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OREGON LAW COMMISSION

245 WINTER STREET SE
SALEM, OREGON 97301

PHONE 503-370-6973
FAX 503-370-3158
www.willamette.edu/wucl/olc

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UCC Article 9 Work Group

KEEPING SECURED TRANSACTIONS LAW EFFECTIVE

Explanatory Report for HB 4035

Prepared by Prof. Carl S. Bjerre
University of Oregon School of Law

From the Offices of the Executive Director
Jeffrey C. Dobbins
and
Deputy Director
Wendy J. Johnson

Approved by the Oregon Law Commission at its Meeting on
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...gon Law Commission ...d at the Willamette University College of Law, which also provides executive, administrative and research support for the Commission.

I. Introduction

The Uniform Commercial Code ("UCC"), which has been the law throughout the United States for several decades, has the principal purpose of encouraging private business transactions by establishing a clear and predictable framework for borrowers and lenders, buyers and sellers, payors and payees, etc. Perhaps the most important type of business deal governed by the UCC is the secured transaction, which is a loan accompanied by personal property collateral (as opposed to mortgages on real property, which is largely left to state-specific non-uniform law). The rules for secured transactions, which appear in UCC Article 9 (ORS Chapter 79 in Oregon), are the subject of the present bill.

In particular the bill resolves a set of practical problems that have arisen since 2001, when the bulk of Article 9's current rules went into effect in Oregon and across the nation. Chief among the problems resolved are (a) the way in which public notice is communicated of secured loans incurred by individuals, (b) the way in which public notice is communicated of secured loans incurred by organizations such as corporations or limited liability companies, and (c) the reliability of collateral taken by a lender in situations where the borrower's location changes from one state to another. The bill also provides a set of transition rules devoted to creating a smooth shift from the rules that are currently on the books to the bill's improved substantive rules.

The UCC as a whole is jointly sponsored by the Uniform Law Commission ("ULC")[1] and the American Law Institute (the "ALI"). When sufficient cause arises, these two organizations occasionally recommend revisions or amendments to portions of the UCC for enactment by the states, and such a recommendation was the genesis of the current bill. A substantial part of the UCC's business-enhancing value stems from the fact that all 50 states, plus the District of Columbia, Puerto Rico and the U.S. Virgin Islands, have enacted virtually identical versions of the UCC with only very minor substantive deviations. As a result, the U.S. national economy is much more closely knitted together than it would otherwise be, as parties to business transactions are freed from the uncertainty or high research costs that would result from each state's laws differing from the laws of other states.

Enactment of this bill is important for keeping Oregon a part of the above-described national framework of commerce. Ten states[2] have already adopted the Act; an additional ten states[3] have already introduced it during these early days of 2012; and introductions and enactments in all of the remaining states are expected during 2012. As explained below, the sound workings of the UCC system call for nationwide effectiveness of the bill's provisions by July 1, 2013, and for that reason we believe the bill should be acted upon during the coming short Oregon legislative session.

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[1] The ULC is also known as the National Conference of Commissioners on Uniform State Laws ("NCCUSL").
[2] Washington, Indiana, Minnesota, Nebraska, Nevada, North Dakota, Puerto Rico, Rhode Island, Texas, and Washington.
[3] District of Columbia, Florida, Kentucky, Massachusetts, Michigan, New Hampshire, Ohio, Oklahoma, South Dakota, and Virginia.

II. History of the Project

The substance of the bill's proposed amendments was promulgated by the ULC and the ALI in 2010, following a process of study and revision of existing Article 9. First, in 2008 a review committee of the UCC's Permanent Editorial Board[4] issued a report identifying a number of specific issues to be considered for statutory changes. Then, the ULC and the ALI appointed a Joint Review Committee (JRC) to review the report and draft any recommended changes to the statutory language, or to the UCC's Official Comments. In this task, the JRC was assisted by a number of advisors and observers, including those from the American Bar Association, the American College of Commercial Finance Lawyers, and a working group of lenders under the auspices of the American Bankers Association. In 2009, the ULC and the ALI considered the first draft of the amendments at their respective annual meetings. In 2010, both organizations approved the proposed amendments and recommended them for enactment by the states. The American Bar Association has also endorsed the proposed amendments.

As noted above, 20 states have already formally moved toward enacting the amendments and similar activity is afoot in all other U.S. jurisdictions. There is no opposition to the amendments.[5]

The Oregon Law Commission Work Group was first convened in October, 2011 for the purpose of evaluating the suitability for Oregon of the proposed amendments and, if suitable, preparing a draft bill for legislative introduction. Members of the Work Group were as follows: John Davenport, Davenport & Hasson LLP; Walter Gowell, Haugeberg Rueter Gowell Fredericks Higgins and McKeegen PC; Dave Hilgemann, Garrett Hemann Robertson, P.C.; Joe Hobson, Ritter Hobson LLC; Andy Morrow, Lane Powell PC; Ken Sherman, Sherman Sherman Johnnie & Hoyt LLP; and Thomas Wrosch, Commercial Registries Manager at the State of Oregon Corporation Division, Secretary of State's Office. Statutory drafting was carried out by Sean Brennan, Oregon Deputy Legislative Counsel. Oregon Law Commission support was provided by Deputy Director Wendy J. Johnson, Law Clerks Chad Krepps and John Adams, and Legal Assistant Lisa Ehlers. Oregon State Bar assistance was provided by David Nebel. The Work Group's Chair was Lane Shetterly, Chair of the Oregon Law Commission. The Work Group's Reporter was Carl S. Bjerre, University of Oregon School of Law.[6] The Work Group was also assisted by the following advisors: Barbara Bradley, Legal Aid Services of Oregon; Paul Cosgrove, Lindsay Hart Neil Weigler; Lana Cully, Oregon Department of Transportation; Sarah Filcher; Susan Grabe, Oregon State Bar; Amy Joyce, Oregon Department of Transportation; John McCulley, Agricultural Cooperative Council of Oregon; Jim Markee, Markee & Associates; and Peter Threlkel, Oregon Secretary of State's Office.

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[4] The Permanent Editorial Board is a committee made up of members of the ULC, the ALI, and the American Bar Association (ABA).

[5] In Kentucky, a bill containing the amendments was vetoed in the last legislative session, but this was only because of an extraneous issue relating to federal tax liens. That federal tax lien issue is not present in either the ULC/ALI recommendations or the present Oregon bill, and even in Kentucky the bill has now been reintroduced without the extraneous issue and is expected to pass.

[6] The Work Group's Reporter was also a member of the JRC referred to above. He thanks Douglass Barron for excellent research assistance with this Report.

As is usual in the case of the UCC, the ULC and ALI process resulted in Official Comments for each statutory provision, as well as for some current statutory sections that the bill does not amend. The Work Group was guided by these Official Comments as well as by the members' knowledge of the applicable law and practice. (The Official Comments are generally and rightly accorded substantial weight by the courts in construing the UCC, and for that reason the legislature should be guided by them as well in considering and enacting this bill. The Official Comments to amended Article 9 are included as Appendix A.)

III. The Major Problem Areas

A. Public Notice of an Individual Debtor's Secured Loan

A lender having a security interest under UCC Article 9 can protect itself against other creditors of the same debtor by giving public notice of the security interest. This is usually done by filing a simple document, called a financing statement, in the filing system maintained by the Secretary of State's office. The act is roughly akin to recording a mortgage, but for personal property collateral. Financing statements describe the collateral for the loan and identify the debtor, and because the financing statements are publicly available, prospective lenders are able (and expected) to check the filing system before making the loan. (To take one example, if a lender takes a security interest and the debtor files bankruptcy, the lender's recovery in the bankruptcy will be protected if the lender correctly filed its financing statement before the bankruptcy. To take a second important example, if two lenders both take a security interest in the same property and then the debtor borrower is unable to repay both loans, the lender who first correctly filed a financing statement will be paid in full before the other lender.) In this way, when the system works properly, any lender can ascertain whether some past lender's security interest already ranks ahead of its own.

The problem is that the debtor's name is the key to the filing system (that is, prospective lenders will look for other lenders' financing statements by checking under the name of the borrower), but that, when the debtor is an individual, there is no clear guidance on what counts as the debtor's name. In the United States a person may have several different names, or several different versions of a single name, all of which are equally legitimate for the purpose of conducting business transactions. Specifically, existing UCC § 9-503 (ORS 79.0503) requires that a financing statement contain the debtor's name; otherwise the financing statement is not effective to protect the lender. Yet the existing statute does not contain any guidelines as to how an individual debtor's name should be determined, and this has presented substantial difficulties for filers and searchers (not to mention courts), because individuals do not necessarily have a single name. An individual may have one name on his passport, another name on his driver's license, and a third name on his tax return.[7] A person may also be known in his or her community by a name that is not reflected on any official document at all, but that is nonetheless the person's legitimate name for borrowing and lending purposes. This situation can cause litigation and uncertainty when the debtor's name listed on a financing statement is distinct from what is alleged to be the debtor's "real" name. In this absence of legal certainty, a prospective

[7] Edwin E. Smith, *A Summary of the 2011 Amendments to Article 9 of the Uniform Commercial Code*, 42 UCC L.J., Art. 4, at 351 (2010).

secured lender may be unable to make educated lending decisions, and may be at risk when relying on collateral.

Illustrating this problem, one court declared a financing statement listing the debtor as "Chris Jones" was ineffective, on the asserted grounds that the debtor's legal name was Christopher Gary Jones.[8] In another case, a court found that the financing statement should have provided the debtor's full legal name, Richard Morgan Stewart, IV, even though the debtor signed an application for credit as "Richard M. Stewart" and a security agreement as "Rick Stewart," and authorized the financing statement to provide his name as "Richard Stewart."[9] Numerous cases could be cited and discussed.

This problem of individual names actually has two facets. The first facet is a problem of filing: a lender making a secured loan cannot be certain that it is filling out the financing statement using the correct version of the individual's name, and the security interest might not be respected in bankruptcy or similar situations. The second facet is a problem of searching: a lender *considering* making a secured loan cannot be certain that it is searching for other lenders' financing statements using the correct version of the individual's name, and the loan might be made based on an incorrect belief that the lender is first in line.[10]

B. Public Notice of an Organizational Debtor's Secured Loan

Under current law, the name to be used on a financing statement when the debtor is an organization such as a corporation or a limited partnership (a "registered organization") is clearer than for individual debtors, but still subject to an important ambiguity. UCC § 9-503(a)(1) (ORS 79.0503(1)(a)) requires "the name of the debtor indicated on the public record of the debtor's jurisdiction of organization which shows the debtor to have been organized." The problem is that this formulation wrongly suggests that there is one and only one such public record. In fact, there may be several records, showing different forms of a name, including among others (a) the certificate of incorporation, certificate of limited partnership, or other analogous document submitted by the organization's sponsors for the purpose of creating the organization (showing the intended name, e.g. Alpha Shoes, Inc.); (b) the Secretary of State's reflection of this name in its databases (showing inaccurate transcriptions of the intended name, in some states more than others, e.g. Alfa Shoes, Inc.); (c) an amended certificate of incorporation that changes the original name (e.g. Beta Shoes, Inc.); and (d) a doing-business certificate (often showing a wholly different trade name, e.g. Al's Main Street Shoe Store). This ambiguity creates problems for searchers and filers analogous to those discussed above for individual debtors.

[8] *Morris v. Snap-on Credit, LLC (In Re Jones)*, 2006 WL 3590097, at *3 (Bankr. D. Kan. Dec. 7, 2006).
[9] *Morris v. Snap-on Credit, LLC (In Re Stewart, IV)*, 2006 WL 3193374, at *2 (Bankr/ D. Kan. Nov. 1, 2006)
[10] In fact, these problems have been severe enough that some states have even enacted non-uniform statutory provisions attempting to improve the situation. These individual-state solutions have tended to worsen the problem rather than improve it, because they are drafted in an unclear matter, and because they undermine the national uniformity that helps borrowers from one state transact with lenders in another.

C. Reliability of Collateral When Debtor's Location Changes

UCC Article 9 takes care to protect a secured lender's collateral even when the debtor's location changes, but current law is inadequate to address turnover collateral such as inventory or accounts receivable in this situation.

Debtors may change their jurisdiction, with the result that a new state's law would control the filing of financing statements or other perfection-related actions. For example, if the debtor is an individual residing in Washington, financing statements should be filed against the debtor with the Washington Secretary of State's office, but if the same individual changes her residence to Oregon, then financing statements should be filed against her with the Oregon Secretary of State's office. See UCC §§ 9-301(1) and 9-307(b)(1), ORS 79.0301(1) and 79.0307(2)(a).[11] But if a secured lender made the loan before the debtor's move, then the secured lender is ordinarily given a four-month grace period of continued perfection under the new state's law, so that the financing statement filed in Washington remains effective under Oregon law for the four months, during which time the lender is expected to discover the move and file a new financing statement in Oregon. UCC § 9-316(a)(2), ORS 79.0316(1)(b). (Correspondingly, Washington's enactment of UCC § 9-316(a)(2) provides the same grace period to a secured lender to a person who moves from Oregon to Washington.) The problem is that this grace period only applies to collateral in which the secured party's security interest was perfected at the time of the debtor's move; in other words the grace period does not currently apply to after-acquired property.

After-acquired property is property that the debtor acquires after the secured loan was made, but is nonetheless collateral for the loan. It is particularly important for property such as inventory and accounts receivable, which by their nature are subject to turnover and are often covered by after-acquired property clauses. A secured lender making a loan to debtor whose important property is, say, jewelry that the debtor sells to customers, needs to be protected not only in the jewelry items that the debtor owns on the date of the loan, but also in the jewelry items that the debtor acquires later, while the loan is still outstanding, in replacement of the original items that routinely get sold. UCC Article 9 ordinarily protects the lender in this after-acquired property – but it does not do so for after-acquired property acquired after the debtor moves to a new jurisdiction.

In the example above, if the Washington resident took out a loan using her jewelry inventory as collateral, and then moved to Oregon and her current jewelry were sold and replaced by new jewelry within the four months, the lender would be left with no collateral at all. Thus, existing 9-316 creates a potentially dangerous situation for the holders of security interests in after-acquired property, forcing them into the choice between wastefully monitoring their debtors over short time periods, or risking losing their collateral. Such a burden is out of keeping with both the pace of modern commerce and the transaction-protecting purpose of the UCC.

[11] Similar examples could be given for debtors that are registered organizations and migrate rather than merge, and for debtors that are non-registered organizations and change the location of their place of business or chief executive office.

D. Reliability of Collateral Following Merger

The problem just discussed in connection with a debtor's change of jurisdiction has a close parallel when the debtor merges or otherwise combines itself into an out-of-state entity. Technically such cases do not involve a single continuing debtor which changes jurisdictions, but rather a change from one debtor (incorporated or otherwise organized in, say, Washington) to another debtor (incorporated or otherwise organized in, say, Oregon). Here too, UCC Article 9 takes care to protect a secured lender's collateral, but current law is inadequate to address turnover collateral such as inventory or accounts receivable.

In these out-of-state merger situations, if a secured lender made the loan before the merger, then the secured lender is ordinarily given a one-year grace period of continued perfection under the new state's law, so that the financing statement filed in, say, Washington remains effective under Oregon law for the one year, during which time the lender is expected to discover the merger and file a new financing statement in Oregon. UCC § 9-316(a)(3), ORS 79.0316(1)(c).[12] (And again, correspondingly, Washington's enactment of UCC § 9-316(a)(3) provides the same grace period to a secured lender to a Washington borrower who merges into an Oregon entity.) The problem here, just as above, is that this grace period does not apply to after-acquired property.

As an example, if ABC Inc., a Washington corporation, took out a loan using its jewelry inventory as collateral, and then merged into ABC Inc., an Oregon corporation, and the current jewelry were sold and replaced by new jewelry within four months after the merger, the lender would be left with no collateral at all. Here too, existing law creates a potentially dangerous situation for the holders of security interests in after-acquired property, forcing them into the choice between wastefully monitoring their debtors over short time periods, or risking losing their collateral.

IV. The Bill's Solutions to the Major Problems

A. Public Notice of an Individual Debtor's Secured Loan

In order to provide more certainty for both filers and searchers, the bill would provide a rule making clear that any of the following names for the debtor would be sufficient on a financing statement: (1) the debtor's name as shown on the debtor's driver's license (assuming the debtor holds an unexpired Oregon driver's license, otherwise an Oregon state-issued identification card); (2) the individual name of the debtor, without further guidance, as under current ORS 79.0503, or (3) the debtor's surname and first personal name. HB 4035 § 12(1)(d).

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[12] The one-year grace period here is longer than the four-month grace period discussed above, because this section applies not only to easily-discovered events such as mergers, but also to difficult-to-discover events such as ordinary sales from an original owner to a separate owner. On the other hand, the post-merger grace period added by the bill for after-acquired property, discussed in Part IV.D below, is limited to four months because ordinary non-merger sales do not involve the after-acquired property problem with which the bill is concerned. If a Washington corporation merges into an Oregon corporation, after-acquired inventory or accounts receivable are routinely involved, but if a Washington corporation remains independent and simply sells some of its property to an Oregon corporation, only the immediate property is sold, and no turnover collateral is implicated.

The Work Group's recommendation on this issue is unanimous. Under the recommended rule, the debtor's unexpired driver's license name would provide a "safe harbor," under which filers and searchers who follow Article 9's rules can be sure of the effectiveness of their actions.

At the same time, the recommended rule would protect other lenders who, perhaps because they are one-time or nonprofessional lenders and do know Article 9's intricacies, might use forms of the individual's name other than that which appears on the driver's license. These lenders would still be protected as long as they used either a legitimate individual name as under current ORS 79.0503, or the debtor's surname and first personal name.[13] (In the Work Group's unanimous view, it would *not* be desirable for the bill to legitimize *only* the driver's license name. One can easily imagine situations where such a narrow rule would create a trap for the unwary. For example, suppose that in 2010 the debtor acquires a driver's license correctly showing her name as Alice Maiden-Name, and further suppose that in 2011 the debtor marries and begins using the name Alice Married-Name in her business matters. If this debtor obtains a secured loan without getting a new driver's license, nonprofessional secured lenders would be much more likely to file a financing statement under the married name than under the old and generally inaccurate maiden name. The Work Group concluded that it would be illogical and unduly harsh to penalize a lender who did not know to file under the old name.) Overall then, the recommended rule provides certainty for those who know the rules, while also allowing a desirable degree of flexibility for those who are not experts in the system.[14]

B. Public Notice of an Organizational Debtor's Secured Loan

The bill clarifies the correct name of a registered organization to be included in the financing statement. Under the bill, the name to be provided is "the name that is stated to be the registered organization's name on the public organic record most recently filed with . . . the registered organization's jurisdiction of organization that purports to state, amend or restate the

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[13] The amendments proposed by the ULC and the ALI invite states to choose between two alternative solutions on this issue. In adopting the solution just explained, the bill chooses one of those alternatives, which is sometimes called the "safe harbor" approach because of its combination of certainty and flexibility. The other alternative, which is sometimes called the "only if" approach because of its strictness, was rejected by the Work Group for reasons that are explained in the text. Among the states that have enacted the Act, most have adopted the only if approach, but the Work Group is of the firm view that the safe harbor approach is sounder and creates a better system. We also note that our neighboring state of Washington is one that has adopted the safe harbor approach as we recommend, and that the high volume of cross-border business between Oregon and Washington makes this an important additional reason for Oregon to adopt the safe harbor approach as well.

[14] One might argue that a stricter rule, permitting only the driver's license name without any flexibility for non-experts, would theoretically make it easier for a prospective secured lender to search for prior filings. The Work Group rejected this argument for several reasons. First, the increased easiness of searching comes only at the expense of unwary filers who might not know to follow the stricter rule. Second, searching is hardly burdensome even under the current rules, because electronic searches of the Secretary of State's database of filings are free and nearly instantaneous. Third, any increased ease of searching is probably illusory, because federal tax lien notices are not necessarily filed under the driver's license name, yet virtually every prospective lender searching for prior financing statements will also search for federal tax lien filings. See 26 U.S.C. § 6323(f)(3) (name used on federal tax lien notices is subject only to IRS regulations, not other law); *In re Spearing Tool and Manufacturing Co., Inc.*, 412 F.3d 653 (6th Cir. 2005). And fourth, during the bill's five-year period of transition between the current and revised rules (see Part IV.E below), financing statements filed before July 1, 2013, under names other than the driver's license would continue to be effective, if they were effective under current law.

registered organization's name." HB 4035 § 12(1)(a). "Public organic record," in turn, is defined in pertinent part as "the record initially filed with or issued by a state . . . to form or organize an organization and any record filed with . . . the state . . . that amends or restates the initial record." HB 4035 § 1(ooo). The effect of this language is to clearly designate the name as it appears on the current version of the certificate of incorporation, certificate of limited partnership, etc. As a result, searchers and filers can carry out their lending decisions with confidence.

On a related point, the bill clarifies the definition of registered organization to which the above rule applies. The new definition covers, in pertinent part, any organization "formed . . . by the filing of a public organic record with . . . the state." HB 4035 § 1(rrr). This directly reflects standard practice in which a corporation, limited partnership, or the like is formed by the filing of the certificates described above. (The same section of the bill also clarifies that a common-law business trust, though formed by private action rather than public filing, is nonetheless a registered organization, if the state's statute governing business trusts requires that the trust's organic record be filed with the state.)

C. Reliability of Collateral When Debtor's Location Changes

The bill extends the four-month grace period to after-acquired property. HB 4035 § 6(8). It does so by providing that "a financing statement filed before the [debtor's] change [of location] pursuant to the law of the jurisdiction designated in ORS 79.0301(1) [i.e. filed in Washington, in our example above] . . . is effective" regarding "collateral to which a security interest attaches within four months" of the change. Secured parties with security interests in after-acquired property are thereby relieved of the dilemma of either constantly checking upon their debtors' locations or of losing their collateral. The amendment remedies the distinction between the treatment of previously acquired and after-acquired property.

D. Reliability of Collateral Following Merger

The bill extends the same four-month grace period to after-acquired property following a merger as it does to after-acquired property following a single debtor's relocation. HB 4035 § 6(9). It does so by providing that "a financing statement naming an original debtor . . . is effective to perfect a security interest in collateral acquired by a new debtor before, and within four months after" the merger. (The terms "original debtor" and "new debtor" are defined in current ORS 79.0102(ggg) and (ccc) respectively and are not changed by the bill. They may be conveniently understood as referring to the non-surviving and surviving entities in a merger.) Here as above, secured parties holding after-acquired property as collateral are relieved of the dilemma of either constantly checking for mergers by their debtors or of losing their collateral.

E. Transition Rules, Including Uniform Effective Date

In a nationally integrated statutory design such as UCC Article 9, it is important for all relevant jurisdictions' rules to lead to the same result; otherwise unjust results could be reached by forum-shopping, and the fluidity of reaching interstate loan agreements so important to a "uniform" commercial code would be severely impaired. For this reason, every state adopting

the Act is taking care to provide for its version to become effective on the same "uniform effective date," namely July 1, 2013. See HB 4035, § 28. In order for Oregon to stay in step with the other 52 jurisdictions, it is important for the bill to move through the legislature during the current legislative session.

Other technical questions might also arise as a result of the shift from current law to the bill's new substantive rules, and these are addressed in HB 4035, §§ 20-27. These "transition rules" are closely modeled on previous transition rules that were used when Oregon and the other 52 jurisdictions moved in 2001 from older law to current Article 9. They are designed to balance the interests of parties who have already successfully entered into transactions under existing law with the interest of the legal system in moving, in due course, to a reliable and universal application of the new rules.[15]

V. Conclusion

The bill should be adopted because it provides well-tailored solutions to practical problems that are impeding secured transactions under current law, while also keeping Oregon's law of commercial transactions substantially uniform with that of its sister states, to the benefit of the state's and the nation's economy from improved flow of cross-border commerce.

[15] For example, a financing statement filed before the bill takes effect, and meeting the requirements of ORS chapter 79 before its amendment by the bill, generally remains effective even after the bill's operative date, for up to five years. See UCC § 9-805(b), HB 4035 § 23(2).

Of course this protection of pre-operative-date financing statements extends only to financing statements meeting the requirements of all applicable ORS chapter 79 sections as in effect before the bill's operative date, including the sections that the bill does not amend. HB 4035 § 23(2) enumerates the sections of ORS chapter 79 that are being amended by the bill, and states that pre-operative-date financing statements must meet the requirements of those sections as they existed before the bill's operative date, but this enumeration should not be misunderstood as protecting pre-effective-date financing statements that fail to meet other currently applicable ORS chapter 79 requirements as well. (For example, current ORS 79.0502(1)(c) requires that a financing statement indicate the covered collateral, and this section is not listed in HB 4035 § 23(2) because it is not being amended by the bill, but its absence from the § 23(2) list does not mean that a pre-effective-date financing statement that did not indicate the covered collateral would somehow be protected. On the contrary, ORS 79.0502(1)(c) continues to apply to pre-operative-date financing statements, even after the bill's operative date, precisely because the bill does not amend it.)

Similarly non-restrictive interpretations are intended of the other bill sections containing similar enumerations of the ORS chapter 79 sections being amended by the bill.