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They Came From "Beyond the Pale": Security Interests in Tort Claims

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They Came from “Beyond the Pale”: Security Interests in Tort Claims

BY HAROLD R. WEINBERG*

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INTRODUCTION

"[B]eyond the pale" is how the drafters of Article Nine of the Uniform Commercial Code ("Code" or "U.C.C.")¹ regarded tort claims.² They considered tort claims to be noncommercial assets inappropriate for inclusion as collateral within the scope of a commercial financing statute.³ Tort claims may not be out-of-bounds much longer. The Article Nine Study Committee of the Permanent Editorial Board for the Uniform Commercial Code ("Study Committee") recommends expansion of the Article's scope to encompass security interests in claims arising out of tort.⁴ This recommendation is significant. Tort causes of action comprise

¹ Unless otherwise noted, all references to the "Uniform Commercial Code," the "Code," or the "U.C.C." are to the 1990 Official Text, and all references to "Article Nine" are to Article Nine of the Uniform Commercial Code.

² 1 GRANT GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* 316 (1965). The exclusion provides, "This Article does not apply . . . to a transfer in whole or in part of any claim arising out of tort." U.C.C. § 9-104(k). In 1956, the Editorial Board for the Code recommended the exclusion to achieve greater clarity and precision in defining the transactions "entirely" excluded from Article Nine. AMERICAN LAW INSTITUTE, NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE 257-58 (1956). This recommendation was pursuant to a suggestion by the New York Law Revision Commission. STATE OF NEW YORK, REPORT OF THE LAW REVISION COMMISSION 466 (1956). The exclusion also may have been intended to permit each individual state to apply its own public policies with respect to transactions involving tort claims. See generally William D. Hawkland, *The Proposed Amendments to Article Nine of the U.C.C. - Part IV: The Scope of Article Nine*, 77 COM. L.J. 79, 83 (1972). According to Professor Grant Gilmore, a principal drafter of Article Nine, the extent to which tort claims were actually used as collateral was never investigated. The drafters were told or assumed they were not so used. Professor Gilmore came to the conclusion that tort claims should have been included within the Article's scope. See Letters from Professor Grant Gilmore to Professor Harold R. Weinberg (Feb. 12, 1976 & May 21, 1976) (on file with author) (discussing Harold R. Weinberg, *Tort Claims as Intangible Property: An Exploration from an Assignee's Perspective*, 64 KY. L.J. 49 (1975-1976)).

³ 1 GILMORE, *supra* note 2, at 316. Code commentary states that tort claims are excluded because they "do not customarily serve as commercial collateral . . ." U.C.C. § 9-104 cmt. 8.

⁴ See PEB Study Group Uniform Commercial Code Article 9, Report, Permanent Editorial Board of the Uniform Commercial Code 58-59 (1992) [hereinafter PEB Study Group]. The recommendations are as follows:

an ever-expanding universe of civil wrongs for which courts afford redress.⁵ The owners of tort claims range from financially strong business enterprises seeking redress for patent infringement to impecunious pedestrians injured by automobiles.⁶

The Study Committee's recommendations raise many important questions. Historically, transactions in tort claims, especially "personal" tort claims such as claims for personal injury, have been associated with a "witch's brew" of social evils. Therefore, two issues are whether these concerns are legitimate and, if so, whether these evils would increase if tort claims could be encumbered under Article Nine.⁸ Another set of questions centers on the practices of "reimbursees" such as insurers and medical care providers. They will want to know how the Study Committee's recommendations will impact their rights to be reimbursed from the tort claims of their insureds and patients.

Part One of this Article provides terminology and concepts useful for understanding Article Nine's tort claims exclusion. It also briefly describes issues of interpretation raised by the exclusion's statutory language.⁹ Part Two explores reasons for and against including tort claims as collateral within Article Nine's scope. It concludes that, on balance, expanding the Article's

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- A. Section 9-104(k) should be revised to expand the scope of Article Nine to include security interests in claims (other than claims for personal injury) arising out of tort, to the extent that such claims are assignable under applicable non-U.C.C. law.
 - B. The Drafting Committee should consider seriously whether to expand the scope of Article Nine to include security interests in claims for personal injury arising out of tort.
 - C. Article Nine or the official comments should be revised to make clear that Article Nine applies to security interests in rights to payment that derive from claims arising out of tort (e.g., rights to payment under a settlement agreement or a promissory note given to evidence liability in tort).

Id.

⁵ See W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 1 (5th ed. 1984); Kenneth S. Abraham, *What is a Tort Claim? An Interpretation of Contemporary Tort Reform*, 51 MD. L. REV. 172, 203 (1992).

⁶ See generally GEORGE ALEXANDER, COMMERCIAL TORTS (2d ed. 1988); 2 FOWLER V. HARPER ET AL., THE LAW OF TORTS 261-375 (2d ed. 1986) (concerning business torts); 3 *id.* § 17.5 (relating to statutory standards of conduct).

⁷ This metaphor is derived from the writings of Professor Charles W. Wolfram; he wrote that maintenance, champerty, and barratry were "the Macabethian witches of the common law who stirred the cauldron of despised litigation." CHARLES W. WOLFRAM, MODERN LEGAL ETHICS 489 (student ed. 1986).

⁸ The Study Committee indicated that "caution" should be exercised in deciding whether tort claims for personal injury should be brought within Article Nine. See PEB Study Group, *supra* note 4, at 59.

⁹ See *infra* notes 13-31 and accompanying text.

scope to encompass tort claims is a good idea. However, the various concerns associated with transactions in personal tort claims require that consideration be given to amending other parts of the Article's official text and comments.¹⁰ Part Three of this Article evaluates some amendments directed at these concerns.¹¹ The Article concludes that Article Nine should encompass personal as well as nonpersonal tort claims and that additional tort claim-related amendments are not needed. However, it is necessary to reevaluate the Article's exclusion of judgments as collateral. The conclusion also briefly discusses remedies that would be available to creditors secured by tort claims and defenses that may be asserted against them.¹²

I. TORT CLAIMS AND ARTICLE NINE

A "claim" is an assertion of a legal right to something.¹³ The ultimate value of a tort claim employed as collateral resides in the fund which may be obtained to satisfy the secured obligation through liquidation of the claim.¹⁴ The liquidation process can result in "derivative rights" which are property rights that would not exist but for the tort claim.¹⁵

For example, negotiations between the claimant and a tortfeasor may place a value on a tort cause of action and provide the claimant with derivative contractual rights under a settlement agreement with the tortfeasor. As each payment under the agreement becomes due, the tortfeasor delivers a check drawn upon its bank account to the claimant.¹⁶ The claimant thereby becomes a holder of the check with a

¹⁰ See *infra* notes 32-165 and accompanying text.

¹¹ See *infra* notes 166-96 and accompanying text.

¹² See *infra* notes 197-212 and accompanying text.

¹³ MELLINKOFF'S DICTIONARY OF AMERICAN LEGAL USAGE 81 (1992) [hereinafter MELLINKOFF'S DICTIONARY].

¹⁴ A secured party may have its own tort cause of action for impairment of a security interest even if it does not have a security interest in the debtor's tort cause of action. See, e.g., *Baldwin v. Marina City Properties, Inc.*, 145 Cal. Rptr. 406, 410 (Ct. App. 1978). A security agreement which fails to create a security interest in a tort claim because of the tort claim exclusion from Article Nine's scope may be sufficient to create an extra-Code lien. See *Bluxome St. Assocs. v. Woods*, 254 Cal. Rptr. 198, 202 (Ct. App. 1978).

¹⁵ In Article Nine terminology, derivative rights might be thought of as "proceeds" of the original tort claim. See U.C.C. § 9-306(1). However, the definition of proceeds requires amendment to make this result legally certain. See PEB Study Group, *supra* note 4, at 106, 110-11.

¹⁶ "Structured" settlements apportion a loss by stretching out payment over a period of years instead of providing immediate lump-sum compensation to the injured party. See

derivative contractual right to payment of the instrument.¹⁷ If the tortfeasor's bank subsequently pays the instrument, then the claimant acquires the derivative right to withdraw the funds from the claimant's bank account.¹⁸ Other derivative rights include the claimant's rights under a judgment against the tortfeasor,¹⁹ the claimant's rights under its own insurance policy or the tortfeasor's policy,²⁰ and the claimant's rights under an annuity purchased in settlement of a tort claim.²¹

Article Nine's original drafters gave little or no consideration to the use of tort claims as collateral.²² Therefore, it is not surprising that the Article's official text does not sharply delineate its scope with regard to derivative rights. Ambiguity results because the word "claim" used in the Article's exclusion of any "claim arising out of tort" is undefined.²³ It also lacks a precise usage.²⁴ The phrase "arising out of" contributes to

2 WARREN FREEDMAN, RICHARDS ON THE LAW OF INSURANCE § 12:7[d] (6th ed. 1990).

¹⁷ See U.C.C. §§ 3-105(a), 3-414.

¹⁸ *Id.* § 4-215.

¹⁹ Article Nine does not apply to a right represented by a judgment unless the judgment was taken on a right to payment which was itself collateral. See *id.* § 9-104(h). For further discussion of this exclusion, see *infra* text accompanying notes 25-29, 197-202.

²⁰ Article Nine excludes transfers of interests in or claims under insurance policies unless the insurance is payable to a party to the security agreement by reason of loss or damage to collateral. See U.C.C. §§ 9-104(g), 9-306(1). The Study Committee specifically recommends that if Article Nine is amended to encompass security interests in tort claims, then it should also be revised to govern security interests in rights under a third party's insurance policies. See PEB Study Group, *supra* note 4, at 57 n.5. As a matter of insurance law, a tort victim may have rights against the tortfeasor's liability insurer. See generally 8 JOHN A. APPLEMAN & JEAN APPLEMAN, INSURANCE LAW AND PRACTICE § 4831 (1981). More generally, the Study Committee also recommends that consideration be given to expanding the Article's scope to include security interests in most forms of business insurance and at least some forms of personal insurance such as health insurance. See PEB Study Group, *supra* note 4, at 56-57.

²¹ See *Legal Economic Evaluations, Inc. v. Metropolitan Life Ins. Co.*, 39 F.3d 951 (1994) (describing use of annuities in tort settlements). Some nonuniform variations from the Code's official text exclude security interests in contracts for an annuity. See U.C.C., 3 U.L.A. 182-85 (master ed. 1992) [hereinafter UNIFORM LAWS ANNOTATED].

²² See *supra* note 2.

²³ See U.C.C. § 9-105 (containing definitions and index of definitions). The tort claims exclusion is quoted *supra* note 2. A tort claim is personal property that would fall within the scope of Article Nine absent the exclusion. See U.C.C. § 9-102(1) (stating that Article Nine applies to security interests in "personal property"); see generally Weinberg, *supra* note 2.

²⁴ According to *Black's Law Dictionary*, "claim" is a "broad, comprehensive word." BLACK'S LAW DICTIONARY 313 (4th ed. 1951). A more modern definition provides that it is "an assertion of a legal right to something, often in the form of a demand . . . or pleadings . . . , in an almost infinite variety of legal contexts." MELLINKOFF'S DICTIO-

the ambiguity because it does not strictly limit the exclusion to tort causes of action.²⁵ The exclusion might be read broadly to exclude both tort causes of action and all derivative rights.²⁶ Drafting history may support this interpretation.²⁷ Alternatively, the exclusion might be read more narrowly to exclude tort causes of action but not derivative rights.²⁸ Under either reading, the law of assignments would apply to the extent that Article Nine does not.²⁹ Support for both readings may be found in the case law and legal commentary concerning the exclusion.³⁰

NARY, *supra* note 13, at 81. In insurance usage, "claim" signifies a petition or demand made to the party responsible for a loss or to its insurer. RONALD C. HORN, SUBROGATION IN INSURANCE THEORY AND PRACTICE 4 n.4 (1964).

²⁵ U.C.C. § 9-104(k). Another source of ambiguity is the exclusion's reference to a transfer of any tort claim "in whole or in part." *Id.* Perhaps it reflects the possibility that a cause of action might be split, such as where the same tort causes both personal injury and property damage. A minority of jurisdictions permit the splitting of causes of action. See ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES § 3.10(c)(2) (student ed. 1988).

²⁶ U.C.C. § 9-104(k).

²⁷ See *supra* note 2.

²⁸ U.C.C. § 9-104(k). Ambiguity is heightened because Article Nine expressly excludes from its scope several intangible rights which might be derived from a tort claim. Article Nine does not apply to certain rights represented by a judgment and certain transfers of interests in insurance policies. See *supra* notes 19, 20. In addition, U.C.C. § 9-104(l) provides that Article Nine does not apply "to a transfer of an interest in any deposit account . . . except as provided with respect to proceeds . . . and priorities in proceeds . . ." A "deposit account" includes a time or demand account maintained with a bank. See *id.* § 9-105(1)(e). The Study Committee recommends that Article Nine be revised to include deposit accounts within its scope as original collateral. PEB Study Group, *supra* note 4, at 68.

²⁹ See *In re Ore Cargo, Inc.*, 544 F.2d 80, 82 (2d Cir. 1976); *In re Olm Assocs.*, 98 B.R. 271, 274 (Bankr. N.D. Tex. 1989). See generally RESTATEMENT (SECOND) OF CONTRACTS § 316 cmt. a (1981) (providing that rules applicable to assignments of contractual rights may have some application to noncontractual choses in action); *id.* § 342 cmt. a (stating that assignment rules are applicable to assignments as security for an obligation); 1 GILMORE, *supra* note 2, at 316 (stating that drafters intended that the pre-Code common law of assignments would apply to security assignments of tort claims). There also is extra-Code law relating to the assignment of insurance policies. See U.C.C. § 9-104 cmt. 7.

³⁰ Some cases exclude both tort causes of action and derivative rights. See, e.g., *In re Ore Cargo*, 544 F.2d at 81 (concluding that a security agreement could not encumber proceeds from settlement of a tort claim). Other, predominantly more recent cases include some derived rights within the Article's scope. For example, according to some case law, the exclusion does not apply to proceeds of a settlement agreement entered into by the debtor with the defendant on what may have been a tort claim. See *In re Phoenix Marine Corp.*, 20 B.R. 424, 426 (Bankr. E.D. Va. 1982). Some case law also states that the proceeds of the settlement of an insurance claim for damages to the debtor's property may

This Article employs the term "claim" in its broader sense to encompass both tort causes of action and derivative rights.³¹

II. TO EXCLUDE, OR NOT TO EXCLUDE?

If Article Nine's tort claims exclusion is repealed but all else in the Article is unchanged, then the Article would apply to all transactions intended to create security interests in tort causes of action and derivative rights.³² Tort claims could serve as original collateral and as proceeds of other collateral.³³ The only exceptions would consist of derivative rights that are excluded by some other limit upon the Article's scope.³⁴ A security interest in tort claims would be governed by Article Nine's rules with regard to matters such as perfection, priority, and default.³⁵ Like security interests in other types of collateral, a perfected

be encumbered as original collateral under a security agreement. *See In re Bell Fuel Corp.*, 99 B.R. 602, 606 (Bankr. E.D. Pa.), *aff'd sub nom. Meridian Bank v. Bell Fuel Corp.*, 891 F.2d 282 (3d Cir. 1989). These more recent cases were influenced by U.C.C. § 9-306(1)'s specification that insurance payable by reason of loss or damage to the collateral is proceeds. This language was added by the 1972 amendments to Article Nine. *See PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, FINAL REPORT 95 (1971).*

³¹ The author once argued that it is sensible to read Article Nine to exclude derivative rights as well as tort causes of action. Weinberg, *supra* note 2, at 87. The Study Committee believes that Article Nine does not exclude a right to payment that derives from a tort claim. *See* PEB Study Group, *supra* note 4, at 59.

³² The covered transactions would include security interests created by agreements which facially appear to be absolute assignments, but which are actually intended to create security interests. *See* U.C.C. § 9-102(1)(a), (2). Assignments which are absolute in form and which do not secure payment or performance of an obligation would not be within Article Nine's scope. *See id.* § 1-201(37). Thus, absolute assignments of tort claims do not receive treatment comparable to sales of accounts or chattel paper which are within Article Nine's scope. *Id.* § 9-102(1)(b). Presumably, the Study Committee's recommendations would not change this result. PEB Study Group, *supra* note 4, at 43-48 (recommending that sales of general intangibles for the payment of money be included within Article Nine's scope). With the recommended changes, Article Nine would remain substantially irrelevant to statutory liens that might attach to tort claims. *See* U.C.C. §§ 9-102(2), 9-310. For example, some jurisdictions have statutes providing for attorneys' liens on causes of action. *See, e.g., ILL. ANN. STAT. ch. 13, para. 14 (Smith-Hurd 1963 & Supp. 1991).* The Study Committee recommends that serious consideration be given to extending some provisions of Article Nine to extra-Code liens. PEB Study Group, *supra* note 4, at 181.

³³ For example, a creditor might take a security interest in an existing tort claim as "original collateral." *See* U.C.C. § 9-203(1). A tort claim might be encumbered as "proceeds" where original collateral, a motor vehicle, for example, is tortiously injured and the security agreement contains no after-acquired property clause. *See supra* note 15 (concerning proceeds).

³⁴ *See supra* notes 19-21, 28 and accompanying text.

³⁵ *See* U.C.C. Article Nine pts. 3-5.

security interest in a tort claim could be enforced in the debtor's bankruptcy proceeding³⁶ by the secured party with priority over unsecured creditors.³⁷

Is bringing tort claims within Article Nine's scope desirable? To answer this question, it is necessary to consider reasons pro and con.

A. Reasons for Repealing the Exclusion

Repeal of the tort claims exclusion obviously would eliminate the statutory ambiguity described in Part One.³⁸ Many additional reasons for taking this step exist.

1. Many Tort Claims Are Assignable Property Rights

Including tort claims within Article Nine's scope would be entirely consistent with the substantial body of state law permitting the consensual assignment of many types of tort causes of action.³⁹ Assignable claims typically include torts which arise from wrongs to property, real or personal, or which grow out of breach of contract.⁴⁰ Under this body of law, assignable tort claims can be assigned for security purposes.⁴¹

³⁶ Tort causes of action belonging to the debtor at the time the bankruptcy case is commenced become part of the debtor's bankruptcy estate. 11 U.S.C. § 541(a)(1) (Supp. 1992) (stating that property of the bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case"). The Bankruptcy Code extends the definition of property of the estate to include causes of action that are nonassignable as a matter of state law, such as actions for personal injuries. *See, e.g., In re Cottrell*, 876 F.2d 540, 542 (6th Cir. 1989) (upholding bankruptcy court's declaration that plaintiff's personal injury action against a third party was an asset of the bankruptcy estate); *Sierra Switchboard Co. v. Westinghouse Elec. Corp.*, 789 F.2d 705, 709 (9th Cir. 1986) (holding that regardless of whether a personal injury claim is transferable or assignable under state law, such claims become part of the bankruptcy estate). *See generally* 4 WILLIAM M. COLLIER, COLLIER ON BANKRUPTCY ¶ 541.10 (15th ed. 1979). Because tort claims are property of the debtor's bankruptcy estate, unsecured creditors can reach them in the bankruptcy proceeding. However, the debtor may elect limited protection under either state exemption law or exemptions set forth in the Bankruptcy Code itself. 11 U.S.C. § 522(b), (d) (Supp. 1992).

³⁷ Perfected secured creditors can obtain priority over bankruptcy trustees representing unsecured creditors. *See generally* BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 6.01 (rev. ed. 1993).

³⁸ *See supra* text accompanying notes 23-28.

³⁹ *E.g., City of Richmond v. Haynes*, 122 S.E.2d 895, 898 (Va. 1961) (recognizing that many types of tort actions may be consensually assigned).

⁴⁰ *Id.*

⁴¹ *See, e.g., Harvey v. Cleman*, 400 P.2d 87, 89 (Wash. 1965) (implying that the law

Given the complete assignability of these claims, amending Article Nine to permit security interests in them does not seem to be a drastic step. A security interest in a debtor's tort claim, unlike an assignment which is a transfer of ownership, would merely provide a creditor with a limited right to resort to the claim upon the debtor's default under a security agreement.⁴² Procedures outlined in the security agreement and Article Nine would regulate the manner in which a secured creditor could reach its debtor's tort claims.⁴³

2. *Utility to Secured Creditors*

Tort causes of action and derivative rights are not "beyond the pale" insofar as commercial financiers are concerned. Situations exist in which a security interest in tort claims would be very desirable from a secured creditor's perspective. For example, tangible personal property collateral such as a motor vehicle employed to secure an obligation might be damaged by a tortfeasor. In such a case, the resulting tort cause of action and derivative rights represent a substitute form of collateral. They provide a means to recover the value that the original collateral had prior to the tort or to restore the collateral to its original condition.⁴⁴

A tort cause of action and noninsurance derivative rights may be especially important substitute collateral if insurance protecting the collateral is not readily obtainable in the market.⁴⁵ For example, a secured party may take a security interest in a valuable trade secret

of assignments governs the assignment of a tort claim for security, provided the claim is assignable).

⁴² See U.C.C. §§ 1-201(37), 9-202, 9-203(1)(a).

⁴³ See *id.* §§ 9-501 to 9-507.

⁴⁴ That tort claims may be a form of substitute collateral seems to be recognized in Article Two of the U.C.C., which provides secured sellers (but not secured lenders) with a cause of action against third persons who damage collateral. U.C.C. § 2-722. See generally ROBERT HILLMAN ET AL., COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE ¶ 22.05(1)(a) (1985) (arguing for broad definition of proceeds as any economic substitute for collateral); PEB Study Group, *supra* note 4, at 110-11 (explaining how a tort claim can replace the value collateral would have had to the secured party absent the tort and how the tort claim is closely associated with the collateral). Of course, the tort cause of action or the derivative rights may not be a perfect replacement since damages and other relief may not fully compensate the creditor.

⁴⁵ When market insurance is available, secured parties typically look to insurance proceeds as substitute collateral. See U.C.C. § 9-306(1). See generally 14 BRADFORD STONE, WEST'S LEGAL FORMS: COMMERCIAL TRANSACTIONS — DOCUMENTS OF TITLE § 57.2 (2d ed. 1985).

because of its commercial value.⁴⁶ If a third party misappropriates the trade secret, then the debtor may have to resort to its rights to recover damages such as a reasonable royalty for the misappropriator's use or disclosure of the trade secret.⁴⁷ These remedies provide the debtor/trade secret owner with a means to recover the value that the trade secret would have provided the debtor absent the infringement. In general, infringement torts⁴⁸ may be important substitute collateral in the case of security interests in many forms of intellectual property including patents, copyrights, and trademarks.⁴⁹

A secured financier may find it necessary to look to a tort claim as substitute collateral even when insurance can be purchased. This situation might occur, for example, when, unbeknownst to the secured party, an insurance policy lapses because of the debtor's failure to pay a premium. Or it might occur when an effective policy has a substantial gap in coverage because of appreciation of the insured asset, a deductible, or inadequate policy limits.

Tort causes of action and derivative rights also may have value as original collateral. For example, medical care providers that render services on credit may seek security in patients' personal tort claims.⁵⁰ In general, tort claims may represent valuable original collateral from the perspective of creditors after appropriate discounting for the time value of money and for uncertainty and other costs.⁵¹

⁴⁶ See generally DONALD S. CHISUM & MICHAEL A. JACOBS, UNDERSTANDING INTELLECTUAL PROPERTY LAW § 3C[1][d] (1992).

⁴⁷ See *id.* § 3F[2][a].

⁴⁸ Infringement causes of action are torts. See *Carbice Corp. v. American Patents Dev. Corp.*, 283 U.S. 27, 33 (1931) (stating that patent infringement, "whether direct or contributory, is essentially a tort"); RESTATEMENT OF TORTS § 757 (1938) (stating that liability for improper disclosure or use of trade secrets sounds in tort); 2 J. THOMAS MCCARTHY, TRADEMARKS AND UNFAIR COMPETITION § 25:3 (1973) ("[T]rademark infringement and unfair competition are torts.").

⁴⁹ For example, a creditor who employs a debtor's patents or trademarks as collateral typically also takes assignment of the debtor's rights to the proceeds of infringement litigation. See THOMAS S. HEMMENDINGER, HILLMAN ON COMMERCIAL LOAN DOCUMENTATION 318 (4th ed. 1994); Robert S. Bramson, *Intellectual Property as Collateral — Patents, Trade Secrets, Trademarks and Copyrights*, 36 BUS. LAW. 1567, 1599 (1981).

⁵⁰ See *North Carolina Baptist Hosps., Inc. v. Mitchell*, 374 S.E.2d 844, 846 (N.C. 1988).

⁵¹ Costs relevant to the discount would include the risk that enforcement efforts ultimately may fail, the probable future costs of the litigation process, and the risk that the tortfeasor may become insolvent or be uninsured. See Grant Gilmore, *The Assignee of Contract Rights and His Precarious Security*, 74 YALE L.J. 217, 224 (1964) (suggesting that lenders can take steps to reduce their risks and protect their security

3. *Consistency with Article Nine's Mandate*

Nothing inherent in the nature of tort causes of action and derivative rights demands their exclusion from Article Nine. The Article is not merely a "commercial financing" statute. Its mandate is not so narrow. Article Nine is intended to provide a "comprehensive scheme for the regulation of security interests in personal property."⁵² This mandate does not limit the Article to security interests in more common forms of commercial collateral such as inventory, accounts receivable, and equipment.⁵³ For example, the Article also applies to security interests in beneficial interests under wills and trusts.⁵⁴ It has been aptly described as an "octopus" because of its very broad reach.⁵⁵

4. *The Virtues of Public Filing*

Long-standing public policy concerns exist regarding transactions in which a debtor assigns intangibles to a creditor/assignee but remains in control of the assets or situations in which a secured transaction is kept secret.⁵⁶ Filing statutes provide a common and inexpensive means to publicize these transactions.⁵⁷ Thus, public policy argues in favor of including tort causes of action and derivative rights within Article Nine's scope because the Article provides a notice filing system.⁵⁸ The law of assignments applies to secured transactions involving these assets to the extent that Article Nine does not.⁵⁹ Neither common law nor statutory assignment law provides a means to publicize the existence of assign-

interests).

⁵² U.C.C. § 9-101 cmt. 1.

⁵³ See *id.* § 9-102(1)(a) (stating that Article Nine applies to "personal property").

⁵⁴ *Id.* § 9-302(1)(c).

⁵⁵ CLARK, *supra* note 37, ¶¶ 1-13.

⁵⁶ See *Benedict v. Ratner*, 268 U.S. 353, 360 (1925) (holding that an assignment of accounts receivable is invalid if debtor reserves dominion over the accounts receivable inconsistent with the effective disposition of title). See generally Charles W. Mooney, Jr., *The Mystery and Myth of "Ostensible Ownership" and Article Nine Filing: A Critique of Proposals to Extend Filing Requirements to Leases*, 39 ALA. L. REV. 683, 725-36 (1988).

⁵⁷ See generally 1 GILMORE, *supra* note 2, § 8.7 (discussing accounts receivable statutes).

⁵⁸ See U.C.C. §§ 9-401 to 9-408. Arguments based upon these policies are not necessarily overwhelming. Article Nine itself permits some "secret liens." See, e.g., *id.* § 9-302(1)(e) (permitting automatic perfection of security interests in isolated assignments of accounts).

⁵⁹ See *supra* text accompanying notes 29, 39, 41.

ments of tort causes of action and derivative rights comparable to Article Nine's filing system.⁶⁰

5. *Reducing Uncertainty and Complexity*

The uncertainty and complexity that result from the interaction of assignment law and Article Nine also are reasons for bringing security interests in tort claims into Article Nine. For example, consider the plight of the secured creditor in *In re Ore Cargo, Inc.*⁶¹ In order to secure a loan, a bank entered into a general security agreement drafted and filed in conformity with Article 9 of the Uniform Commercial Code. This document created a security interest in the debtor's credits, claims, demands and any other property, rights and interests and gave the bank the rights in the security of a secured party under the Uniform Commercial Code.⁶² The bank contended in the debtor's bankruptcy proceeding that the security agreement encumbered the proceeds from the settlement of a tort claim arising out of a nautical accident involving one of the debtor's ships.⁶³

The Second Circuit Court of Appeals concluded that the security agreement could not encumber these funds.⁶⁴ The court reasoned that an agreement creating the rights of an Article Nine secured creditor cannot bestow a security interest in property which is not within the Article's scope. Unfortunately for the bank, the agreement also was insufficient to reach the tort claim proceeds under the law of assignments.⁶⁵ The lesson is that any creditor wishing to employ a tort claim or derivative rights as collateral must understand that the law of assignments rather than Article Nine may be applicable and must correctly apply assignment doctrine. If the secured transaction involves both collateral within the scope of Article Nine and excluded tort claims, then the creditor must work with both bodies of law.

*In re Monroe County Housing Corp.*⁶⁶ presents another interesting example of the complications created by the relevance of both assignment

⁶⁰ See RESTATEMENT (SECOND) OF CONTRACTS §§ 341 cmt. d, 342 cmt. c (1981) (discussing filing statutes applicable to assignments); cf. 35 U.S.C. § 261 (1992) (authorizing the recording of assignment of interests in patents).

⁶¹ 544 F.2d 80 (2d Cir. 1976).

⁶² *Id.* at 81.

⁶³ *Id.* The bank admitted that it did not know of the tort claim when the agreement with the debtor was executed.

⁶⁴ *In re Ore Cargo*, 544 F.2d at 81.

⁶⁵ *Id.*

⁶⁶ 29 B.R. 686 (Bankr. S.D. Fla. 1983).

doctrine and Article Nine to secured transactions involving tort causes of action or derivative rights. Reduced to its bare operative facts, the case involved a priority dispute between a judgment lien creditor and a secured party. The judgment creditor obtained a writ of garnishment which was served upon a tortfeasor who previously had entered into a settlement agreement with the judgment debtor. One day after the judgment creditor obtained its lien, the secured party filed a financing statement to perfect a security interest in the judgment debtor's rights under the settlement agreement. Apparently the security agreement was entered into prior to the judgment lien, although the opinion is unclear concerning timing.⁶⁷

The court recognized that under Article Nine, the judgment creditor was entitled to priority because it became a lien creditor before the security interest was perfected.⁶⁸ Noting the tort claims exclusion, the court further reasoned that the secured party was precluded from holding a security interest in the settlement agreement.⁶⁹ Unfortunately for the secured party, neither it nor the court recognized that if Article Nine did not apply to the security interest, then the Article's priority rules were irrelevant to the dispute between the secured party and the lien creditor.⁷⁰ Had this been recognized, the secured party might have prevailed under assignment doctrine.⁷¹

B. Reasons for Retaining the Exclusion

1. The Spectre of the Witch's Brew

"Personal" tort claims are claims for wrongs done to the person or reputation or for personal wrongs aside from injury to property or contract.⁷² Transactions in personal tort claims traditionally are problem-

⁶⁷ *Id.* at 687.

⁶⁸ *Id.* at 688; see U.C.C. § 9-301(1)(b).

⁶⁹ *In re Monroe County Hous. Corp.*, 29 B.R. at 688.

⁷⁰ *Id.*

⁷¹ See generally *Neilson Realty Corp. v. Motor Vehicle Indem. Corp.*, 262 N.Y.S.2d 652, 658 (Sup. Ct. 1965) (recognizing that a bona fide common law assignment of proceeds of tort litigation gives priority to the assignee over judgment creditors whose liens attach only to such interest as remains in the judgment debtor); RESTATEMENT (SECOND) OF CONTRACTS § 341 (1981) (stating that the right of an assignee generally is superior to a judicial lien subsequently obtained).

⁷² See, e.g., *Hedlund Mfg. Co. v. Weiser, Stapler & Spivak*, 539 A.2d 357, 358 (Pa. 1988); *City of Richmond v. Hanes*, 122 S.E.2d 895, 898 (Va. 1961). See generally R.D. Hursh, Annotation, *Assignability of Claim for Personal Injury or Death*, 40 A.L.R. 2d 500

atic for policy reasons. They are not assignable in many jurisdictions.⁷³ Other jurisdictions may generally permit the assignment of personal claims but prohibit particular assignments on account of public policy.⁷⁴

In both types of jurisdictions the policy concerns are overlapping and mutually reinforcing. They relate to a "witch's brew" of evils that are collectively so referred to by this Article. The witch's brew includes the possibility that unscrupulous interlopers and litigious persons would purchase personal injury claims and prosecute them in court qua assignees if such transactions were not restricted.⁷⁵ This evil is one of "trafficking" in lawsuits for pain and suffering.⁷⁶ The witch's brew also includes large portions of champerty⁷⁷ and maintenance ("C & M").⁷⁸ Frequent-

(1955).

⁷³ See, e.g., *Hanes*, 122 S.E.2d at 898. The set of nonassignable personal tort causes of action is not the same in all jurisdictions. Some courts, reluctant to extend the prohibition to other torts such as an insurer's refusal to settle, have limited the prohibition against assignment to personal injury claims. E.g., *Mello v. General Ins. Co.*, 525 A.2d 1304, 1305-06 (R.I. 1987) (stating the general prohibition is "salutary," but it should not be applied in a context in which it has no meaning). In other jurisdictions, courts have extended the prohibition to actions founded upon wrongs of a purely personal nature, such as injury to reputation or feelings, or to other causes of action. See *Goodley v. Wank & Wank, Inc.*, 133 Cal. Rptr. 83, 86 (Ct. App. 1976). For example, legal malpractice claims have been held nonassignable because of "the uniquely personal nature of legal services and the contract out of which a highly personal and confidential attorney-client relationship arises, and public policy considerations based thereon." *Id.* at 84-85. However, the opinion that legal malpractice actions are nonassignable is not unanimous. See generally Tom W. Bell, Comment, *Limits on the Privity and Assignment of Legal Malpractice Claims*, 59 U. CHI. L. REV. 1533 (1992).

⁷⁴ *D'Angelo v. Cornell Paperboard Prod. Co.*, 120 N.W.2d 70, 73 (Wis. 1963) (stating that assignment of cause of action for personal injuries is generally permissible in Wisconsin, although a particular assignment may violate public policy against speculation in personal injury claims).

⁷⁵ *Berlinski v. Ovellette*, 325 A.2d 239, 242 (Conn. 1973).

⁷⁶ See, e.g., *Croxton v. Crowley Maritime Corp.*, 758 P.2d 97, 99 (Alaska 1988); *Harleysville Mut. Ins. Co. v. Lea*, 410 P.2d 495, 498 (Ariz. Ct. App. 1966).

⁷⁷ Champerty involves a "bargain by a stranger with a party to a suit, by which such third person undertakes to carry on the litigation at his own cost and risk, in consideration of receiving, if successful, a part of the proceeds . . . sought to be recovered." BLACK'S LAW DICTIONARY 292 (4th ed. 1951). Put another way, champerty is the "purchase of an interest in a thing in dispute, with the object of maintaining and taking part in the litigation." *Id.*

⁷⁸ Maintenance "consists in maintaining, supporting, or promoting the litigation of another." BLACK'S LAW DICTIONARY 292-93 (4th ed. 1951). It is the malicious intermeddling with a suit that does not belong to one, by providing monetary or other assistance to either party to the suit. *Id.* at 1106. Judicial opinions concerned with C & M sometimes also mention barratry which, in criminal law, is the "offense of frequently

ly raised in cases involving transactions in personal tort claims,⁷⁹ these are the evils of excessive litigation or the commercialization of litigation.⁸⁰ Restrictions on assignability also may be justified by other judicial reasoning.⁸¹

The witch's brew of evils reputedly stemming from unbridled transactions in personal tort claims could be associated with transactions in nonpersonal tort claims as well. For example, causes of action for collision damage to automobiles conceivably could be the subject of unsavory trafficking. Similarly, nonpersonal as well as personal claims might be the subject of excessive or commercialized litigation.⁸² Why

exciting and stirring up quarrels and suits." *Id.* at 190.

⁷⁹ E.g., *Caldwell v. Ogden Sea Transp.*, 618 F.2d 1037, 1048 (4th Cir. 1980); *City of Richmond v. Hanes*, 122 S.E.2d 895, 898 (Va. 1961). See generally Susan Lorde Martin, *Syndicated Lawsuits: Illegal Champerty or New Business Opportunity?*, 30 AM. BUS. L.J. 485, 488-89 (1992) (containing a study of a C & M statute and case law).

⁸⁰ Max Radin, *Maintenance by Champerty*, 24 CAL. L. REV. 48, 66 (1935); see also MELLINKOFF'S DICTIONARY, *supra* note 13, at 49 (stating that the essence of the offenses is that they are made punishable in order to discourage litigation).

⁸¹ Some jurisdictions hold that personal injury tort claims do not survive the death of the tort victim and therefore are too "personal" in nature to be assigned. *Berlinski v. Ovellette*, 325 A.2d 239, 241 (Conn. 1973). See generally Weinberg, *supra* note 2, at 50-78 (discussing the equating of assignability with survivability). Concerns about the assignment of tort claims may represent the last vestiges of an ancient hostility towards the assignment of all choses in action. RESTATEMENT (SECOND) OF CONTRACTS § 317 cmt. c (1981) (stating that the historic rule of nonassignability of choses in action remains applicable to some noncontractual choses such as for personal injury). See generally JOHN CALAMARI & JOSEPH PERILLO, THE LAW OF CONTRACTS § 18-2 (3d ed. 1987) (stating that the hostility towards assignments was based upon the personal nature of contracts and the social policy against C & M). An additional reason for restricting transactions in tort claims may exist. The conduct of potential tortfeasors might be influenced if tort claims are freely alienable. The fewer the restrictions on alienability, the greater the chances that an assignee of a tort claim might facilitate a lawsuit that, absent the assignment, would not have been brought or would have been prosecuted with less vigor. A heightened probability of liability imposes increased prevention costs on persons engaged in socially useful but occasionally injurious conduct such as operating a bus line. Cf. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 162-63 (3d ed. 1986) (discussing the relationship between liability rules and activity levels of potential injurers).

⁸² For example, New York has a statute which prohibits champertous transactions involving any "thing in action." N.Y. JUD. LAW § 489 (McKinney 1983). Currently policy debate exists concerning C & M in the context of the syndication of commercial tort claims. See generally Cynthia L. Cooper, *Champerty Anyone? Modern Investors Are Trying to Sell Shares in Lawsuits*, 10 CAL. LAW. 19 (1990) (describing several recent cases of commercial tort claim syndication); Daniel C. Cox, *Lawsuit Syndication: An Investment Opportunity in Legal Grievances*, 35 ST. LOUIS U. L.J. 153 (Fall 1990) (discussing the implications of allowing civil litigants to finance the cost of litigation by offering shares of stock in the outcome).

then is condemnation so frequently focused upon transactions in personal tort claims?

The fundamental ingredient in the witch's brew is the concern that a personal tort claim provides a means for an injured human being to receive damages necessitated by tortious injury to his or her body, mind, or other personal dimensions.⁸³ Depending upon the jurisdiction and the facts, the personal tort victim may legally deserve recovery for out-of-pocket medical or rehabilitation expenses, pain and suffering, mental anguish, permanent disability, lost wages, and so forth.⁸⁴ Without his or her claim, a personal tort victim might have to turn to other persons or the state for assistance. The same fundamental concern for compensating legally entitled personal tort victims explains related rules of law such as restrictions imposed upon the rights of creditors to execute on personal injury claims.⁸⁵ This Article refers to this fundamental concern for human tort victims as "personal compensation policy."

Concerns based upon personal compensation policy and the other evils of the witch's brew are not outcome determinative in all cases involving transactions in personal tort claims. In some situations assignments of these assets are legally acceptable because they facilitate the compensation of personally injured victims or achieve other socially valuable goals and the spectre of the witch's brew is reduced or not present.⁸⁶ For example, assignments of personal tort claims to or from

⁸³ See *Croxton v. Crowley Maritime Corp.*, 758 P.2d 97, 99 (Alaska 1988) (indicating that assignment of personal claim is permissible if the tort victim's beneficial interest is protected).

⁸⁴ See *Nationwide Mut. Ins. Co. v. DeJane*, 326 N.E.2d 701, 704 (Ohio Ct. App. 1974). See generally 2 AMERICAN LAW INSTITUTE, ENTERPRISE RESPONSIBILITY FOR PERSONAL INJURY 161 (1991) [hereinafter ENTERPRISE RESPONSIBILITY].

⁸⁵ See 9 THEODORE EISENBERG ET AL., DEBTOR-CREDITOR LAW ¶137.03[A][6], at 37-52, 37-53 (1991) (stating that compensation of victims is the "driving force" making personal injury claims resistant to execution in many jurisdictions). Federal bankruptcy law historically restricted the personal tort claims that could become part of a bankrupt debtor's estate, thereby leaving the claim with the bankrupt debtor. See THOMAS D. CRANDALL ET AL., THE LAW OF DEBTORS AND CREDITORS 6-55 (1991). It was believed that the "fresh start" goals of the Bankruptcy Act could not be achieved if the trustee was permitted to take over the bankrupt's unliquidated personal tort claims. See *In re Schmelzer*, 480 F.2d 1074, 1077 (1973) (holding that bankrupt's claim for personal injury was not "property" within a statute that vests a bankruptcy trustee with title to property belonging to bankrupt person). However, this restriction no longer exists. The 1978 Bankruptcy Reform Act, 11 U.S.C. §§ 101-1330 (1982 & Supp. 1992), makes personal claims part of the debtor's bankruptcy estate. See *supra* note 36.

⁸⁶ The issue of legality sometimes turns upon the manner in which the assignment transaction is formally structured. For example, the assignment of a personal injury tort

insurers are permitted because they facilitate compensation of the insured.⁸⁷ Subrogation by which an insurer succeeds to the insured's personal tort claim is judicially justified on compensation grounds.⁸⁸ The

claim may be unlawful, whereas an assignment of the proceeds to be recovered in personal injury tort litigation may be lawful. *E.g.*, *Behm's Estate v. Gee*, 213 P.2d 657, 662 (Utah 1950) (stating that the rule sounds anomalous but is supported by precedent). The policies against C & M are considered to pertain in the former case but not in the latter. *In re Musser*, 24 B.R. 913, 921 (Bankr. W.D. Va. 1982) (assignment of proceeds of personal injury claim by patient to hospital providing medical care held valid). There may be something to this dichotomy. In an assignment of proceeds, control of the action or the formulation and consummation of any settlement agreement remains in the hands of the assignor. *Miller v. Liberty Mut. Fire Ins. Co.*, 264 N.Y.S.2d 319, 323 (App. Div. 1965), *aff'd*, 289 N.Y.S.2d 726 (App. Div. 1968). Some courts believe this is a distinction without a difference. In *Harvey v. Cleman*, 400 P.2d 87, 90 (Wash. 1965), the assignments of proceeds by a personal injury tort victim to an attorney and one other person, as security for indebtedness, were held invalid.

⁸⁷ In one such case, the amount received by the minor children of a passenger killed in an automobile collision with a train from the automobile driver's insurer was less than the maximum obtainable in a wrongful death action. *Cullen v. Atchison, T. & S.F. Ry.*, 507 P.2d 353 (Kan. 1973). A loan receipt agreement between the automobile insurer and the guardian for the children stated that the funds received from the insurer were to be repaid only out of any recovery obtained from the railroad pursuant to the children's wrongful death action. The children's guardian further agreed to prosecute the wrongful death claim against the railroad. *Id.* at 360. The railroad argued that the loan receipt agreement constituted an illegal assignment of a tort claim to the automobile insurer because it violated public policies against C & M. The court disagreed. It reasoned that the assignment was lawful because the insurer had a "possible interest" in any wrongful death action brought on behalf of the children. *Id.* By this, the court probably meant that it did not regard the insurer as an officious intermeddler in the suit. The court noted that the "gist of maintenance" is an officious intermeddling in the suit of another. A person "who has an interest in the subject of litigation may properly purchase an additional interest free from a valid charge of maintenance." *Id.* (quoting 14 AM. JUR. 2D. *Champerity and Maintenance* § 9 (1964)). *But see, e.g.*, *Berlinski v. Ovellette*, 325 A.2d 239, 242 (Conn. 1973) (stating that a trust agreement purporting to transfer insured's personal injury cause of action to insurer is void under common law public policy). For further discussion of loan receipts and trust agreements, see *infra* text accompanying notes 122-30.

⁸⁸ For example, a court considering subrogation rights under a medical insurance policy reasoned that these rights serve beneficial social and economic purposes. *Hospital Serv. Corp. v. Pennsylvania Ins. Co.*, 227 A.2d 105, 109-11 (R.I. 1967). In particular, they reduce insurance rates by shifting to wrongdoers the costs occasioned by their negligence. The court distinguished subrogation from assignments of causes of action for personal injuries which are forbidden on the grounds of C & M. *Id.* Subrogation clauses in medical insurance policies also may be distinguishable from other assignment agreements because they prevent the unjust enrichment of an insured who otherwise could be doubly compensated. *Collins v. Blue Cross*, 193 S.E.2d 782, 785 (Va. 1973). For additional discussion of subrogation by insurers, see *infra* text accompanying notes 102-21.

assignment of a personal tort claim in⁸⁹ and out⁹⁰ of insolvency proceedings has been upheld where the end result is to compensate a tort victim, settle litigation, or accomplish some other laudable end. Assignments of generally nonassignable personal tort causes of action are permissible to secure the cost of medical care.⁹¹ Many jurisdictions have

⁸⁹ See *Picadilly, Inc. v. Raikos*, 555 N.E.2d 167, 168 (Ind. Ct. App. 1990). In this case, a client filed a claim against its attorneys, alleging their failure to exercise proper care in defending against a successful dram shop action brought by Colvin. The trial court granted summary judgment for the attorneys. Subsequently, a bankruptcy court confirmed the client's plan of reorganization under Chapter 11. The plan provided that Colvin's claim would be discharged for consideration, including the transfer to Colvin of the client's malpractice claim against the attorneys. *Id.* In the client's appeal of the adverse summary judgment, the attorneys argued both that Colvin was the real party in interest and that the appeal could not be maintained because legal malpractice claims are not assignable. The appellate court acknowledged that the arguments against such assignments generally are persuasive, but determined that they were not applicable to the case before it. *Id.* at 168-69. The court reasoned that it was not confronted with the establishment of a general tort claims market and that the assignee, Colvin, had an intimate connection with the assigned cause of action. In the court's view, the assignment represented an efficient means to realize the value of the claim because the assignee had the resources to bring the suit. The assignment was particularly appropriate because the action originally was brought in the client's name, and the facts were developed through the client's discovery. *Id.* A concurring opinion was concerned that the majority's holding would lead to a practice of defeated defendants routinely assigning legal malpractice claims as a means of avoiding or deferring the payment of judgments against them. *Id.* at 171-72 (Baker, J., concurring).

⁹⁰ See *Desenne v. Jamestown Boat Yard, Inc.*, 968 F.2d 1388, 1391 (1st Cir. 1992) (upholding assignment by plaintiff of personal tort claim against defendant A to defendant B as not champertous when part of a settlement between plaintiff and defendant B).

⁹¹ See *Hernandez v. Suburban Hosp. Ass'n*, 572 A.2d 144 (Md. Ct. Spec. App. 1990). In this case, the court first determined that the assignment of an unliquidated personal injury tort claim for money damages posed neither any danger of C & M nor any other public policy concern. The patient assigned proceeds of the tort claim. The opinion considered but did not adopt the theory that this arrangement is substantively different from the assignment of a tort cause of action. *Id.* at 147-48. Rather, the high cost of health care provided a good reason to enforce the assignment which afforded a measure of protection to both the patient and the hospital. *Id.* at 148. The court reasoned that patients injured by the actions of others often are not in a position to pay for medical care at the time they receive it. Frequently these costs constitute special damages in the patient's eventual action against the tortfeasor. However, under the jurisdiction's law, funds recovered in such an action are not subject to execution by judgment creditors, including health care providers. As a result, if assignment of the tort cause of action were not permitted, the provider might quickly pursue its claim against the patient-tort victim. An enforceable assignment forestalls such action by providing assurance that proceeds

workers' compensation statutes which assign employees' wrongful death claims against third parties to employers.⁹²

Security interests in tort claims, including personal claims, would not necessarily fall victim to condemnation on account of the spectre of the witch's brew. The law of C & M is instructive. Today these doctrines are "vestigial."⁹³ Strangers who, motivated by profit, buy their way into a legal dispute are still the subjects of lingering suspicion.⁹⁴ However, a doctrine of primary purpose may permit the acquisition of an interest in a lawsuit for a business purpose so long as the purpose of suing is incidental.⁹⁵

2. *Fear of Dragnets*

The Study Committee's proposal could further exacerbate concerns about the witch's brew because it may result in a significant increase in the number of transactions involving tort claims. Many security agreements encumber general intangibles.⁹⁶ These provisions could "drag in" tort causes of action and derivative rights if these assets are brought within a revised Article Nine's scope.⁹⁷ This result may benefit secured creditors but provide no commensurate benefit to debtors such as a lower interest rate. Some, perhaps many, creditors and debtors entering into these security agreements may not fully appreciate that they are encumbering existing and future tort claims.⁹⁸ A security interest in general

from the tort claim will be used to defray the cost of medical care. *Id.*

⁹² See, e.g., *Croxtan v. Crowley Maritime Corp.*, 758 P.2d 97, 99 (Alaska 1988) (discussing ALASKA STAT. § 23.30.015(c) (1991)); see also ILL. ANN. STAT. ch. 13, para. 14 (Smith-Hurd 1963 & Supp. 1991) (providing attorneys with liens on causes of action to secure their legal fees).

⁹³ WOLFRAM, *supra* note 7, at 489.

⁹⁴ See *id.* at 490.

⁹⁵ See *id.* at 489, 490 n.56.

⁹⁶ See JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 981 (3d ed. 1988) (noting that the Code categories for collateral contained in many security agreements, such as "general intangibles," are "strong evidence of the parties' actual intentions. . . ." (emphasis in original)).

⁹⁷ See U.C.C. §§ 9-102(1)(a), 9-106. Broadly drafted collateral descriptions are sometimes referred to as "dragnet" clauses. See *In re Eastern Marine Inc.*, 104 B.R. 421, 424 (Bankr. N.D. Fla. 1989). The term is also employed to describe future advance clauses. See CLARK, *supra* note 37, ¶ 10.01[3].

⁹⁸ See *In re Ore Cargo, Inc.*, 544 F.2d 80, 81 (2d Cir. 1976) (refusing to imply a security interest in tort claim on the basis of the general language of a security agreement). An after-acquired property clause is probably necessary to encumber tort claims which arise after the security agreement is signed by the debtor. See *infra* note 188

intangibles which sweeps in tort claims also may be objectionable on the grounds that it "picks the debtor clean." This Article refers to concerns about the potential increase in the number of agreements encumbering tort claims as "dragnet" concerns.

3. *Interference with Reimbursees*

Insurers that have paid policy proceeds or benefits may look for "reimbursement" through their insureds' tort causes of action and derivative rights.⁹⁹ Other persons such as medical care providers also may seek reimbursement from tort claims.¹⁰⁰ All such persons are collectively referred to by this Article as "reimbursement claimants." Reimbursement claimants may object to the Study Committee's proposed inclusion of tort claims within Article Nine's scope if they believe it would impact their existing business practices or take away legal advantages they enjoy under existing law.¹⁰¹ Evaluating this potential

and accompanying text.

⁹⁹ As used in this Article, "reimbursement" means repayment. The term is not used in its narrow suretyship sense of a recovery obtained by a surety from a principal obligor. See RESTATEMENT OF THE LAW OF SURETYSHIP § 18 (restating duty of principal obligor to reimburse secondary obligor).

¹⁰⁰ Medical care providers may obtain contractual assignments of patients' tort claims in return for the provision of medical services. See, e.g., *North Carolina Baptist Hosps., Inc. v. Mitchell*, 374 S.E.2d 844, 847 (N.C. 1988). A statutory right to obtain reimbursement may exist in favor of these persons, see *Ehlers v. Perry*, 494 N.W.2d 325, 331 (Neb. 1993), as may a state law statutory lien on patients' recoveries from tortfeasors, see, e.g., MD. CODE ANN., COM. LAW I §§ 16-601 to 16-605 (1974). See generally Carol A. Crocca, Annotation, *Construction, Operation, and Effect of Statute Giving Hospital Lien Against Recovery from Tortfeasor Causing Patient's Injuries*, 16 A.L.R. 5TH 262 (1993). Currently Article Nine lacks a provision dealing with the priority of nonpossessory liens. See U.C.C. §§ 9-104(c), 9-310. The Study Committee has recommended that consideration be given to the relationship between Article Nine and statutory and common law liens. See PEB Study Group, *supra* note 4, at 181. Other persons also may look to tort claims in order to obtain reimbursement for an expenditure. See generally V. Woerner, Annotation, *Right of One Who Pays Medical or Similar Expenses of Injured Person Under Life Care, or Similar Contract to Recover the Cost Thereof From Tortfeasor*, 78 A.L.R. 2D 822 (1961); H.C. Lind, Annotation, *Right of Recovery by Means of Subrogation or Similar Theory, Against a Third-Person Tortfeasor, of an Employer Who Has Paid Salary, Wages, Sick Leave Pay, Medical Expenses, or the Like, to or for an Injured Employee*, 70 A.L.R. 2D 475 (1960).

¹⁰¹ Insurers have been influential in shaping the scope of Article Nine. See 1 GILMORE, *supra* note 2, at 315 (stating that Article Nine's insurance exclusion in U.C.C. § 9-104(g) was "politically inspired"). Surety companies also were successful in protecting their reimbursement rights during the original drafting of Article Nine. See

objection requires an explanation of the nature of reimbursement rights and their relationship to secured transactions governed by Article Nine. This Article focuses on the reimbursement rights of insurers.

a. Subrogation

Insurers' reimbursement rights frequently are couched in terms of "subrogation." A general definition of subrogation is "[w]hen by law or agreement, a person is required to (and does) discharge a debtor's obligation to a creditor, that person (the *subrogee*) acquires (is *subrogated to*) the rights that the creditor (the *subrogor*) had against the debtor."¹⁰² Similar definitions are employed in insurance and suretyship law.¹⁰³ A subrogee may be viewed as being substituted for the subrogor, or as "standing in the subrogor's shoes." Subrogation developed as an equitable doctrine intended to avoid unjust enrichment.¹⁰⁴ From a remedial standpoint, a subrogee may be entitled to an equitable assignment of a subrogated cause of action,¹⁰⁵ a constructive trust or equitable lien on the proceeds derived from the cause of action, or other forms of relief.¹⁰⁶

An insurer that indemnifies its insured as required by the insurance contract may be permitted to assert the insured's cause of action against the tortfeasor that allegedly caused the insured's loss.¹⁰⁷ The insurer/subrogee would be subject to any defenses that the tortfeasor has against the insured/subrogor.¹⁰⁸ In reality, subrogation proceedings frequently are between the insurers of the tort victim and of the tortfeasor.¹⁰⁹

infra note 158.

¹⁰² MELLINKOFF'S DICTIONARY, *supra* note 13, at 625.

¹⁰³ See *National Shawmut Bank v. New Amsterdam Casualty Co.*, 411 F.2d 843, 844 (1st Cir. 1969) ("The equitable principle is that when one, pursuant to obligation — not a volunteer, fulfills the duties of another, he is entitled to assert the rights of that other against third persons."). See generally RESTATEMENT OF THE LAW OF SURETYSHIP § 23 cmt. a (Tentative Draft No. 2, 1993); HORN, *supra* note 24, at 11-14.

¹⁰⁴ KEETON & WIDISS, *supra* note 25, at 219; see RESTATEMENT OF THE LAW OF SURETYSHIP § 23 cmt. a (Tentative Draft No. 2, 1993).

¹⁰⁵ See RESTATEMENT OF THE LAW OF SURETYSHIP § 23 cmt. a (Tentative Draft No. 2, 1993); HORN, *supra* note 24, at 15.

¹⁰⁶ See *United States Fidelity & Guar. Co. v. First State Bank*, 494 P.2d 1149, 1157 (Kan. 1972); KEETON & WIDISS, *supra* note 25, at 244-46.

¹⁰⁷ KEETON & WIDISS, *supra* note 25, at 219.

¹⁰⁸ ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 462 (1987).

¹⁰⁹ HORN, *supra* note 24, at 14.

An insurer's right of subrogation may be independent of any express provision for subrogation in the insurance contract and thus based entirely upon legal principles ("legal subrogation").¹¹⁰ It also may be provided by express contractual language of assignment ("conventional subrogation").¹¹¹ In some cases it is unclear whether an insurer is relying on legal or conventional subrogation rights.¹¹² Explicit conventional subrogation provisions generally are enforced on account of the freedom of contract policy.¹¹³

Two justifications are most frequently offered in support of the insurer's right to subrogation. First, it avoids the unjust enrichment of the tortfeasor who might otherwise escape damage liability if the insured is compensated for its losses by the insurer.¹¹⁴ This result furthers the economic goal of loss prevention.¹¹⁵ Second, subrogation avoids overcompensation of the insured that otherwise might successfully pursue damages from the tortfeasor after being compensated by the insurer.¹¹⁶

Despite these and other claimed benefits,¹¹⁷ insurance subrogation has its critics. It has been described as a "monolithic and clumsy" approach to

¹¹⁰ KEETON & WIDISS, *supra* note 25, at 220. Legal subrogation is not available for every type of insurance. It is commonly afforded under property or casualty loss insurance where there is a fixed financial loss, but it is less frequently provided under personal insurance such as life and health insurance. See generally 3 APPLEMAN & APPLEMAN, *supra* note 20, § 1675. A right of subrogation also may be provided by federal or state statute. KEETON & WIDISS, *supra* note 25, at 220. Federal statutes providing for subrogation can preempt state anti-subrogation statutes. See *FMC Corp. v. Holliday*, 498 U.S. 52, 65 (1990) (holding that Employee Retirement Income Security Act preempts application of Pennsylvania anti-subrogation law to self-funded employee benefit plans). If the Study Committee's recommendations concerning tort claims are included in the U.C.C. and enacted by the states, then it is possible that someday a clash might occur between a federal subrogee and a secured party claiming rights in the same tort claim.

¹¹¹ KEETON & WIDISS, *supra* note 25, at 220.

¹¹² See HORN, *supra* note 24, at 54. The right of subrogation may be characterized as legal even when the insurance contract provides for conventional subrogation or when subrogation is authorized by statute. See FREEDMAN, *supra* note 16, § 12:6[a]; 16 GEORGE J. COUCH, COUCH ON INSURANCE 2D § 61:20 (rev. ed. 1983).

¹¹³ KEETON & WIDISS, *supra* note 25, at 252.

¹¹⁴ *Id.* at 220.

¹¹⁵ KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 154 (1986).

¹¹⁶ KEETON & WIDISS, *supra* note 25, at 220.

¹¹⁷ See ABRAHAM, *supra* note 115, at 154 (stating that subrogation may help reduce the long-run cost of insurance); HORN, *supra* note 24, at 24-26, 106-07 (stating that subrogation facilitates loss shifting between insurers and entities outside the insurance industry); Roger M. Baron, *Subrogation on Medical Expense Claims: The "Double Recovery" Myth and the Feasibility of Anti-Subrogation Laws*, 96 DICK. L. REV. 581, 581 (1992) (stating that subrogation may facilitate prompt indemnification of the insured).

coordinating the allocation of risk.¹¹⁸ It also has been portrayed as creating a windfall for insurers because subrogation recoveries are not considered in setting insurance rate structures.¹¹⁹ In some jurisdictions, subrogation is prohibited for certain types of insurance by statute or case law.¹²⁰ Subrogation to nonassignable tort claims may or may not be allowed.¹²¹

b. Devices in Aid of Subrogation

Insurance policies often contain express language providing for conventional subrogation.¹²² Insurers may also employ a "loan receipt."¹²³ This device typically provides that the insurer loans funds to the insured to be repaid if, and only to the extent that, the insured obtains a recovery from the tortfeasor. Loan receipts sometimes "pledge" the

¹¹⁸ ABRAHAM, *supra* note 115, at 154. Professor Abraham also points out that in some cases subrogation may impair full indemnity of the insured. *Id.* at 155. He argues that subrogation should not be permitted unless it results in significant cost reduction or loss prevention. *Id.* at 170.

¹¹⁹ Baron, *supra* note 117, at 582. *Contra* HORN, *supra* note 24, at 25, 190.

¹²⁰ ENTERPRISE RESPONSIBILITY, *supra* note 84, at 164 & n.5; *see also* MD. ANN. CODE art. 48A, § 540 (pertaining to no-fault motor vehicle liability insurance); Allstate Ins. Co. v. Druke, 576 P.2d 489, 492 (Ariz. 1978) (holding that subrogation provision in medical insurance policy violates prohibition against assignment of tort claims). Federal statutes providing for subrogation can preempt state anti-subrogation laws. *See supra* note 105.

¹²¹ *See* 16 COUCH, *supra* note 112, § 61:101 & n.16.

¹²² *See* 2 FREEDMAN, *supra* note 16, § 12:6[u] (stating that a right to conventional subrogation may also be expressed in a "subrogation receipt"). Also, compare the Business Auto Coverage Form (1985):

TRANSFER OF RIGHTS OF RECOVERY AGAINST OTHERS TO US

If any person or organization to or for whom we make payment under this Coverage Form has rights to recover damages from another, those rights are transferred to us. That person or organization must do everything necessary to secure our rights and must do nothing after "accident" or "loss" to impair them.

KEETON & WIDISS, *supra* note 25, at 1113, with the Homeowners 4 Contents Broad Form (Ed. Apr. 1984):

Subrogation. An Insured may waive in writing before a loss all rights of recovery against any person. If not waived, we may require an assignment of rights of recovery for a loss to the extent that payment is made by us. If an assignment is sought, an Insured must sign and deliver all related papers and cooperate with us. Subrogation does not apply under Section II to Medical Payments to Others or Damage to Property of Others.

Id. at 1147.

¹²³ JERRY, *supra* note 108, at 478-82.

insured's claim against or recovery from the tortfeasor as security for repayment of the loan.¹²⁴

Frequently, the loan receipt is based upon a legal fiction since the "loan" is actually a payment of policy proceeds.¹²⁵ The fiction is employed because in many jurisdictions an insurer qua subrogee owns the cause of action and is the real party in interest for purposes of instituting a lawsuit. Therefore, the insurer qua subrogee must sue in its own name. Insurers preferring not to appear before a jury may be permitted to avoid real-party-in-interest status by means of a fictitious loan to the insured, in which case the insured remains the owner of the claim and the real

¹²⁴ See Francis I. Kenney Jr., *The Loan Receipt and Its Use by Insurers: Considerations and Suggestions*, 10 FORUM 920, 921-23 (1975). For example, in *City Stores Co. v. Lerner Shops, Inc.*, 410 F.2d 1010, 1011 (D.C. Cir. 1969), the divided court held that the insurer was a real party in interest under the following loan receipt:

RECEIVED FROM Lumberman's Mutual Casualty Company Twenty seven thousand eight hundred ninety and 18/100 — Dollars, as a loan and repayable only to the extent of any net recovery we may make from any person or persons, corporation or corporations, on account of loss by fire to our property on or about September 7, 1963 or from any insurance effected by such person or persons, corporation or corporations.

As security for such repayment, we hereby pledge to said Lumberman's Mutual Casualty Company the said recovery and deliver to it all documents necessary to show our interest in said property, and we agree to enter and prosecute suit against such person or persons, corporation or corporations on account of said claim for said loss, with all due diligence, at the expense and under the exclusive direction and control of said Lumberman's Mutual Casualty Company.

Id. at 1011 n.1 (emphasis added). Not all trust receipts contain language expressly pledging the insured's claim or recovery, as illustrated by this example:

Received from . . . the sum of . . . Dollars not as payment of any claim but as a loan and repayable (without interest) only to the extent of any net recovery the undersigned may make from any person or persons, corporation or corporations, or others, on account of loss by . . . to . . . on or about . . .

As security for such repayment the undersigned hereby agrees with said insurer to enter and prosecute suit against such person or persons, corporation or corporations, or others, on account of said claim for said loss, with all due diligence, at the expense and under the exclusive direction and control of said insurer.

It is admitted and agreed by the undersigned that the amount due the undersigned, by reason of the loss referred to in this agreement, is irrevocably fixed at the amount of the loan designated in this agreement.

It is further agreed that, in the event the undersigned shall recover any amount in excess of . . . Dollars, he shall be entitled to retain such excess, and shall not be required to pay over to said insurer any portion of said excess.

2 FREEDMAN, *supra* note 16, § 12:6[t], at 396 (emphasis added).

¹²⁵ JERRY, *supra* note 108, at 479.

party in interest.¹²⁶ However, occasionally the loan is, in reality, a loan. For example, an insurer with uncertain liability to its insured may be willing to loan funds to the insured secured by any future recovery from the tortfeasor.¹²⁷

"Trust agreements" or "trust receipts" are also employed by insurers in aid of subrogation.¹²⁸ These devices create an express trust requiring the trustee/insured to repay the beneficiary/insurer from any recovery obtained from a tortfeasor.¹²⁹ Like the loan receipt, the purpose of these devices is to keep the insurer from being a real party in interest.¹³⁰

c. Insurers' Subrogation Rights and Article Nine

How would insurers claiming subrogation be affected if the Study Committee's proposal to include tort claims within Article Nine's scope

¹²⁶ See generally V. Woerner, Annotation, *Insurance: Validity and Effect of Loan Receipt or Agreement Between Insured and Insurer for a Loan Repayable to Extent of Insured's Recovery From Another*, 13 A.L.R. 3D 42 (1967).

¹²⁷ JERRY, *supra* note 108, at 479-80. An insurer that makes such a loan must make clear that the tort claim and its proceeds are collateral. See *Arkwright Mut. Ins. Co. v. Bargain City, U.S.A., Inc.*, 373 F.2d 701, 703 (3d Cir.) (holding that insurer did not acquire an equitable lien on the proceeds of a tort claim), *cert. denied*, 389 U.S. 825 (1967).

¹²⁸ 2 FREEDMAN, *supra* note 16, § 12:6[v]; HORN, *supra* note 24, at 77-78.

¹²⁹ For example:

Trust Agreement: In the event of payment to any person under this Part:

(a) the company shall be entitled to the extent of such payment to the proceeds of any settlement or judgment that may result from the exercise of any rights of recovery of such person against any person or organization legally responsible for the bodily injury because of which such payment is made;

(b) such person shall hold in trust for the benefit of the company all rights of recovery which he shall have against such other person or organization because of the damages which are the subject of claim made under this Part;

(c) such person shall do whatever is proper to secure and shall do nothing after loss to prejudice such rights;

(d) if requested in writing by the company, such person shall take, through any representative designated by the company, such action as may be necessary or appropriate to recover such payment as damages from such other person or organization, such action to be taken in the name of such person; in the event of a recovery, the company shall be reimbursed out of such recovery for expenses, costs and attorneys' fees incurred by it in connection therewith;

(e) such person shall execute and deliver to the company such instruments and papers as may be appropriate to secure the rights and obligations of such person and the company established by this provision.

KEETON & WIDISS, *supra* note 25, at 1119 (quoting Family Combination Automobile Form (Rev. Jan. 1, 1963)) (emphasis added).

¹³⁰ 2 FREEDMAN, *supra* note 16, § 12:6[v], at 400.

is ultimately enacted into state law? This question may be broken into two constituent issues. First, would insurers' subrogation rights be treated as Article Nine security interests? If not, then how would their extra-Code rights fare in competition with Article Nine security interests encumbering tort claims?

The answer to the initial issue is that the legal and conventional subrogation rights of insurers generally would not be treated as Article Nine security interests. A persuasive argument supporting this conclusion can be built upon the statutory bedrock of the U.C.C. The building blocks are as follows.

First, extra-Code principles of law and equity supplement the Code unless displaced by its particular provisions.¹³¹ Subrogation doctrine has frequently been employed as a supplement to Article Nine and has not been displaced by the Code.¹³² Second, Article Nine applies to security interests created by consensual agreement.¹³³ Legal subrogation rights are not consensual, as they arise instead by operation of law independent of contract terms.¹³⁴ Therefore, such rights are not within the Article's scope. Third, Article Nine applies to interests that are intended to secure a debtor's obligation.¹³⁵ In most cases, insurers' legal and conventional subrogation rights are not intended to create a security arrangement and do not secure an obligation of the insured.¹³⁶ Rather, the assignment of the insured's tort claim is absolute in nature and comes about because the insurer has honored its obligation under the insurance contract to pay policy proceeds.¹³⁷ The assignment results in the "complete surrender" of the insured's tort claim to the insurer.¹³⁸ That subrogation rights do

¹³¹ U.C.C. § 1-103. See generally HILLMAN ET AL., *supra* note 44, ¶ 1.04[2], at 1-7 (stating that U.C.C. § 1-103 "preserves the evolving body of common law and equitable doctrine").

¹³² See HILLMAN ET AL., *supra* note 44, ¶ 24.01 (discussing priority through subrogation).

¹³³ See U.C.C. §§ 1-201(37), 9-102(1), (2), 9-105(1)(i). The Study Committee's many proposals would not alter this fundamental character of Article Nine.

¹³⁴ See *supra* text accompanying note 105.

¹³⁵ See U.C.C. §§ 1-201(37), 9-102(1), 9-105(1)(i).

¹³⁶ Subrogation rights do not secure the insured's obligation to pay premiums. Failure to pay premiums generally terminates the insurer's obligation to pay policy proceeds. JERRY, *supra* note 108, at 387-88.

¹³⁷ To obtain subrogation, the insurer must make payment to the insured. *Id.* at 465-67.

¹³⁸ See *City Stores Co. v. Lerner Shops, Inc.*, 410 F.2d 1010, 1015 (D.C. Cir. 1969) (holding that an insurer becomes the real party in interest in a lawsuit against a third party when the insurer's liability is absolute and the insurer settles a claim by the loan receipt method).

not secure insurers is also indicated by the rule in many jurisdictions that the insured is reimbursed first out of any recovery from the tort claim for losses not covered by insurance before the insurer obtains any reimbursement.¹³⁹

Loan and trust receipts sometimes muddy the waters by disguising an absolute transfer of a tort claim as a security arrangement. Thus, it may seem that an insurer employing one of these devices is subject to a risk that it will be hoist by its own petard and have its rights judicially assimilated to an Article Nine secured party's.¹⁴⁰ This result would be clearly incorrect. Under Article Nine, substance controls form.¹⁴¹ The reality is that these devices in aid of subrogation merely provide a means, sanctioned in some but not all jurisdictions, for an insurer to use an insured's name as a party plaintiff in litigation controlled by the insurer.¹⁴²

Despite the conclusion that subrogation rights are generally not security interests, an insurer may be properly concerned about having to comply with a revised Article Nine if it in fact makes a loan to the insured because the insurer's liability under the policy is uncertain or for some other reason. If the loan is contractually secured by the insured's tort claim,¹⁴³ then the insurer would be subject to the Article Nine revision encompassing tort claims as collateral. The transaction would have to comply with the Article to create an enforceable and perfected security interest because the insurer and the insured have entered into an

¹³⁹ This result sometimes may be altered by agreement. See KEETON & WIDISS, *supra* note 25, § 3.10(b)(1) (explaining alternative approaches of allocating recoveries when an insurer has a subrogation interest).

¹⁴⁰ Loan receipts may contain a "pledge" of the insured's tort claim. See *supra* text accompanying notes 122-25. An insurer's trust receipt might be improperly likened to the security device of the same name. See U.C.C. § 9-102(2) (providing that Article Nine applies to "trust receipts" that are security devices). See generally 1 GILMORE, *supra* note 2, § 4.2 (discussing trust receipts).

¹⁴¹ See U.C.C. § 9-102(1)(a) (providing that Article Nine applies to transactions intended to create security interests). See generally CLARK, *supra* note 37, ¶ 1.03[1], at 1-14 (stating that the "key" to coverage by Article Nine is an intent to create a security interest).

¹⁴² See *City Stores Co.*, 410 F.2d at 1015 (stating that an insurer cannot avoid becoming a real party in interest through a "sham loan agreement"). These devices are used for other nonsecurity reasons as well. For example, they are employed to establish conventional subrogation when the insurance contract is silent on the matter. See generally HORN, *supra* note 24, at 84-87.

¹⁴³ This situation occasionally occurs. See *supra* text accompanying note 126.

agreement creating a security interest in a tort claim.¹⁴⁴ This requirement is appropriate.

Having concluded that insurers' subrogation rights generally would not be treated as Article Nine security interests, it is possible to consider the second issue constituent in the question of how insurers would be affected if an Article Nine amended to encompass security interests in tort claims were enacted into state law. The question is, what priority rules apply to these insurers? In particular, how would their extra-Code rights fare in competition with an Article Nine security interest encumbering tort claims?¹⁴⁵ Here, case law is informative.¹⁴⁶

d. The "National Shawmut Bank Line".

Article Nine's historic failure to encompass tort claims as collateral naturally resulted in a lack of case law dealing with the interaction of insurers' subrogation rights and security interests in tort claims. The brightest judicial illumination available for these potential conflicts is provided by a long line of cases dealing with Article Nine and the subrogation rights of construction sureties. The leading opinion is *National Shawmut Bank v. New Amsterdam Casualty Co.*¹⁴⁷

In *National Shawmut Bank*, a general contractor entered into construction contracts with the United States and applied to a surety for

¹⁴⁴ Perhaps insurers would welcome the relative legal certainty afforded by compliance with Article Nine. *Cf. Arkwright Mut. Ins. Co. v. Bargain City, U.S.A., Inc.*, 373 F.2d 701, 703 (3d Cir.) (holding that insurer did not acquire an equitable lien on the proceeds of a tort claim), *cert. denied*, 389 U.S. 825 (1967).

¹⁴⁵ The priority issue of insurers versus secured party does not actually arise unless the insured/debtor is in default under the security agreement. *See* U.C.C. § 9-501(1).

¹⁴⁶ Article Nine contains a rule stating that security interests are effective according to their terms against purchasers of the collateral and creditors. U.C.C. § 9-201. It also contains rules governing competition between some extra-Code rights and security interests, *see, e.g., id.* § 9-310 (governing priority between security interests and possessory liens), and provides that the debtor's rights in collateral may be voluntarily or involuntarily transferred. *See id.* § 9-311. However, the Article contains no provision explicitly addressing the priority of subrogation claims. No such provision is recommended by the Study Committee. The case law discussed in the text is not the only conceivable approach for resolving priority between a secured party and an insurance subrogee. Commercial law and assignment principles also might be applied. *See* Steven L. Harris, *Using Fundamental Principles of Commercial Law to Decide UCC Cases*, 26 LOY. L.A. L. REV. 637 (1993); *supra* note 71.

¹⁴⁷ 411 F.2d 843 (1st Cir. 1969). The court applied the Code as enacted in Massachusetts. *Id.* at 847. Differences between this statute and the current official text of the Code are noted as necessary for clarity and accuracy.

payment and performance bonds.¹⁴⁸ The application for the bonds contained an assignment to the surety "of earned monies that may be due or become due under said contract."¹⁴⁹ This assignment was not perfected under Article Nine. Subsequent to posting the bonds, the contractor obtained credit from a bank. For collateral, the bank obtained a perfected Article Nine security interest in the contractor's present and subsequently acquired funds from the United States.¹⁵⁰

After the contractor defaulted, the surety completed the work pursuant to its bond obligations. Both the surety and the bank sought to satisfy their respective claims from earned progress payments. The First Circuit viewed the critical issue as whether the doctrine of subrogation survived the enactment of Article Nine.¹⁵¹

Much of the court's reasoning is similar to this Article's analysis of whether insurers' subrogation rights would be security interests under an Article Nine revised to encompass tort claims.¹⁵² The court concluded,

¹⁴⁸ These bonds were required by the Miller Act governing federal construction projects. See 40 U.S.C. § 270(a) (1988).

¹⁴⁹ *National Shawmut Bank*, 411 F.2d at 844.

¹⁵⁰ *Id.* Notice of the assignment was given by the bank to the United States as required by the Assignment of Claims Act, 31 U.S.C. § 203 (1964) (current version at 31 U.S.C. § 3727 (1988)). However, no written notice was given to the surety as also required by the act. The First Circuit found it unnecessary to decide the effect of this failure. *National Shawmut Bank*, 411 F.2d at 844.

¹⁵¹ *National Shawmut Bank*, 411 F.2d at 844.

¹⁵² See *supra* text accompanying notes 131-39. The court reasoned as follows. First, subrogation is based upon extra-Code legal principles that supplement Article Nine's provisions and are not displaced by the Article. *National Shawmut Bank*, 411 F.2d at 845. Second, subrogation rights do not constitute an interest in personal property securing payment or performance of an obligation. *Id.* Rather than an interest in personalty, the surety's security is its opportunity upon the contractor's default to finish the job and apply any available funds against its cost of completion. The surety's right to minimize its loss by finishing the job is not the kind of independently valuable personalty which falls within a statute applying to transactions intended to create a security interest. Nor are the surety's rights the same as the interest of a buyer of accounts or contract rights which are also encompassed in the definition of security interest under Massachusetts law. (An "account" is a nonnegotiable right to payment for goods sold or leased, or services rendered, and a "contract right" is any nonnegotiable contractual right to payment not yet earned by performance.) *Id.* at 846. No account exists because when the contractor defaults, no right to payment exists. A contract right is a right to receive payments from one who continues with the performance rather than a right conditioned on performance by the transferee of the right, the surety. See *id.* (Contract rights are no longer a separate class of Article Nine collateral. See U.C.C. § 9-106. See generally UNIFORM LAWS ANNOTATED, *supra* note 21, at 20-21.) Third, Article Nine applies to security interests created by contract. *National Shawmut Bank*, 411 F.2d at 846. The surety's rights arise by virtue of its status independent of any express contractual terms. These rights may

"[E]quitable subrogation is too hardy a plant to be uprooted by a Code which speaks around but not to the issue."¹⁵³

National Shawmut Bank and its many progeny generally are read as holding that conflicts between construction sureties and secured parties fall entirely outside of Article Nine and that subrogating sureties prevail in that environment.¹⁵⁴ Sureties prevail in cases involving private construction contracts as well as those, like *National Shawmut Bank*, containing federal or state statutory bonding requirements.¹⁵⁵ Sureties prevail even when the secured party's perfected security interest is prior in time to the suretyship contract or to the surety's payment which triggers its subrogation rights.¹⁵⁶ Multiple rationales for favoring

grow out of a contractual setting and be articulated by a contract. However, they are created by law to avoid injustice. *Id.* at 847.

¹⁵³ *National Shawmut Bank*, 411 F.2d at 849.

¹⁵⁴ See CLARK, *supra* note 37, ¶ 1.07; HILLMAN ET AL., *supra* note 44, ¶ 24.01[2][a][ii]; WHITE & SUMMERS, *supra* note 96, at § 21-6. However, some reasoning in *National Shawmut Bank* may suggest that the subrogation rights of a construction surety supplement Article Nine and must be accommodated within the Article's sphere. Drafting history may also support this conclusion. See Edward A. Dauer, *Government Contractors, Commercial Banks, and Miller Act Bond Sureties — A Question of Priorities*, 14 B.C. INDUS. & COM. L. REV. 943, 970 & n.143 (1973). The *National Shawmut Bank* line has not been without critics. See *id.* at 943, 966-71. See generally Benjamin Geva, *Bonded Construction Contracts: What Are a Surety's Rights to Withhold Funds?*, 3 CORP. L. REV. 50 (1980); John C. Tecklenburg II, Comment, *Equitable Subrogation — Too Hardy a Plant to be Uprooted by Article 9 of the UCC?*, 32 U. PITT. L. REV. 580 (1970-1971).

¹⁵⁵ See, e.g., *Framingham Trust Co. v. Gould-Nat'l Batteries, Inc.*, 427 F.2d 856, 858-59 (1st Cir. 1970) (stating that the propositions enunciated in *National Shawmut Bank* are not confined to cases where the United States is the owner).

¹⁵⁶ The following are some of the analytic threads running through the *National Shawmut Bank* line. First, the funds in dispute never become the debtor's property because of the surety relationship, and therefore the security interest cannot attach to them. See, e.g., *Centex-Simpson Constr. Co. v. Fidelity & Deposit Co.*, 795 F. Supp. 35, 41 (D. Me. 1992). Second, timing is irrelevant to an analysis of the surety's rights under the doctrine of equitable subrogation. See, e.g., *In re Ward Land Clearing & Drainage, Inc.*, 73 B.R. 313, 315 (Bankr. N.D. Fla. 1987). Third, a construction surety's rights relate back to the time of the suretyship contract. See, e.g., *United States Fidelity & Guar. Co. v. First State Bank*, 494 P.2d 1149, 1157 (Kan. 1972). Fourth, the surety's priority is justified on the grounds that secured financiers such as banks either are or should be aware that payments due the debtor on account of a construction contract may be subject to subrogation rights. See, e.g., *Mid-Continent Casualty Co. v. First Nat'l Bank & Trust Co.*, 531 P.2d 1370, 1376 (Okla. 1975). Fifth, the surety prevails under subrogation principles unless its claim is grounded "solely" upon an express assignment, in which case its priority is governed by Article Nine. See, e.g., *Alaska State Bank v. General Ins. Co.*, 579 P.2d 1362, 1371-72 (Alaska 1978). Sixth, a surety's assignment is contingent upon the surety's payment in the event the debtor defaults, which distinguishes its rights from those of an Article Nine

sureties are advanced in the case law, many of which could be extended to a subrogating insurer seeking reimbursement from a tort cause of action or derivative rights also claimed by a secured party under a revised Article Nine. For example, timing arguably is irrelevant to an analysis of the surety's subrogation rights, and the surety's priority is justified because secured financiers should be aware that tort claims may be subject to subrogation.¹⁵⁷

Of course, only the rights of construction sureties were before the First Circuit in *National Shawmut Bank*. It is arguable that the opinion provides little or no authority for the proposition that subrogating insurers should prevail in competition with Article Nine security interests in tort claims. *National Shawmut Bank*'s precedential value on this issue also is arguably weak because of statements by the First Circuit concerning the nature of construction sureties and their subrogation rights.¹⁵⁸ The court reasoned that the surety enjoys a "unique" cluster of subrogation rights when it pays the outstanding bills of the construction job and completes

secured creditor. See, e.g., *Transamerica Ins. Co. v. Barnett Bank, N.A.*, 540 So. 2d 113, 116 (Fla. 1989). Seventh, priority for the surety is justified because the interests of all concerned with a construction project are best served by the surety's prompt performance. See, e.g., *id.* Eighth, the purposes of Article Nine's filing requirements are not served by holding that subrogation rights are security interests. *J.V. Gleason Co. v. Aetna Casualty & Sur. Co.*, 452 F.2d 1219, 1222-23 (8th Cir. 1971) (involving priority contest between construction surety and bankruptcy trustee).

¹⁵⁷ See *supra* note 156.

¹⁵⁸ The *National Shawmut Bank* court also supported its holding with arguments that are not specifically applicable to subrogating insurers or other reimbursement claimants. An important prong in the court's reasoning was the historic fact of the Code drafters' rejection of a proposed U.C.C. § 9-312(7) which would have subordinated construction sureties to the rights of secured lenders. The court viewed this as demonstrating that the construction sureties "had won the battle to defend the preserve of subrogation." *National Shawmut Bank v. New Amsterdam Casualty Co.*, 411 F.2d 843, 846 (1st Cir. 1969). See generally Dauer, *supra* note 154, at 968-69 (discussing the rise and fall of proposed U.C.C. § 9-312(7)). Post-*National Shawmut Bank* cases dealing with disputes between secured parties and sureties have employed this reasoning. See, e.g., *United States Fidelity & Guar. Co. v. United Penn Bank*, 524 A.2d 958, 964 (Pa. Super. Ct. 1987). Also important to the *National Shawmut Bank* court was a substantial body of precedent which it viewed as upholding the right of a competing surety to earned but unpaid progress payments. *National Shawmut Bank*, 411 F.2d at 847-48. Some of the additional reasoning in *National Shawmut Bank* is more relevant to insurance subrogation. For example, the court relied upon a prior holding that "[n]o provision of the U.C.C. purports to affect the fundamental equitable doctrine of subrogation." *Id.* at 847 (quoting *French Lumber Co., Inc. v. Commercial Realty & Fin. Co.*, 195 N.E.2d 507, 510 (Mass. 1964)). This precedent involved a priority contest between two creditors, neither of which was a construction surety. See HILLMAN ET AL., *supra* note 44, ¶ 24.01[1] (discussing priority through subrogation).

the job.¹⁵⁹ These rights, it stated, are instrumental in the surety's business, which also is unique. According to the opinion, it is not a business of "ordinary" insurance because the surety's risk is not actuarially linked to premiums and the risks are not pooled.¹⁶⁰

These statements to the contrary notwithstanding, *National Shawmut Bank* supports the conclusion that insurers' reimbursement rights would prevail over security interests in tort claims. In portraying the construction surety as unique, the First Circuit was emphasizing the strength of the surety's equities relative to the bank's.¹⁶¹ The subrogation rights of insurers possess their own strong equities, enjoy a long history, and are widely recognized in many jurisdictions as being supported by sound policy.¹⁶² Construction suretyship principles like those considered in *National Shawmut Bank* are integral to insurance theory and practice, particularly where subrogation is concerned.¹⁶³

¹⁵⁹ *National Shawmut Bank*, 411 F.2d at 845 (stating that the surety "stands in the shoes of the contractor insofar as there are receivables due it; in the shoes of laborers and material men who have been paid by the surety — who may have had liens; and, not least, in the shoes of the government for whom the job was completed").

¹⁶⁰ *Id.* The First Circuit also pointed out that the construction surety's business is not one of "ordinary" financing either. The court reasoned that an ordinary financier such as a bank faces specific requests for funds which it links to suitable collateral. Subsequent requests are determined by an assessment of the debtor's then current management and available additional security. In case of default, the bank takes its security. On the other hand, a construction surety extends credit to the project owner as the ultimate guarantee of the job, hoping this credit will never be drawn upon. The surety's collateral is its confidence in the contractor and the opportunity to prevent or minimize its ultimate loss by its own performance. If the surety's confidence in the contractor is misplaced, then it receives very little from the contractor but the right to complete the job. In case of default, the surety must go ahead and perform. *Id.*

¹⁶¹ *See id.* at 845 (citing *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 140 (1962), a case awarding priority in retained funds to a surety over a bankruptcy trustee in which the Supreme Court noted that the equities of construction sureties are "deeply imbedded" in our commercial practices). The *National Shawmut Bank* line of cases indicates that construction sureties trump other claimants because construction bonds protect material providers and other persons responsible for the physical completion of construction projects and that the surety's role is essential to the economy. *See, e.g., United States Fidelity & Guar. Co. v. First State Bank*, 494 P.2d 1149, 1154 (Kan. 1972) (stating that the completion of construction contracts is vital to the economy); *Canter v. Schlager*, 267 N.E.2d 492, 496 (Mass. 1971) (suggesting that subcontractors rely on payment bonds).

¹⁶² *See HORN, supra* note 24, at 15-17.

¹⁶³ *HORN, supra* note 24, at 223. In his discussion of corporate suretyship, the author of this treatise stated that "the doctrine of subrogation is common to both bonds and contracts of insurance and constitutes a conceptual meeting ground for the two mechanisms." *Id.* at 242-43. Because of their similar purposes, textual discussions of subrogation by sureties and insurers may be intertwined. *See* 16 COUCH, *supra* note 112,

C. Towards a Balance

The reasons for including tort causes of action and derivative rights within Article Nine's scope are persuasive. Article Nine and the *National Shawmut Bank* line of cases provide insurers and others with a robust argument that their reimbursement rights should not be affected by the inclusion of tort claims within the Article's scope except in a minority of cases where these rights are actually security interests that should be subject to a revised Article Nine.¹⁶⁴ However, concerns stemming from the spectre of the witch's brew and the fear of dragnets seemingly have merit. Failure by Article Nine's revisers to carefully consider these concerns and draft accordingly could result in a revised official text that does not contain the "best" solutions to commercial law issues, that is less likely to be enacted, or that may be enacted with nonuniform language concerning tort claims.¹⁶⁵ Yet, it seems undesirable to load a

§§ 61:18, 61:306 - :322. Construction suretyship has been described as a type of insurance. *E.g.*, *J.V. Gleason Co. v. Aetna Casualty & Sur. Co.*, 452 F.2d 1219, 1223-24 (8th Cir. 1971) (involving priority contest between construction surety and bankruptcy trustee).

¹⁶⁴ Read together, Article Nine's text and the *National Shawmut Bank* line strongly suggest that most insurers' subrogation rights would not constitute security interests and that these extra-Code rights would trump security interests in tort claims if Article Nine were revised to permit them. *See supra* text accompanying notes 131-63. Although, in the author's opinion, it is not necessary to do so, it would be possible to amend Article Nine to address these issues. For example, consideration might be given to amending U.C.C. § 9-104 to provide that the Article does not apply to transfers by subrogation. This amendment would make clear that a subrogating insurer (or other reimbursement claimant employing a subrogation theory) does not have to comply with Article Nine. It would not expressly address the question of a subrogating insurer's priority against security interests, but perhaps it would do so by implication if it is read as broadly codifying the *National Shawmut Bank* line. Sometimes insurers enter into transactions that would create Article Nine secured transactions in tort claims if the Article were amended to permit them. As previously indicated, the author believes that in these cases insurers should comply with Article Nine, including filing a financing statement to perfect their security interests. *See supra* text accompanying notes 143-44. However, the Article could be amended to provide for automatic perfection without filing for security interests created in tort claims by insurers. *Cf.* U.C.C. § 9-302(1) (providing various automatic perfection rules). Of course, an automatically perfected security interest can be defeated in a priority dispute with another secured party. *See* U.C.C. § 9-312(5) (stating that competing security interests rank in order of filing or perfection). Therefore, maximal protection for insurers would require a special priority rule. *Cf. id.* § 9-312(2) (providing a special priority for current crop production loans). Some reimbursement claimants may not rely on subrogation theory. Their rights might also be reflected in amendments to the official text of Article Nine. *See supra* note 100.

¹⁶⁵ *See generally* Kathleen Patchel, *Interest Group Politics, Federalism, and the*

revised Article with extensive provisions governing security interests in tort claims in order to address concerns which may vary in merit and intensity from jurisdiction to jurisdiction. Where lies the balance?

The next part of this Article considers possible amendments to Article Nine specifically addressing the spectre of the witch's brew and the fear of dragnets. This discussion should help make it possible to gauge the extent and complexity of amendments necessary to address these concerns and to reach a final conclusion concerning what amendments are desirable in bringing tort claims into the Article's scope.

III. REVISING ARTICLE NINE

Tort claims should be included within the scope of a revised Article Nine. Nonetheless, while the Article's current broad exclusion should be repealed, a case for a limited exclusion of personal tort claims may still exist.¹⁶⁶

Personal claims are never proceeds of original collateral within Article Nine's scope.¹⁶⁷ Therefore, the argument that personal tort claims should be included under a revised Article because they are a substitute for tortiously damaged collateral can simply not be made.¹⁶⁸ An exclusion of personal tort claims would answer many of the objections that might be raised against including tort claims in a revised Article Nine. For example, if personal tort claims were excluded, then objections to the revision by reimbursees such as insurers would fall away to the extent they seek reimbursement from personal claims. Also reduced, possibly substantially, would be objections based upon the spectre of the witch's brew and dragnet concerns.¹⁶⁹ Thus, the question of whether to exclude personal tort claims is a threshold issue.

Uniform Law Process: Some Lessons from the Uniform Commercial Code, 78 MINN. L. REV. 83 (1993) (arguing that the process of making uniform law should be highly representative).

¹⁶⁶ This possibility was recognized by the Study Committee. See PEB Study Group, *supra* note 4.

¹⁶⁷ Presumably a creditor cannot take or enforce a security interest in a human being. See U.C.C. § 9-102 (stating that Article Nine applies to security interests in "personal property"); see also U.S. CONST. amend. XIII (abolishing slavery). *But see* SPANOGLE ET AL., CONSUMER LAW: CASES AND MATERIALS 586-87 (2d ed. 1991) (considering incarceration as a debt collection tool).

¹⁶⁸ See *supra* text accompanying notes 44-50.

¹⁶⁹ Objections against including non-personal tort claims within the Article's scope could still be made.

A. Whether to Exclude Personal Tort Claims Only

It would be easy to amend the existing broad exclusion of all tort claims contained in section 9-104(k) of the Code so that it becomes a limited exclusion of personal tort claims only.¹⁷⁰ Using the convention that additional words are underlined, the amended exclusion would read as follows: "This Article does not apply . . . to a transfer in whole or in part of any claim arising out of personal tort . . ." The term "personal tort" has a sufficiently certain yet flexible meaning so that it is appropriate to employ it in a uniform law without definition.¹⁷¹ Whether a particular tort claim is personal in nature would be governed by the extra-Code law of each enacting jurisdiction. The phrase "arising out of" and the term "claim" continue the ambiguity currently residing in the official text's exclusion of all tort claims.¹⁷² Retaining this ambiguity seems desirable because it would provide the opportunity for a court to uphold a security interest in a derivative right arising out of a personal tort cause of action, such as a right to payment pursuant to a settlement agreement between a tort victim and a tortfeasor, even though the cause of action itself would not fall within the Article's scope.¹⁷³

The case for this limited exclusion is far from open and shut. Including personal tort claims as collateral within the scope of Article Nine would not be the equivalent of a pronouncement from The American Law Institute and The National Conference of Commissioners on Uniform State Laws that tort causes of action and derivative rights should be employed as collateral under all circumstances and for all purposes, all nonuniform state law and policy to the contrary notwithstanding.¹⁷⁴ A jurisdiction that repeals Article Nine's

¹⁷⁰ See *supra* note 2. Other ways to address concerns regarding personal tort claims exist. One way would be to add statutory language or official commentary to the revised Article Nine in order to make clear that repeal of the general tort claims exclusion is not intended to affect state laws restricting the alienability of tort claims. Cf., e.g., U.C.C. § 2-306(2) (providing reference to possibility that an exclusive dealing contract might be unlawful under antitrust laws); *id.* § 9-201 & cmt. (providing references to statutes or regulations governing credit transactions); *id.* § 9-206(1) (containing references to consumer protection statutes or case law). See also, e.g., *id.* § 9-102 (providing note to adopting legislatures).

¹⁷¹ See *supra* text accompanying notes 39-41, 71-72. The original Restatement of Contracts provided that an assignment of a claim for damages "the gist of which is to the person rather than to property" is illegal. RESTATEMENT OF THE LAW OF CONTRACTS § 547(1)(d) (1932). Commentary indicated that damages for injuries including assault, libel, slander, and breach of promise to marry are personal in nature. See *id.* cmt. e.

¹⁷² See *supra* text accompanying notes 23-25.

¹⁷³ See *supra* text accompanying notes 25-28. To help insure this result, the exclusion might be worded to recognize an exception for the proceeds of personal tort claims. Cf. U.C.C. §§ 9-104(g), (l); 9-306.

¹⁷⁴ Cf. PEB Study Group, *supra* note 4, at 178-80 (recommending consideration be

current broad tort claim exclusion would not by implication repeal extra-Code law and policy restricting transactions in tort claims.¹⁷⁵ Secured transactions involving tort causes of action and derivative rights would continue to be subject to restriction or invalidation to the extent they are inconsistent with extra-Code legal principles.¹⁷⁶

The wisdom of excluding personal tort claims from a revised Article Nine also is questionable when one recalls that in some jurisdictions derivative rights may fall within Article Nine's scope even if tort causes of action do not.¹⁷⁷ Even in jurisdictions where both tort causes of action and derivative rights are excluded, creditors may be permitted to employ assignment law to encumber these assets.¹⁷⁸ It also is difficult to see why secured creditors should not be permitted to take Article Nine security interests in personal tort claims when unsecured creditors can participate in the proceeds of a bankrupt debtor's personal tort claims.¹⁷⁹

Nor would an exclusion of personal tort claims only prevent financiers from taking security interests that directly contravene personal compensation policy. A revised Article Nine, like the existing Article, would not preclude secured parties and debtors/tort victims from encumbering means to cure or rehabilitation such as wheel chairs, artificial limbs, or medicine.¹⁸⁰ Even Tiny Tim's crutches are fair game insofar as the Code is concerned.¹⁸¹ The policy of permitting debtors the contractual freedom to create security

given to amending Article Nine to permit a secured party to take a security interest in otherwise nonassignable rights of the debtor in certain contracts or permits).

¹⁷⁵ Article Nine generally is not intended to validate practices which are illegal under extra-Code statutory or regulatory law. See U.C.C. §§ 9-201, 9-203(4). Legal principles relative to an "invalidating cause" supplement Article Nine unless displaced by its particular provisions. See *id.* § 1-103. It has been held that extra-Code law may preclude the use as collateral of some types of general intangibles within Article Nine's scope. Liquor licenses are an example. They may not be employed as collateral in some jurisdictions because of public policies favoring moderation in the consumption of alcoholic beverages. See *In re Eagles Nest, Inc.*, 57 B.R. 337 (Bankr. N.D. Ind. 1986) (holding liquor licenses unusable as collateral). See generally CLARK, *supra* note 37, ¶ 1.03[2], at 1-18 to 1-21. The intent to not repeal extra-Code law could be expressed in amendments to Article Nine. See *supra* note 170.

¹⁷⁶ Principles of unconscionability originating outside Article Nine have been employed to invalidate security interests. See HILLMAN ET AL., *supra* note 44, ¶ 19.02[2] (Supp. 1992).

¹⁷⁷ See *supra* text accompanying notes 28-30.

¹⁷⁸ See *supra* text accompanying note 29.

¹⁷⁹ See *supra* notes 36, 37.

¹⁸⁰ See U.C.C. § 9-102 (stating that Article Nine applies to goods); *id.* § 9-109 (defining "consumer goods").

¹⁸¹ There are extra-Code state and federal restrictions on the use of security interests in consumer goods. See CRANDALL, *supra* note 85, at 3-19 to 3-22. None are specifically based upon personal compensation policy.

interests in assets of their choice supports such security interests and cuts against excluding personal tort claims from the revised Article.¹⁸²

B. Addressing Dragnet Concerns

One dragnet concern may be that security agreements encumbering general intangibles could, contrary to the expectations of many debtors and perhaps of many creditors as well, “drag in” tort causes of action and derivative rights and “pick debtors clean.”¹⁸³ Another concern may be that these security interests may benefit secured creditors but provide no commensurate benefit to debtors such as more favorable credit terms. For these reasons, it may be desirable for the revised Article Nine to expressly restrict the breadth of security interests that could encumber tort claims generally or personal tort claims in particular.

One way to accomplish such a restriction would be to modify Article Nine’s security agreement description-of-collateral requirement.¹⁸⁴ It could be amended to require tort claims to be described with a degree of specificity above and beyond a broad reference to general intangibles. For example, the revised Article might require a security agreement reference to “tort claims” if it is intended to cover them. To achieve even greater specificity, the Article might require a reference sufficient to identify the tortfeasor by name, the tort by description of the circumstances giving rise to it, or even the docket number of a pending lawsuit.

A problem with this approach is that Article Nine provides very little precedent for it. The Article employs a general description requirement that the security agreement must make possible the identification of the collateral.¹⁸⁵ The single exception requiring greater specificity of description has been the subject of convincing criticism.¹⁸⁶ The Study Committee has recommended its repeal.¹⁸⁷

¹⁸² See *id.* § 1-102(2)(b) (stating that one underlying purpose of the U.C.C. is to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties).

¹⁸³ See *supra* text accompanying notes 96-97.

¹⁸⁴ See U.C.C. §§ 9-110, 9-203 (providing Article Nine’s description-of-collateral requirements).

¹⁸⁵ See *id.* § 9-110 & cmt.

¹⁸⁶ *Id.* § 9-203(1)(a) requires a description of the land concerned in the case of security interests covering crops growing or to be grown or timber to be cut. The reason stated for this special requirement is that a reference to the land is the “best” identification of the collateral. *Id.* cmt. 2; see CLARK, *supra* note 37, ¶ 8.05[1][b][ii] (stating that such requirement serves no practical function and is filled with pitfalls).

¹⁸⁷ PEB Study Group, *supra* note 4, at 182.

A better approach for dealing with the dragnet problem is to recognize that it comes about largely, though not entirely, through the operation of security interests that attach to after-acquired general intangibles.¹⁸⁸ It is possible to limit the effectiveness of a security agreement encumbering after-acquired assets, and Article Nine has done so to protect consumers¹⁸⁹ and farmers.¹⁹⁰ Concerns that owners of tort claims lack bargaining power, do not appreciate the consequences of signing a security agreement encumbering after-acquired general intangibles, or receive no compensation for the possibility that future tort claims may be encumbered might similarly be addressed by a limitation on the encumbrance of tort claims that arise in the future. By reducing the number of security interests created in tort claims, this provision also would address concerns relating to the spectre of the witch's brew and the

¹⁸⁸ General intangibles are a type of collateral that, unlike cyclic assets such as accounts receivable, generally do not turn over in the regular course of a debtor's business. Thus, the intent to have a security interest attach to them as they arise in the future probably needs to be expressed in the security agreement and is unlikely to be implied. See CLARK, *supra* note 37, at 2-26 to 2-27. Tort claims owned by the debtor when the security interest in general intangibles initially attaches would not be affected by a limitation on the reach of an after-acquired property clause. However, a court might nonetheless interpret the security agreement as not encumbering some or all presently owned tort claims. See generally U.C.C. § 9-203(1) (providing that in order for a security interest to attach, the debtor must agree to it); WHITE & SUMMERS, *supra* note 96, §§ 22-3, 22-4.

¹⁸⁹ See U.C.C. § 9-204(2) which provides that a security interest cannot attach under an after-acquired property clause to consumer goods when given as additional security unless the debtor obtains rights in them within ten days after the secured party gives value. This provision's general effect is to limit security interests in consumer goods to those based on purchase money. CLARK, *supra* note 37, ¶ 12.04[4]. It is noteworthy that the class of persons who own consumer goods as defined by Article Nine and the potential victims of personal tort claims are substantially, if not entirely, the same natural persons. Consumer goods are goods acquired primarily for personal, family, or household use. See U.C.C. § 9-109(1). Thus, they are acquired by natural persons. See CLARK, *supra* note 37, ¶ 12.01[2] (distinguishing between goods acquired for consumer use and goods acquired for business use). The gist of a personal tort is injury to natural persons. See *supra* notes 72, 171 and accompanying text.

¹⁹⁰ Prior to its 1972 amendments, Article Nine provided that "no security interest attaches to crops which become such more than one year after the security agreement is executed" UNIFORM LAWS ANNOTATED, *supra* note 21, at 447. This provision's purpose was to protect necessitous farmers. *Id.* at 448. It was dropped from the official text because the provision appeared meaningless in operation, caused unnecessary paper work, and was uncertain. *Id.* However, it was retained by some jurisdictions. *Id.* at 450.

reimbursement rights of insurers and others. A provision limiting after-acquired property clauses encumbering tort claims might be drafted as follows: "No security interest attaches under an after-acquired property clause to personal tort claims unless the debtor has rights in them at the time the security agreement is executed."¹⁹¹ This amendment would not affect security interests in tort claims that are claimed as proceeds of other collateral.¹⁹²

The case for this amendment is not open and shut either. The dragnet problem is alleviated to some degree by case law recognizing that intent to create a security interest in specific assets may be lacking even though they are encompassed by the literal terms of the security agreement.¹⁹³ For this reason, a leading commentator recommends that a bare reference to general intangibles be avoided, especially where it is possible to identify a specific class of general intangibles (such as tort claims) in advance.¹⁹⁴ Unconscionability principles also might be judicially applied to police the breadth of a security agreement which appears to be overreaching because it encumbers a particular tort claim under general descriptive language.¹⁹⁵ An obvious shortcoming of both of these alternatives is that most security interests are enforced without judicial review. Neither of these approaches to the dragnet problem is as certain as a statutory limitation in the Code on the reach of after-acquired property clauses encumbering future tort claims. However, even without this limit, extra-Code consumer protection legislation may preclude a creditor from taking a security interest in a personal tort claim.¹⁹⁶

¹⁹¹ Presumably a debtor has rights in a tort cause of action when it arises as a matter of tort law. See generally WHITE & SUMMERS, *supra* note 96, § 22-6 (stating that one must look outside of Article Nine to determine the extent of a debtor's rights). Other drafting possibilities exist. For example, another approach would require the debtor to have rights at the time the secured party gives value. See U.C.C. § 1-201(44) (defining "value").

¹⁹² Since proceeds are substitute collateral, it seems appropriate to allow the security interest to attach to future tort claims that are proceeds. See *supra* note 44. The Article Nine Study Committee has recommended that the definition of proceeds be amended to include tort claims. PEB Study Group, *supra* note 4, at 106.

¹⁹³ See generally CLARK, *supra* note 37, ¶¶ 2.02[3][a], 2.09[5][c], [d]; WHITE & SUMMERS, *supra* note 96, § 21-5.

¹⁹⁴ See CLARK, *supra* note 37, ¶ 2.09[5][c], at 2-112, 2-113. See generally *supra* note 170. Of course, creditors might begin to routinely include a reference to tort claims in security agreement collateral descriptions if Article Nine is amended to encompass them.

¹⁹⁵ See generally CLARK, *supra* note 37, ¶ 12.04[2], at 12-22 & n.48.

¹⁹⁶ See UNIFORM CONSUMER CREDIT CODE § 3.301 (1974) (providing that creditors

IV. CONCLUDING THOUGHTS

Article Nine's scope should be expanded to encompass security interests in *all* types of tort causes of action and derivative rights. The arguments for excluding personal tort claims only are not persuasive. However, it must be acknowledged that the continued exclusion of personal claims could help to alleviate fears relating to the witch's brew, dragnet problems, and the rights of reimbursement claimants. Whether or not personal claims are excluded from Article Nine, no other amendments to the Article's official text or comments are necessary or desirable to address these fears.

The inclusion in Article Nine of tort claims of any type may necessitate an amendment to the Article's existing scope language which excludes some judgments.¹⁹⁷ The Article does not apply to a right represented by a judgment unless the judgment was taken on a right to payment which was itself collateral.¹⁹⁸ Thus, the Article applies if, for example, the security interest is in an account receivable which subsequently is reduced to a judgment against the account debtor.¹⁹⁹ Assuming that tort claims were brought within Article Nine's scope, the Article would apply where the security interest is in a tort claim which is subsequently reduced to a judgment if the tort claim is a "*right to payment*."²⁰⁰ A settlement agreement and some other derivative rights provide rights to payment. However, a tort cause of action is a right to sue for redress and probably is not a right to payment.²⁰¹ If a tort cause of action is not a right to payment, then it would be effectively excluded from Article Nine whenever it is reduced to judgment without first being converted to a derivative right that is both collateral and a right to payment.²⁰²

It is important to note the limited results of making tort claims available as collateral under Article Nine. Tort claims would not become negotiable.²⁰³ Should its debtor default, the secured party enforcing a

generally may not take security interests in assets of the debtor other than what has been sold). See generally CRANDALL, *supra* note 85, at 3-19 to 3-22.

¹⁹⁷ See *supra* note 19.

¹⁹⁸ See U.C.C. § 9-104(h).

¹⁹⁹ See CLARK, *supra* note 37, ¶ 1.08[8].

²⁰⁰ See U.C.C. § 9-104(h) (emphasis added).

²⁰¹ See MELLINKOFF'S DICTIONARY, *supra* note 13, at 68.

²⁰² The entry of a judgment is declaratory of the fact and amount of the defendant's liability. See JACK H. FRIEDENTHAL ET AL., CIVIL PROCEDURE § 15.7, at 708 (1985).

²⁰³ Otherwise, a good faith purchaser from a tort victim could cut off the tortfeasor's defenses. Professor Gilmore wrote that it is in the nature of intangible claims employed

security interest in a tort claim would, as a matter of commercial law, be subject to the same defenses that might be asserted against the debtor/tort victim by the tortfeasor and have the same burdens of proof as the debtor.²⁰⁴

In the event of default, a secured creditor would have multiple remedial options. One would consist of "collection rights."²⁰⁵ For example, suppose the debtor/tort victim and the tortfeasor previously entered into a settlement agreement providing for periodic payments. Collection rights would permit the secured party to notify the tortfeasor to make the payments directly to the secured party.²⁰⁶

Article Nine provides two other remedies that might be invoked by the secured party. One would be a right to dispose of the collateral and apply the proceeds to the secured debt.²⁰⁷ The other, provided that it is amended to apply to nonpledgeable intangibles, is a strict foreclosure right to retain the collateral in satisfaction of the debt.²⁰⁸

Upon default, the secured party would also have the rights and remedies provided in the security agreement.²⁰⁹ The agreement might include provisions governing the post-default prosecution of a tort cause of action, its settlement, and the disposition of its proceeds. Similar language is sometimes included in security agreements encumbering accounts receivable.²¹⁰ Finally, the secured creditor would have the

in market transactions to move toward negotiability. 1 GILMORE, *supra* note 2, at 381. Tort claims are a very long way from this stage of development.

²⁰⁴ This result follows from the fundamental "derivation" principle that a transferee acquires only the rights of the transferor and no more. See Harris, *supra* note 146, at 638-39; cf. U.C.C. 9-318(1) (concerning rights of an assignee).

²⁰⁵ See U.C.C. § 9-502.

²⁰⁶ The tortfeasor, provided it is "obligated," would be an "account debtor" under Article Nine terminology. See *id.* §§ 9-105(1)(a), 9-106, 9-502.

²⁰⁷ See *id.* § 9-504.

²⁰⁸ See *id.* § 9-505. As currently drafted, this remedy requires the secured party to be "in possession" of the collateral, *id.*, which seemingly would be impossible in the case of a nonpledgeable intangible such as a tort cause of action or nonpledgeable derivative rights such as contractual rights under a settlement agreement. But see *In re Martin-Musumeci*, 1994 U.S. App. Lexis 4622; 24 U.C.C. Rep. Serv. 2d (Callaghan) 698 (9th Cir. 1994) (holding under "unique facts" that a trust interest can be possessed for purposes of strict foreclosure). By way of comparison, the promises or orders to pay money represented by a negotiable promissory note or check are pledgeable intangibles. This possession requirement for strict foreclosure may be modified or eliminated. See PEB Study Group, *supra* note 4, at 239-41.

²⁰⁹ U.C.C. § 9-501(1).

²¹⁰ See 14 STONE, *supra* note 45, § 57.3, at 783 (setting forth a revolving loan agreement). Insurance policies routinely deal with such matters in the event of

right to enforce its security interest by "any available judicial procedure."²¹¹ These procedures would include supplementary proceedings utilized by judgment creditors to reach rights of action.²¹²

subrogation. See 10 AM. JUR. LEGAL FORMS § 149:335 (2d ed. 1972) (setting forth a subrogation agreement).

²¹¹ U.C.C. § 9-501(1), (5).

²¹² See 9 EISENBERG, *supra* note 85, at 37A-117; see also *id.* 37-53 to 37-56 (discussing execution against tort claims).