷ See note 14 *supra* and accompanying text.

his accounts as security for Obscure's debt to Conservative.¹⁸ In Code terms, Conservative would be the "secured party," and Credson would be the "debtor" since, under the Code, "debtor" is defined to include the owner of the collateral, or the obligor, or both.¹⁹ In subordination terms, Obscure is the obligor, Conservative the senior creditor, and Credson the junior creditor.

B. *Ab Initio Subordinations*

Unlike subsequent subordinations, there are other types of subordinations which are far from the Code's concept of "security interest." We will call these "ab initio subordinations" because the obligation is subordinated from its inception.

For example, assume that Conservative Insurance Company, on March 1, 1965, loans one million dollars to Obscure Electronics Company, due February 1, 1985. The loan agreement provides that Obscure shall not become liable in respect of any funded indebtedness other than subordinated debt until its debt to Conservative is paid in full. It defines subordinated debt, *inter alia*, as debt: (1) with no payment of principal or interest until February 1, 1985, and (2) which contains a provision stating that upon any payment or distribution of

¹⁸ See Henson, *The Problem of Uniformity*, 20 Bus. Law. 689 (1965) where, in referring to an agreement similar to the subsequent subordination, he said: "This kind of transaction is intended to and does involve a security interest. . . ." *Id.* at 693. It would seem, however, that parties like Credson and Conservative have never "intended" a security interest when executing this type of subordination agreement, but rather think more in terms of "contractual hierarchy of payments." 1 Coogan, Hogan & Vagts, *Secured Transactions Under the U.C.C.* § 5.03(2)(e) (1963).

¹⁹ See the definition of "secured party" in § 9-105(1)(i). The definition of "debtor" found in § 9-105(1)(d) is somewhat confusing. In the Spring, 1950 Proposed Final Draft of the Code, "debtor" (then in § 9-105(1)(e)) was defined as the owner of the collateral whether or not he was the obligor. This obviously would not do. In the Final Text Edition of November 1951, the definition was changed to two sentences. The first is unchanged today: "'Debtor' means the person who owes payment or other performance of the obligation secured, whether or not he owns or has rights in the collateral. . . ." In other words, the debtor is the obligor even if the obligor doesn't own the collateral—180 degrees from the 1950 language. However, the second sentence stated that where the debtor and the owner of the collateral were not the same person, the term "debtor" would include the owner of the collateral unless the context required otherwise. This was criticized at the New York Law Revision Commission hearings because it seemed to conflict with such sections as § 9-112 which speaks of collateral being owned "by a person who is not the debtor." Although the definition was finally approved by the Law Revision Commission subject to certain "questions," (see Report of the N.Y. State Law Rev. Comm. App. IV at 466 (1956)), the criticism led to an amendment to the second sentence in the 1956 revision to provide that either the obligor or the owner of the collateral or both may be the "debtor" depending on the context. Unfortunately this change was made to the second sentence without making a corresponding change in the first sentence. Thus the second sentence seems to be in conflict with the first. The first says, in effect, that the obligor is the debtor whether or not he is the owner of the collateral; the second says that the owner of the collateral and not the obligor, may be the debtor if the context so requires. This may eventually be troublesome, especially in fields such as conflicts of law. See U.C.C. § 9-103(2).

the assets of Obscure, the senior debt (defined as all debt of Obscure except specifically subordinated debt) shall be paid in full before the holders of subordinated debt shall be entitled to retain any assets so paid or distributed. In 1967 Obscure floats a bond issue and Credson purchases one of the bonds which complies with the subordination requirements of the loan agreement between Obscure and Conservative. In 1975 both Obscure and Credson are in bankruptcy. Credson's trustee claims that the subordination in the 1967 bond created a security interest in Conservative as against Credson. The trustee argues that, since Conservative failed to perfect this interest, it is inferior to his rights under Section 70(c) of the Bankruptcy Act²⁰ and under section 9-301 of the Code.

Although this position is not tenable, counsel for lenders have been reluctant to give opinions that no security interest is created, perhaps because of the highly conceptual nature of the supporting argument.²¹ The argument is that since Credson never had any right other than his right to payment as a subordinated creditor of Obscure, no property of Credson was given as security for Obscure's debt to Conservative. Contrast Credson's position here with his position in the subsequent subordination. There, Credson loaned money to Obscure and got a "bundle of rights" in return. He later gave up part of this "bundle" as security for Obscure's debt to Conservative. In the *ab initio* subordination, Credson did not give up part of his bundle of rights; he simply bought a smaller bundle. He purchased a junior interest.²² As previously mentioned, the Code's definition of security interest states, in effect, that the secured party must have an interest in the debtor's property which secures payment or performance of an obligation. Here, Conservative has no such interest in Credson's property because Credson, in purchasing a junior interest, never owned the "property" serving as security for the obligation.

While it may be somewhat unnecessary in this discussion, it is worthy of note that a single thread, however gossamer, runs through all of chattel security law: protection against the secret lien. Modern law has never been opposed to creditors obtaining lawful liens or preferences, but it has often been opposed to obtaining these preferences or liens secretly.²³ In the subsequent subordination it could be

²⁰ 30 Stat. 565 (1898), as amended 11 U.S.C. § 110(c) (1964). This is the so-called "strong-arm" clause which gives the trustee the rights of an hypothetical lien creditor as of the date of bankruptcy.

²¹ See text accompanying note 106 *infra*.

²² Golin points out that the purchaser of the junior interest is "invariably" compensated for taking a subordinated position "by an interest rate somewhat higher than the then current rate for senior debt." Golin, *supra* note 9, at 377.

²³ See 1 Coogan, Hogan & Vagts, *supra* note 18, § 6.01(1) (1963):

A history of chattel security could well be written in terms of the 400-year

argued that Conservative obtained a kind of secret lien on Credson's right to receive his general creditor's share on the distribution of Obscure's assets. Such is not the case in the *ab initio* subordination,²⁴ however, since there the junior creditor's position vis-à-vis the senior debt is clear from the terms of the subordinated obligation. Thus, it would seem that the distinction made here is not inconsistent with the general thrust of chattel security law.

The important point, however, is that it is possible to make a logical argument that subsequent subordinations may fit within the Code's definition of security interest; this is not so with *ab initio* subordinations, for such a finding would result in a completely impossible situation. Section 9-203 requires that a security agreement be executed by the debtor in all cases where the security interest is not perfected by possession,²⁵ and failure to do so will make the security interest unenforceable even between the parties. In the *ab initio* subordination situation, the purchaser of subordinated indebtedness does not execute anything. He merely buys a bond signed by the obligor which, by its terms, provides for the subordination. With respect to new transactions,²⁶ it might be possible to require all bond purchasers to execute a form of security agreement, but this would be extremely impractical, especially in the case of a public issue of subordinated obligations, and would not help their saleability. Moreover, it is almost inconceivable that the drafters of the Code intended to require that this be done.

C. Variant Forms of Subordinations

Since subordination agreements reflect the negotiations of parties to specific financial transactions, there can be as many different

struggle by debtors and their secured creditors to create security interests of various sorts in the debtors' property without affording notice to buyers or other creditors, and the attendant demands by unsecured creditors generally for some kind of notice when all or part of the debtors' assets become subject to security interests. The parties favoring secrecy have, for the most part, been the losers; Lord Coke . . . in 1601 . . . insisted upon some form of public notoriety where the debtor transfers an interest in some or all of his property: "1st, Let it [the transfer] be made in a public manner, and before the neighbours, and not in private, for secrecy is a mark of fraud." 3 Coke 80b, 81a, 76 Eng. Rep. 809, 814 (Star Chamber 1601).

²⁴ It is true that even in the *ab initio* situation, the trustee in bankruptcy of Obscure will apply to the payment of Obscure's debt to Conservative, what would have been Credson's general creditor's share, but for the subordination provisions of the note. See p. 24 *infra*. However, it is Credson's rights that the courts must look to in determining whether a security interest has been created. And neither Credson, nor Credson's creditors were ever entitled to payment as an unsubordinated general creditor.

²⁵ See p. 14 *infra*, with respect to the means of perfection of a subordination security interest. The conclusion reached is that possession besides being impractical, is not the correct method of perfecting a security interest created by a genuine subordination.

²⁶ See p. 22 *infra*, with respect to pre-Code security interests.

variations from the subsequent/*ab initio* pattern as the minds of the parties can imagine. The problem is that the more a subordination agreement combines and varies the elements of the two types outlined above, the more difficult it becomes to determine whether a security interest can be considered created and to support, on any logical basis, the conclusion reached. Basically, however, subordinations fall into the subsequent/*ab initio* categories previously discussed, and, for this reason, a further analysis of their elements will help in dealing with variant forms of subordinations as they arise.

1. *Subordination Ab Initio*

The most significant element distinguishing the subsequent from the *ab initio* subordination is the fact that in the former, the subordinating creditor, Credson, had an unrestricted general obligation of Obscure Electronics which he later subordinated, while in the latter, Credson invested, *ab initio*, in a subordinated obligation. Certainly this distinction is crucial in determining whether Credson's interest serves as security for Obscure's debt to Conservative. However, if Credson had exchanged his unsubordinated note for one subordinated on its face, could it not be argued that here, as well, Credson is giving up an interest in property to serve as security for Obscure's debt to Conservative? There is no question that the new note is subordinated *ab initio* for, additionally, the subordination language here is on the face of the note itself as distinguished from the subsequent subordination where it is embodied in a separate agreement. Nevertheless, the exchange of notes makes it more difficult to argue that the *ab initio* subordination, in this particular situation, does not create a security interest.

2. *Subordination on the Face of the Instrument*

Tied closely with the foregoing discussion is the fact that in the subsequent subordination, the subordination occurred outside the note, while the note itself in the *ab initio* subordination constituted a subordinated obligation. Where the subordination language is found in the note, it is less likely that the junior creditor ever had an interest to serve as security for an obligation while, conversely, it is difficult to argue that a creditor never had the right to payment as a general creditor when the note contains no subordination language. This is true even where the note and the subordination agreement are executed simultaneously or where the note is exchanged for a subordinated note. The Code, however, does not provide for perfection by incorporation on the face of an obligation but rather inquires whether the debtor's property actually serves as security for an obligation. Thus it would seem that incorporation of subordination language in the

agreement is not, by itself, necessarily determinative as to whether a security interest has been created.

3. *Parties to the Agreement*

a. *Senior Creditor.*—In the subsequent subordination, the actual subordination was accomplished by agreement between the senior creditor and the junior creditor, while in the ab initio subordination the senior creditor was not a party to the agreement. Although it is probably easier to argue that a security interest is created when the senior creditor is a signatory to the agreement, it is not essential to the definition of a security interest that this be so. Thus, subordinations may create security interests even though the senior creditor is not a party thereto. For example, assume the following change in the subsequent subordination illustrated above: the subordination is accomplished by agreement between Obscure and Credson, without the senior creditor, Conservative, as a party.²⁷ In this situation it might be difficult for Conservative to prevent the parties at a later date from voiding the subordination, whereas in the typical subsequent subordination, Conservative, as a party to the agreement, would have direct control over modifications. Nevertheless, at least until any such modification is actually made, it may be argued that Credson's property is serving as security for Obscure's debt to Conservative.

b. *Junior Creditor.*—The junior creditor was a party to the subsequent subordination, but in the ab initio subordination, he simply purchased a junior obligation signed by the obligor. The most incongruous aspect of this discussion is that if an ab initio subordination were held to create a security interest, it would, subject to the discussion below with respect to methods of perfection, probably be invalid without the subordinated creditor's signature for failure to comply with the statute of frauds requirements of section 9-203.²⁸ Of course, it would be possible to have an ab initio subordination in which the purchaser's signature appears on the note, but this fact might tend to support an argument that in the ab initio situation the purchaser actually has given something up, and cloud any determination that an ab initio subordination does not create a security interest.

4. *Language of Assignment*

In the above subsequent subordination example, Credson "assigned" certain rights in the bankruptcy of Obscure to Conservative.

²⁷ But if the senior creditor is unaware of the subordination, the result might be different. See *In re Joe Newcomer Fin. Co.*, 226 F. Supp. 387 (D. Colo. 1964) in which the court refused to enforce the subordination where it found that the holders were not given sufficient notice that their notes were subordinated and the senior creditors had not relied on the subordination.

²⁸ See p. 8 *supra*.

The *ab initio* subordination example, however, contained no such assignment language, thus illustrating that most *ab initio* subordinations do not contain such assignment language while many subsequent subordinations do.

Assignment of Credson's note as security for Obscure's debt to Conservative would, of course, create a security interest in the instrument itself. But, as will be shortly observed,²⁹ a subordination does not normally involve an assignment of the note, nor does the senior creditor normally have the rights that such an assignee would be expected to have. The assignment language being discussed here covers the assignment of certain rights arising by virtue of the note, such as the right to payment as a general creditor upon the insolvency of the obligor; but even this assignment language might be indicative of an attempt to create a security interest. However, perhaps the majority of subsequent subordinations do not employ any assignment language, and while it is possible to insert assignment language in the *ab initio* subordinated debt without the subordinated creditor's signature, the effect of such language would seem questionable.

The argument is heard that where a subordination agreement contains no language of assignment, but merely prescribes a contractual hierarchy of payments, no security interest is created.³⁰ Certainly a hierarchy of payments does not in itself create a security interest, just as statutes which provide for priority of payments do not create liens in those who have priority, either *vis-à-vis* the debtor or *vis-à-vis* each other.³¹ However, it is not the hierarchy, but rather the method by which the hierarchy is created, that determines the existence of a security interest. Regardless of whether assignment language is employed, the legal effect in the case of the subsequent subordination might be to create a kind of assignment of right,³² while in the *ab*

²⁹ See p. 14 *infra*.

³⁰ Mr. Coogan alludes to subordination agreements in his Code treatise and hints that this argument may be significant:

If *A* in a subordination agreement assigns to *B* his right to collect from *C* *A*'s share of *C*'s assets in an insolvency situation, *A*'s creditors may see in this a security transaction. But not all subordination agreements involve such assignments; some may prescribe a contractual hierarchy of payments. Generally, the person whose possible insolvency we worry about is not *A*, but *C*, and failure of *B* to perfect his security interest against *A*'s creditors should have no bearing on *B*'s right against *C* in *C*'s bankruptcy.

1 Coogan, Hogan & Vagts, *supra* note 18, § 5.03(2)(e). He concludes that "if there is doubt, the safe rule is to comply with Article 9." *Ibid*.

³¹ E.g., Bankruptcy Act § 64, 30 Stat. 563 (1898), as amended 11 U.S.C. § 104 (1964). See generally 3 Collier, Bankruptcy ¶ 64.02[2] (14th ed. 1964).

³² See Kripke, Practice Commentary 8 to § 9-302, 62½, McKinney's Consol. Laws of N.Y., Part 3, at 454 (1964) where he discusses whether subordinations of accounts which are not by their terms "an assignment by the subordination creditor to the

initio subordination, all the assignment language in the world would not accomplish such an assignment if there were nothing to assign. In any case, the prudent lender should not rely on the presence or absence of assignment language in determining whether or not a security interest has been created by terms of the Code definition, although such language is one of the factors which may be considered in determining whether a subordination creates a security interest.

5. *Subordination in Favor of One Senior Creditor*

In the above subsequent subordination illustration the subordination was in favor of Conservative only, while in the ab initio subordination the note was subordinated to all other indebtedness. The fact that the subordination is in favor of one creditor would seem to give some support to the position that the subordinating creditor's rights are serving as security for the obligation to that senior creditor, but, although the definition of security interest speaks in terms of securing "an obligation,"³³ there is little basis for arguing that specific personal property cannot serve as security for several obligations. After all, as to each security interest held by each senior creditor, the property serves as security for *an* obligation. In any case, it would seem that this is another variable which may be employed by the parties to confound their attorneys, and the courts.

It should be clear from this discussion of some elements of subordinations that the more these elements are varied, the more difficult it becomes to determine whether a security interest has been created and to justify the Code's involvement with subordination agreements.

II. "PERFECTION" OF SUBORDINATION AGREEMENT SECURITY INTERESTS

Generally, an unperfected security interest under the Code is practically valueless. Section 9-301(1) lists those persons who take priority over unperfected security interests. They include, *inter alia*, anyone with a perfected security interest, lien creditors without

priority creditor," amount to an assignment and thus a security interest. He states that: it could be argued that a subordination constitutes an assignment in legal effect, because upon a distribution in bankruptcy or similar procedure the share which would otherwise be distributed to the subordinating creditor is given to the priority creditor. At any rate, that problem is usually rendered moot because the subordination is typically accompanied by express language of assignment. Here it would seem Mr. Kripke is referring to an outright assignment of the accounts themselves as distinguished from the type of assignment language which might normally be used in connection with subordination of notes or debentures. Since the writing of the Practice Commentary quoted above, Mr. Kripke has refined his views and now believes that the argument that the subordination of an account is an assignment of the account would be specious.

³³ U.C.C. § 1-201(37).

knowledge and a trustee in bankruptcy.³⁴ It is essential, therefore, for a secured party to see that his security interest is perfected. Of course one must not conclude that once the security interest is perfected it is good against all the world, for what Mr. Coogan calls the "quality" of the security interest will determine its strength vis-à-vis certain conflicting interests;³⁵ but it must be perfected if it is to afford any adequate protection against third parties.

Section 9-303 states that a security interest is perfected "when it has attached and when all of the applicable steps required for *perfection* have been taken." (Emphasis supplied.) This normally requires four steps: three making the security interest attach and the fourth perfecting it. The three requirements for attachment specified in section 9-204 are (1) an agreement that the security interest attach; (2) the giving of "value"; and (3) the debtor's obtaining "rights" in the collateral.³⁶

When a subsequent subordination agreement has been signed and the senior creditor has extended credit to the obligor, these three steps would seem to have been taken. When Conservative makes the loan to Obscure, it has given value; when Credson made his loan to Obscure two years before, he became entitled to payment under Obscure's note and thus acquired rights in the collateral. Of course, it could be argued that the parties never agreed that the security interest attach, especially where they never believed that a security interest was created. It would appear, however, that agreement by the parties that the subordination agreement become effective would constitute agreement that any security interest created thereby should attach.³⁷ On the other hand, if it should be found that a security interest were created in connection with the *ab initio* subordination, it would be more difficult to argue that the parties agreed that the security interest

³⁴ U.C.C. § 9-301 provides that even though the trustee had knowledge of the unperfected security interest, he will still be prior to it "unless all the creditors represented had knowledge of the security interest." However, even if all the creditors had knowledge, it would seem that § 70(c) of the Bankruptcy Act, which has been interpreted as giving the trustee the rights of an "ideal" hypothetical lien creditor, would afford the trustee all the priority he needs. Bankruptcy Act § 70(c), 30 Stat. 565 (1898), as amended 11 U.S.C. § 110(c) (1964); see generally 4 Collier, Bankruptcy ¶ 70.49 (14th ed. 1964).

³⁵ 1 Coogan, Hogan & Vagts, *supra* note 18, § 3.03 (1963). For example, a perfected security interest in after-acquired property may be subordinate to holders of later perfected purchase money security interests. See U.C.C. §§ 9-312(3), (4). And, a security interest perfected by filing is invalid even between the parties if a security agreement describing the collateral is not signed by the debtor pursuant to § 9-203.

³⁶ U.C.C. § 9-204(1).

³⁷ It would do the senior creditor no good to argue that there was no such agreement. This would make the subordination no less a security interest. It would only mean that the security interest did not attach, and that in addition to everyone else, holders of prior unperfected security interests in the same collateral would take priority. See U.C.C. § 9-312(5)(c).

attach. Further, it is difficult to see how it could be maintained that the debtor ever had rights in the collateral (i.e., the right to payment as a general creditor) unless it is argued that the collateral is the note itself. This will be discussed in more detail below.

The fourth step which perfects an attached security interest generally consists of filing a financing statement or taking possession of the collateral, although under some special circumstances perfection may be had without taking either of these steps.³⁸ The method of perfection will depend upon the kind of collateral involved. There are seven classifications of personal property collateral in Article 9.³⁹ Most corporate subordination agreements involve the subordination of a note or debenture. When such is the case, we can safely eliminate five categories and state that the collateral will be classified either as "instruments" or as "general intangibles."⁴⁰

A. *The Collateral as Instruments*

A security interest in an instrument may be perfected by taking possession of the instrument; filing will not be sufficient.⁴¹ In our example of the subsequent subordination, if the agreement were an attempt to create a security interest in Obscure's note to Credson, then Conservative could perfect only by taking possession of the note. While Credson might be willing to give up possession of his note, the subordinating creditor's position might be quite different were he not an officer of the obligor.

As we move closer to the ab initio subordination, it becomes increasingly difficult to convince the subordinating creditor to relinquish the note, and in the strict ab initio subordination situation, it becomes virtually impossible. Consider the reaction of banks, investment companies and members of the debenture buying public to Obscure's offer to sell subordinated debentures under the stipulation that the purchaser get no debentures. And, consider further the plight of Conservative Insurance Company in trying to police the subordination. Conservative might not even know that Obscure has floated another issue of debentures, much less know who all the purchasers are.

³⁸ See generally U.C.C. § 9-302; note 41 *infra*.

³⁹ The seven types of collateral and the sections of the Code in which they are defined are as follows: § 9-105(1)(b) (Chattel Paper); § 9-105(1)(e) (Documents); § 9-105(1)(f) (Goods); § 9-105(1)(g) (Instruments); § 9-106 (Accounts); § 9-106 (Contract Rights); and § 9-106 (General Intangibles).

⁴⁰ Where a note or debenture is not involved, the collateral may fit within one or more of the other types. See p. 20 *infra*.

⁴¹ U.C.C. § 9-304(1). However, under certain circumstances a security interest may be perfected in an instrument without filing or the taking of possession. See § 9-304(4) which provides for such perfection for 21 days from the date of attachment, and § 9-304(5) which permits some secured parties to deliver to the debtor, for 21 days, instruments perfected by possession, for specific purposes such as collection.

Fortunately, it is fairly clear that, at least in the ab initio situation, there is little likelihood that the subordination creates a security interest. And the difficulty of perfection, as an instrument or otherwise, is probably another argument in support of that conclusion. However, until that conclusion is supported by an amendment to the Code or by court decision, all doubt cannot be removed. Thus the question of whether a subordination agreement creates a security interest in an instrument is an important one. Yet here, too, the answer is not entirely clear.

"Instrument" is defined in section 9-105(1)(g) of the Code as follows:

"Instrument" means a negotiable instrument (defined in Section 3-104), or a security (defined in Section 8-102) or any other writing which evidences a right to the payment of money and is not itself a security agreement or lease and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment.

"Instrument," then, is not limited to negotiable paper but may be almost any writing evidencing an indebtedness and normally transferred by delivery as long as it is not a security agreement or lease. Clearly, the subordination agreement itself is not an instrument. It does not evidence any obligation, is not normally transferred by delivery and may even be a security agreement. The real danger is that the subordination agreement will be held to be an attempt to assign, or create a security interest in the note itself, and the note is clearly an instrument.

It should be noted that assignment language in a subordination agreement which purports to assign the entire note as collateral security for the obligation would undoubtedly create a security interest in the note itself, and thus be a security interest in an instrument. However, such assignments are rare. In most cases, assignment language, if it appears at all in the subordination agreement, is only an assignment of certain rights arising by virtue of the note, such as in the subsequent subordination example where the right to payment as a general creditor in bankruptcy was assigned. The question is whether in those cases where there is assignment language covering only certain rights arising under the note, and in the majority of cases where there is no assignment language at all, the subordination agreement will be deemed tantamount to an assignment of, or lien upon, the note itself. The answer should be that any such assignment or lien reaches only certain rights arising under the note, and not the note itself. Thus the collateral should not be classified as instruments.

The senior creditor in a genuine subordination situation does not

have the same rights he would have had if the notes were also pledged as security. Subordination agreements vary greatly in form and it is dangerous to generalize. However, the more typical provisions support the conclusion that the collateral is not an instrument. Many subordination agreements provide that no payments may be made on the junior debt until the senior debt is paid in full; or that upon the obligor's bankruptcy, the junior creditor's share is assigned to the senior creditor; or that the junior creditor is permitted to receive payment and dispose of the proceeds for his own benefit without accounting to the senior creditor⁴² only until the liquidation of the obligor, at which time the senior debt will be paid in full before any further payment is made on the junior debt.

An assignee of the note would not be restricted to these rights. If the note itself were assigned, the senior creditor could, on default by the obligor under the senior indebtedness, foreclose his interest in the assigned indebtedness, have the security sold for whatever it was worth, and the proceeds applied to the payment of the senior indebtedness. While it is highly unlikely that the senior creditor would take such steps since both notes have the same obligor, the fact that the senior creditor has such a right points up the difference between an assignment of the note and a mere subordination. Under the language of the usual subordination agreement, the senior creditor could not sell the junior obligation if he desired.

In Mr. Calligar's article on this subject,⁴³ which does not cover the effect of the Code on subordinations, there is a discussion of whether it would be wise for the senior creditor to insist on a collateral assignment of the subordinated debt in the agreement. The clear implication is that there would be no assignment without such express language. Mr. Calligar points out that the junior creditors are generally opposed to the inclusion of such assignment language because they would lose the degree of control over the debt they retained under the usual subordination agreement. Further, the author states that such an assignment might contravene the terms of a negative pledge clause between the junior creditor and his creditor, and would cover only present indebtedness, requiring supplemental assignments to perfect equitable assignments of future debt as such debt comes into existence. Finally, he maintains that the senior creditor might not want an assignment because on bankruptcy the responsibility for filing proofs of claim

⁴² With the advent of § 9-205, this language should no longer make an assignment for security invalid and fraudulent as to creditors under the "Dominion Rule," as expanded by *Benedict v. Ratner*, 268 U.S. 363 (1925), and later cases. See Zinman, *Dominion and the Factor's Lien: Does Section 45 of the New York Personal Property Law Abrogate the "Dominion Rule"?* 30 *Fordham L. Rev.* 59, 61-64 (1961).

⁴³ Calligar, *supra* note 9, at 397-98.

might then devolve on him. What Mr. Calligar is saying, then, is that there are many results, affecting both the senior and junior creditor, which occur when the note is assigned as security, but do not obtain when there is simply a subordination.

It should be re-emphasized that the argument is not being made that there cannot be an assignment of, or lien on, the note itself as part of a subordination transaction. If there is such an assignment or lien, the fact that there is also a subordination agreement will not alter the fact that a security interest is created in a note. What is contended is that in the ordinary subordination situation, the language used does not constitute an assignment of, and hence, an outright security interest in the note.

As a practical matter, this is the interpretation which has, in the past, been placed on subordination agreements by the parties, long before the problem of perfection under the Code was even a twinkle in lender's counsel's eye. As a general rule lenders will not take an assignment of a note for security without obtaining possession even where it is fairly clear that the note is not negotiable. Lenders would not as a general rule, however, demand possession of the note when it had been subordinated, for the parties never considered the subordination as constituting an assignment of, or security interest in, the note. The parties' intention in this respect is significant, for while the Code says that a security interest in a note is a security interest in an instrument, it would appear that the courts should look to the intention of the parties to determine whether, in fact, they did create a security interest in a note.⁴⁴

Notwithstanding the force of the above argument, some attorneys might be reluctant to advise their clients that a court would not hold the other way. A court might argue, probably incorrectly, that even if the wording of the typical subordination agreement does not encompass all that is usually found in an assignment of a note, it is tantamount to such assignment and should be considered as such. The Code sorely needs clarification on this point.

⁴⁴ See U.C.C. § 9-102(1)(a). Mr. Henson, commenting on a subsequent subordination of an "inside loan," indicates the security interest is in the note itself. He said: "If the inside loan is not evidenced by an instrument, one can be executed and pledged to the bank, thus creating a perfected security interest in the instrument." Henson, *supra* note 18, at 693. Mr. Henson feels that this subsequent subordination transaction "is intended to and does involve a security interest, and it is easily accommodated under the Code." *Ibid.* Rather than being the intention of the parties, it would seem from the above discussion that the creation of a security interest in the note itself is far from the parties' minds. Of course, it is possible for the parties to attempt to obviate their Code problem by converting a subsequent subordination into an assignment of an instrument as security. But surely the drafters did not intend to force the parties to change the terms of their agreement in order that it may be accommodated under the Code.

B. *The Collateral as General Intangibles*

Section 9-106 defines general intangibles as "any personal property (including things in action) other than goods, accounts, contract rights, chattel paper, documents and instruments." In the words of the Comment to this section,⁴⁵ the term "brings under this Article miscellaneous types of contractual rights and other personal property which are used or may become customarily used as commercial security." The original draft of the Code⁴⁶ did not include "general intangibles" as one of the types of collateral. The only intangibles were "accounts" and "contract rights;" the term "general intangibles" was inserted as an additional "catch-all" classification pursuant to the 1956 Recommendations of the Sponsoring Organizations' Editorial Board.⁴⁷ Obviously it was impossible to classify good will, literary rights and rights to performance as rights "to payment under a contract."⁴⁸ Further, if the Code were to remain viable under changing commercial practices, it would have to provide for "developing forms of collateral."⁴⁹ This was accomplished by adding the category of "general

⁴⁵ Comments of the Sponsoring Organizations. These comments are found in the Official Text editions of the Code, and also in many state versions. Some states have promulgated their own comments as a supplement to the official version. The comments were meant to "set forth the purpose of various provisions of this Act to promote uniformity, to aid in viewing the Act as an integrated whole, and to safeguard against misconstruction." ALI & National Conference of Commissioners on Uniform State Laws, *supra* note 11, at 1.

⁴⁶ See Final Text Edition, November 1951, promulgated by the Sponsoring Organizations. While the Code was not in final edition until the fall of 1951, there are various earlier drafts which make interesting reading. Compare, e.g., the Proposed Final Draft, Spring 1950, with Tentative Draft No. 1, Art. VII (now Article 9), April 21, 1948.

⁴⁷ See ALI & National Conference of Commissioners on Uniform State Laws, 1956 Recommendations of the Editorial Board for the Uniform Commercial Code, 261.

⁴⁸ "Contract Rights" are defined in § 9-106 as "any right to payment under a contract not yet earned by performance." The Comment to § 9-106 mentions good will, literary rights and rights to performance as examples of what was meant by "general intangibles."

⁴⁹ See Action of Sponsoring Organizations for the Proposed Uniform Commercial Code with Respect to Views of Special Committee of the American Bankers Association 89 (March 27, 1957). Although they had found that Article 9 "contains a brilliance of concept and a boldness of approach that cannot be ignored and should not be discharged," the American Bankers Association had refused to recommend it for adoption and criticized many of its provisions in the Report of its Special Committee on the Proposed Uniform Commercial Code, dated October 17, 1954. *Id.* at 77. The Sponsoring Organizations were most anxious to obtain the support of the American Bankers Association which support would have a significant effect on the conclusions of the New York Law Revision Commission, then holding its extensive hearings on the Code. As a result of conferences and meetings, the "Action of the Sponsoring Organizations" memorandum was promulgated on March 27, 1957. In 1954 the Bankers had criticized § 9-106, which at the time did not include a category of "general intangibles," because "your Committee is not yet convinced of the desirability of including in Article 9 or in any similar statute, intangibles other than commercial accounts of the kind normally included in accounts receivable financing." *Id.* at 83. In the 1957 memorandum, that criticism was answered by Mr. Homer L. Kripke who stated that the provision, now including general intangi-

intangibles." This seems to be the only category encompassing the miscellaneous rights arising out of subordinations of notes or debentures.

Security interests in general intangibles may be perfected only by filing,⁵⁰ while security interests in instruments can generally be perfected only by possession. Consequently, an abundance of caution might require the senior creditor to file a financing statement *and* obtain possession of the instrument in order to be fully protected.

Further complications arise in multi-state transactions and a careful study must be made of the Code's conflicts' provisions in order to determine what law, or laws, apply. Basically, section 9-103(2) provides that the law of the jurisdiction where the "debtor" has his chief place of business will govern with respect to general intangibles. However, if such jurisdiction does not provide for perfection by filing, "the security interest may be perfected by filing in this state." The problems here are many but somewhat outside the scope of this paper since they are generally applicable to all security interests in general intangibles. Some of the more significant questions to be resolved are: (1) Who is the "debtor"?⁵¹ (2) Where is the "chief place of business"?⁵² (3) What is meant by "may be perfected by filing in this state"?⁵³ For-

bles, "brings the law up to date by recognizing developing forms of collateral and provides rules for perfection and enforcement of security interests therein." *Id.* at 89.

⁵⁰ U.C.C. § 9-302(1). But see Cal. Commercial Code § 9302(1)(g), which exempts general intangibles from the requirement of filing. See Mr. Coogan's comments on this. 2 Coogan, Hogan & Vagts, *Secured Transactions Under the U.C.C.* § 21.05(2)(d) (1964).

⁵¹ The Code defines "debtor" to include either the obligor or the owner of the collateral or both if the context so requires. See note 19 *supra*. In the subordination situation the owner of the collateral (Credson) and the obligor (Obscure) are always different people. While one would think that Credson's state's law should govern, it would be wise to conform as well to the law of Obscure's chief place of business when that differs from Credson's.

⁵² The drafters comment that the "chief place of business" while not defined in the Code, is the place "from which in fact the debtor manages the main part of his business operations . . . the place where persons dealing with the debtor would normally look for credit information. . . ." U.C.C. § 9-103, Comment 3. Where there is doubt, as in a situation where there are autonomous regional offices, Comment 3 states that there would have to be "filing in each of several places." More important a problem is the movement of the chief place of business. Under the Official Code, on such a move to a new jurisdiction, the law of the new jurisdiction will have to be complied with. See U.C.C. § 9-103, Comment 5, which states in part that if the chief place of business is moved into "this state," "the secured party should file in this state." In New York, U.C.C. § 9-103(6) provides that "the validity and perfection of a security interest in accounts, contract rights or general intangibles continues even though after the security interest has attached the office where the assignor of accounts or contract rights keeps his records concerning them or the chief place of business of the debtor is moved to some other jurisdiction." The Permanent Editorial Board did not recommend the New York provision for general adoption on the ground that it "protects the secured party at the expense of subsequent creditors" who will be unable to determine from the record "the true state of the debtor's affairs." See Report No. 2 of the Permanent Editorial Board for the Uniform Commercial Code 172 (1964).

⁵³ The meaning of this phrase is somewhat obscure: the provision is permissive

tunately, in the vast majority of situations the facts are such that these problems do not seem to arise. Where they do, however, they can make your hair stand on end.

C. Other Possibilities

When a note is subordinated, the only two types of collateral normally involved are instruments and general intangibles. However, where the subordination involves something other than what the Code defines as an instrument, something other than a note, debenture or the like, the security may be other types of collateral.

1. Accounts, Contract Rights

In connection with some corporate loan agreements, for example, a parent or subsidiary of the obligor may agree to extend credit or supply goods or services to the obligor on an open account basis. The parent or subsidiary may agree that the right to payment for any credit so extended or any goods or services so supplied shall be subordinated to the obligor's debt to the institutional lender. Here there is no note involved: what is being subordinated are rights to payment under a contract and accounts receivable, "contract rights"⁵⁴ and "accounts" under Code terminology.⁵⁵ The subordination may be either

("may") and it is not clear what happens if the parties do not take the hint; it speaks only of perfection and still leaves the security interest subject to the laws of the state of the debtor's chief place of business, other than the law relating to perfection; and the words, "this state," on their face at least, seem to give the parties the option of perfecting in any state that has adopted the Code, which fails to simplify the process of searching the record. No mention of the general intangibles conflicts problems would be complete without a reference to the incomprehensible insertion of the words "general intangibles" in New York's own § 9-302(1)(i). As it applies to general intangibles, the subsection seems to say that if an assignor of accounts keeps his records concerning the accounts in a jurisdiction outside the United States, you do not have to file to perfect a security interest in general intangibles. Obviously, something is wrong.

⁵⁴ U.C.C. § 9-106 defines contract rights as rights "to payment under a contract not yet earned by performance." The Comment gives as examples of performance "deliveries" made or "work" completed. It would seem that the extension of credit or the making of an advance by the parent or subsidiary to the obligor would constitute "performance" under the above definition.

⁵⁵ U.C.C. § 9-106. Contract rights are described in the Comment to § 9-106 as "potential accounts." This is not always the case. Accounts are limited by the definition of rights to payment "for goods sold or leased or for services rendered." A right to payment under a contract governing patent rights would be a contract right. When this contract right matured, it might not mature into an account because it would not be a right to payment for goods sold or leased or for services rendered. It would thus probably mature into a general intangible. So if there were a subordination of a right to payment under such a patent contract which amounted to a security interest, the collateral might change in midstream from contract rights to general intangibles. Fortunately, filing is required for perfection of accounts, contract rights and general intangibles. U.C.C. § 9-302. However, different conflict rules apply to accounts and contract rights as distinguished from general intangibles. See U.C.C. § 9-103. "This slippage between the definitions of 'contract rights' and 'accounts' was the result of drafting inadvertence," said Professor Grant Gilmore, Associate Reporter and Reporter for

"subsequent" or "ab initio" and the same rules and problems which arise in determining whether a security interest is created with respect to the subordination of a note are applicable here. If it is determined that a security interest is created, perfection ordinarily must be by filing.⁵⁶ In multi-state transactions, the law of the jurisdiction where the assignor of the accounts or contract rights keeps his records concerning them will generally govern. However, there are conflicts problems here too.⁵⁷

2. *Chattel Paper*

In other circumstances, a security interest itself may be subordinated. The Code specifically recognizes such subordination in section 9-316 where it provides that "nothing in this Article prevents subordination by agreement by any person entitled to priority." It does not, however, discuss the consequences of such subordination from the standpoint of creating security interests.

When a security agreement or lease serves as collateral, it is called "chattel paper" under the Code.⁵⁸ Here the problem is similar to that which arose in connection with the subordination of a note. Assume, for example, that a chattel mortgage is subordinated. If the subordination agreement is construed as creating a security interest in the chattel mortgage itself, the collateral would be "chattel paper." But if the subordination creates a security interest only in certain rights arising out of the chattel mortgage, the collateral is probably our old friend, general intangibles. A security interest in chattel paper may be perfected either by filing or by possession.⁵⁹ However, perfection of a security interest in chattel paper by filing is a kind of "second class" perfection in that a purchaser of the chattel paper without knowledge in the ordinary course of his business will take priority over the security interest thus created.⁶⁰ The law of the jurisdiction where the

Article 9 from 1946 to 1952. Gilmore, *The Assignee of Contract Rights and His Precarious Security*, 74 *Yale L.J.* 217, 250 (1964). See generally 2 Coogan, Hogan & Vagts, *supra* note 50, § 15.05.

⁵⁶ U.C.C. § 9-302. The rule is, however, not without exceptions. See, e.g., U.C.C. § 9-302(1)(e) on insignificant assignments.

⁵⁷ U.C.C. § 9-103. Some of these problems involve (a) determining the record keeping office, (b) the change in the law resulting from the change in location of the record keeping office (except in New York—see note 52 *supra*), and (c) determining what is an "appropriate" relation to the state in applying optional subsection (5) where the records are kept outside the United States. By and large these problems are a little easier to deal with than those arising in connection with general intangibles.

⁵⁸ U.C.C. § 9-105(1)(b) defines chattel paper as "a writing or writings which evidence both a monetary obligation and a security interest in or lease of specific goods. When a transaction is evidenced both by such a security agreement or a lease and by an instrument or series of instruments, the group of writings taken together constitutes chattel paper."

⁵⁹ U.C.C. §§ 9-302, -304.

⁶⁰ U.C.C. § 9-308.

chattel paper is located will govern⁶¹ and the main conflicts problem revolves around what happens when there are an unknown number of executed counterparts at large in the country.

The point made here is that, while in most situations, subordinations, if they create security interests at all, create them in instruments or general intangibles, other types of collateral cannot be ignored. It is, therefore, necessary to look to what is being subordinated before a determination is made as to what the collateral is.

D. *Pre-Code Subordinations*

Under non-uniform transition provisions adopted in New York, California and Wisconsin, the perfection of all security interests which were perfected without filing prior to the adoption of the Code, and which would have required a filing had the Code been in effect, will lapse unless a continuation statement is filed by the secured party under the Code within a specified period of time.⁶²

New York, which was the first to adopt this non-uniform provision, originally required the filing of the continuation statement within twelve months of the date the Code became effective. With time for such filing about to run out,⁶³ the legislature amended section 10-102(2) to extend the period for filing such continuation statements from twelve to thirty-six months in all cases except those in which the collateral was accounts.⁶⁴ This change was necessitated by the fact that problems such as those discussed herein made unclear exactly what was covered by the broad definition of security interest. In addition, institutional lenders and others were hard pressed to complete a review of their portfolios in time to file on the date specified.⁶⁵

An effort was made to induce the California legislature to again follow New York and enact a similar amendment. However, some in California felt that such a change was unnecessary inasmuch as filing is not required there for security interests in general intangibles.⁶⁶ What may have been overlooked is that some subordination agreements, if

⁶¹ U.C.C. § 9-102(1).

⁶² U.C.C. § 10-102. The list of states requiring the filing of continuation statements for pre-Code security interests originally perfected without filing may have been increased by action of 1965 legislatures, unavailable at the date of publication of this article.

⁶³ The New York Code became effective on September 27, 1964, and all such continuation statements were to have been filed by September 26, 1965.

⁶⁴ N.Y. Sess. Laws 1965, ch. 868.

⁶⁵ Since anything in a loan agreement which made payment more probable might fit within the broad language of § 1-201(37), a careful study of each of many thousands of individual transactions must be made by many lending institutions. This can be a difficult task.

⁶⁶ These views were expressed rather forcefully by Mr. Robert L. Hunt, Vice President and General Counsel of the Security First National Bank.

they do create security interests, do not necessarily create them in general intangibles. From the discussion above it is clear that subordination agreement security interests may be in accounts, contract rights or chattel paper, all of which require or permit perfection by filing—even in California.⁶⁷ Furthermore, the area of subordination agreements is not the only one under the Code where many felt that no security interest was created prior to the Code but where filing may now be required. For one example, the assignment of a so-called “back-stop” agreement, by which a parent or subsidiary of the borrower will agree to buy certain of the borrower’s products whether the borrower produces them or not, probably creates a security interest in contract rights.⁶⁸ In any case, the cut-off date for the filing of continuation statements in California remains December 31, 1965. In Wisconsin, the time limit is June 30, 1966.⁶⁹ In these three states, then, if it is determined that a subordination agreement creates a security interest,⁷⁰ it may be necessary to file a continuation statement to preserve its perfection. Outside of these states, the uniform provision, or variations thereof, which would not appear to require that any action be taken with respect to pre-Code subordinations,⁷¹ have been adopted.

III. THE RISK

If a lender wishes to protect himself fully against the possibility that a subordination agreement creates a security interest, he may decide to obtain possession of the notes being subordinated and to file financing statements in the appropriate places. However, there is no doubt that there will be many situations where the senior creditor will be unable to comply with these requirements, either because it is impossible to do so, or because the expense of compliance will be prohibitive. In these circumstances the senior creditor will have to consider the risk of loss in failing to comply with all the possible Code requirements in determining whether the loan should be made. Fortunately, the risk is not as great as it might at first seem. The agreements will be valid between the parties, and third parties, such

⁶⁷ See p. 20 *supra*.

⁶⁸ See note 6 *supra*.

⁶⁹ Wis. Sess. Laws 1965, ch. 51.

⁷⁰ Conflicts rules cannot be ignored here. For example, if general intangibles are involved, the law of New York would be applied if the debtor's chief place of business were located there. Also the law of New York might apply if the conflicts rules of another jurisdiction would require the application of New York law. Finally, if the chief place of business were located in New York when the loan was made but later moved to another jurisdiction, the law of New York would still be applicable (perhaps in addition to the law of the other jurisdiction) because New York's version of the Code provides that movement of the chief place of business will not change the applicable law. See N.Y. Uniform Commercial Code § 9-103(6).

⁷¹ U.C.C. § 10-102(2). This section provides that pre-Code transactions may be “terminated, completed, consummated or enforced” under the old law.

as the trustee in bankruptcy, will become involved only when the obligor or the junior creditor becomes insolvent.⁷²

A. *Insolvency of the Obligor*

Under pre-Code law, the courts have generally enforced subordination agreements upon the insolvency of the obligor and applied the junior creditor's share to the debt owed the senior creditor to the extent necessary to make the latter whole.⁷³ In such cases, however, the courts have felt it necessary to justify this enforcement by fitting the subordination agreement into some tested legal cubbyhole.⁷⁴ Mr.

⁷² This statement ignores the possibility of transfer of the subordinated note to a third party before insolvency. If the subordination was of the *ab initio* type and the subordination language was found in the note itself, no problem would arise. However, in a subsequent subordination where the subordination language is contained in an agreement outside the note, trouble could arise on transfer, but it would not differ greatly from that existing prior to the Code. Thus, if the note were negotiable, the holder in due course would take free of the subordination agreement whether or not the subordination agreement were deemed to create a security interest and whether or not the security interest were in the note itself or in certain rights arising from the note. This result would appear to be the same before as well as after the Code (see §§ 9-309 and 3-305). Where the note is not negotiable, transfer to the bona fide purchaser would serve only to cut off outstanding equities, unless some form of estoppel is employed against the senior creditor. See 46 Am. Jur. Sales § 464 (1943). Some pre-Code cases justified the enforcement of subordination agreements on the ground that they were equitable liens or equitable assignments. See text at note 81 *infra*. Transfer to the bona fide purchaser would normally cut off equitable rights. However, if the "equitable" interest were perfected under the Code, it could be argued that transfer could not cut off the security interest. Here, then, is a situation where perfection under the Code might be helpful in obtaining rights that might not have been available prior to the Code.

⁷³ See *Austin v. National Discount Corp.*, 322 F.2d 928, 931 (4th Cir. 1963). In one case, however, a bankruptcy referee refused to enforce the subordination because it was not a legal assignment and, since there was no appropriation of a fund to be assigned, it did not amount to an equitable assignment. In *re Goodman-Kinstler Cigar Co.*, 32 Am. Bankr. R. 624 (S.D. Cal. 1914). The court said: "The bankruptcy court should not be involved in the enforcement of a covenant between the bank and the claimant which does not amount to an equitable assignment, and the bankruptcy court has no jurisdiction to enforce such a covenant." *Id.* at 628. This case seems to be a lark and does not appear to have been followed, at least with respect to subordination agreements on the bankruptcy of the obligor. It was specifically disapproved in *Bird & Sons Sales Corp. v. Tobin*, 78 F.2d 371 (8th Cir. 1935). As will be seen from the discussion above, some courts have found equitable assignments in similar circumstances and others, not feeling themselves "pinioned on the horns" of this referee's dilemma, were able to find other theories to affirm the subordination. But cf. *re Railroad Supply Co.*, 78 F.2d 530 (7th Cir. 1935) and *Nixon v. Michaels* 38 F.2d 420 (8th Cir. 1930).

⁷⁴ Mr. Calligar comments that the theories employed by the courts were conclusory, and that they were "ways of rationalizing, rather than reaching, a desired result. In total, they show a general willingness on the part of courts to find a legal reason to enforce subordination agreements." Calligar, *Subordination Agreements*, 70 Yale L.J. 376, 389 (1961). At least one court felt the theories of enforcement were secondary to the substance of the transaction and the intention of the parties. Thus in *re Itemlab, Inc.*, 197 F. Supp. 194 (E.D.N.Y. 1961) the court upheld a subsequent subordination either as an equitable lien, equitable assignment or a constructive trust.

Everett⁷⁵ and Mr. Calligar⁷⁶ have discussed these cases and the theories employed therein at length. This author will not repeat these discussions but will merely point out that there are primarily four theories in vogue and that they tend to parallel, to some extent, the distinctions made herein between the subsequent and the ab initio subordinations.

The four theories are: (1) the equitable assignment;⁷⁷ (2) the equitable lien;⁷⁸ (3) the contract;⁷⁹ and (4) the constructive trust.⁸⁰ Two of these have a distinct flavor of a security transaction—the equitable assignment and the equitable lien.⁸¹ It was Judge Learned Hand in the landmark *Schinzel & Son* case⁸² who said that since there was no outright mortgage or pledge as security, any right in the senior creditor must have been “by an equitable lien.” He stated that the

⁷⁵ Everett, *Subordinate Debt—Nature, and Enforcement*, 20 Bus. Law. 953 (1965).

⁷⁶ Calligar, *supra* note 74, at 383-92.

⁷⁷ See *In re Handy-Andy Community Stores, Inc.*, 2 F. Supp. 97 (W.D. La. 1932), where the court found that a subsequent subordination amounted to an agreement to “convey a present title to the claimants.” *Id.* at 98. The court also speaks of “enforcement of a valid contract.” *Id.* at 99.

⁷⁸ See *Searle v. Mechanics' Loan & Trust Co.*, 249 Fed. 942 (9th Cir. 1918), cert. denied, 248 U.S. 592 (1918); *In re Geo. P. Schinzel & Son, Inc.*, 16 F.2d 289 (S.D.N.Y. 1926); and *Bank of America Nat'l Trust & Sav. Ass'n v. Engleman*, 101 Cal. App. 2d 390, 225 P.2d 597 (1950).

⁷⁹ See *Bank of America Nat'l Trust & Sav. Ass'n v. Erickson*, 117 F.2d 796 (9th Cir. 1941) (citing equitable lien as well as contract theory cases); *In re Aktiebolaget Kreuger & Toll*, 96 F.2d 768 (2d Cir. 1938); *Bird & Sons Sales Corp. v. Tobin*, *supra* note 73; and *In re Associated Gas & Elec. Co.*, 53 F. Supp. 107 (S.D.N.Y. 1943), *aff'd*, *Elias v. Clarke*, 143 F.2d 640 (2d Cir. 1944), cert. denied, 323 U.S. 778 (1944). But see *In re Joe Newcomer Finance Co.*, 226 F. Supp. 387 (D. Colo. 1964) where the court based its conclusion on a third party beneficiary contract theory and refused to enforce the subordination provisions of the notes on the ground that the holders were not given sufficient notice that their notes were subordinated (each note was entitled “Subordinated Debenture Note”), and that the senior creditors had not relied on the subordination language.

⁸⁰ In the *Matter of Dodge-Freedman Poultry Co.*, 148 F. Supp. 647 (D.N.H. 1956), *aff'd sub nom. Dodge-Freedman Poultry Co. v. Delaware Mills, Inc.*, 244 F.2d 314 (1st Cir. 1957). In this case the subordinating creditor (the obligor's principal stockholder's wife) attempted to waive her claim in bankruptcy to enable the obligor company to retain the award which would have gone to the senior creditor. The court rejected the equitable lien and equitable assignment theories but found that the subordinating creditor could not waive her rights because by virtue of the agreement she was a constructive trustee for the senior creditor. One recalls Professor Scott's dictum to his class about constructive trusts. “Did you ever see a constructive horse?” he asked. “The one thing you know about a constructive horse,” he said, “is that it isn't a horse.”

⁸¹ Cases in this area are not helpful in solving the question of whether the subordination, if it is a lien or assignment, is a lien or an assignment of the note itself or of certain rights arising by virtue of the note. See p. 14 *supra*. *In re Handy-Andy Community Stores, Inc.*, *supra* note 77 (no discussion); *In re Geo. P. Schinzel & Son, Inc.*, *supra* note 78 (equitable claim) and *Searle v. Mechanics' Loan & Trust Co.*, *supra* note 78 (equitable lien) spoke of an interest in the funds in the hands of the bankruptcy court. Mr. Golin comments that “the theory of assignment comes into play only as a prop to sustain the practical enforcement of the ranking agreement.” Golin, *Debt Subordination as a Working Tool*, 7 N.Y.L.F. 370, 371 (1961).

⁸² *In re Geo. P. Schinzel & Son, Inc.*, *supra* note 78, at 289.

junior creditors intended that the senior creditor have first call on any payments made, and from this arose an equitable claim as against the signing creditors. In this case, and in the other cases involving the equitable lien or equitable assignment theory, the subordination was a subsequent subordination, or close to it.⁸³

Where a subsequent subordination is not involved, the cases invariably utilize other theories. The contract theory would seem to be "the most logically supportable and sensible of all the theories"⁸⁴ whether the subordination is of the "subsequent" or "ab initio" type, and has been employed in both situations. In any case, the courts have enforced the subordination on the bankruptcy of the obligor. There should be no reason why the bankruptcy court should refuse to carry out an agreement between two of the bankrupt-obligor's creditors since it does not affect the rights of the other creditors. The Code should not change this result. Even if a security interest were created, it would operate against the junior creditor, and thus it would be the junior creditor's bankruptcy where the unperfected subordination would be vulnerable. However, there is at least one question of interpretation here which will now be discussed.

As was noted above, several of the pre-Code cases enforced the subordination on the ground that an equitable lien or equitable assignment had been created. Section 60(a)(6) of the Bankruptcy Act⁸⁵ declares that "recognition" of equitable liens is contrary to the policy of the section where available means of perfecting legal liens have not been employed. The argument follows that the Code provides an available means of perfecting what were equitable liens prior to the Code, and that the bankruptcy courts therefore should not recognize the unperfected subordination security interest. This might seem to be supported by the next sentence of section 60(a)(6)⁸⁶ which provides that a transfer creating an equitable lien is not perfected if the applicable law required a filing and there was none.

This entire argument, however, ignores the fact that the section

⁸³ In *Schinzel & Son*, the creditors agreed with the bankrupt obligor in writing in effect that all persons who would supply goods to the obligor would have priority over their claims. In *Searle*, supra note 78, the junior creditors had signed a subordination agreement covering notes already held by them. The court found an equitable lien. In *Handy-Andy*, supra note 77, two officers of the obligor agreed with a bank to subordinate their claim for \$20,000 to a prospective loan from the bank for \$15,000. There was no assignment language in the agreement; the language provided that "in the event of insolvency or liquidation, your note aforesaid shall be paid as between you and us by preference and priority, over our claim." *Id.* at 98. The court said that assignment language was unnecessary since the document amounted to an agreement to convey present title to the senior creditor which became enforceable as an equitable assignment.

⁸⁴ Calligar, supra note 74, at 388.

⁸⁵ 64 Stat. 25 (1950), 11 U.S.C. § 96(a)(6) (1964).

⁸⁶ *Ibid.*

was designed to protect the general creditors of the *bankrupt*. To deny enforcement of the subordination agreement in this situation does not help the bankrupt's creditors one whit. The same amount of money must be paid out of the bankrupt's estate to the parties to the subordination agreement. Enforcement of the subordination merely means that the trustee will apply the junior creditor's share to the senior creditor to the extent necessary to make the senior creditor whole.

Section 60(a)(6) was added to the Bankruptcy Act in 1950, when the lien creditor test of when a transfer takes place, for the purpose of the preference provisions, was substituted for the bona fide purchaser test.⁸⁷ The change was necessary because of certain cases which indicated that some customary and widely used security transactions might be struck down as preferences because the bona fide purchaser had certain rights superior to those of the secured party.⁸⁸ The bona fide purchaser test had effectively eliminated the equitable lien theory as a viable doctrine, for equitable liens could not meet that test because sale to a bona fide purchaser would normally cut off all outstanding equities.⁸⁹ As pointed out by Professor MacLachlan, the

bona fide purchaser test was not abandoned for the purpose of validating equitable liens, but that consequence would presumably have followed if the subject had not been specifically dealt with in [section 60(a)(6)].⁹⁰

Thus, the purpose of section 60(a)(6) was to provide the protection against equitable liens, or at least some of the protection, available under the bona fide purchaser test.⁹¹ It was not meant to expand the powers of the bankruptcy court. The bona fide purchaser test would never have prevented the enforcement of equitable liens as between two creditors of the bankrupt; it dealt merely with transfers made by the bankrupt. There would thus seem to be no basis for arguing that section 60(a)(6) now prevents the enforcement of agreements creating

⁸⁷ 64 Stat. 25 (1950), 11 U.S.C. § 96(a)(2) (1964).

⁸⁸ See H.R. Rep. No. 1293, 81st Cong., 1st Sess. 4-6 (1949); 3 Collier, Bankruptcy ¶ 60.38 (14th ed. 1964).

⁸⁹ 3 Collier, supra note 88, ¶ 60.50; 46 Am. Jur. Sales § 464 (1943).

⁹⁰ MacLachlan, Bankruptcy 307 (1956).

⁹¹ To a certain extent, the amendment gives equitable liens a more liberal treatment. By virtue of the bona fide purchaser test all equitable liens were subject to some attack by the bankruptcy trustee. The 1950 amendment placed a policy limitation on that attack to those situations where there is a legal means of perfection. This was done because the object of the drafters was to prevent the recurrence of the pre-1939 (pre-bona-fide purchaser test) situation where courts were validating security interests consummated within four months of bankruptcy on the ground that the equitable right was created before that period. This relation-back doctrine is discussed in the congressional report accompanying the 1950 bill. H.R. Rep. No. 1293, supra note 88, at 4; see generally Weinstein, The Bankruptcy Law of 1938, at 120 (1938) (comments to section 60a). Mr. Weinstein was one of the principal drafters of the Chandler Act.

equitable rights as between two creditors of the bankrupt. This section becomes a real problem, however, upon the bankruptcy of the junior creditor.⁹²

In spite of the force of the above argument, the history of the Bankruptcy Act in the courts does not permit one to completely ignore the possibility of a different result.⁹³ Although it is possible for a court to find that equitable rights are created in other situations, this risk would seem limited to subordination agreements which pre-Code courts would have found to have created equitable assignments or equitable liens. As pointed out above,⁹⁴ these cases seemed limited to subsequent subordination situations. Fortunately, if any subordination agreement creates a security interest, it is probably this type which is the easiest to perfect under the Code.

B. *Insolvency of the Junior Creditor*

If the obligor remains solvent and only the junior creditor becomes bankrupt, no problem should arise in connection with the enforcement of the subordination agreement. Since the subordination secures the obligor's performance, the senior creditor will not incur any loss unless the obligor defaults. Thus, in order for the senior creditor to be hurt, there will have to be insolvency of both the obligor and the junior creditor. In this situation the obligor's trustee should have no difficulty in determining that he will enforce the subordination agreement. But if any security interest created by the subordination were not perfected, the subordinating creditor's trustee would argue that the unperfected security interest was invalid as to him by virtue of sections 9-301(1)(b) and 9-301(3) of the Code, and section 70(c) of the Bankruptcy Act.⁹⁵ And, if a security interest were in fact created but not perfected, the trustee would probably win. If the double insolvency occurs simultaneously, the junior creditor's trustee will claim the right to payment under the subordinated note as a general creditor of the obligor. If, on the other hand, the junior creditor becomes insolvent before the obligor, the junior creditor's trustee may then attempt to dispose of the note, free of the subordination, for the benefit of the bankrupt's estate.

The real risk of loss for the senior creditor lies in a double bank-

⁹² See pt. III, § B *infra*.

⁹³ Cf., e.g., *Moore v. Bay*, 284 U.S. 4 (1931) which according to Prof. MacLachlan, who authored the sections the case interpreted, constitutes "one of the most glaring misconstructions . . . in the history of Anglo-American law," MacLachlan, *supra* note 90, at 330; *Constance v. Harvey*, 215 F.2d 571 (2d Cir. 1954), overruled, *Lewis v. Manufacturers Nat'l Bank*, 364 U.S. 603 (1961).

⁹⁴ See note 83 *supra* and accompanying text.

⁹⁵ 30 Stat. 565 (1898), as amended 11 U.S.C. § 110(c) (1964); see note 34 *supra* and accompanying text.

ruptcy situation. Fortunately, double bankruptcy is more likely to occur with a subsequent subordination, where the junior creditor is often closely associated with the obligor. Of course, in extreme cases, double bankruptcy could also be expected in an ab initio situation. The point is, however, that the closer we get to the subsequent subordination, the greater is the likelihood that a security interest will be held to have been created and the greater is the risk in failing to perfect. However, the closer we get to the subsequent subordination, the easier it becomes to perfect any security interest held to have been created. Conversely, as we move toward the ab initio subordination, there is less likelihood that a security interest has been created, it is harder to perfect any security interest, and the risk in failing to perfect is smaller.

It has been noted that, outside the Code, courts have generally enforced subordinations on the bankruptcy of the obligor, but there is a paucity of cases involving the action of courts on the bankruptcy of the junior creditor. However, a recent case not involving the Code, *In the Matter of Wyse*,⁹⁶ has raised numerous eyebrows and much blood pressure.

In that case, the junior creditors not only subordinated present and future debts of the obligor (a subsequent subordination) but also agreed to guarantee the obligor's debts to the senior creditor. On the bankruptcy of the obligor in Canada, the Canadian bankruptcy court enforced the terms of the subordination agreement in distributing the obligor's assets. Since the assets of the obligor were insufficient to satisfy its debts to the senior creditor even with the subordination, the senior creditor filed a proof of claim in the junior creditor's bankruptcy proceeding in the United States for the difference, based on the contract of guaranty. The United States court held that the senior creditor had already been paid the junior creditor's share of the obligor's assets and could receive nothing further as a general creditor until all general creditors of the junior creditor had received a like portion out of the latter's estate. The Canadian decision, said the court, was not res judicata on the issue involved in the American bankruptcy. According to the Sixth Circuit:

The guaranty contract was an unrecorded agreement, of which none of Wyse's creditors had notice. Although it may have been good between the parties, when Pioneer received the dividend on Wyse's claim from the Canadian bankruptcy, equity required subordination of Pioneer's claim filed in the Wyse bankruptcy case, until the other unsecured creditors of Wyse had received a like percentage of their claims.⁹⁷

⁹⁶ 340 F.2d 719 (6th Cir. 1965).

⁹⁷ Id. at 724.

The reference to the "unrecorded agreement" has led some investors to fear that the courts might hold subordinations invalid as against the creditors of the junior creditor on the ground that they create equitable interests unenforceable in such a bankruptcy.⁹⁸ Even if a bankruptcy court held that the subordination created an equitable interest, however, it should enforce this interest where there is no available legal means of perfection.⁹⁹ If subordination agreements create security interests under the Code, then the Code would seem to provide a legal means of perfection. The failure to so perfect might then be the basis for arguing that the subordination is unenforceable on the bankruptcy of the junior creditor. While the Code, then, does seem to provide a means of solving the problem raised in *Wyse*, if any such problem actually exists, the failure to perfect under the Code in the absence of an appropriate Code amendment would complicate the *Wyse* problem. In any case, the fears raised by *Wyse* are perhaps exaggerated. The *Wyse* case dealt with enforcement of a guaranty agreement, the subordination having already been enforced in the prior bankruptcy. When the *Wyse* court talked of an "unrecorded agreement," it was referring to the guaranty agreement, although the subordination language was contained in that agreement.

The troublesome implication from the subordination standpoint is that the recovery by the senior creditor of the junior creditor's share under the subordination agreement upon the bankruptcy of the obligor was an advance recovery under the guaranty agreement. It was a form of preference, although the court did not use this term, over the other

⁹⁸ Mr. Calligar raised this question outside of the Code long before the decision in the Matter of *Wyse*, supra note 96. See Calligar, supra note 74, at 395-96 where he points out that there were numerous instances where bankruptcy courts have refused to enforce equitable rights running in favor of third persons:

A subordination agreement does not constitute a present legal transfer, and in the absence of such a transfer the subordinating creditor's trustee in bankruptcy might be able to take title to the subordinated debt free and clear of all equitable or contractual rights created by the subordination agreement The claim of the trustee to the subordinated debt, as a lien creditor, might . . . be regarded as superior to the unsecured right of the senior creditor. No cases have been found involving the bankruptcy of the subordinator.

Ibid. He concluded that while it was not clear how much trouble the senior creditor would have on the bankruptcy of the junior creditor, the question could be avoided by including "a present assignment of the subordinated debt in the subordination agreement," so that a "legal transfer . . . takes place on the date of the subordination agreement"; thus the "senior creditor, as a prior assignee, would unquestionably prevail over the trustee." It should be pointed out, however, that an assignment of certain rights arising under the note would be just as present and legal an assignment as the assignment of the entire subordinated debt. Also, the assignment suggested by Mr. Calligar would clearly make the collateral "instruments" and require possession of the note for perfection under the Code. An important aspect of Mr. Calligar's comment is that it shows, outside of the Code, how far from an assignment of the note the ordinary subordination was considered to be by the leading authority on subordinations.

⁹⁹ See text accompanying note 85 supra.

general creditors. Since the subordination language was found in the guaranty agreement, the court combined the two and found it inequitable to allow the holder of the guaranty to obtain a greater percentage than other general creditors. However, the subordination agreement and the guaranty agreement were entirely different—one dealing with obligations owed by the obligor to the junior creditor, and the other creating a new obligation of the junior creditor to make good the obligor's debts to the senior creditor—and they should have been treated as such.

The *Wyse* case would thus appear to be wrongly decided. Further, it is clearly distinguishable from the normal subordination situation.¹⁰⁰ This, however, will not prevent the junior creditor's trustee from using the *Wyse* arguments in an attempt to prevent enforcement of the subordination. Thus the Code problem is not the only one facing the lender. No doubt the *Wyse* question will be clarified by subsequent court decisions; it is hoped that the Code problem will be clarified by amendment.

IV. AMENDMENT OF ARTICLE 9

Amendment of the Code is necessary. It should be clear by now that Article 9 was never designed to deal with subordination agreements and applies, if it applies at all, only by accident. How ironic it is to find areas where the Code makes legitimate aspirations of the parties difficult to achieve—and how far from Mr. Schnader's goal.

This article is not a condemnation of the Code, for there is no question that the Code, and especially Article 9, represents one of the greatest legal accomplishments in modern law. It stands as a monument to the unselfish devotion of the numerous drafters who spent significant portions of their lives in this cause. It is for this reason that the Code should be corrected in any area where it does not work, not only to enhance its reputation, but also to preserve support for uniform legislation.¹⁰¹

¹⁰⁰ Subordinations are usually not part of guaranty agreements and senior creditors are not usually creditors of the junior creditor. The court, influenced by the coincidence of the two agreements in one document, seemed to feel that all unsecured creditors were not getting equal treatment. The court said: "One of the fundamental principles of bankruptcy administration is equality among unsecured creditors." *Supra* note 96, at 724.

¹⁰¹ The drafters themselves have adverted to the necessity for amendment in certain areas. See Section SEVENTH of the agreement dated August 5, 1961, between the American Law Institute and the National Conference of Commissioners on Uniform State Laws, as amended by Supplement dated August 5, 1961. In this section, the Editorial Board stated as its policy the approval of a "minimum number" of amendments in order to maintain uniformity. But the section goes on to say that "amendments shall be approved" in four circumstances, including, when "it has been shown . . . that a particular provision is unworkable or for any other reason obviously requires amendment." That situation would certainly seem to exist in the case of § 9-104 with respect to subordination agreements.

There is no doubt that a serious problem exists with respect to subordinations that places in jeopardy the future of such agreements as financing devices. In this article, Mr. Calligar has been quoted as comparing subordinations to chattel mortgages,¹⁰² Mr. Coogan as considering the possibility that at least subsequent subordinations create security interests,¹⁰³ Mr. Kripke as once suggesting a subordination of accounts creates a security interest,¹⁰⁴ and Mr. Henson as finding a security interest in the note itself in any subsequent subordination.¹⁰⁵ Mr. Denonn's view is that there is danger that most subordinations create security interests.¹⁰⁶ As a result, it is difficult to obtain a clear opinion from most law firms as to the enforceability of any particular transaction involving subordinations. Of course, one can not blame counsel. This is a new area; the statute is unclear; dangers exist—they would be remiss if they failed to point these dangers out.

In the 1965 New York legislative session, Senator Jack E. Bronston introduced a bill¹⁰⁷ at the behest of Mr. Lester Denonn and some members of a committee of lawyers he formed for this purpose.¹⁰⁸ The Editorial Board and the New York Commission on Uniform State Laws objected to the bill on the twin grounds that it was hastily drafted¹⁰⁹ and would result in a disruption of the pattern of uniformity. At a hearing on proposed Code amendments in Albany on May 4, 1965, sentiment favored postponing action on the proposed amendment with respect to subordinations until the Editorial Board had an opportunity to propose uniform amendments in the fall. On the other hand, there was support for the enactment of S. Intro. 3472 which would

¹⁰² See note 16 *supra*.

¹⁰³ See note 30 *supra*.

¹⁰⁴ See note 32 *supra*.

¹⁰⁵ See note 44 *supra*.

¹⁰⁶ See "Author's Comment," West's McKinney's Forms, U.C.C., § 2050 (1965).

¹⁰⁷ Much credit must go to Senator Bronston for his interest in Code problems and his willingness to sponsor corrective legislation. The Senator, after reading a talk delivered by Mr. Denonn (N.Y.L.J. Feb. 18, 1965, p. 4, col. 1) wrote to Mr. Denonn suggesting the preparation of some amendments to meet the problems pointed out by Mr. Denonn which were troubling the New York financial community. It was Senator Bronston who, on the request of certain institutional lenders, introduced S. Intro. 3472 which dealt with the New York transition problem, and was passed by the legislature in the 1965 session. See p. 22 *supra*.

¹⁰⁸ The "committee" met only once, on March 29, 1965, in Mr. Denonn's law offices, although there were some letters and telephone communications between the "members" prior to and after that date.

¹⁰⁹ The provision dealing with subordinations, S. Intro. 4237 § 4, as finally introduced, amended § 9-104 to provide that Article 9 would be inapplicable to any interest or right created by debt subordination provisions or agreements in or to payments or distributions which may be made in insolvency, bankruptcy or other proceedings involving the estate of the person obligated on or with respect to the subordinated debt, or any other payment of distribution on or with respect thereto, whether or not such debt is expressly assigned by the one subordinating the same.

allow additional time for the filing of continuation statements with respect to certain pre-Code security interests perfected originally without filing. By this means it was felt that the subordination problem could be avoided, at least as far as pre-Code interests were concerned, until the Editorial Board could act. The *coup de grace* was probably the reading of a letter from Mr. Schnader himself in which he promised, *inter alia*:

As Chairman of the Permanent Editorial Board, I shall convene the Board after the final action on the Code by the 1965 Legislatures. We shall then have before us all amendments which have actually been made by Legislatures, as well as any proposals which come to us from legislators, lawyers, or any groups affected by the provisions of the Code. The Board will review all these amendments and proposals and will, as promptly as possible, make a report to the sponsors of the Code for their approval.¹¹⁰

As promised, a screening committee of the Editorial Board, consisting of Mr. Homer Kripke and Professors Soia Mentschikoff and Robert Braucher, are now meeting to consider the subordination problem and other suggestions for amendment.

How, then, should the Code be amended? There are several possible alternatives. One, an amendment to section 1-201(37) to provide that a subordination agreement does not create a security interest. This, of course, determines the very nature of subordination agreements and it must be clear that such a determination will do no violence to the effectiveness of subordination agreements outside the Code. Another alternative lies in an amendment to section 9-302 to provide that filing is not required to perfect a security interest created by a subordination agreement.¹¹¹ This is unsatisfactory, for it almost implies that subordination security interests are perfected by possession.

Another suggestion is an amendment to section 9-304 to provide that any security interest created by a subordination agreement is perfected without filing and without taking possession of the subordinated paper. This might help solve the problem that may have been raised by the *Wyse* case inasmuch as the senior creditor could argue that he has a perfected security interest.¹¹² The problem here is that such an amendment makes a determination of the nature of subordination agreements and such a determination may raise more problems than it settles.

¹¹⁰ Letter from William A. Schnader to Commissioner Alfred A. Buerger, New York Commission on Uniform State Laws, April 22, 1965.

¹¹¹ This, in effect, was what the original draft of S. Intro. 4237 (N.Y. 1965), introduced in the last session of the New York Legislature, provided. The bill was later changed to amend N.Y. Uniform Commercial Code § 9-104.

¹¹² See p. 29 *supra*.

For example, if subordinations create security interests, will the taking of subordinated debt by a corporation constitute a violation of negative pledge clauses in the corporation's other financial transactions? Will the taking of subordinated debt constitute a violation by institutional lenders of provisions of state law which restrict to varying degrees the right of such lenders to pledge their property as security?¹¹³

Perhaps the most satisfactory alternative, then, is an amendment to section 9-104 to provide that Article 9 is inapplicable to subordination agreements. This would cleanly resolve the Code problem, and any other questions with respect to the validity of subordinations would then be left to the courts or to special legislation. While not attempting to write final language, the following is submitted as a tentative draft of such an amendment:

§ 9-104. This Article does not apply . . . (1) to a subordination by any secured or unsecured creditor of a right to payment from a debtor, whether or not such subordination is effectuated by an assignment of such subordinating creditor's right to payment from the debtor.

The reference to the use of assignment language does not mean that an actual assignment of the note itself would be free from the Code provisions. It is simply meant to cover the assignment of rights to payment arising by virtue of the note, such as the assignment of rights on bankruptcy of the obligor. Such assignment language is sometimes implied or found in genuine subordinations.¹¹⁴ The reference to a secured creditor will help to clarify section 9-316 which permits subordinations by persons entitled to a priority, without stating whether or not such subordinations create security interests.¹¹⁵

It is suggested that the comment to this section be so worded as to indicate that the amendment does not change the Code but merely clarifies what always was the purport of the Code. Thus subordination agreements executed prior to the amendment would be free from any implication that the Code was applicable to them.

V. CONCLUSION

If the Code is not amended to correct the problems discussed herein, the result may be to substantially curtail the use of subordination agreements as a tool to facilitate corporate financing.

The problem of the subordination agreement is a small one when the "great uniform commercial code" is viewed as a whole. But it has been a source of concern to institutional lenders and, if it were to cur-

¹¹³ E.g., N.Y. Ins. Law § 78(2).

¹¹⁴ See p. 10 *supra*.

¹¹⁵ See p. 21 *supra*.

tail the use of subordinations in future financing, it would also be a source of concern to corporate borrowers. This problem, and the few other small, but highly complex, unsolved Code problems, will undoubtedly be resolved in time by amendment and court decision. When this comes to pass, the full promise of Mr. Schnader's words twenty-five years ago will have been realized.¹¹⁶

¹¹⁶ See note 1 *supra* and accompanying text.