REPORT OF FINANCE AND TRANSACTIONS COMMITTEE

I. CHANGES TO UNIFORM COMMERCIAL CODE ARTICLE 9

A. Introduction

Revised Article 9 (Revised Article 9) of the Uniform Commercial Code (UCC) has been adopted in most jurisdictions, effective as of July 1, 2001.[1] It implements substantial changes to the former provisions of Article 9 of the UCC (1995) (Former Article 9), including a broader scope and simplified filing procedures. The changes introduced by Revised Article 9 are of particular importance to financing transactions, including limited recourse project finance transactions often used for power plants and other types of energy facilities. In contrast to corporate-type financing, where lenders rely on the general credit and/or assets of a diversified company, limited recourse financing allows lenders to look to the future revenues of a specific project for the repayment of their loan and to the assets of the project as collateral. As a result, lenders in project finance transactions typically require security interests in all assets of the project company in order to assume control of the project in the event of a borrower default.[2] This article is an introduction to the major changes and issues of Revised Article 9 as they relate to finance transactions in general and project financings in particular. Section *B* discusses the changes to the scope of Revised Article 9 brought about by new categories of collateral and modifications to existing collateral definitions. Section *C* examines attachment under the Revised Article 9 provisions. Section *D* discusses governing law provisions for perfection and priority under both Former Article 9 and Revised Article 9. Section *E* describes the mechanisms of perfection under both versions of the statute. Section *F* examines the priority rules also under both versions of the statute. Section *G* describes the impact of Revised Article 9 on anti-assignment clauses and certain defenses. Part *H* describes the transition rules.

B. Scope of Revised Article 9

Article 9 applies to any transaction, regardless of form, which creates a security interest in personal property or fixtures.[3] Revised Article 9 generally broadens the scope of Article 9 by (i) limiting and narrowing the number of ex-

1. The revisions to Article 9 became effective in Connecticut on October 1, 2001, and in Alabama, Florida and Mississippi on January 1, 2002.

2. Lenders in project finance transactions will generally require the project company to provide security in all of its assets, including: (i) a mortgage on the project site and related real property; (ii) liens on personal property; (iii) a pledge of stock in the project company; (iv) an assignment of contracts; (v) an assignment of operating revenues; (vi) control of deposit accounts; (vii) an assignment of insurance proceeds; and (viii) liens on permitted investments.

3. U.C.C. rev. § 9-109(a)(1) (2001).

clusions; (ii) providing for new types of collateral; and (iii) modifying certain definitions. The following subparts summarize some of the most important revisions to the scope of Article 9 brought about by Revised Article 9 with respect to secured lending transactions.

1. Deposit Accounts

A deposit account is "a demand, time, savings, passbook, or similar account maintained with a bank."[4] Lenders in project finance transactions typically require the project company to pledge its bank accounts to ensure that any revenues received are applied in accordance with the loan documents. Under Former Article 9, security interests in deposit accounts were excluded, causing lenders to look to the common law for guidance and resulting in increased costs and uncertainty.[5] Except in consumer transactions, security interests in deposit accounts are now covered under Article 9.[6]

2. The Parties

Under Former Article 9, the determination of whether a party was a debtor required an examination of the context in which the word was used.[7] Revised Article 9 eliminates the need for this analysis by adding new definitions for the terms "obligor" and "secondary obligor."[8] The new definitions reflect generally three classes of persons that are relevant for purposes of the default and enforcement provisions of Article 9. The debtor has a stake in the proper enforcement of a security interest as a result of its ownership interest. The obligor's stake arises from its obligation to pay the secured debt. The secondary[9] obligor has an obligation to pay the secured debt, but has no stake in the proper enforcement of the security interest.[10] These distinctions are important in the implementation of the default and enforcement provisions of Part VI of Revised Article 9.

In addition, Revised Article 9 defines "debtor" more broadly to include all persons with an interest in the collateral, other than a secured party.[11] The new

4. *Id.* § 9-102(a)(29). A deposit account does not include investment property or accounts evidenced by an instrument, which are subject to the rules governing instruments, but would include an uncertificated certificate of deposit and a nonnegotiable certificate of deposit if it does not qualify as an instrument. U.C.C. rev. § 9-102 cmt. 12 (2001). An instrument is a negotiable instrument or any other right to payment of a monetary obligation that is evidenced by a writing of a type that in the ordinary course of business is transferred by delivery. *Id.* § 9-102(a)(47).

5. U.C.C. fmr. § 9-104(l) (1995) (providing that Article 9 does not apply to a transfer of an interest in a deposit account, except as provided with respect to proceeds and priorities in proceeds).

6. U.C.C. rev. § 9-109(d)(13) (2001) (excluding deposit accounts in consumer transactions).

7. U.C.C. fmr. § 9-105(1)(d) (1995) (stating that where the debtor and the owner of the collateral are not the same person, the term "debtor" means the owner of the collateral in any provision of Article 9 dealing with the collateral, the obligor in any provision dealing with the obligation, and may include both where the context so requires).

8. U.C.C. rev. § 9-102(a)(59), (71) (2001).

9. *Id.* at cmt. 2(a) (noting that the law of suretyship determines whether an obligation is secondary).

10. U.C.C. rev. § 9-102 cmt. 2(a).

11. *Id.* § 9-102(a)(28) (2001).

definition is broader than under Former Article 9 because it now includes transfers of collateral, whether or not the secured party was aware of the transfer.[12]

A "secured party" is the person in whose favor the security interest has been created.[13] Revised Article 9 also modifies this term by clarifying that lender representatives, such as collateral agents, are secured parties. This is of particular interest to project finance transactions, where a group of lenders are commonly represented by a collateral agent. Under Former Article 9, the collateral agent was deemed the secured party whether or not the lenders would have preferred to remain as secured parties.[14] Under Revised Article 9, however, the parties have the option of expressly determining in the security agreement whether the lenders or the collateral agent is the secured party.[15]

3. Supporting Obligations

Revised Article 9 defines "supporting obligations" broadly to include most common types of credit enhancements.[16] Credit enhancements, such as guarantees and letters of credit, are commonly used in limited-recourse financed projects as a means to secure performance under project contracts.[17] Revised Article 9 clarifies that the attachment and perfection of a security interest in collateral, supported by a credit enhancement, also results in the attachment and perfection of such credit enhancement.[18]

4. As-Extracted Collateral

Oil, gas, and minerals that have not been extracted from the ground are real property and therefore excluded from Article 9.[19] Revised Article 9 adds the defined term "as-extracted collateral" to provide for the inclusion in Article 9 of those minerals upon extraction.[20] The new definition does not add substance to the treatment of oil, gas and mineral rights under Article 9, but it facilitates the provisions of special rules for such collateral.[21] Like its predecessor, Revised Article 9 allows debtors to grant a security interest in oil, gas, and minerals, which interest would attach as the oil, gas, or minerals are extracted.[22]

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12. U.C.C. rev. § 9-102 cmt. 2(a) (2001) (noting that former § 9-112, which governed situations in which the collateral was not owned by the debtor, is no longer necessary).

13. U.C.C. rev. § 9-102(a)(72)(A) (2001).

14. U.C.C. fmr. § 9-105(1)(m) (1995) (providing that when the holders of obligations issued under an indenture of trust or the like are represented by a representative, the representative is the secured party).

15. U.C.C. rev. § 9-102(a)(72)(A), (D) (2001).

16. *Id.* § 9-102(a)(77) (2001).

17. *See generally* Scott L. Hoffman, *A Practical Guide to Transactional Project Finance: Basic Concepts, Risk Identification and Contractual Considerations*, 45 BUS. LAW. 181, 204-208 (1989) (describing the role of credit enhancements in project finance transactions) [hereinafter Hoffman].

18. U.C.C. rev. §§ 9-203, 9-308, 9-310 (2001).

19. *Id.* § 9-109(d)(11) (2001).

20. U.C.C. rev. § 9-102(a)(6) (2001).

21. U.C.C. rev. §§ 9-301(4) (governing law), 9-501 (place of filing), 9-502 (2001) (contents of financing statement).

22. *Id.* § 9-102 cmt. 4(c) (2001) (setting forth some examples).

5. Government Units

Security interests created by governmental authorities were excluded under Former Article 9.[23] Revised Article 9 also excludes security interests created by "governmental units,"[24] but only to the extent another statute governs the creation of security interests.[25] Revised Article 9 makes a distinction between statutes from the jurisdiction of the forum state and statutes of other states or foreign countries. With respect to the former, Revised Article 9 defers to all the statutes applicable to security interests of the forum state.[26] In contrast, when the statute governing the security interest of the governmental unit is not from the jurisdiction of the forum, Revised Article 9 defers to such statute only to the extent that such statute contains rules applicable specifically to security interests created by the governmental unit.[27] That is, a foreign statute generally applicable to security interests would not prevent the forum state from applying Revised Article 9.[28]

C. Attachment

The attachment of a security interest is important for three reasons: (i) a security interest becomes enforceable against the debtor upon attachment;[29] (ii) some security interests, such as supporting obligations, become automatically perfected upon attachment;[30] and (iii) the time of attachment determines the priority as to unperfected security interests.[31] For a security interest to attach, the following three elements must be met: (i) value has been given;[32] (ii) the debtor has rights in the collateral;[33] and (iii) either (a) the debtor has authenticated[34] a security agreement, (b) the collateral must be in possession of the secured party, (c) with respect to certificated securities, the certificate(s) representing the securities has been delivered to the secured party, or (d) the secured party has control of the collateral.[35]

23. U.C.C. fmr. § 9-104(e) (1995).

24. U.C.C. rev. § 9-102(a)(45) (2001) (defines "government units" as "a subdivision, agency, department, county, parish, municipality, or other unit of the government of the United States, a State, or a foreign country. The term includes an organization having a separate corporate existence if the organization is eligible to issue debt on which interest is exempt from income taxation under the laws of the United States.").

25. *Compare* U.C.C. rev. § 9-109(c)(2) (2001) *with* U.C.C. fmr. § 9-104(e) (1995).

26. U.C.C. rev. §§ 9-109(c)(2), cmt. 9 (2001).

27. *Id.* § 9-109(c)(3) (2001).

28. U.C.C. rev. § 9-109 cmt. 9 (2001) (setting forth some examples).

29. U.C.C. rev. § 9-203 (2001). In contrast, a security interest becomes enforceable against other creditors upon perfection. *See generally infra* Part *E* (discussing perfection).

30. *See generally infra* Part *E*(13) (noting that a security interest in a supporting obligation is automatically perfected upon attachment).

31. *See generally infra* Part *F*(1) (describing the perfection rules).

32. U.C.C. rev. § 9-203(b)(1) (2001).

33. U.C.C. rev. § 9-203(b)(2) (2001).

34. The term "authenticate" means a signature but also includes an electronic transmission with the intention to adopt or accept a record. U.C.C. rev. § 9-201(a)(7) (2001).

35. U.C.C. rev. § 9-203(b)(3) (2001).

D. *Law Governing Perfection and Priority*

While the parties to a secured transaction may designate in the choice of law clause of their security agreement, the law applicable to their contractual rights and obligations,[36] such a clause will not govern the law of two crucial aspects of secured transactions: perfection and priority of security interests.[37] This means that the parties must pay particular attention to the governing law rules of Revised Article 9.

1. Application of "Local Law"

Whereas Former Article 9 directed the courts to apply the "whole" law of a jurisdiction, including the choice of law rules of such jurisdiction, Revised Article 9 now directs the courts to apply the substantive or "local" law of the jurisdiction and not its choice of law rules.[38] This is done to provide greater simplicity and avoid the circularities inherent in applying "whole" law provisions.[39]

2. General Rule: Location of Debtor

The governing law provisions of Revised Article 9 simplify former governing law rules which varied for different types of collateral and which sometimes required the determination of the location of the collateral at a particular point in time.[40] Under Former Article 9, for example, the governing law applicable to ordinary goods was determined based on the location of the collateral at the time the last event on which perfection is based occurred,[41] whereas the law governing mobile goods was based on the location of the debtor.[42] With some exceptions discussed below, Revised Article 9 provides that the governing law for most types of collateral is based on the location of the debtor.[43] In addition, Revised Article 9 has also simplified the rules used to determine the location of the debtor by adopting a general rule that registered organizations are located in their jurisdiction of organization.[44] This simplifies filing requirements for single purpose project companies, where the location of the project company for Article 9 purposes often depended on an analysis of where the company's books and records were located, as well as, the location of the actual project. Because the governing law provisions dictate filing, simplification will reduce uncertainty and transaction costs.

36. U.C.C. fmr. § 1-105(1) (1995) (explaining that the jurisdiction must have a reasonable relation to the transaction); U.C.C. rev. § 9-301 cmt. 2 (2001) (noting that governing law provisions do not address choice of law for purposes other than perfection or priority).

37. *Id.* § 9-301 (2001).

38. U.C.C. rev. § 9-301 cmt. 3, ex. 2 (2001).

39. *Id.*

40. U.C.C. fmr. § 9-103 (1995).

41. *Id.* § 9-103(1)(b) (1995).

42. U.C.C. fmr. § 9-103(3) (1995).

43. U.C.C. rev. § 9-301(1) (2001).

44. U.C.C. rev. § 9-307(e) (2001).

3. Domestic Organizations

A "registered organization" is an organization organized in a state or territory of the United States for which a public record is maintained.[45] Such organizations include corporations, limited partnerships, and limited liability companies, but do not include general partnerships (which are not publicly registered). For purposes of Revised Article 9, registered organizations are located in their state of organization.[46] Non-registered organizations, such as partnerships, are located at their place of business or chief executive office.[47] This is a welcome departure from Former Article 9, which provided that all debtors were located in their place of business or chief executive office.[48] For debtors with multiple offices and no clear chief executive office, Former Article 9 governing law provisions created uncertainty as to the location of the debtor, resulting in multiple filings and increased costs.

4. Foreign Organizations

Former Article 9 provided rules for the location of the debtor based on the location of the foreign debtor's major executive office in the United States.[49] In international project finance transactions, however, foreign debtors often did not have an executive office in the United States or if they did, it was difficult to identify the "major" executive office. Revised Article 9 simplifies this exercise by adopting a clearer approach. For purposes of Revised Article 9, an organization that is neither registered nor located in the United States would be "located" in the District of Columbia.[50] Generally, foreign project companies are organized under the law of the foreign state. Such organizations are neither registered nor located in the United States. Therefore, perfection and priority would be governed by the law of the District of Columbia.

5. Governing Law: Exceptions to the General Rule

The general rule applies where perfection occurs by filing. However, if perfection is accomplished by different means, such as possession or control, the relevant provisions of Revised Article 9 need to be examined more closely. The following subparts summarize governing law rules for certain types of collateral when perfected by means other than filing.

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45. U.C.C. rev. §§ 9-102(a)(70) (defining "registered organization"), 9-102(a)(76) (2001) (defining "state").

46. U.C.C. rev. § 9-307(e) (2001).

47. U.C.C. rev. § 9-307(b)(2), (3) (2001).

48. U.C.C. fmr. § 9-103(3)(d) (1995). Note, however, that under Revised Article 9 the location of the debtor's domicile is still relevant for purposes of determining the law applicable to individuals and general partnerships. U.C.C. rev. § 9-307(b) (2001).

49. U.C.C. fmr. § 9-103(3)(c) (1995).

50. U.C.C. rev. § 9-307(b)-(c) (2001) (explaining that subsection (b) only applies if the debtor is located in a jurisdiction that requires notice of the security interests in a filing, recording or registration system; otherwise the debtor is located in the District of Columbia); *Id.* cmt. 3 (setting forth some examples).

6. Possessory Interests

Generally, goods, money, and instruments may be perfected by possession.[51] Instead of the local law of the jurisdiction of the debtor, the local law of the jurisdiction where the collateral is located governs the perfection and priority of a possessory interest in such collateral.[52]

7. As-Extracted Collateral

As discussed above, as-extracted collateral consists of oil, gas, and minerals that have been extracted from the ground.[53] The local law of the jurisdiction in which the wellhead or minehead is located governs perfection and priority of a security interest in as-extracted collateral.[54]

8. Investment Property

Investment property is comprised of certificated and uncertificated securities, security entitlements, security accounts, commodity contracts, and commodity accounts.[55] This collateral is relevant because the pledge of the equity of the project company to the secured lenders is common in project finance transactions and because the project funds may be invested in certain permitted types of securities. The general rule applies when a security interest in investment property is perfected by filing.[56] As discussed below, however, perfection by filing of a security interest in investment property is inferior to a security interest in the same investment property perfected by control. If the security interest in investment property is not perfected by filing, the determination of what local law governs depends on the type of investment property. For a certificated security,[57] the local law where the certificate is located governs.[58] For an uncertificated security[59] or a security entitlement,[60] the local law of the issuer's jurisdiction governs.[61] For a securities account[62] or commodity account, the local law of such account's intermediary (*e.g.*, the financial securities firm with whom the securities account is maintained) applies.[63]

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51. *See generally infra* Part *E*(9) (discussing perfection by possession).

52. U.C.C. rev. § 9-301(2) (2001).

53. *See generally supra* Part *B*.4. (discussing as-extracted collateral).

54. U.C.C. rev. § 9-301(4) (2001); *see also id.* cmt. 5(d) (explaining that local law of the location of the wellhead governs oil and mineral rights because such security interests, like fixtures, require local filing).

55. *Id.* § 9-102(a)(49).

56. U.C.C. rev. § 9-305 (2001).

57. *Id.* § 8-102(a)(4) (2000) (defining certificated security).

58. U.C.C. § 9-305(a)(1) (2001).

59. U.C.C. rev. § 8-102(a)(18) (2001) (defining uncertificated security).

60. *Id.* § 8-102 (a)(17) (2000) (defining security entitlement).

61. U.C.C. rev. § 9-305(a)(2) (2001).

62. U.C.C. rev. § 8-501 (2001) (defining securities account).

63. U.C.C. rev. §§ 9-305(a)(3), (4), 9-305(b) (2001) (setting forth the rules for determining the commodity's intermediary jurisdiction).

9. Deposit Accounts

As discussed above, deposit accounts were excluded from Former Article 9. Revised Article 9 includes deposit accounts within its scope and provides that the local law of the jurisdiction of the depositary bank governs the perfection and the priority of a security interest in a deposit account.[64] The jurisdiction of the bank may be set forth in the depositary agreement.[65] If the depositary agreement does not specify the law of the jurisdiction of the bank, Revised Article 9 looks at the choice of law provision of the depositary agreement.[66]

10. Negotiable Documents, Goods, Instruments, Money, and Tangible Chattel Paper

In some instances, while the law of the location of the debtor governs perfection, the local law of the jurisdiction where the collateral is located governs the effect of perfection and the priority of a non-possessory interest in the collateral.[67] The bifurcation of perfection from the effect of perfection and priority is intended to avoid certain problems that arise when the debtor and the collateral are in different jurisdictions.[68] For example, if a project company located in Delaware (*i.e.*, it is organized in Delaware) has goods located in Florida, lenders would file a financing statement in Delaware covering the goods, and Delaware law would govern the perfection of such security interest. The priority of the lender's perfected security interest in the Florida goods against a lien creditor, however, would be governed by Florida law.[69] The drafters of the UCC are of the opinion that this is the proper approach.[70]

E. Perfection

Generally, a security interest is perfected when it has attached and when all of the applicable steps required for perfection have been taken.[71] Without perfection, a secured party has limited rights against third parties. In most circumstances, the holder of a perfected security interest: (i) may prevail against lien creditors or a representative of creditors in bankruptcy proceedings; (ii) has an interest which is superior to the unperfected interest of a third person in the same collateral; and (iii) may have priority over buyers of the collateral. The following subparts discuss the necessary steps under Revised Article 9 to perfect a se-

64. U.C.C. rev. § 9-304(a) (2001).

65. *Id.* § 9-304(b)(1) (2001).

66. U.C.C. rev. §§ 9-304(b)(2)-(5) (2001) (otherwise, the jurisdiction of the bank will be the jurisdiction in which the chief executive office of the bank is located).

67. *Id.* § 9-301(3)(C) (2001) (stating that the local law of the jurisdiction where the collateral is located governs the effect of perfection or non-perfection and the priority of a non-possessory interest in negotiable documents, goods, instruments, money, or tangible chattel paper).

68. U.C.C. rev. § 9-301 cmt. 7 (2001).

69. Carl S. Bjerre, *International Project Finance Transactions: Selected Issues Under Revised Article 9*, 73 AM. BANKR. L.J. 261, 275-281 (1999) (discussing the advantages and some of the shortcomings caused by the bifurcation of perfection from the effect of perfection) [hereinafter Bjerre].

70. U.C.C. rev. § 9-301 cmt. 7 (2001) (noting that the priority of an execution lien on goods located in one state should not be governed by the law of another jurisdiction).

71. *Id.* § 9-308 (2001).

curity interest in certain types of collateral.[72]

1. Perfection By Filing

Generally, perfection as to most kinds of collateral may be accomplished by filing a financing statement in a public office. Perhaps one of the most important contributions of Revised Article 9 is the simplification of the filing process. Because filing under Former Article 9 was generally tied to the location of the collateral, and provided for a less certain method in determining the location of the debtor,[73] secured financing transactions typically required filings in multiple jurisdictions. In some instances, multiple filings were required out of caution because Former Article 9 filing rules created uncertainty as to the appropriate jurisdiction in which to file. This resulted in increased costs from additional lien searches and filing fees.[74] Revised Article 9 attempts to overcome the shortcomings of Former Article 9 by adopting a location of debtor rule.[75] Note, however, that a security interest perfected by control has priority over a security interest perfected by filing.[76]

2. Where to File

Under Revised Article 9, the determination of the proper jurisdiction in which to file a financing statement derives from the governing law rules for perfection and priority.[77] As discussed in Part 4 above, however, Revised Article 9 has substantially simplified the governing law provisions. Under Revised Article 9, the general rule for determining the governing law (thus determining in which jurisdiction to file) for purposes of perfection and priority is to look at the jurisdiction where the debtor is located.[78] In turn, Revised Article 9 has simplified the rules for determining the location of the debtor.[79]

3. Central Filing

Former Article 9 provided three alternative filing approaches depending on whether the state desired central filing, local filing, or both.[80] As a result, some states, the so-called "dual jurisdiction states," required filing both at the state level and at the local or county level. In contrast, Revised Article 9 dictates central filing in most situations.[81] Perfection is accomplished by filing at the desig-

72. *See generally infra* Part *F* (discussing priority).

73. U.C.C. fmr. §§ 9-103, 9-302 (1995).

74. *But see also infra* Part *H* (recommending lien searches be performed under both Revised Article 9 and Former Article 9 jurisdictions during the five year period of transition where old financing statements might still be effective under Revised Article 9).

75. *Compare* U.C.C. rev. § 9-301 (2001) *with* U.C.C. fmr. § 9-401 (1995).

76. *See generally infra* Part *F*(2) (discussing exceptions to first to file priority rule).

77. U.C.C. rev. § 9-501 (2001).

78. *Id.* § 9-301 (2001).

79. *See generally supra* Part *D*.2. (explaining the location of debtor rules of Revised Article 9).

80. U.C.C. fmr. § 9-401 (1995).

81. U.C.C. rev. § 9-501 cmt. 2 (2001) (noting that a centralized filing system results in a system that makes it easier and cheaper to procure credit information).

nated office for public filing in the applicable state[82] (*e.g.*, the Secretary of State of the State of Delaware).

4. Local filings

Central filing, however, is not applicable to certain types of collateral. Extracted collateral requires a local filing in the real estate recording office of the applicable jurisdiction which is determined based on the location of the wellhead.[83] Fixtures require local filing if the financing statement is filed as a fixture filing.[84]

5. Special Rule: Transmitting Utilities

Filing to perfect security interests granted by transmitting utilities[85] is done at a special office designated by the state.[86] The reason for this special rule is that transmitting utilities often have real property in several jurisdictions. By requiring a centralized filing, Revised Article 9 avoids the requirement of having to file in every county where the debtor has property.[87]

6. Financing Statement

Revised Article 9 maintains the system of "notice filing"[88] of Former Article 9. Revised Article 9 does not require the filing of the entire security agreement to perfect a security interest because filing a financing statement in compliance with the provisions of Article 9 (discussed below) is sufficient.[89] Public notice, however, merely indicates that a person may have a security interest in the collateral. Further inquiry from the applicable parties is still necessary to determine the state of their affairs.[90] In addition, Revised Article 9 simplifies or eliminates some of the requirements of the financing statement imposed by Former Article 9, such as eliminating the requirement that the debtor sign the financing statement.[91]

7. Contents of the Financing Statement

A financing statement is sufficient for filing if it (i) contains the name of the debtor;[92] (ii) contains the name of the secured party or its representative (*i.e.*, the

82. *Id.* § 9-501(a)(2) (2001).

83. U.C.C. rev. § 9-501(a)(1)(A) (2001) (providing for filing in the office where a record of a mortgage on the related would be filed).

84. *Id.* § 9-501(a)(1)(B) (2001).

85. A "transmitting utility" is an entity primarily engaged in the business of (i) operating a rail system; (ii) transmitting communications electrically; (iii) transmitting goods by pipeline; or (iv) transmitting or producing and transmitting electricity, steam, gas or water. U.C.C. rev. § 9-102(a)(80) (2001).

86. U.C.C. rev. § 9-501(b) (2001) (noting that such filing also constitutes a fixture filing).

87. *Id.* § 9-501 cmt. 5 (2001).

88. U.C.C. rev. § 9-502 cmt. 2 (2001) (explaining the advantages of notice filing).

89. *Id.* § 9-502 (2001).

90. U.C.C. rev. § 9-502 cmt. 2 (2001).

91. *Compare* U.C.C. fmr. § 9-402(1) (1995) *with* U.C.C. rev. § 9-502 (2001).

92. U.C.C. rev. § 9-502(a)(1) (2001).

collateral agent);[93] and (iii) describes the collateral.[94] Since financing statements are indexed under the name of the debtor, Revised Article 9 requires the name of the debtor to meet certain sufficiency requirements.[95] For example, if the debtor is a registered organization, the financing statement must provide the name of such debtor as indicated on the public record of its jurisdiction of organization.[96] Providing simply the debtor's trade name is not sufficient.[97] Revised Article 9 provides that the debtor no longer has to sign the financing statement,[98] which facilitates electronic filing.[99] While rev. § 9-502 does not require that the financing statement contain the address of the secured party for the financing statement to be effective,[100] the filing office of the applicable state may still reject a financing statement that does not include the address of the secured party.[101] The description of the collateral is sufficient if it reasonably identifies the collateral described.[102] Revised Article 9 allows for flexibility in describing the collateral, but, in accordance with prevailing case law, a very general description, such as "all assets," would be insufficient.[103]

8. Duration

A financing statement lapses after five years unless a continuation statement is filed prior to the lapse.[104] A continuation statement may be filed within six months preceding the expiration of the five year period.[105] If the financing statement lapses, it will cease to be effective and any security interest that was perfected by filing will cease to be perfected.[106] A financing statement filed against a transmitting utility, however, remains effective indefinitely until a termination statement is filed.[107]

9. Perfection by Possession

Article 9 permits a security interest to be perfected by taking possession of

93. *Id.* §§ 9-502(a)(2); 9-503(d) (2001) (failure to indicate the representative's capacity does not affect the sufficiency of a financing statement).

94. U.C.C. rev. § 9-502(a)(3) (2001).

95. *Id.* § 9-503(a) (2001).

96. U.C.C. rev. § 9-503(a)(1) (2001).

97. *Id.* § 9-503(c) (2001).

98. The potential for filing abuses generated by a lack of debtor signature is limited by the necessity that the financing statement be authorized in an authenticated security agreement. U.C.C. rev. § 9-509 (2001) (describing who is authorized to file the financing statement).

99. U.C.C. fmr. § 9-402 (1995).

100. U.C.C. fmr. § 9-402 (1995) (requiring an address for the secured party).

101. U.C.C. rev. §§ 9-516, 9-520 (2001) (the filing office must provide prompt notice of rejection of the financing statement).

102. *Id.* §§ 9-108(a)-(b) (2001) (stating that any method of identification is allowed as long as the collateral is "objectively determinable").

103. U.C.C. rev. § 9-108(c) (2001) (providing that a description of the collateral as "all the debtor's assets" or "all the debtor's personal property" or similar words is not sufficient).

104. *Id.* § 9-510(a) (2001).

105. U.C.C. rev. §§ 9-510, 9-515 (2001).

106. U.C.C. rev. § 9-510(b), (c) (2001).

107. *Id.* § 9-510(b) (2001).

most types of collateral, such as goods, money, instruments and letter of credit rights.[108] Similarly, a security interest in a certificated security may be perfected by the secured party taking delivery of the security certificate in accordance with § 8-301.[109] Revised Article 9, following the approach of Former Article 9, does not define "possession." Rather, possession is determined by using the rules of agency.[110] Note that except for money, for which a security interest can only be perfected by possession, perfection of possessory collateral may also be accomplished by filing.[111]

10. Perfection by Control

Former Article 9 allowed security interests in investment property to be perfected by control (as well as filing, and in the case of certificated securities, by possession). Revised Article 9 expands the classes of collateral that can be perfected by control to other classes of collateral, such as deposit accounts.

11. Investment Property

The elements of control with respect to investment property are: (i) the delivery, with endorsements, of certificated securities to the secured party; (ii) an agreement by the issuer of uncertificated securities that the issuer will honor the instructions from the secured party without further consent from the debtor; (iii) an agreement by a commodities intermediary[112] that it will honor the instructions from the secured party without further consent from the debtor; or (iv) the registration of the securities, the securities account or the commodities account, as applicable, in the name of the secured party.[113]

12. Deposit Accounts

Unlike investment property, which can be perfected by filing or control, a security interest in a deposit account can only be perfected by the secured party obtaining control of the deposit account.[114] With respect to deposit accounts, "control" means that the secured party, the debtor, and the bank have entered into an agreement, commonly called a depositary agreement in project finance transactions, pursuant to which the bank agrees to comply with the instructions of the secured party as to the disposition of the funds on deposit without requiring consent from the debtor.[115] Control is accomplished even if the terms of the

108. U.C.C. rev. § 9-313 (2001).

109. *Id.* §§ 9-313(a), (e) (2001) (providing that a possessory interest in a certificated security will remain perfected until the debtor obtains possession of the security certificate).

110. U.C.C. rev. § 9-313 cmt. 3 (2001) (setting forth some examples).

111. U.C.C. rev. § 9-313(a) (2001).

112. *Id.* § 9-102(a)(17) (2001) (a "commodity intermediary" is a person that (i) is registered as a futures commission merchant or (ii) provides clearance or settlement services in the ordinary course of business).

113. U.C.C. rev. §§ 9-106, 9-314 (2001).

114. *Id.* §§ 9-312(b)(1), 9-314 (2001). Note that while filing does not perfect security interests in deposit accounts, filing is still effective to perfect proceeds to the extent provided in U.C.C. rev. § 9-315.

115. U.C.C. rev. §§ 9-104(a)(1), (a)(2) (2001) (providing that control is automatic when the secured party is the bank with which the deposit account is maintained).

depositary agreement allow the debtor to retain the right to direct the disposition of the funds from the deposit account.[116]

13. Automatic Perfection

Security interest in some classes of collateral are automatically perfected when they attach. The following security interests are automatically perfected upon attachment under Article 9: a security interest in investment property created by a securities intermediary or commodity intermediary;[117] a sale of payment intangible and a promissory note;[118] a security interest arising under Articles 2, 2A, or 4 of the UCC;[119] and an isolated assignment of accounts which does not transfer a significant part of the outstanding accounts of the assignor to the same assignee.[120] While implicit under Former Article 9, Revised Article 9 specifically provides that the security interest in a supporting obligation is automatically perfected where the security interest in the underlying collateral is perfected.[121] For example, the perfection of a security interest in a contract obligation, the performance of which is secured by a letter of credit, will also result in the perfection of a security interest in the letter of credit. These automatic perfection provisions for supporting obligations reflect that credit enhancements are incident to the collateral they support, much like proceeds.[122] Unlike Revised Article 9, however, Former Article 9 did not contain such provisions, requiring lenders to perfect their security interest in such credit enhancements separately as general intangibles, resulting in additional cost and uncertainty.[123]

14. Temporary Perfection: Proceeds

Former Article 9 defined proceeds as "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds."[124] Revised Article 9 broadens the definition of proceeds to clarify that the following are proceeds: distributions on account of supporting obligations, partnership interest distributions, and licensing royalties.[125] Article 9 provides that a security interest in proceeds is in most cases automatically perfected for a limited time if the security interest in the original collateral was perfected.[126] Revised Article 9 expands the time of automatic perfection from ten to twenty days, after which the secured party must take further action to continue perfection in the proceeds,[127]

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116. U.C.C. rev. § 9-104(b) (2001).

117. *Id.* § 9-309(10), (11) (2001).

118. U.C.C. rev. §§ 9-309(3), (4) (2001).

119. *Id.* § 9-309(6), (7) (2001).

120. This list is not comprehensive.

121. U.C.C. rev. §§ 9-203(f), 9-203 cmt. 8 (2001) (explaining that complex issues may arise where a supporting obligation is assigned as collateral to several secured parties).

122. *Id.* § 9-102 cmt. 4(f) (2001).

123. U.C.C. rev. § 9-102 cmt. 4(f) (2001).

124. U.C.C. fmr. § 9-306(1) (1995).

125. U.C.C. rev. §§ 9-102(a)(64), 9-102 cmt. 13(c) (2001) (the definition of proceeds does not include proceeds of proceeds); *Compare Id. with* U.C.C. fmr. § 9-306 (1995).

126. U.C.C. rev. § 9-315(c) (2001).

127. *Id.* §9-315(d) (2001).

unless: (i) a previously filed financing statement covers the original collateral and the proceeds are collateral which can be perfected by filing in the same place, or (ii) the financing statement covers the original collateral and the proceeds are identifiable cash proceeds.[128]

F. Priority

The priority rules of Article 9 govern the priority of competing security interests in the same collateral, emphasizing the importance of perfection and attachment described above. Generally, after perfection, the secured party is protected against creditors and transferees of debtor and in particular against any representative of creditors in insolvency proceedings instituted by debtor.[129]

1. General Rules

Revised Article 9 provides the following three general priority rules that were also implied under Former Article 9: (i) among competing perfected security interests, the first secured party to file or otherwise perfect has priority;[130] (ii) among competing security interests, a perfected security interest has priority over an unperfected one;[131] and (iii) if both competing security interests are unperfected, the first to attach has priority.[132]

2. Exceptions to the First to File Rule

In some cases, however, the first to file or perfect rule is not applicable. With respect to security interests in investment property, Revised Article 9 provides that a security interest perfected by control has priority over a security interest in investment property perfected by filing.[133] Similarly, a security interest in a deposit account perfected by control has priority over a security interest perfected by any other method.[134] A security interest perfected by control in favor of the bank with which the deposit account is maintained, and such bank's right of recoupment and set-off, are superior to a security interest of a competing secured party obtained by any other method, including control.[135] The superiority of control over other methods of perfection cannot be ignored in the context of limited-recourse financings, where having security interests in all assets of the project is fundamental. Practitioners are therefore advised not to rely on filings to perfect their security interests in investment property and deposit accounts;

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128. U.C.C. rev. § 9-315(d) (2001).

129. *Id.* § 9-322; U.C.C. fmr. §9-303 (1995).

130. U.C.C. rev. § 9-322(a)(1) (2001). Any method of perfection discussed in Part *E supra*, including automatic or temporary, provides priority. U.C.C. rev.§ 9-322 cmt. 4. *Compare* U.C.C. fmr § 9-312(5) (1995).

131. *Compare* U.C.C. rev. § 9-322(a)(2) (2001) *with* U.C.C. fmr. § 9-301(1) (1995).

132. U.C.C. rev. §§ 9-322(a)(3), 9-322 cmt. 11 (2001) (noting that it is hard to imagine a situation where the case would come into a litigation without a secured party having perfected the security interests).

133. *Id.* § 9-328 (2001).

134. U.C.C. rev. § 9-327 (2001).

135. *Id.* § 9-327(3), (4) (2001).

they should also enter into the necessary arrangements to meet the conditions for control under Revised Article 9. Possessory liens, such as materialmen's liens, may also have priority over a perfected security interest.[136]

G. *Other Provisions*

1. Anti-Assignment Clauses

Participants in energy and other commercial transactions often draft anti-assignment clauses to restrict or prevent the assignment of the rights and obligations of the contractual parties.[137] These clauses have been generally upheld at common law.[138] The analysis of the impact of such a clause is relevant because it may result in the project company not having sufficient rights in the collateral to create a valid and enforceable security interest.[139] Former Article 9 rendered anti-assignment clauses "ineffective" for certain types of collateral, including the assignment of contractual rights to payments, but the scope of the anti-assignment provision was limited.[140] Unlike Revised Article 9, however, Former Article 9 did not expressly state that no default will result from the debtor's violation of the anti-assignment clause from granting a security interest.[141] This created a problem because if the grant of a security interest constituted a breach of the contract, the security interest enabled by the anti-assignment clause prohibition would have less value to the secured party.[142] In addition, Revised Article 9 broadens the scope of the circumstances in which an anti-assignment clause would be ineffective primarily in two ways: (i) by expanding the definition of those types of collateral for which the anti-assignment clause prohibition of Revised Article 9 applies;[143] and (ii) by extending the anti-assignment clause prohibition to legal restrictions.[144]

2. Certain Defenses.

The rights of the project company under a contract may be subject to certain defenses and offsets of the obligor under such contract. Typically, lenders in

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136. U.C.C. rev. §§ 9-333(a) (defining "possessory liens"), 9-333 cmt. 2 (2001) (noting that possessory liens have priority under a security interest unless the statute under which they were created provides otherwise).

137. Hoffman, *supra* note 17, at 212-214 (discussing anti-assignment clauses).

138. *See generally* RESTATEMENT (SECOND) OF CONTRACTS §§ 317, 322 (1981).

139. Hoffman, *supra* note 17, at 213.

140. *Id.* at 214 (noting that Former Article 9 and Revised Article 9 merely provides for the free alienability of contractual rights to payments but not to rights to enforcing a security agreement in the remaining contract rights, such as the rights to perform or assign the contract).

141. U.C.C. rev. § 9-406(d) (2001).

142. Bjerre, *supra* note 69, at 297.

143. *Id.* at 295 (explaining the impact of the definition of account under Revised Article 9 in the context of anti-assignment provisions).

144. U.C.C. rev. §§ 9-406(f); 9-406 cmt. 6 (2001) (noting that former Article 9 was silent as to legal restrictions on assignment because legal restrictions on rights to payment had largely disappeared); Bjerre, *supra* note 69, at 300-02 (explaining the impact of anti-assignment clause prohibitions on governmental permits and licenses).

project finance transactions try to limit the rights of the obligors by entering into a consent agreement.[145] Revised Article 9, like its predecessor, would validate an agreement between the obligor and the assignor that the obligor will not assert against an assignee (the secured lenders) claims and defenses that it may have against the assignor.[146]

H. Transition Rules

Practitioners need to be aware that security interests perfected under Former Article 9 remain perfected to the extent provided in Part 7 of Revised Article 9. Generally, that means that if the steps taken to perfect the security interests comply with Revised Article 9, nothing is required after the effective date. Otherwise, the secured parties risk losing the lien or priority if additional steps are not taken to comply with Revised Article 9. In most circumstances lien searches, under both Revised Article 9 and Revised Article 9 jurisdictions, will be required for a five-year transition period.

1. Security Interest Perfected under Former Article 9

As it would be expected, if the steps taken to perfect the security interests under Former Article 9 also comply with Revised Article 9, no further action is required under Revised Article 9.[147] As discussed above, Revised Article 9 substantially simplifies the filing procedures by adopting a location of debtor rule, but the new rule will likely result in financing statements having been filed in the improper jurisdiction for purposes of Revised Article 9. To protect secured parties against this possibility, the transition provisions of Revised Article 9 provide that a financing statement properly filed in accordance with the provisions of Former Article 9 (that does not meet the new filing procedures) remains effective until the earlier of such financing statement's lapse date and June 30, 2006.[148] Note that because pre-effective date financing statements will be effective for five years, secured parties will still need to perform UCC lien searches under the filing provisions of both Former Article 9 and Revised Article 9. In contrast, perfected security interests under Former Article 9 by methods other than filing which do not meet the elements of attachment or perfection under Revised Article 9 will remain perfected for only one year after the effective date of Revised Article 9 (in most jurisdictions, until June 30, 2002).[149] The secured party must then take further action to ensure perfection.

2. Unperfected Security Interest

Similar to the provisions set forth above regarding the continuity of perfected security interests, security interests that are enforceable but unperfected under Former Article 9 would remain enforceable for one year after the effective

145. Hoffman, *supra* note 17, at 218.

146. U.C.C. rev. § 9-403 (2001); U.C.C. fmr. § 9-206 (1995); Hoffman, *supra* note 17, at 218 (explaining the rights available to lenders under Former Article 9).

147. U.C.C. rev. § 9-703(a) (2001).

148. *Id.* § 9-705(c) (2001).

149. U.C.C. rev. § 9-703(b) (2001).

date of Revised Article 9.[150] The secured party must then take further action to ensure attachment.

3. Amendments to Financing Statements

Because Revised Article 9 applies to all security interests, even if those security interests were entered into or created before the effective date, a financing statement filed prior to the effective date may be amended, continued, assigned, or terminated in accordance with the provisions of Revised Article 9.[151] With respect to financing statements filed in the proper jurisdiction under Former Article 9, but the improper jurisdiction under Revised Article 9, the secured party must file during the five-year moratorium period a new initial financing statement in the proper filing office in lieu of a continuation statement.[152]

I. Conclusion

Revised Article 9 introduces several changes that are of particular importance to project finance transactions. Revised Article 9 includes deposit accounts and supporting obligations as new types of collateral under Article 9, simplifies filing procedures and facilitates the perfection of security interests against foreign debtors and government authorities. These changes should reduce costs and uncertainties for most financing transactions. Unfortunately, the new provisions governing secured transactions are still far from simple and include numerous exceptions. Practitioners should read thoroughly Revised Article 9 and the accompanying Official Comments to fully understand the new provisions and their impact on future and past transactions.

II. NOPR ON ACCOUNTING AND REPORTING OF FINANCIAL INSTRUMENTS, COMPREHENSIVE INCOME, DERIVATIVES AND HEDGING ACTIVITIES

On December 20, 2001, the Commodity Futures and Trading Commission (CFTC) issued a notice of proposed rulemaking (NOPR),[153] which proposes to establish uniform accounting requirements applicable to jurisdictional entities, including electric utilities, natural gas companies and oil pipelines, for the recognition of changes in the fair value of certain security investments, items of other comprehensive income, derivative instruments, and hedging activities.

The NOPR also raises the more controversial issue of whether to extend the new accounting requirements to power marketers and other entities selling electric power at market-based rates. Such entities have previously been exempted from the CFTC's financial reporting requirements.

Essentially, the CFTC wants the accounting information it requires from entities it regulates to be consistent with the requirements contained in Financial

150. *Id.* § 9-704 (2001).

151. U.C.C. rev. § 9-702 (2001).

152. U.C.C. rev. §§ 9-706(a), 9-706 cmt. 1 (2001) (noting that filing a continuation filing statement would not be effective).

153. Notice of Proposed Rulemaking; *Accounting and Reporting of Financial Instruments, Comprehensive Income, Derivatives and Hedging Activities*, 67 Fed. Reg. 1,025 (Jan. 8, 2002) (to be codified at 18 C.F.R. pts. 101, 201, 352).

Accounting Standards 115, 130, and 133. The specific proposals are outlined below.

A. Changes in Accounting for Derivatives and Hedging Activities

Since the CFTC's existing accounting requirements do not provide for specific accounts to record changes in the fair value of derivative instruments used in hedging and non-hedging activities, the CFTC believes that the addition of new accounts and instructions would provide improved visibility, completeness of accounting and reporting of derivatives activities by jurisdictional entities. This would assist the CFTC in its analysis of profitability, efficiency and risk management, as well as its overall monitoring efforts. In essence, the CFTC is proposing to implement a form of annual mark to market accounting for derivative instruments.

As proposed, a new general instruction would be added to require public utilities, natural gas companies, and oil pipelines to record changes in the fair value of the derivative instruments designated as a cash flow hedge to other comprehensive income. To the extent that the cash flow hedge is not fully offset by earnings, the ineffective portion of the hedge would be charged to the same income or expense account that would have been used if the hedged item had been disposed of, or otherwise settled.

The proposed instructions would also require jurisdictional entities to record changes in the fair value of a derivative instrument designated as a fair value hedge with a concurrent charge to a subaccount of the asset or liability that carries the item being hedged. The ineffective portion of the fair value hedge would be charged to the same income or expense account that would have been used if the hedged item had been disposed of, or otherwise settled.

B. Other Changes in Accounting for Derivatives

Also proposed are asset and liability accounts to include amounts related to the changes in the fair value of derivative instruments not designated as cash flow or fair value hedges. Recognizing that companies are required to classify derivative assets and liabilities as current or long-term on their balance sheets, the CFTC proposes to permit companies to create current and long-term subaccounts associated with the proposed new derivative balance sheet accounts in order to facilitate reporting derivative assets and liabilities to shareholders in general purpose financial statements. In addition, there is a proposal to establish new asset and liability accounts to include amounts related to the changes in the fair value of derivative instruments designated as cash flow or fair value hedges.

C. Changes in Accounting for Exchange-Traded Allowance Futures Contracts

In order to be consistent with the proposed accounting for derivatives, the CFTC proposes to make certain technical changes to its existing general instructions concerning the accounting for hedge transactions related to exchange traded allowance future contracts.

D. *Changes in Accounting for Trading and Available-for-Sale Type Securities*

Under the CFTC's Uniform Systems of Accounts applicable to public utilities and gas companies, all types of securities are recorded at cost and subsequent changes in the fair value of security investments are not recognized in the financial statements. The Uniform System of Accounts for oil pipelines requires adjustments to the carrying value of security investments when certain conditions are met.

The CFTC now believes that fair value measurement of the trading and available-for-sale type securities present relevant and useful information to existing and potential investors, creditors, regulators, and others in making credit and other decisions. The CFTC, therefore, proposes to permit, in security investment accounts, the recognition of changes in the fair value of trading and available-for-sale types of securities due to unrealized gains and losses.

E. *Changes in Accounting for Other Comprehensive Income*

The CFTC proposes to revise the Uniform Systems of Accounts for jurisdictional entities to provide accounting for items of other comprehensive income, such as changes in the fair value of available for sale type securities. As proposed, a new equity account would be created to include the accumulated balance for items of other comprehensive income. Another account would be established to record the activity for items of other comprehensive income during the year. At year end, amounts recorded in the activity account would be transferred to the accumulated balance account, so that the activity account would always have a zero beginning and year end balance. The activity accounts then would not be included as part of balance sheet schedules.

Recorded activity during the year for items of other comprehensive income would be reported in a proposed new schedule entitled "Statement of Comprehensive Income and Hedging Activities." In addition, the proposed instructions to the other comprehensive income accounts would require that supporting records be maintained by each category of other comprehensive income. The CFTC believes that this level of detail is required so that the entity is able to identify the amounts associated with the item when it enters into the determination of earnings in current or subsequent periods.

Since reclassification adjustments are required to be made for items of other comprehensive income to avoid double counting an item in net income and other comprehensive income, the CFTC proposes that reclassification adjustments be made directly to other comprehensive income accounts, as appropriate.

F. *Changes to the CFTC's Annual Reports Forms*

The CFTC proposes certain changes to its reporting forms to accommodate the proposals described above, if adopted. The proposed new schedule entitled "Statement of Comprehensive Income and Hedging Activities," which is modeled after an income statement approach to provide the most transparency for the components of other comprehensive income, is consistent with the overall framework of the FASB Concepts Statements. The statement would show the components of other comprehensive income and require:

(1) The reporting of categories of other comprehensive income on a net-of-tax basis, where appropriate, along with the reporting of the related tax effects allocated to each component;

(2) The reporting of other accumulated comprehensive income balances at year end by category, in a footnote to the schedule; and

(3) The reporting of fair value hedge balances at year end by category, in a footnote to the schedule.

G. *What's Next*

Interested parties have approximately two months in which to file comments on the FERC's proposals. As noted, the lightning rod will be the CFTC's pitch to rescind the waiver of accounting and financial reporting requirements for power marketers and other entities that sell power at market-based rates. Given that issues concerning the financial stability of energy trading concerns are very much in the news and high on the minds of members of Congress, one can expect that the CFTC may assume an aggressive stance on its proposals.

III. IN RE AVISTA ENERGY INC. AND MICHAEL T. GRISWOLD[154]

The CFTC ruled on August 21, 2001 that Avista Energy, Inc. (Avista Energy), a Washington state energy marketer, along with a small group of its traders, engaged in a scheme to manipulate the settlement price of Palo Verde (PV) and California Oregon Border (COB) electricity futures contracts that were traded on the New York Mercantile Exchange (NYMEX) on several occasions during the period April 1998 through August 1998. During the period under review, the CFTC found that "Avista Energy entered into cash-settled over-the-counter (OTC) derivatives contracts, whose value at expiration was based on the daily settlement price of one of the two Western U.S. electricity futures contracts on the expiration day of options trading (the Options Expiration Day)."[155] The CFTC concluded that Avista Energy was able to realize or increase its net gain on these option contracts that were in or near the money.

Avista Energy created artificial settlement prices in NYMEX PV and/or COB electricity contracts when its traders placed large, market moving orders in an illiquid market for NYMEX Western U.S. electricity futures contracts on the Options Expiration Days in April, May, July, and August, 1998. Specifically, the CFTC found that Avista Energy's traders had engaged in the following manipulative practices: (a) selling May and June 1998 NYMEX PV electricity futures contracts at prices less than prevailing bids during the close on the April and May 1998 Options Expiration Days; (b) purchasing August and September 1998 NYMEX PV electricity futures contracts at prices higher than the prevailing offers during the close on the July and August 1998 Options Expiration Days; and (c) purchasing August 1998 NYMEX COB electricity futures contracts at prices higher than the prevailing offers during the close on the July 1998

154. *In re* Avista Energy, Inc. and Michael T. Griswold, C.F.T.C. Docket No. 01-21, 2001 CFTC LEXIS 107, at *1 (Aug. 21, 2001) [hereinafter Avista Energy and Michael T. Griswold].

155. *Id.* at *3.

Options Expiration Day. In addition, the CFTC held that Avista Energy traders supported one of the manipulations through non-competitive trading. Also, the CFTC found that Avista Energy failed to keep adequate records of the positions established through its OTC derivatives contracts or its cash-market positions as required of reportable traders.

In addition, the CFTC found that Michael T. Griswold, one of Avista Energy's physical Western electricity traders, willfully aided and abetted Avista Energy's manipulations by trading in the physical market so as to create a false impression of the company's need for Western U.S. electricity. Griswold was found to have furthered the scheme by hedging positions in NYMEX Western U.S. electricity futures contracts that were entered into as part of the manipulative scheme.

Based on these factual findings, the CFTC ruled that Avista Energy and Griswold had violated several provisions of the Commodities Exchange Act (CEA), including section 9(a)(2), 7 U.S.C. § 13(a)(2), which states that it is unlawful for "any person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or to corner or attempt to corner any such commodity . . . ."[156] To sustain a finding of manipulation requires a finding that: (1) the respondent had the ability to influence market prices; (2) that the respondent specifically intended to do so; (3) that artificial prices existed; and (4) that the respondent caused the artificial price. The CFTC found that the evidence in the proceeding demonstrated all the elements of a section 9(a)(2) violation. It is noteworthy that key evidence against Avista Energy and Griswold was acquired from tapes of trade calls. Taping trade calls is a routine industry practice.

In settlement of the case, the CFTC accepted a $2.1 million civil penalty from Avista Energy and a $110,000 civil penalty from Griswold.

IV. IMPACT OF MISO RTO FORMATION ON "INTO CINERGY" TRANSACTIONS

In April, 2000, the Edison Electric Institute sponsored the publication of a standardized trading document (EEI Agreement) that resulted from two years of collaboration amongst industry participants. The EEI Agreement established a basic framework for bilateral trading relationships. The EEI Agreement provided standardized definitions for commonly traded electricity products. The EEI Agreement also provided for parties to trade new products as they were developed. Companies continue to re-examine products that are traded under the EEI Agreement. One example of this ongoing re-evaluation is the "Into Cinergy" product. The Cinergy trading hub is one of the most liquid trading points in the Eastern Interconnection. The "Into Cinergy" product was initially designed by a group of industry traders and operations personnel in 1998 and was further clarified in the EEI Agreement. Essentially, the "Into Cinergy" product enabled the Seller to choose to deliver energy to any one of the ten interfaces connecting Cinergy to adjacent control areas (*i.e.* Dayton Power & Light, Louisville Gas & Electric Company) provided that there was enough available transmission capa-

156. Avista Energy and Michael T. Griswold at *22-23; 7 U.S.C. § 13(a)(2) (2002).

bility over the particular interface that the Seller chose. Until recently, the definition of the "Into Cinergy" product set forth in the EEI Agreement served a benefit as it clarified many of the issues surrounding the original product, namely the risk allocation associated with transmission, and has contributed to making "Into Cinergy" one of the most actively traded products in the electricity industry.

As of February 1, 2002, transactions to be delivered into the Cinergy control area were administered by the Midwest ISO. To implement this change to the marketplace, the Midwest ISO filed an Open Access Transmission Tariff that made delivery of electricity to many of the interfaces under the current definition of the "Into Cinergy" product an impossibility. In response to this development, a group of industry participants, including members of the EEI Master Agreement Drafting Committee, recognized that the product definition needed to be changed and created a "conversion convention" to address this issue with a minimal amount of disruption for existing transactions and forward transactions. This "conversion convention" maintains the initial allocation of risk set forth in the original "Into Cinergy" product to the greatest extent possible.

V. RING-FENCING

One response to the California energy crisis and other problems facing the electric industry has been the use of "ring-fencing" to protect certain non-utility assets from bankruptcy and to maintain the credit worthiness of other assets. This is accomplished through measures to increase the degree of separation between a parent-head of a consolidated group and a subsidiary. Ring-fencing techniques include: creation of or conversion of subsidiaries into special purpose entities, or "limited-purpose operating entities;" adoption of certain structural devices and covenants which regulate the flow of internal financing to and the payment of dividends from the ring-fenced subsidiary; provision of a non-consolidation opinion; appointment of independent directors to the board of the ring-fenced entity obligated under relevant charter provisions to consider creditor interests in exercising their fiduciary duties and whose approval is required before the entity can file bankruptcy; and the pledging of the ring-fenced entity's assets and its ownership interests to creditors who are expected to rely on the ring fencing measures.[157] In 2001, Edison International, parent of the financially stressed Southern California Edison Co., used ring-fencing strategies to wall off its special purpose subsidiaries, Edison Mission Energy, which develops and operates power plants, and the related Mission Energy Holding Co. The ring-fenced entities were able to secure debt financing at significantly lower rates than they would have without the ring-fences.[158]

Before its subsidiary Pacific Gas and Electric Co. filed for bankruptcy in April 2001, PG&E ring-fenced its subsidiary, PG&E National Energy Group, LLC. California Attorney General Bill Lockyer has since filed suit against

157. *See generally* James Penrose, Esq., *Ring-Fencing a Subsidiary*, (Oct. 19, 1999) *at* http://www.standardandpoors.com/ResourceCenter/RatingsCriteria/Corporate Finance/index.html.

158. Tim Reason, *Ring Around the Subsidiary*, (Oct. 19, 2001) [hereinafter Reason] *available at* http://www.cfo.com/ Article?article=5217.

PG&E alleging the ring-fencing violated previous agreements with the state.[159] Also, the California PUC is investigating whether PG&E's ring-fencing was a violation of the deal it made when PG&E's holding company structure was initially approved by the PUC in 1997.[160] In addition, Lockyer has asked the Securities and Exchange Commission to review PG&E Corp. for potential transgressions in the transfer of assets between subsidiaries.[161]

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159. Press Release, Attorney General Lockyer, Attorney General Lockyer Sues PG&E Corporation for Unfair Business Practices Involving Financial Draining of California Utility (Jan. 10, 2002), *available at http://caag.state.ca.us/newsalerts/2002/02-003.htm.*

160. Jennifer Bjorhus, *Utility's Move to Isolate Assets Raises Controversy*, San Jose Mercury News, Aug. 28, 2001, *available at* http://www.powertothepeople.org/newswire/082701-1.shtml.

161. Reason, *supra* note 158.

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From coast to coast, in cities, suburbs and rural areas, electric cooperatives serve more than 35 million people in 46 states. Millions of American businesses, homes, schools, churches, farms and ranches depend on co-ops for their light and power needs.

In any light, it is easy to see electric cooperatives are a remarkable source of energy.

America's electric cooperatives—discover the difference.

National Rural Electric Cooperative Association®
A Touchstone Energy® Cooperative

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Putting Consumers First