AN ORGANIZATIONAL APPROACH TO RESOLVING THE ATTACHMENT AND PERFECTION PROBLEMS OF IDENTITY CHANGES UNDER § 9-203(1)(A) & § 9-402(7) OF THE UNIFORM COMMERCIAL CODE

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"Look to the essence of a thing, whether it be a point of doctrine, of practice, or of interpretation."[1]

INTRODUCTION

The purpose of the Uniform Commercial Code (U.C.C. or "Code") is to provide clear and concise answers to practical commercial questions. In some circumstances, however, courts have interpreted and applied the Code in a way that blurs its intended effect. This Article will focus on one such distortion. This distortion is a result of the judicial attempt to resolve the effect that a postperfection change in corporate form, or "identity change," has upon an otherwise valid security interest in after-acquired property.

An identity change occurs when a debtor (the "original debtor") changes its corporate form, transfers assets subject to a security interest to the postchange entity (the "new debtor"), and continues business as the new debtor. A change of form can occur in various ways. For example, an entity can change from a proprietorship or partnership to a corporation, a subsidiary may be created, or a merger may result. A transfer of assets pursuant to an identity change is different from a transfer of assets to a third party because an identity change involves a transferor and transferee that are similar, if not substantively identical.

Changes in corporate form occur constantly within the national economy. An entity has creditors and clients before the change and continues to operate as an economic unit, regardless of form, after the change. Unfortunately, the problem of how to treat the effect of a change in form on a prechange security interest in after-acquired property has not been satisfactorily resolved. The Permanent Editorial Board of the Uniform Commercial Code has recognized this problem and is considering revising Article 9 to make the intended effect of the applicable sections more clear.[2] However, the special committee set up to review Article 9 (the "Study Committee") itself is split on which of the two prevailing approaches to adopt: the identity approach or the Burke approach.[3] Regardless, the Committee has been unable to articulate a statutorily valid means of implementing the identity approach.

This Article fills the gap in the Committee's analysis by proposing a statutorily valid means of implementing the identity approach through use of the term "organization." For

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1. Marcus Aurelius Antoninus, A.D. 121-180 (translated by Morris Hickey Morgan [1859-1910]).

2. *See* PEB Study Group, Uniform Commercial Code Article 9 Report 140-51 (December 1, 1992); *id.* at 141 ("Accordingly, the Committee thinks that Article 9 should distinguish between name changes, in which the original debtor continues as the same legal entity, and other changes, in which the original debtor does not so continue.").

3. *Id.* at 144-45.

purposes of simplification, this statutory interpretation will be referred to as the organizational approach or organizational interpretation. Though the organizational approach relies on many of the policy justifications of the identity approach, it reaches the same result in a more practical and certain manner.

The organizational approach uses language already present in the Uniform Commercial Code to provide a means by which to implement the identity approach, while at the same time avoiding the current problems of that approach. Specifically, this approach uses the definition of "organization" as the means to differentiate between transactions involving identity changes where the transferor and the transferee are related entities, from those transactions involving unrelated third parties. The goal of this Article is twofold. First, this Article will demonstrate why the result reached by the identity approach is the preferred result, and how the traditional problems with that approach may be avoided with the proposed interpretation. Second, in case the Committee does not revise Article 9 to reflect this interpretation, this Article provides an analysis by which courts that agree with the policies underlying the identity approach may use the language of the current U.C.C. to legitimately reach an appropriate result.

The first Part of the Article provides the context for considering the issue by setting forth the essential aspects of a secured transaction and the practical policies which underlie Article 9 of the Uniform Commercial Code. Part II traces the development of the response to the issue within the Code and judicial opinion. This Part specifically addresses the foundations and problems of the two different approaches courts have taken to resolve the issue. Part III considers the effect of the two approaches upon the various commercial constituents and concludes that the identity approach is vastly superior, though problematic as currently applied. Part IV provides a means to overcome the problems of the identity approach through use of the term "organization." This Part sets forth the means by which the approach should be judicially applied. Finally, Part V proposes a set of official comments that would legislatively adopt the organizational approach, whether by the Committee or individual state legislatures.

I. BACKGROUND

The secured transaction plays an important role in modern commercial and consumer relationships.[4] Secured transactions provide creditors, who deal with debtors who are otherwise unable to access credit resources, with a mechanism to inject value into individual and organizational endeavors.[5] A secured creditor has a significant power over debtors because of the ability to seize a debtor's property upon nonpayment. As a result, the Code generally requires the secured transaction to be memorialized in writing.[6] A potential

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4. *See* ROBERT M. LLOYD, SECURED TRANSACTIONS 1-18 (1988).

5. The collateral of a secured transaction allows the secured creditor to finance an individual or business which is a larger credit risk by minimizing the risk of nonpayment. If a default results, the creditor has a claim against the debtor for the amount owed, against the collateral to satisfy the deficiency, or both. The subsequent decrease in the creditor's risk may be passed on to the debtor in the form of a more favorable interest rate or payment plan. F. Stephen Knippenberg, *Debtor Name Changes and Collateral Transfers Under 9-402(7): Drafting from the Outside-In*, 52 MO. L. REV. 57 (1987).

6. This requirement "is in the nature of a Statute of Frauds." U.C.C. § 9-203 Official Cmt. 5 (1994).

problem arises when the secured transaction leaves the debtor in possession of the collateral. The debtor's possession of the collateral has the potential to mislead other creditors into believing that the property is unencumbered.[7] Creditors operating under that mistaken belief may lend on the collateral.[8] The U.C.C. provides a solution to this problem of "ostensible ownership" by requiring the original secured party to file a financing statement declaring and detailing the security interest in the debtor's collateral, a description of the collateral, and the amount of the security.[9] This system of "notice filing"[10] provides an incentive to prospective secured parties to search for applicable financing statements: debt secured by collateral already securing another debt is inferior in terms of satisfaction to the previous debt.[11] If prospective secured parties do not investigate prior to providing value, then they bear the risk of receiving an inferior security interest. Essential to fair application of the notice filing system is the ability of diligent, prospective secured parties to locate filings relevant to the debtor, and thereby act knowledgeably if lending on collateral securing a superior security interest.

The particular method of secured lending at the center of this Article is lending upon after-acquired property.[12] Due to their nature, many businesses have a constant turnover in a significant amount of potential collateral. The clearest examples of this type of business

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It fulfills an evidentiary function by establishing the terms of an agreement, thereby decreasing the likelihood of a future dispute. A written agreement is not necessary where the secured party maintains possession of the collateral. Possession by the secured party provides an equally effective means to ensure that both parties agree on and understand the particular collateral subject to the security interest. *Id.* The terms of the security agreement can have a significant impact in that they bind not only the parties, but other creditors of the debtor and purchasers of the collateral. U.C.C. § 9-201.

7. This is known as the problem of "ostensible ownership." LLOYD, *supra* note 4, at 5.

8. When the subsequent secured party lends and takes an interest in the collateral, no problem will occur if the collateral is of sufficient value to cover both liabilities in the case of a default. If that is not the case, then the problem of how to divide the proceeds of the collateral among the conflicting secured parties arises. On one hand, the original secured party should be favored, because it provided the value initially. On the other hand, how could the second secured party have known that the collateral was secured by an earlier agreement?

9. U.C.C. § 9-402(7). Where such a filing is not made, the collateral is open for other secured parties who filed before the original filing or to judgment debtors seeking to satisfy their judgments. Where a filing is properly made, the security interest of later secured parties is subject to that of the original secured party—the original secured party has "priority." U.C.C. § 9-312. A secured party may also perfect a security interest by possessing the collateral. U.C.C. § 9-203.

10. U.C.C. § 9-402 Official Cmt. 2.

11. U.C.C. §§ 9-301(1)(a), 9-312(5).

12. Article 9 provides a mechanism that allows secured parties to lend on types of collateral which would be ineffectively secured under a traditional secured transaction. This type of lending generally involves inventory or accounts receivable financing, or may include any type of collateral held by a debtor for a short period of time, being subsequently replaced by other items. *See* LLOYD, *supra* note 4, at 208-09 (for example, new shoes in the inventory of a shoe store). The Code provides an effective means of securing these types of collateral through the use of an after-acquired property clause to subject property acquired by a debtor after the execution of a security agreement to the security interest. U.C.C. § 9-204. The secured party may continue to advance funds with the expectation that, if necessary, the debtor will have the collateral necessary to satisfy whatever obligation remains outstanding.

include manufacturers and sellers of consumer goods, such as a shoe store or an electronics wholesaler. The assets of such entities are primarily inventory and accounts receivable. However, both inventory and accounts receivable undergo constant turnover, making lending documentation with respect to single pieces of collateral impossible. Instead, the U.C.C. established section 9-204, which allows the secured party to take a security interest in a *type* of collateral, for instance accounts receivable and inventory, that a debtor currently has or will acquire in the future. The debtor benefits by being able to acquire credit based upon a significant amount of its assets and the secured party benefits by a constant flow of present collateral from which it may, if necessary, satisfy the debt.

After the security interest is attached and perfected, debtors are capable of undergoing many types of changes which may frustrate the secured relationship and the notice system for prospective secured parties. Postperfection changes can be categorized as external or internal. External changes involve changes in the debtor's environment that affect the validity of the security interest or financing statement. They include changes in: the debtor's residence, place of business, location and/or use of collateral,[13] and the location of the debtor.[14] Generally, external changes are resolved by the Code with a strong degree of certainty.

One example of such a change is a debtor name change, which may adversely impact the ability of a prospective secured party searching the filing system to learn of a prechange security interest, thus bringing into question the effectiveness of the prechange financing statement.[15] Internal changes involve a change in the debtor itself which affects the validity of the security interest or financing statement.

One type of internal, postperfection change that the Code does not clearly address is an "identity change." As set forth above, an identity change occurs when a debtor changes legal form, transfers all or part of its assets to the successor entity, and continues business as the new entity. Only through a change in corporate form can a debtor accomplish an identity change, because the corporate form is the only legal mechanism that creates a different legal entity.[16] Regardless of whether the debtor is a proprietorship, partnership, or existing corporation, it can form a new corporation and transfer all or part of the assets and business operations of the original entity to the successor. A change in form may also result from a merger or occur as a result of a business transfer between a parent corporation and its subsidiary. Scenarios that involve an identity change are potentially very factually complex.

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13. U.C.C. § 9-401(3).

14. U.C.C. § 9-103.

15. The Code provides answers to how most types of internal changes affect the validity of an underlying security interest and the effectiveness of a financing statement. In the case of a name change that renders the financing statement "seriously misleading" to a reasonable searcher, the secured party is given four months in which to file a new amended financing statement or the perfected status of the security interest lapses. U.C.C. § 9-402(7); § 9-402 Official Cmt. 7. In the case of a transfer of the collateral from one debtor to an unrelated entity, the security interest and its perfected status continue in the collateral unless the secured party authorized the sale. U.C.C. § 9-306(2). The effect of the name change rule is to place a general duty of research on prospective secured parties regarding the collateral: "any person searching the condition of the ownership of a debtor must make inquiry as to the debtor's source of title, and must search in the name of a former owner if circumstances seem to require it." U.C.C. § 9-402 Official Cmt. 8.

16. *See* United States v. Fidelity Capital Corp., 920 F.2d 827 (11th Cir. 1991).

However, at the core of each scenario is the use of corporate form to create distance between the prechange and postchange debtor.

Theoretically, an identity change creates two issues regarding the validity of application of a prechange security interest in after-acquired property to the postchange debtor. First, the postchange entity has a different legal identity than the prechange entity. This calls into question the enforceability of the security agreement signed by the prechange entity against the postchange entity with respect to collateral acquired after the change that otherwise would have been subject to the original security interest in after-acquired property. Second, the change may have the effect of hampering prospective secured parties from determining the existence of a prechange security interest. The identity change may have been accompanied by other internal and external changes, the most common of which seems to be a name change. The combined impact of the identity and accompanying changes may hinder the effectiveness of the prechange financing statement in fulfilling the goals of notice filing. As discussed below, the evolution of the statutory and judicial responses to identity changes has only recently confronted these two issues effectively. However, the approach that courts have used can be changed to achieve better results.

II. A CHANGE OF FORM AND ARTICLE 9

The problem of internal postperfection changes affecting an after-acquired security interest did not arise under pre-Code law.[17] The courts first confronted the issue under the 1962 version of Article 9, which provided little guidance.[18] Those courts divided postperfection changes into two categories: name changes and transfers.[19] In the case of a name change, refiling or amendment of the financing statement was not necessary to continue the perfected security interest absent knowledge of the impending change by the secured party prior to filing.[20] When a change of form occurred with a subsequent transfer of collateral and business to the successor entity whose name was similar, courts often held that the change should be treated as a name change, at least indirectly conceptualizing the pre and postchange debtors as the same entity.[21] Most courts did not distinguish between collateral

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17. State of New York, Report of the Law Revision Commission for 1955, Study of the Uniform Commercial Code 281 (1955).

18. RAY D. HENSON, HANDBOOK ON SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 4-6 at 67 (2d ed. 1979).

19. *See generally* Knippenberg, *supra* note 5.

20. *In re* Kalamazoo Steel Process, Inc., 503 F.2d 1218 (6th Cir. 1974). *In re* The Grape Arbor, Inc., 6 U.C.C. Rep. Serv. (Callaghan) 632 (Bankr. E.D. Pa. 1969) (postfiling change of name from The Philadelphia Eating Society did not invalidate financing statement); Continental Oil Co. v. Citizens Trust & Savings Bank, 244 N.W.2d 243, 244-45 (Mich. 1976); *see also* WILLIAM B. DAVENPORT & DANIEL R. MURRAY, SECURED TRANSACTIONS 166 (1978).

21. DAVENPORT & MURRAY, *supra* note 20, at 166. *See also* Ryan v. Rolland, 434 F.2d 353, 357 (10th Cir. 1970) (secured party is not required to refile as to present or after-acquired property after debtor transfers to successor corporation); Avdoyan v. Sun Bank at Pine Hills, N.A. *(In re* Sofa Center, Inc.*)* 18 U.C.C. Rep. Serv. (Callaghan) 536, 539 (M.D. Fla. 1975).

acquired before and after the change, nor did they consider the effect of a change in form on the validity of the security agreement and security interest.[22]

A. The Effect of the 1972 Revision: § 9-402(7)

Part of the 1972 revision of Article 9 was aimed at resolving the effect a postperfection, internal change in the debtor has upon a prechange security interest.[23] Section 9-402(7) of the revised Code expressly addresses the problem. Two sentences of that section bear upon this discussion:[24]

> Where the debtor so changes his name or in the case of an organization its name, identity or corporate structure that a filed financing statement becomes seriously misleading, the filing is not effective to perfect a security interest in collateral acquired by the debtor more than four months after the change, unless a new appropriate financing statement is filed before the expiration of that time.[25] A filed financing statement remains effective with respect to collateral transferred by the debtor even though the secured party knows of or consents to the transfer.[26]

The drafters did not clearly indicate which portion of section 9-402(7) they intended to govern a change in form.[27] The language of the Official Comment is somewhat ambiguous: "Subsection (7) also deals with the case of a change of name of a debtor and provides some guidelines when mergers or other changes of corporate structure of the debtor occur with the result that a filed financing statement might become seriously misleading."[28]

B. The Identity Approach

Shortly after section 9-402(7) was codified, the majority of courts confronted with identity changes began to rely on the language of the new statute while still applying the prerevision reasoning.[29] Changes of corporate form were given the name, "identity changes

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22. *See In re* A-1 Imperial Moving & Storage Co, 350 F. Supp. 1188, 1189 (S.D. Fla. 1972).

23. Subsection 7 of U.C.C. § 9-402 was added "[t]o solve [the] dilemma of whether to require the filing of an amendment upon a significant change of identity of the debtor." American City Bank v. Western Auto Supply, 631 S.W.2d 410, 418-19 (Tenn. Ct. App. 1981). "The decisions [under the 1962 Act] do not, however, supply a satisfactory rule for practice; their rationale is frequently narrow." DAVENPORT & MURRAY, *supra* note 20, at 166.

24. The first version, which stands virtually unchanged today, was proposed in Preliminary Draft 2, February 1970.

25. Hereinafter referred to as the "second sentence."

26. Hereinafter referred to as the "third sentence."

27. *See* Review Committee of Article 9 of the U.C.C., Final Report 246 (1971) (discusses change of name and "new" debtors).

28. U.C.C. § 9-402(7) Official Cmt. 5. The intent of the section is to govern only the effectiveness of the filing. "Obviously, the subsection does not undertake to state whether the old security agreement continues to operate between the secured party and the party surviving the corporate change of the debtor." U.C.C. § 9-402 Official Cmt. 7. *See* PEB Study Group, *supra* note 2, at 143 ("Some courts have failed to recognize that § 9-402(7) addresses only the question of the effectiveness of a filed financing statement and not the question of whether a security interest attaches to particular property."). Therefore, application of this section necessarily assumes the validity of an underlying security interest.

29. *See, e.g.*, Corwin v. RCA Corp., 516 F.2d 24 (6th Cir. 1975) (applying Ohio law, which had yet to

or intrafamily transfers."[30] Courts applying this approach classified internal postperfection changes of a debtor into three categories: name changes, identity changes or intrafamily transfers, and transfers to an unrelated party.

The identity approach interprets the language of the *second sentence* of section 9-402(7) as governing more than a simple name change;[31] it also governs changes in the debtor's corporate form or "identity."[32] When only the form of the entity changes, the postchange debtor is not treated as a distinct and separate entity from the prechange debtor for purposes of Article 9.[33] Under the identity approach, the *third sentence* is interpreted as applying only

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adopt the revised U.C.C. § 9-402(7). However, the court made mention of the revised section in its analysis). *Corwin* involved the creation and subsequent transfer collateral to a new corporate entity, Kittyhawk Television Corp., by the original corporation, Kittyhawk Broadcasting Corp. The security agreement granted the secured party a security interest in present collateral; the agreement did not contain an after-acquired property clause. Following the transfer, the secured party failed to execute either a new security agreement or a financing statement showing the name of the new corporation. The debtor subsequently filed for bankruptcy. The trustee sought to avoid the security interest by arguing that the security interest did not survive the transfer. The court disagreed. In its reasoning, the court disregarded the separate and distinct status of the corporations to hold that a name change had taken place.

See also Houchen v. First Nat'l Bank of Pana, 445 F. Supp. 665 (S.D. Ill. 1977). *Houchen* involved a bank loan to individual debtors for the purpose of starting a business. The bank took a security interest in the fixtures, equipment, inventory and after-acquired property of the business. After receiving the loan, the debtors transferred all of the business assets to a corporation, Taylorville Eisner Agency, Inc., which they had previously formed. Thereafter, the corporation assumed the debt of the individual debtors and ran the business.

When the debtor filed voluntary bankruptcy two years later, none of the merchandise and inventory held for sale was present at the time of the transfer of assets to the corporation. The corporate debtor had not signed a new security agreement, nor had the bank filed a new or amended financing statement. The bankruptcy court held that a failure to file an amended financing statement made the bank unsecured as to collateral acquired by the debtor more than four months after the transfer. The district court reversed. It read the definition of collateral in the *third sentence* to mean all collateral subject to the security interest. The financing statement "remain[ed] effective with respect to collateral transferred, which included any property to be acquired by the corporation which would fall under the after-acquired property clause." *Id.* at 669.

30. Claude Michael Stern, Note, *Debtors' Name or Identity Changes: Distributing Benefits and Burdens Under Article 9*, 31 HASTINGS L.J. 959, 983 (1980).

31. "The court was probably correct in concluding that the transaction fell within the second sentence of 9-402(7) as a 'change in corporate structure.' There was only one debtor, not a sale of collateral to an independent third party." BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE S2-29 (2d ed. Supp. No. 2 1992) (referring to Bank of the West v. Commercial Credit Fin. Servs., Inc., 852 F.2d 1162 (9th Cir. 1988)).

32. Barkley Clark, a noted commentator on the U.C.C., agrees:

> The better construction of § 9-402(7) is that incorporation of proprietorships should be treated in the same way as name changes and mergers. This approach is consistent with the definition of "organization" in § 1-201(28). The incorporation of a proprietorship easily fits within the phrase "changes in name, identity or corporate structure." More important, there is no good policy justification for treating these transaction under the third sentence of § 9-402(7).

Id. at 2-116.

33. The separate status of the entity should be respected for matters outside of the secured transaction (*i.e.*,

to transfers of "unrelated" parties.[34] Where a debtor undergoes a change in form with a subsequent transfer of collateral to the successor entity, the identity approach treats the two entities as so related that the *third sentence* does not apply. Rather, the effectiveness of the financing statement is controlled by the *second sentence.*[35]

The Ninth Circuit in *Bank of the West v. Commercial Credit Financial Services*[36] applied the identity approach to resolve the effect of a transfer of assets by a parent corporation from one subsidiary to another. Bank of the West provided four million dollars of financing to Allied, a wholly owned subsidiary of Boles World Trade Corp (BWTC), secured by present and after-acquired inventory, accounts and proceeds of Allied. Two years after the Allied financing, Commercial Credit entered into account factoring financing with respect to a beverage wholesaling business operated by Boles & Co., Inc. (BCI), another wholly owned subsidiary of BWTC. Shortly thereafter, BWTC transferred the beverage business from BCI to Allied. Bank of the West asserted that it had priority over Commercial Credit for the accounts generated by the beverage business after its transfer from BCI to Allied. The court held that the transfer was a "change in corporate structure of the debtor."[37] Therefore, the Continental financing statement continued to be effective as to collateral acquired by Allied for a minimum of four months. The court reached this conclusion by interpreting the term "debtor" in the second sentence "to mean not only the transferor, but also to include the transferee."[38]

The identity approach is supported by practical and sound policy. The approach is oriented toward practicality. When only a change in corporate form has occurred, the prechange debtor's clients and creditors perceive the pre and postchange entities as the same organization. As a result, the change in form cannot practically be said to have created a completely different entity. Furthermore, the identity approach frustrates attempts of debtors to make unsecure an otherwise valid security interest in after-acquired property by changing corporate form. The Ninth Circuit recognized this policy in *In re West Coast Food Sales, Inc.*[39] In *In Re West Coast*, the court refused to allow "a debtor . . . to evade the obligations of a validly executed security agreement by the simple expedient of an alteration in its business structure."[40]

As currently advocated and applied, the identity approach has two problems that render it ineffective in resolving the effect of a change in form on a prechange security interest in after-acquired property: (1) it fails to provide a reliable and generally applicable means for parties and courts to determine whether an identity change or a third party transfer has

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the extent of a shareholder's liability on a corporate debt). *See infra* note 44 and accompanying text.

34. *Bank of the West,*852 F.2d at 1169.

35. "Under the facts of this case and in order to effectuate the purposes of the Uniform Commercial Code, we think it is proper to disregard the form of the transaction and instead to focus upon its substance." Corwin v. RCA Corp., 516 F.2d 24, 27 (6th Cir. 1975) (transfer of substantially all of corporation's assets to newly formed corporation). *See supra* note 29.

36. 852 F.2d 1162 (1988).

37. *Id.* at 1169.

38. *Id.* at 1170.

39. 637 F.2d 707 (9th Cir. 1981).

40. *Id.* at 709.

occurred; and (2) it fails to address the issue of whether a prechange security interest may be properly asserted against the postchange debtor.

Courts that have applied the identity approach have failed to set forth a consistent set of factors on which to base future determinations of whether a transaction is an identity change or a transfer to an unrelated party. Furthermore, the application of the factors that have been enunciated has been haphazard. Courts have used a variety of factors and a fact-centered analysis, incapable of general application, to determine that particular transactions result in identity changes.

Two factors that several courts have considered are the ownership and control of the prechange and postchange debtors. Those factors were the focus of the court's reasoning in *In re Meyer-Midway,*[41] where the court found that the transaction constituted an identity change. The case involved the merger of two separate corporations, Meyer and Midway, into a newly formed corporation, Meyer-Midway, Inc. The court held the original financing statement sufficient to overcome the bankruptcy trustee's challenge to the after-acquired security interest in accounts receivable generated within four months after the merger.[42] In *Corwin v. RCA Corp.*,[43] the Sixth Circuit focused on the ownership and control of the original and successor entities.[44] That court placed emphasis on the fact that the original and successor entities occupied the same location in making its determination that the transfer of assets should be governed by the second sentence.[45]

The court in *In re Cohutta Mills*[46] focused on ownership and control, as well as other factors, to determine that a prechange and postchange debtor were "related" parties. The original debtor, King's Tuft, Inc., procured a loan from a local bank that was secured by a note on the debtor's equipment, machinery, and after-acquired property. The bank filed a proper financing statement, perfecting the security interest. Two years after the filing, the debtor formed a new corporation, Cohutta Mills, Inc., and transferred King's Tuft's assets to that corporation. The court noted that the two corporations had the same president, the successor corporation followed in the same line of business as King's Tuft, at the same location, using the same machinery and equipment. As a result, the court stated that "[r]ather than merely a transfer of assets between two corporations, King's Tuft essentially became Cohutta Mills as a result of the transaction."[47] Although courts have considered various factors, they have failed to provide a coherent rule or test for applying their approach.

A second problem of the "identity" approach is the assumption that a prechange security interest may be asserted against a postchange entity. The courts applying the identity

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41. 65 B.R. 437 (Bankr. N.D. Ill. 1986). *But see In re* Paramount Int'l v. First Midwest Bank, 154 B.R. 712 (Bankr. N.D. Ill. 1993) (The court declined to follow *Meyer-Midway*, but the issue of the case was whether the use of the debtor's trade name on the financing statement was sufficient to perfect a security interest in the collateral.).

42. In dicta, the court recognized that a new filing would be required by the end of the four month period because the name of the successor entity rendered the financing statement seriously misleading. *Meyer-Midway*, 65 B.R. at 443.

43. 516 F.2d 24 (6th Cir. 1975).

44. *Id.* at 26.

45. *Id.* at 24.

46. 108 B.R. 815 (Bankr. N.D. Ga. 1989).

47. *Id.* at 820.

approach have not confronted this issue. However, as critics of the identity approach recognize, an issue exists as to whether the original security agreement is effective to create a security interest in collateral acquired by the postchange entity after the transfer. On its face, section 9-402(7) governs only the effectiveness of a financing statement; it does not control the validity of the underlying security interest.[48] The validity of a security interest is governed by section 9-203(1), which requires that:

> (a) the collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral and in addition, when the security interest covers crops growing or to be grown or timber to be cut, a description of the land concerned.[49]

The result of a change in form is the transfer of the security obligation from one entity to a different legal entity. Because the two entities are legally distinct, the signature of the original debtor would seem insufficient to qualify as the "signature" of the postchange debtor for purposes of section 9-203(1)(a).[50] Therefore, the prechange security agreement would not extend to cover collateral acquired after the change of form. Because the secured party would not have a security interest in the collateral, the identity language of section 9-402(7) in itself would be insufficient to subject that collateral to the prechange security interest.

C. The Burke Approach

In response to the above two problems, the critics of the identity approach developed a new approach.[51] It is authored by William Burke, Chairman of the Article 9 Study Committee and is based upon a strict, albeit narrow, interpretation of the relevant language of the Code. It attempts to provide a bright-line test for determining the effect of a postperfection change in form on a prechange security interest.

The Burke approach argues that section 9-402(7) governs two types of postperfection changes. The first category includes simple name changes and mergers, which leave the original debtor as the successor entity. The narrowness of the approach is based on a

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48. "[T]he language of § 9-402(7) cannot properly be construed to dispense with the specific requirements of § 9-203(1)." Bank of Yellville v. Scott, 113 B.R. 516, 522 (Bankr. W.D. Ark. 1990); *see also*, U.C.C. § 9-402 Official Cmt. 7, discussed in *supra* note 15.

49. U.C.C. § 9-203(1)(a). The two other requirements for a valid security interest are not affected by a change in form. They are that "value" has been given and that the debtor has rights in the collateral. U.C.C. § 9-203(1)(b), (c).

50. If this construction of "the debtor" is correct, the assumption that the security interest may be asserted against a successor entity is invalid. That construction also would make invalid the reasoning of courts that applied successors and assigns clauses to validate the security interest. Again, U.C.C. § 9-203 requires that "the debtor" sign the security agreement. In the case of a "successors and assigns" clause, the successor debtor has not "signed" the "security agreement." Even though such a clause may be sufficient to enforce a general agreement against the successor entity, it would be insufficient to meet the signature requirement for establishing a valid security interest under the statute.

51. William M. Burke, *The Duty to Refile Under Section 9-402(7) of the Revised Article 9*, 35 BUS. LAW. 1083 (1985). "However, [the identity approach] is a weak foundation upon which to build a refiling doctrine since it offers no neutral principles upon which one can determine when a transfer will be honored and when it will be disregarded." *Id.* at 1092.

perception that the two references to "the debtor" in the second sentence "make it clear that the section applies only to change of name category cases."[52] In these situations, the *second sentence* of section 9-402(7) governs and provides that the financing statement remains effective to perfect collateral acquired within four months[53] after the change and will continue to do so unless the change makes the financing statement seriously misleading.[54] The second category of changes, resolved under the *third sentence* of section 9-402(7), includes all transfers of collateral: those from a debtor to a third party, as well as when a debtor changes corporate form and transfers the collateral from an original to a successor entity.[55]

The court in *Bank of Yellville v. Scott*[56] applied the Burke approach to two individuals who borrowed $185,000 from a local bank to purchase an audio/video business and subsequently incorporated. Prior to incorporation, they executed a security agreement granting the bank a security interest in all present and after-acquired property of the business.[57] The bank filed a financing statement listing the individuals, as well as the business, KC Audio Video Center of Camden, as the debtors. During the following month, the individuals formed a corporation and transferred all assets of the business to that corporation, KC of Camden, Inc., in return for all but one share of the corporation's stock. Shortly thereafter, the corporation entered into an agreement with Borg-Warner to finance the corporation's purchase of additional inventory.[58] The bank did not become aware of the debtor's incorporation until the following year. The bank did not take steps to execute a new security agreement, nor did it file a new or amended financing statement.[59] Borg-Warner asserted that it had priority to the inventory it helped finance,[60] even though its financing statement postdated the one filed by the bank and covered the same type of collateral. The court used the Burke approach to find for Borg-Warner. It held that the original secured party did not have a security interest in collateral acquired by the debtor after the incorporation.[61]

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52. *Id.* at 1095; *see also* ELDON H. REILEY, GUIDEBOOK TO SECURITY INTERESTS IN PERSONAL PROPERTY § 3.07 (1994) ("While this sentence refers to changes other than name changes, it is not clear that it has any meaningful application to any change other than a simple name change.").

53. This period will be the shorter of four months or the effective time remaining on the financing statement. U.C.C. § 9-402, Official Cmt. 7.

54. The timeframe is the effective period of the financing statement. *Id.*

55. This is the position advocated by the Sixth Circuit. Bluegrass Ford-Mercury, Inc. v. Farmers Nat'l Bank of Cynthiana, 942 F.2d 381 (6th Cir. 1991). The debtor sold a car dealership to a third party, who retained a similar corporate name and remained at the same location. The court held that the transaction was governed by the *third sentence*. The court placed emphasis on the "unrelated" ownership in reaching that result. *Id.* at 388.

56. 113 B.R. 516, (Bankr. W.D. Ark. 1990).

57. *Id.* at 518.

58. These items included stereo equipment and other property capable of being identified by serial number. *Id.*

59. *Id.* at 518-19.

60. The arrangement was such that Borg-Warner could not assert a purchase money security interest override. *See* U.C.C. § 9-312(4).

61. Two factually similar bankruptcy cases reached the same result. *See* Northeastern Bank of Penn. v. Spirit of the West, Inc. (*In re* Spirit of the West, Inc.), 164 B.R. 34 (Bankr. M.D. Pa. 1993); *In re* Just for Kids, Inc., 150 B.R. 123 (Bankr. M.D. Pa. 1992).

III. COMPARING THE TWO APPROACHES

Prior to considering whether revitalization of the identity approach is possible through use of the term organization, it must first be determined whether the identity approach outcome warrants the effort.

One way of examining the relative merits of the two approaches is to consider the practical effects of the different approaches on the participants involved in secured transactions. This seems to be the most appropriate mechanism to test the effectiveness and policy implications of the available approaches. After all, the Code is meant to provide practical guidance. Manifestly, therefore, it would seem that the most practical approach should be preferred. Five different parties feel the impact of either approach, and therefore deserve consideration. These parties are: the original secured party, the prospective secured party, unsecured and lien creditors of the successor entity, and the debtor.

A. The Original Secured Party

A change of form "is fraught with risks"[62] and causes monitoring problems for the original secured party. Practically speaking, a debtor can alter its form without significant difficulty.[63] A transfer of assets from the original to the successor entity may be accomplished by a minimal exchange of paper. The transferee may retain the debtor's location, line of business, ownership, and name. Even a diligent secured party, policing the debtor as to changes that may impair his security interest, would unlikely be able to discern that a change of form has occurred.[64] Regardless of the secured party's expectations or the security agreement, the approach taken by a court in resolving the situation will dictate whether the secured party has a security interest in collateral acquired by the debtor after the change in form.

The Burke approach provides that when a debtor changes its form the prechange security interest will not extend to any collateral acquired after the change.[65] The burden on a secured party is acutely felt, especially in cases of inventory or accounts receivable

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62. DAVENPORT & MURRAY, *supra* note 20, at 167.

63. For example, the incorporation of a proprietorship or partnership may only require the filing of a Certificate of Incorporation in the proper government office.

64. A presently secured party could be required to monitor the secretary of state's office for recent incorporations and mergers. Under either approach the secured party will monitor those filings, for as discussed *infra* in note 108 and accompanying text, only a narrowly qualified transaction should be treated as an identity change. Qualified transactions include cases with characteristics that make it difficult for a secured party to learn of a change that threatens his security interest. In situations not covered, the secured party will encounter characteristics that should put him on notice to check other sources of information to determine whether a change has occurred that would threaten his security interest. At that point, he would monitor the recent filings in the secretary of state's office. A requirement that the secured party constantly monitor those filings makes the balance of his duties onerous and is devoid of policy justification. *See* CLARK, *supra* note 31, at 2-111.

65. The Ninth Circuit expressed strong antipathy to that result: "To hold otherwise would permit debtors to decide which sentence of section 9-402(7) applies merely by choosing an advantageous formal arrangement for the desired transaction." Bank of the West v. Commercial Credit Fin. Servs., 852 F.2d 1162, 1171 (1988).

financing, where present collateral[66] will be unavailable to satisfy the debtor's obligation. Without that collateral, the likelihood that the obligation will be fully secured decreases,[67] which frustrates the fundamental purpose of the secured transaction—to provide security for credit extended.[68] Part of the Study Committee recognized the problems involved with placing such a strict monitoring burden on presently secured parties: "[the Burke approach] would unduly prejudice secured parties whose debtors engage in corporate or similar restructurings without their knowledge or consent. . . . [E]ven a diligent secured party may be unaware that individual debtors have incorporated their business into a new debtor . . ."[69] The secured party could add a clause to the security agreement requiring the debtor to inform the secured party of an impending change of form, but such contractual rights have little value when most needed—bankruptcy.[70] The holder of mere contract rights stands as an unsecured creditor.[71] Therefore, the holder takes last from what is almost always an insufficient pool of assets.[72]

The "identity" approach, on the other hand, provides diligent prechange secured parties a reasonable period of time in which to discover and resolve the potentially threatening situation. Where the debtor in the course of the change in form also changes its name, so that the financing statement becomes seriously misleading, the original secured party has four months in which to file a new financing statement.[73] In that case, the Code expressly allows a secured party to refile under the name of the postchange entity, without requiring the consent of the debtor.[74] Where the name remains the same or the change does not render the financing statement seriously misleading, the collateral remains perfected until the end of the effectiveness of the financing statement.[75]

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66. Present collateral is transferred by the original to the successor entity and is protected under the *third sentence*. As discussed earlier, particular items of those types of collateral are generally held by the debtor for a limited time before they are sold and replaced with other similar items. *See* U.C.C. § 9-204.

67. Although a proceeds claim under § 9-306 is available, the tracing requirements make it difficult to use.

68. The secured transaction provides the secured party the stability to make advances. Allowing the debtor to cut off the security interest undermines this stability. *See supra* notes 5-11 and accompanying text.

69. PEB Study Group, *supra* note 2, at 144.

70. "It is often said that the acid test of a security interest is in the debtor's bankruptcy." HENSON, *supra* note 18, at 258. The trustee in bankruptcy may successfully avoid (*i.e.*, render the transaction unsecured) where the security interest is unperfected. 11 U.S.C. § 545 (1988). In bankruptcy, any prepetition contract claim the secured party may have against the debtor is treated as an unsecured obligation. Unsecured obligations receive pro rata satisfaction, to the extent of their claim, from the remains of the debtor's estate after administrative expenses and priority claims are satisfied. 11 U.S.C. §§ 507(a), 726(a), (b) (1988).

71. 11 U.S.C. § 502 (1988).

72. 11 U.S.C. § 726 (1988).

73. Four months is a more reasonable period of time in which to expect a present secured party to monitor its debtor closely enough to discover a change of form accompanied by a name change. Regardless of theoretical reasonableness, the drafters of the Code established four months as a reasonable time for prospective and current secured parties to become aware of changes of name and form. *See infra* note 82 and accompanying text.

74. The secured party may refile a financing statement without the debtor's consent in the case of a change in name, identity, or corporate structure. *See* U.C.C. § 9-402(6).

75. Such a result properly recognizes the difficulty a secured party would have in determining such a change during his monitoring.

B. The Prospective Secured Parties

Extending the current secured party's security interest a minimum of four months after the identity change does not unduly burden prospective secured parties. By providing a four month "safe"[76] period for present secured parties following a simple name change, the Code has already "allocated the burden of discovering" changes in the debtor "to later lenders."[77] Furthermore, prospective secured parties already have a clear duty to inquire into the prior ownership of collateral[78] and as a result, they are "better situated to reduce or eliminate the risk of loss—*e.g.*, by inquiring into the new debtor's corporate history and the source of its property."[79]

Requiring prospective secured parties to search the recent[80] corporate history of a debtor would not be inconsistent with the already existing burden.[81] It is implicitly included in the prospective secured party's current duty to inquire into the background of the debtor four months prior to a contemplated transaction.[82] In addition, the duty of inquiry is not limited to the filing system, and therefore may include state incorporation records. The court in *In re Pasco Sales Co.*[83] recognized that a prospective secured party should not rely on the filing system as the sole source of information, but should instead treat it as "a starting point for investigation which will result in fair warning concerning the transaction contemplated."[84] Placing the burden of searching state incorporation records on the prospective secured party is also consistent with section 9-401(3),[85] which generally places the burden of changes that the present secured party cannot control upon the prospective secured party.[86] Finally, courts

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76. Any collateral acquired within that period is subject to the financing statement, regardless of whether the change makes the previous filing seriously misleading. U.C.C. § 9-402 Official Cmt. 7.

77. Bank of the West v. Commercial Credit Fin. Servs., 852 F.2d 1162, 1173 (9th Cir. 1988).

78. "[A]ny person searching the condition of the ownership of a debtor must make inquiry as to the debtor's source of title, and must search in the name of a former owner if circumstances seem to require it." U.C.C. § 9-402 Official Cmt. 8; *see also* Peter F. Coogan, *The New UCC Article 9*, 86 HARV. L. REV. 477, 526 (1973).

79. PEB Study Group, *supra* note 2, at 145.

80. "Recent" includes the four months prior to the anticipated transaction. If the change occurred prior to that period and an amended financing statement has not been filed, the subsequent secured party would gain priority over the unperfected previous security interest. REILEY, *supra* note 52, at 3.07[3].

81. Some courts disagree: "To require a searcher to determine to what extent a debtor entity is owned or controlled by owners of the transferor debtor would render the filing system of Article 9 unreliable. The potential structural variations of the new debtor are infinite." Bank of Yellville v. Scott, 113 B.R. 516, 522-23 (Bankr. W.D. Ark. 1990).

82. This duty flows from the *second sentence*, which implicitly requires prospective secured parties to search under prior names of the debtor.

83. 354 N.Y.S.2d 402 (1974), *rev'd on other grounds*, 52 N.Y.S.2d 42 (1976).

84. *Id.* at 405 (quoting Beneficial Fin. Co. of N.Y. v. Kurland Cadillac-Oldsmobile, Inc., 32 A.2d 643, 645 (1969)).

85. "A filing which is made in the proper place in this state continues effective even though the debtor's residence or place of business or the location of the collateral or its use, whichever controlled the original filing, is thereafter changed." U.C.C. § 9-401(3).

86. "[I]t was not intended . . . that interested parties be completely absolved from any inquiry as to the past history of the debtor." *In re* Pasco Sales Co., 354 N.Y.S.2d 402, 405 (1974).

that have considered the effect of a change of form on potential and present secured parties are more comfortable in placing the burden of searching recent corporate history on prospective secured parties:

> We decline to adopt the position advocated by the trustee . . . that a creditor *must* file a new financing statement whenever a debtor changes from a proprietorship or partnership to a corporation. . . . Section 9-402(7) requires a new statement only when the change renders the existing financial statement "seriously misleading". . . . Since . . . we find that a creditor doing a lien search would have been on actual notice of . . . [the] security interest and the identity of the debtor despite the bank's failure to completely observe the "corporate technicalities," it would be inappropriate to hold that a change in the entity . . . is seriously misleading as a matter of law. . . . A flat rule that a new financing statement must be filed whenever a debtor incorporates might be easier to apply, but that standard is not supported by a plain reading of the statute or the existing law in the jurisdiction.[87]

C. The Unsecured Creditors

The rights of unsecured creditors are also affected by the approach applied.[88] Unsecured creditors are interested in the validity of a security interest to the extent that collateral subject to an invalid security interest is available to satisfy their claims in bankruptcy.[89] When the Burke approach is applied, unsecured creditors benefit from the generally larger amount of assets available. When the identity approach is applied, the number of available estate assets decreases as the assets are made subject to the original, prechange security interest.[90]

Allowing unsecured creditors access to collateral acquired after the change is illegitimate. The original secured party injected value into the debtor based upon the assumption that the after-acquired collateral would provide security for the debt. The unsecured creditor would unfairly take advantage of that value and the expectation of the secured party, undermined by an action of the debtor, where that value would not have been present had the expectation of the secured party been upheld or the secured transaction not been executed. Application of the identity approach deprives unsecured creditors of this windfall and favors the secured party who provided the debtor with the means to acquire the collateral or operate the enterprise. The unsecured creditors who would take advantage of the after-acquired collateral are not treated unfairly when their access is denied.

D. The Lien Creditors

The treatment of lien or judgement creditors[91] is similar to that of unsecured creditors; when the identity approach is applied they will have access to less collateral in bankruptcy than under the Burke approach. The justification of denying unsecured creditors a windfall in bankruptcy applies with equal weight to lien creditors.

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87. *In re* Darling Lumber, Inc. 56 B.R. 669, 674 (Bankr. E.D. Mich. 1986).

88. Knippenburg, *supra* note 5, at 65.

89. An invalid security interest increases the pro rata proportion of satisfaction the unsecured creditors would receive in a Chapter 7 bankruptcy proceeding. *See* 11 U.S.C. §§ 544(a), 558 (1988).

90. Knippenburg, *supra* note 5, at 65.

91. Lien or judgment creditors are entities that have received a state court judgment. U.C.C. § 9-301(3).

Lien creditors do have an advantage over unsecured creditors under the identity approach; outside of bankruptcy, lien creditors have priority over unperfected security interests.[92] Under the identity approach, the secured party has four months in which to refile or amend a financing statement made seriously misleading by the change of form. Failure to refile or amend results in the security interest becoming unperfected as to collateral acquired four months after the change. The lien creditor can satisfy its judgment with unperfected collateral, whereas an unsecured party takes subject to the security interest, regardless of whether it is perfected.[93]

E. The Debtor

A debtor subject to a valid security interest in its after-acquired property has only one interest in which approach is applied to its change of form. The debtor wants to avoid the security interest. However, the original security interest was the result of a bargain between the debtor and the secured party, and the debtor should be bound by that agreement.

If the Burke approach is applied, the debtor's collateral will no longer be subject to the original, bargained-for security interest. Instead, the debtor will be free to induce a new secured party to provide credit by offering that party the primary security interest in the collateral. The effect of the Burke approach is to provide the debtor with a windfall. The amount of credit provided to the debtor by the original secured party was determined, at least in part, by the amount of collateral that would secure the debt. If less collateral were available at the time of lending, only the credit capable of being secured with that collateral would likely have been extended. Under the Burke approach, the debtor removes the bargained for collateral from the original credit relationship while still retaining the original amount of credit. Furthermore, that collateral may be used to induce other secured parties to extend credit. In that sense, the debtor can "have its cake and eat it too."

Therefore, the Burke approach provides a debtor with the incentive to undergo a change of form any time it wishes to increase available credit. This incentive is detrimental to the original secured party. The problems inherent in this incentive provide significant policy support for the identity approach.

The identity approach precludes a debtor from acting unilaterally to sever a prechange security interest in after-acquired collateral. Instead, the debtor is held to the original bargain. Under the identity approach, the debtor is no worse off than it would be under its bargained-for position. The debtor is not permitted to obtain double the credit for the same collateral.

The results reached by the identity approach, in contrast to those of the Burke approach, are manifestly supported by policy, as well as by actual commercial practice and expectation. A debtor that changes its form should not be able to cut off a previously valid security interest in after-acquired property.

Only secured parties who are diligent in their efforts to police debtors may take advantage of the identity approach. Failure to file an amended financing statement within four months after a change in form that caused the financing statement to become seriously misleading causes the security interest to become unperfected. At that point, any prospective secured party that lends on collateral will have a superior interest in the after-acquired

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92. U.C.C. § 9-301(1)(b).

93. *Id. See also* HENRY J. BAILEY III, SECURED TRANSACTIONS 233-34 (3d. ed. 1933).

collateral. Of course, if the change of form did not make the financing statement misleading, the less than diligent secured party will pay the price for its lax search. This analysis concludes that the identity approach is preferable to the Burke approach. But it must overcome two problems in order for the identity approach to be generally applicable.

IV. SUBSTANCE OVER FORM: AN "ORGANIZATIONAL" INTERPRETATION

The two problems of the identity approach are a failure to adequately address the effect of a change of form on the validity of the prechange security agreement, and a failure to provide a clear means of distinguishing between identity changes and third party transfers. While avoiding these two problems, the benefits of the identity approach can be realized by focusing on whether the pre and postchange entities are the same "organization." An entity that is the same organization both pre and postchange should be treated as having undergone an internal change governed by the *second sentence.*

This approach is supported by the policies underlying the U.C.C. The legal form that an entity takes or the fact that an entity changes its form does not affect its treatment under the Code. The U.C.C. is limited to governing commercial relationships. The policies that justify distinguishing entities by their legal form do not apply in the commercial context.[94] The rights and responsibilities that the U.C.C. articulates do not, nor should they, vary with the type of entity involved. For instance, when a seller of goods who breached a duty to a buyer is found liable, the legal form of the seller may play an important role in satisfying the judgment. However, the seller's form does not control the nature or extent of the duty that it breached. Issues internal to the U.C.C. are answered regardless of an entity's legal form. Resolution of those issues depends solely upon the role that the entity plays in the relationship.

The Code has codified this understanding through the expansive definition of "organization," which provides: "'Organization' includes a corporation, government or governmental subdivision or agency, business trust, estate, trust, partnership or association, two or more persons having a joint or common interest, or any other legal or commercial entity."[95]

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94. Traditionally, various forms of legal entities have been assigned different characteristics, which impact their relationships with other entities. The doctrine which has grown up to justify treating the various forms of entities differently is limited by the reasoning upon which it is based. For example, the separate existence of a corporation from its founders was recognized on the ground that those founders should be able to limit their liability in order to promote investment. Traditional doctrine provides, therefore, that after a proprietorship incorporates, the corporation should be treated as a separate and distinct entity from the proprietor. *See* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS 23-35 (3d ed. 1983). The law recognizes the flexible nature of business entities in general. A change in the ownership of a corporation does not change the responsibilities or existence of the corporation. Donnell v. Herring-Hall-Marvin Safe Co., 208 U.S. 267 (1908); Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U.S. 206 (1908). Furthermore, where control of a corporation changes, for example through a wholesale replacement of the board of directors, the corporation remains the same entity. The justification of limited liability does not extend to treating the proprietorship and corporation differently with respect to their obligations under a security agreement.

95. U.C.C. § 1-201(28). The definition has not changed since adopted in the May 1949 draft, where it was codified as § 1-201(23).

By creating an expansive definition of "organization," the drafters created a means for disregarding the legal form of entities for purposes of determining their rights and responsibilities within the U.C.C.[96] The end result of this effort is that the substance,rather than the form of the entity identifies an "organization" for the purposes of the U.C.C. generally, and Article 9 specifically. If the entity changes form, but its substance remains the same, it remains the same organization.

The definition and purpose of the term "organization" has value in interpreting the language of the applicable sections of Article 9 in relation to the U.C.C.'s purposes as a whole. The term "organization" is listed in the *second sentence* as one of the entities that may undergo an "identity change." The placement of that expansive word within the sentence that allows for the continued effectiveness of the financing statement provides the very mechanism by which to apply the substance-based concept of the Code to the effect of changes of corporate form on a pre-change security interest in after-acquired property. Because the U.C.C. is concerned with the role of an entity and not its legal form, the substance rather than the form of an entity should determine the validity of the security interest and financing statement.

Consideration of the definition of "organization" also serves to undermine and discredit a major statutory interpretation argument of the Burke approach. That approach concludes that the *second sentence* does not apply to changes in form because those changes involve more than one debtor and the sentence only states "the debtor." Upon review, however, the definition of debtor is an aid to the identity approach. The definition of organization is included within the definition of "debtor." The definition of debtor includes: "the person who owes payment or other performance of the obligation secured."[97] The definition of person ties "debtor" and "organization" together: "Person" is defined to include an "individual or an organization."[98] Therefore, as long as an entity remains the same organization, it remains the same debtor.

The Comment of the Article 9 Review Committee supports an interpretation of the word "debtor" as focusing on the substance of an organization and not its form. That Comment makes clear that the Committee perceived only two categories of debtors: the same debtors and new debtors.[99] Given the purposes of the Code, the most plausible meaning for "new debtor" is a substantively different organization.

The interpretation that a debtor does not become a different debtor as a result of a change in form is supported by consideration of what such a change resembles. Furthermore, the expectation of the parties supports treating a debtor which has undergone a change of form as the same debtor. One commentator commented on both of these arguments:

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96. The definition of "organization" is expansive because it includes "every type of entity or association, excluding an individual, acting as such." U.C.C. § 1-201 Official Cmt. 28. The exclusion of an "individual, acting as such" from the definition does not have an impact on the purpose of this inquiry, since an individual can only undergo a name change. Any other type of action by an individual (*i.e.* proprietorship) would qualify the individual for treatment as an organization.

97. U.C.C. § 9-105(1)(d).

98. U.C.C. § 1-201(30).

99. Final Report, *supra* note 27, at 244.

> [C]hanges in business form seem more analogous to name changes. If a debtor changes his name, the creditor continues to deal with the same person. So too, if the debtor incorporates, although his legal form has changed, the ultimate players remain the same. . . . Although at law, each entity is an entity unto itself and recognized at law, we all know the law indulges in legal fictions. If the creditor is still talking to, working with and loaning money to the same people, isn't the change in business form like a change in name?[100]

In addition, at least one court has properly criticized the argument that a pre and postchange debtor are separate and distinct: "[T]his reasoning assumes two debtors though factually there is only one."[101]

By construing "organization" to focus on the substance of the entity and not its legal form, the original and successor entities may be regarded as the same organization and therefore the same debtor. The expectations of commercial parties, discussed above, are affirmed.[102] Finally, a plain reading of section 9-402(7) in light of the substance-based interpretation of the above definitions leads to the conclusion that where an entity changes form, but not substance, the change should be governed by the *second sentence*.

A. Solution to the Attachment Problem

Construing "organization" to include both the pre and postchange entities also provides a solution to the attachment problem of the identity approach. As discussed above, an organization that merely undergoes a change in corporate form remains the same debtor. Because the pre and postchange debtors are the same debtor, the signature of the prechange debtor will qualify as the signature of the postchange debtor. Consequently, that prechange signature will remain effective to maintain the validity of the original security agreement against the postchange entity. Therefore, the security interest will attach to collateral acquired after the change by the postchange entity.

B. Factors on Which to Base the Same "Organization" Determination

The issue of whether a change of form or third-party transfer has occurred is focused on whether the pre and postchange entities are the same organization. If they are not, then the postchange debtor is a "different" debtor and a third-party transfer has occurred.

The last step in setting up this new interpretation in support of the identity approach is providing a generally applicable method for determining when a transaction involves the same or a different organization. More practically, this last step requires a decision as to whether the transaction and the resulting effect upon the security interest should be governed by the *second* or *third sentence* of section 9-402(7).

Critics of the identity approach emphasize that such an approach fails to provide a sound basis for a notice system. "[The identity approach] is a weak foundation on which to build a refiling doctrine since it offers no neutral principles upon which one can determine when

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100. 1 UCC Serv. (MB) Sec 6.10[5], at 6-218.

101. First Agri Services v. Kahl, 385 N.W.2d 191, 193 n.5 (Wis. Ct. App. 1986) (citations omitted).

102. According to the expectations of the parties, a successor entity which maintains many of the same essential characteristics as the original entity acts in the capacity as that debtor. In some instances, the similarities may be so pronounced that a secured party is unaware that any change has occurred.

a transfer will be honored and when it will be disregarded."[103] Unfortunately, prior to this point, those critics were correct. The identity approach lacked statutory support and was applied haphazardly, with no court nor commentator proposing a generally applicable analysis that was both reliable and practical. The following approach meets that goal.

The focus of the inquiry is the essential characteristics of an "organization." Additionally, the different traits of an organization that may impact the efficacy of the notice filing system should be considered. The two major considerations of the Article 9 filing system are: first, to provide notice to prospective secured parties of an existing security interest; and second, to ensure that the duty of the present secured party to protect its security interest by monitoring changes in the debtor is not onerous.[104]

1. Ownership and Control.—At first glance, there seems to be an essential and distinguishing trait of an organization: its membership. However, defining an organization by its whole membership may be painting with too broad a brush. It may not be useful for definitional and practical purposes to include the organization's receptionist and janitorial staff as part of its membership. Instead, the proper focus of the membership inquiry is those individuals most deeply involved in the significant business activity of the organization; those individuals or entities that act as owners and those that are in control or act as managers. Therefore, part of the analysis must focus on the ownership and control of the entity immediately prior to and after the change to determine whether the postchange entity is the same organization.

Focusing on the elements of ownership and control of the pre and postchange entities to determine whether an identity change has occurred is supported by one of the main reasons the identity approach is preferred to the Burke approach. The identity approach blocks a debtor from cutting off a valid security interest in after-acquired property by altering its corporate form. An effort aimed at avoiding such activity should focus on the typical characteristics of such a debtor. Generally, an organization attempting to circumvent a security interest maintains the same ownership and control throughout the change. If the ownership and control are different after a change, then the likelihood that the transaction was a bona fide transfer to a third party increases. It follows that the greater the similarity in ownership and control, pre and postchange, the greater the likelihood that an identity change has occurred.[105]

Looking to the ownership and control of the debtor to determine whether an identity change has occurred is also supported by practical considerations. An important part of a secured transaction is the individual or individuals who form the relationship between the secured party and debtor. If the individuals who comprise the debtor are the same before and after the change, a secured party is less likely to become aware of a change affecting his

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103. Burke, *supra* note 51, at 1092.

104. U.C.C. § 9-402 Official Cmt. 2.

105. Courts have previously relied on ownership and control in finding that a transaction resulted in an identity change. For example, the Ninth Circuit focused on ownership of the pre and postchange debtor to hold: "We conclude as a matter of law that the security agreement executed by the proprietorship continued to be effective as to the accounts receivable generated by the corporation after the change in entity status." Towers v. B.J. Holmes Sales Co., 637 F.2d 707, 709 (1981). *See also* Cohutta Mills v. Small Business Admin., 108 B.R. 815 (Bankr. N.D. Ga. 1989), discussed *supra* at notes 46-47.

security interest. Furthermore, the presence of the same people in the pre and postchange entity provides prospective secured parties with the resources to learn about prior forms of the entity and any liens against its property.

2. Line of Business and Location.—The reasoning which places importance on the ownership and control of the pre and postchange entities extends to place importance on whether a debtor maintains the same line of business and the same location. Both considerations may act to mislead current secured parties as to identity or offer prospective leads to prospective secured parties searching for prior liens. For instance, where the prechange entity stays in the same location, a present secured party would probably not realize that a change in form had occurred. It is unlikely that a transfer of assets to an entity located in the same location as the transferor was a transfer to an unrelated party. Additionally, an entity that merely changes form would probably continue in the same line of business. Adding the pre and postchange entities' line of business to the analysis offers an additional factor that therefore improves the accuracy and certainty of the approach.[106]

Application of these factors without guidance raises two problems. First, it fails to provide parties with an understanding of what consequences they may expect from changes of form. Second, it provides little guidance to courts applying the approach. This results in inconsistent opinions and fact-sensitive deliberations. A clear rule of general application that commercial actors are capable of following is preferable. Therefore, the analysis of the identity approach should be structured and limited to considering relevant factors in a way that provides clear and consistent results. The inquiry should be limited to comparing the four factors listed above immediately prior to and following the transfer to the postchange entity.[107]

Where the four factors are identical immediately pre and postchange, the transaction should be treated as an identity change. The four factors must be essentially identical, otherwise the certainty of the approach is undermined. Where the debtor has changed legal form in an attempt to circumvent the original security interest, minor dissimilarities may be overlooked. Courts must keep in mind that the more the factors are dissimilar and they use their discretion to find an identity change, the greater effect the ruling will have on undermining the efficiency of the notice filing system and the stability of commercial conduct generally.[108] As a result, judicial discretion should be used sparingly.

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106. The more factors available to courts in determining whether an identity change has occurred, the more precise and clear the analysis provided by the courts. The clearer the analysis, the more commercial parties are able to forecast the results and consequences of their conduct, and plan accordingly.

107. The relevant points in time are immediately before and after the actual change. Since all four of the factors may change during the course of an organization's existence, their value in this deliberation is at the time of the transfer itself. The focus at this time causes the identity approach to arrive at a result with the same level of certainty as the Burke approach. *See* Bluegrass Ford-Mercury v. Farmers Nat'l Bank of Cynthiana, 942 F.2d 381 (6th Cir. 1991).

108. Where all but one share of a successor corporation is owned by the same persons who owned the original debtor, the change should be treated as an identity change. These facts were held to constitute a transfer to an unrelated party in *Bank of Yellville v. Scott*, 113 B.R 516 (Bankr. W.D. Ark. 1990) (decided under the Burke approach).

V. Proposed Legislative Response

Though the "organizational approach" may be used by courts under the current language of the U.C.C., some legislative action is preferable. That action would ensure application of the identity approach and the protection of current secured parties.

As shown above, actual revision of the text of the Uniform Commercial Code is not necessary to apply the modified interpretation of the identity approach. However, legislatures could adopt some variation of the following as an "Official Comment" to the following sections to make clear their intent that the identity approach should be applied where a pre and postchange entity are the same organization:

1-102(28) "organization":

> An organization remains the same organization, notwithstanding a change in corporate form, where all of the following four factors are substantially similar immediately before and after the change in corporate form: ownership of the entity; individuals that manage or control the entity; location of the entity's business or offices; and the entity's line of business.

9-203(1)(a):

> A debtor that undergoes a change in corporate form remains the same debtor where it is the same "organization" under section 1-201(28). As a result of being found the same debtor, the pre-change signature of the debtor shall be effective to continue the validity of the security agreement to collateral acquired after the change.

9-402(7):

> The second sentence of section 9-402(7) is intended to cover instances where a debtor changes corporate form but remains the same "organization" under section 1-201(28). Where a change in form results in a different "organization," the effectiveness of the financing statement is governed by the third sentence of section 9-402(7).

Conclusion

The different results that the identity approach and Burke approach reach on any given set of facts provide a disruptive context for parties to predict the consequences of their actions as well as for courts to resolve conflicts. A postperfection change in form has a large impact upon the parties to a secured transaction, as well as to others affected by the status of the security interest. The above discussion outlines a method for resolving postperfection changes that provides courts with a statutorily valid means to enforce the expectations of the parties in a way that promotes certainty.