July 17, 2000

REPORT OF THE NATIONAL ASSOCIATION OF BOND LAWYERS OPINIONS AND DOCUMENTS COMMITTEE RE: REVISED ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

The Committee on Opinions and Documents carried out the following with respect to Revised Article 9 of the Uniform Commercial Code ("1998 Revision"):

1. A review of the 1998 Revision;

2. A survey of NABL membership with respect to the effect of the 1998 Revision on the laws of their jurisdictions and on governmental transfers within their jurisdictions; and

3. Discussions by Committee members with members of the Uniform Laws Commissions concerning the 1998 Revision. (informal discussions only; substantive discussions have not yet been held).

The Committee's assessment of key issues to be addressed in the 1998 Revision is attached as Exhibit A. Exhibits B and C set forth the states in which the 1998 Revision has been enacted and the states in which the 1998 Revision has been introduced and is pending. At the date of this report the 1998 Revision has been enacted in 27 states and is pending in another 12 states and the District of Columbia, respectively. The Committee has ascertained, through its survey, that Iowa has enacted the 1998 Revision with amendments limiting its effect on governmental transfers. A similar amendment is attached to the 1998 Revision bill pending in Colorado and similar amendatory legislation is being drafted for Nevada.

The Committee is of the view that, as with other enactments of Uniform Commercial Code revisions, there will be the need for the enactment of technical corrections. Consequently, even in states where the 1998 Revision has been enacted, remedial legislation is still an option. To avoid the impact summarized in this report, states could take remedial action that includes: modifying Article 9, as revised, to continue the current exclusion of governmental transfers from Article 9; enacting a general bond statute governing the perfection and priority of governmental pledges to pre-empt Article 9, as revised; modifying Article 9, as revised, to make perfection of bond pledges automatic; modifying selected sections of the 1998 Revision; or modifying the transition provisions of Article 9, as revised, to preserve the status of prior grants without further action to perfect.

The remedial action, if any, warranted in any particular state or territory will depend on state constitutional issues, local practice and the current state of non-UCC statutes dealing with governmental transfers, to which the 1998 Revision generally defers. Accordingly, the committee does not believe that NABL can recommend specific common action to avoid the impact summarized in this report. However, the committee recommends that NABL collect remedial action taken by the states and territories and that it make its collection readily available to members who wish to develop and recommend remedial action in their own states.

Workshops devoted to the 1998 Revision will be held as part of this year's Bond Attorneys' Workshop. They may reveal additional impacts or suggest other possible remedial action.

IMPACT OF UCC ARTICLE 9 REVISIONS ON PUBLIC FINANCE

Article 9 of the Uniform Commercial Code (UCC) governs security interests. Under the 1972 Revision, currently in effect in most states, Article 9 does not apply to security interests created by a government or governmental subdivision or agency. Under the 1998 Revision, proposed to be effective July 1, 2001, Article 9 will apply to governmental security interests except to the extent that another statute (i.e., not just a home rule charter) expressly governs the creation, perfection, priority, or enforcement of the security interest. The 1998 Revision includes definitions relating to governmental transfers which require examination. Examples include "governmental unit" and "public finance transaction". Following is a brief listing of potentially significant negative effects that could result from the 1998 Revision unless remedial action is taken by enacting state legislatures.

1. Increased Importance of Perfection: The Bankruptcy Code "strong-arm" clause empowers debtors to ignore security interests that, because unperfected, can be subject to judicial liens. Since, under the 1972 Revision, Article 9's statutory means of perfecting security interests are unavailable to governmental units, in many states there is no statutory means to perfect governmental pledges made to secure bond issues. However, the "strong-arm" clause does not apply to unperfected security interests that cannot be perfected, according to its legislative history. Consequently, absent means to perfect, governmental pledges to secure bond issues are not subject to "strong-arm" clause risks. Under the 1998 Revision, even governmental issuers will have statutory means to perfect their pledges under the UCC if statutory means to perfect are not otherwise available. Consequently, under the 1998 Revision, governmental issuers must perfect (or at least file notice of) their bond pledges under the UCC in order for bondholders to avoid risks of pledge avoidance under the "strong-arm" clause in bankruptcy, unless pledged revenue or other collateral is exempt from judicial liens or another statute (e.g., the enabling act for the bond issue) governs perfection of the pledge. Disclosure of the associated increase in creditor risk and the actions necessary to comply with the 1998 Revision could increase borrowing costs.

2. Net Revenue Pledges: It is unclear whether "net revenue" pledges will be enforceable under the UCC (if it governs creation), since that term may not describe objectively determinable "property." Under the 1998 Revision, the instrument creating the pledge must include a description that makes the collateral's identity objectively determinable. "Net revenue" might not satisfy that requirement, since it is typically commingled with gross revenues, all of which are available to pay trade creditors, until transferred to a debt service account. If a bond statute or other legislation expressly authorizes a pledge of net revenues (which is most often the case), it likely would govern creation, and the UCC requirements would be moot. If, however, creation were authorized merely by a home rule charter or similar authority, the UCC might preclude lawful creation of a net revenue pledge.

3. Revenues in Deposit Accounts: Under the UCC, bondholders' interests in revenues that are earned after a bankruptcy petition is filed and are deposited to a deposit account could be subordinate to the rights of the bankruptcy trustee, unless the interests are perfected by an account control agreement or the deposits are identifiable proceeds of a perfected security interest. (Bankruptcy trustees are included in the definition of "lien creditor;" a security interest cannot be perfected until the debtor has rights to the collateral; consensual security interests are subordinate to the rights of a person who has become a lien creditor before perfection or filing; and filings in respect of deposit accounts are not effective to perfect and therefore may not defeat judicial lienholder interests.) For reasons described in 4 below, many issuers may not be authorized to enter into account control agreements covering their deposit accounts. Accordingly, unless an appropriate portion of the deposit account balance can be identified as proceeds, pledge of revenues deposited to the deposit account will not be perfected and, accordingly, will be subject to "strong-arm" clause risks as described in 1 above. This consequence could make moot the municipal bond exception to Bankruptcy Code §552, which otherwise voids security interests in property acquired post-petition.

4. Control Agreements: Many bond issuers will not be authorized to or are prohibited from entering into account control agreements, because deposited revenues must be used to operate the financed enterprise as well as pay debt service, because gross revenues may not be pledged, and/or because such an agreement would be an impermissible contracting away of governmental control (except possibly as described in 8 below). Moreover, unless their bond pledges run in favor of a trustee, account control agreements would be impractical even if lawful (since there is no bondholder representative to exercise control), and the secured party could not control the account by becoming the account owner. Accordingly, many issuers (particularly issuers who do not use trustees) will be unable to perfect security interests in revenues held in deposit accounts under the UCC.

5. Financing Statement Requirements: Revenue bond issuers who do not use trustees may be unable to perfect pledges by filing, since a financing statement is ineffective unless it includes the name and address of the secured parties, i.e., the bondholders in a trustee-less financing, which is an impractical requirement. (In the case of "book-entry-only" bonds, DTC might be listed as the secured party, unless its protocols prohibit that practice, but that course would not be available to outstanding certificated issues.) In addition, governmental issuers' legal names, as opposed to "trade names," must be included on financing statements. It is often unclear whether a governmental issuer is an independent unit of government or merely an unincorporated operating division of another governmental unit. In that case, as well as cases of inconsistent statutory name references, it may be unclear as to which debtor name will be effective to perfect the security interest.

6. Continuation Statements: No continuation statements need be filed to continue the perfection of pledges that secure bond issues that are "debt securities" with terms of 20 years or more, but financing statements providing notice of other pledges must be extended once every five years. In many states lease-purchase and "subject-to-appropriation" financings (and even revenue bonds generally) are not considered "debt," at least for some purposes. These and shorter termed issues may require continuation statements. Particularly when there is no trustee to make or monitor the filing of continuation statements, these issues will be subject to risks of lapsed financing statements. (It is not clear, although likely, that security interests granted by non-governmental borrowers to secure conduit financings would be equally exempt from the requirement to file continuation statements.)

7. Invalidation/Subordination of Prior Pledges: Pledges that were effective when made, but would be ineffective under revised Article 9 (e.g., because creation is authorized by home rule charter, rather than by another statute, and the instrument making the pledge does not adequately describe the collateral pledged), will become invalid on July 1, 2002, unless action is taken before then to make the pledges effective under revised Article 9. Even if enforceable, prior pledges will not be deemed perfected (and therefore could be subordinated to other interests or avoided in bankruptcy), unless steps are taken to perfect the pledge under revised Article 9 by July 1, 2002 (except that prior financing statements filed in a previously effective office remain effective for 5 years after filing, even if revised Article 9 requires filing in a different place). In either case, the owners of outstanding bonds will be at risk for any necessary issuer or trustee action, which may not be required by outstanding bond contracts, unless these effects of the 1998 Revision are proscribed by the Contract Clause of the U.S. or state constitution. If prior pledges are not perfected and outstanding bond legislation permits additional pledges only on a parity with or subordinate to the prior pledges, it may be impossible to lawfully secure additional bonds by a perfected pledge.

8. Repeal of Restrictions on Transfers: The 1998 Revision makes ineffective any statute, regulation, or rule of law that restricts or prohibits the transfer or pledge of accounts (e.g., utility system receivables) or chattel paper (e.g., an equipment financing lease), or the creation of security interests while making the UCC inapplicable to the creation of pledges to the extent governed by another statute. Although ambiguous, these provisions could invalidate many restrictions (e.g., Dillon's Rule) on the creation of competing assignments and security interests by governmental units, thus increasing the practical risk of unperfected bond pledges. In addition, statutes and rules of law requiring consent to the assignment of claims against governmental units are made ineffective.

CURRENT LIST OF STATES HAVING ADOPTED REVISED ARTICLE 9

Alaska
Arizona
California
Delaware
Hawaii
Illinois **
Indiana
Iowa
Kansas
Kentucky
Maine
Maryland
Minnesota
Montana
Nebraska
Nevada
North Carolina **
Oklahoma
Rhode Island **
South Dakota
Tennessee
Texas
Utah
Vermont
Virginia
Washington
West Virginia

** Awaiting Governor's Signature

STATES WHERE REVISED ARTICLE 9 IS INTRODUCED

Colorado
Delaware
District of Columbia
Florida
Idaho
Michigan
Mississippi
Missouri
New Jersey
New Mexico
New York
South Carolina
Wyoming